

M&A Deal Term Trends for 2008/2009

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Understanding prevailing market conditions for middle market transactions in the United States is crucial in negotiating the best deal for buyers and sellers, and fair and equitable deals. There are always natural tensions between buyers and sellers. In today's market -- with diminished liquidity and, therefore, fewer prospective buyers -- those tensions have heightened, with the pendulum swinging toward the buyers who are sitting on cash and have access to debt financing. These are relative -- not raw -- matters, and sellers still enjoy a foothold in negotiating some matters, but in general, the eligible buyers have gained a bit of an upper hand.

I loosely define the middle market as deals of between \$10 million and \$1 billion, with most deals valued at \$200 million and below.

Beyond diminished liquidity, sellers are legitimately concerned about an economic recession and threats of inflation. Furthermore, the upcoming presidential election may result in less favorable tax treatment of mergers and acquisitions by corporations and individuals.

Meanwhile, prospective buyers -- private equity or hedge funds, international buyers, special purpose acquisition corporations (SPACS), or private or public companies -- face similar market uncertainties and a double-edged sword. An economic downturn makes it harder for them to raise capital. At the same time, however, it allows them to capitalize on sellers' motivations to expedite sales, giving them leverage to re-negotiate purchase prices and lower the expectations of sellers in terms of reduced PE multiples.

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Because deal terms ultimately reflect the ability and willingness of buyers and sellers to accept certain risks, deal terms in today's economic climate need to be more creative and flexible. In my practice, where I represent buyers and sellers in acquisitions, I routinely encounter and consider the key issues that drive the middle market, and offer them here, along with some thoughts on how to confront them.

All Cash vs. Earn-Outs

Most economic downturns and valuation adjustments are accompanied by revived interest in bridging valuation gaps through seller financing and earn-outs.

In the coming year, cash will still be king when making an offer. Many buyers will seek to look at deals where they can pay a reasonable EBITDA multiple and pay half of the purchase price in cash and the other half from debt. If and when the liquidity crunch loosens, such Buyers will be in position to re-finance the business and reap strong returns.

Alternatively, buyers' and sellers' lawyers and investment bankers may seek to have sellers accept a portion of the purchase price in the form of earn-outs, in an attempt to combat sellers' expectations of higher multiples. A carefully drafted earn-out provision can afford a seller the opportunity to receive the highest price if the company performs to agreed-upon financial criteria. This forces sellers to maintain a vested interest in the success of the business being sold. Earn-outs should also protect buyers from assuming the risks associated with buying a business in uncertain economic and political times.

The ultimate tool for bridging seller-buyer valuation gaps is the "earn-out," where a portion of the purchase price is calculated based on the company's post-closing performance. Transactions involving seller financing and equity rollovers are more document-intensive, but may increasingly become the only way to get some deals done.

Earn-outs are among the most detailed to negotiate and draft because they must address relevant performance standards, add-on acquisitions, overhead allocations and other issues. Parties should make certain that earn-out provisions are detailed enough to avoid disputes over whether relevant benchmarks have been reached. Parties should also agree on accounting standards that may affect seller's realization of certain thresholds.

While the frequency of earn-outs has fallen in recent years, they may make a noticeable comeback because they allow buyers to force sellers to ensure that their valuations are accurate. The current credit crunch will also increase the frequency of earn-outs

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More Detailed Letters of Intent

In the first half of 2008, pending litigation surrounding several high profile deals have demonstrated the importance of carefully drafted letters of intent. I believe that more detailed letters of intent will result in a higher percentage of completed transactions. A properly detailed letter of intent should discuss issues including how the deal will be structured (in terms of both legal and tax issues), price and terms of consideration, the terms of representations, warranties and indemnities, baskets, included and excluded assets and liabilities, working capital adjustments, due diligence provisions, and conditions to close. (For a more detailed discussion of issues to be covered in letters of intent, please see Herrick Feinstein LLP's website for this author's article entitled "**Ins and Outs of Private Equity Letters of Intent**", which was also contributed to the February issue of this newsletter).

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With times of greater economic uncertainty, buyers will need to make sure that their investors are getting the deal as promised. Sellers will seek to shorten the due diligence period, and therefore buyers (especially the private equity and hedge funds) are going to seek longer due diligence time frames. Both buyers and sellers will benefit from stating a time frame for completion of due diligence and notification of any deal-breaker issues.

Material Adverse Change and Material Adverse Effect Clauses

Material adverse change ("MAC") or material adverse effect ("MAE") means, when used in connection with a target, any change, event, violation, inaccuracy, circumstance or effect that is materially adverse to business, assets, liabilities, financial condition results of operations or prospects of a target and its subsidiaries. Because the MAC clause allows a buyer to back out if a MAC occurs and harms the seller's company or its assets, it is often the most heavily negotiated section in transactions. Case law implies that MAC clauses that are either too broad or too narrow can have unintended consequences, and parties should be discerning regarding what is included in a MAC clause.

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Sellers will want to try to limit the MAC clause's impact as much as is reasonably possible. To accomplish this, Sellers should negotiate the exclusion of specified events, e.g., failure to obtain governmental approvals, regulatory changes, economic effects, terrorist attacks, or GAAP changes. Sellers should also restrict buyers' remedies, allowing them only a predetermined reduction in price rather than the ability to back out of the deal entirely.

From a buyer's perspective, a MAC clause should contain forward-looking language particularly when speaking of events reasonably likely to materially decrease short-term earnings. Buyers should be consistently precise in their drafting because specifying certain events could cause a court to disregard more general language upon which a buyer might later seek to rely if it tries to cancel the deal after an unspecified event occurs.

Buyers are seeking to get out of deals that contain MAC clauses such as downturns in the financial markets, general economic or industry downturns, war/terrorism, changes of law/accounting principles or announcement of the deal.

The litigation surrounding high-profile transactions should produce the first judicial interpretations of concepts such as MACs and "reasonable best efforts", as well as the enforceability of termination fees and specific enforcement clauses.

Purchase Price Adjustments/Escrows

Buyers will seek protection from an economic downturn and the risks associated with reduced profitability by seeking post-contract signing purchase price adjustments. These price adjustments will seek to capture changes in value that occur between the negotiation stage and closing. Because transactions are typically structured, negotiated, and finalized well before closing date financial statements are available, parties often use previously issued financial statements as a basis for the transaction. The post-closing purchase price adjustment will reflect any changes from the referenced financial statements. Buyers will safeguard against the uncertain economy by relying on post-closing purchase price adjustments rather than committing to a higher stated purchase price.

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Buyers will seek a larger portion of the purchase price to be held in escrow. Generally, the term of the escrow can run from 12 to 18

months. Longer escrow periods help guarantee that buyers are paying a fair price by postponing the date for the post-closing adjustment of the purchase price.

On the other end of the deal, sellers need to ensure the terms of the purchase price adjustment, the escrow release, and any related dispute resolution provisions are clear. Parties often disagree on the amount of the purchase price adjustments because the provision in the agreement is unclear. Therefore, buyers and sellers should be sure that the agreement specifies whether the purchase price adjustment is governed by changes in net assets, net worth, stockholder's equity, retained earnings, working capital, inventories, sales volumes, or some combination thereof.

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Indemnification Issues

Indemnification provisions seek to balance the buyers' desires to keep sellers on the hook for breaches, on the one hand, against the sellers' wishes to eliminate any continued responsibility for the business. Survival periods for sellers' representations and warranties have steadily declined from 24 months -- prevalent when liquidity was great and buyers were around every corner -- to 18 months or as little as one audit cycle after closing. Because of relative illiquidity and a shrinking pool of buyers, the market standard may swing back to 24 months or more, at least for certain types of liabilities, including those related to intellectual property.

Losses eligible for indemnification may increasingly include those relating to diminution in value, as opposed to actual damages or third-party claims.

Conservatism among buyers may also result in smaller indemnification baskets, increased indemnification caps and escrows, and fewer carve-outs from each. It is unclear how much, if anything, buyers will have to pay as a premium to get these changes.

Buyers are seeking to limit the ability of sellers ability to qualify or hedge their representations, and many battles undoubtedly will be fought over the limitations sellers traditionally seek to place on their representations, including "materiality," "to the best of knowledge," "on a consistent basis," and others. We are seeing buyers attempting to carve out completely the materiality provisions of

representations and warranties -- a likely hot-button issue in any purchase agreement.

Longer No-Shops, Reverse Due Diligence

Everyone expects private equity funds to increase due diligence, so auction processes and no-shop provisions will often be longer. To avoid an unnecessarily lengthy transaction process, which can create uncertainty and depress transaction prices, savvy sellers will plan ahead and instruct their accountants and lawyers to conduct reverse due diligence. They will also amend management and third-party assignment or control provisions in an effort to head off surprises and delays. Sellers will need to be careful not to have their companies taken off the market too long without some sort of economic protections.

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Seller Paper, Employment Arrangements

Should the unavailability of credit continue to roil the middle market, buyers may increasingly ask sellers to accept promissory notes for part of the purchase price -- especially to bridge valuation gaps or to overcome due diligence concerns by using note setoffs as an escrow alternative.

Sellers also may be convinced to leave more equity in the deal to reduce the buyers' needs for debt or equity financing. Sellers may have to agree to take part of their payment for their equity as compensation under an employment agreement, frequently with time- and performance-based vesting provisions. This allows the target to pay the money over time and take a deduction for tax purposes.

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Financing Contingencies, Termination Fees, Sponsor Guarantees

I expect sellers to be more cautious about "financing outs." In contrast to larger public deals, however, we have not seen "reverse" termination fees, sponsors' guarantees, or penalties for buyers' failure to obtain financing in the middle market and below.

Conclusions

Competing pro-buyer and pro-seller forces make it difficult to predict the precise dynamics and terms for smaller and middle



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market transactions. Competition among buyers will definitely increase, allowing sellers to exercise more leverage regarding deal terms. Valuation multiples may decline or normalize. In any event, arguments about what terms are “market” may become less effective as a negotiating strategy.

In these particularly tumultuous economic times, buyers, sellers, their accountants and attorneys will be called on to structure transactions creatively... [and] what terms are “market” may become less effective as a negotiating strategy...

In these particularly tumultuous economic times, buyers, sellers, their accountants and attorneys will be called on to structure transactions -- and the terms of them -- creatively. The ability and willingness to do so will create opportunity for middle market participants -- buyers and sellers -- to close beneficial deals. The flip side is that rigidity and insistence on terms better suited to calmer and more liquid environments will tend to stall deals that otherwise would benefit the principals.

This article is only a general outline of deal trends and you should consult with an attorney and your financial advisor(s) before negotiating and finalizing any M&A transaction.

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