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DEAL SEASON TRIAGE

As the year winds down, the pressure on M&A lawyers heats up.

From the Experts

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Q4 IS UPON US, AND WITH IT THE ONSET OF year-end deal season. Notwithstanding the pressure by internal corporate clients at year's end to "just get the deal done," doing so without proper focus on certain predictable material issues will increase the likelihood of post-closing disputes. Proper due diligence and alignment on certain critical issues will mitigate potentially costly mistakes. Here are three areas upon which to focus to achieve positive outcomes when faced with a year-end rush to close an M&A transaction.

1. UNDERSTAND THE TRUE NATURE OF THE TARGET'S BUSINESS

At the outset of the M&A process and through closing, it is critical for a buyer to gain a solid understanding of the target's business. Failure to understand what you are really buying can result in oversights and additional time, effort and expense that could otherwise be significantly reduced—if not avoided. Related to such investigation, a buyer will provide the target with an extensive due diligence checklist identifying all information about the target in areas such as financial statements, taxes, legal liabilities, intellectual property, environmental issues and numerous others. The buyer's counsel should take great care to understand the nature of the target's business and tailor the due diligence request to adequately

prepare the buyer for all related negotiations.

Consider the following example from a recent asset sale transaction when the failure to truly understand the target's business resulted in a costly transfer tax. The target was an energy services company with a considerable number of vehicles, trailers and other related equipment (the fleet). While the buyer, a private equity-backed enterprise, was provided an initial registration list for the fleet, it focused much of its due diligence inquiries on post-closing employee integration—down to the correlation of vacation and holiday schedule discrepancies between both companies as well as the types of employee uniforms and shoes to be worn post-closing.

Integration issues are important, even critical to the success of most transactions, but the buyer's failure to focus on the core of the target's business led to a last-minute recognition that certain assets of the target (including the fleet) would be subject to significant transfer taxes at closing. As the definitive agreement was silent on the payment of transfer taxes, such costs were, by statute, borne by the buyer, and the buyer was unable to negotiate any shifting of this liability as part of the underlying negotiation. Obviously, the failure to focus upon the nature of the target's business—a large fleet of vehicles that should have raised a red flag regarding potential transfer tax considerations—resulted in unnecessary costs for the buyer at closing.

2. NET WORKING CAPITAL ADJUSTMENTS

M&A transactions often include a closing date payment and post-closing true-up for net working capital (NWC). The buyer wants to ensure that the target will retain sufficient NWC to meet its prospective operating needs, while the seller desires full compensation for its fair market value. To prevent a post-closing dispute, language in the definitive agreement regarding determination of NWC requires forethought and precision.

There may be no way to eliminate all risk, but there are certainly **WAYS TO MITIGATE RISK.**

NWC, under general accepted accounting principles (GAAP), is

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defined as the difference between a company's current assets and current liabilities. Consequently, it incorporates a variety of financial elements such as cash, inventory, prepaid expenses, accounts receivable, accounts payable, contingent liabilities and accrued expenses. However, according to the nature of the target and its historical financial performance, as well as the type of industry in which it operates, the buyer and seller may have reasonable differences of opinion about which elements should be included when calculating the pre-closing NWC statement delivered by the seller and the post-closing statement delivered by the buyer.

To avoid any ambiguity, the buyer's counsel should consider including a mutually agreed-upon calculation methodology. This could take the form of a schedule to the definitive agreement, which will be used by both parties for the pre-closing and post-closing statements. Together with clear definitions in the definitive agreement, such

a schedule should ensure that the post-closing calculation, and any resulting purchase price adjustment, is non- (or less) adversarial.

Consider the following example from a recent transaction. The target was a manufacturing company with seasonal revenues. The buyer was a private equity-backed enterprise. While buyer and seller were in general agreement as to the NWC methodology to be used post-closing, the definitive agreement's definitions on NWC lacked the necessary precision in light of the company's seasonality of revenues, and the parties did not schedule the NWC methodology. Further, the parties agreed that a Big Four accounting firm would serve as the accounting referee for any dispute related to NWC.

When the buyer provided a post-closing NWC statement that asserted a significant purchase price adjustment, the seller disputed the buyer's statement, resulting in the dispute being handled by the accounting referee. The definitive agreement provided the accounting referee with authority to settle the disputed items applying the principles of GAAP, but the ambiguity in determining the NWC—namely, the absence of certain departures from GAAP to be applied—in concert with the authority of the accounting referee to resolve disputed items resulted in an undesirable outcome for the seller. In this instance, scheduling the methodology, and requiring the accounting referee to apply the methodology, would have mitigated the seller's post-closing risks.

3. EARN-OUTS

When a difference of opinion emerges between the buyer and the seller on enterprise value, often a portion of the consideration paid by the buyer will be contingent upon the achievement of post-closing milestones by the target. However, the manner and scope of such milestones can be ripe for ambiguity and dispute if not clearly defined prior to closing. Similar to the post-closing NWC statement prepared by the buyer, a post-closing earn-out statement should be negotiated and agreed to by the parties prior to closing.

The earn-out statement should set forth with a fair degree of specificity which financial metrics will be measured and what criteria will be used to determine their achievement for purposes of payment of the earn-out. Such a scheduled methodology, in concert with clear, correlated definitions in the definitive agreement, will also mitigate the amount and scope of post-closing disputes.

THE BOTTOM LINE

While any seasoned general counsel knows that it is impossible to eliminate all forms of deal risk, there are steps that can be taken to mitigate them. With proper focus on certain critical issues, coupled with the drive to close in a timely manner, general counsel can achieve expediency without sacrificing focus.

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