

ROBERT G. HUTCHINS – LEGAL ESSAYS

Buying Private Companies, Subsidiaries and Divisions - Part I - Launching the Acquisition Program

Preliminary Note

It is axiomatic that successful business acquisitions are produced most reliably by a comprehensive expansion strategy that has been carefully planned and meticulously executed by the buyer. The axiom applies with greatest force when the target is a private company, a subsidiary or a division. No meaningful information about such targets is readily available to the public. There are no organized trading markets for securities issued by private companies and thus no objective benchmarks for a valuation of them, or of the enterprises that issue them. Unless subsidiaries or divisions are owned by reporting companies, there will be no public disclosure of even general information about them. Financial information for subsidiaries that *are* so owned will be consolidated with information for the other members of the relevant corporate group. Segregated results will be presented only in summary form as schedules to the consolidated financial statements of the ultimate corporate parent. There will be no information in the public domain that would permit a potential buyer to analyze these subsidiaries as stand-alone entities.¹

The success or failure of an acquisition is measured by the performance of the target after the closing. The buyer will declare success when the target meets or exceeds the objectives established for it, justifying the final price. The buyer's realization that an acquisition has failed dawns when the objectives are not satisfied and it becomes apparent that the price was too high.

The *symptoms* of failure include an ill-considered or poorly defined set of acquisition objectives, a flawed analysis of the target and a lack of appreciation of regulatory or contractual issues. The usual *cause* reflects the hectic pace of modern business; the buyer rushed the acquisition process.

¹ A business *divestiture* of one of these units, of course, will reflect the strategy carried out by the seller. See this Website, Publications, Essays, *Selling Private Companies – How to Prepare*; and *Selling Private Companies – the Case for an Auction*. The acquisition of a private company, subsidiary or division by a publicly held buyer is subject to detailed SEC disclosure requirements if the underlying investment represents more than 10% of the buyer's total assets. It does not matter whether the acquired unit otherwise would be considered "material."

This is the first of a series of three Essays that examine business acquisitions from the buyer's perspective. It discusses the preliminary authorization that must be obtained by the buyer's management to pursue an acquisition involving more than a nominal commitment of resources.

The remaining Essays in the series discuss the methods usually employed by a sophisticated buyer to identify, investigate and analyze the target. They also review the negotiating process from "lock up" through closing and discuss the essential features and major consequences of a typical acquisition contract.

Threshold Issues

The prudent buyer will establish strategic and financial objectives for its acquisition program *before* entering the market. The program objectives will emerge from an array of expansion initiatives compiled by the buyer's management. The initiatives will be assessed in light of the buyer's present and anticipated product and geographic markets, distribution channels, technological requirements, management depth and financial capacity. The buyer's senior executives will establish the final objectives, based on complex business judgements. Successful achievement of the objectives, however, requires additional skills. Unless the executives are sophisticated respecting merger and acquisition practice, I recommend that they engage a qualified investment banker to comment upon financing alternatives and to assist in developing a profile of an appropriate target.²

The *legal* analysis that predominates during the initial planning stage concerns the question whether the buyer's management has or can obtain authority to pursue its acquisition program. To a considerable extent the answer is influenced by the structure of the proposed transaction.

Obtaining Authority to Proceed - The General Rule

To the surprise of some aggressive executives, the buyer's management is not always free to close an acquisition without first obtaining the approval of the buyer's equity holders, its owners. Management may also be required to obtain the consent of other parties having a contractual right to approve specific transactions, such as lenders and other secured creditors. In most jurisdictions, the buyer will need the approval of those who hold its voting securities if (a) the acquisition is to be structured as a merger or exchange of securities, (b) the target will be purchased with the proceeds of a new offering of the buyer's securities, or (c) the acquisition will

² Sometimes fortuitous circumstances permit the acquisition of a private entity without elaborate preliminary analysis, but two factors are usually present: First, buyer and target are long term participants in a joint venture or have some other close working relationship and each possesses comprehensive information about the other. Second, their management teams work well together, unburdened by competing egos or cultures.

plunge the buyer into a business at odds with the fundamental purpose expressed in its charter.

Under most credit arrangements, the buyer will need the approval of its lenders of *any* business acquisition, even one financed with internally generated cash, if the transaction will cause a measurable change in the buyer's financial position. The approval requirements contained in standard loan documents rarely distinguish between positive, negative, significant and insignificant changes.

Approval by Owners

When approval by the buyer's security holders is required the process can be time consuming and the burden of persuasion formidable. The notice and quorum requirements for necessary meetings will vary slightly with the buyer's charter documents and form of organization, but it is not unusual for the buyer's management to confront a procedural labyrinth. Written notice of special meetings for approval of an acquisition normally must be provided to holders of the buyer's outstanding voting securities a minimum 20 and a maximum of 60 days in advance of the meeting date. The notice must describe the action to be taken at the meeting in reasonable detail. The presence at the meeting (in person or by proxy) of holders of at least one-third of those securities is usually necessary for a quorum.

If the acquisition will result in a significant change in the buyer's capital structure, the affirmative vote of holders of a super majority of all classes of the buyer's securities will often be required, even classes not entitled to vote on other matters. In the case of a merger, to give one example, the super majority threshold is generally two thirds.

If the acquisition will leave the buyer's capital structure intact, but the target's business is not permitted by the buyer's Articles of Incorporation, Partnership Agreement or other charter document, the minimum vote required for approval is the vote that would be sufficient to pass an authorizing amendment, usually a simple majority. Because of the widespread use of broadly worded charter documents, the possibility that a specific acquisition may be beyond the current power of the buyer is often overlooked.

In any case, the buyer should provide its owners with all significant information about the acquisition when soliciting their approval. If the buyer has more than a few owners, I recommend that the information be included in a formal proxy statement that accompanies the notice of the meeting. In addition to describing the business purpose, price and terms of the deal, the statement should

explain how the acquisition will change the owners' participation in the earnings, assets and management of the buyer as constituted after the closing.³

While owners can be informed about the acquisition program in general terms from the beginning of the planning process, confidentiality restrictions in Letters of Intent and related preliminary documents entered with a specific target will prevent dissemination of meaningful information while a transaction is being negotiated. Accordingly, full disclosure can rarely be provided until a definitive acquisition contract (which will be subject to all necessary approvals) has been signed. These contracts are complex and their consequences must be explained carefully. Eleventh hour pre-closing attempts to obtain owner approval are procedurally and practically daunting to say the least. Post-closing efforts to obtain owner ratification of a completed transaction are of dubious legality and carry unacceptable risk even if successful. A generous allowance for the disclosure process and owner authorization should be included in the buyer's acquisition timetable from the outset.

When Approval by the Buyer's Owners is not Required – Approval by Owners of the Target

In the absence of special charter or contractual provisions, an acquisition financed solely with internally generated cash or a bank loan will not require approval by the buyer's owners unless the loan is convertible to equity or its creation otherwise has the effect of changing or eliminating rights or preferences of the buyer's outstanding securities. The buyer's board of directors, general partner, or other governing body is usually given statutory or charter document authority to expend cash or borrow money when necessary to carry out the business of the buyer, including business conducted through acquisitive transactions. A rational business decision by such a body will be protected against outside interference or judicial second-guessing if it is made in good faith and on an informed basis. The applicable legal principle is called the "business judgment" rule.

Further, the buyer occasionally can use a newly formed subsidiary to close an acquisition without triggering statutory owner approval requirements that would apply if the buyer purchased the target directly. That possibility is worth investigating in any instance in which approval formalities might otherwise delay or complicate an acquisition program. It will not be feasible, however, unless the

³ The SEC regulation on the subject requires disclosure to security holders of "material" information concerning "those matters about which an average prudent investor ought reasonably to be informed." That standard, while not a model of clarity, is accompanied by detailed guidelines. Public companies are bound to follow them. To ensure that binding approval is obtained, private companies should follow them as well unless the holders of their securities are sophisticated in business and financial matters and have access on their own to all relevant information.

buyer's charter documents authorize the use of a subsidiary to conduct the target's business and either (a) the consideration to be paid for the target is cash, or (b) the target's owners are willing to accept securities of the subsidiary that are neither convertible to nor exchangeable for securities of the buyer itself.

The target must obtain the approval of its owners of any merger or any sale of substantially all of its assets outside of the normal course of its business. The acquisition of a privately held target structured as a purchase or exchange of securities could be closed without observance by the target of statutory formalities if a majority of the target's owners agreed individually to sell their interests to the buyer. In most acquisition contracts, however, the buyer conditions the closing upon the tender to it of interests representing "financial" as well as "operating" control. Operating control (i.e. ownership of 51% of the target's voting securities) confers the right to elect a majority of the target's board of directors or other governing body and thus direct the target's normal business activities. A buyer acquiring financial control (i.e. 67% of the target's voting securities) obtains the additional power to sell the target after the closing, or to commit it to a new acquisition, against the wishes of minority holders.

Separate negotiations with the target's individual owners can be difficult to arrange if the owners are numerous or widely disbursed. The negotiations can also trigger protracted and sometimes acrimonious maneuvering among owner groups. To streamline the negotiations by confining them to the target's management, the buyer can structure the transaction as a statutory sale of assets, a merger or a share exchange. So structured, the transaction must be approved by holders of a minimum 67% of the target's voting securities. If that approval is obtained, however, minority holders who remain opposed need not be dealt with separately, either by the buyer or the target, and they cannot block the closing. Instead, they are granted "dissenters' rights" to be cashed out of their holdings at a judicially determined "fair" price. If the negotiated price is plausibly market based, it will be difficult for dissenters to prove they should be paid more than their ratable share. Obviously, the buyer has also gained financial control of the target.

Approval by Lenders

The question whether the buyer must obtain advance approval of an acquisition from its banks, factors or other lenders does not require independent investigation when the same lenders will provide some or all of the financing. In that context, the lenders will participate in the acquisition planning from the outset. All relevant credit documents can be revised as necessary in a collaborative effort to reach the desired financial model.

When the buyer believes it can finance an acquisition on its own, however, its existing contracts with lenders (and with other secured creditors for that matter) are fruitful sources of trouble if ignored. Standard commercial credit documents uniformly require that the creditor have a senior lien on defined assets belonging to the debtor that collateralize the debtor's repayment obligation. Many such

documents will have been entered by both buyer and target in the normal course of their respective businesses. The acquisition will create competition for a senior lien position in the collateral represented by the assets of those parties after the closing.

If the acquisition is structured as an asset purchase, the target's credit agreements will usually require that its debts be paid at closing unless the creditor consents, expressly and in writing, to an assumption of the debt by the buyer. Buyers wishing to assume indebtedness of the target should address the consent issue as soon as possible. Even buyers with high credit ratings may be asked to pay additional interest or significant transaction fees to induce the creditor to approve the debt assumption.

If the acquisition is structured as a merger or share exchange, considerable confusion can arise as to the precise status of pre-closing credit commitments made by the parties. All such commitments will remain outstanding unless they are satisfied separately. In a merger, unsatisfied obligations incurred prior to closing by the disappearing company will, as a matter of law, become obligations of the surviving company secured by all of the original collateral.

In a share exchange, both parties will survive the closing, but their ongoing operations can be clouded by conflicts between their respective obligations to creditors. Complex inter-creditor agreements must often be negotiated in advance of closing to resolve the conflicts. The negotiations can be disquietingly time consuming for parties with a closing date at hand.

In every case, the buyer must review its own loan and general credit documents before entering the market to be certain that debt limits, financial ratios and other terms they contain are consistent with the financing method proposed for the acquisition. A detailed review should also be conducted of the definitional provisions, representations, warranties and covenants in these documents. For example:

- The definition of the word "borrower" typically includes all subsidiaries and affiliates. An acquired target will thus become a "borrower" subject to the buyer's pre-closing credit documents. A new subsidiary formed by the buyer to affect a closing will suffer the same fate. The buyer, however, may have good reason to separate the post-closing credit arrangements of the acquired business from those associated with the buyer's other operations.

- The definitions of the words "collateral" and "indebtedness" will also be comprehensive sweeping up all assets, liabilities or claims of all parties to the transaction regardless of its structure. The effect can be to alter significantly, sometimes to the point of default, the relationship between the net collateral available to the buyer's lender and the aggregate indebtedness of the target and buyer after the closing.

- Third party “loan,” “security,” or “lien” arrangements must be approved by the buyer's lenders. They will be defined to include all writings or liens evidencing or securing any conceivable financial accommodation granted by or to any party to an acquisition transaction. So-called "negative" covenants will expressly require lender approval of any additional indebtedness incurred by the buyer. These provisions will require lender consent to any form of *seller* financing.

- Even where the express terms of its loan agreements permit the buyer to close an acquisition without prior lender approval, there is usually imposed a separate obligation to maintain specified financial ratios. That obligation can be breached unwittingly by the financial impact of the transaction (e.g., where the target's net current assets do not cover the reduction in the buyer's current ratio caused by its payment of the cash price [or initial cash installment of the price] at closing).

- Term loan and line of credit agreements will require that the buyer warrant on an ongoing basis the continuation of its legal identity and form of organization, the absence of a material adverse change in its financial status, the validity of its outstanding contracts, its ownership of its "properties," and the absence of any material change in its past business practices. All of these warranties can be breached by the buyer's acquisition of the wrong target.

- Finally, the buyer's credit documents invariably will require that it furnish to its lenders detailed information about its business and financial affairs including, obviously, material information about the target. To comply with that obligation, it may be necessary to include the lenders in the acquisition planning process even though no financing will be sought from them.

Most buyers successful enough to consider an acquisition program at all will have a close working relationship with their lenders. Consultation between buyer and lender on all significant financial matters will be routine and ongoing. Nevertheless, a careful review of credit documentation should be part of the initial planning process.

Practical Issues – Bank Financed Acquisitions

Buyers contemplating lender-financed acquisitions should remember that commercial banks are among the most highly leveraged of all business enterprises. Banking executives view the world from the perspective of one whose livelihood depends upon managing the cost of capital. Banks will typically value the assets of the buyer and target on a liquidation rather than a going-concern basis when assessing the collateral pool that will be available to support an acquisition loan. There is no room in the analysis for speculative value or planned business synergies. That can lead to serious disagreements when a buyer is engaged in an aggressive acquisition program motivated by an "up" market and ambitious expansion plans.

Accounts receivable and inventory financing supplemented by term loans on fixed assets are accepted vehicles for funding growth, including growth that is acquisition driven. When buyers apply for acquisition financing, the available collateral sources will be scrutinized rigorously in the normal manner. The quality of the management proposed for the acquired business after the closing, however, will be the most important single factor considered by a commercial lender when determining whether to participate. Selling the lender on management quality depends, among other things, upon the submission of a first-rate and detailed business plan for the acquisition program.

Investigation and Disclosure Issues - Subsidiaries and Divisions:

It can be extraordinarily difficult to identify the assets, liabilities and employees actually associated with a division or subsidiary. Generally loss reserves for these units are established, and financial reporting for them is done, at the parent level. Subsidiaries and divisions usually depend upon their parent's resources for operations and their "earnings" are net of arbitrarily allocated general and administrative expense. Often they will require continued support after the closing until they can become established as stand-alone entities. That may, as a practical matter, make it necessary for the buyer to negotiate contracts for the post closing purchase of products and services by the acquired business from its former parent.

Subsidiaries and divisions are usually sold by sophisticated corporate entities engaged in a divestiture program. While these entities often will help the buyer compile a satisfactory picture of the business to be acquired, they are as reluctant as any seller to disgorge confidential information, or to disclose risks that might not be apparent. Sophisticated sellers and their advisers will submit an acquisition contract and create a negotiating environment that shifts risk to the buyer. The buyer's initial effort to obtain necessary approval from its owners and lenders is made more difficult by this natural tendency.

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