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Business Transaction Marketplace

Information about Business Valuations, M&A and Corporate Finance   September 2012

Purchase and Sale Agreement

The process of buying and selling a business generally takes place over four phases: I. Planning, II. Research, III. Negotiation and IV. Integration. During the Negotiation phase, the parties negotiate the price & terms, the tax & financing structure, respond to and satisfy the buyer's due diligence requests – all leading to attorneys drafting and negotiating a definitive Purchase and Sale (P&S) Agreement.

This issue of *Business Transaction Marketplace*℠ provides an overview of the components and terminology commonly seen in P&S Agreements. The information presented here was obtained from various treatises and other sources available in the public domain, and should not be considered as rendering legal advice.

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P&S Agreement - Components

Andrew J. Sherman, Esq., one of the authors of the book titled *Mergers & Acquisitions: From A to Z*, breaks down an acquisition agreement into the following three components:

Consideration: Structure – Scope of Purchase – Price – How/When Paid – Deferred Consideration/Security – Earn-outs and Contingent Payments – Other Ongoing Financial Relationships Between Buyer and Seller – Employment/Consultant Agreements – Post-closing Adjustments

Mechanics: Conditions to Close – Timetable – Covenants (including covenants not to compete) – Third Party and Regulatory Approvals – Schedules (exceptions/substantiation) – Opinions – Dispute Resolution

Allocation of Risk: Representations and Warranties (R&Ws) – Indemnification – Holdbacks and Baskets – Collars – R&W Insurance – Methods for Dealing with Surprises

P&S Agreement - Terminology Definitions

The following are definitions of certain terminology commonly found within a P&S Agreement:

Allocation of Purchase Price: Where the structure of an acquisition is an asset purchase, it's the allocation of the purchase price to certain asset categories. Tax rules require that that buyers and sellers report this allocation at the time their tax returns are filed.

Basket: The dollar amount set forth as the minimum loss that must be suffered by the buyer before the buyer can recover damages under the indemnification provisions. Deductible Basket: Seller is only responsible for damages exceeding the basket amount (e.g., under a deductible basket of $100, if a claim of $150 is made then the seller must pay $50). Dollar-One Basket (Tipping Basket): Seller is responsible for all damages once damages reach the threshold basket amount (e.g., under a dollar-one basket of $100, if a claim of $150 is made then the seller must pay $150).

Cap: The maximum amount of damages the buyer can recover from the seller under the indemnification provisions. Many agreements include separate caps for different types of breaches.

Collar: The ceiling and floor of the price fluctuation on an underlying asset. For example, the price fluctuation where stock in part of the consideration; or, the fluctuation in the amount of trued-up working capital compared to estimated working capital.

Conditions to Closing: Certain obligations that must be fulfilled in order to legally require the other party to close the transaction. Other than conditions to closing relating to corporate approvals and governmental filings and approvals, compliance with a particular condition to closing may be waived by the party that benefits from the condition.

Covenants: Negative covenants restrict the seller from taking certain actions prior to the closing without the buyer's prior consent. Negative covenants protect the buyer from the seller taking actions prior to the closing that change the business that the buyer expects to buy at the closing. Affirmative covenants obligate the seller or the buyer to take certain actions prior to the closing.

Earn-Outs: An agreement in the sale of a company where the buyer agrees to pay the seller consideration in the future (typically cash or stock) based upon certain future events or performance of the business post-close. Because earn-out payments are contingent on the future performance of the acquired company, they are not included in the purchase price.

Escrow: A portion of the consideration that is deposited with a neutral third party (in the case of an escrow) or withheld by the buyer (in the case of a holdback) to be applied toward future indemnification claims by the buyer. After a specified period of time, any consideration remaining in the escrow or holdback account is released to the seller.

Escrow Period: The length of time (in months) after the closing date that the escrow is held before being released to the seller.

Indemnification: Where one party (typically the seller) to an agreement reimburses the other (typically the buyer) for any losses they incur as a result of the transaction.

Post Closing Working Capital Adjustment: In a merger and acquisition transaction, a working capital adjustment typically represents a pre-determined amount of working capital the selling company must have on the books as of the closing date. If the actual amount is more than the pre-determined target amount, the purchase price is increased by the excess. If it is less, the purchase price is decreased.

Purchase Price: The total consideration paid to the target company and/or its shareholders by the buyer upon consummation of the transaction. The purchase price amount includes cash, debt assumed, seller notes and escrowed amounts, and excludes non compete payments, earn-out payments, royalty payments, revenue sharing payments and other specified adjustments.

Representations and Warranties: Specific assurances in a purchase and sale agreement stating that certain statements are true. The purchase and sale agreement also includes specific remedies should assurances made turn out to be false or inaccurate

Rollover: The amount of equity retained by the selling shareholder(s) and is measured as a percentage of total equity of the new company and the dollar value of equity retained.

Seller Note: A note payable or loan to the shareholder(s) or owner(s) of a business provided in the sale or transition of a company by the buyer. Seller financing is typically used to bridge a valuation gap either where other forms of financing are not available or where a buyer desires to preserve the borrowing ability of the selling company for secured financing. Seller financing is typically unsecured and subordinated below all other debt.

Survival Period: The length of time (in months) after the closing date during which the representations and warranties must be true and the seller is responsible for indemnifying the buyer (e.g., claims by the buyer must be made on or before that date).

Structure (Transaction Type): The method in which the target and the buyer exchange value. The target sells either assets or stock, and the buyer provides consideration primarily in the form of either cash or stock. The parties could also merge by exchanging stock.

Terms with Special Legal Meaning: Double Materiality Scrape, Fair Presentation, In All (Material) Respects, Knowledge, Material Adverse Effect, Operation in Ordinary Course, Sandbagging, 10b-5 Full Disclosure, etc.

Final Comment

Parties to a business acquisition are advised to seek the assistance of legal counsel who are trained and experienced in drafting and negotiating P&S Agreements.

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Sponsored by: Minnesota Society of CPAs
October 3-4, 2012; Minneapolis, MN

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