Merger & Acquisition Focus

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Don't let one trip up your business sale

Get your deal off to a good start with a letter of intent

Ask the Advisor

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What the new tax law means for M&A deals

Much to the relief of many Americans, Congress reached a compromise on tax policy and the president signed the American Taxpayer Relief Act of 2012 (ATRA) into law on Jan. 2. By steering clear of the "fiscal cliff," the government deferred mandatory spending cuts and minimized income, capital gains and estate tax increases that were scheduled to go into effect in 2013.

Some of ATRA's changes could affect M&A deals for those on both sides of a transaction. Business owners facing a greater tax burden and more estate tax exposure may be eager to sell in the near future. And buyers, particularly private-equity (PE) firms whose favorable tax treatment remains unchanged (for now), may shy away from new acquisitions because they fear that future tax legislation could erode profits.

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Incentives for sellers?

Many owners of public and private companies face higher individual income and long-term capital gains tax rates in 2013. The new law brings back the top individual income tax rate of 39.6% (up from 35%) and the top long-term capital gains tax rate of 20% (up from 15%) for taxpayers with taxable incomes exceeding $400,000 (singles), $425,000 (heads of households) or $450,000 (married couples filing jointly). Qualified dividends will continue to be taxed at long-term capital gains rates (instead of at ordinary-income rates as had been scheduled for 2013), but of course this will be at the higher 20% rate if applicable. For some owners who have considered selling, such tax hikes could be an incentive to make the move now because they anticipate more tax hikes in the future.

The increase in the top estate tax rate from 35% to 40% could also provide an incentive for some owners — worried that estate tax rates will rise further as a result of subsequent budget negotiations — to sell. An owner eyeing retirement may be willing to accept a fair offer by an appealing buyer now instead of taking a chance that better offers will come along. By selling in the near term, the owner can eliminate the risk that, should the owner die suddenly, his or her family would have to sell the business quickly and possibly at a lower price to pay off higher estate taxes.

The PE question

Much to the relief of many buyers and investors, ATRA doesn't change the tax treatment of carried

interest income (PE groups' share of income after investors recoup principal and preferred interest); it continues to be treated as long-term capital gain for hedge fund and PE managers. Usually set at 20%, carried interest income, also known as performance fees, continues to produce sizable revenues for PE managers. This continued favorable tax treatment could spur some buying activity.

That said, PE firms are bracing for the possibility of losing such favorable tax treatment in future tax legislation. In a 2012 bill, Rep. Sander Levin proposed treating 100% of carried interest as ordinary income. Recent drafts of proposed legislation have restored some carried interest protections. However, PE firms fear that future budget deals could classify some profits from business sales as ordinary income and so tax them at a higher rate.

Some clarity

ATRA also provides some much-needed clarity on tax-related due diligence. Specifically, it has resolved a conflict between two outstanding IRS rulings regarding calculations used to determine seller expenses, such as qualified rehabilitation expenditures (QREs), which are tax credits for qualified costs of substantial property rehabilitation. One IRS ruling had instructed buyers to include all of an acquired corporation's QREs for the entire tax year, as well as the acquisition's full-year base amount attributes.

But ATRA confirmed the other ruling, which said that a buyer can prorate the impact of the seller's QREs and base amount attributes based on the number of days between the acquisition date and the end of the buyer's tax year. The new law also provides guidance for working out discrepancies between a buyer's and seller's tax years.

Dealing with uncertainty

ATRA is only the first round in a year's worth of difficult budget negotiations in Washington. Therefore, 2013's tax forecast remains partly cloudy. For the M&A market, this could mean some disparity between a greater number of tax-incentivized sellers and fewer buyers. ■

Big mistake!

DON'T LET ONE TRIP UP YOUR BUSINESS SALE

Selling a business is hard. From vetting potential buyers to preparing financial statements to keeping deal negotiations on track — all while running your company — there's a lot that can go wrong. In fact, almost no detail is too big or too small to affect the eventual outcome of an M&A deal. However, you can reduce the odds that you'll make a deal-killing mistake by knowing where similar transactions have gone astray.

First things first

Some sellers hurt their deal's chances before they even put their business on the market — mainly by overestimating its value. You're risking

a letdown when you make overly optimistic future earnings projections or put too much weight on variable measurements, such as the sale prices of

Tying up loose ends

Leaving a lot of "loose ends" hanging after you sell your business certainly won't endear you to your buyer. Sellers that close a deal with unresolved internal issues could hinder integration and future profitability.

What counts as a loose end? Any internal problem or issue that will take time for the buyer to resolve. Common ones involve:

Minority interests. If you have minority investors or shareholders, buying them out before a sale means that your buyer won't have to deal with their demands later.

Employee controversies. Are there long-standing disagreements between managers and certain employees or any open legal issues involving alleged discrimination or harassment? Your buyer's integration team doesn't want to deal with these while trying to build a new common culture.

Copyright confusion. Make sure all of your patents, copyrights, trademarks and other IP holdings are in order. If you've neglected to verify and document ownership of these assets, it could diminish the value of the deal for your buyer.

similar companies in stronger M&A markets. If you refuse to budge from a distorted or unrealistic sale price, you may drive away an otherwise appealing buyer before negotiations even begin.

Before you sell, work with a financial professional to assess the value of your company as well as estimate an offering price that the current market can support. The two numbers probably won't match because the latter figure depends on contemporary economic, M&A market and sector conditions. Take the banking sector. During the mid-2000s M&A boom, aggressive buyers typically paid selling banks at least two times book value. After the 2008 financial collapse, banks were lucky to get book value at all.

Timing errors

Other critical seller mistakes revolve around timing — whether internal or external. For example, selling at the wrong time, such as at the end of a market cycle, could mean fewer buyers and, possibly, lower offers. If your sector has experienced a recent wave of M&A deals, the buyer base could be depleted and you may want to hold off until the cycle begins an upswing.

Sometimes business sales are spurred by internal circumstances, such as the retirement or death of a founding owner. Such situations shouldn't necessarily lead to a rushed sale. If your company isn't adequately prepared for the market, consider appointing an interim head to make necessary improvements and preparations and to carefully screen potential buyers.

Sellers, particularly those selling for the first time, also often greatly underestimate the amount of work and hours it takes to adequately prepare for sale. For example, have you allocated enough time to implement strategies to maximize your sale's value? And is your company ready to promptly and accurately respond to hundreds of specific buyer requests? If you haven't yet assembled a deal team with the time and resources to handle these requests, it could bring your potential deal to a standstill and scare off an otherwise interested buyer.

Neglected housekeeping tasks

Housekeeping issues aren't as trivial as they may sound. This category includes such time-consuming — and essential — tasks as ensuring that contracts and legal obligations are in order. Some of the other neglected items that can trip up your deal are:

Poor accounting. If your financial records and statements are poorly organized and presented, it reflects badly on your management of the company and the due diligence process will likely take longer. Sloppy accounting and calculation errors could expose you to tax or legal problems after the deal closes.

Neglecting key players. Buyers want assurance that key managers and employees won't fly the coop once the sale is completed. Make sure your best performers support the sale by offering them financial and other incentives to stay.

Locking in contracts. Don't renew an expensive contract with a vendor just as you're ready to transfer ownership to a buyer. Buyers don't appreciate being saddled with long-term contracts they didn't negotiate — particularly if they'll be penalized for breaking them. If you're planning to sell, either negotiate short-term contracts or push for favorable terms.

Mistakes can be avoided

These are only a few of the many potential pitfalls that await business sellers. You can avoid others by talking to owners who have successfully completed sale transactions and working with experienced M&A advisors. ■

Get your deal off to a good start with a letter of intent

Although it isn't mandatory, a letter of intent (LOI) can help facilitate a smoother M&A transaction. These documents are drafted before the due diligence and negotiation stages and set forth the principal points of a merger, define critical terms and even resolve potentially contentious issues. All of this reduces the risk that the deal will end in failure.

Regulating the process

To be effective, LOIs must specify which provisions are binding and which aren't. In general, *binding* provisions regulate the negotiation process. They may:

- Specify the seller's cooperation in the due diligence process,
- Describe the buyer's access to the selling company's facilities and records,
- Require the seller to continue to operate the business while the deal is being negotiated, and
- Mandate that both parties observe certain confidentiality provisions.

and a summary of the target's executives' employment agreements.

Your LOI might further address the preparation and approval of definitive documentation regarding representations, warranties, indemnities, terms and conditions. And it could set forth escrow provisions for holding back a portion of the purchase price for specified contingencies.

Another common binding provision is the "no-shop" or exclusivity clause. It prohibits the seller from directly or indirectly soliciting or entertaining offers from, or negotiating with, third parties in a transaction similar to the one the LOI outlines for a period of time — typically between 60 to 90 days.

Consider including a provision relating to the LOI's termination, perhaps incorporating a breakup fee to compensate for time, resources and opportunity costs. Specify jurisdiction and venue for any disputes, discuss how IP and other sensitive information will be handled, and insert a statement that the binding provisions constitute the entire agreement between the parties, superseding all prior oral or written agreements. Also, state that the LOI may be modified only in writing, signed by both parties.

A broad scope

An LOI's *nonbinding* provisions outline the transaction and its structure. These may be broadly scoped and include: a description of the transaction form (stock vs. assets); estimates of purchase price and postclosing purchase price adjustments (based on, for example, changes in the stockholder's equity following a specified date); a proposed closing date and description of closing conditions;

The preparer of your LOI should be careful to ensure that nonbinding provisions can't morph into binding ones. Courts sometimes find levels of enforceability that the deal's parties didn't intend. The most powerful weapon against this danger is clear and concise draftsmanship — preferably by a lawyer who routinely prepares LOIs.

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Finally, although they aren't set in stone, your LOI's nonbinding provisions should be regarded as a "moral commitment." Do everything in your power to abide by them or you may damage the trust of the other party and make the deal impossible.

Simple or complex

It's possible to conduct a simple M&A transaction without an LOI, but more complex deals almost always need them. And if your deal is contingent on bank financing, your lender is likely to require a signed LOI before agreeing to underwrite the acquisition. ■

Ask the Advisor

Q. What is reputational risk and how might it affect my deal?

A. Regardless of your M&A deal's type or size, there's a chance it will fail and, as a result, your business's reputation will suffer. This risk applies to buyers and sellers alike. A buyer that fails to close an acquisition deal may, for example, face shareholder repercussions if it's publicly owned. Sellers could gain a "damaged goods" reputation among other prospective buyers.

The reasons deals fail are myriad. Failure to obtain adequate financing, disagreement over value, inadequacies or improprieties uncovered during due diligence, and botched integration are only a few. Any one of these issues could become a black eye for a buyer's or seller's postbreakup reputation.

Measuring risk

Many types of reputational risk are relatively easy to measure. For example, Riggs Bank's market capitalization fell 22% after it settled charges of money laundering violations, while JP Morgan reportedly lost more than $20 billion in market cap after disclosing a $2 billion trading loss. The reputational risk of a failed merger is less tangible.

Take a seller whose deal fails because of publicly disclosed financial irregularities. Even if the irregularities are later found to be accidental, when the business enters the market again sellers are likely to regard it with greater skepticism. The owners may have to accept a lower price or agree to more contractual obligations, such as greater seller financing.

Buyers also might find it harder to get future deals done. Sellers may be reluctant to enter into negotiations with a buyer that couldn't secure enough deal financing during its first acquisition attempt. In such cases, sellers often ask for higher breakup fees and other penalties should the transaction fail.

Prevention is best

It's possible to minimize the chance of a damaged reputation. Start by making sure that:

- Your company is ready for the scrutiny of financial, legal and operational due diligence,
- Your buyer or seller has signed a confidentiality agreement,
- You or your buyer has lined up adequate funding, and
- You're working with experienced M&A advisors.

Even if the deal falls apart, try not to burn your bridges with the other party. And to prevent rumors from sabotaging future deals, always be honest with any prospective merger partner.

Risk of fearing risk

Finally, beware of completing a shaky transaction simply because you're afraid of what will happen if it doesn't close. It's better to walk away and accept the consequences than to complete a bad deal and later regret it. ■

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In 1995, he received the Outstanding Young Texas-Ex award from the Ex-Students' Association and previously served on the University of Texas at Austin's Commission of 125, *Planning for the Future*. In 2008, he received the Chairman's Award for Distinguished Service to the Houston Hispanic Chamber of Commerce. He has authored numerous articles and publications (http://www.herrera.com/newsletter.html) on the financial industry and has spoken at numerous conferences and forums on various topics including debt restructuring, operational turnarounds, bankruptcy and financing alternatives.

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