

Acredula

Bricker & Eckler LLP

100 South Third Street
Columbus, Ohio 43215-4291
(614) 227-2300
FAX (614) 227-2390

info@bricker.com
www.bricker.com
www.BoardandExecutive.net

Bricker & Eckler LLP's *Acredula* is available to clients and friends of the firm, and highlights information of particular importance to boards and executives. The information contained in this newsletter is not to be construed as legal advice or opinion.

We invite you to photocopy and distribute this newsletter as you wish. Or, request additional copies from us.

Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

A Mock Merger or Acquisition Is Good Preparation for the Future

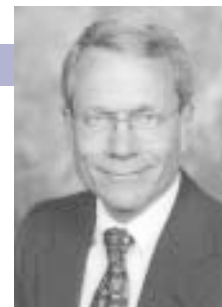
Many believe that merger and acquisition activity will dominate both the United States and the world economies as soon as market prices for equity securities begin to rebound. Some businesses will look to be acquired in order to provide liquidity to their owners. Others will pursue acquisitions in order to consolidate, expand or diversify their operations. Some will seek additional forms of alliances other than a traditional merger or acquisition.

Businesses often find it useful to prepare both management and, if they have independent boards, their board members for either an unsolicited offer or a planned acquisition. *Acredula* can assemble a team of representatives from legal, investment banking, public rela-

Editor's Note

tions, auditing and employee retention firms to conduct a program culminating in a one-day training session that guides management and board members through a mock merger or acquisition. The mock training session is designed to prepare management and its board for making an offer as well as for responding to an unsolicited offer.

For more information, please contact John Beavers at 614-227-2361, jbeavers@bricker.com, or 100 South Third Street, Columbus, Ohio 43215.



John P. Beavers
Partner,
Bricker & Eckler LLP

Creating a Merger and Acquisition Strategy Is Essential for Success

Part I: Protecting Resources and Defining Principal Business Terms

John P. Beavers and Michael F. Sullivan, Bricker & Eckler LLP

In this two-part series, we will address the guidelines for developing merger and acquisition strategies for both emerging and established businesses. This first installment focuses on the preliminary steps to creating these strategies as well as some of the principal business terms that need to be determined when structuring transactions and valuating businesses.

Mergers and Acquisitions vs. Public Offerings

Today, more businesses are emerging through a strategy of mergers and acquisitions than through the traditional



John P. Beavers
Partner,
Bricker & Eckler LLP



Michael F. Sullivan
Partner,
Bricker & Eckler LLP

strategy of an initial public offering. In fact, a public offering is becoming the exception rather than the norm. For every business that emerges with a public offering, four are acquired by another enterprise. With the economy

becoming more global and technology increasing competition, the need to commercialize and “get to market” quickly now favors mergers and acquisitions instead of public offerings for several reasons:

	Merger or Acquisition	Public Offering
Access to resources	Well-planned acquisitions should result in direct access to necessary resources.	Public offerings typically result in cash, not resources. Businesses must locate and purchase, or otherwise develop, their own resources.
Access to additional capital or other resources the business' earnings.	In acquisitions with established businesses, access to capital or other resources often depends on an economic analysis of fundamental factors, such as the impact on impact on the business' trading prices.	Access to capital or resources by a business with publicly traded securities often depends on a market analysis of technical factors, such as the
Public disclosure	Businesses without publicly traded securities do not have to satisfy ongoing reporting obligations.	Businesses with publicly traded securities must fulfill ongoing reporting obligations that often result in disclosure of otherwise confidential information that may benefit competition.
Cost	Acquisition accounting fees are usually less than those incurred in public offerings. Additionally, there are no underwriting commissions or discounts, or printing expenses.	In addition to legal and accounting fees, public offering costs include up to 10 percent commission or discount to underwriters and printing costs.
Market conditions	Acquisitions are less dependent on market conditions than public offerings.	Public offerings are subject to market conditions beyond the business' control.
Liquidity for founders	Acquisitions can be designed to provide owners with liquidity.	Public offerings often do not result in immediate liquidity to founders, except for certain broker transactions.

In addition, shareholders of emerging businesses are finding that strategic mergers or acquisitions result in earlier liquidity with less uncertainty than public offerings. The emerging business' operations often jump forward in a merger or acquisition by an established enterprise with a ready sales, warehousing, distribution or manufacturing infrastructure. A strategic merger or acquisition of an emerging business often allows an established enterprise to utilize more fully its own infrastructure, increasing return on its assets.

Preliminary Steps

Before considering a merger or acquisition, businesses must complete the preliminary steps of protecting resources and planning for a jointure. The first step in any merger and acquisition strategy for either an emerging or established business is to protect resources.

Protecting Resources

The two most important resources of both a business seeking to make an acquisition and a business seeking to be acquired are:

- The human resources of their management team and other key personnel; and
- The intellectual property of their business, products, and services.

Employment terms. With respect to human resources, *not* having members of management and other key personnel obligated to the venture through employment contracts is a detriment to an acquisition. Two of the most important provisions of an employment contract are:

- **Notice provisions**, which require an employee to give advance notice (typically 30 days to six months) before resigning or quitting; and
- **Discharge provisions**, which authorize someone, typically the CEO with respect to non-officers or the board with respect to officers, to remove an individual from his or her authority and responsibilities as an officer and employee, with or without cause.

Often these notice and discharge provisions provide different levels of compensation through either continuation of salary and bonus or payment of separate severance benefits if there is cause for discharge or good reason for quitting.

Restrictive covenants. Other provisions, typically referred to as “restrictive covenants,” are also important considerations. The most common of these covenants place restrictions on:

- **Outside activities.** These provisions are typically provided either in the affirmative, requiring employment “on a full-time basis,” or in the negative, prohibiting any other employment or activity that impairs the person’s ability to exercise his or her authority and to meet his or her responsibilities fully.
- **Ideas developed.** Usually an affirmative covenant, this provision states that any idea or invention developed by the employee for the venture’s business belongs to the venture and often includes an assignment of any such ideas, including inventions, to the venture.
- **Use of confidential information.** Typically a negative covenant, this provision prevents the use of business or trade secrets and other confidential information, except as authorized, in the course of the venture’s business.
- **Solicitations of resources.** These provisions are generally a negative covenant prohibiting the solicitation of any employee, customer or client, vendor or supplier, or similar resources of the venture to cease their relations with its business.
- **Competition with business.** Typically a negative cov-

enant, this provision prevents competition with the business of the venture during, and often for a period after, employment.

Third-party nondisclosure agreements. In addition to protecting the human resources of the management team and other key personnel, businesses should protect their business and trade secrets and other confidential information, including technology and inventions. In addition to affirmative covenants and assignment by employees of ideas or inventions developed for the business, third parties, including potential acquirers or targets of an acquisition, should sign a nondisclosure agreement before being given access to any such business or trade secrets and confidential information.

Trademark, trade name, and domain name protection. Other deterrents to an acquisition include a lack of adequate protection for the business’ entity name, often involving exclusive rights to an Internet domain name identifying the business, and a lack of trade and service mark protection for the business’ products or services.

Identifying Goals

For businesses considering a merger or acquisition, the first step in adopting a strategy is identifying what they want to gain from such a transaction. The principal reasons that an emerging business considers acquiring or being acquired are:

- **Liquidity**, for founders and investors; and
- **Access to resources**, including financial resources, such as working capital, infrastructure, such as a ready sales force or warehousing, distribution, or manufacturing facilities, strategic products or services and expansion of markets.

For an established business, the main reason to consider acquiring an emerging business is greater utilization of its resources, including its sales force or warehousing, distribution, or manufacturing facilities. Other reasons include:

- Acquisition of key technology;
- Addition of new products or services;
- Entry in a new market;
- Elimination of competition; and
- Acquisition of creative talent.

Describing Itself

After determining what it wants from a merger or acquisition, a business must next prepare a description of itself. This is easier for publicly held businesses, which describe in detail their operations, assets and liabilities in annual reports

to their security holders and reports to the Securities and Exchange Commission (SEC).

An emerging business may wish to base its description on its business plan. That description should focus on the business summary, management expertise and experience, security ownership, management's discussion and analysis of the plan of operation, financial statements, and projected financial information.

SEC Regulation S-B provides helpful guidelines detailing the issues to consider for each of these items. Regulation S-B is available on the SEC's Internet website, www.SEC.gov, and its direct address is www.sec.gov/smbus/forms/regsb.htm.

Retaining a Business Broker or Investment Banker

Any business considering acquiring or being acquired may want to have the help of a business broker or investment banker with merger and acquisition experience in its industry. A business broker or investment banker can help evaluate enhancing and detracting factors of the business itself as well as those of candidates to acquire or be acquired. They can also help offer and evaluate alternatives.

Business brokers or investment bankers often take the lead in planning an acquisition strategy for a business seeking to be acquired. In addition to evaluating the business' strengths, weaknesses and industry position, business brokers or investment bankers will lead the business in finalizing its presentation of descriptive materials and in identifying, contacting, and qualifying potential candidates.

Finally, business brokers or investment bankers can help with the most critical business term: valuation. Business brokers and investment bankers typically require an exclusive representation agreement providing for payment of a percentage of the purchase price. These agreements can and should be negotiated by someone familiar with trade practice in this area.

Contacting Candidates

A business seeking to be acquired will want to contact buyers that are looking for either a strategic business or investment opportunity. Established businesses are generally interested

in an acquisition that strategically complements or supplements their business and increases the return on their assets.

A business broker or investment banker is invaluable in identifying and making initial contact with candidates. Potential acquirers generally view the involvement of a broker, or in larger transactions an investment banker, as advantageous because it means that some third-party due diligence has been done substantiating what is being offered. The involvement of a broker or investment banker also means that someone is likely to have dealt with any unrealistic expectations of the acquired business' management.

Before any representative should have any discussions with any acquirer candidate, a confidentiality agreement must be signed. That agreement should protect not only the confidentiality of all information to be presented, but also the "novelty" of any proprietary technology information, products, and processes. Sometimes these agreements contain prohibitions on offering employment to company personnel involved in the transaction.

SEC Regulation S-B provides helpful guidelines for describing a business. Regulation S-B is available on the SEC's website, www.SEC.gov, and its direct address is www.sec.gov/smbus/forms/regsb.htm.

Sharing of Information

In the next stage of the process, information is shared. Potential acquirers will want to meet the management of the potentially acquired business. Often, they will want to visit the other business' offices or facilities. A knowledgeable company will provide disclosure in stages, withholding the most competitively sensitive information until the acquisition is almost certain to occur.

Because time is not an ally to maintaining confidentiality, the business that may be acquired will want to proceed quickly to a discussion of principal business terms. Its representatives and its management should be familiar with what the principal business terms are in any deal as well as what they want as the principal terms in their deal.

Principal Business Terms

Structure of the Transaction

Although not the most critical term, one of the first business terms that needs to be determined is the structure of the transaction.

From a legal viewpoint, the structure is usually one of the following:

- **Asset acquisition**, in which the acquirer receives assets and only designated liabilities of the business being acquired. Unlike a stock acquisition or a statutory merger, an asset acquisition benefits the buyer because it does not acquire unknown liabilities, except to the extent that there are unknown adverse claims against the acquired assets. A big disadvantage to the acquired company going out of business is the potential for double taxation—once on the sale of assets and again on the distribution of proceeds to shareholders. A corresponding advantage to acquirers is the ability to increase tax basis in the assets. Another advantage of an asset acquisition to both parties is that it does not require a unanimous affirmative vote of the acquired business' outstanding capital stock to effect the transaction. Under most corporate statutes, the required affirmative vote ranges from a majority to two-thirds of the acquired business' outstanding capital stock. As long as the required affirmative vote is attained, dissenting holders cannot block the asset sale. They are entitled only to dissenters' rights to receive fair consideration determined by a statutory process akin to an appraisal.
- **Stock acquisition**, in which the acquirer receives the outstanding capital stock of the business being acquired. Unlike an asset acquisition, a disadvantage of a stock acquisition is that all of the liabilities of the selling entity are acquired. For this reason, acquirers often will create or use a subsidiary to purchase their stock, in order to shield themselves from unknown liabilities. Another disadvantage of a stock acquisition is that all of the holders of the acquired business' capital stock must sell in order for the acquirer to obtain absolute control. As a result, stock acquisitions can be difficult if there are many holders who have to participate or even one holder who will not participate in the transaction.
- **Statutory merger**, in which the entity of the business being acquired becomes part of the acquirer, or more

A knowledgeable company will provide disclosure in stages, withholding the most competitively sensitive information until the acquisition is almost certain to occur.

likely a subsidiary of the acquirer, whereby the successor entity succeeds by operation of law to all of the assets and liabilities of the acquired business' entity. As with a stock acquisition, an acquirer often will create or use a subsidiary as its constituent entity to the merger, in order to shield itself from unknown liabilities. An advantage of a statutory merger over a stock acquisition is that it requires less than a unanimous affirmative vote of the acquired business' outstanding capital stock to effect the transaction. Under most corporate statutes, the required affirmative vote ranges from a majority to two-thirds of the

acquired business' outstanding capital stock. As long as the required affirmative vote is attained, dissenting holders cannot block the merger. They are entitled only to dissenters' rights to receive fair consideration determined by a statutory process akin to an appraisal. Mergers may be structured as a:

- **Straight merger** into the acquirer, where the acquirer is the survivor. A straight merger is used only in a merger of equals or where it is impractical to shield one entity from the liabilities of the other;
- **Forward triangular merger** into an acquirer's subsidiary, where that subsidiary is the survivor. A forward triangular merger is used when it is desired to shield the acquirer from the liabilities of the acquired business; or
- **Reverse triangular merger** with an acquirer's subsidiary, where the entity whose business is being acquired is the survivor. A reverse triangular merger is used when the assets being acquired have contracts subject to termination if the entity does not survive. A reverse triangular merger is subject to more stringent requirements than a straight merger or forward triangular merger, in order to constitute a tax-free reorganization.

From a federal income tax viewpoint, the transaction may be structured between corporations as a tax-free reorganization if the consideration given is capital stock of the buyer or certain related entities resulting in continuity, after the transaction, of the prior ownership of the business being acquired in the following types of transactions:

- **Stock for asset acquisition**, in which at least 80 percent of the total consideration paid for the assets must be capital stock of the acquirer or certain related entities;
- **Stock for stock acquisition**, in which the shareholders (other than those perfecting dissenters' rights) of the business being acquired must exchange their shares of capital stock solely for capital stock of the acquirer or certain related entities and the acquirer must obtain at least 80 percent of the acquired business' outstanding capital stock; or
- **Stock merger**, in which the consideration paid meets the following requirements depending upon the type of merger:
 - For a straight merger, at least 50 percent of the total consideration paid must be capital stock of the acquirer;
 - For a forward triangular merger, at least 50 percent of the total consideration paid must be capital stock of the acquirer; and
 - For a reverse triangular merger, at least 80 percent of the total consideration paid for the assets must be capital stock of the acquirer.

From an accounting viewpoint, the transaction will be treated as either a pooling or a purchase:

- **In pooling accounting**, the past financial statements of acquiring and acquired entities are combined and restated as though both entities had always been one. The value at which the assets are recorded on the balance sheet of the business being acquired is carried forward to the balance sheet of the acquiring entity with no recognition of goodwill and no resulting amortization thereof reducing future earnings.
- **In purchase accounting**, past financial statements remain separate, and statements only at dates and for periods after the closing may be combined. The assets being acquired are recorded at their fair market value on the balance sheet of the acquiring entity. The excess of the fair market value over the value that such assets were recorded on the balance sheet of the business being acquired is recognized as goodwill, and that good will must be amortized, reducing future earnings.

Unless the transaction meets the special requirements for pooling accounting, it will be accounted as a purchase.

Specific criteria relating to the historic capitalization of the corporate parties and the terms of the acquisition are addressed in Opinion 16 of the Accounting Principles Board. After June 2001, the availability of pooling is uncertain based on timetables for its elimination established by the Financial Accounting Standards Board.

Valuation of the Business Being Acquired

The most critical business term is the valuation of the business being acquired. Valuation is highly subjective. Although there are economic parameters and measures, the goal of the process is a "fair" rather than a "precise" result. In fact, the statutory test under most organizational laws is whether the result of the transaction is "fair" to the shareholder or other owners.

Three of the most common methods of valuating an acquired company are:

- **Multiple of Earnings Method.** This method determines what the multiple of the capital stock's market value is of the annualized earnings of publicly traded companies in the same industry and then adjusts that multiple to take into account size, competitive position, liquidity, and performance differences between the business being valued and those publicly traded companies.
- **Consideration in Comparable Transactions.** This method determines the consideration paid in comparable transactions in the same industry typically as a multiple of revenues or earnings of the business being acquired.
- **Discounted Cash Flow Method.** This method determines the present value of the cash flow generated for reinvestment in the business or distribution as dividends from the project operations of the business being acquired.

Conclusion

Planning for a jointure and protecting resources are key steps to creating a successful merger and acquisition strategy. Another essential ingredient is determining principal business terms. Next month's installment will continue our focus on business terms and provide guidelines for evidencing the deal and for navigating the process of the deal.