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MERGERS AND ACQUISITIONS

As the pace of business begins to pick up in anticipation of a new, post-recession economy, many firms are considering making an acquisition or putting themselves up on the block. Yet they often have done insufficient groundwork to be ready to enter into a transaction when the time is right. Here the author details a wide range of actions and considerations that companies need to address well ahead of entering into the merger and acquisition process.

Ready to Sell Your Company? The Time to Start Thinking About It Is Now

BY EUGENE J.M. LEONE

Prior to the collapse of the credit markets, my firm worked on a number of public and private company mergers and acquisitions in the real estate space. For the most part, our clients were the hopeful and occasionally successful acquiring parties, and the deals took the form of public-to-private transactions. In almost every instance, we found that the target was not nearly as well prepared for a transaction as it purported to be. Even in situations in which the target either anticipated offers or put itself up for sale, the lack of preparedness often thwarted the deal or resulted in less favorable execution.

With business activity way down, this might be the time to prepare for the next wave of activity. After all, the markets are likely to recover, and some planning right now can create huge benefits in the future. Moreover, we may encounter a number of forced transactions as weakened companies are compelled to put themselves up for sale. Whether a company is a willing

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or reluctant target, it may as well take measures to achieve the best possible results. Finally, the problems in the credit markets have made it harder to produce buyers. If a potential target does not present itself well, a buyer may simply fail to emerge.

Long before a transaction is even on the horizon, a company should enter into loan agreements, ground leases, venture agreements, and major contracts with an eye toward the impact that a change in control will have on its rights and interests. If a company has a 50 percent venture interest in a major New York City office tower, and the company experiences a change in control (i.e., a buyout of the public shareholders or a merger of the parent into another entity), will that change in control trigger a right of first refusal in favor of the venture partner? Will it cause the acceleration of the company's secured or unsecured indebtedness? When ventures are formed, ground lease interests are acquired and loans are arranged. A company must be mindful of the circumstances in which a change in control can trigger a default, a consent requirement, or the acceleration of debt. A company must keep its exit strategy in mind and account for inevitable changes in control at the parent level.

Structuring a Transaction. If a target company decides to pursue a divestiture of assets or a merger, the time spent on the transaction structure will be invaluable. Most importantly, the target must appreciate that buy-

ers will come in different shapes and sizes, and a one-size-fits-all approach may limit the universe of potential buyers.

For numerous reasons, a target company may prefer a stock sale or a merger transaction to a sale of assets. A sale of assets can result in double taxation as both the company and the shareholders are subject to tax. If the target is a real estate investment trust, a sale of assets will not permit the limited partners of the REIT's operating partnership to roll their partnership units into a new operating partnership formed upon the merger of the target and the acquiring partnership. Additionally, an asset sale is more likely to trigger local transfer taxes and requirements that consents be obtained, that permits and licenses be re-issued, and that properties be reassessed. Finally, unlike a stock sale or merger, an asset sale will leave any company obligations that are not assumed with the target.

Although it may be of less concern if the target is a public company, buyers have a justifiable preference for asset purchases and a reluctance to inherit the undisclosed liabilities of the target. In this context, buyers may have the sense that Securities and Exchange Commission disclosure and reporting requirements may render a public company less likely to have undisclosed liabilities.

Even if the buyer can overcome its concern about undisclosed liabilities, it may find that the tax issues are insurmountable. Among other issues, the buyer will not want to succeed to the basis of the target company in its assets. There is some potential for a target company to anticipate the buyer's concerns about the seller's tax basis by, for example, putting appreciating assets into a separate entity. This step may enable the parties to deal separately with appreciating assets.

Whatever the preferred approach, the target company and its advisers should thoroughly analyze potential deal obstacles in light of the universe of possible buyers. If a company has assets that will make it unattractive to a potential type of buyer, such as assets that cannot be sold prior to the expiration of a long holding period, will these assets have a chilling effect on a deal? If a company has securities, such as publicly-held debt instruments, that will require the company to continue as a reporting company, will the securities limit the universe of potential buyers to other public companies? A target company must understand its capital structure and its tax issues in evaluating prospective bidders.

The buyer that has been pursuing you off and on for five years “if the price were ever right” may ultimately be your buyer, and you will not want to pay a full commission or fee for a transaction that only takes a phone call to a known party.

Investment Banks, Brokers, and Company Insiders. Investment bankers and specialized brokers who deal with particular types of companies, assets, and transactions can be invaluable. More valuable than someone with industry expertise is someone who truly under-

stands your business and your objectives. Once the target company has identified the right broker or banker, it is never too early to bring that group aboard. However, make sure that you have them doing the right things. As explained below, investment bankers and brokers should *not* create your data or war rooms. They do not know a survey from a site plan, they usually assign these functions to the most junior personnel, and the data assembly and presentation usually suffers accordingly. Use your bankers and brokers for their knowledge of deal terms, structures, and market receptivity to proposed transactions.

Do not forget that you may need to reserve a buyer or two. The buyer that has been pursuing you off and on for five years “if the price were ever right” may ultimately be your buyer, and you will not want to pay a full commission or fee for a transaction that only takes a phone call to a known party. Company insiders may emerge as the buyer. If your company is public, it will be particularly important for your attorneys to guide you through the complexities of managing a process that is fair to both insiders and outsiders. Even if your company is private, you will not want to defend the perception that the company officials have the inside track. This perception can dampen enthusiasm for a transaction.

Organizing the Flow of Information. In most cases in our electronic era, an internet-based database or “war room” serves as the source for all data. Some of these are more user friendly than others. Although *Realcapitalmarkets* does not have nearly the market penetration of some other sponsors of databases, its war room is well organized and easy to negotiate. In the author's opinion, *Realcapitalmarkets* offers a superior experience.

No matter who provides the technology for the war room, the company must use experienced professionals to download data. When the task is left to inexperienced persons who are not familiar with the company's documents, the deficiencies cause extensive delays in the review process. Here are a few examples of deficiencies that we regularly encounter:

- Outdated and incomplete title policies and title commitments (often issued to someone other than the company or an affiliate) are posted. Underlying title documents are missing. The “exception documents” do not match the list of exceptions to coverage specified in the title policy or the commitment.

- Surveys, which are often multiple-page documents, are generally incomplete. Documents appearing to be surveys, such as plats or site plans, are posted as surveys because the person posting the surveys did not appreciate the difference.

- Leases and loan documents are often incomplete—not because the complete documents are unavailable but because the person assembling the documents did not know how to determine if the documents were complete.

- Venture operating agreements and partnership agreements often lack signature pages, exhibits, and amendments. This deficiency seems particularly acute if the target company has grown its business in the past by merger or entity acquisitions.

- Physical and environmental reports are often outdated or, in the case of companies that have grown by way of mergers and entity acquisitions, missing alto-

gether. The buyer will almost certainly insist on obtaining reliable reports—whether in the form of new reports or updates to existing reports. The target should anticipate this concern and arrange for new reports, updated reports, and reliance letters.

In sum, the company must develop the war room early in the process, and the company must take care to post documents thoroughly and accurately. If it does not, the company will expend substantial time and resources responding to due diligence requests, locating the requested documents, posting these documents, and, finally, addressing the concerns that the newly posted documents engender. We have encountered several transactions in which the mismanagement of the war room created doubts about the target company's candor and competence.

Balancing Confidentiality With the Need for Information.

For some years, when a public or a private company was in play, it was really in play. Target company executives were generally of the view that the disclosure of a potential transaction to company personnel was of no concern because (a) everyone associated with the transaction was likely to become richer by virtue of the transaction and therefore would welcome the transaction, (b) it did not matter if a transaction failed because another one would emerge in short order, and (c) the disclosure of a possible deal would cause additional buyers to jump into the fray. As long as the target company observed securities laws and contractual obligations relating to disclosures of material, non-public information, the target company was free to go after deals with a vengeance.

The thinking has reversed itself. Failed deals can discourage or demoralize employees and cause them to head for the exits. Failed deals can also tarnish the image of a company, and, if the target is a public company, put additional pressure on the company's stock price. As a consequence, target companies work hard to maintain not simply the confidentiality of deal terms but confidentiality regarding the deal itself.

The effort to keep the possible existence of a deal as quiet as possible often results in poor communications between the buyer and the target. The target is reluctant to allow the buyer to perform its due diligence or to speak with company employees. The buyer often arrives at the impression that the target is either unwilling or unable to provide information.

Perhaps the best way to manage inquiries and the flow of information is by authorizing key persons in the company to respond to specific types of queries. For example, the general counsel can answer inquiries regarding litigation, the chief financial officer can address questions regarding the capital structure, and the vice president of operations can respond to queries about management issues. What rarely works is communications through investment bankers. They generally have no idea how a company is run. They do have the advantage of acting as a conduit, but, in so serving, they can also act as a roadblock.

How Will a Buyer Value Assets. If the buyer is motivated by a desire to own the target's core assets, the target may own certain assets to which the buyer allocates modest value. A buyer that desires operating cash flow may place little value on development properties. In fact, the buyer may consider those properties to be liabilities rather than assets.

Artwork often cuts both ways. The buyer may perceive it as having little value or may feel that it represents hidden value. Generally speaking, corporate jets are undesirable, especially in today's climate, and the buyer will not want to be stuck with long-term leases or aircraft that have little resale value. The key here is having a plan to deal with the extraordinary assets that may or may not be intrinsic to the buyer's business.

What About the Employees? In recent years, most real estate merger and acquisition activity has focused on the underlying assets. Unfortunately for the talented professionals who run most real estate companies, the buyer may want the assets but wish to terminate the employees other than key personnel. The target must therefore account for, and be prepared to explain to the buyer, the terms of employment contracts, the rights of employees to severance benefits, and any impact that a change in control may have upon the rights of employees. In large part, the analysis will boil down to the cost associated with retention and termination of employees. Remember that there may be state and federal laws relating to the termination of employees, such as the federal law known as the Worker Adjustment and Retraining Notification Act (the WARN Act) or similar state laws.

Statutory, Tax and Regulatory Hurdles. Just as the WARN Act may be applicable to a particular transaction, there may be a myriad of state and federal laws that come into play upon the transfer of assets by the target company or the merger of the target company with the buyer. The securities, antitrust, and tax laws provide the best examples. However, less well known legal requirements affecting a company's holdings may be activated by reason of a parent company transaction. For example, if a property owner provides its residents with utility services, the change in control of the property owner's parent—even several layers removed from the property owner—may require the issuance of new utility licenses. The utility licensing process is complex and time-consuming. As another example, the parent company transaction may trigger a state law giving a homeowner's association the right to acquire a mobile home park owned by the subsidiary of the parent company. These legal requirements may not be on the radar screen of your corporate counsel if the counsel is not familiar with your real estate activities.

Is Financing Available? Late last year, one of our clients found a desirable acquisition target that was on the ropes. Prior efforts to acquire the target had proved unsuccessful as the per share price always seemed a bit (or more than a bit) out of reach. Our client refused to chase a deal that required a substantial premium to a full market price and the assumption of substantial leverage. However, the collapsing debt and equity markets presented an opportunity. Instead of repaying the existing debt and incurring substantial prepayment penalties in doing so, the market price had fallen to a point where it made sense to assume the existing debt. While new sources of financing had dried up, the existing financing would do just fine, and the path was cleared to a viable deal.

Is It Over When It's Over? From the target's perspective, a merger of the target into the buyer or the acquisition of the target's stock by the buyer generally pre-

sents the most favorable deal structure and provides for a certain finality. There is no entity or reservoir of assets from which the buyer can recover if, following closing, it learns of undisclosed liabilities. As buyers pursuing public companies know all too well, there is generally no other way in which to consummate a public-to-private transaction. The buyer inherits the assets and liabilities of the target as they existed prior to the closing. Purchasers attempt to address the specter of unforeseen liability through due diligence and carefully crafted representations and warranties. In deals involving private companies, a portion of the purchase price can be held back and escrowed so that the funds are available to pay a claim.

It Is All About Anticipation. Remember that for most companies the process of selling itself occurs on just one occasion. Certainly, that is the goal. As a result, there is no dress rehearsal, and the entire process boils down to getting it right the first time. If the value of real estate is a function of location, location, location, then the process of selling the company is about anticipation, anticipation, anticipation.

Whether developing a deal structure, hiring an investment banker, engaging counsel, building the war room, or establishing points of contact, the efforts boil down to running the best possible process. If the company has a clear vision of its goals and can anticipate the issues that are likely to stand in the way of its goals, then the company will be successful. It must anticipate the buyer's structuring issues and the concerns that a buyer is likely to raise. For example, if a company has an environmental problem at a particular property, the

company should disclose it up front and assume that it *will* be a concern to the buyer. By doing so, it can develop an explanation as to why the problem should not be a concern, or it can develop a plan for addressing the buyer's concern. The later the buyer discovers a due diligence problem or any deal impediment, the greater the problem it will pose for the target. The impediment may become a means for exacting a price concession from the target or it may become an insurmountable problem at a time when other interested parties have disappeared.

Even in circumstances in which the target is mindful of a buyer's concerns, it may not properly allow for everything. We worked on one public company merger that required the re-issuance of licenses to operating subsidiaries. While the target expected that the buyer would have to obtain new licenses, no one anticipated the time that it would take to obtain them. However, by anticipating the issue, we at least had a chance of managing the process in a reasonable amount of time.

The schedules to merger agreements and asset purchase agreements provide a good opportunity for planning and anticipation of a buyer's concerns. The target and the target's counsel know that schedules are likely to be necessary, and they can generally anticipate the nature of the schedules. The parties should attend to them early in the process of negotiating the key transactional documents.

A target company cannot think of every possible concern that its prospective buyers may have, or every possible issue that may arise, but the time that a company spends anticipating those concerns and issues will go a long way toward ensuring a successful deal.