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## **Managing the Acquisition and Divestiture Process**

**An In-House Counsel's Perspective**

**September 25, 2008**

**Association of Corporate Counsel  
www.acc.com**

## How many people are in your legal department?

- 1-9
- 10-20
- 21 or more

## How many acquisitions or divestitures does your company complete in a year?

- 1-5
- 6-10
- 11-20
- 21 or more

## **What is the typical size of your acquisition or divestiture transactions?**

- \$0 - \$5,000,000
- \$5,000,001 - \$50,000,000
- \$50,000,001 - \$100,000,000
- \$100,000,001 or more

## **Does your company generally perform more acquisitions or divestitures?**

- More acquisitions
- More divestitures

## Presenters

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## Overview

- Preparing for a transaction
- Completing a transaction
- Integrating or “dis”-integrating a business

## Major Planning Areas

- Formulate an exit plan
  - Develop a strategy for dealing with shareholders, board of directors, and employees
  - Establish a timetable
    - Sale process takes at least six months
    - Buyers (especially private equity) may expect senior management to remain on the job for two or more years
    - Work backward from the date of senior management's expected retirement or departure

## Major Planning Areas (cont.)

- Answer the following questions:
  - Does seller want to retain equity interest in the business post-closing?
  - Does seller want to continue to supply parts or products to or distribute parts or products through the business post-closing?
  - Does seller want to continue to acquire parts or products from the business post-closing?
  - Is current management team capable of running the business?
  - Does current management want to remain with the business post-closing?
  - Does current management want to acquire the business themselves?

## Transaction Team

- The right transaction team can significantly enhance shareholder value
- Actual team members dictated by whether the transaction is a sale or an acquisition, and the size of the transaction to the company

### Internal team

- Chief executive officer
- Corporate counsel
- Corporate development officer
- Chief operating officer
- Chief financial officer
- Chief information officer
- Human resources officer

### External team

- Outside counsel
- Investment banker
- Lender
- Outside accountants
- Transaction service provider (accounting and quality of earnings diligence)
- Environmental consultant
- Insurance advisor

## Prepare for the M&A Process

- Audited statements
  - Prepare audited financial statements for business (usually at least three years)
- Create barriers to entry
  - Patents
  - Exclusive licenses
  - Long-term contracts
- Bring your top three to five managers into process early
  - Bringing them "into the loop" will convey their importance and engender loyalty and sense of ownership
  - Take care of them; they will support the company during the process
  - Implement incentive packages for key managers (the "keepers")

## Prepare for the M&A Process (cont.)

- Stabilize top management through incentive packages
  - In sale process, it's critical that key managers be motivated to
    - Maximize value realized from sale
    - Stay with business post-closing to help buyer address integration challenges
  - Incentive packages typically provide a year's compensation or more for the top three to five managers (usually paid by seller)
  - Packages can be structured to increase with sale proceeds
  - Incentive payments usually staged, with portion paid at closing and balance a year after

## Pre-Process Due Diligence

- Address potential due diligence issues
  - Engage "transaction services" team from Big Four or major second-tier accounting firm to provide a "pre-emptive" sell-side accounting review to avoid surprises
  - Be proactive about environmental compliance: perform Phase I audit to identify problem areas early
  - Confirm OSHA compliance
  - Resolve major litigation
  - Resolve open contractual issues with customers and suppliers
  - Protect intellectual property through patent applications or other avenue
  - Be prepared for full disclosure—minimize indemnification risk
  - Run a squeaky-clean operation—no shortcuts!

## Pre-Process Due Diligence (cont.)

- Identify and sort out legal issues
  - Transaction-related structural and tax issues
  - Employee noncompete agreements and NDAs/ rights to technology
  - Develop critical supply, sales, and distribution agreements

## Process Options

- Appropriate marketing approach depends on individual circumstances and client objectives

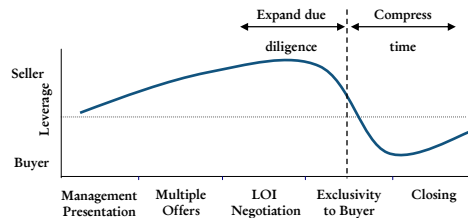
	Single-Buyer Process	Limited Market Approach	Broad Market Approach	Auction
Description	Negotiated sale to one buyer	Process limited to a narrow group of qualified potential buyers	Process includes numerous qualified potential buyers	Process open to all reasonable potential buyers
Pros	<ul style="list-style-type: none"> <li>• Potentially shortest time frame</li> <li>• Lowest chance of information leaks</li> </ul>	<ul style="list-style-type: none"> <li>• Targets most likely buyers</li> <li>• High probability of achieving premium valuation and favorable contract terms</li> <li>• Staged information flow</li> </ul>	<ul style="list-style-type: none"> <li>• Highest probability of achieving premium valuation and favorable contract terms</li> <li>• Identifies all interested and qualified buyers</li> <li>• Staged information flow</li> <li>• Seller has more leverage</li> </ul>	<ul style="list-style-type: none"> <li>• Completeness of market test</li> <li>• Identifies all buyers</li> </ul>
Cons	<ul style="list-style-type: none"> <li>• Financial and non-financial terms may be significantly below market</li> <li>• Reduced negotiating leverage</li> <li>• Increased risk of timing delays or "busted process"</li> </ul>	<ul style="list-style-type: none"> <li>• Information flows to more parties</li> </ul>	<ul style="list-style-type: none"> <li>• Information flows to more parties</li> <li>• Logistics and timing are more difficult</li> </ul>	<ul style="list-style-type: none"> <li>• Logistics and timing extremely difficult</li> <li>• Difficult to control confidentiality</li> <li>• May require public announcement</li> <li>• Loses intimacy of direct negotiations</li> </ul>
Estimated Duration	• Two to three months	• Four to six months	• Five to six months	• Six to eight months

## Sale Process

Activity	October			November				December				January				February			March			April								
	6	13	20	27	3	10	17	24	1	8	15	22	29	5	12	19	26	2	9	16	23	29	6	13	20	27				
Organizational Meeting/ Company Review	●																													
Prepare offering memorandum																														
Prepare buyer briefs and teaser /CA																														
Contact buyers																														
Sign confidentiality agreements																														
Distribute offering memorandum																														
Buyer evaluation of memorandum																														
Management meetings																														
Purchase Agreement draft, Dataroom, Preliminary Diligence																														
Receive initial offers																														
Evaluate offers & select buyers for further due diligence																														
Detailed Accounting and Business Diligence																														
Receive final offers																														
Evaluate and negotiate final offers																														
Final due diligence and documentation																														
Weeks	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25	26	27	28	29	30

## Negotiating Leverage

- Lazard Middle Market: decisions of when and to whom exclusivity is granted critical to ultimate success of sale process
  - Seller leverage declines dramatically after exclusivity is granted
    - All business terms must be negotiated before exclusivity
    - Maximum due diligence must be completed prior to exclusivity
  - Buyer #2 and buyer #3 must be fully developed as viable backups with adequate due diligence
  - Potential “two finalist” strategy keeps two participants through 100% of due diligence and contract markup period



## Opportunities in the Process

- Come with authority—bring key decision makers
- Be sensitive to seller's competitive concerns—share!
- Sell yourselves—what differentiates you?
  - Knowledge of the business
  - Certainty to close
  - Timing—especially if you don't need financing
  - If financing the transaction, bring your lenders to management presentations
- Be prepared to compete with private equity—offer incentive plans
  - Stock options
  - Bonuses

## Transaction Structure

- Buyer generally wants to make an asset purchase
  - Ability to exclude liabilities
  - Stepped-up basis in assets for tax purposes
  - Ability to hold business in a pass-through entity
- Seller generally wants an equity sale
  - All liabilities to go with sale
  - Minimize taxes from the sale: long-term capital gain; no double taxation; potential tax-free rollover
- Careful consideration of tax and non-tax characteristics of target required to determine if most buyer and seller goals can be met

## Due Diligence

- Diligence requests
  - Dataroom
  - Generally, after review of initial diligence response there will be several follow-up requests
- Seller
  - Important to review all diligence turned over to buyer
  - Review helps identify consents required to complete transaction
- Buyer
  - Review various items (employee benefits, customer contracts, environmental items, etc.)
  - Identify action items for closing and items for specific indemnification

## Transaction Approvals

- Internal
  - Board of directors
  - Shareholders
  - Lenders
- External
  - Hart-Scott-Rodino
    - Size of transaction test: \$63,100,000
    - Size-of-parties test: \$12.6 million in net assets or net revenue for one party and \$126.2 million in net assets or net revenue for the other party
  - Permits, licenses and other government entities
  - Customer/supplier arrangements

## Purchase Agreement

### • Process

- Generally, buyer drafts the purchase agreement
- In an auction, generally seller posts a form of purchase agreement which buyer comments on

### • Important deal terms (based on 2006 transactions)\*

- Escrow
  - >7% to <10% of transaction value in 14% of transactions
  - 10% of transaction value in 21% of the transactions
  - >10% to <15% of transaction value in 16% of transactions

\*Source: 2007 Private Target Mergers & Acquisitions Deal Points Study, Mergers & Acquisitions Market Trends Subcommittee of the Committee on Negotiated Acquisitions of the American Bar Association's Section of Business Law

## Purchase Agreement (cont.)

- Survival of representations and warranties
  - 26% of transactions were 12 months
  - 34% of transactions were 18 months
- Baskets—median of transactions
  - Deductible: .4% of transaction value
  - First dollar: .39% of transaction value
- Caps—median of transactions
  - 10.14% of transaction value

## Schedules

- Sellers
  - Important to disclose all items that are exceptions to the representations and warranties
  - People in company with appropriate knowledge should review representations and warranties and schedules for completeness
- Buyers
  - Important to review the schedules in connection with diligence
  - Generally, disclosing items on schedules prevents seller from indemnifying buyer for related losses

## Deal with Surprises in the Process

- Bring up large diligence issues and deal terms as soon as possible
- When an issue comes up
  - Determine if it can be resolved before closing
  - Determine if indemnification will make all parties comfortable
  - If a purchase-price renegotiation, is there another way to structure the transaction (e.g., seller notes, earnouts)?

## **Why Integration (or “Dis”-Integration) Matters**

- Need to meet performance goals on which transaction was approved
- Poor execution can lead to unexpected costs or lost opportunities
- Failure can limit the company’s future acquisition and divestiture options

## **Choosing an Integration Team**

- Business group takes responsibility
- Selecting team leader
- Functional areas represented
- Interaction and overlap with transaction team

## **Developing an Integration Plan**

- When to start
- Identifying strategic objectives and priorities
- What to include
- Communicating the plan

## **Integration Meetings and Milestones**

- Kick-off meeting
- Closing and beyond
- Contractual milestones
- Business milestones

## **Post-Closing Interaction with Buyer or Seller**

- Establish a primary contact on each side
- Set regular dates for meetings and calls
- Dealing with issues not covered in transaction documents

## **Post-Transaction Tracking and Learning**

- Financial performance tracking
- Learning from mistakes
- Reinforcing successes
- Communicating results

## Conclusion

## Questions and Answers

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