



## 208:Soured M&A Deals: What Happens When Bad Facts Surface between Signing and Closing

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***Busted M&A Deals: What Happens When Bad Facts  
Surface Between Signing and Closing of an Acquisition Agreement***

**Hypothetical**

Keep Warm, Inc., a privately held corporation, is in the business of home heating appliances, primarily electric space heaters and electric blankets. It has high quality products, has been very successful, and has a great engineering department, which has developed very innovative technologies, some of which are patented. The founder, CEO and majority owner of Keep Warm, Mr. James Watt, is a 55-year-old entrepreneur who has been contemplating a sale of his business for several years.

In April 2003, Keep Warm acquired by merger a corporation that is in the electric blanket business and now operates it as a wholly owned subsidiary that is a limited liability company. Keep Warm has projected that the electric blanket division will contribute about 10% of Keep Warm's overall profits.

In March 2004, Keep Warm engaged an investment banker to find a buyer for the company and the investment banker has sent "books" about Keep Warm to a number of prospective purchasers, both financial and strategic buyers. Each of these potential buyers has signed a confidentiality agreement that provides, among other matters, that Keep Warm is making no representations and warranties as to any disclosed information except as may be contained in a definitive purchase agreement.

As a result of this "auction" process, Multi-Electric, Inc., a publicly traded corporation, which is in the home appliance business, and which is a fierce competitor of Keep Warm, has been selected as the buyer with which Keep Warm will negotiate an agreement.

Because Keep warm is an S corporation, and because of Multi-Electric's concern about Keep Warm's liabilities and its desire to obtain a stepped-up basis in Keep Warm's assets, the parties have agreed upon an asset transaction.

The purchase price, based on Keep Warm's recast year 2003 financials, is a multiple of EBITDA. The purchase price will be paid in cash with a certain portion of the purchase price to be held in escrow for post-closing purchase price adjustments (based on an audited closing date balance sheet) and as protection against certain breaches of representations, warranties and covenants. Multi-Electric has also insisted that Keep Warm's net working capital at the time of the closing be not less than \$25 million.

The following additional facts are pertinent:

Pre-Signing Facts

1. Keep Warm has furnished audited financial statements to Multi-Electric as of December 31, 2003 and for the year then ended, and for the prior two years, together with the audit report of Always Accurate Auditors, LLP.
2. Keep Warm has furnished unaudited financial statements for its first three quarters of 2004.
3. Multi-Electric has reviewed these financial statements and Keep Warm's strategic business plans, marketing studies and projections for the next three years. Some of the projections are quarterly and some are year by year.
4. Keep Warm discovered, in June 2004 that its acquired electric blanket company has engaged in possible financial shenanigans that may cause Keep Warm to take a significant charge against earnings with regard to that company. In the disclosure schedule to the no undisclosed liabilities representation of the Asset Purchase Agreement, Keep Warm has represented that there are no undisclosed liabilities "...except for any further liabilities (in addition to Keep Warm's restatement of earnings in its 3<sup>rd</sup> quarter 2002) associated with certain improper accounting practices in its electric blanket division."
5. The Asset Purchase Agreement contains no representations about financial projections of Keep Warm.
6. Multi-Electric was unyielding in its insistence that Keep Warm agree to the following representations in Multi-Electric's draft of the Asset Purchase Agreement:

Financial Statements (Section 3.4)

No Undisclosed Liabilities (Section 3.13)

7. Keep Warm was able to negotiate a no material adverse change representation that differs from the representation presented by Multi-Electric (Section 3.15) in that it excepts from the definition of "no material adverse change", general economic conditions and changes affecting the industry.

8. The conditions to closing (Sections 7 and 8) are as proposed by Multi-Electric, including an additional condition to Multi-Electric's obligation to close that Keep Warm's net working capital at the time of the closing be not less than \$25 million.
9. Keep Warm rejected Multi-Electric's provision (Section 11.1) that Multi-Electric's investigation or knowledge of a breach by Keep Warm would not adversely affect Multi-Electric's right to sue for breach of representation or warranty or for indemnification. In other words, the Asset Purchase Agreement contains neither a "sandbag" nor "anti-sandbag" provision.

#### Post-Signing Facts

1. Two of Keep Warm's space heaters have overheated, causing substantial fire damage to two homes. Fortunately there were no deaths or serious injuries.
2. Multi-Electric has discovered that the financial problems in the electric blanket division are substantially more serious than were disclosed by Keep Warm to Multi-Electric prior to the signing of the Asset Purchase Agreement.
3. Multi-Electric is suspicious that in Keep Warm's unaudited quarterly financial statements, Keep Warm has been booking certain sales before orders are shipped and that it has been too conservative in amortizing certain software development costs. Multi-Electric also believes that inventories may not be properly stated.
4. Multi-Electric has discovered that James Watt holds one broad patent for some of Keep Warm's core products that he obtained before Keep Warm was organized and was never assigned to Keep Warm.
5. Following the announcement of the deal, a number of Keep Warm's substantial customers have expressed reservations about Multi-Electric's dedication to quality products and service. In addition, several employees have expressed concern about Multi-Electric's heartless employment practices.
6. It is now late October 2004, and, because of a second request by the Federal Trade Commission, the HSR waiting period has not yet expired, although the parties believe that the FTC has become satisfied that there are no substantive antitrust issues with the deal. In the meantime, *The Farmers Almanac* has forecasted that the winter of 2004-2005 will be unusually warm.

7. Multi-Electric's CEO, John Positron, is getting "cold feet" about Keep Warm. He is concerned about continuing problems in the global economy. He is upset about the problems in Keep Warm's electric blanket division and the possible premature booking of sales by Keep Warm. He is also worried that a number of Keep Warm's customers will not do business with Multi-Electric and that certain employees of Keep Warm will refuse to be employed by Multi-Electric. He is also losing sleep about the possibility of products liability lawsuits with respect to a certain brand of space heaters manufactured by Keep Warm. He wants to explore whether (a) Multi-Electric can get out of the deal, or (b) whether Multi-Electric could close the transaction and sue for substantial damages. Mr. Positron calls a meeting of his board, investment bankers, accountants, a number of Multi-Electric's executives, and Multi-Electric's general counsel, George Patrick, and distinguished deal counsel, Byron Egan.
8. Keep Warm's CEO, Mr. Watt, is deathly afraid that Multi-Electric will either (a) try to terminate the deal, after learning a lot of Keep Warm's trade secrets and identifying its key employees, or (b) Multi-Electric will close the deal but then try to sue Keep Warm and its shareholders for breaches of representations, warranties and covenants. Mr. Watt is conferring nervously with his eminent silver haired, not to mention silver-tongued, deal counsel, Larry Tafe. Famous Delaware corporate litigator, Frank Balotti, will confer on occasion with Mr. Tafe. However, Mr. Balotti will also provide advice and commentary to Multi-Electric. Being the highly ethical lawyer that he is, Mr. Balotti would never dream of counseling both sides. He is doing so only for purposes of this program.

#### A Few Additional Facts

1. Keep Warm is a Massachusetts corporation that transacts business in many states and countries. For some strange reason, however, it does not transact business in Delaware.
2. Multi-Electric is a Delaware corporation that is headquartered in Texas.
3. The Confidentiality Agreement is governed by Delaware law and contains a provision stating that Delaware will be the exclusive venue for any litigation between the parties with respect to that agreement. The Asset Purchase Agreement is governed by New York law and has no venue provision.