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An M&A Deal in Your Future? Considerations Before You Begin.

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Oregon is a hotbed for innovators creating businesses, and has been over the last several decades.

A substantial number of those companies grew into viable mergers and acquisitions ("M&A") targets. Many of the companies' owners ("Owner") also reached a point in their lives where it is appropriate to consider an M&A transaction. This article focuses on five considerations an Owner should consider before entering into a letter of intent ("LOI") with a potential purchaser of the business.

1. Asset Sale vs. Stock Sale.

A transaction for the sale of a business can include a myriad of structures, including structure as an asset sale, stock sale, merger, and various combinations, including certain portions of the consideration being passed as employment or non-competition compensation to the existing Owner. A major consideration in many transactions is whether: (a) the existing company will sell the "assets" of the business to the acquirer, or (b) the Owner will sell the stock of the Company to the acquirer. The acquirer generally prefers an asset purchase because there is less potential liability for pre-closing liabilities of the company and an ability to depreciate the assets. However, a stock sale is generally favored by the existing Owner because of lower capital gains rates or dual taxation issues, but less favored by the acquirer because of liability issues, and the acquirer is generally not able to re-depreciate the acquired company assets.

2. Cash vs. Deferred Payment to the Owner.

Prior to the 2000s, sales of smaller businesses (defined herein as businesses with $10 million or under in annual sales) were often sold with the Owner receiving a substantial down-payment, and the balance of the purchase price paid over time ("Deferred Payments"). As more and more venture capital money flowed into the economy, and as such venture capital firms are required to purchase smaller and smaller revenue businesses, a substantially larger percentage of transactions are now "cash-out" transactions. That being said, there are often negotiations regarding the amount of up-front "cash" the Owner receives versus the Deferred Payments, and the security (personal guarantees, stock or LLC pledges, security interests in the assets of the company being sold, outside security) for such Deferred Payments. Obviously, the more of the payment to the Owner that is deferred, the greater the risk that the acquirer will dissipate the business or assets of the business, leaving the seller with unfulfilled payments and inadequate security if a default of the Deferred Payments occurs.

3. Allocation of Purchase Price.

Because various assets held by a company may be treated differently for tax purposes (some may have already been depreciated, and the sale of such assets may trigger the recapture of depreciation at ordinary income tax rates), it is imperative to have early negotiations regarding the allocation of the purchase price to determine what is to be taxed (and at what rate) by the seller, and the deductibility (if any) of payments by the acquirer.

4. Non-Competition.

A standard requirement of most business sales is inclusion of covenants that the existing Owner will not compete, solicit customers, or hire employees of the business being sold. An upfront, in-depth discussion of the types of business that the Owner cannot compete with, the geographic area where the owner cannot compete, and the length of the non-competition limitations is imperative. Whether or not liquidated damages are available for the Owner's breach may also be an area of negotiation between the acquirer and Owner.

5. Clawback.

Many transactions specify that if the seller breaches its warranties or indemnifications, or if claims are made against the company (such as for warranty work, taxes, etc.), then an escrow account or an offset to Deferred Payments will be available to the acquirer to cover those unexpected losses or costs. The amount of such “clawbacks,” as well as the time that such clawbacks are available, are often hotly negotiated issues in the M&A arena. Having upfront discussions about specifics helps alleviate substantial, costly negotiations of such issues later.

In general, in-depth discussions with your M&A attorney and accountant, prior to seeking offers for the business, can often lead to substantially greater after-tax sales proceeds in the Owner’s pocket, and substantially less stress during the negotiation process.

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