Negotiating the Stock Purchase Agreement: What You Need to Know to Control Legal Fees in an M&A Transaction

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Presenters

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Agenda

- MAC (Material Adverse Change) Clause Issues
- Financial Statements
- Knowledge Issues
- Post-Closing Purchase Price Adjustments
- Baskets
Agenda (cont.)

- “No Undisclosed Liabilities” Representation
- Survival/Time to Assert Claims
- “Sandbagging”
- When Must Target’s Representations Be Accurate?
MAC (Material Adverse Change) Clause Issues

1. What Constitutes a MAC

- What if Seller cures the event or occurrence giving rise to the invocation of the MAC Clause?
- What if Buyer had knowledge of the event or the circumstances at the time the SPA was entered into?
- Should general business/economic conditions be a ground for invoking the MAC Clause, even if all companies in Seller’s industry affected in the same way?
MAC Clause Issues

1. What Constitutes a MAC (cont.)

- Should Buyer’s inability to operate the business of Target immediately after closing in the manner operated by Seller be considered a MAC?
- Should change in Target’s “prospects” be deemed a MAC?
- Should drop of backlog or loss of significant customer be a MAC?
MAC Clause Issues

2. Enumeration of Included But Not Limited to MAC Events – Examples:

- Asset dispositions
- Entering into contracts/licenses out of ordinary course of business
- Cancellation/change of contracts/licenses, grants out of ordinary course of business
- Imposition of liens or assets
- Capital expenditures/investments in excess of $______
- Borrowed money in excess of $______
MAC Clause Issues

2. Enumeration of Included But Not Limited to MAC Events (cont.)

- Delayed payment of accounts payable outside ordinary course of business
- Charter or ByLaw Amendment
- Change in capital structure, issue stock, options, securities
- Dividends
- Damage to property
- Insider transactions
MAC Clause Issues

2. Enumeration of Included But Not Limited to MAC Events (cont.)

- Employment, union contracts
- Change in salary, compensation, bonuses, profit sharing plans
- Change in employment terms, officers, directors, employees
- Pledge charitable contributions
- Made loans
- Disclosed confidential information
MAC Clause Issues

3. Since What Date?
   - Since date of Stock Purchase Agreement (SPA)
   - Since date of last year-end audited financials
   - Since date of last interim period financial statement

Suggestion:
   - Go back in time as far as possible.
   - Using interim financial statement date presupposes that all these events will be captured in the interim balance sheet or its footnotes, which is not the case.
   - Using the date of SPA leaves gap for events occurring between date of last fiscal year-end and date of SPA.
MAC Clause Issues

4. How to Deal with the Future Without Creating a Massive Fight with Seller’s Counsel

- This will create a fight:
  - “Material Adverse Change” means any result, occurrence, fact, change, event or effect that has a materially adverse effect on the business, assets, liabilities, capitalization, condition (financial or other), or results of operations or prospects of target
MAC Clause Issues

4. How to Deal with the Future Without Creating a Massive Fight with Seller’s Counsel (cont.)

- This achieves same result without a battle over the word “prospects”:
  - “Material Adverse Effect” means any result, occurrence, fact, change, event or effect that has, or could reasonably be expected to have, a materially adverse effect on the business, assets, liabilities, capitalization, condition (financial or other), or results of operations of Target.

MAC Clause Issues

5. Difference Between MAC and Material Adverse Effect
   - Sample Material Adverse Effect Definition:
     - “Material Adverse Effect” means..., except to the extent resulting from (A) changes in general local, domestic, foreign, or international economic conditions, (B) changes affecting generally the industries or markets in which Company operates, (C) acts of war, sabotage or terrorism, military actions or the escalation thereof, (D) any changes in applicable laws or accounting rules or principles, including changes in GAAP, (E) any other action required by this Agreement, or (F) the announcement of the Transactions (provided that such event, change, or action does not affect Company in a substantially disproportionate manner).

MAC Clause Issues

5. Difference Between MAC and Material Adverse Effect (cont.)
   - Material Adverse Effect Clause used defensively to soften effect of Reps & Warranties – Example:
     - “[XM] is duly qualified and in good standing to do business in each jurisdiction in which the nature of its business or the ownership or leasing of its properties makes such qualification necessary, other than in such other jurisdictions where the failure so to qualify and be in such standing would not, either individually or in the aggregate, reasonably be expected to have Material Adverse Effect on [XM]” *

MAC Clause Issues

5. Difference Between MAC and Material Adverse Effect (cont.)
   ▪ Material Adverse Effect Clause Used Offensively
     ▪ In addition to using the Material Adverse Effect qualifier defensively, it is common for acquisition agreements to contain a representation to the effect that since the date of its last financials:
       ▪ there has been no change that has had a Material Adverse Effect, or
       ▪ there has been no Material Adverse Effect Change*

Financial Statements

1. “Fairly Presents” & GAAP

   “Fairly presents” is GAAP qualified

   The financial statements fairly present (and the financial statements delivered pursuant to Section 5.8 will fairly present) the financial condition and the results of operations, changes in shareholders’ equity and cash flows of [Target] as at the respective dates of and for the periods referred to in such financial statements, *all in accordance with GAAP.*

Financial Statements

1. “Fairly Presents” & GAAP (cont.)

- “Fairly presents” is not GAAP qualified

- The Financial Statements (i) fairly present the consolidated financial condition and the results of operations, changes in shareholders’ equity, and cash flows of the Company and its Subsidiaries as at the respective dates of, and for the periods referred to in, the Financial Statements, and (ii) were prepared in accordance with GAAP, subject, in the case of the Unaudited Financial Statements, to normal recurring year-end adjustments.

(ABA Model Stock Purchase Agreement, Second Edition)
Financial Statements

2. What Is the Difference Between “Fairly Presents” and GAAP? And Does It Matter?

- What GAAP does not deal with:
  - Deferred tax liability
  - LIFO v. FIFO
  - Accelerated v. Straight line depreciation
  - Whether capital lease or operating lease method should be adopted for long term, non-cancellable leases
  - Valuation of marketable securities
  - What method cash received from installment sales should be recognized as revenue?
Financial Statements

2. What Is the Difference Between “Fairly Presents” and GAAP? And Does It Matter? (cont.)

- Even if none of the above are applicable or relevant in your transaction, “Present Fairly” should elevate value and reliability of interim financials
Knowledge Issues

1. Definition of Knowledge

- “To the knowledge of…..”
- “To the actual knowledge of…”
- “Actual knowledge or knowledge which would have been acquired in the course of a diligent investigation”
Knowledge Issues

2. Whose Knowledge

- “To the knowledge of the Seller…..”
- “To the actual knowledge of Seller’s Officers, Directors, and employees charged with duties relevant to the disclosure or representation…”
- “To the knowledge of Seller’s CEO, President, CFO”
- “To the knowledge of Joe Smith, Sam Hill, etc.”
Knowledge Issues

3. Why Is It Important?

- Particular importance in private deals.
- Knowledge qualifiers are particularly important in non-public deals because in such deals, the selling shareholders generally indemnify the acquirer against false or materially false representations and warranties.
- However, if a representation that turns out to be false is qualified by the selling shareholder’s knowledge and in fact the selling shareholder did not have knowledge that the representation was false, then the selling shareholder has no indemnification liability.*

* S.C. Thompson, Jr. Mergers, Acquisitions and Tender Offers SUPRA at Section 2:10.5
Post-Closing Purchase Price Adjustments

1. Working Capital Adjustments

- The “Adjustment Amount” (which may be a positive or negative number) will be equal to the amount determined by subtracting the Closing Working Capital from the Initial Working Capital. If the Adjustment Amount is positive, the Adjustment Amount shall be paid by wire transfer by Seller to an account specified by Buyer. If the Adjustment Amount is negative, the difference between the Closing Working Capital and the Initial Working Capital shall be paid by wire transfer by Buyer to an account specified by Seller.

- “Working Capital” as of a given date shall mean the amount calculated by subtracting the current liabilities of Seller... as of that date from the current assets of Seller... as of that date. The Working Capital of Seller as of the date of the Balance Sheet (the “Initial Working Capital”) was __________ dollars ($______).
Post-Closing Purchase Price Adjustments

2. Net Worth Adjustments

- A similar adjustment formula is also used, substituting “Net Worth” for “Working Capital”

3. Implications of Choice Between Working Capital Used Net Worth Adjustments

- If Working Capital formula is used, Seller will not use cash between signing the SPA and Closing to buy long lived capital assets as to do so would reduce the cash component of Working Capital without a corresponding increase in Current Assets. If Net Worth adjustment formula used, Seller may use the cash to buy Capital Assets as the drawdown in cash will be offset by the price paid for the Capital Asset, thus not affecting Net Worth.
Baskets

1. Deductible

- Sellers shall not be required to indemnify Buyer for Losses until the aggregate amount of all such Losses exceeds $300,000 (the “Deductible”) in which event Sellers shall be responsible only for Losses exceeding the Deductible.

2. First Dollar

- Sellers shall not be required to indemnify Buyer for Losses until the aggregate amount of all such Losses exceeds $500,000 (the “Threshold”) in which event Sellers shall be responsible for the aggregate amount of all Losses, regardless of the Threshold.

Baskets

3. Combination

- Sellers shall not be required to indemnify Buyer for Losses until the aggregate amount of all such Losses exceeds **$500,000 (the “Threshold”)** in which event Sellers shall be responsible **only for Losses in excess of $300,000 (the “Deductible”).**

“No Undisclosed Liabilities” Representation

1. Buyer-Favorable Formulation

- Target has no liability except for liabilities reflected or reserved against in the Balance Sheet or the Interim Balance Sheet and current liabilities incurred in Target’s ordinary course of business since the date of the Interim Balance Sheet.

2. Target-Favorable Formulation

- Target has no liability of the nature required to be disclosed in a balance sheet prepared in accordance with GAAP except for...

Survival/Time to Assert Claims

1. Survival

- All representations, warranties, covenants, and obligations in this Agreement, the Disclosure Letter, the supplements to the Disclosure Letter, and any certificate, document, or other writing delivered pursuant to this Agreement will survive the Closing and the consummation and performance of the Contemplated Transactions.

2. Time Limitations

- If the Closing occurs, Sellers shall have liability under Section 11.2(a) with respect to any Breach of a representation or warranty (other than those in Sections . . ., as to which a claim may be made at any time), only if on or before the date that is _____ years after the Closing Date, Buyer notifies [Target’s representative] of a claim, specifying the factual basis of the claim in reasonable detail to the extent known by Buyer.

(ABA Model Stock Purchase Agreement, Second Edition)
“Sandbagging”

1. **Pro-Sandbagging Provision**

   • The right to indemnification, payment, reimbursement, or other remedy based upon any such representation, warrant, covenant, or obligation will not be affected by...*any investigation conducted or any Knowledge acquired at any time*, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of, or compliance with, such representation, warranty, covenant, or obligation.

   (ABA Model Stock Purchase Agreement, Second Edition)

“Sandbagging”

2. **Anti-Sandbagging Provision**

   - *No party shall be liable* under this Article for any Losses resulting from or relating to any inaccuracy in or breach of any representation or warranty in this Agreement *if the party seeking indemnification for such Losses had Knowledge of such Breach before Closing.*

When Must Target’s Representations Be Accurate?

1. Single Point in Time: At Closing
   - Each of the representations and warranties made by Target in this Agreement shall have been accurate in all respects as of the Closing Date as if made on the Closing Date.

2. Two Points in Time: At Signing and At Closing
   - Each of the representations and warranties made by Target in this Agreement shall have been accurate in all respects as of the date of this Agreement, and shall be accurate in all respects as of the Closing Date as if made on the Closing Date.

Questions?