The Philosophy of Acquisitions

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Chapter 6

Philosophy of Acquisitions*

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Acquisitions of operating businesses are always complex processes with levels of risk for buyer and seller. The goal of the buyer is to pay a specified price, and receive the value, on both an operating and financial statement basis, which it believes is inherent in the acquisition. To accomplish this, buyers conduct due diligence/1/ directly and through their lawyers, accountants, and lenders to verify financial statements, to understand the obligations and contracts which are being assumed, and the nature and scope of other liabilities which are incurred. Assets are verified by physical examination and other direct confirmations.

The seller views the transaction differently. The seller wants a different level of certainty — that after the sale there is no ongoing exposure from the business, that the consideration received is not contingent, and that post-sale adjustments or liabilities are not his concern.

Those competing interests of buyer and seller are reflected in acquisition documents crafted by buyer, seller, and their respective counsel, which allocate risk by agreement. Representations, warranties, covenants, and indemnification are classic devices which perform dual functions. Representations disclose facts about the business which assist buyer in making a reasoned decision to purchase. Separately, they represent a contractually bargained allocation of specific risks. Covenants provide a commitment by the parties to future actions. Indemnification protects each party (in theory) against violations of those agreements.

The essence of a privately negotiated transaction between sophisticated, financially responsible parties, is that each is left to bear designated, or at least agreed upon, liabilities, and receives agreed upon consideration in exchange. The parties to the negotiation are few, being primarily seller, buyer, and their respective counsel. The acquisition agreement covers: (a) price; (b) payment terms; (c) representations and warranties;/2/ (d) conditions to closing; (e) conduct of business between signing and closing; (f) indemnification; and (g) closing documentation, including all ancillary agreements such as employment agreements, noncompetes, transfer of intellectual property, and other comparable matters.

Although the variables and goals may be the same in the acquisition of a financially distressed company, the process and product are dramatically different.

Consider a not uncommon seller. A middle market, family owned and managed company. It is near or in Chapter 11 bankruptcy proceedings. The family net worth is eliminated. Personal guarantees are on the bank debt. The lender has stopped funding or threatened to stop funding. The controlling shareholder of seller is hostile, in a state of denial, and soon to be unemployed. The business is dissipating or eroding

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daily, and time is of the essence if the buyer is to acquire anything of value.

Without knowing more, you would commonly assume that payables are stretched, receivables are overstated (or more kindly, "under reserved"), suppliers are cutting off credit, inventory is aged, employees are leaving, financial records are a mess, and the secured lender (or lenders) are between anger, despondency, and hysteria.

Not an easy set of circumstances for buyer to conduct a thorough, cautious, painstaking due diligence. The reward system is out of kilter. If buyer gets every representation and warranty in the world, but the seller and its shareholders are not financially capable of providing meaningful indemnification, the agreements lose a certain amount of their vigor. If buyer closes the deal, and the sales force, which has been slow on receiving commissions for six months moves to their solvent competitor, buyer has bought nothing. If problems like OSHA and EPA compliance have been ignored due to cash shortages, the buyer will bear unknown and unquantifiable liabilities which have the net effect of either increasing the purchase price, decreasing the value of the acquired assets, or both.

What makes the acquisition of the distressed company different, and requires an alert, risk-sensitive buyer and similarly attuned lawyers, accountants, institutional investors, and lenders, are the following. Time is short. Analysis must be made quickly and from inadequate or insufficient data. The parties to the negotiation process are numerous. Buyer must deal with seller, seller's lenders, unsecured creditors, nervous suppliers, increasingly disloyal customers, unhappy employees, undisclosed liabilities, and generally suspect (or delinquent, or four month old) financial statements. If the business makes it to Chapter 11, then the vagaries and unpredictability of the judicial proceedings get added to the uncertainty of the process. Protection cannot be achieved by the written word, because indemnification from an insolvent entity is meaningless.

How, and why then, should the acquisition be pursued? Everything has a value at a price, so the first goal is to have a price that reflects reality, not the desperate needs and dreams of the tottering seller. Recognize that "deal creep" is probable. Problems will arise that can only be solved by money, usually buyer's money, and the true purchase price will tend to increase. Terms of payment must be time delayed and subject to buyer's right to offset so that the buyer provides a portion of his own indemnification. Promissory notes with rights of offset, escrows with funds secured in favor of buyer, payments contingent on subsequent verification of historical financial statements or future revenue or income stream, all help center the purchase price near the received (or perceived) value.

Asset verification must be rigorous. Is the inventory there? Have the receivables all been sold on nine-month terms? Are the contracts being assumed in default and nonassignable? Who owns the real property?

Liability avoidance is critical. The federal and state laws which may affect the distressed company are legion. The spectre of fraudulent conveyance on the one hand, and the unanticipated liability of a successor under the Bulk Sales Act or other creditor protection laws, is real. Concerns over successor product liability, claims of unsecured creditors, successor liability under state or federal environmental, tax, or labor laws, and unfunded pensions must be reviewed.

The practical concerns cannot be ignored either and may, in fact, predominate. Even an acquisition structure which legally eliminates an unsecured creditor's claim will be a Pyrrhic victory if the creditor is the only supplier of critical machinery or services, and decides that future service will be very slow until he gets his unpaid dollars.

Buyer must understand several basic truths. The acquisition of a financially distressed company is risky and fraught with legal, emotional, and financial land mines. What is being bought is uncertain. What is being paid is less certain. Because so many people are involved in the negotiation (seller, lender, creditors, courts), reaching an agreement is harder. (Remember, a camel is a horse designed by a committee.) The risk of failing to reach an agreement is high and the soft costs (*i.e.*, legal, accounting, due diligence) are expensive. The probability of uncovering a deal-killer during the due diligence process is higher than normal because sellers bent on survival routinely hide problems. Certain problems cannot be waived or eliminated. Finally,

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and most importantly, execution of the piece of paper that symbolizes and codifies the deal cannot and does not guarantee the attainment of buyer's goal. That is achieved only by the buyer acquiring not just the tangible assets, but more importantly the intangible assets that are the real value in most companies — a supplier network, a customer or distribution chain, a branded product name, a productive, competent work force, and qualified management. That is the essence of an acquisition, not the collection of hard assets which dot the balance sheet. Real value is obtained only by a competent buyer doing the hard work of analyzing, calming, reassuring, and convincing all of the people who collectively are the "intangible" assets of a business, that they should remain with the business because a bright and promising future is possible.

What that means is that the buyer must be both risk-sensitive and risk-reward sensitive. Acquisition structures must be responsive to the needs of the particular deal, because the facts are never the same. Solutions must be economically and politically acceptable to numerous constituencies. Creativity, not cookie cutting, is the stuff of these acquisitions. Buyer's lender must be comfortable with buyer's judgment, because no amount of due diligence (let alone what is practically possible) will be possible or effective in the available time periods. And the entire buyer's team — buyer, lawyers, accountants, lenders, and key management must be smart, sophisticated, and capable of clear and effective communication with each other to reach an end product which acceptably minimizes the inherent and unremovable risks of the acquisition.

Acquisitions of a financially distressed company can be extremely profitable. Realists and pragmatists only should apply. History is prologue, but a tempered vision of the future is the key.

ENDNOTES

/1/ For a practical introduction to due diligence, see "Guide to Performing a Businessman's Review," by Arthur Andersen & Co.

/2/ Attached as Exhibit A is a fairly standard list of topics customarily dealt with in representations and warranties.

Exhibit A

Topics Normally Covered by Representations and Warranties

1. Ownership of assets
2. Organization and qualification of seller
3. Capital stock of seller
4. No subsidiaries or equity interests
5. Title to properties, conditions of properties
6. Financial statements
7. Absence of undisclosed liabilities
8. Absence of certain changes
9. Payment of taxes
10. Accounts receivable and accounts payable
11. Inventories
12. Banking relations
13. Trade names, trademarks and copyrights
14. Patents and intellectual property
15. Trade secrets
16. Customers and sales
17. Contracts
18. Litigation
19. Compliance with laws
20. Insurance
21. Finder's fees
22. Permits and burdensome agreements
23. Choses in action and litigation claims
24. Officers and directors
25. Agents and employees — collective bargaining agreements
26. Legality of transaction
27. Authority
28. Powers of attorney
29. Environmental matters
30. OSHA matters
31. ERISA
32. Transactions with management and affiliates
33. Suppliers
34. Product warranties
35. Customer deposits
36. Unsecured creditors
37. Expenses in connection with the transaction
38. Bulk Sales Act and creditors laws compliance
39. Full disclosure and survival of representations

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