Key Considerations When Entering into an M&A Transaction

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If you are contemplating a sale of your company, there are several different ways in which you can both 1) properly prepare your company for an exit, and 2) make the process of an acquisition smooth for you, your company, and any prospective buyers. The following are some key items that are almost always major topics discussed during both the negotiation and execution of an M&A transaction. Understanding them and preparing for potential challenges, can make a big difference.

Corporate Books and Records

Good Standing. Ensure your company is in good standing in all the jurisdictions where it is qualified to do business. This includes any subsidiaries, including dormant ones. Sometimes entities are formed years prior for business purposes that are never consummated. You don't want the closing of a deal to be delayed because of a discovery at the eleventh hour that your company owes back franchise taxes in another state, for example.

Corporate Minutes. Ensure your corporate minutes are up to date and adequately reflect the past actions of the board and shareholders of the company. Also ensure that the proper bodies authorized any significant corporate action such as debt, prior acquisitions, and equity issuances. If there are any gaps, ratifying resolutions or even ratification of defective corporate acts may be necessary to ensure your corporate records are clean. It helps to be familiar with the capitalization table and governance documents of the company to understand what percentage and classes of shareholder votes were required for previous actions and ensure that you can show that you received such required votes.

Material Contracts

Contractual relationships can be an important aspect of a company's value. Ensuring these contracts are transferrable or, if consent of the counterparty is required, that you have or can obtain those consents is critical in an acquisition. In many cases, these contracts can include change of control or non-assignment provisions. If these are triggered, they could have an adverse effect on the selling company. This is especially important if you are a local, state, or federal government contractor. Often, obtaining consents for these contracts can take some time so beginning that process as soon as possible is recommended; keeping in mind, confidentiality obligations may preclude you from discussing the deal with third parties until it is final or near final. Ultimately, buyers will want to know that these contracts will continue in force and effect following closing. If there is any belief they may not, then the sellers should communicate this possibility, have a plan in place to effectively transfer as many as possible, and be prepared to consider a potential effect on the purchase price. During diligence, sellers should make all these contracts available to the buyers and be prepared to answer pointed questions regarding their content. The above concepts also apply to any leased property that the selling company uses, particularly if such property is essential to business operations. Oftentimes, landlords will require their consent for tenants to assign their lease.

Intellectual Property

If your business is a technology intensive business you may own or possess third party licenses for key intellectual property. These intellectual property rights should be reviewed to ensure that the company holds a clean title and rights to use such intellectual property, particularly intellectual property that is material to the business. It is important to understand how much revenue is tied to this intellectual property, and in the future, how it distinguishes your company from its competition and any potential replacement cost. In conjunction, ensuring that the company's employees are obligated to invention assignment provisions is an important step to insulating against potential third party claims. The sellers of any company should also consider whether to carve out any intellectual property from selling company before the sale.

Proper Classification of Workers

Ensure that your workers are properly classified. Many buyers in an M&A transaction spend a significant amount of time in diligence looking at classification of workers because the risks for misclassified workers can be quite costly. Massachusetts is very strict when it comes to misclassification of workers, and any misclassification can result in severe fees, penalties, and civil or criminal liability for the employer. Sometimes misclassification issues can lead to buyers walking away from the deal or requesting special indemnity and additional funds set aside in escrow.

It is important to understand the law when it comes to properly classifying your workers as either an employee or an independent contractor. Employees have rights to the availability of certain benefits. Employers also need to make sure they are making the appropriate withholdings. There are several factors that must be considered when determining employee or independent contractor status, including examining the means, time, manner, and place of the work. Massachusetts uses a three-prong test to determine whether work is (i) being performed at the direction and control of the employer, (ii) being performed outside the usual course of the employer's business, and (iii) being performed by someone who has their own independent trade or business in that type of work. Misclassifying a worker as an independent contractor rather than an employee can result in steep tax penalties, civil lawsuits, and potential criminal penalties.

Another common form of misclassification is classifying workers as exempt employees while paying them below the state and/or federal minimum salary. You should be familiar with the applicable federal and state minimum salary laws (as well as minimum wage hourly laws) and ensure that your company's workers are properly classified (i.e., exempt vs non-exempt) or you may be subject to severe fees and penalties. This may include back-wages over several years and unpaid withholding taxes and possibly even unpaid 401(k) employer contributions.

Non-Competition and Non-Solicitation

While non-competition provisions have become less common in employee agreements in Massachusetts over the recent years, they are still quite common during the M&A process. It is not atypical for a buyer to ask that the seller of a company enter into non-competition and non-solicitation provisions, in which the key executives of the seller will agree not to solicit any customers or employees of buyer or engage in any competitive activities against the buyer for a definitive amount of time. These restrictions are usually heavily negotiated regarding the time, scope of the competition, and geographical restrictions, as well as adequate compensation for entering into such agreement.

Deal Structure

Be prepared to discuss deal structure during the letter of intent phase of an M&A transaction. An M&A transaction can be set up as an asset sale, stock sale, or merger. When considering the best structure, there are a number of considerations that should be discussed, including tax considerations (for example, whether the structure of the transaction will be a taxable or tax-free), stockholder approval (can the company obtain all of its stockholders' approval of the transaction?), transfer of liability (does the buyer wish to purchase the entire company or just certain of its assets while excluding certain liabilities?), and third party consents required under the selling company's customer contracts (asset sales will typically require more contracts to be assigned).

Representations and Warranties; Indemnification; Escrow; and Representation & Warranty Insurance

The representations and warranties in a definitive acquisition agreement will likely be quite detailed and lengthy. However, the buyer relies on these statements when acquiring a company. Typical representations and warranties will cover a number of topics such as authority, capitalization, good standing, debts and liens, financial statements, litigation, compliance with laws, privacy matters, ERISA and benefits, employee matters, taxes, material contracts, and intellectual property. If a seller cannot make a representations or warranty, exceptions must be listed in a document called, disclosure schedules, to prevent a seller from breaching a particular representation.

Indemnification protects a party from losses associated with a breach of a representation or warranty. In most cases, the seller will indemnify (meaning to defend, hold harmless, and typically make whole for losses) the buyer for any breach in the representations and warranties. The indemnification section in a definitive agreement is typically heavily negotiated between the buyer and seller to provide the buyer with adequate protections to cover losses from a seller's breach. Typically, the seller will want to limit how long beyond closing, and up to what amount a seller may seek indemnification. Often, buyers request to carve out certain "fundamental representations" that will not be subject to indemnification caps. There are additional finer elements such as indemnification baskets, representation and warranty insurance, and indemnification escrows that may be explored during the indemnification negotiations.

Taking these administrative steps and preparing for these points of negotiation will position your business to be in good health prior to an exit. Additionally, these housekeeping items operate to ensure that when it comes time to sell, the process will go forward with few impediments, and your company will be positioned to try to maximize the value of any potential purchase price.

For more information on M&A transactions, please contact Peter Cifichiello or Elizabeth Resteghini.