Perkins Coie

September 23, 2009

TO: Center for Entrepreneurial Studies, Stanford Graduate School of Business

FROM: Perkins Coie LLP

RE: **Summary of Primary Issues in Acquisition Transactions**

This memorandum provides a general overview of some of the primary considerations relating to mergers and acquisitions ("***M&A***") of privately held companies. While this memorandum is intended as a general primer of some of the key terms in M&A transactions, each transaction is unique and is typically highly negotiated. Accordingly, the terms of specific M&A transactions can vary significantly based on a number of variables, including market and industry conditions, the profile of the buyer (e.g., private equity vs. strategic buyers), the tax status of the target entity, the nature of the consideration paid (e.g., cash vs. buyer stock), the availability and terms of debt financing, business-specific risk factors, the number of potential acquirers, regulatory hurdles and bargaining leverage of the parties.

If you have any specific questions regarding the content of this memorandum, please feel free to contact Mark Albert (650-838-4300; malbert@perkinscoie.com) or Jason Schneiderman (650-838-4300; jschneiderman@perkinscoie.com) at Perkins Coie LLP.

I. Form of Transaction

M&A transactions are generally structured in one of three forms: a stock purchase, an asset purchase or a statutory merger. Mergers can take on different forms, such as "forward triangular mergers," "reverse triangular mergers," direct mergers of the target company into the buyer, or "two-step" mergers. Tax and accounting issues often dictate the final structure of these transactions, so it is important to involve tax and accounting advisors early in the structuring process.

A. Stock Purchase

In a stock sale, a target's stockholders sell all or a portion of their ownership interests in the target to a buyer. After the sale, the buyer owns all or a portion of the equity interests of the target, but the target's structure remains unchanged. A buyer might not acquire 100% of the equity interests of the target, but might instead acquire "control"- i.e., at least a majority ownership interest of the target. In this case, the remaining "stub" equity will be held by either legacy stockholders of the target who have opted to "roll over" their shares (often on a tax-free basis) or by a co-equity sponsor.

Acquiring a controlling interest of the target empowers the buyer to elect a majority of the members of the board of directors. The board of directors, in turn, generally maintains control of the target and has the power to make strategic decisions, including the appointment of the target's officers to implement day-to-day decisions.

A target company with a large or fractious stockholder base might not be a good candidate for a stock purchase transaction (which would require all stockholders to sign the definitive agreement as direct parties) as compared to a merger or asset purchase (where minority stockholders can effectively be dragged along).

Some advantages of a stock sale generally include:

- The target's stockholders will generally recognize capital gain treatment on any gain on the sale;
- Net operating losses and tax credits are typically "carried forward" (subject to limitations and exceptions), which may limit the buyer's future tax liability on post-closing income of the target;
- The target's corporate form remains intact, which often minimizes the need for asset transfer documents or consents from third parties; and
- Stock sales can be relatively simple and cost-efficient to consummate.

Some disadvantages of a stock sale generally include:

- The buyer assumes all of the target's liabilities since the target entity remains unchanged (subject to any risk sharing arrangements with the sellers);
- All stockholders of the target must agree to the sale and sign the primary acquisition agreement in order for the buyer to acquire 100% of the target's outstanding stock; and
- The target's tax basis in its assets typically remains unchanged, which minimizes the buyer's ability to take depreciation and amortization deductions based on a (generally) higher, "stepped-up" basis (unless a "Section 338(h)(10)" tax election is available).

B. Asset Purchase

In an asset purchase, a buyer purchases all or substantially all of a target's assets and assumes all or a specified portion of the target's liabilities. If the target is selling only a portion of its assets or one of its divisions or business lines, an asset purchase is usually the optimal form. If the assets sold represent all or substantially all of the target's assets, the target will typically liquidate after the sale, and the proceeds of the sale would be distributed to the target's stockholders.

Some advantages of an asset sale generally include:

- The buyer can "cherry pick" which assets to buy and which liabilities to assume. Any assets not acquired by the buyer or liabilities not assumed by the buyer remain with the seller (subject to various successor liability laws under which a buyer can ultimately be held responsible for liabilities not expressly assumed in acquisition);

- The target's tax basis in the acquired assets will usually be "stepped-up" to current fair market value, which enables the buyer to take greater depreciation and amortization charges against future income post-acquisition;

- The acquisition agreement is entered into between the buyer and the target and the target's stockholders do not need to be direct parties to the agreement; however the buyer sometimes requires certain stockholders to be parties to the definitive agreement so they remain personally liable for post-closing obligations; and

- Minority stockholders can be forced into accepting the asset sale, as the target will typically need approval only from its board of directors and a majority of its stockholders to consummate the transaction.

Some disadvantages of an asset sale generally include:

- Potential negative tax treatment for the target and its stockholders (in part based on potential "double taxation" resulting from the asset sale itself and the subsequent distribution of sale proceeds to the stockholders);

- Net operating losses and tax credits are typically not "carried forward";

- The target's binding agreements sometimes include anti-assignment provisions that prohibit assignment of such agreements without the consent of the other party to such agreements;

- Certain material assets of the target may require special transfer procedures in order to effect an enforceable assignment (e.g., registered intellectual property and certain types of equipment); and

- It is generally more expensive to consummate an asset sale as compared to a stock purchase.

C. Statutory Merger

In a statutory merger, two or more entities merge into one entity, and the stock held by the target's stockholders converts into the right to receive a portion of the merger consideration from the buyer (or its parent company). After the merger, the "surviving corporation" of the merger inherits all of each merged company's assets, liabilities and commitments. To effect a merger, the parties must file a merger certificate with the applicable state office.

The structure of a merger as a "reverse merger" (where the target corporation survives the merger) or a "forward merger" (where the acquiring entity or its subsidiary survives the merger) is especially significant for tax purposes. A reverse merger is generally treated as a stock purchase for tax purposes, whereas a forward merger is generally treated as an asset purchase for tax purposes.

Some advantages of a merger generally include:

- In the case of a reverse merger, the target's stockholders will generally recognize capital gain treatment on any gain on the sale;

- The merger agreement is entered into between the buyer and the target, and the target's stockholders do not need to be direct parties to the agreement; however, the buyer sometimes requires certain stockholders to be parties to the merger agreement so they remain personally liable for post-closing obligations;

- The target will typically only need approval from its board of directors and a majority of its stockholders to consummate the merger;

- Unlike a stock sale (unless all stockholders agree to the sale), upon consummation of a merger, the buyer will obtain 100% ownership of the target; and

- Depending on the form of merger, there may be no change in corporate form of the target, which minimizes the need for asset transfer documents or consents from third parties.

Some disadvantages of a merger generally include:

- The buyer assumes all of the target's liabilities (subject to any risk sharing arrangements with the selling stockholders);

- In a reverse merger, the target's tax basis in its assets typically remains unchanged, which minimizes the buyer's ability to take depreciation and amortization charges based on a higher, "stepped-up" basis in assets; and

- Mergers are generally more complex and expensive to consummate as compared to stock sales.

II. Primary Issues in Acquisition Transactions

Regardless of the form of transaction, most acquisition transactions will include the following discussion points:

A. Purchase Price

The form of consideration payable by the buyer typically consists of either cash, stock of buyer or its parent (either common or preferred), debt instruments (so-called "seller notes"), earnouts, the assumption of specified liabilities or a combination of the foregoing. If all or a portion of the consideration is payable in stock, a number of other issues must be addressed by the parties, including, among others, tax considerations, liquidation preferences, voting rights, transfer restrictions, dilution issues and compliance with federal and state securities laws. It is important to fully explore the tax and accounting issues relating to the form of consideration payable in the transaction to maximize the tax and accounting benefits to both the buyer and the seller.

B. Earnouts

In many instances where a buyer and seller are unable to agree on a definitive purchase price for the acquisition, an earnout can be used to bridge the gap between the seller's perceived value of the business and the amount the buyer is willing to pay. An earnout is a future payment obligation by a buyer to the seller contingent upon the achievement of specified milestones during a specified post-closing period. Earnout payments are frequently based upon hitting future revenue, EBITDA or net income targets, the successful launch/development of future products, the satisfaction of certain customer acquisition targets or the satisfaction of other critical business metrics. Earnouts can be one of the most intensely negotiated aspects of M&A transactions. Tensions between a buyer and a seller that naturally emanate from the nature of the earnout can expose the parties to significant risk of a post-closing dispute regarding, among other things, (1) whether the buyer operated the business appropriately in order to reach the agreed-upon milestones, (2) whether the buyer invested sufficient funds to accomplish the targeted business objectives; or (3) whether the applicable financial line items were properly calculated. Accordingly, great care should be taken in structuring and negotiating earnout provisions.

C. Purchase Price Adjustments

In arriving at a proposed purchase price, a buyer generally makes certain assumptions regarding the target's business, financial condition and operating results and may require a purchase price adjustment if those assumptions prove to be inaccurate. Many purchase price adjustments are reciprocal and can therefore work to the seller's benefit and increase the purchase price if actual results of the target exceed the buyer's assumptions. Common purchase price adjustments include net working capital, net worth, net income, operating revenues, EBITDA and net financial debt. Purchase price adjustments can also include a "window" – a range of closing values such that if the actual item subject to measurement falls within the range, no adjustment is made – or "caps," "collars" and "floors." Additionally, purchase price adjustments may involve known areas of potential liability, such as environmental clean-up issues or pending litigation.

D. Representations and Warranties

In virtually all M&A transactions, the target (and/or its stockholders) will make a series of representations and warranties to the buyer with respect to virtually every aspect of the target's business. Such representations and warranties generally include, among other customized representations based upon a particular transaction: (1) representations relating to a party's ability to consummate the transaction (Organization, Existence and Good Standing, Power and Authority, Enforceability, No Conflicts, Required Consents, etc.); (2) financial representations (Financial Statements, Bank Accounts, Inventory, Accounts Receivable, Fixed Assets, No Undisclosed Liabilities, etc.); (3) business representations (Customers, Suppliers, Distributors, Subsidiaries, Brokers, Capitalization, Full Disclosure, Sufficiency of Assets, Intellectual Property, Insurance, Related Party Transactions, Litigation, Product Liability, Product Warranties, etc.); (4) representations relating to legal compliance (Compliance with Laws, Required Permits and Licenses, Tax, ERISA, Environmental, Labor, etc.); (5) representations relating to contracts, leases and real property; and (6) representations relating to material changes in the target's business (MAC clauses, Changes from the Date of the Last Financial Statements, etc.).

The representations and warranties generally serve three purposes: (1) they provide disclosure to the buyer with respect to the historical performance and operations, current status and forward-looking risks of the target's business; (2) they provide the buyer with the ability to terminate the transaction if something is uncovered through disclosure that makes the representations and warranties materially false; and (3) they provide the buyer with a basis to make indemnification claims against the target and/or its stockholders after the consummation of the transaction based on an inaccuracy of the representations and warranties.

Representations and warranties are generally drafted in absolute statements that various aspects of the target's business do not exist. Such representations and warranties are then supplemented and qualified by the target in a schedule delivered to the buyer at signing (commonly referred to as a "disclosure schedule"). These disclosures are deemed exceptions to the target's representations and warranties. This process ensures that any disclosed item will not be subject to a post-closing indemnification claim by the buyer, because the disclosed exception renders the related representation true. A disclosure schedule would typically include (1) lists of items being purchased/assumed by the buyer (such as the tangible assets, accounts receivable (with aging) and intellectual property owned by the target, the current capitalization of the target by specific equity holder, a list of contracts binding on the target, a list of the current employees of the target (together with their start dates, current salaries, severance obligations, etc.), a list of the current customers, suppliers and/or distributors of the target, a list of the permits and/or licensees necessary to operate the target's business, a list of the current insurance policies and coverages maintained by the target, a list of the liabilities of the target not disclosed in the financial statements, etc.); and (2) any general exceptions to the representations and warranties (such as pending or threatened litigation, environmental or tax issues, termination of current relationships, disclosure of related party transactions, uncollectible receivables or unsalable inventory, etc.).

Representations and warranties are usually heavily negotiated because they determine (1) the level of disclosure the target is obligated to provide to the buyer; (2) the buyer's ability to terminate the transaction; and (3) post-closing remedies of the buyer against the target and/or its stockholders.

E. Indemnification

Subject to certain negotiated limitations, the target and/or its stockholders will generally be required to indemnify the buyer for the target's operation of its business prior to closing to the extent that items are not disclosed to the buyer in the disclosure schedule. The primary purpose of indemnification is to allocate the risk between the seller (and/or its stockholders) and the buyer for pre-closing items of the target's business that were either not disclosed to the buyer in the disclosure schedule or are known liabilities for which the target and/or its stockholders have agreed to retain responsibility (so-called "Specific Indemnities").

Some of the most common limitations to the target's indemnification obligations include:

1. Baskets and Thresholds

In broad terms, a basket or threshold is a specified amount of damages that must be accrued before the buyer can make an indemnification claim. Baskets and thresholds generally ensure that the buyer will not "nickel and dime" the target and its stockholders for small claims that are uncovered post-closing. Specific examples of baskets and thresholds include (a) limitations on claims under a specific dollar amount that will never be subject to indemnification (a so-called "per-claim threshold"); (b) an aggregate amount that will never be subject to indemnification claims (a so-called "true threshold"); or (c) an aggregate amount that all claims must exceed before an indemnification claim can be made, but which allows the buyer to recover for all damages once that amount is surpassed (a so-called "tipping basket").

2. Caps

A cap is a specified maximum exposure for indemnification claims. Purchase agreements will sometimes include different caps for different types of claims depending on the importance of the specific item to the buyer. For example, if the buyer is purchasing a software business, a claim relating to ownership of intellectual property may have a larger cap than other representations. Additionally, other types of claims will sometimes not be subject to a cap, such as breaches of representations relating to the target's ability to consummate the transaction, the capitalization of the target in a stock sale or merger transaction or claims relating to taxes. Other items may be "carved out" of a cap or other indemnification limitations, such as breaches of post-closing covenants (covenants not-to-compete, non-solicitation provisions, use of intellectual property, confidentiality provisions, etc.) or liabilities relating to specific identified disclosures in the disclosure schedule (pending lawsuits, environmental clean-up matters, payment of specified liabilities, etc.).

3. Security for Indemnification Claims: Escrows, Holdback and Offsets

In most transactions, a target will have no assets after the closing or will be owned by the buyer. In either case, the buyer's ability to obtain payment for indemnification claims can be severely limited. Additionally, the target's stockholders usually attempt to minimize their personal liability to the buyer following the closing.

To provide the buyer with security for payments of indemnification claims and to limit the target's (and/or its stockholders') exposure to the buyer following the closing, in many transactions, a portion of the purchase price will not be paid to the target (or its stockholders) at the closing and will either be "held back" by the buyer or placed in escrow with an independent third party (typically a bank) for a specified period of time after closing. The escrow or holdback can be structured as the buyer's exclusive source of funds for indemnification payments or a non-exclusive source, in which case the buyer would preserve recourse directly against the target or its stockholders once the escrow or holdback is fully tapped or liquidated.

In transactions that include an earnout payment or a seller note, the buyer will often negotiate the right to offset payments under such seller note or earnout payment obligations against accrued indemnification obligations.

4. Survival

In most transactions, the parties' representations and warranties expire after a specified period of time, and claims for indemnification due to breaches of representations and warranties must be made prior to the date of expiration. This negotiated period of time for the buyer to make indemnification claims attempts to give the target and/or its stockholders some "peace of mind" that they will not remain liable for pre-closing liabilities indefinitely, while providing the buyer with a reasonable period of time to uncover potential claims of the acquired business.

In most transactions, the buyer will often demand that representations and warranties survive for a minimum of 1-2 years so it will have sufficient time to uncover any undisclosed liabilities or other issues within the target's business. Additionally, there are sometimes different survival periods for different types of representations and warranties depending on the importance of the specific representation to the buyer. For example, in a stock sale or a merger transaction, knowing the current capitalization of the target is vital to properly calculating and allocating the purchase price among the target's stockholders. Representations and warranties relating to capitalization would therefore typically survive until former stockholders of the target would no longer have a claim against the buyer for a greater allocation of the purchase price. Other representations and warranties that typically have a longer survival period include representations relating to taxes, the target's ability to consummate the transaction, intellectual property where the acquired business heavily relies on this asset, and representations that are extremely important to a particular transaction (ERISA risks, environmental risks, permit and licensing issues, warranty and/or product liability issues, etc.).

F. Covenants

Some M&A transactions are structured as "simultaneous sign and close" transactions where the parties sign the definitive agreement and close the transaction on the same day. In many instances, however, there is a period of time between the signing and closing to, among other things, allow the buyer, the target and the stockholders of the target to accomplish certain items after the parties enter into a binding agreement but prior to closing. Examples include obtaining third-party consents or governmental approvals, securing funding for the purchase price and obtaining stockholder approval of the transaction. During this interim period, a buyer will want to ensure that the target continues to operate its business in the same manner as it was operated prior to signing, and both parties will want to ensure that the various items that need to be accomplished prior to closing are accomplished in a timely manner. To protect against these items, both parties will agree to certain covenants relating to what should and should not happen during this interim period.

Additionally, acquisition agreements contain various post-closing obligations of the parties, such as, non-competition and non-solicitation agreements, confidentiality obligations, use of intellectual property, handling of employment related matters, transfer of various assets, access to information, filing of tax returns and related tax matters, etc.

G. Closing Conditions

In addition to negotiating the primary acquisition agreement, there are a number of other items that typically must be agreed upon and accomplished prior to the closing. These items are typically conditions to the closing of the acquisition and often include (1) entering into employment agreements and/or non-competition agreements with the key employees of the target; (2) entering into other strategic agreements, such as supply agreements, distribution agreements, manufacturing agreements, real property leases, license agreements, service agreements, stockholder agreements, registration rights agreements, etc.; (3) obtaining assignment of material contracts; (4) resolving specific concerns with respect to the target's business, such as the resolution of litigation or specifically identified liabilities; (5) paying or assigning bank debt; (6) securing financing necessary to fund the purchase price; and (7) obtaining necessary government approvals.

If any closing conditions are not satisfied (or waived) by a specified date, the party who had the benefit of the closing condition would have the right to terminate the agreement.

H. Legal Fees

In many instances, each party will bear the cost of their legal fees, but in some cases, the buyer will agree to pay all or a portion of the legal and related fees and expenses of the target if the transaction is completed. In a merger, where the buyer will own the target after the transaction is consummated, the buyer frequently requires the stockholders of the target to pay for the target's legal costs and expenses.

IRS CIRCULAR 230 DISCLOSURE: To ensure compliance with Treasury Department and IRS regulations, we inform you that, unless expressly indicated otherwise, any federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties that may be imposed under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein (or any attachments).