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Deferred Price Issues

MBBI Luncheon Meeting 11/13/2008

Seller Financing

Seller Financing: When a seller agrees to loan money to a buyer

# NOTES

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as part of the purchase price.

1. Why is seller financing desired? Skin in the game
2. What % of purchase price?

a. Trending up or down?

b. Higher with customer concentration

1. Term of the note?
2. Interest rates – trending down
3. Subordination required?
4. Security
   1. Personal Guaranty?
   2. Security Agreement? What is covered in security

agreement? – only assets purchased or also home

and other assets?

1. Right to offset
2. Cure period on default
3. How to communicate with the client (seller or buyer)

Earnouts

# NOTES

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Earnout: Purchase price dependent on performance.

1. What is an earnout?

a. Helps buyers have assurance that the business is

performing in accordance with projections

b. Earnouts may be determined for the entire company

or only part of a product line

1. Situations when an earnout might be appropriate
   1. Proverbial hockey stick
   2. Uncertainty about future
      1. About the company
      2. About the economy/industry
   3. Unstable businesses or rapidly growing businesses
   4. New business
   5. Used to be more of a valuation issue and now becoming

more of a risk mitigation issue

f. Seller is key to business and wants to leave business

1. Situation where an earnout is not appropriate

# NOTES

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* 1. Usually used with stand alone businesses and not

those being integrated into another entity

1. Potential pitfalls with earnouts
2. Calculating earnouts - Accounting issues
   1. Can really be based upon any type of business

parameter that can be measured but will usually be

tied to some sort of financial performance indicator

and not upon volume, e.g., revenues rather than

number of units produced

* 1. Top of the income statement, e.g., gross revenues
     1. Easier to determine
     2. Favored by the seller because of ease in audit rights
     3. Seller concerned with improper expenses

and auditing takes longer

* 1. Bottom of the balance sheet, e.g., net income or

EBITDA, favored by the buyer

* + 1. Takes into account the costs of operations
  1. When recognition of income occurs for seller and

expense for buyer from an accounting perspective

1. Seller issues
   1. Seller’s continued role in company after sale
   2. Audit rights
   3. Veto rights on certain decisions
   4. Seller’s due diligence – seller investing in the buyer
2. Buyer favored because:
   1. Price assurance – comfortable that price is based on

performance and did not overpay

* 1. Takes into account uncertainty of future economic times
  2. Relieves some due diligence concerns
  3. Makes up for lending shortfalls
  4. Resolves the price difference between seller and buyer

1. Potential issues with earnouts
   1. Cost of verifying numbers
   2. Potential litigation, arbitration, or mediation

regarding disputes

* 1. Incentive for the buyer to not run the business in the

ordinary course

* 1. May be difficult to administer from an accounting

perspective in segregating earnings – e.g., if buyer is

integrating the target company into buyers’ operations,

post January 1, 2009 GAAP accounting issues

* 1. SBA financing limits – August 2008 guidelines
  2. Broker fee issues – have this in your engagement agreement

1. Open forum of how audience members have been these play out in recent deals

Consulting Agreement

# NOTES

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1. Why is this a deferred price issue?
2. When is it used?
3. Length of time?
4. Duties?
5. Benefits?
6. Salary? – IRS issues
7. How to account for money earned?
   1. Expense for seller
   2. Income for buyer
   3. Who pays what taxes – Independent

Contractor v. Employee

1. Broker fee issues - have this in your engagement agreement

Escrow

# NOTES

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Escrow: Holding property of another until a later defined date or event

1. Usually a portion of purchase price held to ensure

financing paid, reps and warranties are correct,

environmental liabilities taken care of, etc.

1. What are we seeing in this area lately?
   1. Time Frame
   2. Amount