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VIEWPOINT

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ANATOMY OF A P&S AGREEMENT: AVOID NASTY SURPRISES BY KNOWING WHAT'S IMPORTANT

By Laura Kevghas

WHY THIS MATTERS:

- *Understanding the framework of a P&S agreement will prepare you to focus on the issues that will have the biggest impact on the outcome when you sell your company.*
- *Making sure you fully understand how various risks are allocated in your P&S agreement will help you avoid nasty surprises after the sale has been completed.*
- *The negotiation process can become emotional for sellers; having a good understanding of the types of issues that might arise in advance may help you keep the process in perspective and your emotions in check.*

Few legal documents you'll sign in your lifetime are more complex or more daunting than the agreement that accompanies the sale of your business. While most sellers naturally focus their chief attention on purchase price and any hold-back amount, there are often other terms within a purchase and sale agreement that can have greater impact on the final, long-term outcome for the selling shareholder(s).

In this month's Viewpoint we demystify the contents of purchase and sale ("P&S") agreements. Knowing more about this typically long and dry legal document will help you be better prepared to analyze your own P&S agreement effectively and understand what portions require the most attention.

Ultimately, within every M&A transaction there will be an allocation of risk between seller and buyer, and most negotiated terms boil down to a single question: "Who should bear this risk?" Looking at a P&S agreement through this lens can help a seller focus on what's really important, rather than getting stuck on emotional or insignificant issues.

According to attorney **Jim Dawson**, a partner in the Business department of Nutter McClennen & Fish LLP, first-time sellers arrive more slowly than repeat sellers at the understanding that the agreement is all about allocating risk.

What issues are most critical in a P&S agreement is highly situational. Some issues that are of paramount importance in one transaction may have little significance in another.

"Issues about their company become very personal," he says of first-time sellers. "The concept of economic risk allocation is more difficult for them to grasp."

Harold Leach has been through the P&S process both as an attorney advising clients and then as co-founder of **Lextranet®**, a leading provider of hosted litigation support software that was sold last year to **Merrill Corporation** in a deal in which Mirus served as Lextranet's advisor. "I remember having a sense that this was different from the business side than from the attorney's side," he says. "Much of that difference was that we were focusing more on the business terms, and I had a much deeper understanding of those than I did when I was an attorney."

"As an attorney, I had clients who didn't want to read the documents they were signing and I had others who did," adds Leach, who now serves as a senior vice president with Merrill. "You're better off making an effort to understand the major issues, and hopefully your lawyer can explain them to you. If you don't try to understand them, you run the risk of a nasty surprise later."

What issues are most critical in a P&S agreement is highly situational. Some issues that are of paramount importance in one transaction may have little significance in another. For example, intellectual property can be a huge issue for some companies and barely worth talking about for others. This variability makes it difficult to give generic advice on where to focus one's attention in a P&S negotiation.

Most often, the buyer's lawyer produces the first draft of the P&S and sends it to the seller's lawyer. Leach felt that the P&S drafted by Merrill Corporation was reasonably balanced. "It was not a one-sided document, and I think that reflects the fact that they wanted to do the deal and they wanted to be reasonably fair about it," he says. "They didn't want to do anything risky, but by the same token they didn't want to be obnoxious."

Still, the sides held differing views on several key points. "We argued over the period of the escrow," he says. "They wanted two years and we wanted one year and so we came down in the middle at 18 months. We also dickered about what was the appropriate period in which we had to collect the receivables. We wanted a longer period and they wanted a shorter period and we compromised."

INSIDE A P&S AGREEMENT

Here's a look at the key components of a typical P&S agreement:

- **Form of agreement:** Will the buyer be purchasing the stock in the company or the assets of the business? This decision typically carries tax and liability ramifications, and it is not unusual for sellers to prefer to sell stock while buyers prefer to buy assets. Also, some corporate entities don't lend themselves to certain types of transactions (e.g. it's often tax-inefficient to buy assets from a C-corporation).
- **Purchase price and form of consideration:** This is where first time sellers often focus the bulk of their attention. It addresses topics such as how much the buyer will pay, when will it be paid, in what form (cash, promissory note, buyer's stock, earn-out), how much will be held in escrow (an account into which the buyer deposits a portion of the deal consideration as an initial source of recovery if something goes wrong) and for how long, and what factors will trigger an adjustment in the purchase price at or after closing (e.g. working capital surplus or deficit). -

In a **study done by the law firm of WilmerHale**, among 33 transactions done in 2007, the shortest escrow period was six months and the longest was 60 months. Twelve and eighteen months tied as the most frequent length of the escrow among the study group.

In that same study, WilmerHale found that 39 percent of deals had an earn-out and 61 percent did not. With the volatility of the stock market and a weakening economy, valuations have come down somewhat from the top of the market in 2007. When a buyer and seller can't come to an agreement on price, an earn-out structure is a common technique for bridging the gap. But sellers should be wary of earn-out structures where the "target" is based on a metric that is easy to manipulate – such as earnings. Earn-outs that are based on revenue or some other element of performance that is easily measured tend to be more successful, and less contentious.

- **Representations ("reps") and warranties:** What is the seller telling the buyer about the business, which, if proven false, will give the buyer the right to go after the seller for breach of contract? This is the longest and most potentially mind-numbing part of the agreement, often running 20 pages or more with between 20 and 40 subsections, each addressing a separate topic. Lengthy paragraphs discussing arcane topics such as accounting standards, compliance with employee benefit laws, taxes, and ownership of stock, are almost certain to cause your eyes to glaze over. But most lawyers view this as the heart of the agreement because it establishes the bounds of the parties' obligations to one another.

If you do not "rep to" a particular assertion of fact (i.e., represent that the assertion is true), the buyer has no recourse if the converse turns out to be true. For example, if a business has been notified that one of its key customers intends to switch suppliers, and the buyer doesn't require the seller to

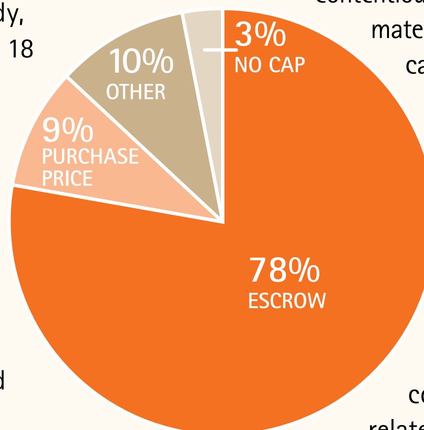
represent that no such notifications have been received, the customer can stop buying from the business, and the buyer may not be able to assert any claim against the seller.

One commonly identified subset of representations is the group of so-called "fundamental reps," which usually include incorporation, title to assets, capitalization, and ownership of stock. Buyers typically reserve more drastic remedies for themselves if these fundamental reps turn out to be false than if less critical reps prove to be false.

Reps relating to tax and environmental issues sometimes are deemed as fundamental, or are at least subject to different dollar caps (limitations on the seller's liability) and survival periods. The survival period stipulates how long the buyer has a right to sue the seller if a rep turns out to be false. Like everything else, this is an allocation of risk. After the passage of a certain amount of time, sellers want to know that they're off the hook, and by that time buyers should be able to determine what's true and what's not. In the WilmerHale study, most survival periods were between 12 and 18 months.

- **Indemnification:** How much can the buyer recover from the seller for a breach of a rep? Is the buyer limited to the amount retained in escrow at closing, 10 percent of the purchase price, or even 50 to 100 percent of the purchase price? This is an area that lawyers pay a lot of attention to, as should sellers.

In the 2007 deals studied by WilmerHale, 97 percent of the transactions had caps on the indemnification obligations. Seventy-eight percent limited the cap to the escrow, 9 percent limited it to the purchase price, and 97 percent included exceptions to these limits [see pie chart]. Generally, the exceptions were for fraud and willful misrepresentation.



Caps on seller's indemnification obligations
Source: WilmerHale 2008 M&A Report

Sometimes, there are different caps for different reps: 100 percent of the purchase price (or even unlimited indemnification) for breach of fundamental reps, tax, environmental, etc., and lower limits for less "critical" reps.

Indemnification provisions often contemplate the concept of a "basket," which refers to the dollar amount a claim needs to exceed for the buyer to be entitled to recover the amount from the seller. If a claim (or group of claims) is too small, the parties will typically agree that it isn't worth fighting over.

- **Timing of closing, pre-closing matters and closing conditions:** There are two ways to stage an M&A transaction: a "simultaneous sign-and-close" or a "deferred closing." In a simultaneous sign-and-close, the parties negotiate the P&S agreement in parallel with the completion of their due diligence, and in a single sitting, they sign the P&S agreement, close the transaction, and wire the money. This is often (but not always) more favorable for sellers, who aren't bound to the buyer until the last minute.

In a deferred closing, the parties sign a P&S agreement and then complete their due diligence between signing and closing. Buyers sometimes prefer this approach because it allows them to lock up the seller before completing the due diligence process, and the buyer can always walk away if the due diligence doesn't pan out.

In the case of a deferred closing, the P&S agreement needs to address certain often-contentious matters that don't arise in a simultaneous sign-and-close. These include:

- ➤ How the seller's business will be conducted prior to closing – can the seller hire and fire employees, issue stock options, incur capital expenditures?
- ➤ What conditions need to be satisfied for the buyer to be obligated to consummate the purchase. Typically, the most contentious of these closing conditions is the so-called materially adverse change (MAC) clause (sometimes called a material adverse event or MAE clause): how disastrous an event has to befall the business for the buyer to be relieved of its obligation to close the deal?

In the WilmerHale study, 97 percent of the deals included a MAC in favor of the buyer and 44 percent included a MAC in favor of the seller. Also, 91 percent of the time, the MACs in favor of the buyer contained specific exceptions, which mostly related to general industry and economic conditions.

- ➤ If one or the other party walks away, is there a break-up fee? Sellers often want breakup fees to protect them from the disruption and expense of a failed process, as well as to assess the buyer's seriousness about the deal, but breakup fees to sellers are extremely rare in private-company sales.

- **Covenants:** What promises do the parties make to one another about their conduct after the closing? This section typically includes non-competition, confidentiality and publicity, cooperation, and any ongoing business relationship between the parties or employees.

Some of these topics can get personal for sellers. "In every deal there is something that gets personal," says Dawson. "One often overlooked issue in this regard is the length and scope of the non-compete and the employment agreement. Most sellers think they will be able to work for the buyer for much longer than most sellers will actually want to. Successful buyers go in and get the sellers to fall in love with them. They establish a good relationship and a lot of sellers think, 'I can work for these guys going forward.' But there are very few sellers who will be happy to work long-term with the buyer running the seller's company. In fact, most of them have to grit their teeth

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to get through a year. So you need to look at what your exit will be like. How long is the non-compete, what's the scope, how long is the employment contract, and how tied up are you going to be down the road."

- **Disclosure schedules:** This is a lengthy set of documents prepared by the seller (or its attorneys) to accompany the P&S agreement. It usually contains many laundry lists of exceptions to the reps in the P&S, which protect the seller from undue liability. For example, the rep in section 4.13 might include a statement that no tax returns filed by the company have been audited by the IRS or any other taxing authority, "...except as set forth in schedule 4.13." Schedule 4.13 might then disclose that the IRS is auditing the company's 2006 tax return. In that case, a buyer couldn't assert a claim for breach of the "no audited tax returns" rep based on the 2006 audit, because it was divulged in the disclosure schedule. Disclosure schedules can be time-consuming to prepare and are critical to ensuring that both parties know what they're agreeing to.

AVOID GIVING AWAY KEY POINTS IN THE LOI

Dawson has an important piece of cautionary advice for first-time sellers. "Unfortunately, a lot of the key provisions of the P&S agreement can be negotiated away early in the letter of intent (LOI) and you're often stuck with what you agreed to in the LOI," he says. "This happens more frequently than you'd think. There are companies that live their lives without having a relationship with a lawyer or an investment banker they call on for advice and counsel. I see sellers who will negotiate the first couple of rounds of the LOI and then send it to me. When I point out an issue that presents a problem, they say, 'Oh, but I already agreed to that.'"

KNOW WHAT MATTERS AND WHAT DOESN'T

Looking back on his company's experience, Leach feels they were fortunate in a number of ways. "One of the ways was an associate who did a lot of the work at our law firm had been in business for a while and he had a fairly practical viewpoint," he says. "That is something a lot of business people look for in a lawyer, but those who don't appreciate the significance of it are harmed. Some lawyers tend to be more intellectual and theoretical and sometimes they tend to be caught up in the details and not seeing the big picture. So one of the things I'd recommend is to find a lawyer who has business experience because that makes the P&S negotiating go more smoothly. Another piece of advice I'd give is that it's important to know yourself what things are important and what aren't so important–what's worth fighting about and what's not worth fighting about."

By being alert to the meaning and importance of all portions of your P&S agreement, you can help ensure that you won't be in for unpleasant surprises once the ink on the document is dry. Jim Dawson offers this advice: "Decide what are you really worried about and hold firm on those issues, but if you really want to get this deal done, you'll have to compromise somewhere. There is a give and take in a successful negotiation. Generally, you are able to get down to a list of 10 or so key issues that are in dispute. While successful sellers and buyers always need to be prepared to walk away from the deal, they understand the need to hold firm the most important issues and compromise on the others. When a deal is struck on a handshake and then founders, it's often because someone had to have their own way on all 10 issues."

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