Buying and Selling a Business in Massachusetts

Sterling Education Services, LLC

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Structuring the Deal – Milestones to Achieve

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A useful view of the structure of a business acquisition is in terms of the milestones to an ultimate closing. A merger with or acquisition of one business by another is a delicate process fraught with pitfalls. Since not every planned acquisition actually is completed, one of the most useful things an attorney can do for a client contemplating an acquisition is to apprise the client in advance of the milestones along the way in order that he may know what to expect, and not get farther along in the process in terms of costs than he needs to be at any given time.

A typical script for an acquisition runs as follows:

1. *Non-Disclosure Agreement*. To protect the confidentiality their initial discussions and investigations, the parties enter into a Non-Disclosure Agreement where each agrees to preserve the trade secrets and confidential business information of the other.

2. *Letter of Intent.* When the discussions progress to the point of an agreement on a possible sale, it becomes time for the parties to enter into a partially binding Letter of Intent (LOI) to set the general parameters and time-frame of the deal, including the intended final closing date.

3. *Due Diligence*. With the LOI in place, the acquiror, and to a lesser extent the seller may begin a due diligence analysis of each other's businesses.

4. *Term Sheet*. Once due diligence is complete, the parties must confer and agree on the specific parameters of the deal. It can be useful as the negotiations for specific deal terms begin for the parties to agree, with assistance from their advisors, upon a term sheet to reflect the firm intentions of the parties. The term sheet is also useful to the attorneys because it can indicate each intended document for finalizing the deal. The term sheet may evolve as documents are finalized, but in general will serve as a roadmap to keep all parties from getting lost in the minutiae of the documentation.

5. *Final Preparations*. There follows a period of a month or more as the buyer scrambles to line up financing, and the seller at the same time hurries to ready the business to be transferred. Depending on the issues that were turned up

during due diligence this period can involve a lot of legal and accounting work to shape up the corporation books and records, and the business itself.

6. *Closing.* The closing takes place once all documents have been agreed upon by the parties and their attorneys.

A. *Non-Disclosure Agreement*

The Non-Disclosure Agreement or NDA is useful to both parties. It is usually a single document with mutual terms that binds each party to protect the proprietary information of the other. Because the seller will be "opening the kimono" for the seller to inspect the business, and will also be learning a significant amount about the business practices of the buyer, the essential purpose of the NDA is to give each party comfort that it may be open and honest with the other for the purpose of exploring the merits and demerits of the proposed transaction without fear of consequences.

Negative consequences of not using an NDA may include:

1. Theft of trade secrets without legal recourse;

2. Loss of trade secrets due to their public disclosure;

3. Violation of the discloser's obligation to protect the trade secrets of third parties such as vendors and partners;

4. Convincing the erstwhile buyer that your business is so profitable that, with a few tweaks to the seller's trade secrets, it could enter the market as a competitor;

5. Loss of customers, employees and contractors to the erstwhile suitor.

It is thus important that the agreement protect the trade secrets and know how that inevitably will comprise a significant portion of the value of the seller's business. The agreement should also protect each party's competitive business strategies and plans, and contact information for its employees, customers and vendors. The prudent seller will also include a clause prohibiting the seller from soliciting the customers, employees and contractors of the seller.

The parties -- especially the sellers -- will also wish to protect the fact that the discussions themselves are occurring. Few sellers wish it to become known that they are actively pursuing their own sale. This may be to avoid chilling the interest of customers and vendors and potential to do business. They may also wish to keep the news from leaking prematurely to their stockholders, employees, or other stakeholders.

B. *Letter of Intent*

The Letter of Intent contains some terms that are binding and others that are not. The non-binding terms consist of a sketch of the intended terms of the acquisition itself. These are usually agreed upon and drafted by the clients, with assistance from their attorneys.

The binding portions of the letter of intent provide for such terms as: (a) no-shop, (b) break-up fee and (c) confidentiality. The no-shop or exclusivity clause is a simple agreement that, for a fixed period of time the seller will not to take any action to sell the target company, or otherwise prevent the sale from occurring. Since there are a variety of events that can prevent a sale from occurring, this clause is the most significant one from the buyer's standpoint and the language should be crafted carefully. For example, one alternative to the sale of a small company is to adopt an Employee Stock Ownership Plan, or ESOP. It is important to anticipate these and other similar competing events in the language, and also to pay attention as to the dates that the no-shop remains in effect.

Each party will also incur significant costs during the negotiations, due diligence and document drafting. The legal and accounting fees alone easily can exceed $100,000. Since these will be lost completely if the either party decides to back out of the deal, it is fair in the anticipation of any significant transaction to include a break-up fee payable by party seeking to back out of the deal. Typically, the break-up fee will be payable only during the no-shop period as a form of liquidated damages.

If an NDA has already been agreed to between the parties, the confidentiality provisions of the LOI can be a simple reaffirmation thereof. Otherwise, the primary area of protection should be the fact and terms of the negotiations themselves. The seller will wish this protection for the reasons stated above, and the buyer will wish it in order to buttress the no-shop restriction. That is, if it does not become known that the parties are in M&A discussions, there is less of a chance that a competing buyer will come out of the woodwork to tempt the seller with a better offer.

C. *Due Diligence*

- Due diligence has been defined generally as

  "[S]uch a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case."
  Perry v. Cedar Falls, 87 Iowa 315, 54 N.W. 225 (cited in Black's Law Dictionary)

Thus, in an M&A context, the exercise of due diligence requires the reasonably prudent buyer assiduously to investigate its target. Similarly the seller should also investigate his potential acquiror, since both parties may have to interact with each other well after the closing. This process begins with the sending of a due diligence request to the consisting of a list of documents that the other party should produce by a certain date.

Helpful Hint: Request that all documents be produced in duplicate, double-sided, hole punched for a three-ring binder, and tabbed to each category in your list. This will produce a book that can be easily handled and shared with the client. It can then serve as an essential reference about the target company, both for yourself as the buyer's attorney, and for the client well after the acquisition is complete.

The intent of due diligence is to determine whether: revenues are sound and likely to continue, whether the corporate structure is solid, the accounting has been conducted properly, and the employees are properly bound by contract and compensated at market rates. Vendor contracts are also important. In some instance, a company's lease, if long term and for a below market rate, can be one of the most significant assets of the target. It is also important to investigate any key intellectual property of the target is adequately protected, and to determine whether there are any significant contingent liabilities that should either be reserved for or, if too high, may be grounds for terminating the discussion.

Weaknesses sought will include:

- Documentation gaps of all types;
- Onerous or missing terms in key contracts (look especially to renewal clauses);
- Excessive royalty obligations to vendors, or inadequate royalty payments from key customers;
- Unclear ownership of intellectual property;
- Lease obligations; and
- Claims or lawsuits.

As an attorney representing a buyer, the following are some things to look for in a good acquisition target:

a. Corporate Structure. The savvy seller kept his corporate structure simple from the start. Where there were multiple classes of preferred stock, etc. company used down rounds to recapitalize them. The seller tracked all stock options & warrants carefully. The seller also terminated underwater options whenever possible.

b. Branch and Subsidiary Filings. The seller qualified in all states where doing business, and also withdrew where they were inactive.

c. Secured Financings. In the cased of secured financing, the seller obtained and filed termination statements promptly.

d. Contracts. The seller documented fully and completely all contracts with: customers, distributors, joint venturers, developers, vendors, and landlords.

e. Intellectual Property:

- Trade Secrets. The seller exercised trade secret vigilance, and signed all key personnel to confidentiality provisions under employment agreements and also contractor agreements. The seller routinely entered into NDAs with all key customers, vendors & joint venturers.

- Trademarks & Service Marks. The seller registered key marks, both in the U.S., and in foreign jurisdictions. The seller displayed "TM" next to unregistered marks, and defended key company marks vigorously with cease and desist letters to infringers.

- Domain Names. The seller registered product names, not just company names. The seller policed cybersquatters.

- Patents. The seller filed patents for key inventions within one year of public disclosure. The seller involved its engineers closely in the claims.

- Copyrighted software. The seller negotiated favorable licenses. The seller paid special attention to renewal & termination clauses

f. Existing Claims or Lawsuits. The seller settled claims or lawsuits promptly (if at all possible). Secured insurance coverage for defense costs or, at worst, obtained a written evaluation of the case from the litigation attorneys.

• Corporate Governance Reform Considerations. A wide variety of initiatives for governance reform by the a plethora of governmental or regulatory bodies or both may now come into play in considering the merits of an acquisition target, especially if the buyer is a public company. These may include:

–U.S. Congress -- *Sarbanes Oxley Act of 2002*

–Securities Exchange Commission (SEC) -- *'34 Act Reporting Requirements*.

–Public Company Accounting Oversight Board (PCAOB) – *Audit Standards.*

–Financial Accounting Standards Board (FASB) *Audit Standards.*

–NYSE, NASDAQ, etc.-- *Listing Requirements.*

–Delaware Supreme Court -- *In re Walt Disney Co.,* 731 A.2d 342 (2003)

All have had a say in putting things right!

• Just a sampling of the substantive issues to be aware of in a M&A due diligence context are:

–Prohibition on Personal Loans (SEC Rule)

–Stockholder Approval requirement for Stock Plans (Proposed NYSE rule)

–Board of Directors and Board Committees

• Independent Directors (Proposed SEC rules) are required on a

–Majority of Board

–All of compensation committee

–All of director nominating committee

–All of Audit committee

– (courts will now more likely reverse presumption of BOD independence)

–Audit Committees

• Must have at least one "Financial Expert" SEC defines as: Experience as an accountant or as CFO or controller of a public company

• Must keep detailed minutes

• Must adopt and implement procedures for receiving and handling complaints regarding accounting matters, including

–anonymous submission of employee concerns

•Board Minutes

–No defined standard. However, now, gaps are more likely to be construed to indicate a failure of fiduciary duty. Therefore, more is better, if done carefully.

•"Well-documented minutes, including the steps taken by the members of the board to inform themselves about the potential transaction, will help to create a record of the deliberation process to be used should lawsuits arise questioning the directors' exercise of their fiduciary duties." Goldblatt & Cefalli, *Does M&A Mean Manage & Adjust?*, Business Law Today, 12:16 (July/August 2003).

Clean up. Thus, sometimes, due diligence will flush out issues that have arisen from a neglect of legal niceties by owners of the selling business that may extend back many years. As deal attorney for the seller, it will be incumbent on the attorney to take immediate action to correct, clean up, and update these issues. Actions that may need to be taken in this post-due diligence period may include:

- Recapitalizing the company for the purpose of simplifying its stock structure. In the event that complete cooperation is not available from all stockholders, the seller may resort to the procedures of the merger state with notice and recognition of attendant appraisal and buyout rights, etc.;
- Tracking down directors and stockholders, both present and former, to sign corporate consents;
- Preparing and executing filings with the Secretary of the Commonwealth in order to bring the minute book and official records up to date;
- Updating foreign qualifications;
- Tracking down termination statements for terminated secured financings;
- Locating missing copies of stock options and warrants, both "under water" and otherwise; ascertaining their validity and effectiveness; contacting their holders in order to liquidate or convert them as a part of the transaction;
- Contacting key customers and obtaining their retroactive agreement to fill in significant omissions from vital revenue contracts such as term renewal clauses, intellectual property licenses;
- Documenting real estate leases or other arrangements such as customer contracts that have been extended past their defined terms without formal documentation.
- Conducting searches of trademarks and patents for the purpose of assuring the buyer that no conflicting users or inventors exist that will significantly hamper the use of the seller's intellectual property;
- Obtaining releases or licenses from conflicting users of intellectual property;
- Filing for protection of intellectual property;
- Initiating extensions of existing domestic intellectual property filings within key foreign jurisdictions;
- Settling or attempting to settle existing lawsuits; When all else fails, the attorney can obtain an opinion from company litigation attorneys. (They're always glad to do it!)
- Binding key employees into employment agreements;

•It may prove impossible for the seller's attorneys and accountants adequately to address highly significant due diligence issues prior to the scheduled closing date. This may (a) cause the closing to be postponed, (b) prompt the buyer to demand a holdback from the closing proceeds to cover their projected costs, or (c) if the issues are material and intractable enough, prompt cancellation of the transaction entirely.

•Thus, it is incumbent upon every attorney representing a potential M&A target to attempt to address these issues proactively in the course of the attorney client relationship well before a bona fide potential buyer has appeared on the horizon. Of course the ultimate direction for such actions must come from the client. The competent corporate attorney should thus encourage with every small company client to maintain a working relationship with the attorney in order to keep the company legally watertight at all times. One never knows when the sale of the company will become not only desirable, but necessary!

D. ***Term Sheet***

Simultaneously with exploration and remediation of the due diligence issues, the deal attorneys should take care to confer over the term sheet, and agree at the very beginning who will assume responsibility for providing which first drafts of which documents.

1. **What is Sold?**

Depending on whether the sale will be tax-free or taxable to the seller, the transaction may involve the sale of the entire company, a subsidiary, most of the assets and liabilities of the company, or assets and liabilities representing a division or simply a line of business.

Spin-Out. A spin out is a subsidiary that the seller has planned to sell for a long time. I.e., the parent corporation has set up a separate subsidiary. Usually, it is wholly owned by the parent, or key employees that would go along with the sale have been given equity. Sometimes, the spin-out is partially owned by one or more third parties that have shared the investment risk with the main parent. The purpose of the spin-out is basically to make a planned profit from the sale of a line of business in which the parent seen an opportunity, but doesn't see as a long term contributor to the parent's main line of business.

Sale the Stock of a Subsidiary. A simple subsidiary sale may be similar to a spin-out, except that the subsidiary may not originally have been set up with the intention of selling it.

Asset Sale. From the point of view of the seller, a sale of an unincorporated division tends to be that of a line of business that the seller originally hoped to incorporate into its business, and therefore never incorporated it separately

2. **To Whom?**

The acquisition may be carried out by a single buyer or a separately incorporated subsidiary or acquiring company. The buyer will separately incorporate an acquisition subsidiary either for the purpose of limiting liability, or for keeping the assets separate from the parent with an eye to future sale, or both.

Also, a separate subsidiary may enable the buyer more easily to obtain equity financing, and possibly even venture capital for the acquisition.

3. **Payment**

The simplest form of payment is always cash. However, there will often arise many reasons why the buyer may wish to pay the seller in other forms:

- Stock (or Warrants) of Acquiror). The stock of a public company buyer is often readily accepted as currency for acquisitions almost on a level with cash. Obviously, the degree of volatility of the buyer's stock will need to be taken into account during the pre-closing period.

- Since neither party may want to assume all of the risk of fluctuations of the buyer's stock price, risk can be shared through the use of a collar around the stock price. Of course, the larger the deal, the longer it will take due both to the complexities of the transaction, and the need to obtain regulatory approvals, and the collar gains significance as this period is extended. Collars are therefore much more common in really large deals. For example, Universal Widget Co. may offer 10,000,000 shares of its common stock at the current $10 with a collar of $3. Within the collar, there is no adjustment. Above or below, as of the closing, the seller may get 50% of the difference.

- Another mechanism, more appropriate for the smaller transaction, is to tie the price to revenue targets for the target company prior to the closing. This can also spill over to the post-closing period in the form of a holdback. The longer one expects the process of concluding the transaction to drag out, the more significance these and other hedging mechanisms will become.

- Post Closing Incentives and Holdbacks.

– Performance Targets. In the event that a significant number of the owners of the selling company are expected to remain in place, it may make sense to tie a significant portion of the purchase price to the achievement of performance targets post sale. Conversely, if none of the individual sellers of the target are to remain with the target as of the sale date, post closing incentives will be inappropriate because the sellers would lack the ability to affect the behavior of the target in the marketplace..

- Gross Sales vs. Net Profits. In the event of post closing incentives, the index by which the target's performance will be evaluated should be carefully scrutinized.

The degree of control retained by either party will determine whether a broad measure such as gross sales or cash flow should be used, or a more derivative one such as net profits or EBITDA (earnings before interest, taxes, depreciation, amortization, and other non-cash charges).

- Holdbacks generally are used in the event of a significant contingent liability such as a pending lawsuit, claim or governmental investigation. They may also be appropriate if a significant portion of the projected revenue is to come from an executory contract with a major customer, or to cover doubtful accounts receivable. Holdbacks may also be incorporated within an employment agreement to bind the loyalty of a key seller as an employee of the post-closing entity.

– Employment Agreements. Because employment agreements can prove costly as well as overly restrictive of the employer, they tend to be used sparingly to ensure that key intellectual property and skills of the company doesn't walk out the door as soon as the sale is consummated.

  – Noncompete Covenant. The employment contract in the M&A context, almost always includes a sharply drawn noncompete provision. Although courts are sometimes reluctant to enforce noncompete provisions where to do so would put an innocent employee out of a job, it is quite another matter, and they give very little sympathy to the employee that is sitting on the proceeds of the sale of a business while simultaneously competing with its buyer.

  – Non-Solicitation. Just as with the noncompete provision, it is important for the buyer to include strong non-solicitation clause within an employment agreement with a key employee-business seller.

  – Intellectual Property. Intellectual property protection should also be include, although this language will typically conform to standard language.

  – Sale Price Holdback. Often, a portion of the sale price is withheld through in an employment or consulting agreement. Payment of the holdback to key seller-founder is tied to the successful completion by the seller of a stated term of service, such as three years.

  – Compensation. Because the success of the acquired company will often depend on the strenuous efforts of the key seller-founder, it is typical that the employee receives substantial performance incentive in the form of bonuses tied to revenues or profits of the acquired entity, or options in the parent.

4. **Brokers vs. Finders.**

Often, one will learn that a third party helped to bring about the M&A transaction either as broker or finder. It is important to understand the distinction between the two in terms of the degree of assistance the client may expect from this party in concluding the deal. A “Broker-Dealer” is defined under the state securities laws as "any person engaged in the business of effecting transactions in securities for the account of others or for his own account.” G.L. c. 110A § 401 (c) (“Definitions”). A person or company acting as a Broker-Dealer must register on an annual with the Secretary of the Commonwealth of Massachusetts Securities Division. This is a fairly complicated and thus expensive process that investment banking firms comply with.

There are, on the other hand a wide variety of small firms known as “finders,” or sometimes “business brokers.” These persons rely on the key word “effecting” in the definition of broker-dealer to avoid registering. Not having registered, they are required to avoid actively promoting the M&A deal. Legally, they must avoid doing anything further than merely introducing potential parties to an acquisition, and then fading into the background.