Langdon T. Owen, Jr.[1]
Cohne Kinghorn, P.C.
Phone: (801) 363-4300
Email: lowen@cohnekinghorn.com

STRUCTURING THE ACQUISITION OF A BUSINESS

1. Typical forms of Transactions.

There are four basic forms of corporate transactions:

- Taxable sale of assets
- Taxable sale of stock
- Tax deferred reorganization for assets
- Tax deferred reorganization for stock.

For partnership taxed organizations, there are no tax deferred reorganizations, but there are these typical useful forms of transactions:

- Taxable sale of assets
- Taxable sale of interests
- Mergers
- Liquidations.

Whether in the corporate or partnership taxed worlds, the forms of transactions are either focused on assets or company interests (e.g., stock or membership interests). Each form of transaction has its own tax results which will be discussed in the tax section of the program. Each form of transaction has its own non-tax issues as well which will drive the structuring of the deal. The tax results between corporate and partnership taxed organizations can be dramatically different; however, many of the non-tax issues arise for any sort of acquisition transaction. We will generally use corporate examples in dealing with such non-tax structuring issues.

The two biggest issues in transaction structuring are tax results and liability and risk reduction, with various sub-components relating to each issue. There are other issues beyond these big two, such as regulatory concerns, shareholder or member rights, etc., although many of these could be classified as liability and risk reduction. We will review a number of the significant structuring concerns.

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2. The Starting Place. The starting place for analyzing any potential acquisition transaction is with the primary focus of the forms of transactions – assets or company interests – and then on the liabilities and risks involved. Other factors which may destroy the transaction or significantly affect its structure will need to be analyzed as well.

a. Assets. What kind of assets are in the target organization? Are there many parcels of land in many states? Are there many titled vehicles in many states? Are there hard to transfer assets such as contract rights with limits on transferability? The practical problems in such situations may push the transaction toward a transaction involving company interests (e.g., stock purchase, merger, stock for stock reorganization).

b. Interests. Are there large numbers of stockholders or members? Is 100% ownership desired by the acquirer? If so, a direct stock or interest purchase may be out of the question as a practical matter, and some form of asset purchase, merger, or partial stock acquisition followed by a freeze out merger may be the direction the transaction will take.

c. Liabilities and Risks. What sorts of liabilities does or may the target have? Contingent environmental obligations, product liability, tax audits or aggressive tax positions, labor issues (ERISA, Fair Labor Standard Act, union representation, discrimination, etc.), lawsuits or threats of them, unfunded pension obligations, burdensome agreements (e.g., debt covenants), intellectual property issues, disgruntled stockholders or unclear ownership of interests, etc., all raise issues which will tend to favor an asset based transaction for the acquirer. However, even if the acquisition is of assets, for some legal issues the acquirer may still be treated as a successor to the target and at risk for certain liabilities under common law theories of de facto merger or successor liability, especially when a going business is acquired and the target company ceases to operate, and even more especially (as an added factor) when the target's interest owners receive equity interests in the acquirer. See 63 Am. Jur.2d Products Liability §§119 et seq.; 19 Am. Jur.2d Corporations § 2319 et seq. There are various employment related statutes providing for successor responsibilities in some circumstances, e.g., 29 USC §2611(4)(A)(ii)(II) (under FMLA, the employer may include a successor in interest). See Annotation, Liability under Title VII of Civil Rights Act of 1964 (42 USC §§ 2000 et seq.) of employer as successor employer for discriminatory employment practices of predecessor, 67 ALR Fed. 806. In such cases a transaction using a subsidiary of the acquirer may be useful. On the other hand, if stock or interests are acquired, those same liabilities, and others, certainly will remain with the company and thus the risks will fall to the acquirer indirectly (but not directly) through possible loss of the acquired company's value. With a merger, the acquirer will become responsible directly (see UCA § 16-10a-1106(c)), thus a merger using a subsidiary may be desired. Even with using subsidiaries to isolate risk, the indirect risk of loss of investment value will remain.

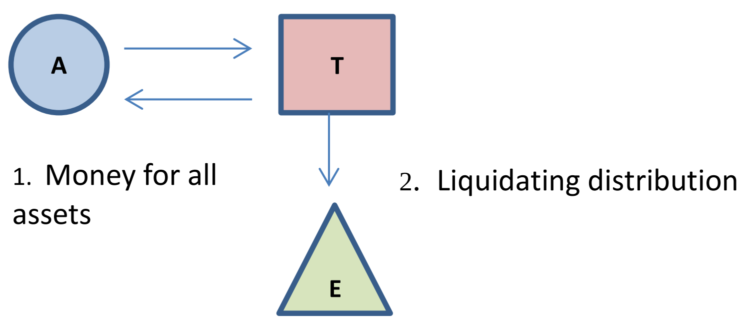
Further, bulk sale act (UCC Article 6) rules (in some states, but not Utah) may affect the structure of an asset transaction. Fraudulent transfer (see UCA § 25-6-1 et seq.) issues will create risks in some leveraged transactions such as where the company pledges its assets to secure an acquisition of its stock, or an affiliate of an acquirer pledges its assets for an acquisition being conducted by another affiliate; in such cases one needs to analyze, among other things, the potential effect of the transaction on creditors of the pledger.

d. Other Factors. Of course, if potential liability exposure is too much, the transaction itself may not be wise for an acquirer. Other issues which also may destroy or alter a transaction, however structured, include antitrust violations, failure of required regulatory or foreign government approvals, significant anti-change in control covenants (e.g., in loans, franchise agreements, major customer or vendor agreements, leases, etc.), and company provisions to prevent takeovers ("shark repellants") or transfers (e.g., small company buy-sell agreements). Even if such matters do not destroy the transaction, they may significantly determine the terms of the transaction. Structures of transactions may also be affected by accounting rules, state and federal securities law requirements (proxies, tender offers, registration or exemption, disclosures to investors, resale restrictions, etc.), sales taxes and other state transfer taxes, state law transaction authorization rules and dissenters' rights, and similar matters. For example, there may be fewer state law concerns in obtaining target shareholder consents where the target is the surviving corporation, so a "reverse" merger may be used.

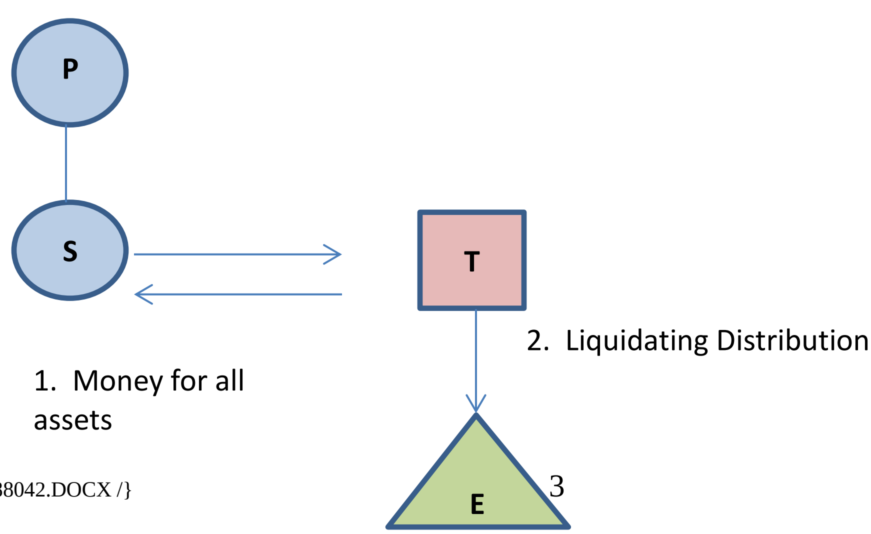
3. Some Structures to Consider. Let's look at some potential transactional structures often used in acquisition transactions. In the following charts the target company (for interests or assets) is "T"; the acquirer may be labeled "A" if affiliates are not involved or "P" for parent and "S" for subsidiary if affiliates are involved. "E" means equity holders in target.

a. Asset Purchase.

Direct:

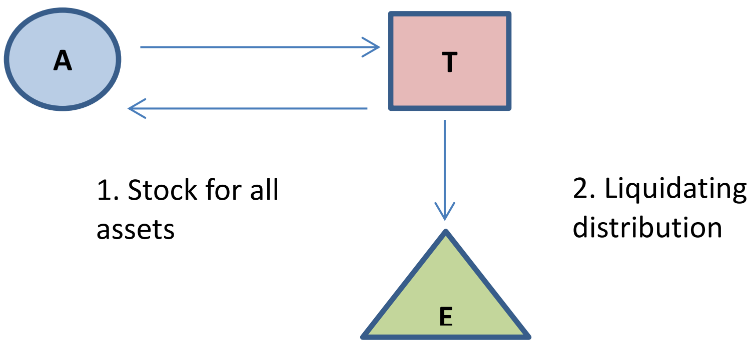


Subsidiary:

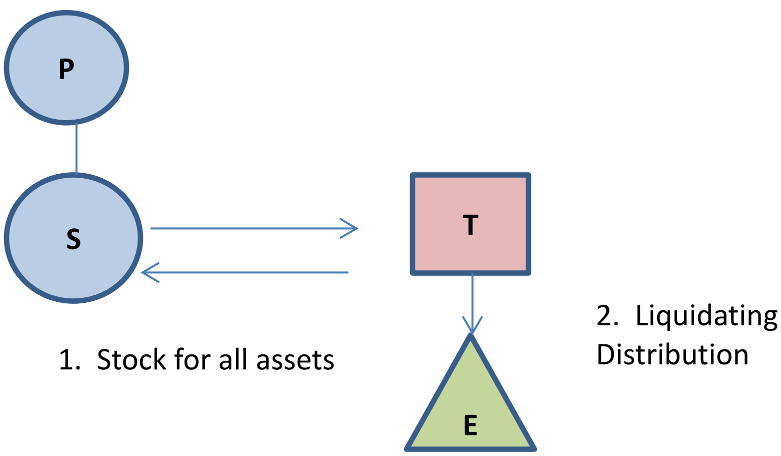


b. <u>Stock for Asset C-Reorgnization</u>

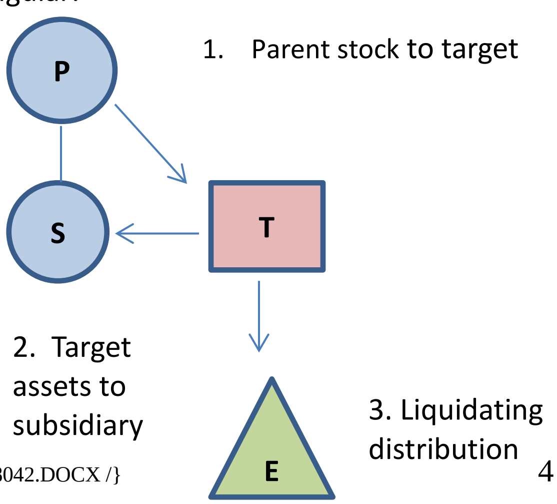
Direct:



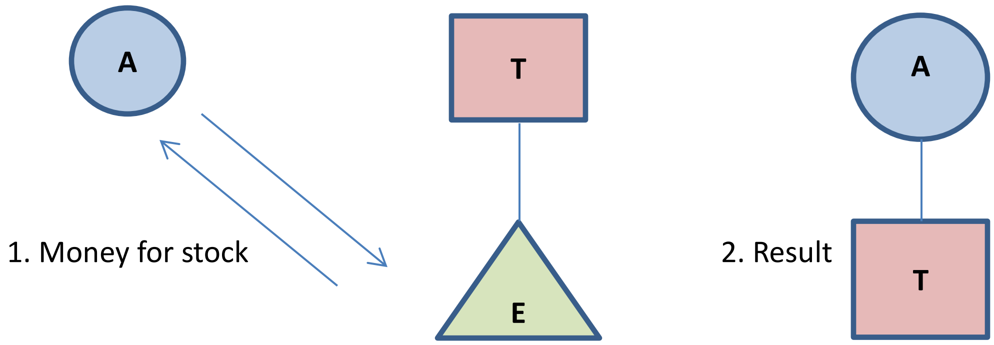
Subsidiary:



Triangular:

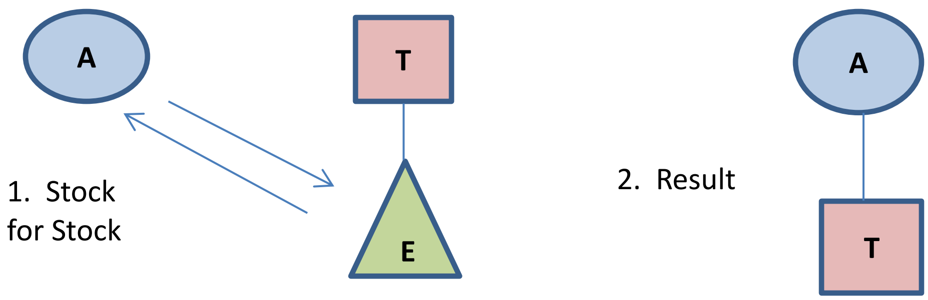


c. <u>Stock Purchase.</u>

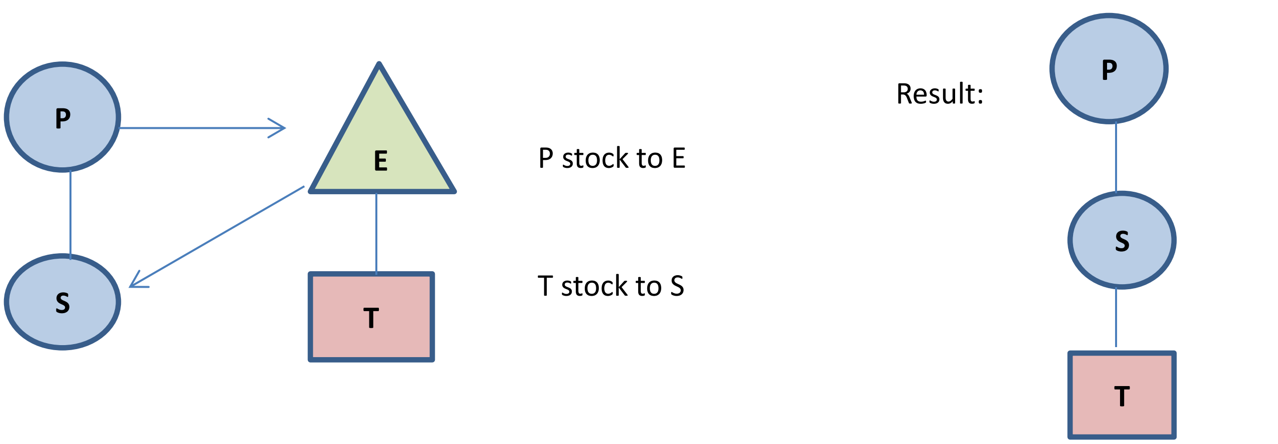


d. <u>Stock for Stock B-Reorganization.</u>

Direct:



Triangular:



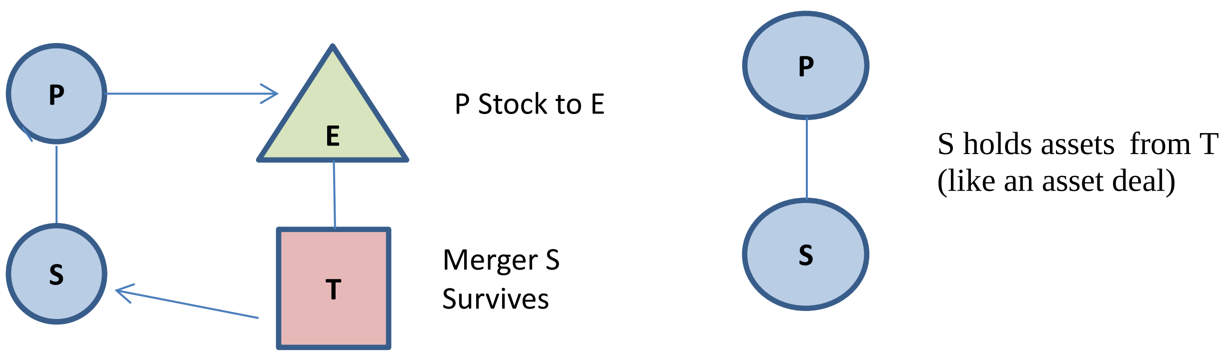
e. <u>Merger</u>

Direct:

2. Result:

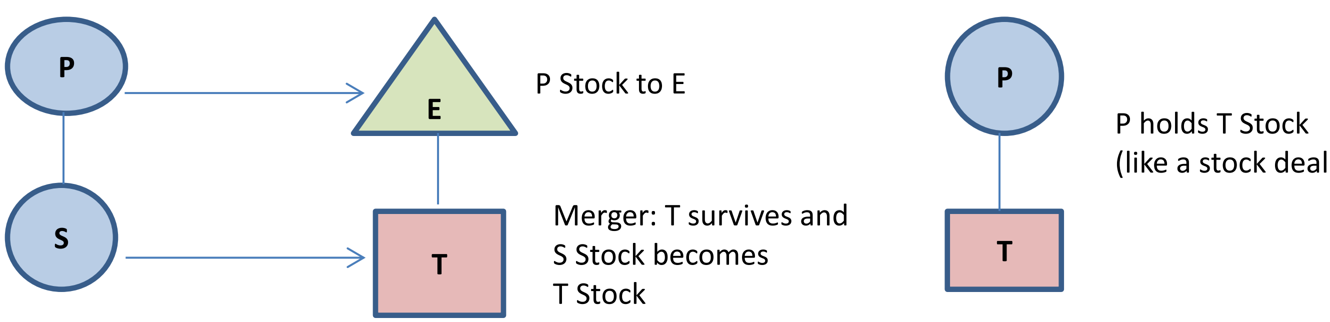
Forward Triangular:

Result:

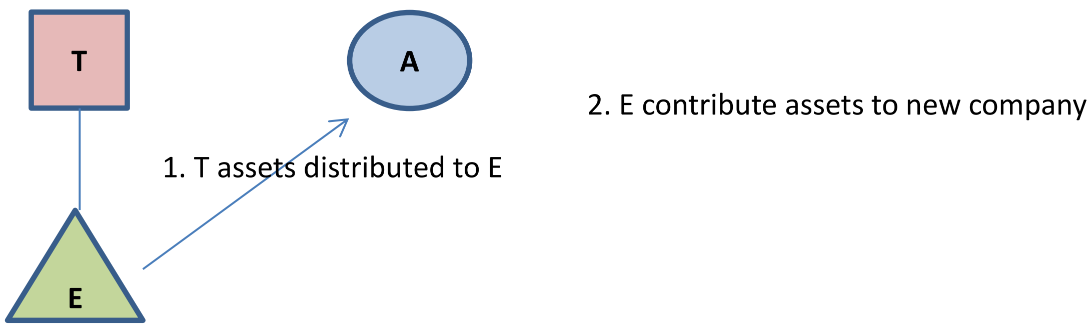


Reverse Triangular:

Result:

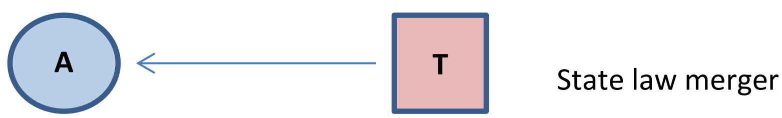


f. LLC Assets- Up Form of Merger.

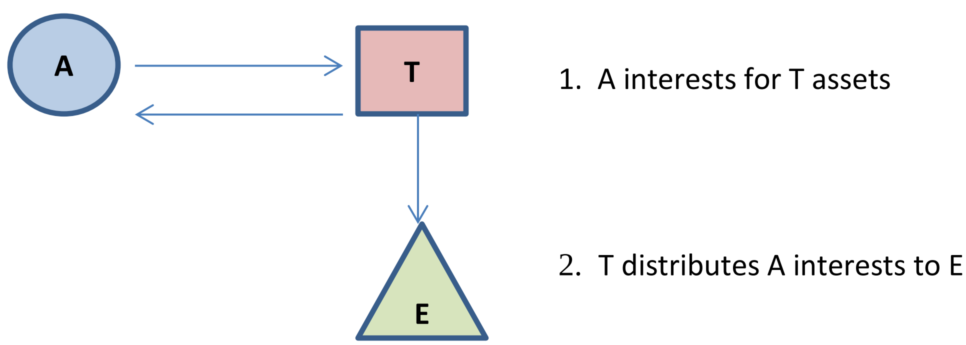


g. LLC assets – Over Forms of Merger.

Plain Merger:

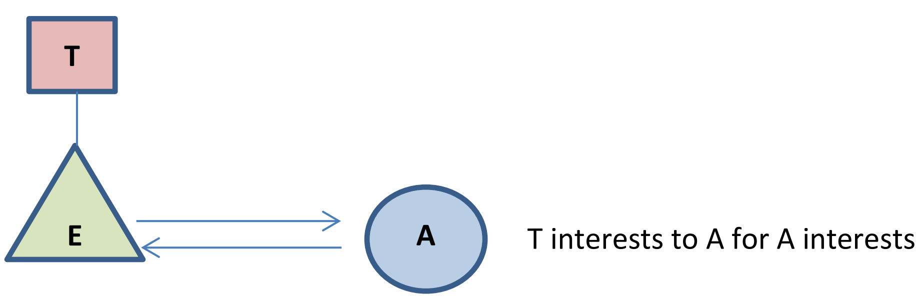


True Assets Over:

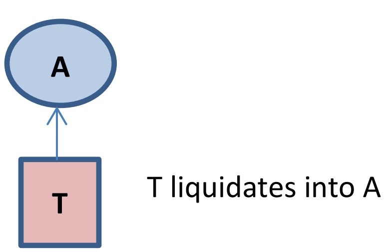


Interests – Over:

1.



2.



4. Corporate Approval Requirements. The rules for the state of incorporation of each party to the transaction will need to be consulted; but we will focus here on Utah law.

a. Merger. Generally, the board of directors of each merging party adopts the plan of merger and the shareholders of each merging party approve it. UCA§16-10a-1101(1), and 16-10a-1103(1).

i. Exception for Survivor. There is an exception to the requirement for shareholder consent where the surviving corporation's articles stay essentially the same, the old shareholders of the survivor remain holders of shares of the same number, class, etc., and the voting shares or participating shares of the survivor do not increase by more than 20%. UCA §16-10a-1104(7) and (8). This is sometimes referred to as a "short form" merger.

ii. 90% Subsidiary Merger. Also, a merger up into a parent of a 90% (of each class) held subsidiary of that parent does not require the vote of the subsidiary's shareholders. Subsidiary shareholder consent is also not needed for the parent merging down into such a 90% held subsidiary. UCA §§16-10a-1103(1) and 1104. However, if the parent does not survive, as in the merging down into the subsidiary, the parent's shareholders need to consent. If the parent survives, as in the merger up of the subsidiary, the short form merger test of UCA §16-10a-1104(7) (i.e., not more than 20% of additional shares, etc.) may apply to remove the need for the consent of the parent's shareholders, but if these tests are not met, shareholder consent is needed. UCA §16-10a-1104(2) and (3).

b. Share Exchange. A plan of share exchange has basic approval requirements somewhat similar to a merger. In a share exchange one corporation requires all of the outstanding shares of one or more classes of one or more other corporations, for shares, obligations, or other securities of the acquiring or some other corporation, or for money or other property in whole or in part. UCA §16-10a-1102. Generally, the board of the target corporation adopts the plan and the target's shareholders approve it. Note, the acquirer needs no such shareholder approval; board approval is sufficient for the acquirer. Even for the target, shareholder consent need not be obtained if so provided in the plan of share exchange. UCA§16-10a-1103(1)(c).

c. Sale of Assets. Board approval is all that is needed (i.e., no shareholder consents unless specially required in the articles) to sell, lease, exchange, or dispose of all or substantially all assets in the ordinary course, or to mortgage or grant security interests in any or all assets whether or not in the ordinary course, or to transfer any or all assets to a corporation of which it owns all shares (i.e., a drop down). UCA § 16-10a-1201. If, however, the sale, lease, exchange, or disposition of all or substantially all assets is not in the ordinary course, then in addition to board approval, shareholder approval is also required. There is an exception for such a sale under a court order. UCA § 16-10a-1202(1). The shareholder consent requirement also applies to require the consent of a parent corporation's shareholders where the assets of a controlled subsidiary (whether a corporation or some other entity) are sold and the subsidiary's stock (or other interests) constitutes all or substantially all of the parent's property. UCA §16-10a-1202(2). Control is defined at UCA § 16-10a-102(a) to mean the direct or indirect possession of the power to direct or cause the direction of the management and policies of an entity, whether through ownership of voting shares, by contract, or otherwise.

d. General. The articles of incorporation could require shareholder consent even where not otherwise required by statute. Where shareholder consent is needed, special notice of the transaction must be given. UCA §§16-10a-1104(4) (merger or share exchange), 16-10a-1202(5) (asset transaction). Generally, unless the articles, bylaws, or board requires a greater vote, a majority is generally sufficient. However, a voting by required voting groups (e.g., classes) may be required where in a merger the plan amends the articles in a way otherwise requiring separate voting group approval, and in a share exchange by each class of shares included in the exchange, and in an asset transaction by each voting group entitled to vote. UCA §§16-10a-1103(6) and 1202(6). The transaction may be conditioned by the board in any manner. UCA §§ 16-10a-1103(3) (merger or share exchange) 1202(4) (asset transaction).

e. Dissenters' Rights. Whether or not entitled to vote, a shareholder is entitled to use the dissenter rights provisions of UCA §§16-10a-1301 through 1331 to obtain the fair value of the shareholder's shares in any of the transactions listed below (UCA §16-10a-1302), but where such dissenters' rights apply, the shareholder may not challenge the corporate action unless it was unlawful or fraudulent as to the shareholder or the corporation. The transactions subject to dissenters' rights are:

i. Merger. A merger where shareholder approval is required by statute (UCA §16-10a-1103) or by the articles will give rise to dissenters' rights as to any corporation the shareholders of which must consent.

ii. Subsidiary into Parent. Where a subsidiary corporation is merged up into its parent (under UCA §16-10a-1104), the shareholders of the subsidiary will have dissenters' rights.

iii. Asset Transaction. The target shareholders in an asset transaction have dissenters' rights where shareholder vote is required (UCA §16-10a-1202(1)). However, no dissenter rights arise if the sale is for cash and substantially all net proceeds will be distributed to the shareholders within one year after the sale.

iv. Assets of Subsidiary Transaction. If the property of a controlled entity is sold where the entity interests are substantially all the assets of a parent (UCA §16-10a-1202(2)) and the parents' shareholders are entitled to vote on the disposition, the parents' shareholders will have dissenters' rights.

v. Special Grants of Rights. If any corporate action occurs which under the articles, bylaws, or board resolution is subject to dissenters' rights, then dissenters' rights apply. These rights apply even if the more general exception relating to publicly traded or widely held (more than 2,000 shareholders) would have applied to eliminate dissenters' rights. (See UCA §16-10a-1302(3) and (4) for the publicly or widely traded exception).

f. Control Share Acquisition. Utah has a Control Shares Acquisition Act (UCA § 61-6-1 et seq.) pursuant to which an acquirer of at least one- fifth of an issuing public corporation's shares generally obtains the voting rights of those shares only with the consent of the holders of a majority of the other disinterested shares of the corporation, voting by voting groups or classes. See, UCA § 61-6-10. The result is that control can be acquired only with the consent of pre-existing disinterested shareholders. The acquirer and affiliates, an officer of the corporation, or an employee of the corporation who is also a director of it, generally all hold "interested" shares and cannot vote to grant votes to the acquirer. UCA § 61-6-4.

There are exceptions to the applicability of these provisions, notably including an acquisition through a plan of merger or share exchange or through a sale of property under the corporate code, UCA §§ 16-10a-1101 through 1107 (merger or share exchange) or §§ 16-10a-1201 and 1202 (sale of property – i.e., an asset acquisition). Thus, the control share act generally applies to tender offers or purchases from one or more existing shareholders. The corporation may opt out of the control share Act under provisions of its articles or bylaws adopted prior to the control share acquisition. UCA § 61-6-6. Also, acquisitions by such means as descent and distribution, security interest foreclosures, and direct issuances by the corporation are excluded. UCA § 61-6-3(4) and (5).

The Act only applies to issuing public corporations which are defined as Utah corporations (other than depository institutions) with (i) 100 or more shareholders, (ii) its principal place of business, principal office, or substantial assets in Utah, and (iii) more than 10% of its shareholders residing in Utah, or more than 10% of its shares being owned by Utah residents, or 10,000 shareholders in Utah. Thus, one holder, out of 100 total shareholders, who resides in Utah and holds 10% of 100 shares, could be sufficient to cause the Act to apply. However, it is relatively rare that the Act will apply to private sales of businesses.

If the acquired control shares acquire voting rights, and the acquirer obtains a majority of voting power, all shareholders of the issuing corporation obtain dissenter's rights at "fair value, meaning the highest price paid per share by the acquiring person in the control share acquisition. Shares acquired in 90 days or pursuant to a plan to make a control share acquisition are part of the same acquisition. UCA § 61-6-3(2).

The control shares acquired might be redeemed by the corporation at fair value market (not the same as "fair value") under certain conditions. If prior to the acquisition the corporation's articles or bylaws already authorize it, the control shares may be redeemed before a required acquiring person statement (UCA § 61-6-7) has been filed with the corporation; after such a statement has been filed, the redemption can only be made if the shares are not accorded voting rights.

5. Limited Liability Company Approval Requirements. Whether the limited liability company is manager managed or member managed, any merger, interest exchange, conversion, domestication, or action outside the ordinary course of the activities and affairs of the company generally will require the consent of all members. UCA §§48-3a-407(2)(d) and (e), and (3)(c). The consent requirements under the specific provisions dealing with mergers (UCA §48-3a-1023(1)(a)), interest exchanges (UCA §48-3a-1033(1)(a)), conversions (UCA §48-3a-

1043(1)(a)), and domestication (UCA §48-3a-1053(1)(a)) are generally parallel and each parallel section states that the plan will not be effective unless it has been approved "by all the members entitled to vote on or consent to any matter." Presumably which members are entitled to vote or consent will be part of the operating agreement, which, as we will see, can vary the unanimous consent requirement; thus the apparent inconsistency between the unanimous consent requirements of UCA §48-3a-407 and the "entitled to vote or consent on any matter" wording of these specific provisions, might be reconciled if voting provisions, such as establishing a non-voting class of interest, are treated as varying the otherwise applicable statutory transaction consent requirement.

a. Unanimity Need Not Apply. Subsections (1)(b) of the foregoing parallel sections dealing with transaction approval for mergers, interest exchanges, etc., deal with provisions by which a member will have interest holder liability after the transaction. The operating agreement may not vary the right of a member that will have such interest holder liability (defined at UCA §48-3a-1001(19) as personal liability solely by reason of status as an interest holder or by the organic rules of the entity) to approve by a record (e.g., in writing) any such transaction under subsections (1)(b) (note: not (1)(a)). UCA §48-3a-112(m). (Note: operating agreements otherwise need not be in writing or in a record; UCA §48-3a-102(16)). However, such subsections concerning approval of the specified forms of transaction, go on to provide that the operating agreement in a record may provide for consent by fewer than all the members. Thus the member, in order to be subject to the interest liability, must itself consent in writing (i.e., in a "record") to it and, if fewer than all members are required, such provision must be in writing (i.e., in a "record").

The general requirement of unanimity for approval of these transactions may be varied by an operating agreement, including by an oral operating agreement, because, unlike the provision relating to interest holder liability, such a variation is not forbidden under UCA §48-3a-112(3). See UCA§48-3a-112(1) (except as otherwise provided in subsections (3) and (4) [of UCA §48-3a-112] the operating agreement governs . . . .").

b. Limited Requirements for Record. In summary: the plans themselves for each type of transaction must be in a record. UCA §§48-3a-1022(1) (merger); 48-3a-1032(1) (interest exchange); 48-3a-1042(1) (conversion); 48-3a-1052(1) (domestication). Except for the provisions dealing with interest holder liability, the consents of members are not required by statute to be in a record. Further, operating agreement provisions requiring less than unanimous approval need not be in a record, except where the approval at issue is of interest holder liability. Naturally, having a written operating agreement requiring written consents to certain matters, or waiving consent requirements to certain matters, is far better practice than relying on oral agreements too easily fabricated by highly imaginative but less than honorable persons who may find it to their advantage, or by persons who misunderstand or misremember the terms discussed often years in the past.

6. Indemnity. Acquisition agreements often include indemnities by which one party agrees to indemnify ("hold harmless") the other as to certain matters. These provisions are typically used to allocate risks between the parties and may apply to past events or circumstances

or to future ones, and usually to both. The use of indemnities raises a number of issues to be considered in structuring the transaction.

a. Coverage. What matters should be covered? Such indemnified matters may include uninsured or underinsured liability claims, property damage, matters required to be covered by insurance but were not (at least to the extent not disclosed to the acquirer or to the extent exceeding the disclosed estimated obligation), breaches of agreement provisions, falsity of warranties or representations in the agreement (a significant area for negotiation), falsity of later provided information, or anything that gets one party sued, or threatened with a claim, by a third party, or that otherwise causes damage to the other party by act or omission of the indemnifying party or perhaps by certain third parties. The target or its shareholders may broadly indemnify as to third party matters arising prior to closing, for example.

b. Fault. What if activities beyond paying money and making transfers are involved, for example property inspections, environmental inspections, physical inventories in industrial locations, etc.? Should a party be indemnified against its own fault, such as negligence? Should comparative fault apply? If so, what level of fault? If a party is indemnified against its own negligence, this will need to be made rather explicit. *Bishop v. GenTec, Inc*., 48 P.3d 218 (Ut. 2002); *Kansas City Power & Light Co. v. United Telephone Co. of Kan.*, 458 F.2d 177 (10th Cir. 1972; Kan. Law); Restatement Second Contracts § 195, comment b. Such agreements are strictly construed and disfavored. *Freund v. Ut. Power & Light Co*., 793 P.2d 362, 370 (Ut. 1990); *Hawkins v. Peart*, 37 P.3d 1062 (Ut. 2001). It is against public policy to indemnify a party against its own intentional wrongdoing. *Equitex, Inc. v. Ungar*, 60 P.3d 746 (Colo. App. 2002). However, if done right, such indemnity and exculpatory provisions relating to simple negligence may be given effect. See *Russ v. Woodside Homes, Inc.*, 905 P.2d 901 (Ut. App. 1995). On the other hand, some forms of indemnification are against public policy. For example, if agreements relating to construction, repair, or maintenance of a building is involved, such provisions relating to the sole negligence of the promisee or its agents, employees, or indemnitee, are unenforceable under public policy. UCA § 13-8-1; *Jacobsen Const. Co. v. Blaine Constr. Co*., 863 P.2d 1329 (Ut. App. 1993). Should insurance be required, and if so, what kinds, in what amounts, and with which insurers?

c. Loss. What loss amounts should be indemnified against? Some possibilities include damages (from judgment or settlement), litigation costs through appeals, attorneys', accountants', experts', and other professionals' fees, response costs even without litigation (*e.g*., in response to threats), penalties, fines, losses from the failure of certain hoped-for tax results, etc. Should such amounts be adjusted for additional taxes or tax savings or for other costs or expenses saved? Should indemnified expenses bear interest, and, if so, when should it commence and at what rate should it accrue?

d. Limits. Should there be thresholds or caps on indemnities? For example, should there be a "basket" of some amount such that damages to that level are not subject to indemnity (presumably the pricing of the transaction assumes this level of risk)? Such provisions help avoid nickel and dime post-closing claims. Or should there be a threshold amount such that when the threshold level of damage is passed, all liability from the first dollar is covered? Or should the indemnity be capped so that it cannot exceed $X, or the purchase consideration, or $X beyond the purchase consideration, with the acquirer taking the risk beyond the level specified.

e. Defense. Who will defend the claim? Should the indemnifying party or the indemnified party hire counsel? Should the other party have the right to approve the counsel handling the defense? Should the other party be able to obtain its own counsel at the expense of the indemnifying party where there arises a conflict on interest in the defense, or a failure to provide an adequate defense?

f. Settlement. Who can control the settlement of the matter? Should a party to control the defense be required to assume that control in writing within a particular time? Should the indemnifying party be able to unilaterally settle so long as the indemnified party obtains a full release? Should any withholding of consent by the other party to a settlement approved by one party be required to be reasonable? Should indemnity be capped at the proposed settlement amount if one party refuses a settlement offer? Should some reasonable prior notice of intended settlement be required?

g. Claims. What procedures should apply? What is timely notice of a claim to the indemnifying party, and if the indemnifying party is not timely informed, what is the consequence to the indemnity? Should late claims be denied totally or only to the extent of prejudice to the other party? Should there be an explicit duty to cooperate and to provide evidence and non-privileged information? Should there be a contractual time limit to raising indemnity claims? Should indemnities expire after a certain time, at different times for different risks, or not expire at all as to certain risks but survive through the otherwise applicable limitations period? It may be against public policy in some states to extend obligations beyond an applicable limitation period before an actual dispute has arisen. Should indemnity rights be made explicitly personal and non-assignable? Should advance expense reimbursements be allowed or required subject to repayment if indemnity is determined not to apply? If so, what time limits and consequences (*e.g.*, damages, interest) for unreasonable delay should apply?

h. Subrogation. Should there be explicit subrogation rights for the indemnifying party? Should indemnity be expressly conditioned on the protection of subrogation rights such as by timely informing the indemnifying party of the potential recovery source and assigning rights relating to the recovery source? Should the indemnity be made secondary to other sources of recovery?

i. Exclusivity. Should contract indemnity be the exclusive remedy for some or all matters covered, thus excluding additional statutory or tort claims or remedies, etc.?

j. Responsibility. Who should stand responsible for indemnities? Some or all interest holders (e.g., only controlling or knowledgeable holders) as to interest transactions? The company in asset transactions or before closing on interest transactions? Certain executive officers or controlling interest holders in either sort of transaction? Should the responsibility be joint and several or proportionate, e.g., to shareholdings? Should there be a side agreement among those responsible spelling out contribution allocations (e.g., proportionate instead of per capita)? Should joint and several liability apply to some warranties or representations and not others? Should there be a difference as to warranties intended to allocate risk (e.g., allocated among all shareholders) compared to representations intended to give rise to tort liability for negligent or intentional misrepresentations (e.g., allocated only to controlling shareholders who should know)?

k. Difference Between Contract Breach and Indemnity Claims. A claim for breach of contract requires a showing of breach, while a claim for indemnity a party only requires a showing that the indemnified party has suffered the loss against which it was indemnified, which may be a lesser showing depending on the terms of the indemnification. Similarly, basic contract damages require a showing that the loss was a reasonably foreseeable consequence of the breach of contract, while indemnity damages are recovered on a showing that the loss was a loss against which it was indemnified. There may be a failure to mitigate loss defense to a general contract claim, while an indemnifying party cannot reduce its liability by showing a failure to mitigate loss by the indemnified party.

7. Securing Obligations.   The recipients of the purchase price will be interested in securing the payment of amounts if not fully paid in cash at closing, and the acquirer will be interested in securing warranty and representation indemnities and similar post-closing items. Let's review some of the security mechanisms available.

a. Offset Rights. Common law and contractual offset rights can help protect an acquirer where the purchase price is payable over time. Payments of the price may be offset and withheld if there are violations by the seller, for example, of the warranties and representations giving rise to an indemnity obligation to the acquirer. See, e.g., *Zion's Sav. Bank & Trust Co. v. Rouse*, 47 P.2d 617 (Ut. 1935) (general rule on setoff of mutual obligations, but subject to one action rule on mortgages).

b. Escrow of Funds. Funds may be placed in escrow with a third party (e.g., a bank trust department) to provide assurance to the acquirer that funds will be available to pay any indemnity claims it may come to have or to make any post-closing adjustments (e.g., based on final post-closing financial statements), and to provide assurance to the seller that cash is available so that the purchase price will be timely paid after any such adjustments or offsets are concluded. The procedures for payment can be very important to the parties so that one party cannot stop a required distribution wrongfully. The amount to be held and the time until release to the seller of the funds not subject to a claim will be important negotiating points.

c. UCC Security Interests. In addition to cash security, a security interest may be granted by a party owing an obligation in just about any form of personal property. Most of these security interests will be governed by Article 9 of the Uniform Commercial Code. See UCA §§ 70A-9a-101 et seq., particularly -109 (scope). Some types of collateral, even if otherwise covered, are perfected by means outside Article 9, such as autos, aircraft and certain vessels, livestock, etc., which are governed by other statutes or treaties on these matters. See UCA § 70A-9a-311. The collateral in which a seller being paid under a deferred payment arrangement may be interested can include tangibles such as furniture, equipment, fixtures, or inventory, or intangibles such as investment securities, accounts receivable and payment rights, patents, trademarks, books and records, and so on. Proceeds and products of collateral may also be covered. A grant of security, attachment of the security interest to property, and perfection are the key elements to obtaining the security interest with priority over other interests to the extent allowable.

d. Real Estate Security. The seller could receive a security interest in the real estate sold or held by the target or in other real estate interests of the acquirer, such as by means of a trust deed or mortgage, in order to secure payment of a deferred price. Either party could receive a trust deed or mortgage to secure guarantees of payment of the price or of indemnities.

e. Letter of Credit. Letters of credit can be a particularly powerful security device because they are divorced from the other rights and obligations of the parties and surety and guaranty defenses do not apply. If the bank or other issuer receives the appropriate documents under the letter of credit, it must pay, and in almost every case, the other party (the bank's customer) cannot prevent payment by claiming a defense but must seek a refund from the party receiving the proceeds (the beneficiary). See *Titanium Metals Corp. of America v. Space Metals, Inc*., *Valley Bank and Trust Co. v. Space Metals, Inc.*, 529 P.2d 431 (Ut. 1974). They are often used where a party is located in another nation, but can be used effectively in other situations, as well. See UCC Article 5; Uniform Customs and Practices of the International Chamber of Commerce. Letters of credit have expiration dates and it is important that they be replaced before expiration.

f. Guarantee and Surety. Personal guarantees by the principals of a party, by related organizations, or by others, are often used to assure payment of the price, indemnities, or other obligations or performance of the contract in other respects. Guarantees may be a critical component of a transaction. Both the seller and acquirer may want guarantees for the obligations owed to them in the transaction. In the following discussion we will typically use as an example of the use of guarantees, the guaranty to the seller of the purchase price by a person related to the acquirer, but the acquirer could just as easily be asking for guarantees from shareholders of warranty and representation and other indemnities. The acquirer's obligation for the price may be fixed in a promissory note or may be an additional price contingent on future earnings or revenues derived from the target business (known as an "earn-out"). An example of an earn out might be something like: the excess of three times the EBITDA (earnings before interest, taxes, depreciation, and amortization) from the target for a post-closing year over the targets' average EBITDA for the 3 years prior to closing, determined and payable annually over the 3 years after closing.

i. Guaranty and Surety. A "guarantee" by a guarantor (a secondary obligor) of the party required to pay or perform (the primary obligor) an obligation to the party entitled to payment or performance (the obligee), makes the guarantor liable to satisfy the obligee's claim on default under the agreement (the underlying obligation). This guaranty obligation is an independent obligation from the underlying obligation. See *Strevell-Patterson Co. v. Francis*, 646 P.2d 741 (Ut. 1982); Restatement (Third) of Suretyship and Guaranty, American Law Institute 1996 ("Restatement of Suretyship") § 15(a). A "surety" contract or "cosigner" arrangement makes the secondary obligor jointly and severally liable with the principal obligor. Restatement of Suretyship § 15(c) and (d).

ii. Reimbursement. The primary obligor, such as an acquirer under a deferred payment arrangement, is responsible to reimburse the secondary obligor, such as a guarantor (who may be a principal or affiliate of the acquirer), where the guarantor has discharged the obligation of the acquirer. Restatement of Suretyship § 22.

iii. Defenses. The big issues relating to guarantees and surety contracts are in the potential defenses to the obligation which are available to the secondary obligor, such as a guarantor. Unless effectively consented to or waived by the guarantor, any action by the obligee (e.g. the seller), which increases the guarantor's risk may be grounds to discharge the guarantor of further responsibility. This change in risk can come from a change in the underlying obligation (such as under the note or contract), or by impairing the ability of the guarantor to obtain recourse against the primary obligor (e.g., the acquirer) or against collateral for the acquirer's performance. Restatement of Suretyship § 37.

Examples of the first kind of risk increase which changes the fundamental obligation, include releasing the acquirer from a duty other than the payment of money, or changing the terms of the note or agreement so that it is like a substituted obligation or so that it imposes fundamentally different risks on the guarantor. Restatement of Suretyship §§ 37(2), 39(c)(iii), 41(b)(i).

Examples of the second kind of risk increase which impairs recourse against the acquirer, include releasing the acquirer from an obligation to pay money, granting an extension of time for acquirer to perform, modifying the acquirer's duties in a way not amounting to a substituted contract or fundamental change, impairing the value of collateral security for acquirer's obligations (see *Carrier Brokers, Inc. v. Spanish Trail*, 751 P.2d 258 (Ut. App. 1988) (substitution of collateral); *Valley Bank and Trust Co. v. Rite Way Concrete Forming, Inc.*, 742 P.2d 105 (Ut. App. 1987) (release of collateral)), failing to sue the acquirer before the statute of limitations expires, or otherwise impairing reimbursement or subrogation rights. Restatement of Suretyship §§ 37(3), 39(c)(ii), 40(b), 41(b)(ii), 42, 43, 44. The discharge will generally be to the extent of the impairment. *Seftel v. Capital City Bank*, 767 P.2d 941 (Ut. App. 1989).

If the impairment occurs after the guarantor has performed or without guarantor's knowledge, the seller could be liable to the guarantor to the extent the impairment would have discharged the guarantor. Restatement of Suretyship § 37(4).

iv. Waivers. Consents and waivers regarding obligation changes and reimbursement impairments generally must be explicit and unequivocal. *Valley Bank, supra, citing Behlen Mfg. Co. v. First National Bank*, 472 P.2d 703, 708 (Colo. App. 1970). Sellers and other creditors thus put a good deal of effort and ink into obtaining advance waivers and consents so that some inadvertent slip does not create a defense to the guarantee.

Among other things, a party holding a guarantee may want to state in the guarantee that it applies despite any invalidity or unenforceability of the underlying payment obligation (e.g., on expiration of statute of limitations, laches, or other time bars) or any discharge in bankruptcy of the underlying obligation, and continues or reapplies if any payments by the primary oligor (e.g., acquirer) are recovered from the seller by a bankruptcy trustee or debtor in possession (preference, fraudulent conveyance, etc.; see 11 USC § 365; UCA § 25-6-1, et seq.).

v. Notice of Disposition of Collateral. Unless notice is effectively waived by the guarantor, the guarantor should be given notice of such things as the disposition of collateral, whether real or personal property, because the guarantor may be or become entitled to be subrogated to that collateral. See UCA § 70A-9a-102(28) definition of "debtor" under Article 9 of the Uniform Commercial Code as including "a person having an interest, other than a security interest or other lien, in the collateral, whether or not the person is an obligor."

The courts may look to actual prejudice and may not relieve a guarantor where there is no substantial prejudice. See *Zions First National Bank v. Hurst*, 570 P.2d 1031 (Ut. 1977) (sale of planes without proper notice to guarantor did not discharge guarantor from deficiency where planes would need to bring three times what they did in order to relieve guarantor of liability); *Royal Tailors v. Newton*, 329 P.949 (Ut. 1925) (return of stock not deposited as collateral security).

vi. Consideration. Another defense which creditors, such as sellers, will want to take care to eliminate is the assertion that the guarantee lacks consideration. Where the guarantee is given by an insider of the debtor to procure the advance of credit or other accommodation, such as a sale of stock or assets, consideration generally will exist. See *Boise Cascade Corp., Bldg. Mater. Distrib. Div. v. Stonewood Develop. Corp*., 655 P.2d 668 (Ut. 1982). However, issues may arise where affiliates in a corporate group guarantee obligations and receive no benefit of significance, or where the guarantee is given after the guaranteed obligation already exists. See generally *Yoho Auto Inc. v. Shillington*, 784 P.2d 1253 (Ut. App. 1989). In such cases, steps should be taken to document the benefits, direct or indirect, to the guarantor and that the credit or other accommodation would not have been made or continued (where there is a right to terminate) but for the guaranty or a commitment to make the guaranty. Fraudulent transfer principles may come into play in some circumstances where third party creditors of the guarantor might be prejudiced. See generally, UCA § 25-6-1, et seq.

vii. Separate Remedies. Also, a creditor (such as an acquirer) generally does not have to exhaust remedies against the primary debtor before proceeding against the guarantor on the independent contract of guaranty. *Machock v. Fink*, 137 P.3d 779 (Ut. 2006) (allowed suit against guarantor on a trust deed without foreclosure, declining to extend one-action rule to guarantees, and adequate notice of deficiency may meet the three-month deficiency action rule, so that new deficiency action in the three months was not needed). Timing remains important, however. *Surety Life Ins. Co. v. Smith*, 892 P.2d 1 (Ut. 1995) (although failure of creditor to exhaust remedies did not alter independent obligation of guarantor, deficiency action under trust deed statute still needs to occur within the statutory three-month period because it is an action to recover the deficiency).

viii. Limited Guarantees. Most guarantees most of the time are drafted to be absolute and for the whole amount owed, including future advances related to the agreement or protecting the seller, interest, attorney's fees, and so on. However, this is not universally the case. Guarantees may be more limited. A guarantee could be of collectability only, in which event the seller needs to pursue the acquirer first to an extent which should be defined in the guarantee, otherwise a judgment and an unsatisfied execution may be required. A guarantee may be limited in time either by a time period (e.g., 4 years) or by the occurrence of an event (e.g., the conclusion of third party litigation; or the realization on certain collateral). A guarantee may be limited in scope such as by limiting it to the base validity of certain obligations (e.g., some accounts receivable or other payment rights given as collateral), to some dollar amount or some percentage of the underlying obligation, to principal only, or to some specified items, etc. Some guarantees are cancelable by the guarantor, although such a cancellation may allow the note to be called immediately due by the seller. All sorts of variations are possible.

ix. Co-guarantors. Where there is more than one guaranty, the guarantees should specify that the release or discharge of one does not release or discharge any other, that other guarantors may be added or substituted, and that the guarantors' obligations will be joint and several among them for the full amount as far as the seller is concerned (absent some specific limitation as to one or more guarantor). The guarantors (e.g., shareholders of the acquirer) themselves may want to have a separate agreement among them specifying the proportion each should contribute and providing rights of contribution against those who paid less where one or more guarantor pays more than the allocated share. Absent such an agreement, the guarantors may be deemed to be responsible for a per capita (i.e., by head count) share, which may not be fair to some of them. Similar contribution issues will also arise where more than one person pledges collateral for the guarantor’s or primary obligor’s obligations.

8. Lender Concerns. The acquirer's outside lender funding part of the acquisition, or the lender for the company after the acquisition, may also be very much concerned with the acquirer's ability to perform both under the payment arrangement with the seller, and with the acquirer’s (or company’s) ability to perform under the loan agreement, as well. The lender may want subordinations from the sellers, either of the entire obligation owed to the sellers, or of the collateral securing such obligation, or both. The subordination may be of the “doormat” variety where the sellers get nothing until the lender has been paid in full or to a certain level, or may be of the “on default” variety where the seller is allowed to receive its payments from the acquirer but the seller’s payments from the acquirer stop if there is a default under the lender’s loan agreement with the acquirer or the acquired company, for example, if certain financial ratios are not met.

Some lenders financing a transaction may insist on stricter warranties and representations from the seller than the acquirer would require to the extent the warranties or representations affect the collateral which will be pledged to the lender, and may insist on being the assignee or third party beneficiary of such warranties and representations.

9. Helpful Credit Provisions. There are a number of provisions typically seen where a payment of money or similar performance is required.

a. Default. All deferred payment arrangements contain financial default provisions. Defaults are often defined, and can include insolvency, bankruptcy (generally not enforceable in bankruptcy itself, but enforceable outside bankruptcy, for example, once an asset is abandoned by the trustee or the bankruptcy is dismissed), unstayed judgments of a certain size, etc. They can also include the insolvency, bankruptcy, etc., of an important guarantor or grantor of a security interest, or the loss in value of important collateral security. Regular financial reports from obligors and guarantors can be required; these should be personally certified by an individual principal in a position to know the accuracy of the reports.

b. Remedies. Remedies for default, the accrual of interest, and so on are also typically covered. On a default, interest often begins to accrue at a substantially higher rate because the risk of non-payment and uncollectability will have increased. Some agreements allow grace periods for payments. However, some obligors (e.g., acquirers) will take advantage of grace periods so that payments may become consistently late without much recourse for the seller. Thus, it may be wise to limit payment grace periods to short times (e.g., 5 days) and to limit their use to only a few times in any given period (e.g., not more than two or three times in any rolling 12-month period). Notice of default may be required for a payment default in addition to a grace or cure period, but this is resisted by sellers for regularly scheduled payments under the note for the price. Frequently in cases of some non-monetary defaults notice and an opportunity to cure (where a cure is possible) may be required; cure periods may not be appropriate, for example, in cases of financial misrepresentation, bankruptcy or insolvency, death of a key guarantor, etc. If there is a default triggering a remedy (e.g., after any notice or grace period) it is often very important that all obligations be accelerated to become immediately payable, and that all related obligations (e.g., the seller may be entitled to consulting or non-competition payments as well as the price) also come due and the obligee's performance obligations cease under cross default provisions. Otherwise the seller may well need to sue the acquirer payment by payment as each payment comes due, or the seller may continue to be unable to compete under a separate non-compete agreement despite the acquirer's default.

c. Covenants. Payment agreements can in appropriate cases contain all sorts of financial or negative covenants by the obligor (e.g., by the acquirer or by the acquired company) designed to prevent the acquirer from weakening the financial strength of the business or rendering itself or the business nearly insolvent, or dilating any future earn-out payments. These sorts of covenants are regularly used in loan transactions and can be used in acquisition payment arrangements, as well, to assure cash flow and a substantial net worth against which recourse may be sought in the event of default. Such covenants may include financial ratio tests, limiting further acquisitions or expansion, requiring special accounting of earn-out revenues (e.g., no expenses from other operations reduce these revenues, and no capital expenditures and no depreciation on other than historic assets reduce these revenues), certain expense levels (e.g., executive compensation) can't increase beyond certain levels, etc.

d. Payment Method. Where large payments are to be made, the seller may want to specify that the payments be made by wire transfers or other immediately available funds, rather than by check, in order to have the money working for the seller right away.

10. Ancillary Transactions. In addition to the acquisition itself and its financing and providing assurances of performance under the acquisition agreement, there may well be, in many cases, other aspects to the overall transaction which will need to be accomplished at the same time as, coordinated with, and analyzed as part of, the acquisition. These arrangements

may come out quite differently in structuring a transaction where the principals of the target are a small group involved in the operations than where there are passive interest holders in the target.

a. Non-Compete Agreements. It is rather common that in an asset transaction the selling company and executives or other principals who will not be hired by the acquirer or engaged as consultants will be required to sign non-compete agreements with the acquirer. If an executive or other principal (possibly a key shareholder of the selling company) is hired by the acquirer or will consult with the acquirer, the employment or consulting agreement would contain the non-compete provisions. Otherwise the non-compete agreement generally will be a separate agreement. Similar matters also arise for executives or principals in the context of a stock or interest sale, although the company itself will not need to be a party to a non-compete agreement. In such event (or even in the employment or consulting situation) there may be separate consideration paid by the acquirer for the non-compete obligation. This can create some conflicting incentives in the transaction, so these issues should be disclosed in obtaining board and shareholder approvals of the transaction. It is possible that the stockholders who do not receive this consideration may believe that at least some of it constitutes an unfair allocation of amounts which should really be part of the purchase price.

i. Public Policy. The issues that arise under the non-compete agreements include the scope of the agreement, its time and geographic limits, and other matters of public policy concern.

ii. Effect of Good Will. Where good will is transferred as part of an acquisition, a longer time element may be enforceable than might otherwise be the case.

iii. Post-employment Covenants. Beginning in 2016, Utah generally imposes a one year restriction on post-employment covenants not tied to the sale of a business. UCA § 34-51-201. The restriction does not apply to nonsolicitation, nondisclosure, or confidentiality provisions or to severance agreements entered into at or after discharge, or to covenants in connection with the sale of a business where the individual subject to the covenant receives value in the sale.

b. Consulting Agreements. As with a non-competition agreement, a consulting agreement of the acquirer with a principal of the target should be disclosed in obtaining board or shareholder or interest holder consents. Again, the compensation payable, if in excess of a reasonable amount, may in fact be disguised purchase price. Also, if the acquirer does not want to do the deal unless certain key people either are hired by it in an asset deal, or remain as employees of the target in an interest deal, or at least consult with the acquirer for a period of time in either sort of deal, then these key people may have the power to destroy the deal by excessive demands, and the target shareholders may not be able to count on the loyalty of these people who may already see the acquirer as their new boss.

11. Duty of Care. Directors have a duty to adequately inform themselves with respect to the worth of the business in any transaction which could shift control of the organization or substantially all of its assets. This duty is designed to help obtain value for the shareholders. Outside opinions on value and on the fairness of proposed transactions may be wise. Unless an inside deal with management is at issue, there is generally no duty to auction the

company; however, reasonable steps must be taken to assure fair value. The highest amount is not always the best offer and the board may consider such things as whether to sell at all, whether the price is adequate and adequately assured to be paid, how to set the rules, time frames, and other parameters for any bidding process, whether a transaction protects employees or others in which the corporation has a legitimate interest (if there is not too large a difference in value), whether to enter into arrangements to allow a potential buyer a period to negotiate, and so forth.

a. Business Judgment. Typically, the business judgment rule applies to create a presumption that a management official has met his or her duties where the transaction is not decided on behalf of the organization by parties with an interest in the transaction, where the board is not negligent but has adequately informed itself, and where the board rationally believes that the judgment made is in the best interests of the organization. See, 18B Am. Jur. Corporations §1470; *Chapman v. Troy Laundry Co*., 47 P.2d 1054 (Ut. 1935) (good faith required for business judgment rule). Without the presumption, the fiduciary would have a burden of persuasion, and if the presumption is overcome, the burden falls again on the fiduciary. *Norlin Corp. v. Rooney Pace, Inc*., 744 F.2d 255 (2d Cir. 1984); see, also, *C & Y Corp. v. General Biometrics, Inc*., 896 P.2d 47 (Ut. App. 1995).

b. Effect of Reduced Standard of Care. Where a reduced standard of care applies (i.e., below negligence), such as gross negligence or recklessness, there may not be a place for the business judgment presumption; this is an issue which could particularly affect Utah limited liability companies, for example. See e.g., UCA §48-3a-409(3) and (9) (the duty of care is to refrain from grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law), but, under UCA § 48-3a-112(4)(c), this duty may be altered by agreement except to authorize intentional misconduct or a knowing violation of law. References to the business judgment rule were removed under this Act. See, however, *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (business judgment rule ceases at the level of gross negligence).

12. Break-Up Fees. Some transactions will involve earnest money or break-up fees. Earnest money (or a "reverse break-up fee") is a deposit payable to the seller if the transaction fails to close without default by the seller. A typical example of such a failure to close would be the inability of the buyer to obtain financing or just cold feet after further due diligence reviews. Such fees cover business disruption, the cost of making disclosures, the loss of key employees at the prospect of a takeover, legal fees, etc.

A break-up fee is generally payable to the buyer if the deal fails to close without default by the prospective buyer, particularly where the transaction is subject to outsider bids, such as where the board is free to entertain other offers to try to obtain greater value for shareholders. A typical example of such a failure to close would be the "auctioning" of the company, or the emergence of discomfort with the potential acquirer. Competitive bidders typically will be covering the break-up fee, so such bids are discouraged by the existence of such fees unless the bids are for significantly greater value, but then the next buyer will adjust its price so the fees may tend to ultimately reduce shareholder value. If too large, such fees may be subject to challenge as seriously precluding obtaining better shareholder value. Fees in the 3% to 4% range may pass muster, but the courts, especially in Delaware, have noted that the matter is highly fact specific and not amenable to a mathematical formula. The value used for the denominator can be a critical part of the negotiation. Such fees cover the costs of due diligence reviews, legal fees, and similar costs.

No-shop provisions may also be negotiated pursuant to which the seller agrees not to solicit or accept offers for a period of time in order to give the potential buyer a clear first shot at the proposed transaction. The perspective buyer could also receive a right to match any competitive bid.

Any such break-up fees (in either direction) or other buyer protections are negotiated at or quite near the commencement of the transaction process.

13. Some Anti-trust Concerns. Anti-trust issues must be considered in every transaction, although in a great many transactions the consideration will quickly lead to a conclusion that there is no significant concern. We won't go into any detail here about federal and state anti-trust and unfair competition laws; however, lawyers for the parties structuring a transaction will want to bear in mind certain matters, and will need to review matters further or obtain further advice if issues arise. Both the purpose and effect of the transaction must be considered as to matters which may raise anti-trust concerns ranging from monopolization to price fixing, market division, and other anti-competitive activities.

a. Market Power. The first thing to consider is whether the transaction will create or increase significant market power. As a very general rule of thumb, if a market share of 30% of a market exists or will result, significant further review is probably justified; below that market share, the matter is less clear but the smaller the market share, the less likely there will be an issue of market domination.

b. Some Size Thresholds. If the transaction is, or participants are, of a certain size, a premerger reporting requirement and a waiting period may apply under Title II of the Hart Scott Rodino Act (unless an exception applies). See, 15 U.S.C. §§ 18a and 19. The dollar limits change annually. Let's use 2013 as an example. The threshold for 2013 was $70.9 Million of voting securities or assets of the acquired target (it was $76.3 Million in 2015). See, http://www.ftc.gov.opa/2013/01/clayton.shtm. For a transaction between the $70.9 Million threshold and $283.6 Million (in 2013; $305.1 Million in 2015), there are further size of the person tests to determine whether the reporting and waiting period requirements apply; there may be a reporting requirement if a manufacturing target with net sales or total assets of $14.2 Million ($15.3 Million in 2015) is acquired by an acquirer with net sales or total assets of $141.8 Million ($152.5 Million in 2015). If the target is not engaged in manufacturing, the above threshold for the target relates to total assets. These thresholds also apply in the opposite direction so that if a $14.2 Million company requires a $141.8 Million company, there may be a reporting requirement. Above $283.6 Million of acquired assets or voting securities, the size of the person's tests do not apply before the transaction becomes subject to the reporting and waiting period requirement. Failure to comply can lead to staggering civil penalties which accrue on a daily basis against the company and its officers and directors. 15 USC §18a(g)(1). For 2013 the penalty was $16,000 per day; it is adjusted every five years. Equitable relief is also available. 15 USC §18a(g)(2).

Interlocking directorates are prohibited under the Clayton Act in certain cases, and the thresholds there (2013) are $28,883,000 for Clayton Act §8(a)(1) which restricts overlapping directorates of companies with capital, surplus, and undivided profits over the threshold, and $2,888,300 for §8(a)(2)(A) which is an exception removing the restriction where competitive sales of either corporation are less than the threshold. There is also an exception where competitive sales are less than certain percentages of each other's sales, i.e., either company's competitive sales are less than 2% of the other's total sales, or the competitive sales of each are less than 4% of that company's total sales.

c. <u>Information Issues</u>. Another concern is to avoid sharing too much information in pre-transaction investigations especially where the deal participants are actual or potential competitors particularly in such sensitive areas as costs and pricing. This is important to avoid allegations of a price fixing conspiracy or other anti-competitive conduct. The participants in the transaction must remain independent until closing. Although some limited integration planning may occur before closing, a good deal of competitively sensitive or proprietary information cannot be exchanged, and certain information may be disclosed only among specified due diligence teams subject to confidentiality restrictions. In some cases, independent consultants or a "clean team" may aggregate some competitively sensitive information in the due diligence process. Actual integration coordination, involvement in each other's operations, or holding out to customers of integration cannot occur until after closing.

The following is an excerpt from an article providing some general guidelines for pre-acquisition conduct based on the author's analysis of case law and federal administrative guidance. State anti-trust and unfair competition law applies as well, but this excerpt focuses attention on the areas likely to be of most concern at both state and federal levels.
ABA Business Lawyer, Vol. 57, No. 4, p. 1463, August 2002.

> M. Howard Morse, Mergers and Acquisitions: Anti-trust Limitations on Conduct Before Closing.
>
> **Prohibited Conduct**
>
> 1. Do not coordinate pre-consummation activities. Do not direct or participate in day-to-day decision-making about the other firm's business affairs. Do not take possession or control of any assets or businesses of the other firm.
>
> 2. Do not hold out employees of one firm as being with the other to customers or the public. Do not use new business cards, answer telephones by reference to other company, or use one company's logo with the other company's products or literature. Do not relocate employees, give employees of one firm office space in other's facilities, or have employees of one firm report to employees of the other.
>
> 3. Do not accept or provide information that is not reasonably necessary for legitimate due diligence or integration planning purposes. Shield or aggregate competitively sensitive information.

4. Merging firms should not:

• Discuss or exchange information regarding customers, distributors, pricing policies, pricing formulas, prices or other terms of sale, business or marketing plans, bidding or other sales solicitation activities, costs or cost structures, profit margins, profitability targets, proprietary technologies, pending or planned research and development (R&D) or product development efforts, except as provided below.

• Agree on, coordinate, or otherwise discuss past, present or planned competition between them, outstanding or prospective competitive bids, pricing, discounts or other terms under which either company might offer its products or services in competition against the other company.

• Agree on, coordinate, or otherwise discuss current product development efforts.

5. Examples of the above rule include: no agreement that only one company will compete for business when both normally might do so; no agreement on the price or other terms either company may offer customers; no agreement or discussion regarding either company's withdrawal or change in any outstanding bid; no agreement or discussion regarding either company's changing the manner it is now servicing or dealing with any existing customer; and no agreement or discussion regarding current product development efforts.

6. Personnel should not disclose to personnel of the other company proprietary information that would not ordinarily be disclosed to the public or to the other company (e.g., pricing and other commercial terms, costs, development plans, customer lists, marketing intentions, and business plans), except through designated due diligence and transition teams subject to confidentiality strictures.

7. Even after all regulatory clearances are obtained, there should be no agreement or understanding with regard to price or customers to be served, until after closing.

Permissible Conduct

1. Due diligence and transition teams may exchange information required for legitimate purposes subject to confidentiality strictures, using of independent consultants to aggregate competitively sensitive information or a “clean team.”

2. Transition teams may collaborate on developing plans for post-closing integration of operations. This may include collection of otherwise prohibited information for the purpose of making decisions about immediate post-closing plans, including:

• evaluation of employees for purpose of making decisions regarding post-closing personnel assignments, combined staffing needs and related matters, and communications about post-merger employment prospects, staffing arrangements, and related matters;

• evaluation of facilities, equipment, information and other operational systems, distribution arrangements, and products for purposes of planning post-merger consolidation;

• evaluation of environmental and other existing liabilities, employee benefits, tax and other financial or related aspects of the business for purposes of planning post-merger corporate organization, and related matters.

3. Personnel may jointly or separately meet with customers for purposes of (a) introduction; (b) generally explaining the contemplated transaction; (c) discussing post-closing plans; and (d) otherwise explaining how the transaction may benefit customers. On the other hand, it is not okay to make joint calls on customers to sell products or services.

4. More flexibility and broader areas of information exchange for purposes of integration planning may be permissible with regard to parts of the business as to which there is no existing or prospective competition between the firms or no impact on consumers in the United States.

14. Brokers. Finding buyers for a business can be difficult. There are those, who for a fee (often a percentage of the deal) will agree to help. The services of such persons can vary in type and quality. Further the licensing and registration requirements for such persons are not always clear. This can lead to risk for the seller of securities. See, *Jacobsen and Pena, Securities Finders – More Confusing Than Ever Before,* Ut. Bar. Journal, vol. 27, No. 1, at page 38 (Jan. – Feb 2014) (the name provides the thrust of the article); see also, UCA § 61-1-22 (sale of securities in violation of various provisions leads to, among other things, potential rescission by the buyer).

We will not go into licensing issues, except to recommend the use of licensed persons. They are typically better trained and more committed, and have something valuable to lose (their license and reputation) if they misbehave. Unlicensed persons are often without sufficient financial resources (personally or through insurance) to respond in damages if they misbehave, while licensed persons tend to be more financially responsible and are often affiliated with an investment banking or similar firm with an ethos of quality service.

Those who help principals sell businesses may only provide an introduction to someone as a potential buyer. Or such persons may analyze the target and the market and help with structuring the business for a more favorable acquisition, provide an analysis of key financial features of different forms of a transaction, identify and contact potential acquirers (often acquirers are in the same industry as the business to be sold), assist in negotiating price and financial terms, coordinate due diligence efforts and negotiations, and otherwise assist in the transactions through closing. These services can be very valuable, and well qualified people providing these services can significantly increase the value to the sellers and significantly reduce the problems in obtaining a satisfactory transaction.

On the other hand, there are persons styling themselves as business brokers who are interested only in pushing a deal, no matter how ill conceived, in order to collect a commission. They bring no substantial analytical ability to the table and often feel quite comfortable "representing" both sides in a transaction. Some even will try to discourage the parties from seeking counsel ("lawyers are deal killers") and may offer a "neutral" or "simple" form of agreement to both sides so they will feel they don't need counsel. Such persons should be avoided. When the almost inevitable lawsuit between the parties results from their services, they have cashed the commission check and are gone or will not or cannot be of assistance.

The issues in agreements with brokers or finders involve defining their compensation, how and when it is payable, and what transactions trigger the payment obligation. The percentage amount is negotiable but will be relatively easy to state (e.g., 3%); the key is what is it a percentage of. Typically, the broker will want it to apply to all sorts of consideration in gross, including cash or securities, etc. received, notes typically at face (not market) value, etc. There may be issues regarding how to value certain types of consideration other than cash received. For example, what is the value of non-marketable securities or warrants or options to be received in a package of merger terms? The broker may want a part of any non-compete or consultation compensation, too; sellers tend to resist this. The transaction may well be broadly defined as stock or asset deals, mergers, etc. This is because, the discussion could well start with a stock deal and turn into an asset deal or vice versa. There will be a time period during which the agreement applies, say six months. It may be exclusive for a time, then non-exclusive, or may be non-exclusive from the start.

The agreement will typically require payment for any transaction within a further period after the expiration of the representation; this is to avoid the situation of a less than honorable seller postponing a deal to avoid the commission. The agreement could apply only to persons introduced as potential buyers by the broker, or to anyone who ends up as a buyer. There can be specific carve outs by the seller of particular persons such as those already contacted by the seller. The terms of payment could include a provision that all of it is payable at closing even if the price is paid over time, or could include a provision that a portion of each payment made is paid to the broker at the time the payment is made. This later method may be used for example in an earn-out transaction where there could be significant additional amounts paid if the business does well after closing.

15. Letters of Intent. Letters of intent are often used to start the acquisition process. It will generally describe, in a preliminary way, the sort of transaction contemplated (stock, asset, merger, etc.) and the financial terms (down payment, note and security, stock to be exchanged, earn-outs, guarantees, etc.) and key conditions (buyer financing, lender releases, regulatory or third party consents, shareholder approvals, etc.). It also generally will describe the acquisition process.

The transaction terms should be non-binding; things may well change as investigations and negotiations continue. The provisions about the acquisition process may well be binding and contain all the typical general provisions used in binding agreements (choice of law, attorneys' fees, integration, etc.) as well as the specifics as to the particular transaction, such as any exclusive negotiation or investigation time period and rights to end discussions, break-up fees, access to company records, confidentiality provisions, access to company properties, employees, key customers, and key vendors, any preliminary representations or warranties (e.g., no other offers pending), expense allocations (e.g., each pays its own professional or broker fees, other than break-up fees), any requirement that interim operations will be in the normal course of business, and a requirement for any definitive agreement to be in a signed formal writing.

Naturally, it is very important that the letter clearly distinguish between the binding and the non-binding portions of it. Sometimes, the same or all of the binding provisions may be placed in separate agreements, such as separate confidentiality agreements or break-up fee agreements, particularly where the provisions on such matters are intricate or may need to be disclosed to others and it is not desirable to disclose other matters contained in the letter of intent.

16. IRC § 6672 - The 100% Penalty. Under IRC § 6672, personal liability is imposed on any person with the duty to collect, account for, and pay over the payroll trust fund taxes of withheld income tax and the withheld employees' portion of the FICA tax, who willfully fails or refuses to do so. "Willful" means a voluntary, conscious, and intentional act. *Denbo v. U.S.*, 988 F.2d 1029 (10th Cir. 1993) (willfulness described); *Howell v. U. S.*, 83 AFTR 2d ¶ 99-308 (10th Cir. 1999) (issue of willfulness may go to jury); *Finley v. U.S.*, 82 F.3d 966 (10th Cir. 1996) (president's failure to make further inquiry after instructing treasurer to pay taxes violates duty under IRC § 6672) remanded after consideration *en banc* by *Finley v. U.S.*, 123 F.3d 1342 (10th Cir. 1997) (possibly not willful where there is reasonable cause). The key element is actual authority and responsibility. *Maggy v. U.S.*, 563 F.2d 1372 (9th Cir. 1977). States also provide for similar 100% penalties. See UCA § 59-1-302. Utah's provision is interpreted similarly to the federal provision. See *Ut. St. Tax Com'n v. Stevenson*, 150 P.3d 521 (Ut. 2006).

Once the liability attaches by reason of a person being responsible for any of the three functions, it does not go away even if the person's duty changes. For example, if a person is responsible to collect the tax, that person is not relieved of liability by reason of a change in functions so that he or she is not responsible to file the return and pay over the tax. *Brown v. United States*, 591 F.2d 1136 (5th Cir. 1979). It is also possible for a person to be liable for the payment of the tax even though he or she was not responsible for the collection of the tax. Thus, a person who assumes control of a business in an acquisition may become personally responsible for the delinquent payroll taxes for the period prior to the acquisition.

Consider the case of *In re Slodov*, 436 US 238 (1978). In that case, Slodov acquired control over three corporations (by stock purchase) when there were delinquent payroll taxes and no funds with which to pay them. Slodov injected additional funds which, with the funds the business operation produced, were sufficient to pay all postacquisition taxes. Nothing was paid on the taxes for the preacquisition period.

Was Slodov responsible for paying over the delinquent preacquisition taxes? Yes. Was he liable for the penalty? No. The court found the element of willfulness to be lacking in this case and stated that an acquiror is not "a guarantor for payment of delinquent taxes simply by undertaking to continue the operation of the business." In the *Slodov* case, at the time of the takeover, there were no funds and the funds generated after control were not directly traceable to collected taxes.

The taxpayer has the burden to prove that no funds are traceable to the withheld trust fund taxes. *Snider v. U.S.*, 655 F.2d 729 (6th Cir. 1981). If there is a security interest in available funds at the time of the takeover, the acquiror and its responsible persons might escape liability if the funds are truly unavailable by reason of the security agreement. *First National Bank v. United States*, 591 F.2d 1143 (5th Cir. 1979).

17. <u>Successor to Employment Discrimination and Related Claims</u>. Discrimination with respect to the terms, conditions, or privileges of employment on the basis of race, color, religion, sex, or national origin is forbidden under Title VII of the Civil Rights Act of 1964. This Act has been amended a number of times, including by the Equal Employment Opportunity Act of 1972, and the Pregnancy Discrimination Act. 42 USC 2000e. There, thus, can be no invidious discrimination in such areas as medical hospital, accident, life insurance, retirement plans, bonus plans, leave, etc., as well as hiring, firing, and paying wages. This Act also prohibits such things as sexual harassment and may, in certain circumstances cause an employer to be liable for the acts of its other employees and agents.

An acquiror treated as a "successor" may be liable for the target's actions prior to the transaction. The standard for a successor is similar to that used in unfair labor practices cases under the LMRA. <u>See</u> *EEOC v. MacMillan Bloedel Containers, Inc*., 503 F.2d 1086 (6th Cir. 1974) (race and sex discrimination); *Trujillo v. Longhorn Manufacturing Company*, 694 F.2d 221 (10th Cir. 1982) (sex discrimination case). Whether the acquiror is a successor depends on several factors, including:

(1) <u>Continuity</u>. Such matters as substantial continuity of business operations, use of the same plant, use of substantially the same work force, use of substantially the same supervisory personnel, whether the same jobs exist under substantially the same working conditions, use of the same machinery, equipment, and methods of production, whether the same product is produced.

(2) <u>Knowledge.</u> Knowing of the claim by the acquirer.

(3) <u>Ability to provide relief</u>. Knowledge of the predecessor's ability to pay and of the liability means the acquiror can get a lower price or other concessions and, thus, may have the ability to pay the "assumed" liability. *EEOC v. Vacitech*, 842 F.2d 936 (7th Cir. 1988).

A similar analysis is used with respect to successor liability under the FLSA (Fair Labor Standards Act), ADA (Americans with Disabilities Act), and ADEA (Age Discrimination in Employment Act), as well. The Title VII definition of employer is used in determining successor liability. <u>See</u> *Milner v. National School of Health Technology*, 73 FRD 628 (CD Pa) (Title VII case); (*E.E.O.C. v. Rockwell International Corp*., 36 F. Supp. 2d 1056 (N.D. Ill. 1999); <u>see</u> also, Annotation, Liability Under Title VII of Civil Rights Act of 1964 (42 USC §§ 2000e *et seq.*) of employer, as successor employer for discriminatory employment practices of predecessor, 67 A.L.R. Fed. 806. Under the FMLA (Family and Medical Leave Act), an acquiror deemed a "successor-in interest" to the target may be subject to broad successor responsibility and may be required to rehire persons on leave. 29 USC § 2611(4)(A)(ii)(II). (Employer includes any successor-interest.) See *Vanderhoof v. Life Extension Institute*, 988 F. Supp. 507 (D.N.J. 1997), acquiror was responsible where after acquisition business operations remained same and all employees hired, although upper level management changes made and benefit changes made and other locations closed and the business targeted different clientele than before.

Also, an agent may be separately liable as an employer if the agent operates on behalf of private employer covered by Title VII (also the ADEA). Under the FMLA, "Employer" also includes "any person who acts, directly or indirectly, in the interest of an employer to any of the employees of such employer." 29 USC 2611(4)(A)(ii)(I). Thus, agents can have personal liability.

18. Employment Relations Generally. For a potential acquiror of a business, employment agreements are highly important to analyze in determining the value of the business. Thus all employers will want to keep in mind what a potential acquiror might find adds or subtracts business value. The key issues in the analysis of the foregoing features of employment agreements or arrangements include:

(1) Is there actual or potential litigation?

(2) Are the employment contracts or arrangements likely to help or hinder obtaining or retaining necessary talent, eliminating unneeded workers, or protecting goodwill or trade secrets?

(3) What will be the costs of the compensation and benefit arrangements?

(4) Is the business in compliance with applicable rules?

Labor relations are a critical aspect of a business. Utah is a right-to-work state. UCA §§34-34-1 to-17 ("right of persons to work… shall not be denied or abridged on account of membership or nonmembership in any labor union…"). Other states allow union membership as a condition to employment. Utah also has rules regarding labor disputes. See UCA §§34-19-1 to -13 and 34-40-201 to-205. However, federal labor law tends to dominate the field.

The National Labor Relations Act of 1935 (NLRA) (29 USC §§ 151-169) requires employers in interstate commerce (and next to none are not) to bargain collectively with a recognized union for bargaining units of employees with respect to "rates of pay, wages, hours of employment, and other conditions of employment."

In order to protect the value of a business for a possible future acquisition, clean labor relations can be very important. Both sellers and acquirors are greatly interested in the nature and extent of collective bargaining agreements, labor disputes, and union organizing efforts. Even in an asset sale, union contracts and representation rights do not disappear and must be dealt with by the parties. The target may have a legal or contractual duty to bargain. The seller may acquire a legal duty to bargain. Labor peace can be critical. The Labor Management Relations Act ("LMRA") and its amending statutes are the key authority concerning collective bargaining. 29 U.S.C. § 151 *et seq.*

The acquiror may not discriminate in hiring union workers based on union affiliation or activities. *Howard Johnson Co. v. Detroit Local Joint Executive Board*, 417 U.S. 249 (1974*); NLRB v. Staten Island Hotel*, 101 F.3d 858 (2d Cir. 1996).

Where a majority of the acquiror's new employees were the target's employees, and where the acquiror continues the target's business substantially unchanged, then the acquiror will be a successor which must recognize and bargain with the union. *John Wiley & Sons, Inc. v. Livingston*, 376 U.S. 543 (1964); *NLRB v. Burns International Security Services, Inc*., 406 U.S. 272 (1972); *Fall River Dyeing & Finishing Corp. v. NLRB*, 482 U.S. 27 (1987). The courts look to the totality of the circumstances: "whether the employees of the new company are doing the same jobs in the same working conditions under the same supervisors; and whether the new entity has the same production process, produces the same products, and basically has the same body of customers." *Fall River Dyeing*, *supra*, at 43. <u>See</u>, also, *Trujillo v. Longhorn Manufacturing Co*., 694 F.2d 221 (10th Cir. 1982). Also, if the acquiror hires a "representative compliment" of bargaining unit employees where a majority of the newly-hired employees were employees of the target, and if the union requests bargaining, then the acquiror is obligated to bargain in good faith with the union. *Spruce Up Corp*., 209 NLRB 194 (1974). In the meantime, while bargaining, the initial terms of employment must be continued until agreement or impasse.