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Transaction Documentation Means Dollars

The finer points of the deal could add up to significant value for the seller.

by Mark D. Working

Fighting hard to come to a conclusion on price and handing off the transaction to lawyers to "paper the deal" risks losing sight of the fact that transaction documentation is an integral part of the economic bargain. Virtually every agreement contains the same components, as illustrated in the adjacent diagram, but the details of the constituent components are unique to each deal. These fine points have important implications to the amount of value a seller receives and keeps.

READING THE AGREEMENT

Purchase agreements are inherently complicated. Defined terms, interconnected references, and schedules and exhibits make understanding the economic issues difficult if read from front to back. Follow the money. There are three critical economic components to each purchase and sale agreement: the transaction description, the promises and disclosures made by the seller (commonly referred to as representations and warranties), and the insurance policy (i.e., indemnification for broken promises). Once the economic components are understood, the other important, but not economic, components, such as the procedures to get to a closing, conditions that must be met prior to the close, and the rules governing how the business will be managed during the interim period between an agreement and the transferring of funds and ownership, can be addressed.

TRANSACTION DESCRIPTION

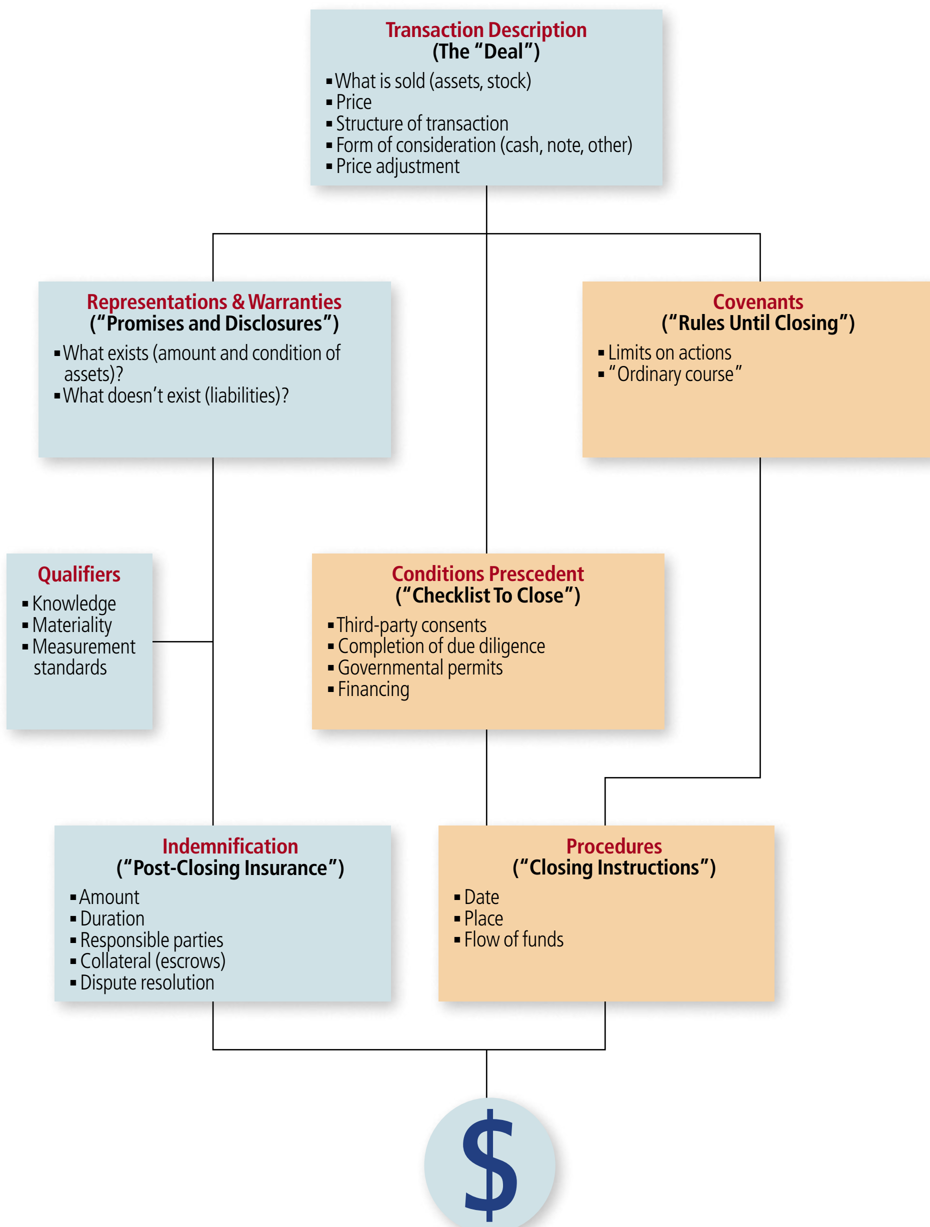
This section provides the overall guidance as to what the parties are trying to accomplish. It defines what business assets will be purchased, which liabilities will be assumed, and the price that will be paid, as well as the timing of payments and currency (e.g., cash, securities, notes).

The form of transaction matters. The broad choice among a merger, purchase of stock, or purchase of assets is based on the objectives to be achieved, as structure can impact the need for third-party approvals, segregation of unknown or unwanted liabilities, and taxes. These issues can complicate the choice because they can affect the economics of the parties differently depending on the specific circumstances of the buyer and seller.

For example, a stock transaction might be highly desirable to more easily transfer important contractual business relationships. The parties can still elect to treat the transaction as an asset sale for tax purposes (commonly referred to as a 338(h)(10) election). Depending on the specific circumstances, this could either result in significant value that can accrue to the parties, or have devastating implications to the seller.

REPRESENTATIONS AND WARRANTIES

There are two purposes for a seller giving



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representations about the business—aiding the buyer in its due diligence and establishing a set of promises of condition that is the basis for allocating responsibility should actual conditions prove to be less than promised.

Supported by an integrated set of schedules, the representations provide an "official" disclosure of the state of the business, which assists the buyer to conduct due diligence. Completeness matters because the clarity and accuracy of the scheduled data provides the buyer with comfort that the business is well managed. A company that has trouble documenting its assets, contracts, or some other aspect of the business, portrays an image of "seat-of-the-pants" leadership and can lead to more concern on the buyer's part for protection against the unknown.

Representations also establish standards against which future claims by a buyer that it did not receive what was bargained for will be judged. While wanting to be positive about the company, representations can become the basis for a future claim of shortfall against that standard and be the responsibility of the seller.

The biggest fear of most buyers is the unknown. Therefore, when a seller is asked to state without exception that there are no other liabilities that will accrue to the buyer (as an example), the question of seller's "knowledge" may become a point of contention. Although a seller might agree to a statement that is accurate "to the best of their knowledge," the buyer might not take comfort in that standard and might require an independent standard such as the knowledge of a "prudent person, assuming appropriate investigations were conducted."

Materiality poses another potential trap. Used throughout the agreement, its definition and application can be critical. Sellers generally fight for materiality exceptions to blanket statements, but embedded assumptions can be missed. A prominent example is granting the buyer a standard of compliance with GAAP. Whether audited or not, financial statements in their entirety can be GAAP compliant without individual accounts meeting the standard so long as the auditor determines there would be no material difference in interpretation of the statements in their entirety. Should the dispute be over a specific account, the seller can get caught.

INDEMNIFICATION

Buyers want assurance that they get what they bargained for, nothing more, and nothing less. The "bright line" concept is often used to establish where the seller's responsibility ends and the buyer's begins. What happened on the seller's watch (before the transaction) is the seller's problem, and what happens thereafter is for the buyer's account. Seller indemnification obligations arise directly as a result of damages incurred by the buyer for infractions of the bright line.

A claim of damages creates the basis for seller liability. The agreement establishes a minimum claim size, a minimum amount of claims that must occur before any seller obligation arises (deductible), total maximum claim liability, a period of time within which claims must be made, and whether, how much, and for how long an escrow might be needed as collateral for potential future claims. Since the buyer and seller often do not have the same perception of the risk of certain items, great pains are made to define various risks (e.g., taxes, environmental, employees, asset condition), and how each will be treated.

An example of where a disaster might arise is the case where an owner represents that the business being sold is an S-corporation and has no tax liability (as a result of its pass-through status). After closing, it is determined that the conversion to an S-corporation was not done properly and the IRS finds it to still be a C-corporation. As a result, all of the past profits of the business actually represent taxable income to the company and the past distributions made to the owner are recharacterized as dividends. The profits are taxable to the corporation and the buyer files an indemnification claim for damages as a result of the company's obligations to the IRS.

Many possible surprises can occur after the deal closes. Better due diligence by both seller and buyer can reduce the number and nature of surprises.

NEGOTIATE A HOLISTIC DEAL THAT CONTAINS ALL ECONOMIC COMPONENTS.

The "deal" and the documentation should be treated as an integrated whole. Principals should make sure they have a qualified team of advisors to deal in advance with all issues that will arise during the process of negotiating and closing a business transaction. Financial advisors working hand-in-hand with the owner's attorneys will greatly improve the overall result. We recommend considering all issues at one time, rather than in sequence, so that the ultimate objective—maximizing the after-tax proceeds after indemnification—remains clearly in focus. **ZS**

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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