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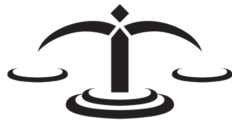

ILLINOIS STATE BAR ASSOCIATION

CORPORATION, SECURITIES & BUSINESS LAW FORUM

The newsletter of the ISBA's Section on Corporation, Securities & Business Law

Negotiating and drafting pre-acquisition documents related to a business sale or purchase

By Markus May

A client comes to you, the business attorney, and asks for advice related to a prospective business sale or purchase. You begin by listening to the client tell you a little about the proposed deal and then the client says "I know we will have a final sales agreement and related documents, but I'm not sure what we need to do before the closing. Are there any other documents that will be needed?" This is your opportunity to educate your client about various pre-acquisition documents typically found in a business transaction including the engagement agreement, the business broker or intermediary agreement, the nondisclosure agreement, and the letter of intent. This article briefly explains these agreements and some of the more common issues related to negotiating these agreements.

The Engagement Agreement

The engagement agreement with the client is a critical document that sets forth the expectations of both the attorney and the client with respect to the proposed transaction. Though seemingly straightforward, one of the first issues the attorney needs to deal with is determining who the attorney represents. In a business context, there will often be individual owners of a business, such as shareholders, as well as a separate business entity such as a corporation. If the attorney is representing the seller of the assets of a business, then the attorney will represent the business entity. However, during negotiations, the deal may change from an asset sale to a stock deal were the ownership of a corporation is being sold. In this event, if the prior engagement agreement was with the corporation, a separate engagement agreement may be required. Further, if there is a potential conflict of interest between the corporation and its shareholders, a review of the appropriate rules of professional conduct and compliance therewith is necessary.[1]

With respect to the buyer of a business, an attorney may have the same question—who is the client? When an individual comes to an attorney and asks for representation regarding the purchase of a business, one of the attorney's first duties is generally to advise the individual that a limited liability entity should be created to purchase the business. In such an instance, representation of the individual needs to transition to representation of the company after the company is formed. With respect to multiple shareholders and shareholder agreements, the lawyer will need to carefully follow the applicable rules of professional conduct.[2]

The engagement agreement also should set forth how the attorney will be paid. Because many deals do not close for various reasons and the complexity of a deal often varies based upon the other party and its attorney, most attorneys charge their clients on an hourly basis. If an initial fee payment or retainer is to be paid, this should be set forth in the engagement agreement. As a practice pointer, it is wise to get money up front from a buyer who the attorney does not know. Additionally, a seasoned attorney will often provide

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that payment in full is expected at the closing, especially on a smaller deal or where the client is not well known to the attorney.

The Broker Agreement

Sometimes when a new client comes to an attorney, the client will already have signed an agreement with a business broker or intermediary. However, in those instances where a client asks the attorney to review the listing agreement, the attorney can provide valuable advice to the client. Obviously the client should be advised about the overall terms and impact of the agreement. Additionally, there are a number of issues the attorney should be prepared to discuss with the client.

Some broker listing agreements provide that a commission is earned when the broker presents a willing buyer to the seller as opposed to when the deal actually closes. From the broker's viewpoint, the broker has done a lot of work in finding the right buyer and the broker wants to avoid losing a fee because the deal does not close due to circumstances outside of the broker's control. However, from the seller's point of view, the seller only wants to be responsible for one broker's fee and should not have to pay a fee if the deal does not close. Most brokers will agree to change this provision.

One of an intermediary's biggest fears is that after having introduced a buyer and seller, the parties cancel the deal in order to avoid paying the intermediary and then later close on the deal. Most listing agreements therefore require for the intermediary to be paid its fee if the seller sells the business to a buyer introduced to the seller by an intermediary. The intermediary should be allowed this protection. However, if the listing agreement does not provide a reasonable time period, the attorney should request one so that if the buyer purchases the business at a much later date, then the intermediary would not be entitled to a fee. The length of this time period is negotiable.

Another issue is whether the client wishes to sign an exclusive listing agreement. If the client wishes to have more than one broker listing the business, then the client also needs to be ready to either pay an hourly rate to compensate the broker for the broker's time and costs, or pay a larger than normal percentage of the selling price as a commission. Unless the broker is compensated for the broker's time, the broker will be unlikely to spend time listing a business where it is not an exclusive broker.

With respect to the fee, broker's fees vary widely. Most have some sort of a commission based upon a percentage fee structure, often with a minimum dollar amount. The commission should be based upon the actual sales price that is finally paid. If part of the sales price is deferred, as with an earnout, the client may wish to negotiate a portion of the broker's fee being paid out over time as well. The broker of course will want to be paid everything at the time of closing because the future collectibility from the buyer is not something over which the broker has control. The broker's commission will also typically be paid on any amounts allocated to an employment agreement with the seller. This prevents the buyer and seller from allocating part of the purchase price to an employment agreement in order to avoid paying part of the commission.

One final topic to address in the broker's agreement has to do with communication between the buyer and the seller. Early on in the process, the broker will often want to avoid having the clients interact with each other because the broker does not want the deal to sour at an early stage. However, if the listing agreement prevents communications between the buyer and the seller at later stages in the sales process this should be modified. The buyer and the seller will typically be interacting during the due diligence process after a letter of intent has been signed.

The Nondisclosure Agreement or Confidentiality Agreement

With respect to a buyer, often the first document signed after the engagement agreement is a nondisclosure or confidentiality agreement provided by a broker or attorney for the seller. The seller does not want to reveal financial and other confidential information regarding the business to a potential buyer without the protection of a nondisclosure agreement. This agreement will provide that the buyer is to hold confidential all information provided to the buyer about the business, for the buyer to not use any such information other than for the proposed purchase of the business, and for the buyer to return all information to the seller if the sale does not close. If the purchaser is providing financial information to the seller in order to demonstrate the purchaser's ability to close the transaction, the purchaser will often desire a reciprocal confidentiality agreement.

The definition of what is considered protected information is something that should be looked at closely by the attorney for each party. The seller will generally want a very expansive definition of what is considered to be protected information. The buyer on the other hand will desire a more narrow definition. Oftentimes the buyer and seller will agree to create exceptions for information previously known to the buyer as well as common industry and public knowledge.

If the purchaser is already involved with the company and has company knowledge, e.g. a current employee, vendor, or customer—then the term "information" should exclude the knowledge which has already been acquired by the purchaser as a result of his or her connection with the company—otherwise, it could lead to the employee signing the equivalent of a non-competition agreement or the vendor not being allowed to start a new business. If a vendor desires to purchase a business within a certain industry and has information which could be considered confidential to the seller, there needs to be a special carve out within the nondisclosure agreement to prevent the seller from enjoining the vendor from purchasing a competitor of the seller.

A seller may want a specific list of people to whom the information can be released, whereas the purchaser will want it to apply to all of the purchaser's agents. The latter provision is preferable so there is no inadvertent disclosure to an agent who was not specifically named in the nondisclosure agreement. The receiving party of any confidential information, usually the buyer, will be responsible for any improper dissemination of the information to a third-party by its agents. However, a purchaser will generally want to add language which provides that it is not liable if the purchaser or its representatives used the same degree of care in protecting the information as the seller uses in protecting the information.

Another issue is the level of protection the purchaser needs to provide if the information is sought by a third-

party. It is common practice for the purchaser to have to notify the seller of any attempt by a third party to seek disclosure of the confidential information pursuant to law. The question arises whether the purchaser is required to use its best efforts to obtain reliable assurances that the information will continue to be treated confidentially. For example, a purchaser will not want to pay attorneys fees to defend the confidentiality of the seller's information. To address this situation, the confidentiality agreement can provide for the purchaser to make "reasonable" efforts to obtain an assurance the information will be treated as confidential by the third-party or the seller will provide for the costs of negotiating the disclosure and providing payment for the buyer's legal fees.

Generally, the nondisclosure agreement will provide for the return of all protected information if a letter of intent is not signed by a certain date, if a party decides that it does not wish to proceed with the proposed acquisition, or if the acquisition is not consummated. There should also be some time in the future when the protected information will no longer be treated as confidential and the agreement will not be enforceable after that date. This is typically two to five years in the future.

With respect to enforcement, there should be language in the agreement which provides for injunctive relief without proof of damages. This clause should provide for the recovery of attorney fees by the prevailing party and that no bond is required. If the purchaser is an entity, the individual owners may be required to sign a confidentiality agreement in order to obtain personal compliance with the agreement as well as corporate compliance.

Regarding actual disclosure of the information, because of the critical nature of the information and a person's ability to use such information to the detriment of the seller, even with a signed confidentiality agreement, the seller will be very careful with respect to what information is provided to the prospective purchaser at what time. The disclosure of information will often be given in different stages during the purchase process with the more sensitive information being provided later in the process. For example, the purchaser will often receive customer lists and key vendor and supplier lists shortly before the closing date.

The Letter of Intent

A letter of intent, sometimes called a term sheet, is used by the parties to determine whether or not there is an agreement sufficient between the parties in order for them to proceed with the transaction and the expense of drafting a comprehensive transaction agreement. Sometimes a term sheet is first drafted which sets forth the basic terms of the proposed deal and then a more comprehensive letter of intent is used to set forth more of the details related to the transaction. A letter of intent is not necessary to close a deal; however, it is frequently used to narrow down the parties' agreement on some of the major issues related to the proposed transaction. By using a letter of intent, the parties can limit the amount of expense and time in determining whether a proposed transaction is even feasible between the parties. After the letter of intent is signed, the buyer usually enters into a due diligence period where significant time and expense is spent investigating the operations of the seller. Typically, the purchaser creates the first draft of the letter of intent.

Letters of intent can be relatively simple documents which basically set forth the purchase price and what is being purchased or they can be much more complex documents which really set forth the structure of the proposed transaction. From a buyer's perspective, a shorter letter of intent is advantageous in that the seller is more likely to not be overwhelmed by a lengthy document and may allow the buyer to begin performing due diligence on the company. Additionally, psychologically a seller will become more invested in the transaction after a letter of intent is signed because they switch into a "sell mode." For these reasons, some buyers prefer to use a relatively simple letter of intent.

The advantage of a longer form letter of intent is that if the deal is going to fall apart because of deal structure or other details which are important to the buyer but are not agreeable to the seller, the buyer will hopefully be able to discover the problem areas prior to spending significant amounts of time and expense in due diligence. The parties can then negotiate some of these "hot button" areas before incurring other expenses. Once these issues have been negotiated the longer form letter of intent will often be used by the parties as the blueprint for creating the final transaction agreement even if the letter of intent provides that its terms are nonbinding. Therefore a more comprehensive letter of intent can actually save the parties considerable expense on the back end when negotiating the final purchase agreement. Sellers' attorneys will generally prefer a more detailed letter of intent so their client is fairly comfortable with the proposed sale before taking the business off the market.

A letter of intent should be carefully drafted by the purchaser to provide that the seller will provide the purchaser with the exclusive right to purchase the business for a certain period of time after the letter of intent is executed. This should also provide that the seller ceases the active marketing of the business. If the purchaser does not have such an exclusive right, the purchaser will bear the risk of entering into an expensive due diligence process only to find that the seller has sold the business to another buyer. A seller may be hesitant to provide exclusivity because of a desire to maximize the sales price and to shop the business to other potential sellers. Additionally, a seller's board of directors may have a fiduciary duty to present to the shareholders all potential deals and the seller's attorney may only be able to negotiate a limitation on the active marketing of the business.[3] The purchaser will usually desire a longer period of exclusivity; whereas, the seller may only want to provide for a 30 day period which can be extended if the negotiations with the purchaser are progressing well.

In order to provide exclusivity, some sellers will ask for the purchaser to provide earnest money. This can be a hotly negotiated issue both as to amount and the conditions upon which the earnest money should be returned. Some attorneys advise their clients to not request earnest money as it often increases the amount of legal fees spent negotiating and ultimately may lead to more expensive litigation when the buyer tries to get the earnest money back if the transaction does not close.

Most experienced attorneys require that the letter of intent be nonbinding other than for certain provisions such as exclusivity, confidentiality, and enforcement. The provision making the letter of intent nonbinding should be carefully drafted or the parties may very well find themselves in expensive litigation trying to sue for or defend against damages for

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breach of a binding sales agreement. A detailed letter of intent typically lists some conditions which need to be met prior to proceeding with the transaction such as obtaining adequate purchaser financing, satisfactory lease or other contractual negotiations, and obtaining required third-party approvals from franchisors or regulators.

Though the letter of intent is technically nonbinding, as mentioned previously, the letter of intent is often used as a blueprint for the final purchase agreement. Just as blueprints often change during the construction process, the due diligence process will often result in a modification of the terms of the deal (e.g. a reduction in purchase price). Due diligence may also result in a deal structure change. For example what begins as an asset purchase deal may turn into a stock purchase deal. So long as the parties are negotiating in good faith and solid reasons are given for proposed changes to the final deal structure, variations from the letter of intent should not be fatal to the transaction.

Summary

Too often, the pre-acquisition documents are not given the attention they deserve by the legal practitioner. Each transaction is unique with different drivers for each of the parties. In a relatively simple transaction, the above information will hopefully help the casual practitioner in the business transaction arena identify and negotiate some of the more sensitive issues. In other transactions, the casual business practitioner is advised to engage co-counsel early in the transaction process and not wait until negotiation of a comprehensive transaction agreement.

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1. Illinois Rules of Professional Conduct 1.7 and 1.9.
2. Id. at 1.7.
3. *Phelps Dodge Corporation v. Cyprus Amax Minerals Co.*, 1999 WL 1054255 (Del. Ch., 1999).

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Consider a Co-op in the sale of a Closely Held Business

By Tracy J. Nugent, Shareholder; Meyer Capel, A Professional Corporation

Owners of closely held businesses often consider establishing an Employee Stock Ownership Plan (ESOP) as a means to share with workers the expected growth in the value of the company and also to provide the additional incentive associated with equity ownership. One well known and important advantage and business planning opportunity offered by an ESOP is the ability to sell at least 30 percent of the stock of a closely held company to the ESOP and obtain the benefits of IRS Code Section 1042 deferring recognition of capital gain on that sale. If the requirements of Section 1042 are met, the "rollover" it offers effectively allows a business owner to diversify and "exchange" stock of the closely held business for stock of publicly traded companies while deferring gain. Unfortunately, many small business owners determine that the complexities, restrictions and initial and ongoing costs involved in establishing and maintaining an ESOP outweigh the perceived benefits.

For a business owner that has made the decision to share ownership with employees, there is another alternative to consider. Sale of stock to an employee cooperative (Co-op) offers the same non-recognition of capital gain under Section 1042. Additionally, since a Co-op is not governed by the Employee Retirement Income Security Act of 1974 the restrictions imposed by that Act and many of the complexities and costs associated with an ESOP do not apply. While cooperatives are not familiar business structures to many business owners or their attorneys, most would be familiar with some of the larger cooperatives, such as the farmer/producer owned Land O'Lakes, Inc. and Ace Hardware, a cooperative of independent hardware store owners.

In order to qualify for the deferral of gain under Code Section 1042 the business owner must sell her or his stock to an "eligible worker owned cooperative." Under Section 1042 an eligible worker owned cooperative is an organization:

(a) that is subject to the tax treatment of cooperatives under subchapter T of the Internal Revenue Code (26 USCS §§ 1838 et. seq.);
(b) a majority of the membership of which is composed of employees of such organization;
(c) a majority of the voting stock of which is owned by members;
(d) a majority of the board of directors of which is elected by the members on the basis of one person one vote; and
(e) a majority of the allocated earnings and losses of which are allocated to members on the basis of:
    (i) patronage;
    (ii) capital contributions; or
    (iii) some combination of patronage and capital contributions.

The selling shareholder must meet a three-year holding period requirement and the shares being sold must be "qualified securities," which means the securities were issued by a domestic C

corporation that does not have stock outstanding that is readily tradable on an established securities market, and the shares were not received as part of certain proscribed transactions.

If the requirements of Section 1042 are met, then the selling shareholder can purchase "qualified replacement property" at any time during the period beginning three months prior to, and ending twelve months after, the date of the sale to the Co-op. Under Section 1042, the term "qualified replacement property" is very broadly defined, and allows the selling shareholder substantial flexibility in selecting investment opportunities that are both liquid and offer what is usually a welcome opportunity to diversify investments. This general overview of key provisions of Section 1042 is not intended to identify all relevant issues, and Section 1042, the relevant sections of Subchapter T of the Internal Revenue Code and the relevant regulations should be reviewed in detail if the establishment of a Co-op and/or the sale of share to a Co-op is considered.

While tax issues are key factors in such a sale, it is also important to address the human factors that will be involved. Often business owners who would consider selling shares to or for the benefit of workers, whether its through an ESOP or a Co-op, are motivated by respect for the workers and a strong desire to give them the opportunity to take control of the business. Under a cooperative structure, the employees are empowered with the authority and responsibility to make the decisions necessary to run the business. While there are many examples of effectively operating cooperatives, the concepts of cooperative governance and the skills and abilities to effectively implement them are not part of the standard training and operating environments in most businesses. The need for these skills and abilities would have to be recognized and emphasized as part of the transition to a cooperative structure.

Key issues in establishing a Co-op include determining the management structure and hierarchy, identifying members willing, capable and qualified to serve as directors and officers, structuring lines of communication within the cooperative, determining how workers' labor contributions to the cooperative are to be valued and compensated, and determining how the net margins resulting from the operations of the cooperative are to be distributed. Provisions establishing the key elements of cooperative governance and operations would need to appear in the articles of incorporation and by-laws, or similar governing documents for the entity.

Another important issue is that a business owner may not want to, or be able to, sell all of her or his stock to the Co-op in one transaction. Reasons for this may include a desire by the business owner to continue involvement in the business and/or concern by the owner for the additional financing burden that may be imposed on the Co-op to fund the purchase all of the shares in one transaction. The business owner may also choose to become a member of the Co-op. For all of these reasons the selling business owner will want to help assure the viability of the Co-op, which may mean helping to assure that the workers find appropriate guidance in establishing the Co-op and planning for its governance and operations.

Substantial information about cooperatives and additional resources for those considering the creation of a cooperative are available from the National Cooperatives Business Association through that organization's Web site (www.ncba.org). Additional resources regarding financial services and financing for cooperatives are also available through the National Cooperative Bank (www.ncb.coop) and the NCB Development Corporation (www.ncbdc.org).

In summary, while an ESOP is often viewed as a vehicle by which a business owner may simultaneously transfer beneficial ownership to employees and obtain the substantial tax benefits of Code Section 1042, the costs and complexity of establishing and maintaining an ESOP often outweigh these benefits. Owners of closely held businesses should consider the possibility of a sale to a worker cooperative as a means to meet both of these goals in a more cost effective and less complicated manner.

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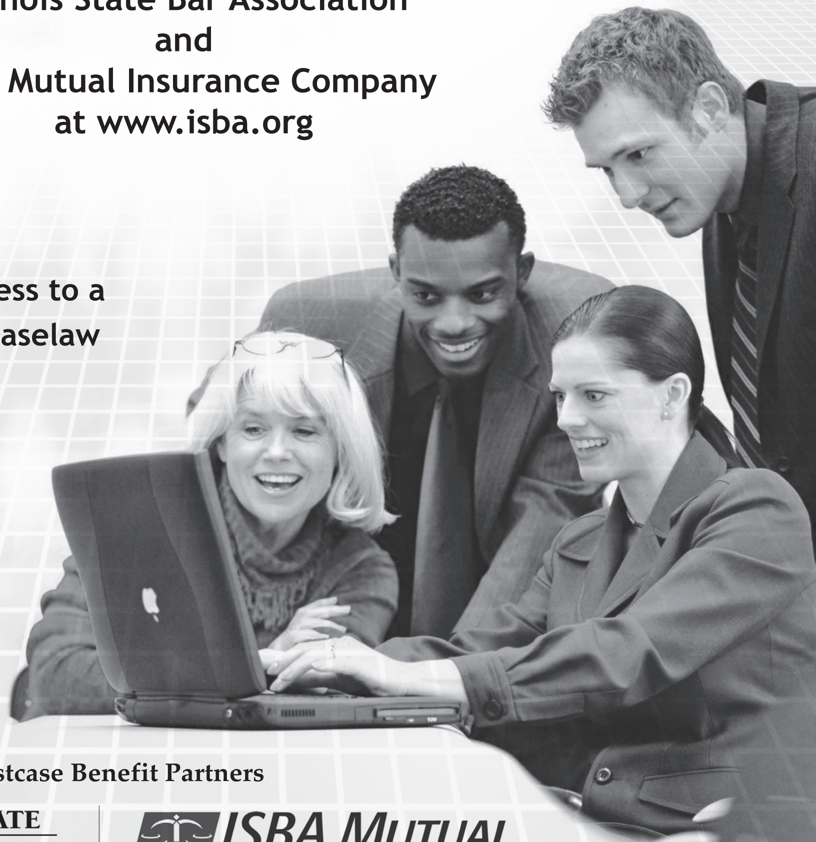

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