

San Diego County Bar Association

**BUSINESS LAW SECTION PROGRAM
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presented by

**George P. Shenan and Marcus Klebe
George P. Shenan, Incorporated**

PROMOTING AND PROTECTING PRICING IN M & A TRANSACTIONS

1. Timing.

a. Know the general and industry-specific economic conditions and public market pricing multiples. Also learn the M&A market multiples being applied to EBIT and EBITDA, etc. Avoid entry when numbers are against your client.

b. Know your client's own financial and other conditions to determine if it should wait in order to get its house in order, in re earnings, balance sheet ratios, debt, etc.

c. Determine if your client has a specific contractual or other condition which very adversely affects its marketability and cure it before entry into market place.

2. Initial Exploration of the Market.

a. Do not let your client fall in love with the initial offeror, except in unique situations. Encourage your client to broaden the search.

b. Strongly consider use of an investment banker familiar with the industry in question to identify possible interested buyers and provide input as to pricing, terms, direction of the market, reducing risk perceived by outsiders, etc. A good banker will also help to create value throughout the entire M&A process.

c. Consider use of bidding approach to maximize total consideration to client if the company is big enough for buyers to put up with it. Otherwise, it has to be very subtle and carefully managed not to lose buyers who will refuse to go into an auction that's openly called such.

d. Even after identifying most likely buyer, keep other prospects alive and interested to keep pressure on the favored buyer.

3. Assemble Preliminary Data Room at Early Stage.

- a. This is essential in order to spot and cure weaknesses before the M&A process seriously begins.
- b. This enables seller to expose all of the “warts” and explain them at the beginning of the M&A process rather than at a critical later stage.
- c. It allows seller to lay out its “specs”, so to speak, so that initial bidders know up front what they are bidding on. Leaves less room for back-tracking later on.
- d. Carefully scrutinize financial statements (audited, if possible) and discuss procedures used to quantify certain line items. Prepare for any challenges to the statements.
- e. Enables M&A counsel to carefully control flow of information, documents and data to interested parties by allowing counsel to review all relevant materials before delivery to others. This helps to avoid overstating historical data or projected earnings, which can haunt seller going forward.
- f. Note that diligence will provide basis for all schedules which are to be attached to purchase and sale agreement. A careful scheduling of all exceptions to representations and warranties is critical to avoiding post-closing indemnity claims.

4. Preliminary Terms of Purchase.

- a. Initial negotiation of price in letter of intent is vital; its morally binding effect is significant. Do not allow client to commit to a “price” without full advice and consultation from M&A counsel and investment banker, if involved. Never let a seller mention a price to a buyer.
- b. Letter of intent should be carefully drafted to cover major deal points.
- c. Obtain early tax advice to determine best tax structure for seller. Consider IRC Sec. 338(h)(10) sale if available to maximize value on both sides. Carefully review with client his net after-tax take depending on the structure which is employed to avoid shock at later point in time.
- d. Identify consideration to be used. If buyer’s stock is involved, consider use of “collar” and discount from public trading price to reflect lack of marketability.
- e. Consider need for earn-out arrangement to bridge differences in pricing.

f. Carefully select date for reference balance sheet to allow for best possible up-tick in pricing at closing . Take seasonal variations into account in selecting date.

g. Push hard for earliest possible closing date. General rule: No good comes from delay!! Immediately establish a schedule of milestones to be adhered to and get sign-off from buyer. Delegate responsibilities within seller's team to meet milestones.

5. Set up the M & A Team.

a. Establish the team within the company. Should include CEO, CFO, CIO, IP person, HR person and key staff person, and only when absolutely needed. All must be sworn to absolute secrecy, under penalty of death!

b. Establish outside professional team, including accountants and expert legal counsel in key areas.

c. Be sure to integrally involve existing corporate counsel, if M&A counsel is brought in as special counsel to handle the deal. Corporate counsel will be an invaluable source of information during diligence period and throughout entire M&A process.

d. Lead M&A counsel is responsible for delegating responsibilities, establishing timetable and making sure that everyone meets deadlines.

6. Negotiating the Purchase and Sale Agreement.

a. Carefully draft and limit reps and warranties. Prepare the client for what to expect – if it's their first time through, they'll be put off if not terrified by what often are common in this area.

- i. Intellectual Property
- ii. Tax
- iii. Environmental
- iv. Employment

b. Make fullest possible use of "knowledge" and "materiality" qualifiers. Define knowledge as "actual knowledge without duty to investigate".

c. Limit survival periods of reps and warranties as fully as possible.

d. Draft indemnification process to clarify that buyer's remedies are limited solely to the claims procedure specified in the Agreement and that seller shall be accountable only for those representations made within the Agreement, and not for incorrect information which may be contained within diligence materials.

e. Incorporate caps and limits on liability and provide for deductibles or thresholds, as applicable. (aka "buckets and caps")

f. Scrub and double-scrub schedules for accuracy. Use schedules to elaborate on formulas, policies, and processes to be employed during closing and post-closing periods.

g. Don't negotiate on a piecemeal basis. Keep all issues on the table until all matters are resolved.

7. The Closing.

a. Carefully describe conditions to closing and documentation and consideration to be delivered at closing.

b. Take all steps to avoid closing delays due to failure to meet all closing conditions, which might give buyer an "out".

c. Identify all consents needed to assign contract, leases, licenses, etc. and arrange to obtain them in timely manner.

d. Arrange for key customer interviews by buyer at right point in time.

e. Confirm accuracy of reps and warranties at closing, as may be required by "bring down" clauses. Provide for revisions to schedules to reflect changes.

8. Balance Sheet Adjustment at Closing.

a. Carefully select adjustment mechanism (e.g. working capital adjustment) and define balance sheet line items to be used in adjustment calculation.

b. Try to limit down-side impact of adjustment by:

i. using a collar in which no adjustment is made if change falls within certain range or use a floor or ceiling for adjustments.

ii. defining type of GAAP to be employed.

iii. providing for seller to be responsible for preparation of initial closing date balance sheet.

iv. giving seller right to offset negative adjustments with positive adjustments.

v. providing that buyer cannot "double dip" on closing date adjustment and indemnification provision.