ANTHEIL MASLOW & MACMINN, LLP

ATTORNEYS & COUNSELORS

BUYING AND SELLING A BUSINESS

Joanne M. Murray, Esquire
Antheil Maslow & MacMinn, LLP
131 West State Street
Doylestown, PA 18901
215-230-7500 Telephone
215-230-7796 Facsimile

BUCKS COUNTY BAR ASSOCIATION BENCH BAR CONFERENCE
OCTOBER 5, 2007

BUYING AND SELLING A BUSINESS

Presented by Joanne M. Murray, Esq.

***Joanne Murray** concentrates her practice in the areas of corporate law, contracts, commercial finance transactions, mergers and acquisitions, real estate and health care transactions. She has represented a variety of financial institutions, privately held businesses, physician practices, and nonprofit entities in a wide range of business transactions, including stock and asset acquisitions, affiliations, financing and loan restructuring, software license agreements, employment contracts, and leasing transactions. Joanne graduated cum laude from Temple University School of Law in 1990. She is a member of the Bucks County, Philadelphia, Pennsylvania, and American Bar Associations.*

Antheil Maslow & MacMinn, LLP
131 West State Street
Doylestown, PA 18901
215-230-7500 Telephone
215-230-7796 Facsimile
jmurray@ammlaw.com

BUYING AND SELLING A BUSINESS

1. Deal Structure

   Threshold decision: what structure to use (sale of company's stock versus sale of assets)

2. Letter of Intent ("LOI")

   a. Why to use an LOI:

      (i) to get preliminary understandings down on paper to avoid pursuing a deal where there is no "meeting of the minds" on the main issues – justifies spending more money on accountants, attorneys, etc.;

      (ii) to show evidence of an agreement in principle to potential lenders or investors;

      (iii) to keep the other party from exploring potential deals with other parties;

      (iv) to initiate or continue the due diligence process with the protection of a confidentiality provision (although this could also be accomplished with a confidentiality agreement); and/or

      (v) to accommodate the wishes of the business people.

   b. Why not to use an LOI: could create a binding obligation even if in the absence of evidence that the parties intended to create one (see Texaco, Inc. v. Pennzoil Co., 729 S.W.2nd 768 (Tex. App. 1987), *cert. denied* 485 U.S. 994 (1998)). Disappointed buyers have used a variety of legal theories to try to enforce an LOI (including breach of contract, as in Pennzoil, breach of the implied contractual duty to negotiate in good faith, and promissory estoppel, to name a few).

   c. How to avoid a Pennzoil result: use clear and unambiguous language to evidence such as the following:

      This letter does not create a binding obligation, but rather outlines the general terms to be included in a mutually acceptable definitive agreement to be executed by the parties. Neither party shall be legally obligated to the other by reason of this letter or the negotiations between the parties.

      Most LOIs identify certain provisions that are binding (confidentiality, exclusivity, costs), with the remainder being non-binding. Some drafters prefer to specifically identify the provisions that are non-binding for the sake of clarity.

d. Clauses to include: If you decide to use an LOI, consider including the following clauses: confidentiality, no shop/exclusivity, and conditions precedent (e.g., board approval, financing, third party approvals, preparation and execution of definitive agreement).

3. Confidentiality Agreements

a. A key provision in any confidentiality agreement is the identification of what information is being protected. This description may vary with the type of business (e.g., patient records for a medical practice, program source code for a software company, etc.).

b. Most confidentiality agreements exclude certain information from the scope of information being protected. These exclusions include information that is already known by the recipient, publicly available, independently developed by recipient or required to be disclosed by law or legal process.

c. Be sure to include an equitable remedies provision to allow injured party to obtain injunctive relief.

d. The parties' obligations under the confidentiality agreement should survive the termination of the transaction if the deal does not close. Avoid including short survival periods if you represent the disclosing party.

e. What if buyer is a competitor of seller? In addition to anti-trust issues, a seller may be reluctant to release sensitive information that will give the buyer a competitive advantage if the deal does not close. Indeed, some companies have a reputation for going through the motions of buying a competitor, completing due diligence and terminating the deal once they've obtained the information they seek. One way to minimize this risk is to delay disclosure of competitively sensitive information until late in the process – as near to closing as possible. Another way is to release this information only to an intermediary (accountant, private funding source, etc.) who agrees not to release it to the buyer until after or just prior to the closing.

4. Due Diligence

a. Most buyers deliver a due diligence request with a checklist of items to be delivered by the seller. As buyer's counsel, be careful to review the form you plan to use before you send it so that it captures the information that is needed to evaluate the seller and its business. As seller's counsel, review the due diligence to make sure it is not overly broad. In certain transactions, it may be appropriate for the seller to deliver its own due diligence request to learn more about the proposed buyer. In larger transactions, there are frequently multiple requests (from buyer's counsel, accounting firm, IT consultant, etc.).

b. A seller should be sensitive to the timing of disclosure (see 3(e) above).

c. The due diligence process is designed to provide the buyer with information it needs to assess the seller and its business, but the process of providing responses to the due diligence requests helps the seller with preparing the disclosure schedules to the asset purchase agreement.

5. <u>Asset Purchase Agreement ("APA")</u>

   a. <u>Parties</u>

      i. Determine how assets are held to ensure that you name the correct "sellers."

      ii. A buyer will want the shareholders/principals of the seller to be parties to the APA in an individual capacity. This resolves the ownership issue identified above and also buttresses the representations and warranties.

   b. <u>Identification of assets to be acquired and liabilities to be assumed</u>

      i. Catch-all identification of acquired assets.

      ii. Commonly excluded assets: cash and cash equivalents, corporate books and records; personal items.

      iii. Assumed liabilities are usually specifically identified (typically include key contracts, office lease, equipment leases). Third party consent to the assignment of these obligations is usually required.

   c. <u>Purchase price issues</u>

      i. Deposits: Issues include how much of a deposit should the seller require, who will hold the deposit, will the deposit accrue interest, and who gets deposit if transaction does not close.

      ii. Seller financing: If the seller provides financing for all or a portion of the purchase price, it needs to decide whether this obligation will be unsecured or secured (typically by a lien on the acquired assets). If the seller is financing a portion of the purchase price with a third party lender also providing financing, that lender will typically require a subordination of the seller's obligation (including a subordination of the seller's security interests).

iii. Adjustments: Post-closing adjustments to the purchase price are often tied to working capital levels. The parties agree on a target working capital amount and, if the actual working capital amount deviates from this target, one party or the other will be responsible for the difference. Sometimes, the parties agree on a cap (the upper limit that a buyer will pay as a result of the adjustment), a floor (the upper limit that a seller will pay as a result of the adjustment) or a collar (incorporates both a cap and a floor). Many agreements include a de minimis threshold range; if actual working capital deviates from the target within this range, no adjustment is made. Other benchmarks used for purchase price adjustments include inventory levels, net worth values, and asset values. In all cases, the APA should identify when the post-closing audit or examination will be conducted and by whom, as well as who will bear the cost of this process.

iv. Earn-outs: Parties often include earn-out provisions in the APA to give the seller the opportunity to receive a higher purchase price and to assure the buyer of future performance by the seller. Earn-outs are risky for a lot of reasons, and many earn-outs result in litigation. It is important to clearly describe the earn-out formula. Since the earn-out calculation is tied to future performance, the seller needs to make sure it will have sufficient operational control post-closing to influence company performance and that the acquired entity will not be merged into an affiliated entity post-closing.

v. Escrow for indemnification: Buyers sometimes require that the seller set aside a portion of purchase price in an escrow account to fund the seller's indemnification obligations under the APA. Issues with this include who holds escrow, for how long, procedures for making claims against the escrow, and procedures for resolving disputed claims.

vi. Allocation: APAs often include provisions that require the parties to agree on an allocation of the purchase price for income tax reporting purposes and prohibit the parties from taking a position that deviates from the agreed-upon allocation. Sellers will want to allocate as much as possible to goodwill, which receives capital gains tax treatment, and as little as possible to the covenant not to compete, which is taxed as ordinary income. Buyers will want to allocate a significant portion to the "hard" assets so as to receive a stepped up basis, which is depreciated and reduces tax obligations in accordance with applicable depreciation schedules for the assets.

d. <u>Representations and Warranties</u>

i. Purposes:

1. to disclose information to the buyer, such as the identification of assets being acquired and contracts that are important to the buyer's business, so that there is evidence of what information the buyer is relying on in making the decision to buy the business

2. provide buyer with right to terminate the transaction if the representations and warranties are untrue

3. establish right to indemnification if untrue

ii. Commonly used representations and warranties:

1. Organization and good standing

2. Corporate authority; due authorization; valid and binding obligation

3. No violation of charter documents, laws, contracts

4. Third party consents (e.g., governmental)

5. Financial statements (Note: a potential pitfall is a representation that the financial statements are compliant with GAAP; many smaller companies do not use GAAP)

6. No undisclosed liabilities

7. Accounts receivable

8. Pending and threatened litigation

9. Ownership of intellectual property

10. No liens on assets; good and marketable title; sufficiency of assets

11. Contracts (valid, binding and in full force and effect; no defaults)

12. Environmental matters

13. Taxes

14. ERISA matters

15. Personnel matters

16. Related party transactions

17. No material adverse change

18. Accuracy of representations (10b-5 type representation)

iii. Seller's counsel will usually try to limit the scope of the representations and warranties requested by the buyer by negotiating knowledge qualifiers and materiality standards.

iv. Most APAs use disclosure schedules to provide details relating to a specific representation or exceptions to a representation. Schedules are prepared by the seller in advance of the closing and are attached to the APA.

e. Covenants: If there is an anticipated gap between when the APA is signed and the closing, the buyer should require a covenant that the seller will not make any material adverse changes to the business or the assets during that time. Other common covenants include further assurance clauses and a covenant to cooperate with the buyer's due diligence efforts.

f. Non-compete provisions

i. A covenant not to complete is often included in the APA to bind the seller and the selling shareholder.

ii. If the principal of the seller is to continue in an employment or consulting capacity, a non-compete provision will be included in that agreement.

g. Termination provisions. A buyer will want the ability to terminate the APA if any of the closing conditions is not met (including if any of the representations in the APA is untrue) or if the buyer is dissatisfied with the results of its due diligence investigation. Both parties should have the ability to terminate the APA if closing does not occur on or before a specified date.

h. Indemnification: Most APAs include a provision whereby the seller agrees to indemnify the buyer against claims resulting from a breach of the seller's representations and warranties. Sellers often try to negotiate a monetary cap on this indemnification obligation and/or a basket (minimum amount of damages that must be reached before the buyer can seek indemnification). A buyer may require that a portion of the purchase price be escrowed to fund the seller's indemnification obligations.

i. Closing provisions

    i. Mechanics of closing: when and where will closing be held; how will purchase price be paid

    ii. Deliverables: identifies documents and other items to be delivered and by whom

    iii. Conditions precedent for both buyer's and seller's obligations

6. Opinion of seller's counsel

    a. Most law firms typically rely on certificates signed by an officer of the seller as to the accuracy of factual matters, as well as certificates identifying what documents have been reviewed for purposes of the opinion.

    b. Matters customarily requested by buyer's counsel:

        i. Due organization, good standing, corporate power and authority to own assets

        ii. Due authorization of agreement

        iii. Valid and binding obligation

        iv. No conflict with organizational documents

        v. No violation of judgments, no violation of law, no governmental approvals required

        vi. Pending and threatened litigation

    c. Exceptions and qualifications: limit opinion to laws of applicable state, standard language concerning creditors' rights in bankruptcy, etc.

7. Ancillary documents

    a. Bill of Sale; Deed (if real estate is being conveyed)

    b. Authorizing resolutions

    c. Certificates (Secretary’s/Incumbency Certificate; Closing Certificate)

    d. Financing documents, if applicable

    e. Assignment and Assumption Agreement

    f. Employment/Consulting Agreement, if applicable

8. Closing