

AN ATTORNEY'S PERSPECTIVE IN NEGOTIATING THE BUSINESS ACQUISITION

The Houston CPA Society

June 25, 2007

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I. General Considerations

A. **Change in Trend.** Until relatively recently, due to the then difficult economic times and the general unavailability of third-party financing, the business acquisition arena was generally a buyer's market. Accordingly, generally speaking, the buyer with financial resources used to enjoy substantially increased leverage in structuring the acquisition and the contents of the legal instruments documenting the transaction. In that type of market, the buyer was often able to successfully negotiate one or more basic business points such as a relatively favorable purchase price, low down payment, substantial deferred payments of the purchase price which were seller financed and no personal guarantee of the deferred payments of the purchase price. In addition, oftentimes the deferred payments were based on contingencies, the most common of which was based on future productivity of the purchased business, sometimes referred to as an "earnout" contingency.

In recent years, in this author's view, the leverage has shifted back toward a "neutral" balance between buyer and seller. Payment of substantial down payments and full payments of the purchase price at closing are not uncommon. Personal guarantees of any deferred payments and less reliance on "earnout" contingencies are also becoming more prevalent. As the economy continues to improve and third-party financing becomes more accessible, the ability of a seller to successfully negotiate more favorable business terms with respect to a sale of the seller's business should likewise continue to improve.

B. **Negotiation Process.** In a typical acquisition involving an attorney, the buyer will generally perform an extensive due diligence review of the company to be purchased and have prepared significant legal documents, usually in the form of an asset purchase agreement, stock purchase agreement or a merger or conversion agreement, along with numerous exhibits and related agreements, such as covenants not to compete, promissory notes, security agreements, consulting or employment agreements and various due diligence and closing certificates of representatives of both buyer and seller. The due diligence and document preparation process not only entails a significant expenditure of both the buyer's and seller's time, emotion and energy, but also, the incurrence of significant expenses in the form of

professional fees and related expenses. It is, therefore, imperative that both parties ascertain that there is a “real deal” at the earliest stage possible, so that a party to the transaction is not placed in the position of making unnecessary concessions in order to avoid losing his considerable investment in terms of time and money, which is growing more and more significant as the acquisition process continues.

Worst yet is the exposure of losing the entire deal at the tail end of the due diligence process, due to the inability of the parties to reach agreement on some material point, which point could have often been resolved prior to the expenditure of substantial time and money in the acquisition process. Although negotiation of some points in the later stage of the transaction is almost always unavoidable, the preparation of the definitive agreements should be almost anti-climatic. The most significant negotiation stage of the business acquisition should be consummated at the beginning of the negotiation process and is best documented through a preliminary document often referred to as a letter of intent. Oftentimes, not enough attention is placed on this important document and, too often, it is omitted in its entirety.

II. **Letter of Intent**

A. **From Buyer’s Perspective.** The letter of intent should clearly outline all major business points, which could be “deal breakers”, including, aside from the obvious amount and payment terms of the purchase price, (i) whether any personal guarantees are to be required of the buyer; (ii) whether any assets of the purchased business or other assets of the buyer are to be used as collateral by the seller; (iii) the contents of warranties and representations and the consequences of any violation of any warranties and representations, including whether a right of offset will be granted; (iv) a long survival period for the seller’s warranties and representations after closing; (v) whether legal opinions will be required; (vi) the establishment of contingencies on deferred payments, including the parameters of any “earnout” provision; and (vii) restrictions on seller conduct pending the closing process.

B. **From Seller’s Perspective.** Aside from the obvious amount and payment terms of the purchase price, the seller will want (i) personal guarantees of solvent individuals or entities associated with the buyer; (ii) a security interest in some or all of the purchased assets of the business or in other collateral of the buyer to secure payment of any deferred payments; (iii) specific and short term dates for each step of the closing process, with required earnest money deposits at each stage; (iv) confidentiality provisions; (v) provision for a “deal-breakup” fee; (vi) specific delineation of employment or consulting agreement terms; (vii) a high “basket” amount before indemnification for breach of seller’s warranties and representations would apply; (viii) an appropriate “ceiling” for which the indemnification obligation for breach of seller’s warranties and representations cannot exceed; (ix) a short survival period for the seller’s warranties and representations after closing; and (x) removal or restriction of contingencies on deferred payments.

III. **Personality Styles.**

A. **Introductory Comments.** Accurately identifying a person’s personality style (“identification”) and then adapting your behaviors to pace the person’s personality style

(“pacing”) is important, not only in life, but in also becoming a skillful negotiator. Skillful negotiators know how to align the differing positions (values) of the parties involved (based on their differing personality styles as they relate to the particular side in the negotiation in which they fall) with their commonality of interest (consummating the transaction being negotiated). A fuller discussion of personality styles is beyond the scope of this writing; however, the following is a very brief summary of the nine personality types based on the system used by this author known as the Personagram®.

B. **The Assertive Types.**

1. **The Dominating Challengers***. Seeking autonomy through domination of the environment. The tough boss type. Under stress, become confrontational and threatening. Turn them into the Empowering Challengers*.

2. **The Competitive Achievers***. Seeking attention through promotion of an image of success. The executive type, the top salesperson or producer. Under stress, become hostile, usually displaying arrogance and contempt. Turn them into the Authentic Achievers*.

3. **The Scattered Enthusiasts***. Seeking security through frenzied activity and excitement. The fun, party type. Under stress, become impatient and pushy. Turn them into the Invigorating Enthusiasts*.

C. **The Withdrawn Types.**

1. **The Stonewalling Peacemakers***. Seeking autonomy through withdrawal and non-confrontation. The pleasant type. Under stress, become stubborn and resigned. Turn them into the Receptive Peacemakers*.

2. **The Moody Individualists***. Seeking attention through dramatic withdrawal. The artistic type. Under stress, become overly sensitive and temperamental before withdrawing. Turn them into the Creative Individualists*.

3. **The Impractical Investigators***. Seeking security through mastery of critical information. The inventive type (computers, scientists). Under stress, become cynical and argumentative. Turn them into the Inventive Investigators*.

D. **The Service Types.**

1. **The Inflexible Reformers***. Seeking autonomy by being right and without reproach. The perfectionist type. Servicing others unemotionally through reason and logic. Under stress, become inflexible and condescending. Turn them into the Discerning Reformers*.

2. **The Meddling Helpers***. Seeking attention through servicing others through emotional support, but expecting a payback. The smothering, mothering type. Under

stress, become manipulating (through guilt) and intrusive. Turn them into the Supportive Helpers*.

3. **The Negative Loyalists***. Seeking security through strategic alliances (strength in numbers). Servicing others to build alliances. Lacking inner support and guidance. Under stress, create in and out groups, incite others against the “enemy”. Turn them into the Dedicated Loyalists*.

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IV. **Negotiation Strategies and Tactics.**

A. **Avoid Issue Isolation.** Never narrow negotiations down to just one issue, as this creates a situation where generally one party must “win” and the other party must “lose.” (Dominating Challengers, Competitive Achievers). Leave room for compromise.

B. **The Extra Concession.** After supposedly reaching agreement on all business points, a party requests an additional, usually small, concession (sometimes called the “nibble”), which was not previously discussed. This tactic is often successful because the other party is feeling good about the agreement at the time and, if such concession were brought up earlier in the negotiation process, it could be eliminated by the other party through the “trade-off” aspect of normal negotiations. (Competitive Achievers, Negative Loyalists, Dominating Challengers). Combat this tactic by making the requesting party feel guilty about his request by stressing what a good deal he has already negotiated.

C. **The Hot Potato.** One party attempts to transfer its problem (usually not a “real” problem; usually limited budget) to the other party. This tactic is often successful, as the other party psychologically takes ownership of the problem by limiting their activities (staying in budget) or spending resources trying to solve the other party’s problem, and the first party has received concessions as a result thereof. (Negative Loyalists). Combat this tactic by immediately testing the validity of the problem and rendering it into a non-problem immediately. (If I find the perfect software program for you for a little more than your budget, would you purchase it or should I only show it to my other customers?)

D. **Higher Authority.** A party that really has the authority to make a decision pretends that it needs to seek approval from another individual or a group of individuals, thus, setting up the ability to achieve concessions at the next meeting. (Negative Loyalists). Combat this tactic by asking at the beginning of the negotiation process who has authority to decide. The lawyers are often used as the “higher authority”, when the clients are talking to each other and the “clients” are often uses as the “higher authority” when the lawyers are talking to each other.

E. **Set-Aside Technique.** Set-aside controversial issues to avoid impasse and first resolve non-controversial issues to build a foundation of consensus that will enable the parties to later agree on the issues previously set aside.

F. **Good Guy, Bad Guy.** One party will have a “good guy” representative and a “bad guy” representative to build a rapport between the other party and the “good guy” representative. Often used in conjunction with the higher authority tactic. Combat this tactic by recognizing it for what it is and confronting the participants with your knowledge of it.

G. **Flinching.** A physical or emotional response to a proposal (the “flinch”) can be very effective. Oftentimes seen as a physical shudder, look of disgust or fright and followed by a statement such as “That’s outrageous!” (Competitive Achievers, Negative Loyalists, Dominating Challengers). If the proposal is sound and reasonable, combat the flinch by staying firm on your proposal.

H. **The Withdrawn Offer.** When the negotiation process is going too long and the other party appears to be attempting to get that “last” minor concession, an often successful technique can be to withdraw your last offer. (Dominating Challengers). This can often be accomplished, without losing face, by using the “higher authority” technique. The other party will oftentimes retreat back to your last offer.

I. **The Red Herring.** Some parties often throw in one or more requirements that are not really important to them in order to effectively utilize the “compromise” or “trade-off” negotiation process. (Competitive Achievers, Negative Loyalists). Combat by knowing enough about the other party to recognize which requirements are real requirements and which are red herrings.

J. **Reluctancy.** Playing the “reluctant buyer” or the “reluctant seller” may give increased leverage in the negotiation process. (Negative Loyalists). Once the other party knows you must do the deal, your negotiation leverage has decreased significantly or disappeared. Always maintain your “walkaway power”.

K. **Concession Counting.** Successful negotiators often make a big deal of any concession made, even minor ones and red herrings, and get a counter-concession for doing so. (Meddling Helpers, Negative Loyalists).

L. **Author of Documents.** Always attempt to get control of the preparation of the legal documents, as they will almost assuredly be slanted, to some degree, to your position.

M. **A Successful Negotiation.** In a successful negotiation, both sides feel a sense of accomplishment, feel the other side cared, feel the other side was fair, would deal again with the other and feels the other will keep the bargain.

V. **The Due Diligence Process**

A. **Seller's Provision of Information.** As a buyer often has the ability to choose among alternative businesses to purchase, for a seller to achieve the highest sales price, most favorable terms and a quick closing, the seller must be prepared to provide pertinent information regarding the business in a highly organized and expedient fashion. In the case of financial information about the business, the seller should be aware that information reported to various taxing authorities, such as federal income tax returns, federal payroll tax returns and state sales tax returns generally will be more credible than internally generated financial statements and reports. Therefore, inconsistencies among such data should be reviewed and handled prior to dissemination of information to the buyer. Additionally, audited or compiled financial statements by a reputable CPA firm should provide additional credibility, as well.

B. **Early Initiation of Third Party Actions and Consents.** Oftentimes, actions or consents of third parties may be required to properly effect the transfer of the business from the seller to the buyer. Early initiation of obtaining such third party actions or consents is imperative with respect to a timely closing. Third party action and/or consent is often involved where there are third party liens that need to be released, real estate leases to be assumed and customer/vendor/franchisor/licensor agreements to be assigned. Curing title to assets may be involved, as well, particularly for real estate, personalty subject to a security interest and intellectual property rights. Be sure to order early a title policy commitment for all real estate to be purchased and a UCC search on each selling party. All environmental studies, structural inspections and heavy equipment testing should be accomplished early, as well.

C. **Quick Closing Desired by Seller.** The seller (and the buyer, for that matter) should desire as short a due diligence and document preparation period, as possible. As the time period before closing lingers on, there is more opportunity for a buyer to find a better deal. Furthermore, because knowledge of an impending sale generally spreads quickly to employees, suppliers and customers (often with detrimental effect), a long preclosing period may have a chilling effect, not only with respect to the current buyer, but with future buyers, as well, in the event the current purchase falls through. Substantial earnest money, with specific time commitments for future actions, should be obtained by seller, particularly in view of the fact that a newly formed corporate shell will often be the party executing any binding agreement involving the acquisition as buyer.

VI. **Definitive Agreements**

A. **Warranties and Representations.** The seller naturally desires to receive the purchase price from the sale of the business with very limited rights of the buyer to obtain a refund back of all or a portion of the purchase price or to reduce or eliminate deferred payments. In addition to certain contingencies which may be placed on deferred payments, a buyer usually obtains warranties and representations from the seller, which if breached and causing damage to buyer, give the buyer certain rights against the seller. Attorneys for sellers typically attempt to restrict the warranties and representations to the basic ones regarding organization and existence, ownership of stock or assets, authority, no violation and no default. Buyer's counsel usually requires a myriad of additional warranties and representations, including accuracy of financial

statements, absence of certain changes, tax matters, contracts and agreements, absence of liens, fringe benefits, pension and other retirement plans (ERISA matters), leases, insurance, intangible assets, permits, personnel data, labor relations, compliance with laws, inventory, transactions with related parties, environmental compliance, accounts receivable, customers and suppliers, improper payments, warranty claims, interests in customers and vendors, litigation and full disclosure. Particularly for larger transactions, the seller's attorney will be required to render a legal opinion as to the validity of certain warranties and representations. As a seller will often be a shell corporation after the sale of the business, it is important from the buyer's perspective to have the ultimate recipients of the sales proceeds, usually the owners or shareholders, join in on the warranties and representations and assume joint and several liability with respect to breaches thereof.

B. Right of Offset. What may be of particular importance to a buyer in an asset acquisition is, not only the content of the warranties and representations regarding the purchased business, but the remedies available in the event of a material breach of any such warranties and representations. Successful implementation of a "right of offset" provision in the asset acquisition documents can completely switch the leverage regarding non-payment of future installments of the purchase price in favor of the buyer and away from the seller, as would be traditionally the case. A "right of offset" allows the buyer to contractually offset from future payments due the seller the amount of any damages suffered by the buyer in the event something is wrong with the acquired business in contravention of any warranty or representation made by the seller. This right is important for a buyer because hidden defects or difficulties involving a business may not be ascertained for a period of time after acquisition, notwithstanding any expansive due diligence work performed by the buyer prior to acquisition. The "right of offset" is not automatically provided for by operation of law and, if properly utilized, forces the seller to initiate court action to disprove the breach of warranty. In contrast, without a "right of offset", the buyer would be required under its contract to continue deferred payments of the acquisition price (and, thus, creating or expanding the seller's litigation war chest) and initiate an expensive and lengthy court action in a suit to recover damages. If properly drafted, the "right of offset" can apply to deferred payments made to the seller in the form of restrictive covenants, such as a covenant not to compete, and in the form of consulting or employee services if the seller (or its owners) continue to provide services to the acquired business.

C. Seller Considerations/Warranties and Representations. In the normal setting involving sophisticated parties, it is difficult for a seller to avoid extensive warranties and representations, sometimes involving a "right of offset". However, important limitations on such warranties and representations often are not difficult to achieve. Since the extensive warranties and representations (and right of offset) usually result from the buyer's fears that its due diligence efforts cannot pick up every material defect, and that only a period of operation can make such defects discernible, the seller can often successfully obtain a removal or lapse of all or most warranties and representations after a reasonable period of time of buyer's operation of the purchased business (for example, one to two years from closing). Additionally, a limitation on the amount of damages that can be recoverable against the seller can be limited to a specified dollar amount ("ceiling"), oftentimes the amount of consideration to be received by seller in connection with the sale of the business or a lesser amount. Furthermore, a "basket" amount can

be specified that any damages must exceed before the buyer is entitled to recover any of the purchase price from the seller (for example, an amount equal to 1% of the purchase price).

D. Other Closing Documents. Aside from the definitive basic agreement, usually in the form of an asset purchase agreement, a stock purchase agreement or a merger or conversion agreement, there are other numerous important legal documents associated with the business acquisition. There will be various documents relating to title of the purchased assets and the release or assumption of prior liens, such as bills of sale, warranty deeds, releases of liens and UCC-3 termination statements. In the case of a seller financed or leveraged buyout transaction, there will be various documents evidencing seller's right to deferred payments, such as promissory notes, security agreements, deeds of trust, UCC-1 financing statements and guarantee agreements. In connection with leased assets, there may be lease agreements, estoppel certificates from existing landlords and assignments of leases, including landlord consents. For intellectual property rights, there may be patent assignments and license agreements to be obtained. Oftentimes, there are restrictive covenant agreements, such as covenants not to compete, employment agreements and/or consulting agreements; whereby the seller, or individuals affiliated with the seller continue to receive payments from the buyer in the future.

VII. Continuing Relationship. Due to the continuing existence of seller financing in many business acquisitions and the often continuing relationship between seller and buyer through employment and consulting agreements, it is important to recognize that often the relationship between buyer and seller does not end at closing, but rather, in a real sense, only begins. The structuring and documentation of all of the important aspects of this ongoing relationship is of vital importance. Throughout the negotiation process and the document preparation stage, the parties must always be cognizant and deal effectively with the ramifications that there will be, in most likelihood, a continuing relationship between the parties, oftentimes for an extended period of time after the transfer of the business from seller to buyer.