INSIDE THE MINDS

M&A Deal Strategies

Leading Lawyers on Executing Negotiation Strategies, Maximizing Deal Protection Provisions, and Assessing Representation and Warranties

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Practical Tips for Preparing and Negotiating M&A Transactions

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A good attorney representing a client in a merger or acquisition does much more than just answering legal questions and giving legal advice. The attorney often plays a key role in determining the structure and organization of the transaction, may be a negotiator on behalf of his or her client, often plays a significant role in the due diligence process, may coordinate accounting and tax issues with the client's accountants, may help clear up title issues, and may play other roles depending on the specific transaction.

Understanding the Business and Forming a Strategy

How does a person fulfill those roles and sort through all the varied and complex options and elements that could be adjusted in so many ways in a merger or acquisition transaction, know what to throw out and what to work on, and give the clients the assistance they need? First of all, it can be nearly impossible to get a good grasp on all the options and elements without first having a thorough knowledge of the business, what is important in running that business, the risks that are inherent in the business, and other aspects of the business.

One of the most helpful things I can do is to sit down with the executive management of the business early on and discuss what they do and what is important to the business. To me, nothing can duplicate a face-to-face meeting and open discussion with people who know their business inside and out. With that, I then have a framework for the more tedious work of sorting through documents and evaluating risks. This means I must first understand what the business does. Is it a manufacturing business, service business, retail business, or construction business? Each area has its own particular legal, and sometimes regulatory, overlay that affects what documentation will be necessary to the deal under consideration. Just as important, and sometimes more difficult, is to find out what makes the business tick—what gives it special value, what personality it brings to its area of business, as well as what makes it stand out among its competitors. Do the owners have a realistic view of the value of their company? If it is owned by an individual, what special meaning does the business have to that person, and will their feelings about the business make negotiations difficult? In Alaska, I frequently have been involved in transactions in which the business being sold had been built and was owned by a single individual or a small group of individuals who may be getting ready to retire or want to move on to other things. In either situation, the business was their baby, to which they felt a great deal of attachment, and their attachment sometimes made our negotiations difficult.

Perhaps the most difficult part of forming a strategy is assessing the bargaining power of the two sides, whether my client will be able to get what he or she wants, and what might be the best route for accomplishing their goals. Understanding the business and personal dynamics helps in forming a strategy and determining ways to keep the negotiation process constructive and fruitful. I begin by learning my client's perspective on the transaction, which may or may not be realistic. If it is a long-time client, I have a much better feel for how realistic their position may be, but I must begin from scratch with new clients. This can be a difficult and touchy area in dealing with a client, especially a new client. I know from experience what kinds of terms are generally achievable in a negotiation and which are not. The client knows his or her business, which is the other significant factor affecting the feasibility of obtaining certain terms. The difficult thing, I have found, is getting through this part of the discussion in a way that convinces a new client you are on their side and you are doing your best to get them exactly what they want, while still injecting the necessary note of realism if the client's expectations seem overly optimistic.

All these things play into a transaction. They shape the type of documentation that will be needed and the degree to which that documentation must be detailed. Within mergers and acquisitions, a variety of laws govern the way to proceed, depending on the type of transaction. For example, even when Alaska corporate law governs the structure of the transaction, federal and state antitrust considerations must also be considered. Laws peculiar to the industry in which the target is situated can affect the manner in which we proceed, and some laws (e.g., employment laws) almost always play a part in a transaction.

Alaska is a relatively young state, without the long history of case law many other states enjoy. This can be both a problem and a benefit. It can be a problem in that sometimes the lack of precedent and case law can make it hard to predict the chances of success of various strategies that might push the envelope a bit. But it can also be a benefit, in that you have the flexibility to be more creative with solutions. For example, in many states there are statutes or case law that specify exceptions to the general rule that a corporation purchasing the assets of another corporation does not, merely by virtue of that purchase, become liable for the debts of the selling corporation. In the absence of such statutes or case law in Alaska, we would have flexibility in dealing with assumption of liabilities and would have to be particularly careful to expressly state the assumption or non-assumption of liability in a purchase and sale agreement. One of my transactions involved property that had been used as a staging area for logging operations, leading to potential liability for debris that might have accumulated under water where logs had been floated and staged for shipment out of state. The liability issues in this unusual situation were very murky under Alaska law, and the parties worked out an agreed allocation to prevent a future dispute if state or federal authorities required remediation.

How Complicated Must the Transaction Be?

As a general rule, large transactions tend to be more complicated and more thoroughly documented than smaller transactions. However, ultimately in my practice there are two factors that primarily drive the level of complication in the transaction. First, how complicated does the client want or need to the transaction to be? And second, how complicated does it have to be?

The first factor is how complicated the client wants or needs the transaction to be. Clients in merger and acquisition transactions can vary widely in terms of needs, sophistication, and approach to transactions. Sophistication of the client is kind of a subset of client needs. I have had clients both as buyer and seller who just wanted to take the most direct approach and had no patience for complicated analysis, and others who wanted to explore every aspect and possible outcome of a certain strategy before they committed to it. Either extreme can be a problem. In today's world, buying or selling a business based on an agreement scratched on the back of a napkin, or the equivalent, is not very wise. On the other hand, an overly detailed and overly examined approach to documentation of a transaction may be disproportionate to the size or nature of the transaction, needlessly running up costs and possibly jeopardizing the transaction. The role of a lawyer as counselor comes into play to explain the necessary complexities of the transaction to the first group and to try to reign in the second group's desire to make things more complicated than they may need to be.

But whatever the situation is, the needs and understanding of my client come first. They will affect the timing and structure of the deal. If the client wants a simplified transaction, and the other party is willing to proceed on that basis, documentation and procedures can be simplified. Such a client must understand, of course, that a simplified transaction leaves some issues undecided, which could result in a tug of war or dispute later on. The client must also understand there are some issues in every transaction, in addition to the basic terms of price and timing, that should be worked out and documented. Achieving the proper balance is not always easy.

The client who wants to pick apart every issue and provide for every possible eventuality is the other extreme. If the client understands the degree to which this approach will drive up the attorneys' fees and other costs of the transaction, and is willing to pay those costs in exchange for the confidence and reassurance they would gain in the thoroughness of the documentation, we are prepared to satisfy those needs. However, the client also needs to consider whether this approach will cause difficulties with the other party to the transaction, and possibly even jeopardize the transaction, since it will drive up the costs for both parties.

The second factor is how complicated the transaction needs to be. No matter how simply the client wishes the transaction to be structured, there are certain legal and practical constraints that provide a baseline below which you cannot go.

The regulatory structure affecting the business, as well as the size of the deal, can have a profound effect on how we must proceed with a particular deal. There are certain things that are not permitted in some industries, and we must be mindful of the regulatory constraints in making any strategy decision or recommendation. For example, in most states the outright sale of a liquor license is forbidden. Therefore, in a merger or acquisition transaction involving a hotel, restaurant, or other business holding a liquor license, the transaction must be structured in a way that will conform to the regulatory requirements. Depending on the jurisdiction, this can take different forms. In some jurisdictions, it may be a sale of assets (e.g., the furniture, glassware, etc.) and an assignment of the rights in the liquor license, with closing contingent on approval of the assignment by the applicable regulatory board. Under some regulatory schemes, it is permissible to sell the alcoholic beverage inventory, but under other schemes it is not. Under some regulatory schemes, the parties can close the transaction prior to approval of the assignment of the liquor license by doing a partial lease-back of the facilities to the seller, pending approval of the assignment.

Regulatory constraints, both state and federal, can apply in many different industries. They create a necessary level of procedure and documentation in the process that must be followed, no matter how simplified the client wishes the transaction to be. I must be conscious of all the different aspects of law that can impact the transaction, and I often call on my partners, who are experts in things like employment law, antitrust, and so on, for assistance in their areas of specialty. Obviously, no one can be proficient in every area of the law, and even a small transaction can require consultation with other lawyers who can advise on specific terms and conditions.

I research the relevant industry, talk to experts in the field whenever possible, and ask some hard questions of my client. However, even after doing all the preparation, some of the needed information may not come until both sides are justifying their positions in the negotiating room. In one of my transactions, the basic deal terms had been agreed upon when the parties discovered the method by which earned but uncollected commissions were calculated in the accounting process was not what the buyer or seller had thought. This required the parties to agree on an adjustment not only of the financial terms, but also of the procedures set up in the purchase and sale agreement. Another example that comes up more frequently is a lease or contract that contains penalty provisions or at least a consent requirement that is triggered by the sale of the business. These terms, although not unusual in leases and contracts, are often hidden deep in the documents and may never have caught the attention of management until they are unearthed in the due diligence process.

Getting through the Tough Spots in Negotiating

In any transaction, there will be difficult periods to get through. Sometimes the difficult periods will involve negotiations on the deal points, and other times they will involve issues that come up regarding documentation. In either case, I have found that a cooperative, problem-solving approach nearly always gets deals completed more quickly and amicably, and in ways that benefit my clients. There are times when a negotiator must be hard-nosed, but offering creative solutions will usually smooth the way to a deal, and this can be one of the most important roles for the lawyer. Working in a cooperative manner to find ways a deal can work leads to a positive attitude among the principals to the transaction. People are at their best when they work together to find solutions for their problems.

Preparation is again a key element. When I have properly worked with my client and prepared for negotiations on structuring the deal, I know what the essential deal points will be on which there is little or no room to give, and in what areas my client has some flexibility. For example, the buyer may feel like it cannot meet an asking price for the business, even though the business may be worth that much, because the buyer needs to retain enough operating cash to ensure the best chance of success in operating the business. In a case like that, a structure that pays the seller a lower purchase price, but adds an additional amount to be paid on a schedule determined by the revenue volume of the business, may satisfy the needs of both parties. When both sides are prepared and working cooperatively in a problem-solving mode, they can usually find solutions to the difficult sticking points that always come up in negotiations.

Negotiating the continuing liability the seller will retain after the sale is complete is one of the negotiating tough spots that can easily become hostile. Similar to this, in terms of emotional loading, is the post-closing escrow and how long a portion of the proceeds will be held to cover the post-closing liability of the seller. Buyers have a strong desire to decrease downside risk by keeping sellers on the hook with continuing liability and a large escrow amount, and sellers want to be able to walk away with their cash and without having to look over their shoulders. I have found this to be true with individual entrepreneurs selling their businesses for amounts up to seven or eight figures, as well as corporations buying or selling business for much larger amounts. The psychological factors appear to be similar in all of these situations. Sellers hate to have any significant amount of cash from the transaction held in escrow, which usually has a low rate of return. Buyers, on the other hand, are normally not willing to rely on the future credit-worthiness of a seller, especially when that seller is converting all or substantially all its assets to cash in the transaction, unless the obligations for future liabilities can be guaranteed by a financially strong parent company or something similar. So buyers often insist on a post-closing escrow and try to stretch out the time those funds must be tied up.

The amount of a post-closing escrow varies greatly, depending on the nature of the industry, the risks and contingencies that could arise after closing, and the peculiarities of the transaction itself. For example, if the buyer is purchasing accounts receivable and the seller is guaranteeing a certain level of collection for those receivables, the post-closing escrow would typically include an amount sufficient to ensure the guarantee is good. The time for which such a post-closing escrow would be held depends on the nature of what is being secured by the escrow. For example, it is typical for a post-closing escrow to cover potential claims that might arise after closing, but that are the responsibility of the seller. If the statute of limitations on tort claims is, for example, two years as it is in Alaska, it would not be unusual for the escrow to be held for a two-year period. However, the parties will often negotiate a stepped release of the funds. For example, the portion of the funds held to ensure a guarantee on the collection of accounts receivable could be released as early as ninety days after closing, depending on the speed with which accounts receivable are typically collected in the particular industry, while the remaining funds may be held for two years. The post-closing escrow can be a cash amount (e.g., a portion of the sales proceeds held in an interest-bearing escrow account), or the same result may be accomplished by the seller bonding its obligations.

Another common dispute I run into is over the value that should be attributed to something such as commissions payable to the business when they are not yet earned but were generated by work that will have been completed by the closing date. Similarly, disputes may arise over placing a value on accounts receivable from customers who are on a quarterly payment system, unlike most customers who pay monthly, when the closing date occurs just prior to one of those quarterly payment dates. Even though it is always easier to have a firm cutoff for such matters on the closing date, a buyer or seller may become tangled up in the debate over the adequacy of the purchase price to reflect the variances inherent in such situations. A cooperative and creative method of post-closing adjustments can make everyone feel satisfied and permit the deal to go forward.

Sometimes I have become involved in situations where the parties are dealing with a tough spot in the negotiations and are having a hard time making progress. In those situations, I have sometimes been able to divert the discussion to a less difficult or controversial negotiating point to return momentum to the negotiations. One of the areas I have found parties to be frequently amenable to negotiating is the way to handle the transition of ownership, such as how to prorate items at closing (e.g., in a hotel transaction, how to allocate room rents collected for the night of closing), how to handle the mechanics of collecting accounts receivable (presuming they are not part of the assets being sold), how to handle confirmation of inventory at closing, and so on. Most businesspeople view these things as a mutual give and take they can work out in the spirit of cooperation, which often leads to an agreement. Also, these types of matters are typically not big-dollar items that will materially affect the bottom line of the deal, so the parties are more willing to be cooperative. This can lead to both sides feeling they have some control over these aspects. For this reason, I find these items to be a good place to focus on when we come close to the end of the deal, especially if we are bogged down in a difficult negotiating point and need to get everyone thinking constructively to get some new momentum.

Working cooperatively, the parties can usually find solutions to the difficult sticking points that always come up in negotiations. However, I have been in situations when a highly aggressive negotiator on the opposing side mistook cooperativeness for lack of backbone and decided they could steamroll my client. In those cases, it is sometimes difficult not to answer back in the same way. In one case, I received mark-ups on a purchase and sale agreement that revised section after section in ways that were outrageously one-sided. With my client's permission, I confronted the other lawyer and told him there was little sense in responding to his suggested revisions if they were things important to his client. The implied message was that my client may well pull the plug on the deal if this was the way he was going to negotiate. Once he knew we could not be bullied, the negotiations got back on track and ended successfully.

Sometimes overly aggressive tactics can backfire on the other side. In a transaction in which I represented the seller, the buyer's attorney set an arbitrarily short deadline for reaching agreement based on his client's timing requirements for getting the benefits of a "1031 exchange" transaction. In a 1031 exchange, the buyer obtains tax deferral benefits if they acquire real property to replace another piece of real property they have sold. However, the Internal Revenue Service imposes very strict time limits between the sale of the old property and the acquisition of the new property. The buyer's attorney used these time limits as an excuse for setting an arbitrarily short deadline for accepting his client's offer. My client refused to be rushed into the transaction, and ultimately the buyer admitted the timing was not a deal-breaker as originally represented. This resulted in the buyer's loss of credibility throughout the remainder of the negotiations. In another case, an arbitrary deadline set by a buyer resulted in my client abandoning negotiations with this party and making a deal with another buyer. The first buyer lost a deal they probably wanted.

I can deal with the negative aspects of negotiations by being firm and calling an overly aggressive negotiator on their tactics. When necessary, I change my style of negotiating in midstream to deal with an overly aggressive negotiator who refuses to work cooperatively. There is, of course, the question of bargaining power. Usually one side wants or needs the deal more than the other. Dealing with an aggressive negotiator therefore requires not only understanding what objectively reasonable terms would be, but also taking into consideration the bargaining power of the parties. Sometimes a client will accept some terms that would not ordinarily be deemed reasonable, in order to make the deal happen.

In general, I make sure I have worked through all the aspects of the transaction with my client, developing a thoughtful and workable position, and building in a buffer to allow some negotiating room so a hostile party may feel as though they are getting something. I find it never pays to respond to hostility with hostility. Though hostility may be used as a negotiating tactic to get the other party's emotions running hot so they make bad decisions, I prefer to operate in a calm but very firm manner. I know my strategy is productive when the opposing parties are working together towards a deal, and I feel successful when I am able to negotiate terms that satisfy my client's needs.

Impossible Deals

As hard as we lawyers try not to earn a reputation as deal-breakers, there are some transactions that simply cannot be done. It is important to be able to recognize those, preferably early in the negotiation stage.

My client is the one who sets the goals and determines the criteria for success. Occasionally I have had clients who insist on walking too close to the ethical line or cutting costs by omitting documentation I believe is essential. In these cases, I explain to them why I cannot represent them, and I suggest they find other counsel. Those are deals that may be able to be made, but not in a way in which I am willing to participate.

On rare occasions, I have had deals that simply cannot be made. This can be because the parties have a fundamental difference in how they value or view the transaction, and neither party is willing to bend, or because it is obvious the other party is not going to be able to close the transaction. The only thing one can do in such situations is walk away from them. There are other situations in which it takes a jolt of reality to bring the opposing party to the realization that they are not dealing with pushovers. If my client has a position it will simply not be able to compromise on, I try to make sure the other side can accommodate this position, and I advise my client to walk away from the table if they cannot. It is cheaper and better for my client when I find out early in the process that there is some deal point that will kill the transaction and there is no way around it.

In a totally different context, when the other side is being completely unreasonable, a desperation move to try to get things on track can be leaving the table. Walking away from the table can, as a last resort, inject a sense of reality into the other party if they insist on positions you believe they should be willing to compromise on, but they persist in holding to their position. However, as a technique, it must be used with caution, as it could kill a deal that would have been beneficial for my client. When possible, a constructive, problem-solving negotiation, including some small talk between the parties, helps build momentum towards the end both parties want to reach.

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