TEXAS LAWYER

An ALM Publication

texaslawyer.com | May 28, 2019

M&A 101: Back To Basics

ROB SHEARER AND JON BOBEN

NESPIX/Shutterstock.com

Sellers and buyers in M&A transactions necessarily have conflicting interests and a natural desire to minimize their risks. These issues are among those that must be negotiated and resolved in most acquisitions of a private company target.

Transaction Structure

Early on, parties must decide whether to structure the deal as a merger, a stock sale or asset sale. That decision is usually driven by 1. tax considerations, 2. equity holder-approval requirements and 3. the desired risk allocation. Generally, an asset purchase may allow a buyer to cherry-pick assets and leave behind unwanted liabilities with the seller, but there remains the possibility of successor liability and a negotiated asset purchase agreement may leave seller holding more post-closing liability than an equity purchase agreement.

The parties will need to determine whether the signing and closing can occur simultaneously, or if time between signing and closing will be required to secure financing or obtain necessary regulatory approvals or third-party consents. In a bifurcated signing and closing, interim operating covenants, closing conditions, and termination provisions will be of particular interest to the parties and their counsel.

Earn-outs

If the parties find themselves at a valuation impasse, an earn-out can help bridge the gap by allowing the seller to earn additional consideration if certain criteria are satisfied. Whether the agreed criteria are complex formulae or relatively mundane financial metrics, everyone at the table should be mindful that the parties must be able to objectively determine satisfaction of the criteria. Even metrics that may seem crystal-clear at the outset can be clear-as-mud at the end of the earn-out period. It is worth the business principals' and counsels' time and effort to carefully craft earn-out provisions.

Furthermore, sellers will demand and buyers will resist operating covenants limiting the buyer's range of freedom to operate the business during the earn-out period. Seller wants to prevent the purpose of the earn-out from being frustrated, while buyer wants to run the newly-acquired enterprise as it wishes. Such covenants should be narrowly tailored and well understood by the business principals to prevent surprises.

Purchase Price Adjustments

Purchase price adjustments for working capital allow the parties to enter into a transaction without knowing the final amount of working capital, with the comfort that there is a mechanism in place to resolve any discrepancies. In a bifurcated signing and closing, a working capital adjustment also gives the buyer comfort that the seller will continue to operate the target company in the normal course before closing. In other words, it will continue to produce inventory, make sales, generate accounts receivable and pay its bills when they are due.

The parties will agree on a target amount of net working capital consistent with the company's historical working capital needs and then compare such target amount to the company's working capital as of closing. If closing working capital is lower than target working capital, then the purchase price paid will be decreased. If closing working capital is greater than target working capital, then the purchase price will be increased. To minimize the amounts paid in the reconciliation process, there will often be two, separate adjustments comparing (1) (x) estimated closing working capital to (y) the agreed-upon target and (2) (x) finally-determined closing working capital to (y) the estimated closing working capital.

The standard by which such items will be determined must be agreed upon (e.g., whether such determinations will be made in accordance with GAAP (subject to any of the company's accounting idiosyncrasies that have been disclosed to buyer on a schedule) and/or in the same manner in which the financial statements were prepared).

Representations and Warranties

The seller will be required to make detailed representations to the buyer to provide comfort as to the quality of the acquired business. Typical representations relate to title to and sufficiency of assets, compliance with law, accuracy of financial statements, payment of taxes, absence of undisclosed liabilities, and absence of environmental liabilities. The seller will typically seek to qualify its representations with knowledge and materiality qualifiers to limit its exposure to risks of which it was not aware or that are immaterial. Because every business has its normal share of liabilities, the seller will be permitted to schedule exceptions and qualifications to its representations and generally will be inoculated from liability for such matters.

Indemnification

Indemnification provisions allow parties to draw a box around their post-closing liabilities (leaving open a backdoor for matters like fraud and intentional misrepresentation). They can customize the indemnity regime by survival periods, caps, deductibles, and specifying which matters in the agreement will be subject thereto.

These provisions are heavily negotiated and vary based on the type of business, the seller's involvement in the company's operations, the relative negotiating positions of the parties, and the post-closing recourse available to the buyer. For example, a typical indemnity regime may provide that:

(1) fundamental representations will survive in perpetuity and will not be subject to a deductible or cap;

(2) representations relating to environmental, labor and employment, and employee benefits matters will survive for some period of time after the applicable statute of limitations has expired and will be subject to the deductible and cap;

(3) all other representations will survive for between 12-24 months following closing and will be subject to the deductible and cap; and

(4) covenants will survive indefinitely and not be subject to a deductible or cap.

The parties may also agree to line-item indemnities, with respect to which they can specifically allocate risk to one party. Line-item indemnities for pre-closing taxes and environmental matters are typical.

An M&A transaction can be transformative for both buyer and seller alike. The buyer is highly motivated to understand and address the potential risks of the acquisition, and the seller is necessarily concerned with its post-closing obligations and liabilities. A carefully crafted acquisition agreement takes all of these concerns into account and memorializes the deal.

Rob Shearer *is a partner in the energy practice at Akin Gump. He has significant experience in public and private mergers and acquisitions for energy, utility, oilfield services, manufacturing and technology companies.* ***Jon Boben****, counsel at Akin Gump, has represented financial and strategic buyers and sellers in public and private mergers, acquisitions, and dispositions in a wide array of industries, with a particular focus on the energy sector.*