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Middle Market M&A in the United States: Opportunities and Challenges

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For M&A practitioners who have been through several business cycles, the effect of the current economic downturn on mergers and acquisitions should mean one thing: opportunity. Although the credit crisis has curtailed the normal cycle of acquisitions and divestitures, time marches on. In the United States, private companies are often owned by entrepreneurs and their families who face generational transitions and corresponding management and tax issues as the founders age, retire and/or pass away, or by private equity funds that have their own self-imposed limited time horizons. Strategic European buyers with available acquisition capital will have access to an excess inventory of niche companies and market entry opportunities as the economy pulls out of the current cycle. In the decade before the current downturn, the percentage of acquisitions in the United States by foreign buyers increased substantially,[1] driven, no doubt, by the still relatively weak dollar and attractive market access opportunities. Professionals advising on or pursuing their own first-time entrées to the M&A market in the United States will benefit from knowing the differences and similarities of doing deals in the United States as compared with the European market generally.

In terms of EBITDA and revenue multiples, European buyers will find that U.S. pricing for middle market transactions has generally trended upward over the past 12 months. A notable exception, however, is at the lower end of the middle market, where multiples for U.S. companies with enterprise values below US$50 million remain low, on par with multiples of comparable European companies.[2]

Strategic buyers (who may currently be better situated than financial buyers to finance acquisitions) have responded accordingly. In the past 12 months, the number of acquisitions in the United States with values between US$250 and US$750 million has doubled, and the number of deals with values of less than US$50 million has also significantly increased.

From a seller's perspective, however, the dramatic reductions in revenue and EBITDA may slow the deal process. Enterprise values may seem discouragingly low and many potential sellers will be reluctant to sell until their business returns to "normal" revenue and EBITDA levels. But not all of these owners will have the luxury of waiting for the rebound. Not only do the generational and private equity liquidity pressures mentioned above continue to mount, increasingly nervous lenders are pressuring non-performing and struggling companies with debt on their balance sheets to seek transactions that will assure an exit for the lender, even though the timing may not be optimal for the owners.

Given these factors, buyers should expect to see reluctant sellers pushing hard to get sale prices based on what they think their companies are worth in a "normal" economy or business cycle. Aggressive buyers will attempt to use earn-out payments contingent on the target achieving performance levels that the sellers believe will be achievable in the near term to bridge the perceived value gap while reducing the risk of overpaying. While earn-outs are also used in many European deals, they are generally not as favored in Europe as in the United States. In today's market, however, buyers of U.S. companies may have to embrace the approach to develop a competitive offer.

Earn-out arrangements must always be carefully conceived and structured. This is all the more critical for a strategic buyer seeking to leverage newly acquired U.S. operations to facilitate growth for its European operations. Such buyers cannot allow the seller's objective of maximizing the contingent payment to frustrate their own strategic objectives in making the acquisition. The criteria selected (sellers usually want to use revenue, or perhaps gross margin, while the buyer may prefer to use EBITDA, and often a combination of the two is agreed upon) and the timeframe (the seller will want as much time as possible to allow for the market to come back, while the buyer should limit the period to no more than 12 months if possible to avoid extended drag on its integration plans) are both critical. Earn-out terms in an acquisition agreement can be relatively simple, but more often than not, they become quite complex as both sides grapple with giving the other party a degree of control over their own financial success. On balance, so long as the buyer retains control over the operations and strategic direction of the target, an earn-out can be a useful tool in this market to encourage buyers to settle on an attractive deal while reducing the risk of overpaying.

European buyers entering the U.S. M&A market for the first time may have some degree of trepidation over the potential legal pitfalls even after they manage to balance the financial risks. They may also find the legal process, from the logistics of the due diligence to the complexity and sheer length of the acquisition documentation, to be daunting. However, as they move through the process, European buyers should find that many of the differences are "pro-buyer" and are intended to prevent the seller from shifting unknown legal risks to the buyer.

For several years, the American Bar Association (ABA) has published studies of key deal points in M&A transactions.[3] This research has recently been extended to include deals in Europe, allowing European M&A practitioners to better educate themselves and their clients as they contemplate entry into the U.S. transaction environment. Exposure to transatlantic transactions has raised awareness of the differences between the relatively streamlined continental approach to acquisition documentation and the comparatively expansive Anglo- American approach. Comparing the ABA's U.S. and European deal points studies provides insight into how these approaches differ, including:

- Acquisition agreements reviewed in the U.S. study nearly always explicitly included a general seller representation as to the absence of undisclosed liabilities, a provision found in fewer than half of the agreements reviewed in the European study.
- U.S. agreements also were much more likely than European agreements to include closing conditions as to the accuracy of the seller's representations and warranties, as well as the absence of any material changes between signing and closing - thus protecting the buyer from, and leaving the seller at risk for, negative developments between signing and closing.
- While most of the U.S. agreements included non-tax legal opinions as a closing delivery, this requirement was found very infrequently in the European agreements. While the requirement for such legal opinions is declining somewhat in the United States, they offer an additional measure of assurance to the buyer that comes from the seller's attorneys confirming that certain formalities have been properly attended to and that they are not aware of any legal defects in the deal.
- Language relating to the buyer's ability to make claims with respect to breaches of representations and warranties of which it was, or should have been, aware prior to close (*i.e.*, sandbagging) was found in more than half of the acquisition agreements in both the United States and Europe. However, the U.S. agreements trended towards permitting such claims, while the European agreements trended toward limiting such claims.
- Dispute resolution through arbitration was found in far more European agreements than U.S. agreements. This may be due in part to the relative homogeneity of the federal and state legal systems within the United States. In Europe, arbitration is seen as the preferred means of conflict resolution in business-to-business relationships. Companies seem to prefer the confidentiality and privacy of arbitration, as well as the ability to appoint a subject matter expert to resolve the dispute. Europeans also generally find the

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arbitration process to be more expedient, while many U.S. practitioners are less willing to give up the structured approach to discovery and the appeal rights that come with litigation.

Two areas of risk allocation that never fail to create angst for European buyers of U.S. companies are product liability and environmental liability. While the United States continues its struggles over the adoption of universal health care, the social safety net for individuals who suffer serious injury depends heavily on the strict liability lawsuit against manufacturers and sellers of products involved in the accident. Buyers wishing to protect against historical product liability risk must not only shift the liability to seller by contract, they should also require that an appropriate "tail" insurance policy, which generally covers post-closing claims based on pre-closing incidents, is acquired by the seller to protect the buyer long after the seller has become unreachable. It is not enough to shift the risk by contract, as third parties (potential plaintiffs) are not bound by the contract. An asset purchase structure that excludes certain liabilities can also be very helpful, but principles of successor liability can still pose a significant risk even in an asset purchase.

Similar concerns exist with environmental liability. The latent nature of these risks and uncertainty as to costs rightfully causes concern for both U.S. and foreign buyers. While insurance is available, it is not as economically efficient or affordable as product liability insurance. Accordingly, the best protection is a thorough environmental audit and pre-closing agreement on the scope and financial responsibility for any indicated remediation or un-remedied risks. The enforcement trends in most U.S. jurisdictions have become somewhat more liberal in recent years, allowing reasonable remediation measures to satisfy the regulators in many cases. In addition to federal laws that relate to matters such as waste disposal and workplace safety, each state has independent enforcement over environmental matters, particularly with respect to air and water quality on owned and adjacent real property and water reserves. Recent trends in regulation enforcement suggest that many state regulators are trying to balance environmental protection with the need to accommodate the conduct of business so as to avoid losing tax-paying employers to other jurisdictions. Although it is too early to tell how the changes in the federal administration will impact federal enforcement, some reversal of the recent trend would not be surprising.

Finally, as with any cross-border transaction, acquiring a U.S. company requires preacquisition tax planning to avoid pitfalls and to take advantage of planning opportunities. U.S. tax issues commonly encountered in M&A transactions include the extent and timing of gain recognition to the seller, the ability of the buyer to take a stepped-up basis in the stock or assets purchased, the impact of the transaction on the target's pre-closing tax attributes, the rules governing repatriation of earnings (*e.g.*, withholding taxes and their mitigation through treaties, the applicability of thin capitalization rules, etc.), and the use of transfer pricing for post-closing intercompany transactions. For example, a foreign buyer may find it advantageous to acquire the target's IP assets separately and license them back to the target as a tax-efficient means of repatriating earnings. Such planning may have consequences that go to the economics of the deal, and therefore is best evaluated as early as possible in the transaction process, rather than after the deal is struck - or worse – closed.

The U.S. market may soon be teeming with opportunities for foreign companies looking to grow by acquisition. While there are several differences in the way in which transactions are conducted in the United States and Europe, approaching potential acquisitions with an appreciation of these differences will facilitate a successful acquisition process.

About the Authors:

Kevin J. Howley is a shareholder and director of Reinhart Boerner Van Deuren s.c., Milwaukee, Wisconsin, USA, Chairman of the Business Law Section of the State Bar of Wisconsin and a member of the American Bar Association's Mergers & Acquisitions Section. Mr. Howley has assisted clients in the acquisition, divestiture and operation of companies throughout the United States for over 25 years and has assisted numerous European clients seeking to establish or expand their presence in the United States through acquisitions, with a special emphasis on Finnish and Swedish clients.

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Messrs. Howley and Tarvainen have collaborated on numerous acquisitions and divestitures in the United States and elsewhere over the past 20 years.

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[1] See Monthly Overview of Global Middle-Market M&A Activity, Merger Tracker

(William Blair & Co); see also *Global M&A Monthly: A Middle-Market Perspective on U.S., Europe, and Asia Mergers & Acquisitions*, M&A Market Analysis (Robert W. Baird & Co.)

2 Id.

3 Copies of these studies are available to members of the Mergers and Acquisitions Committee of the ABA's Section of Business Law.