It's time to talk turkey

Seller strategies to prevent a buyer from wriggling away

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With apologies to Mark Twain, it is one thing to talk about selling a business, but quite another thing to actually do it. This article discusses strategies, from a seller's perspective, to negotiate a letter of intent and a definitive agreement.

Why have a letter of intent? Instead of getting bogged down in the mire and details of a letter of intent, some suggest going full tilt for a definitive agreement. Sellers will avoid a letter of intent when they are discussing terms with multiple buyers, do not wish to grant exclusivity to any buyer and want to retain maximum flexibility. Sellers desire letters of intent, however, to assess the buyer's seriousness (in a nonbinding fashion). Buyers will prefer a letter of intent to get an exclusive right to evaluate the company and to see if the seller is really serious about selling.

On rare occasions, a buyer will provide a letter of intent to a seller at an early stage in a transaction (often prior to due diligence) to demonstrate a price range (or a valuation methodology such as a certain multiple of operating cash flow) that the buyer would be willing to pay if the due diligence analysis is satisfactory.

These letters are sometimes furnished during early stages of controlled auctions to winnow out multiple buyers, or if a buyer wants to pre-empt a seller's discussion with other buyers prior to the buyer spending time and money on a due diligence. Letters of intent furnished prior to the conduct of due diligence, however, may be

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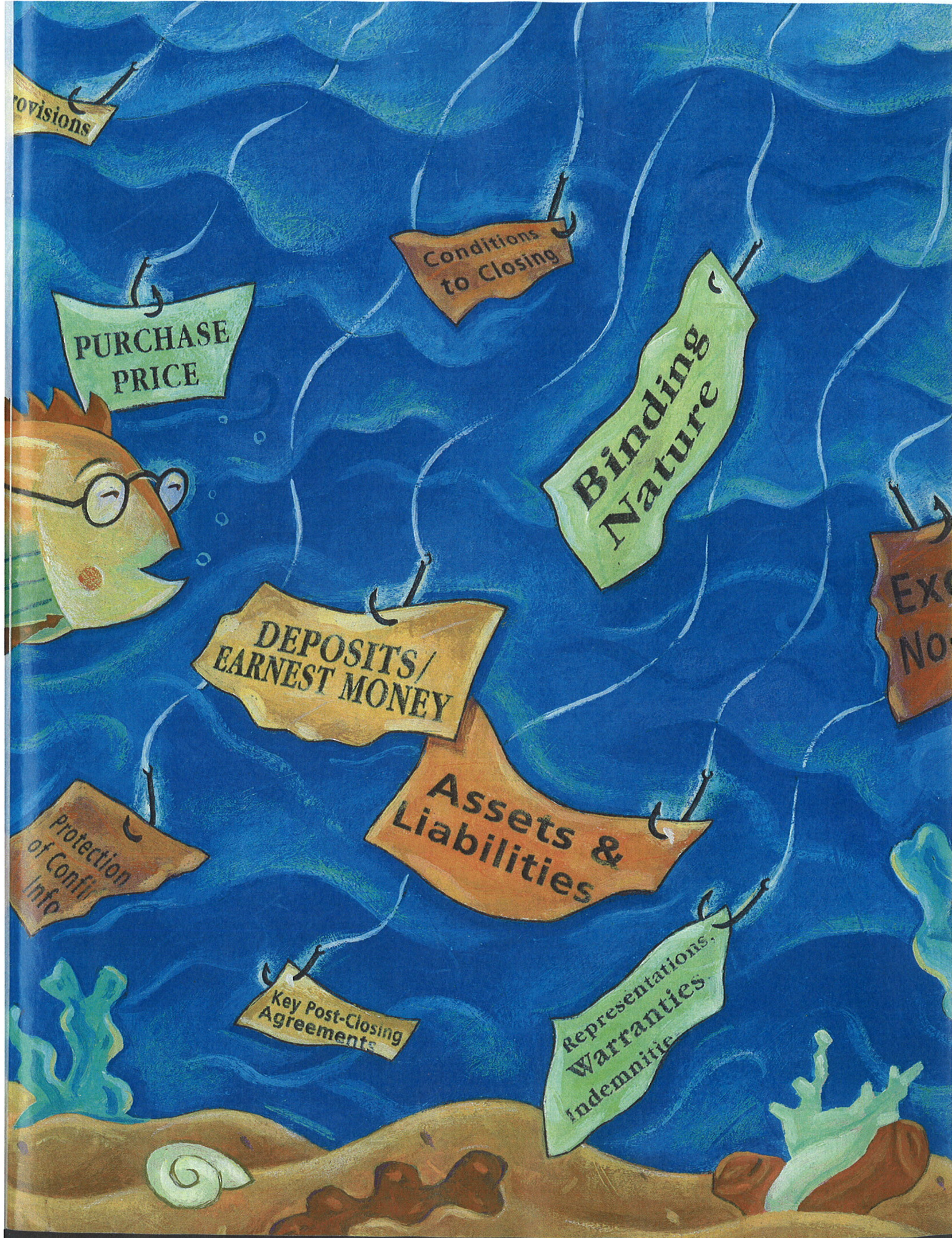

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exceedingly dangerous since they may emotionally lock a seller into a price range that will be difficult to change even if the due diligence uncovers facts that warrant a change.

So what are the key items to cover in a **letter of intent**? Following are several key terms to set forth:

Binding nature. Letters of intent are frequently considered as mere agreements "in principle" and not binding. Some courts have nonetheless imposed a duty of good faith negotiation on the parties and awarded damages for breach of that duty (usually "reliance" damages limited to the harmed party's out-of-pocket expenses; but in some cases, the most notable of which was the Pennzoil-Texaco-Getty dispute, punitive damages). The binding or nonbinding nature of the letter of intent should be carefully stated. Regardless of the legal implications involved, however, execution of a letter of intent typically fosters an emotional and psychological commitment of the parties.

Purchase price. The advisability of a buyer proposing a purchase price in a letter of intent is a function of the timing of the transaction and the stage of the buyer's due diligence. Buyers should be cautioned against stating a firm price in the letter and should clarify that any price is clearly predicated on the consummation and conclusion of due diligence. Too often a buyer unwittingly traps itself into a price commitment. Subsequent discussions about price may appear (stock or assets) to be renegotiating when, in reality, the due diligence contradicted the original assumptions and, therefore, justified a price reduction.

Assets and liabilities. The letter will state whether stock or assets are to be purchased. In the case of an asset transaction, the letter of intent will discuss, in general, the key assets and liabilities to be included and excluded in the transaction. A definitive discussion of assumed/excluded assets and liabilities remains contingent on the completion of the due diligence. For example, are all contracts going to be assumed? The seller may desire to sell its entire business (including all contracts), but a buyer may want to pick and choose which contracts it will assume and does not know enough at this point to make an informed judgment. Are there any assets to be excluded and retained by the seller? Due diligence will also provide better responses to these and related questions.

Representations, warranties, indemnities. Some letters of intent attempt to state the specific representations and warranties sought by a buyer. Sellers may resist this on the grounds that the letter of intent will be too lengthy and protracted. The parties may therefore agree in the letter that the representations and warranties may be of a nature and type appropriate for the type of transaction.

Buyer is not as focused and is likely to concede things.

Further, sellers will sometimes try to negotiate "cushions," "caps" and "survivals" of representations and warranties at the letter of intent stage. This tactic is often advantageous since the buyer is not as focused on the issue at that point, and is more likely to concede these things at this stage before it has any exclusive or other leverage with the seller.

Deposit/earnest money. The entrepreneurial seller will sometimes request a deposit or option fee to prove the buyer's sincerity. The parties must determine to what extent, if at all, this deposit will be refundable and under what conditions. There are often timing problems with this provision that can be difficult to resolve. For example, the buyer will want the deposit to remain 100 percent refundable if the seller is being uncooperative, or at least until the buyer and its team complete and are satisfied with their due diligence. The seller will want to set a limit on the due diligence and review period at which point the buyer forfeits all or a part of its deposit.

The end result is often a progressive downward scale of refundability as the due diligence and the deal overall reach various checkpoints toward closing. To the extent that the buyer forfeits some or all of the deposit, and the deal never closes, the buyer may want to negotiate an eventual full or partial refundability if the seller finds an alternative buyer within a certain period of time.

Protection of confidential information. If the parties executed a confidentiality agreement with respect to the transaction, the letter of intent should remain subject to and not conflict with the confidentiality agreement. The letter of intent should also be kept confidential unless either party has a legal disclosure obligation.

Key post-closing agreements. Letters of intent often set forth the key post-closing agreements that a buyer feels are necessary. These may include certain employment, noncompete and lease arrangements.

Exclusivity/no-shop/standstill provisions. A major benefit of a letter of intent to a buyer is the seller's binding commitment to (a) give it access to conduct a due diligence and (b) agree not to solicit, negotiate with or entertain or accept offers from other buyers. The prospective buyer will typically want a period of exclusivity where it has the confidence of knowing that the seller is fully engaged and committed to the buyer and is not considering other alternatives.

The seller will want to place a limit or "outside date" on this restriction.

Some sellers will seek to limit this exclusivity further if the buyer is not proceeding with all deliberate speed or if it is not negotiating in good faith.

Conditions to closing. Sellers will want to limit the types of conditions to a buyer's obligations to proceed to closing, beyond those that are "normal and customary." Sellers will want to assure that the closing may not be delayed or prevented for any reason except for an event caused by the seller (such as a significant change in its operations) or a third party (such as the withholding of a key consent). For example, the seller will want to assure that the buyer cannot "walk" from the closing as a result of its inability to obtain financing, or its inability to obtain board or shareholder approvals.

And then there's the **definitive purchase and sale agreement** (PSA). Negotiating and drafting this document is the culmination of the multi-step process discussed above. This article will only tangentially highlight major areas of conflict in the PSA. The issues themselves warrant a much more comprehensive discussion, and are only inserted here to apprise the seller about areas that it might expect to confront.

Major battlegrounds in the PSA frequently revolve around six items. These areas frequently were not negotiated, or vaguely addressed, at the letter of intent stage. These major contest areas include:

- Price
- The nature and scope of representations and warranties made by the seller (and selling owners).
- The terms of the seller's indemnification of the buyer.
- The conditions precedent to closing, including the absence of a material adverse change in the seller's business.
- The responsibilities of the parties during the time period between execution of the PSA and closing.
- The scope of post-closing noncompete covenants and any predetermined remedies for breach of such covenants.

To spell these out:

Purchase price — the consequences of structure. Is the client selling the assets of the business or the stock? Frequently, the buyer and seller do not even address this issue when they agree on a "sale" and agree on the "purchase price." While discussion of taxation exceeds the scope of this article, significant price differences arise from the failure of the parties to consider the tax consequences of the transaction. If the basis in the seller's assets is less than the basis in its stock, or even if the basis of both stock and assets are comparable, but the seller is a "C" corporation, the difference in income tax to the seller could be huge. If you also include possible recapture of depreciation, the seller's income tax liability in an asset deal increases even more.

Is the client selling the assets of the business or the stock?

Conversely, the purchase of stock deprives the buyer of the tax benefits from a faster write off of the purchase price and also straddles the buyer with all of the seller's liabilities. This discussion is further complicated by introducing the allocation of some of the price to consulting, employment or noncompete agreements.

In some deals, the parties either accept paying more money (in the buyer's case, if it buys stock), receiving less money (in the seller's case, depending on the circumstance), adjusting the price to share some of the unintended tax burden, or terminating the transaction. In some rare occasions, a consolidated seller, with tax losses from its other subsidiaries or the target itself, may have the opportunity to sell stock but enable the buyer to treat it as an asset purchase and gain the benefits of that treatment.

Purchase price — the working capital. Another economic item that the parties frequently fail to address in formulating the price is the seller's working capital (that is, current assets such as cash, accounts receivable, deposits and inventory minus current liabilities such as accrued expenses, customer deposits, deferred billings and accounts payable). This oversight occurs regardless of the form of transaction. Sellers will insist on either retaining, or requiring the buyer to pay for, all net working capital (assuming this number is anticipated to grow between signing and closing) since this represents the profits of the business from a particular point in time.

Buyers will retort that working capital is just part of a business and was subsumed within the purchase price. Buyers may also contend that paying a seller for its working capital falsely incentivizes a seller to refrain from making capital investments (notwithstanding any covenant to conduct its business in the ordinary course) since it would not be paid for the capital investments but would be paid to sit on its working capital.

Parties often dispute the proper classification of items comprising working capital. While generally accepted accounting principles may classify, for example, cellular telephones as inventory and therefore current assets, buyers have persuaded sellers that cell phones are likely to be held by customers for a long period and therefore are fixed assets. Although accounts receivable may be simple to measure for accounting purposes, the actual amount ultimately collected will not be known until 90 to 120 days after closing.

A variety of compromises resolve dif-

ferences over payment for working-capital items. Frequent approaches include having a buyer pay for (if a positive number) or receive a credit for (if a negative number) all changes in working capital from a certain date (such as from the balance sheet date that formed the basis for determining the price or from the signing date) to the closing, all changes in excess of a certain amount or all working capital period.

Purchase price — hidden assets and liabilities. A final purchase price item that the buyers and sellers seldom discuss in the purchase price discussions is the off balance sheet or hidden asset or liability. In the sale of an Internet service provider business, for example, the seller may also design Web sites as an ancillary service. The buyer may view the assets related to the design business as ancillary to the business and potential sources for service line extensions. The seller may retort that these assets have generated no appreciable revenue, are merely ancillary to the main business and should not be given away gratuitously.

The scope of representations and warranties. A major battleground in the PSA is the scope and breadth of the seller's representations and warranties (reps). The buyer will desire the seller to make a wide range of written and binding reps and warranties in the PSA. Among the assurances that a seller will be expected to provide a buyer are the following:

- The sale is not a breach of any other agreement or obligation;
- the seller has title to and the assets are free and clear of all liens and encumbrances and in good operating condition; and
- all material facts have been disclosed.

The buyer will want the scope of these representations and warranties to be as broad and comprehensive as possible. These clauses serve three purposes:

- They assist in due diligence,
- they form the basis for "kicking out" of the deal between signing and closing if the reps turn out not to be true, and
- they serve as the basis for indemnification if they are breached.

In essence, buyers look to reps as a form of an insurance policy.

As a result, the seller will zealously strive to negotiate limitations on the scope of these provisions where necessary. Particularly, sellers will suggest qualifications of the reps by their knowledge or by a materiality standard. Additionally, sellers will try to eliminate reps and suggest that the buyer is welcome to conduct its own due diligence and find out all facts of the business for itself. In the final analysis, the reps simply shift the risk of the accuracy between the parties.

The reps should seek to give some comfort to the buyer that the seller's financial information is true and the business is sustainable in the future if managed properly and consistently. The typical financial-statement rep usually confirms (with or without a materiality qualifier) that the financial records fairly reflect the results of operations. This rep, standing alone, will not provide sufficient comfort regarding the reliability of a seller's cash flow. Significant liabilities relating to past periods, as well as future periods, could loom and need to be analyzed. For example, has the software developer infringed on other software?

While reps may provide some assurance of the reliability of trailing revenues or operating cash flow, reps will rarely give any comfort that this figure is sustainable. Certainly a seller is well advised to expressly disclaim any guarantee of future results or performance. Sustainability beyond closing is typically a function of both macroeconomic conditions as well as the operating talent of the buyer.

However, reps addressing whether contracts are in default, notice of dissatisfaction or termination from major customers or advertisers, renegotiation of major contracts, notice of termination of key personnel and similar items, notice of complaints from customers, employees, suppliers or the government may provide an early warning signal to a buyer.

Scope of indemnification. Indemnification clauses provide the ultimate protection to a buyer for a seller's breach of a rep or nonfulfillment of a

'A merger? Oh, no -- I have my hostile-takeover suit on today.'

covenant or for liabilities that arose prior to closing. Sellers attempt to limit a buyer's indemnification rights in several ways and these are frequently the most fiercely contested donnybrooks in the agreement.

Battles are typically waged over:

- limiting the time period when the buyer may assert claims,
- the dollars that must be suffered before claims may be asserted (and then whether all damages may be recovered or just those in excess of the agreed amount),
- the total amount of damages for which a seller may be liable,
- the types of damages (that is, whether consequential or punitive damages are excluded or modified in some ways),
- whether damages are calculated before or after taxes, and
- the procedure for controlling third-party claims and handling the disputes between the parties.

Further, buyers will also attempt to hold the owners of the seller, and not just the seller, liable on a joint and several basis. Surprisingly, very few buyers attempt to insert indemnification clauses that specifically recite that the purchase price was based on a certain multiple of revenue (such as in the software industry) or of operating cash flow (such as in the telecommunications industry) and, therefore, any dollar amount of damages suffered should be multiplied by that factor.

Sellers intensely resist that type of provision and a humbled buyer will usually resign itself to deferring that battle to another day when proof of damages is submitted to a trier of fact. The amount of creativity and nuance in devising acceptable peace treaties ending these battles is virtually limitless.

Conditions precedent to closing. Sellers try to limit the conditions to closing to all but the most crucial few, that is, items such as obtaining major third-party or governmental consents and the absence of an injunction. Buyers, on the other hand, will try to finagle wiggle room and seek to impose conditions to closing such as its satisfaction with its due diligence, obtaining financing, receiving board or shareholder approval, obtaining all, not just material, consents and the absence of any actual or threatened litigation challenging the transaction.

One condition to closing that is frequently the subject of fierce negotiation is the right of the buyer not to close as a result of a material adverse change ("mac") in the seller's business, financial condition, assets or properties, and sometimes "prospects" (a "mac out").

Surprisingly, very few buyers attempt to insert these clauses.

A mac out takes many forms. Most clauses tend to be purely subjective in nature. A mac out will occur, for example, if there has been a mac in the seller's business, financial condition, properties or prospects. These are all value-laden concepts and reasonable people can honestly differ on whether any or all of these macs have occurred.

Further, while a mac in the seller's "business, financial condition and properties" has actually occurred and may be analyzed based on the facts as known, sellers should resist a mac out based on a change in "prospects" since this calls for pure prophecy about future events. Sellers should also qualify a mac out based on changes in "properties" if such changes are covered by insurance or relate to intangible and conjectural properties such as goodwill or franchise value.

Sellers frequently attempt to qualify mac-out clauses to exclude events affecting the economy in general or the industry in particular. They justify this qualifier on the grounds that the mac out should only apply to conditions to the business caused by the seller. To the extent that factors outside of the seller's control propagated the mac, the seller should not be penalized. Buyers try to resist these caveats on several grounds. Allocating blame between a seller's management fault or general economic conditions takes solomonic and, in reality, immeasurable precision. Regardless of the source of the mac, moreover, the seller's business has suffered, and it is not the same business that was the subject of the original bargain between the parties.

The parties less frequently attempt to devise an objective mac-out clause. For example, the agreement may specify that a mac out will only be triggered if trailing cash flow or revenues decline by 10 percent or more over the prior measuring period. If this concept is agreed to, buyers try to tie the figure to a less manipulatable item, such as revenues. While the buyer may fixate on revenues in other respects, tying a mac-out clause to revenues is dangerous since many expense items may be deferred or revenue items accelerated to manage the revenues number. While contractual clauses may admonish such devices, they are often subtle and subjective and furthermore typically avoid detection until after closing.

Conduct of the business between signing and closing. Axiomatically, buyers expect to own the same or better business at closing as existed when the PSA was signed. Contractual provisions governing the conduct of the operations (conduct provisions) of the seller's business between signing and closing attempt to assure the normal continuation of the business during this period. The importance of conduct provisions is magnified in transactions where a significant delay, perhaps because of regulatory filings or share-

holder solicitations, is expected between signing and closing.

Conduct provisions in most transactions are drafted subjectively or objectively or both. The most subjective provisions require the seller to continue to conduct its business during this period in the ordinary and usual course consistent with its past practices. The subjectivity of this obligation satisfies many parties, particularly when the seller does not want to incur specific obligations and the buyer is confident that the seller is well managed or has nothing to gain by mischief. The practicality that the seller's employees will begin dividing their loyalties between the parties is also a fact of life that provides comfort to buyers that employees' self-preservation instincts will prevail over any last minute gamesmanship by a seller.

Objective provisions are carefully negotiated. A buyer may insist on approval rights over the change in billing rates or license fee schedules, entry or termination of leases or site acquisitions, acquisitions or dispositions of software or fixed assets, termination of personnel, or paying bonuses or raises. Sellers attempt to fine tune these provisions to make sure that they do not unduly interfere with their management. Sellers should require that the subjective revenue or cash flow requirement is satisfied to the extent that it is modified by the objective components.

Noncompete agreements. PSAs frequently prohibit the selling entity and certain key shareholders from competing against that entity, soliciting its employees and customers, and disclosing confidential information after the closing. While sellers and owners naturally desire these clauses to be as limited as possible, buyers need to be cognizant as well that a narrower covenant has a better chance of enforceability and a broad and overreaching provision may be stricken as an undue restraint of trade.

Several key issues arise in negotiating these restrictions on the seller's post-closing activities. First, the parties will discuss the products or services in which the seller or its owners is precluded from competing. A buyer will want the clause to encompass any product or service from which the seller derived revenues, or had taken steps to develop (such as formulated a business plan to enter into a new product or service). The seller will resist such continuing restrictions that it will be deprived of earning a livelihood. Alternatively, the seller may propose that it be restricted from soliciting existing or past (within the past six to 12 months) customers and employees.

In the context of the sale of a business, the buyer will usually prevail since it is paying a considerable sum to keep the seller from upsetting the marketplace for a period of time. A seller may succeed, however, in carving out certain product or service lines that have not generated significant revenues or profits.

The geographic scope of the noncompete agreement is also a frequent area of discussion. An Internet retailer with sales in a few states will be hard pressed to accept a buyer's demand that the clause encompass the entire planet, since that is the potential reach of Internet sales. However, the buyer's position is much more logical and sustainable in this context since, in reality, the seller has the possibility of making sales throughout the globe. In contrast, if the seller were a cellular telephone company with a defined territory licensed by the Federal Communications Commission, the noncompete clause would not likely be enforceable far beyond the extent of that territory.

The time period of the noncompete and nonsolicitation periods is frequently scrutinized. Sellers of computer and other high-technology entities will rationalize a one-year term because of the lightning-paced changes in the industry. While buyers may agree with this analysis in the context of the noncompete agreement, they will insist on a longer period for a nonsolicitation covenant. This longer period for a nonsolicitation clause may be justified on the grounds that soliciting the customers and employees of seller's business would erode the asset that was the basis of the bargain between the parties.

Sellers will often seek to solicit their former employees in two circumstances: through means of general solicitation and if the employees were terminated without cause. A fair-minded buyer should not be too troubled by these carve outs, although care should be taken to prevent a clever seller from manipulating the spirit of these exceptions.

What is the geographic scope of the noncompete agreement?

A further area of conflict is the persons agreeing to the noncompete. Buyers will sometimes ask that all shareholders agree not to compete and also include their spouses and affiliates. Sellers will try to narrow the signers to those active in the business and exclude passive owners and investors.

Finally, some sellers will attempt to void the noncompete and other restrictive covenants if the buyer is in default of any of its post-closing obligations, such as payments under a note. While this approach may be tempting and sound symmetrical, sellers should remain skeptical of its practicality. If sellers were allowed to compete because of a breach by the buyer under a note, and then the breach were cured, should the seller then have to stop competing; and, if so, forego the costs it incurred in setting up a competitor? BLT