

# Sweat the Small Stuff: Acquisition Agreement Terms to Which Target Companies Should Pay Closer Attention

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In the heat of negotiating the financial terms of an acquisition—the purchase price, earn-outs, the mix of cash and acquirer stock that will constitute the acquisition consideration—a target company's management and its lawyers sometimes neglect a number of important provisions in the acquisition agreement and acquisition-related agreements. Failing to address these matters can result in the target's and its stockholders' disappointment with the target's attorneys and sometimes the acquisition as a whole, even when the target and its stockholders have gotten a good deal.

1. **Ownership of the target's legal files.** Where the acquirer is purchasing the target's entire business, whether by merger, stock sale or asset sale, some thought should be given as to whether the target's acquisition-related legal files should be included in the sale. The acquirer may object to it, but there are two important reasons why the target, either directly (where the target survives the acquisi-

tion as an independent entity) or indirectly (through a stockholder representative or its stockholders), should retain ownership of these files.

First, if established early in the process (*e.g.*, at the letter of intent stage) that the target's successors in interest will retain ownership of the files and that the confidentiality of the target management's communications with the target's lawyers will thereby be preserved, this will promote necessary candor between the target's management and its lawyers to make appropriate disclosures and identify and address significant legal issues during the acquisition process. Second, the target's successors in interest may need the acquisition-related legal files in the event of a

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dispute related to the acquisition agreement, such as a purported breach of the representations and warranties or a disagreement over the interpretation of the terms of an earn-out. The target's successors in interest cannot rely on the discovery process to recover these files. In fact, if the target entity survives the acquisition as a subsidiary of the acquirer, the files may be protected by attorney-client privilege in favor of the post-acquisition target entity! The target should also consider if its successors in interest should retain any legal files not related to the acquisition.

## 2. Selection of the stockholder representative.

Where the target does not survive the acquisition as an independent entity, a stockholder representative is oftentimes designated to look after the interests of the target's stockholders. In fact, the acquisition agreement in such transactions many times gives the stockholder representative the exclusive right to bring action on behalf of the target's stockholders, thereby barring other parties from taking legal action on behalf of the target's stockholders. The role of the stockholder representative is especially important where the acquisition contains an earn-out. It is the stockholder representative's duty to ensure the acquirer fulfills the terms of the earn-out and other post-closing obligations.

The target usually assigns the role of stockholder representative to one or more members of its management or board of directors. It is generally a challenge just finding someone willing to take on the responsibility. However, the process should be one of selecting an individual or individuals best situated to take on the role, bearing in mind that the stockholder representative will need to act quickly and consistently and may sometimes be at odds with the acquirer. Following are some options to consider.

If the target selects multiple individuals to bear the burden of stockholder representative, it can be beneficial to create a corporation or limited liability company owned and managed by such individuals to act as the stockholder representative. Equityholders and management are shielded from the liability of such entities provided that corporate formalities are met. And although acquisition agreements oftentimes release the stockholder representative from liability in fulfilling its obligations as stockholder representative in good faith, the extra liability shield

provided by such an entity can help convince individuals to accept the responsibility of serving as the management of the stockholder representative entity and give them the peace of mind to effectively make decisions. In addition, corporations and LLCs provide a framework for equityholders and management to make decisions. If properly set up, the possibility of deadlock among the equityholders and management of the stockholder representative entity can be minimized.

It can be advantageous to appoint a single individual as the stockholder representative. By doing so, the target does away with the possibility of inaction due to disagreements among multiple individuals, and one would think that an individual stockholder representative should generally be able to make decisions more quickly and consistently than multiple individuals. However, the weight of being the sole individual stockholder representative can be oppressive and may lead to inaction. If opting for an individual stockholder representative, the target needs to choose an individual who has demonstrated the ability to make hard decisions. Note that a single individual can serve as stockholder representative through an entity as well, to take advantage of the liability shield.

Finally, whether the target appoints a single or multiple individuals, and whether these individuals serve as stockholder representative directly or through an entity, the target must anticipate conflicts of interest. Will any such individual be employed by the acquirer post-acquisition? If so, the target must determine whether this conflict will prevent the individual from effectively carrying out his or her duties. What if such an individual later goes on to found a company with technology suspiciously similar to that of the target? The acquisition agreement should contain a mechanism to allow the target's stockholders to replace the stockholder representative generally, including in the event of such a conflict of interest. If the stockholder representative is an entity, the charter documents of the entity should have a mechanism for its stockholders and/or management to be replaced in the event of such a conflict of interest.

## 3. Funding the stockholder representative's activities.

Even if an acquisition closes smoothly, the stockholder representative will incur expenses fol-

lowing the closing in carrying out its duties. Some of these expenses will be basic, such as the costs incurred in exchanging telephone calls, facsimiles and correspondence (including FedEx charges) with stockholders. However, other expenses will be more specialized and more expensive. The stockholder representative will generally need legal services in its continued dealings with the acquirer, to help to respond to stockholders' legal questions and with other acquisition-related matters. It may also need accounting services to prepare or review balance sheets necessary for post-closing consideration adjustments and, if applicable, earn-out metrics. And, in the event of a dispute that leads to litigation, the stockholder representative will need legal, accounting and a myriad of other services.

A portion of the closing consideration should be held back to cover the stockholder representative expenses described above. If applicable, the stockholder representative should be entitled to hold back a portion of the earn-out consideration to cover expenses. In both cases, any unused funds can be remitted to the stockholders. Such provisions are generally included in the acquisition agreement.

In the event of litigation, the stockholder representative will need funding of a much larger magnitude. Whereas \$100,000 might be a generous sum to fund the stockholder representative's other activities, it can constitute a mere drop in the bucket in terms of the costs of a serious litigation matter. In order to address such a possibility, the stockholder representative and the stockholders should enter into a stockholder representative agreement that allows the stockholder representative to draw funds directly from the stockholders. That is not to say that the stockholder representative will have *carte blanche*. A portion of the funding can be guaranteed (*e.g.*, up to \$1,000,000 in the event of litigation related to the acquisition agreement), with additional funding requiring certain conditions or the approval of a majority or supermajority of the stockholders. In addition, where there are some stockholders with small ownership interests, the stockholder representative agreement should give the stockholder representative the option to defer or waive entirely smaller or *de minimis* contributions, lest the stockholder representative end up spending too much of its time chasing after and collecting small checks.

**4. Anticipating the post-acquisition legal needs of the target's successors in interest.** Where the target entity survives the acquisition as a subsidiary of the acquirer, the target's pre-acquisition lawyers continue to owe certain fiduciary duties to the post-acquisition target entity. This is true even when the post-acquisition target entity terminates the engagement of its pre-acquisition lawyers at closing, as is generally the case. However, it is almost always desirable for the target's lawyers to continue to provide some services following the acquisition to the stockholder representative or directly to the target's stockholders. In order to undertake such a representation, the target's successors in interest need to obtain a conflict waiver from the post-acquisition target entity and the acquirer as its parent. Such conflict waivers can be drafted directly into the acquisition agreement. The target should consider this issue prior to closing and arrange to receive necessary conflict waivers from the post-acquisition target entity and the acquirer at closing. In fact, in order to ensure continuity of legal services, it is advisable that the target's successors in interest enter into an engagement letter with the target's pre-acquisition lawyers at closing.

**5. Identifying the escrow agent and negotiating the terms of the escrow agreement.** In many deals, escrow agents are entrusted with paying out the merger consideration to the target's stockholders. However, the escrow agent is generally engaged by the acquirer, and the target and the stockholder representative are oftentimes not made parties to the escrow agreement. In such an arrangement, the escrow agent has very little incentive to provide excellent service to the target's stockholders.

The target should require the acquirer to identify its escrow agent early in the process so that the target can conduct diligence with respect to the escrow agent prior to entering into the acquisition agreement or escrow agreement and make objections to the escrow agent if necessary. Admittedly, it can be difficult to convince an acquirer to change its escrow agent. And it is nearly impossible to negotiate such a change where the acquirer is a public company, part of the acquisition consideration is acquirer stock and the acquirer wants to use the exchange agent for its stock as the escrow agent. The exchange agent is ideally situated to act as escrow agent.

In addition, the target should require that it (where it survives the acquisition as an independent entity), the stockholder representative or someone else with the vested interests of the stockholders be made a party to the escrow agreement and negotiate the escrow agreement so that the target's stockholders are ensured prompt payment of the acquisition consideration. Such prompt payment is particularly important where the target stockholders are receiving registered securities of the acquirer as part of the acquisition consideration. In a volatile market, a few days' delay can result in drastic depreciation of securities' value and materially diminish a stockholder's realized pay out.

**6. Address treatment of employees in the acquisition agreement.** Employees are oftentimes one of the target's most valuable assets. Although the target and acquirer can spend a significant amount of time negotiating the employment, noncompetition and other agreements for key employees, many times very little of the negotiation addresses the rank-and-file employees beyond which are being retained, who will want to know if their compensation and ben-

efits and their day-to-day routines will change. Uncertainty can hurt their morale and productivity.

If possible, the target should ensure that the acquisition agreement covers basic terms regarding the employees, such as: when employees will be notified if they are being retained; how and when retained employees' salaries will be set; what benefits the employees will receive from the acquirer; whether employees will become immediately eligible for such benefits (or if there will instead be a gap in coverage); and what credit, if any, the acquirer will give to the employees with respect to seniority for their service to the target. There are various other steps that can be taken with respect to retained employees to help ensure a smooth transition and maintain morale and productivity, but most of these lie outside the acquisition agreement and are therefore outside the purview of this article.

By addressing the six issues above, a target company's management and its lawyers can help ensure that a good deal does not come to be perceived as a bad one by the target's stockholders.