Green Mergers

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ABOUT THE AUTHOR

Robert C. Hackney is the founder of Hackney Law, P.A., a Palm Beach County Florida based law firm, and also serves as Executive Director of the Alternative Energy Association, a Florida not for profit corporation. For over three decades his law practice has included public and private securities offerings and syndications, mergers and acquisitions, real estate finance transactions, and complex real estate and corporate transactions. He is a former securities fraud prosecutor and state securities regulator. Mr. Hackney is a member of The Florida Bar, the United States District Court, Southern District of Florida, the United States District Court, Middle District of Florida, the United States Court of Appeals for the Fifth Circuit, and the United States Court of Appeals for the Eleventh Circuit. He received his Juris Doctor degree from Stetson University College of Law and his Bachelor of Arts degree from Florida State University. Mr. Hackney is the author of *The Energy Revolution-277 Things Every American Needs to Know About the New Energy Paradigm*. He has also lectured and authored several books in the area of corporate and securities law, including this publication "*Green Mergers*," "*Firesale! Advice on Buying Financially Distressed Companies*," "*An Insider's Guide to Non-Bank Business Financing*," "*The Complete Guide to Mergers & Acquisitions*," and "*The 7 Secrets of Successful Real Estate Syndicators*." Mr. Hackney serves on the Advisory Board of the International Green Technology Center, and is a Director of the Marine Industry Education Foundation of Palm Beach, a non-profit organization. Mr. Hackney also served as a member of United States Senator Connie Mack's Senate Roundtable, is the past President of the Rotary Club of Palm Beach Gardens, Florida, the past President of the Guild of Catholic Lawyers of the Diocese of Palm Beach, past Palm Beach County Co-Chairman of the Bill Richardson for President campaign and is listed in the Who's Who Registry.

TABLE OF CONTENTS

Foreword

This book is designed to take you through the mergers and acquisition process and to acquaint you with all the important aspects of the process as well as familiarize you with all of the pitfalls that can be, and usually are, encountered in connection with the process of a merger, or purchase, or sale of a business. The book is designed for all business executives who are interested in mergers and acquisitions; buyers and sellers of businesses as well as investment bankers, business intermediaries, accountants, lawyers, and others who want to become more familiar with the merger and acquisition process.

Let me tell you what this book is and what it is not. It is merely a guide, it is an overall view, an overview to assist you in seeing what the picture of the merger and acquisition process is all about. This book is not a substitute for legal or accounting advice. What it may do, however, is save you a few dollars when you are dealing with attorneys and accountants who charge substantial fees for their time. If this book helps you save an hour or two hours worth of time so that your attorney or accountant does not have to stop and explain these issues to you, then this book will hopefully have been worth your while. Remember that the tax, securities and corporate laws are changing and evolving every day. Remember that if you get involved in a merger or acquisition transaction, that you should seek competent legal and accounting assistance.

Once again, the main thrust and focus of this course is to give you some hands on knowledge and expertise with regard to mergers and acquisitions and how they work, and the main idea is to use as much plain English as possible so that you don't have to be a lawyer or an accountant to understand the concepts involved in the process.

Chapter 1

Introduction

Wake up America!

In November, 2008, the International Energy Agency ("IEA") released its World Energy Outlook 2008, viewed by most industry analysts as the world's most authoritative source of global energy trends. The information in the World Energy Outlook is a massive wake up call, but it is hard to determine if anyone with any power or authority is listening.

The report updates projections for the next 22 years, to 2030. The report indicates that the 800 plus oil fields now in production will experience fast declines in the coming years, and even if oil demand were to remain flat until 2030, the world would need to build four times the current capacity of Saudi Arabia just to maintain status quo. Even factoring in the present global slowdown, the IEA predicts energy demand growing by an annual average of 1.6% until 2030, which means a 45% increase in demand for energy by 2030.

The Energy Outlook starts out with a bang. In the first paragraph, it states that "Current global trends in energy supply and consumption are **patently unsustainable**…"

In similar fashion, in 2005, the US Department of Energy published a report titled "Peaking of World Oil Production: Impacts, Mitigation, & Risk Management." Known as the Hirsch Report, it stated, "The peaking of world oil production presents the U.S. and the world with an unprecedented risk management problem. As peaking is approached, liquid fuel prices and price volatility will increase dramatically, and, without timely mitigation, the economic, social, and political costs will be unprecedented. Viable mitigation options exist on both the supply and demand sides, but to have substantial impact, they must be initiated more than a decade in advance of peaking." According to the Hirsch Report, world oil peaking is going to happen, and will likely be **abrupt and revolutionary**. Oil peaking will adversely affect global economies, particularly those most dependent on oil.

While at the moment in late 2008, early 2009, we are experiencing some relief in the price of oil, and many Americans believe that the crisis has passed, the IEA projects that the average price of a barrel of oil will reach $100 between 2008 and 2015, rising to $120 by 2030. These prices are reflected in terms of 2007 dollars, and in real terms means that oil will be $200 per barrel in 2030, in the opinion of the IEA.

What does this mean in terms of global investment? The IEA says that the world needs to invest $26.3 trillion by 2030, which is $4 trillion more than they projected last year, and means more than $1 trillion per year until 2030. Of this amount, the IEA projects that $13.6 trillion will be needed for the electricity sector, with one-half for electricity generation and one-half for transmission.

Many industry analysts believe that the IEA has been overly conservative in the past, and think that even these projections are dramatically underestimated. The IEA states that securing the supply of reliable and affordable energy is one of the two key factors upon which the future of human prosperity depends. The other major factor is climate stability, based on low-carbon systems of energy supply.

According to industry sources, global financial transactions in sustainable energy, including acquisition activity, was $204.9 billion in 2007, with corporate mergers and acquisitions activity increasing 52% in 2007 to $25.7 billion. The industry tracked 237 transactions that accounted for that number.

While all of the 2008 numbers are not yet in, merger and acquisition activity doubled in the first quarter of 2008, compared to the first quarter of 2007. There is clearly a trend toward consolidation and combination.

A view of the wider global power market activity in mergers and acquisitions reflects the trend. Merger and acquisition activity in 2007 in the wider power market increased by 25% to $373 billion.

The majority of transactions in sustainable energy in 2007 were in the wind sector. Wind sector transactions are generally of two kinds, the first being the acquisition by utilities of wind assets from developers, and the second being larger wind manufacturing companies buying suppliers to insure their supply chain.

Target companies for mergers and acquisitions in 2007 were primarily based in the United States and Europe, with the number of transactions being split fairly evenly.

Some Basics

The term "merger" simply describes the process where you have two companies starting out as independent, separate entities that come together with the result being that one company survives and continues, and the other company disappears. The resulting company contains all of the assets of the two original companies.

An example of a merger in the "green world" was the merger of VeraSun Energy and US BioEnergy. In this transaction, US BioEnergy merged into VeraSun Energy. The result was that the former US BioEnergy shareholders owned 40.5% of the surviving company, with the original VeraSun Energy shareholders owning 59.5%. In the merger, the US BioEnergy shareholders received stock in VeraSun, and four of its former directors became members of the board of directors of the surviving company, with six of the VeraSun Energy board members remaining in place.

The legal term "consolidation", on the other hand, is where you have two or more companies that come together and agree to consolidate and create a new corporation that absorbs the entities that come into it. For example, you might have Smith Corporation and Jones Corporation and they consolidate to form Parker Corporation, as opposed to a merger where you would have Smith Corporation and Jones Corporation - the survivor being Smith Corporation after the merger. There just is no Jones Corporation anymore, it totally and completely disappears.

Both a merger and a consolidation are animals that are statutorily created so that there is technically no merger or no consolidation until the formal transaction is all signed and the documents are filed with the States where the corporations were incorporated. Again, for example, you might have Smith Corporation as a Delaware corporation and Jones Corporation as a Florida corporation, and you are going to merge them together with Smith Corporation being the survivor. What happens is that the documents would be filed in Delaware and in Florida that would indicate that a merger was taking place and the survivor would be the Delaware corporation. Once the documents were filed and accepted by the Secretary of State or other appropriate state agency, and then the merger would be effective.

The next term that you are going to hear a lot about is "acquisition" or "corporate acquisition" and all that means is the process by which one company, which is typically called the Buyer or Acquiror either buys the stock of another company or buys the assets of the other company. In other words, it acquires the stock or the assets, and the company that is being acquired is usually referred to as a target. Generally speaking, from a state law standpoint, every merger is going to require that stockholders of both corporations vote affirmatively to merge. There is one exception to this general rule, and that is that if a short form merger is permitted in the state, (which it is in most states), you can merge without a vote of the stockholders when all or substantially all of the stock of one of the merging corporations is owned by the other. For example, in Florida if the Smith Corporation owns ninety percent of the Jones Corporation, it can do a short form merger and merge the Jones Corporation into the Smith Corporation without a vote of all of the company stockholders. So again in Florida, for example, ninety percent or more of the stock owned by one company is all that is required to go ahead and do a short form merger. That ninety percent standard is fairly typical among states that do permit short form mergers.

Chapter 2

Finding a Target

The most important thrust of this book is not to help potential buyers find targets, but to give a more in depth understanding of the overall merger and acquisition process. Consequentially, I think it is important to touch upon some of the procedures involved in finding a target, but not to dwell upon the subject.

In many cases, finding a target will be obvious. Take the case of Solar Works and SolarWrights. Both companies are in the solar equipment installation business. In that case, a Boston based private equity firm bought a controlling interest in SolarWrights, a Rhode Island based company. Once that deal was agreed upon, principals of SolarWrights approached the President of Solar Works, a Vermont company. The end result was that Solar Works then sold a controlling interest to the Boston private equity firm, and the two solar installation companies were then merged. Similarly, Real Goods Solar, a Colorado company merged with Regrid Power, Inc., a California company. Both of these solar installation companies were focused on the residential market, and their merger brought strength and economies of scale.

Conversely, some mergers are complimentary in a different way, such as the acquisition of solar installer EI Solutions, by Suntech Power, a manufacturer of solar panels.

Types of Buyers

Operational Buyers

There are generally two different kinds of buyers. The first type is the one that's looking for an operating company so that they can work in the company and operate it themselves. An operational buyer is usually looking for a company to expand its product lines or possibly change the direction of its business. It may wish to improve its technical capacity or obtain a good research and development core. It may just want to avoid all of the cost and expense involved in starting up in a new area or industry when it can just short cut the time frame of developing a business in that area by just buying one that is already operating. For the operational buyer, the planning process and the integration of the new business with the buyers existing business are the primary concerns.

Investor Buyers

The second basic type of buyer is the straight investor buyer. This buyer is not an operations person or group, but is typically just looking for a good investment and will want to either keep existing management in place or bring in their own management team to actually run the company. The investor buyer's main concerns, however, are going to be the price of the acquisition, what the cash flow will be, and the overall financability of the transaction.

Typically, the investor buyer does not have any concern about the interrelationship of the acquisition with any of his existing businesses. This buyer usually would prefer to not have the acquisition interrelate too closely with any other business owned by the buyer, so that the company will always be in a position to be sold or be taken public or be disposed of in some other manner. I would advise a buyer, whether it is an investor buyer or an operational buyer, to always work from a specific written plan.

The first thing that a buyer should do prior to looking at specific target companies, is to sit down and to write out a detailed specific check list that outlines the criteria that a target candidate must meet if the buyer will consider it an attractive possibility for acquisition. If you don't do this as a buyer, you will run around in circles and look at a number of different companies, and you will get a good general feel for what they are doing, but you will be spinning your wheels if you don't have a specific written plan and some form of a criteria checklist.

Criteria

One of the things that you should look at as part of your criteria, is going to be the growth cycle question. In an old classic book entitled <u>One Up On Wall Street</u>, one of the most successful mutual fund managers has a good outline of the growth cycle of specific industries and a categorization system that he has used that might be helpful to you to determine if any takeover target is in a cyclical industry or is at the beginning and or the middle of its particular growth cycle.

The other obvious questions are if you are an investor buyer group you want to know whether or not existing management will be willing to stay in place or whether or not you would want them to stay in place or if you have access to management and personnel in that particular industry. You also want to look at how the target's marketing program as it exist fits with the wants and the needs of the potential buyer. Consequently, it is very difficult to outline the acquisition criteria, because that is something that is going to be specific to the particular buyer, but again, I can't stress strongly enough that a buyer needs to really sit down and think on paper and set forth this acquisition criteria before the actual search takes place. In today's marketplace, there are just an incredible array of databases and sources of information on potential targets.

Alternative Energy Sources

To find targets in the alternative energy industry, there are numerous obvious sources. The following is a list of websites with information and links to alternative energy industry companies. These provide a starting point for your search:

American Wind Energy Association www.awea.org

Alternative Technology Association www.ata.org.au

American Solar Energy Society	www.ases.org
Florida Solar Energy Center	www.fsec.ucf.edu
Energy Efficiency and Renewable Energy	www.eere.energy.gov
International Solar Energy Society	www.ises.org
The National Wind Technology Center	www.nrl.gov/wind/
Home Power Magazine	www.homepower.com
Department of Energy	www.energy.gov
Green Power Network	www.eere.energy.gov/greenpower
The Hydrogen & Fuel Cell Letter	www.hfcletter.com/
National Renewable Energy Laboratory	www.nrel.gov/
Resources for the Future: Energy	www.rff.org/
World Energy Council	www.worldenergy.org/
Fuel Cell Development Information Center	www.fcdic.com/eng/
Fusion Energy Sciences Homepage	www.ofes.fusion.doe.gov/
Renewable Fuels Association	www.ethanolrfa.org/
Ocean Thermal Energy Conversion	www.nrel.gov/otec
The American Coalition for Green Energy	www.agreenamerica.org
The National Biodiesel Board	www.biodiesel.org
The Biomass Energy Foundation	www.woodgas.com
The American Coalition for Ethanol	www.ethanol.org
The International Hydropower Association	www.hydropower.org
The American Hydrogen Association	www.clean-air.org
Hydrogen Energy Center	www.hydrogenenergycenter.org
The Global Wind Energy Council	www.gwec.net

American Biofuels Council	www.americanbiofuelscouncil.com
Renewable Fuels Association	www.ethanolrfa.org
American Soybean Association	www.soygrowers.com
American Council on Renewable Energy	www.acore.org
Clean Fuels Development Coalition	www.cleanfuelsdc.org
National Ethanol Vehicle Coalition	www.e85fuel.com
International Association of Natural Gas Vehicles	www.ngvglobal.com
Natural Gas Vehicle Coalition	www.ngvc.org
International Association for Natural Gas Vehicles	www.iangv.org

Public Company Sources

A company called Thomson Financial, which is based in Bethesda Maryland, offers database information at what is considered by most to be very affordable even for the small investment group. Their DISCLOSURE DATABASE® provides business and financial information on approximately 12,000 public companies. This information is derived from reports filed with the U.S. Securities and Exchange Commission (SEC). Financial information includes annual and quarterly balance sheets, income and cash flow statements (in a structured as reported format), annual financial ratios, and weekly price-earnings information. Business information includes the full text of the management discussion, the President's letter to shareholders, footnotes to financials, officers, directors, subsidiaries, and exhibits. Disclosure also contains resume information on each company including the address, telephone number, Fortune and Forbes numbers, SIC codes, auditor, stock transfer agent, legal counsel, and more. I am not affiliated with this company in any way, but do believe that they provide a good product which is useful for those seeking easily accessible information on public companies.

There are general sources including the United States Department of Commerce, which has a number of statistical publications. The second general source would be stock brokerage firms, banks, research organizations and trade organizations, which have industry and company studies. A third general source would be the securities manuals, which are generally published by companies like Moody's and Standard and Poor's.

The SEC as a Source

A fourth source would be reports filed with the Securities and Exchange Commission by public companies which include the 10-K form (the annual form that is filed by reporting companies) which must be filed within ninety days of the end of a company's fiscal year. These reports are available online at the sec.gov site by clicking on the links for EDGAR. The information is available here, but hard to search so I would suggest you narrow your search before going to the SEC website. This way, if you have a pretty good idea of what specific information you are seeking on a specific company, you may actually be able to locate the information.

Reporting companies also have to file reports on Form 10-Q. These are the quarterly reports that contain unaudited financial statements as opposed to audited financial statements that are contained in the 10-K Forms and 10-Q forms are filed within forty five days of the end of a company's fiscal quarter. Then there is the other most typical filing by reporting companies and that is on Form 8-K, and a Form 8-K is filed when there has been some kind of material acquisition, or divestiture by a company as well as other material circumstances such as change of a public company and its accounting firm. When there has been some disagreement with the prior accountants or when a director of a public company resigns or is removed, a Form 8-K is filed and sometimes states various types of objections to the way that the business has been run. You can obviously glean a lot of information out of these types of reports.

Another area is the annual reports that are distributed by public companies. These are the glossy type publications that contain some of the information that is in a Form 10-K, such as the audited financial statements, but it's got a lot more of the hype and pizzazz that most companies want distributed to their shareholders rather than the dry, factual kind of information that is in a 10-K. If you are given a choice, take the 10-K, because you will get closer to the heart of the company with that document than you ever could with an annual report.

Corporate Industry Sources

To be more specific, the following are reference sources that contain industry information. One is Value Line Investment Survey, (www.valueline.com) there is also a wealth of information that can be found through the United States Department of Commerce (www.commerce.gov). There is a publication called Directory of Corporate Affiliations, Who Owns Whom, which is updated on an annual basis and is a good reference source with all the mergers and acquisitions that have taken place. This information can be accessed at www.corporateaffiliations.com

Standard and Poor's also publishes numerous publications that could be of specific interest in your search for a target. You can view all of their publications at www.standardandpoors.com. There is also a wealth of information that can be obtained through Moody's, which is located at www.moodys.com .

I'd also advise you to review trade publications and websites, like the ones listed above. If you contact some of the people who produce those trade publications, you can also obtain insight and information regarding what is really going on in the industry. Frequently, the trade association people will have insight into companies that may be available for your acquisition.

It’s generally much harder to get information regarding private companies than public companies, but there are various sources that you can use, and one of them is Dun and Bradstreet’s. You can obtain company profile reports from Dun and Bradstreet, and can search of other industry information. Their site can be found at www.dnb.com.

A lot of states require that companies incorporated or operating within their state file an annual report that contains a substantial amount of information. That kind of information can be found from the corporate divisions from each state. For example, in Florida you would go to www.sunbiz.org.

A company called Washington Researchers, Ltd., based in Arlington, Virginia, obtains information on private companies from various public sources and publishes that information. They also have published a number of books, like “How to Find Information About Private Companies,” How to Find Information About Acquisition Candidates,” How to Find Company Intelligence in Federal Documents,” and even “How to Find Information About Japanese Companies and Industries.” Their website can be found at www.washingtonresearchers.com.

I should also mention that there are mailing list brokers in every major city in the United States and if you look in your Yellow Pages under mailing lists, you will be able to find a number of different types of businesses which can generally be sorted for you in various ways either by number of employees, SIC code or geographical location and even by revenue.

Business Brokers

I would also have to say that generally the place not to look would be with business brokers or with companies that list businesses for sale. One of the worst ways to sell a business is to have everyone in the world know that the company is for sale. An astute seller who has a business that he wants to sell generally knows that as soon as his suppliers, his employees, and his customers find out that the business is for sale, his credit terms with his suppliers are in jeopardy, and his ability to sell to existing customers is jeopardized because the see an unsure future with the company and usually begin searching for other sources. Employees start looking for other jobs and stop paying attention to what they are doing at the company. Aside from those general factors, what you find is that the additional fees to an intermediary could make the purchase price prohibitive or unacceptable to a buyer.

Intermediaries

This leads us to another area, and that is the area of intermediaries. When I say generally that you don’t want to go to business brokers, or intermediaries, what I really meant is that you want to avoid the companies that have been on the market for a long time and have been shopped by a number of people and have been openly for sale, and that fact is common knowledge on the street. Many business brokers or business opportunity brokers are either former real estate brokers, or are also still real estate brokers, and they generally list and sell the "mom and pop" type of businesses. What you find with some intermediaries, is that you receive unsolicited offers to sell you various companies and those are usually not the companies that you will have much of an interest in buying. There are, however, very reputable finders, and brokers and other merger and acquisition intermediaries such as investment bankers who are aware of companies who are discreetly for sale and they are in the business of putting you together with those companies. These can be good sources for acquisition leads, but they can also be problematic if the relationship with the intermediary is not crystal clear from the very beginning.

The Critical Difference between Finders and Brokers

When I talk generally about intermediaries, what I am really referring to is mainly the two distinct players that are in this area that are known as finders and brokers. There is a very specific difference between a finder and a broker and, unfortunately, in many cases, the distinction gets very hazy, and that is where the problems come in.

By definition, a broker is an agent for either the buyer or the seller. As an agent, he has a fiduciary duty to his client and as such he can only obtain a fee from his client and must act in good faith when he is dealing on behalf of his client. A portion of his job may be to bring the two parties together, but another major portion of his job is to act in the negotiation process itself. A pure finder, on the other hand, is merely a party who puts the two parties together and obtains an agreement in advance from either side, or from both, to obtain a finder's fee. A finder can not and may not negotiate the transaction.

The problems really come in where a finder, who is an unlicensed person, puts two parties together and then gets into the middle of the deal and begins negotiating on behalf of one or both parties. This act of negotiation makes this party a broker, and not a finder, and thus subjects him to the law of agency and creates fiduciary duties. It also puts him in a position in most states where he would have to have a license such as a securities brokerage license in order to obtain a fee or a commission in connection with the acquisition.

If you are an intermediary in a transaction, I cannot stress too strongly the importance of obtaining a written agreement in advance prior to introducing any parties. The agreement should set forth exactly what the intermediary is supposed to do in the transaction and must set forth the compensation that the intermediary will receive and who is to pay the fee and under what circumstances or conditions. For example, most finder's fee agreement will say that the Finder agrees to introduce parties to buyers and in the event that a buyer consummates a purchase with the party introduced by the Finder, than at closing, the Finder will receive a fee of $25,000, (or whatever the figure is). The agreement should also say that the Finder is acting as a finder, and not a broker, and that the party signing the agreement agrees and understands that the Finder will not, and can not, negotiate on his behalf in connection with the transaction.

I am not aware of any state, other than the State of New York, that has any law that indicates that a non-negotiating finder must be licensed in any way. (This does not mean that such a law does not exist, check with your individual state.)

The generic term broker, on the other hand, can encompass a lot of different activities and each state has a different scheme for regulating persons who may be involved in merger and acquisition transactions. For example, people who are known as business opportunity brokers that list businesses for sale in some states must be licensed to perform that function. If the sale of a business also involves obtaining the financing on a piece of real estate that is part and parcel of the business and an intermediary is to receive a fee in connection with that financing, he may also need to have a mortgage brokerage license. If the sale of a business is structured as a stock sale, as opposed to an asset sale, and an intermediary has acted as a broker and has negotiated the transaction between the parties, in most states that broker would need to have a securities brokerage license, because he would be obtaining a fee, or a commission, in connection with the purchase or the sale of securities.

If you are a potential buyer and you are contacted by an intermediary who wants to introduce you to potential targets, I cannot stress too strongly that you need to ask the intermediary for whom he has working and if he expects to obtain a fee from you and if so, under what circumstances. The worst thing that you can hear from him is to have him say "We'll talk about it later" or "We'll worry about it later" or "If you decide to reach an agreement with the people that I introduce you to, we can work it out at that time". Believe me, it cannot be worked out at that time. It must be worked out in advance, and if you don't to that you are buying yourself a lawsuit. Also, if the intermediary says that I'm not expecting or anticipating to obtain a fee from you, I am going to get it from the guy on the other side, make sure that you get that kind of a statement in writing.

If there is no finder or broker involved in a transaction, it is typical for the contract of purchase or acquisition to have reciprocal provisions whereby each party indemnifies the other against any brokers or finders claims. Be sure that your agreement contains such representations if no broker or finder is involved.

The most asked question always seems to be "What do you pay a finder?" While there is no universal answer, many people use the Lehman formula, or some variation of the Lehman formula. The Lehman formula basically is a descending scale beginning with 5% on the first million dollars, 4% on the second, 3% on the third, until you reach 1% of the fifth, and then any fee on the amount in excess of five million dollars would be 1% of the excess. In the one million dollar and under transaction it is fairly typical to see a 5% commission of some sort paid.

The other area of concern usually is if the intermediary wants to bill on some kind of an hourly basis. A buyer should try to determine what the range of fees will be and see if the intermediary would accept a cap or limit on the total fee. Occasionally circumstances take place that put an intermediary into a position that makes them believe that they are entitled to a fee. If may be because the intermediary sent information to a buyer on an unsolicited basis or for some other reason.

For whatever reason, if an action is brought for a brokerage fee or a finder's fee, you should be aware of the three most often used affirmative defenses to such claims. Intermediaries, listen closely, and cover these bases before you get yourself into a bad situation.

Number one: the agreement between the intermediary and the other party is not in writing and the state law applies provides that such agreements must be in written form pursuant to that state's statute of frauds.

Number two: Illegality – the transaction is void or unenforceable because the broker or finder needed to be licensed under state law and was not licensed.

Number three: A broker failed to disclose a commission or other material agreement between the broker and the prospect to his client and thus breached his fiduciary duty to his client.

My final word on the broker and finder situation is that it is important that whether you are acting as an intermediary or as a buyer or a seller, that you obtain whatever

Chapter 3

Valuation

Let's move now to the next chapter which is the "approaches to valuation" chapter. The purpose of this chapter is not to teach you formulas or to go through the mechanics of spreadsheet analysis, but to give you an overview of the various ways of looking at valuation and to discuss why some methods of valuation are used more frequently than others.

The first warning that I have for you is that a seller of a business will initially have an over inflated opinion of the value of his business. This is simply because it is such an emotional issue for a seller who has created or grown the business from sometimes absolutely nothing to where it is today. The seller, having gone through the hard times and the periods when he didn't know whether or not he was going to make it, places a very high value on his business that the marketplace really doesn't take into account. So, the first hurdle you have to get over as a seller or a buyer is to get past the emotionalism in this issue and get down to the cold hard facts of what the marketplace is willing to pay for a business based upon a number of standard factors.

Since valuation is nothing more than an opinion of what a company is worth, it is equivalent to an appraisal of real estate, which again is nothing more than some professional's opinion of what the real estate would bring in the marketplace. A seller should be leery of an intermediary who wants to help him place a value on his business, because in some circumstances, the intermediary is doing nothing more than looking for a listing and is more likely to tell the seller what he wants to hear about the opinion of the value of the business. It's somewhat like the management consultants that I have hired in connection with analysis of law firms. They go around and interview all of the partners and ask them for the good news and the bad news and then regurgitate all that information in a pretty brochure that is attached to a $50,000 bill for services rendered. A frank discussion between the parties would be cheaper, faster and more efficient.

My advice to a seller is that he needs to employ a professional valuation expert who has nothing to gain by what he views as a favorable opinion of value because his opinion is not tied to a commission on the sale of the business. Secondly, I would suggest that when a seller is shopping for a valuation expert, that the seller realize that there are specialists that deal only with certain industries. Some valuation experts deal only with professional firms such as accounting firms and law practices. Some deal with just retailing or pharmaceuticals or the manufacturing industry generally or within some subspecialty of manufacturing. You really should shop around for a good valuation expert in your field and watch out for the "jack of all trades" valuation expert that will place a value on your steel mill, your flower shop and also your pharmaceutical company.

Valuation Methods

Next, let me outline for you some of the traditional valuation methods as well as what appears to be now the most accepted method of valuation. Let me first say that you need to distinguish the difference in the terms "valuation" and "price". The buyer and the seller will each come up with what they believe to be the value of a company. They'll then sit down together and discuss and negotiate regarding what the price of that company should be and obviously each party is going to have a range within which they will accept a price offered by the other party. Of course, price goes hand in hand with the terms of the purchase. I will talk some more about price and terms when we get into the sections on financing and also on structuring the transaction from a tax standpoint, because you will have to take some of the tax considerations into play when you talk about what the price should be.

Book Value

The first approach to value that I want to discuss is book value. Unless you are talking about a business that consists of totally liquid assets such as an investment company or in some cases a bank, the concept of book value is of little significance. Book value, as you know, is simply the net value as shown on the seller's balance sheet once you subtract all of the liabilities from all of the assets. Even in a situation involving a company that consists mainly of highly liquid assets, there will need to be adjustments made to the balance sheet if you are ever going to consider giving book value any significance whatsoever. Within the generally accepted accounting principals, there are provisions under certain circumstances for accelerated depreciation and variations on the way inventory is treated, whether it is booked as "last in first out" (LIFO) or "first in first out" (FIFO). There are also various methods for treating reserves that have the effect of inflating or deflating the company's book value. In the vast majority of cases, however, the book value of the company will have little or no impact or significance when viewed in relation to the company's earnings and consequently, most of the earnings based methods of valuation are generally viewed as more reliable and acceptable, and in today's marketplace, the emphasis is less on hard assets and more upon the ability of the company to generate cash flow and earnings.

Earnings Calculations

Even many of the earnings based calculations can be viewed as flawed because those methods are generally also measured by accounting standards. Variations in earnings calculations occur depending on which deprecation method is used by the accountants and whether they have used a LIFO or FIFO approach computing cost of sales. Consequently, in today's marketplace some form of a discounted cash flow analysis is most commonly used.

Let me mention a few of the other methods before we go into the discounted cash flow technique. Two of the earnings based methods that are popular are "return on investment" and "return on equity." The first of these, return on investment is computed by taking the net income divided by total assets. Return on equity is calculated or computed by net income divided by book value of shareholder's equity. The difference in the two calculations is that total assets is used as the denominator in the return on investment calculations and shareholder's equity is used as the denominator in the return on equity calculation.

The return on equity calculation is a calculation that is quite sensitive if leverage is involved in your transaction. The results can be somewhat misleading because return on equity will increase as the amount of leverage increases. The problem there is one of risk. If you leverage up your company so much that the debt is overly burdensome, the true value of the company should really decrease because you have substantially increased the risk of failure of the company, but the calculations will show that return on equity will be increased and consequently, I think that the results of that calculation are misleading and can tempt an investor to take risks that are unwarranted.

Price Earnings Ratio

Now let's address an area that gets a lot of attention and that is the valuation method of the "price earnings ratio." A price earnings ratio is simply the number that is derived by dividing the purchase price of a company's stock by one year's after tax earnings. You can see the price earnings ratio or as it's referred to its short form- the PE ratio, every day in the newspaper when you read about various public companies. For example, if you know the stock market has recently valued certain types of manufacturing companies at a price earnings ratio of 12 and you are looking at the same kind of manufacturing company, you would take the company's earnings per share and multiply it by 12 to come up with a price for the company's stock.

I recently dealt with a private acquisition where the buyer was originally taking that valuation method into consideration before we talked. He had studied the PE ratio for companies in the same industry as the company he wanted to buy and felt that a reasonable price could be computed simplistically by using the PE ratio. The first problem with that analysis was that my client was looking at a private company and not a public company. There is a substantial premium that can and should be paid on the stock of a public company due to that substantial liquidity provided by the public marketplace. Another problem is that no two businesses are alike, even if they are in the same industry and consequently I don't think a PE ratio has any relationship to the future profitability or potential for a company, and of course that is what you are paying for. Again, the element of risk comes into play because no matter what price earnings ratio you think is appropriate, in your judgment as a buyer or a seller, the general rule is that the riskier the business, the lower the PE ratio.

I would advise a buyer to look at what the projected return on his investment into the company will be, and then compare that to other types of investments, such as government bonds and other safe liquid investments. Then interject the risk that is involved in the business that he will be acquiring. What you may find after taking this PE ratio approach and comparing an investment in the company to other types of investments, is that the risk may substantially outweigh the reward in that the same or similar reward may be available at a substantially lower risk.

The other problem with PE ratios is that it depends on which historical time period is used in evaluating the appropriate PE ratio for the type of company in which you are interested. During the 1980s, we experienced purchases of companies that when looked at from a price earnings ratio showed incredibly high PE ratios. During difficult economic times, such as the early 1990s, obviously, PE ratios are substantially depressed. Looking at the market in January 2009, it is obvious that the market has not been this depressed in many decades, so remember that you have to consider market conditions, as well as other situations such as the method of payment that will be used in the transaction, when considering PE ratios as a guideline to evaluation.

Discounted Cash Flow Method

The method that is popular and seems to reflect many of the important variables is commonly referred to as the discounted cash flow analysis method. The theory behind this method holds that a company is worth the present value of all of its future cash flow discounted back to the present as a specified rate and that rate is one that is proportional to the risk of the actual realization of the cash flow. The problem with discounting cash flow analysis is that like any other valuation process there are certain underlying assumptions and estimates that have to be made about future performance. While earnings based valuation methods can be viewed as flawed because of the variations that relate to generally accepted accounting principals, discounted cash flow analysis valuation can also be flawed if the underlying assumptions that are being made are not valid and if the estimates of future performance are inaccurate.

During the 1980s, buyers of companies were will to take those calculated risks, by trying to do their homework as best they could to make some determinations and assumptions about future performance. The discounted cash flow analysis method became popular based on the theory that the breakup value of companies was greater than the market value of such companies when viewed in their entirety. In other words, the sum of the parts exceeded the value of the whole.

On the positive side, the discounted cash flow analysis method does take risk into account, as opposed to the methods based earnings which actually excluded risk from their calculation. Since risk is usually viewed as a part of the economic value of an asset, then discounted cash flow analysis can be more accurate because a discount rate is selected that reflects the element of risk. Of course, variations on that discount rate may not reflect the appropriate amount of risk.

Discounted cash flow analysis also takes into account how leverage or debt affects the risk level. The discounted cash flow analysis method tries to determine an economic value by taking into consideration the fact that debt not only increases net income as long as the earnings generated by debt financing exceed interest expense, but also that debt increases risk and the increase in earnings will increase the discount rate and may not necessarily lead to an increased economic value calculated using the discounted cash flow analysis method.

In using an earnings based valuation method, the risk and the higher potentiality of insolvency due to the introduction of debt is not addressed, therefore an earnings based calculation will show that increased net income and will appear to show a substantial return without taking into consideration that the risk is greatly increased.

Another problem with earnings based calculations is that generally no consideration is given to the time value of money. Discounted cash flow analysis does specifically in-corporate the idea that if you received cash today that that cash is worth more than the same amount which would be received a year from today, because that cash you received today can be invested and over the next year, will earn a return.

Discounted cash flow analysis is generally involved in forecasting what the cash flow will be for a certain period of time. That period of time may be a ten year period or a five year period, it's generally is not beyond ten years. Of course, this doesn't give the entire picture, because the value of a company may be greater than the amount of value that can be attributed to the cash flow over that time period. You have to take into consideration also that there is some residual value that is calculated and added to the valuation process.

Let me mention here that there are also numerous publications that you can obtain on your own that can be of great value to you. On of those, for example, is called The Handbook of Small Business Valuation Formulas and Rules of Thumb which was written by Glenn Desmond and John A. Marcell. Other helpful books are Handbook of Business Valuation by Thomas L. West and Valuing a Business by Alina V. Niculita. There are a number of other valuation handbooks that are available on websites like amazon.com.

Types of Buyers

There are different types of buyers and those buyers relate in different manners to the valuation process. What a seller obviously has to realize is that there are in essence two basic types of buyers, the operating buyer sees the target as a company that will fit with his existing operations and consequently he'd be willing to pay one price for the company. The other type of buyer is the investor buyer or the investor group that is generally a leveraged buyout type buyer and typically this is a group that wants to use a small amount of equity and intends to finance most of the purchase price with funds that are borrowed using the assets and the cash flow of the target as collateral.

While these investor groups generally buy a number of companies, for the most part they do not like to look towards the combination of any of their investments because they want to be able to dispose of each company separately and they don't want to have to unwind or untangle the management or operations of any of their entities. If you are dealing with a "leveraged buyout" type buyer and you are a seller, what generally will happen will be that the investor group will do their analysis, then they will quickly try to get to the bottom line as to what the seller will accept. In the process, they will be analyzing how much debt the company can carry.

The bottom line is that if the investor group really wants the target, then they will find some creative way to justify the price that they will have to pay and they will, through various layers of debt, try to convince all of their lenders that the deal is worth the risk.

A substantial leveraged buyout usually includes at least two or three different types of debt and equity investors, each of which has somewhat different goals and objectives. Senior debt lenders generally are given the right to buy equity as part of their loan agreement. These are the most secured lenders and sometimes receive some type of equity as a kicker which generally tends to increase or boost their return. Subordinated debt is usually obtained from insurance companies or junk bond buyers who generally get equity kickers which boost their return into somewhere in the mid 20 percent area and then the management team of the company is usually an equity investor.

In most situations, the management team does not have a substantial amount of equity to contribute and consequently receives a smaller equity stake in the transaction. There are some variations on this theme depending upon whether or not the investor group is part of the management team.

In the marketplace in 2009, there are very few of these deals of any substantial size that are getting done, due to the financial difficulties of institutional lenders and the nervous nature of private lenders.

Now let's summarize this section on valuation. Remember the following:

1. Valuation firms specialize, use a specialist.
2. Valuation is phase one, which culminates in phase two, which is price.
3. The discounted cash flow analysis method of valuation has become the standard in the industry and seems to have the best chance of using all the variables that yield the most accurate valuation in today's marketplace.
4. investor buyers in financed buyouts will fit the maximum debt to the valuation process to see if they can buy your company with a small amount of equity.

Chapter 4

Financing Techniques

Two Basic Types of Acquisitions

When you are talking about financing techniques there are two generic types of acquisitions: - the financed acquisition and the non-financed acquisition. A while ago, I represented a company that was acquired by one of the largest insurance groups in the country. From a financing standpoint, the transaction was simplistic in nature. The insurance group purchased the stock of the selling shareholders for cash and therefore as a non-financed transaction, the financing portion of the deal consisted of the insurance group writing checks to the selling shareholders.

More common in today's marketplace, however, are the financed transactions which were commonly referred to as leveraged buyouts, but have come to be known simply as "financed buyouts." The term "leveraged buyout" simply means that to finance the cost of the acquisition the borrower borrows generally as much as possible against the assets and the cash flow of the target. With all the leveraged buyout activity that took place in the 1980s, many transactions were financed with as little as five percent equity and sometimes even less than that. Many of those transaction were over-financed and gave a substantial amount of work to the bankruptcy lawyers. That trend has reversed and today, while we still see financed buyout, virtually none are done with the large percentage of debt that was commonplace in the 1980s.

In this chapter we're going to talk primarily about buyout and financing involving private companies. There are transactions that involve a public company going private, and there are numerous issues and considerations that are involved in the going private transaction which we will not touch upon because again, the main focus of this section is going to be dealing with the private company acquisition.

Because the assets and cash flow of the acquired company are located at the beginning of the transaction in the target and not in the buyer, the main objective involved in a leveraged buyout is to get those assets and get that cash flow into the buyer so that it can be pledged to the lenders so that the funds can be used to pay the selling stockholders, or the target company if it is an asset acquisition.

This is done typically in three ways. The first being, that if it is an asset acquisition, the buyer simply buys the assets and pledges them to the lender. The second way that this is accomplished is that the buyer purchases the stock from the selling shareholders of the target and immediately after that a merger is accomplished between the buyer and the target. The third way to get that borrowing base into the buyer is for the buyer and the target to do a merger of their companies without going through the stock purchase stage. When we get into structuring the transaction, we'll talk about how lenders usually look at the timing aspects of when these elements fall into place so that the lender feels secure that its collateral is going to be unimpaired immediately after the loan has been made.

Categorizing the Candidate

As an investor buyer when you are looking for a candidate for a financed buyout transaction, you obviously want to look for a company that's got consistent cash flow and hopefully some historical basis of consistent cash flow. Industry experts refer to six categories of businesses as: slow growers, stalwarts, fast growers, cyclicals, asset plays and turn arounds.

If you use those six categories, the kind of companies you would need to research for a financed buyout would be the slow growers, the stalwarts, and the asset plays, because the fast growers, the cylicals and the turn arounds are the catagories that obviously do not lend themselves to any kind of a consistent cash flow. Obviously startups and venture capital type deals are not the type of transactions that lend themselves to being financed buyout candidates.

Green Companies

In the marketplace today as it relates to Green companies, many of them are more in the fast grower category, and therefore, to acquire such a company, the borrowing ability of the buyer is the important factor, not the ability to pledge assets of the seller. Much of what we will discuss below will not relate to the acquisition of fast growers, but is important information for the future, as I see some of these companies rapidly becoming asset plays.

Lenders in a financed acquisition will take four major areas into consideration. They are:

Previous cash flow history of the business
The credit history and experience of borrower
The management experience of the purchaser
The quality and condition of the acquired assets

Areas of Funding

When you are planning for a financed buyout type acquisition, you have to take into consideration four, and sometimes five, areas that will need to be funded. The first is the most basic and that is the amount you are going to pay for the stock of the target or the assets of the target. The second is any debt that the target presently has may need to be refinanced at closing. The third is working capital. In every situation, you are going to need working capital immediately upon closing and while you may actually not get that kind of cash for working capital at the closing itself, you will almost definitely need to have to have some kind of revolving credit arrangement so that working capital funds will be available to you. The fourth is your costs of the acquisition and this involves various fees to the lenders for things such as the commitment letter, investment banking fees, finder's fees, accounting fees and legal fees. The fifth area that you need to look at in connection funding is the amount of any actual cash that is in the company or assets that can be converted to cash on a short term basis by some form of a spin off or divestiture. This could include a sale lease back transaction for real estate owned by the target or computers or other equipment that could be sold and leased back.

Two Critical Points

1) Refinancing Debt

Let's talk for a few minutes about two of the most important things that you will need to review when you are preparing your plan and determining how much funding you are going to need at closing. The first and most important problem that you are going to run into is the fact that every target is going to have existing debt on its books. You are going to have to review very carefully the loan agreements and other loan documentation that the target has in connection with the debt that it carries. Obviously, as a financed buyout buyer, you want to try to keep as much of that debt that is on the target's books in place and you don't want to have to refinance that debt at closing. Not only may your interest rates increase on that debt but also there are going to be fees and costs in connection with any refinancing. If those fees and costs and higher rates of interest on the existing debt add a substantial amount that would need to be borrowed to complete the transaction, then the lenders that you think you may have in place may evaporate if there is a basic change in circumstances.

In an asset sale transaction in particular, you have to look at all of the target's loan agreements, leases and other financing documents, because typically they will contain a prohibition against the sale of the target's asset without the lender's consent. Obtaining the lender's consent may be more difficult than refinancing, and consequently it is a problem that you have to face right away while you are in the planning stage and not after you've signed an acquisition agreement.

If your transaction takes the structure of a stock purchase with a contemplated merger thereafter, you are going to be faced with the potential legal issue of whether or not that merger is going to constitute a transfer of ownership under the terms of the various loan agreements in place that would require lender's consent. If the surviving entity of the merger is the target, than you have a much better chance of avoiding that problem because the argument is that the debtor remains the same and there has been no transfer to another entity. The answer to that question is going to depend upon which state law governs the lending documents and an analysis will have to be done to determine if that is a problem in your transaction.

If you're dealing with a public company that's spinning off entities or assets to you as a buyer, then this issue can become even more complicated because you may be dealing with indentures that have been put in place in connection with unsecured borrowings and indentures of that type generally will contain some covenant that may prohibit the imposition of liens on assets of the debtor. In recent years there are even prohibitions against the creation of different classes of debt and different layers of debt that became popular during the maturation process of the leveraged buyout phenomena.

From a practical standpoint, if the target has either a secured or an unsecured revolving credit loan from an institutional lender, it will have to be refinanced to get your transaction done because that kind of a loan generally has all of the target's assets tied up and those are principally the assets that you are going to need to use to get your first layer of senior debt.

If you are buying a spin off company, there might be some loans in there from the parent and you might be able to restructure some of those so that they are either maintained as existing debt or repackaged into some type of a seller financing at closing as one of the layers of debt.

As far as working capital debt is concerned, you're going to have to see what the arrangements are with the target suppliers because if the suppliers feel less secure with you than the more stable parent company, you can find yourself in trouble over credit terms. For the most part, it seems that suppliers are happy to keep customers and if you are going to continue the operations in much the same form as they have been they can rely on having someone to sell to, which is obviously much better for them than having the target be liquidated or moved out of the state or moved out of the country.

Less typically, but something that you need to be aware of, is that the target may have some kind of a letter of credit arrangement in connection with the payment of suppliers and those arrangements need to be looked at very carefully.

2) Raising Capital Through Potential Sale of Assets

Remember, I said that there were two areas that we wanted to look at and one was refinancing of debt on the target's balance sheet. The other is the ability to sell off or break up a portion of the target to generate some funds from the sale of some of its parts. I'm sure you have heard a lot about break up value and a lot of deals have been done as bust up deals where you take the pieces and sell them for more than the whole company could be sold for. That's not quite what I am talking about here. What I am really trying to focus on is any separate parts of the company that can be sold off but that in doing so you are not impairing the company's ability to create cash flow. In other words, you're not selling off the heart of the business, but you are looking to see if there is something that won't affect the company's operations that can be disposed of.

One example is real estate owned by the company that may be sold off to an investor related partnership and then leased back by the buyer. The target may have some small divisions that are not of interest to the buyer and could also be sold off.

Obviously the element of timing is important and a buyer for these components should be sought soon after the acquisition agreement is signed. If you try to put the buyer in place before you sign your agreement, you may lose your whole deal, because the target may find out about it and bypass you.

Because it is important that you do get funding at closing you may have a timing problem in finding a buyer for parts of the target and closing the transaction simultaneously with your closing. If that is the case, you may be able to obtain bridge financing at your closing for your divestiture assuming you have a solid contract for sale in connection with that portion of the transaction.

Types of Debt

Let's talk about the structure of the debt or the structure of the financing and the types of debt that you will see in a financed buyout. These types of debt are designed to produce specific results for you as a financed buyout borrower. The goals that you are trying to achieve are, first, to get as much of the debt to be senior debt as possible. The reason for this is that senior debt carries the lowest interest rate, is the most highly secured and consequently is the easiest to obtain.

If you are lucky, and you are buying a strong cash flow business to finance the business you may only need one secured lender. I once represented a company in a management buyout that had such a strong historical cash flow, and such a small debt to equity ratio, that we were able to obtain all of the financing for the transaction from one secured institutional lender at a very reasonable interest rate. And even more importantly, without having to give any equity kickers whatsoever, so that management ended up with all of the equity of the company after the merger of their acquisition vehicle with the target.

Now secondly, as part of the balancing of your financing there needs to be a sufficient cash flow after payment of the senior debt to support a layer of subordinating debt that carries a higher interest rate. This is commonly referred to as mezzanine debt and will sometimes include some seller financing. Don't overlook the possibility that the seller may finance part or perhaps even all of your purchase price.
But more typically, to get the transaction the seller will consider taking a portion of his purchase price in the form of some type of subordinated debt.

Third of all, when you are laying out your financing plan after you have analyzed how much your senior debt will be and then have added to that your carrying charge for subordinated debt, you need to be sure that there will be sufficient working capital to permit the company to continue operations. This plan also must have a contingency in the working capital section for substantial cash flow variations that can be caused by either general economic conditions or specific foreseeable problems in the company or its industry. In other words, your plan shouldn't just count on steady cash flow in your projections. There must be some accommodation for a bad time in business.

Along with those working capital problems, your plan should require that you have the ability to make prepayments to your lenders without penalties when you are doing well. You also need some provisions for abatement or a temporary halt in payments of subordinated debt without that being an element that creates a default in your subordinated loan agreements, in the event you experience a temporary substantial decrease in cash flow.

Fourth, you need to look at the specialized situations and lenders such as the sale and lease back arrangements that we mentioned before to see if there is a place for a sale lease back of other real estate or business equipment, machinery, computers or other items used in the business.

7 Categories of Debt

As far as the layers of debt that are generally recognized in connection with financed buyouts, there are seven commonly referred to categories. Number one is senior revolving debt and senior term debt. Both senior revolving debt and senior term debt are typically provided by institutional lenders such as banks and sometimes insurance companies. Senior term debt is used for the acquisition of the assets or stock and is secured by a first lien on all of the target's fixed assets – that's the equipment that the target owns as well as any property. It is also secured by either a first or second lien on inventory and accounts receivable. It may also be secured by liens on intangibles. Senior revolving debt, which is used for acquisition financing and working capital is always secured by a first lien on inventory and accounts receivable. It can also be secured by a first or second lien on the target's fixed assets and possibly by a lien on intangibles and fairly frequently a pledge of stock of the acquired company. The management leveraged buyout that I just alluded to consisted solely of this category of financing with senior term debt that was secured by real estate and senior revolving debt that was secured by inventory, accounts receivable and a pledge of the stock of the target company.

The second most common category is the subordinated debt that we have already referred to in this chapter. In the industry it is frequently called mezzanine debt. This debt is a higher interest debt. It may be completely unsecured or it could be secured by liens that are secondary to the senior financing. This is the kind of debt that is drying up rapidly as we speak because it has principally been placed by investment bankers and sold to insurance companies, pension funds, banks, and savings and loan institutions. With present economic conditions, the placement of this debt has become more and more difficult. The territory of investment bankers themselves has been encroached upon by the invasion of the banking institutions into the investment banking field. In other words, competition to place the type of financing is much tougher than it has ever been before and that coupled with the lack of appetite in the marketplace, is changing the way that subordinated debt has been placed in the past.

The third category, or layer of financing, is the sale/lease back category. As I have previously mentioned, the sale of the target's real estate can be ranged to either an independent third party or a group related to the buyer, usually in the form of an investment partnership, which then leases the real estate back to the target. Sale/lease backs often come into play in short term financing of office equipment to long term leases of substantial computer equipment and other machinery used by the target.

The fourth layer of financing can take the form of either the seller's subordinated debt or alternatively seller's preferred stock. If the seller takes subordinated debt, this debt can either be secured or unsecured and depending on your negotiation, can be convertible to stock of the target. In the alternative, the seller may accept preferred stock and that stock may either be convertible or exchangeable for subordinated debt.

The fifth layer of financing is the sale of preferred or common stock to a third party. The third parties that buy this stock are either financed buyout investment funds or one of the senior lenders as part of their lending package.

The sixth layer of financing is the common stock that is sold to the buyer or principals of the buyer and even management of the target if they are going to stay on and be part of the new ownership. This is the equity or down payment portion of the transaction.

The last commonly referred to category is that of warrants or options to acquire stock. These are granted to all or some of the participants in the financing and even sometimes to the seller. These are usually referred to as inducements or kickers and later through their exercise they may provide additional funding to the company.

Now that we have named the seven categories or layers of financing, let's talk in a little bit more depth about each one of these. We mentioned the first kind of debt which is senior debt, and as I indicated, that usually takes the form of part revolving loan, which is used to provide the working capital, and part term loan, which is used to pay for the purchase price of the asset or the stock.

Senior Debt

The most important thing about senior debt is that you're senior lender should be involved in your transaction from the earliest possible point in time because you can't do a financed buyout without leverage and you cannot get leverage without a lender. If you can't get senior debt, and you can't get any other type of debt, then consequently your deal cannot be done. So you need to know very early on about the basic financiablity of the deal.

Senior debt lenders are also getting more astute and getting more involved in the operational end of a borrower's business. In the old days of banking, senior debt had a fixed term. There were specific non-intrusive type covenants and the reliance of the banker was not only on the business, but on the personal guarantee of the borrower, who in many cases was a known entity of long standing with the bank. In today's marketplace, there is more demand lending. By that I mean the term of the loan may not be fixed and the bank may have the right to call the loan at any time.

Senior revolving loans may now have discretionary clauses which permit the bank to only make advances at its discretion, similarly the covenants contained in these agreements have become more protective and set forth requirements for the bank to consent to numerous actions which may not be in the ordinary course of business, but which under old banking standards would not have required the consent of the lender. In essence, the banks have become more involved in their client's business. The biggest problem that this seems to create is among fairly unsophisticated bankers who take some of these provisions at face value and may not be aware of the fact that there is a commercial reasonableness standard that is imposed upon the bank which does not permit them to act arbitrarily, therefore, if a bank takes some action which a court at some time in the future determines to be unreasonable, and the business suffers damage, or even goes out of business, the bank could be held liable for the resulting losses.

As far as senior lending is concerned, let me mention some of the basics that are usually contained in the commitment that you will receive from a senior lender. First, you will probably think most importantly to the bank, the commitment letter will set forth the fees that will be paid to the bank and these are generally about as many as the bank can think of and sometimes as high as they can get you to accept. You can expect to pay a commitment fee when the letter is signed by the bank and sometimes even a second commitment fee is due upon the execution of the commitment letter by the borrower. I have also never seen one of those fees that was refundable.

Another fee that is typically charged is some kind of a syndication fee which can be called a management fee or possibly an agency fee, and this is a fee that is charged when the bank has put together other lenders as part of the senior lending group, (if there is to be a group). Sometimes you can get credit for these commitment fees at closing and they would be credited to what is known as a closing fee that the borrower pays. So, for instance, if your closing fee were $50,000 and you had paid $20,000 in commitment fees you would only have to pay $30,000 at closing. This closing fee and commitment fee can range generally from one percent to three percent. Another fee that you will see will be referred to as a facility fee and this is a fee on the amount that is available and not yet drawn upon under the revolving credit line. This fee can be as low as a quarter of a point but more typically a half or three quarters of a point.

If there is a standby or commercial letter of credit involved in the transaction, the bank will of course charge a letter of credit fee. There you will have to pay one percent to a point and half per annum.

One thing you are going to have to look out for in your senior lending is that there will be some sort of a penalty fee usually on the term loan if it is paid back prior to maturity. The reason for this is that if you find a less expensive lender a year or two after the transaction has been completed and the company is operating within your projections and you refinance your loan, the original senior lender is going to lose money because of the early termination of the loan. Consequently the senior lender will try to impose some kind of a penalty which is an amount that usually decreases on an annual basis as the loan heads towards maturity.

Since the bank doesn't want to lose that anticipated profit on your loan, they figure they are going to get it out of you one way or another. Most lenders are not going to be willing to drop those fees, but they may be willing to limit them to one or two years instead of having them run out the full term of the loan which could be five years, seven years or more. The lenders have taken the risk, and consequently, they want that anticipated profit locked in for a certain period of time.

Next you are going to see more information about your prepayment rights and what the prepayment penalties may be that are proposed by the bank. Third, the bank will outline the collateral that is going to be required. Fourth, the bank will specify in its commitment letter how you are supposed to use the money that it is lending to you. Fifth, the bank may outline a required amount of equity and some limitations upon the subordinated debt that is contemplated in the transaction as a condition of making the loan.

Last, but not least, the bank will outline for you the fact that you will have to pay all of its expenses in connection with the loan. This expense provision I have found to be almost never negotiable. You should carefully review your commitment letter because the fees accessed against the borrower will generally be for all of the lender's expenses which include its fees to the bank's attorneys. The commitment letter may provide that if the loan doesn't close, that you as the borrower may be never the less liable for these out of pocket fees and expenses.

Subordinated Debt

Now let's talk about the subordinated debt layer or category. The subordinated debt category, which is referred to in the industry as mezzanine debt, includes what is commonly referred to as high yield bond financing. High yield bonds became popular during the buyout activity during the 1980s, and were referred to as "junk bonds" because they were unrated and viewed as speculative. The typical high yield bonds are gap fillers, and by that I mean that the high yield bond debt is layered in between the senior debt that we have just discussed and sometimes the layer of debt following the high yield bonds that is usually the seller financing. You will even see layers of high yield bonds and those will be referred to as senior subordinated debt and junior subordinated debt.

High yield bonds generally have the following attributes. First of all they are usually not short term obligations. Their term usually runs in the range of ten to fifteen years, although, of course, there are certain circumstances where they could be for a seven year period or for twenty years or more. They are always subordinated to the senior debt. They carry interest rates that are substantially higher than the interest rates related to senior debt. A rate in access of sixteen percent may not be an unusual number to see for this kind of debt and with equity kickers, it may produce a return in the range of twenty five percent.

With high yield bonds, there is usually a provision that does not permit prepayment, certainly for the first two years and sometimes for as long as five years. If they are prepaid after that initial two to five years, then there is usually some form of prepayment penalty which is accessed. Normally junk bonds are unsecured.

You will also frequently see warrants attached to high yield bonds. As you know, warrants are nothing more than a right to buy the stock from a company at a specific price during a specified time period. For example, you might have a warrant to purchase a hundred shares of common stock of a target at a price of ten dollars a share and the warrant may be good for a period of two years from the date that it is issued. After that time period has passed, the warrant has expired. If you want to purchase the stock from the company at the given price, you must exercise the warrant, pay the purchase price and do so before the expiration of the warrant. This is another inducement to a high yield bond purchaser which is also commonly referred to as an equity kicker. In the past, buyers of large blocks of high yield bonds have sold the warrants that they have received with the high yield bonds to other investors or back to the underwriter of the bonds. The effect of the sale of the warrants is to put the bonds in the hands of the buyer at a discount.

Seller Financing

We have covered some specifics on senior debt and also on subordinated debt and sale/lease backs are fairly self-explanatory, so now let's cover seller financing. Sellers are generally not crazy about taking debt or equity financing back in connection with the sale of their business. As we have discussed, this form of seller financing is usually subordinated to senior debt as well as mezzanine debt and consequently the seller realizes that being at least third in line, he won't get paid unless the company does very well after the acquisition. The use of seller financing also solves that basic psychological problem that we talked about early on in this course and that is that if the seller has over estimated the value of his business the way that seller's sometimes do, he can save face by having a purchase price that may be close to his original estimate with a substantial portion of that purchase price being seller financing.

Seller financing also a big plus to the seller if the company is very successful and does very well because he will end up sharing in that success by actually realizing payment of the debt that he took back as part of the seller financing. The question usually boils down to whether or not the seller will take a note in connection with his financing or preferred stock. The most advantageous position to the buyer is to get the seller to accept preferred stock. The reason for this is that preferred stock appears as equity on the target's balance sheet and in a highly leveraged deal, he can substantially decrease the possibility of a technical insolvency.

A seller taking back preferred stock also gives the senior debt lenders and the mezzanine debt lenders more comfort and more incentive to participate in the transaction. This can also be very important in connection to what is commonly referred to as a fraudulent conveyance problem, which we will cover later in this book.

The disadvantage to the buyer of preferred stock is that it will produce dividends to the seller and those dividends are not deductible by the buyer. If the buyer had given a promissory note, the interest payments under the note would be deductible. One other disadvantage to a buyer in connection with preferred stock is that you can't have more than one class of stock in an S corporation, so it is going to prevent the buyer from electing S corporation status. There also are some other tax consequences which can be adverse and we will talk about those more specifically when we get to the chapter on structuring from a tax standpoint.

From a seller's standpoint, generally debt in the form of a promissory note is more advantageous because, generally speaking, the interest payments will be due no matter what occurs with regard to corporate earnings. Under various state laws, dividends which would be payable under preferred stock are not permitted to be paid unless the company has earnings. There is no such restriction upon interest, however.

There are two other considerations that benefit the seller if he takes a promissory note. The first is that he may be planning to sell the note and it will be much easier for him to sell a note than to sell preferred stock. The other is a perception situation and by that I mean that the seller may want to totally divest himself from the situation and if he continues on in some form as a stockholder, he may not feel that he has accomplished that goal whereas being a lender is a little different category and the seller may feel that he wants that complete divestiture of ownership.

Even if the seller does take a note, an added incentive to him might be to give him some form of an equity kicker, and that again would become stock or preferred stock and in recent times the use of warrants to purchase common stock has become very popular. If after the acquisition, the target wants to be eligible for S corporation status, than the use of warrants can facilitate that eligibility, and do not preclude S corporation eligibility as is the case when preferred stock is used.

One area that you need to be careful about in the use of warrants in connection with an S corporation is the exercisablity of the warrants. Generally, the warrants cannot be immediately exercisable since their exercise would probably trigger the loss of S corporation status. Usually warrants used under these situations would be exercisable or exercise would be triggered by sale of all of the target's stock or assets or secondly a public offering or third, a change of control of the target. Those situations will usually cause the loss of S corporation status anyway, and you might as well go ahead and let the warrant holders obtain that benefit of equity ownership that would be derived upon the sale of the company stock or assets or public issuance of its stock.

The other benefit of the use of warrants is that the seller may not want to be a common stockholder and as a warrant holder, he only has the right to acquire common stock and therefore is not a common stockholder and may be able to maintain that sense of detachment that he is looking for. The benefit to the buyer is that since he is not a common stockholder under most the state's laws, he probably would not be entitled to receive the kind of corporate information that a common stockholder is granted under the various state corporate laws.

Preferred Stock

Next let's move to the category or layer of debt that has been described as preferred or common stock sold to an independent third party. These independent third parties are frequently acquisition buyout investment funds. These investment funds are usually limited partnerships which frequently have raised funds or obtained commitments, not through a public offering, but through some form of a private placement by selling the interest in the fund to institutional investors, pension funds and well-heeled private investors. These funds are usually structured as blind pool investments.

Since transactions of this type need to be done quickly, it is beneficial to have either the funds or a commitment for the funds readily available because the best deals are snapped up very quickly. Consequentially the limited partners in these partnership investments have no idea when they make their commitment as to what companies the fund will choose for investment. The investment decision is made by the general partner and the limited partner will have no say in how the funds are invested. One of the reasons that these funds raise their money through private placements involves various exemptions from the Investment Company Act of 1940. If you are raising money from the public and you are investing that money in the stock or other securities of various other companies, you are going to need to be in compliance with the Investment Company Act. The Act contains various registration requirements as well as public reporting requirements and prohibitions against interrelated financing. Some of these finance buyout investment funds will also provide bridge financing which is short term funding that is used during an interim period before permanent financing can be arranged. The short term bridge financing is usually for a period of six to nine months and it is only in place until such time as all of the work can be done to put the permanent financing in place. Bridge loans also typically involve equity kickers.

Fraudulent Conveyance Issue

Let's go back and discuss one issue I raised earlier, and that is the issue of fraudulent conveyances and why the fraudulent conveyance issue is important in financed buyouts. In the unfortunate event that your deal doesn't make it and the target files for protection under the bankruptcy laws, the senior lenders obviously want to be assured that their lien on the assets and the note that they have received will be enforceable. Federal bankruptcy law and the comparable state laws contain the concept of a fraudulent conveyance or transfer. A promissory note may be worthless and the lien may be void if the pledge of the assets and the granting of the promissory note by the target are deemed to be fraudulent conveyances or transfers. The underlying purpose of this doctrine is to protect general creditors of targets where the acquisition transactions have the resulting effect of depriving the acquired company of the means to pay its debt to its general creditors. It usually has nothing to do with whether or not there was an attempt to defraud anyone, although in some cases there has been held to be such an intent.

The problems specifically related to financed buyout loans is that a lien on the assets or the promissory note will be held to be fraudulent if the company receives less than reasonably equivalent value in exchange for the pledge and the note and any one of the following three situations exist. First, that the company was insolvent at the time of the transfer or became insolvent as a result of the transfer. Second, that the company was left with unreasonably small capital as a result of the transfer. Or third, the company incurred or intended to incur debt beyond its ability to pay.

The issue of whether or not the company received reasonably equivalent value in the transaction is frequently raised in bankruptcy situations because when you look at the transaction, usually what has occurred is that the selling stockholders got all the money and the resulting target ended up with heavily encumbered assets. Of the three situations that are problematic, the insolvency issue is the most difficult because the loans were based partially on projections. The target should be able to demonstrate that it has neither unreasonable small capital or the inability to pay its debts.

Let's address the insolvency question and why it is a problem. The main problem is that the definition of solvency as used under bankruptcy law was different from the definition used under generally accepted accounting principles or GAP. Under GAP, if a company has assets that are greater than liabilities, then it is solvent. Also under GAP, if the company has assets that are sufficient to pay its debts as those debts mature, it will also be considered to be solvent. Usually one or more of the GAP solvency definitions can be met in any financed buyout situation, but that doesn't solve your problem, because under the bankruptcy laws, the company is solvent only if the fair salable value of its assets is greater than its probable liabilities. Under this definition, assets are valued at their worth upon disposal and in many situations, that means their liquidation value, and not their book value.

At this point, let's summarize what we have learned in the section on financing techniques:

1. At closing, you need to consider funding for the following:
    A. Purchase price of the stock or assets
    B. Target's debt that need to be refinanced
    C. Working capital
    D. Acquisition costs and expenses
    E. Assets that can be converted to cash
2. In refinancing debt, check for prohibitions against transfers without consent of the lender – remember that you may need consents even if it is a merger transaction and not an asset purchase;
3. Revolving credit arrangements nearly always need to be refinanced;
4. Be sure to check the arrangements that you have on supplier financing;
5. When you are looking at the target, check for non-essential assets that can be liquidated;
6. Organize a financing plan taking into consideration the seven categories of financing;
7. Always remember that seller financing can be debt or equity or it can be some combination of the two;
8. Always be aware of the fraudulent conveyance issue and how it may affect your transaction.

Chapter 5
Due Diligence Investigation Process

The process of the due diligence investigation is one that can take as few as a week or as long as a year. It can run from a fairly inexpensive process to an extremely expensive process depending upon how much cost the buyer is willing to incur. There are two main thrusts of the due diligence process. The first one focuses on the financial condition of the target, its prospects for the future, and the intricacies of its operations, primarily with a view towards evaluating the company from a buyer's pricing standpoint. The purpose here is obviously for the buyer to come to some conclusion as to what he would be willing to pay for the company.

The second purpose, or focus, of the due diligence process is to uncover or ferret out any problem areas that will either kill the deal or will at least make the buyer think twice about what he is buying. The due diligence information that the buyer will accumulate will come from two generic sources. The first being the target itself and the second being outside sources, such as the state agency that regulates corporations, the local property appraiser's office, the local governmental offices where deeds and uniform commercial code lien documents are filed and the other applicable federal, state and local regulatory authorities.

A buyer should always work from a due diligence checklist. I'm going to give you an outline of what I typically use as a due diligence checklist, but keep in mind that the checklist has to be tailored for the specific target. The checklist I use, is usually broken down between a checklist for reviewing and evaluation the target's financial condition, and a checklist for reviewing and evaluating the target's operations.

Let's talk about operations first before we get into the financial component of the target's business. I always start at the target's beginning. By that, I mean that I want to know about the target's organizational structure. First you should obtain the company's certificate of incorporation or articles of incorporation as filed with the state agency that granted the company its original charter to begin business. One of the most important basic things that you can glean immediately from the articles of incorporation or certificate of incorporation is the exact specific name of the target, because some targets you will see referred to as having their name ending in "Inc.", or "Corp." and their name might really end in the full word "Corporation" as opposed to "Corp." or "Incorporated" as opposed to "Inc." and there are variations on names that create problems when you start doing your checking on property and liens as filed with the governmental agencies.

Be sure that you obtain not only the original incorporating documents of the target, but all of the amendments that have been made over the years. There could have been a name change of the company or more typically there may have been a rearrangement of its capital structure. You want to know how many classes of stock there are outstanding and if the different classes carry different voting rights or preferences with regard to dividend or distribution. You need to also look in the certificate and the amendments for items such as preemptive right and control provisions and/or any anti-takeover provisions that may be contained in those documents.

Along with the incorporating documents from the state agency you will need to also obtain the corporations Bylaws and corporate minutes. These documents will tell you information such as the terms of office of your directors, whether or not you have a staggered term for the board of directors, who the officers and directors of the corporation are and whether or not any poison pill type anti-takeover provisions have been adopted by the company.

You are also going to want to obtain the stock record book showing what transfers of shares have taken place and analyze whether or not those transfers were done properly. This is fairly easy in a small closely held company, but if your target is a public company, you are obviously going to have to get a stockholder list and other information from the company's transfer agent. You want to also ask the target if there are any stockholder's agreements among the majority stockholders because they may contain buy-sell agreements or restrictions on voting or there may even be a voting trust agreement among some of the more substantial stockholders.

Any reports that the company has issued to stockholder obviously if they are a public company they will have annual reports of some type, but also many privately held companies prepare some form of an annual report so you want to see if they have any documents like that. When you are reviewing the corporate minutes, they should reflect whether or not a pension, profit sharing, or stock option plan of any type has been adopted. If such is the case, you need to obtain a copy of any such plans that would currently be in effect. You should also ask for all employment contracts to review their substance.

The next section on the operational side after you look at all of the organizational type documents, is usually the contracts or agreements that the company has in place and these would include the following: any and all loan agreements, which includes security agreements, agreements regarding lines of credit, promissory notes, corporate bonds, corporate debentures, or other debt instruments including any guarantees that may have been made by some of the target's management or stockholders. Underneath the loan agreements you want to look at and ask for any correspondence with the lenders to see if there are any defaults or there were any defaults or if there has been any acceleration of any loan agreement, or if any loan agreements have previously been terminated or are on the verge of being terminated.

Second, you want to know whether or not there are any collective bargaining agreements or other negations regarding union or any unionization attempts that are being made. Third, you want to review any real estate leases that the company has or leases that they have on equipment, such as computers, heavy machinery or other items that are material to the operation of the business. Fourth, you want to ask if there are any royalty or license agreements and you want to review those agreements if they exist.

Fifth, you want to determine if there are any marketing or distribution contracts and if the company uses some independent distributors, you want to determine the depth of those relationships. Sixth, you want to find out if the company is a participant in any joint venture or partnership and get copies of those agreements if they exist. Seventh, you want to find out if there are any patents or trade secrets or any confidentiality agreements that relate to those patents or trade secrets.

One of the most important groups of contracts that you need copies of will be the company's insurance contracts. You are looking to determine if you have got enough coverage for the risks that the company incurs. You want to review the liability limits and the amounts of deductible. You need to know whether or not these policies are on a "claims made" basis or on an "occurrence" basis, do the policies have reservations of rights clauses, and what are the exclusions under the policies. Next, are there any product warranty agreements and what are the terms of those agreements, if they exist?

Moving out of the contracts and agreements area, you want to go to the asset identification area and here you are going to be looking for deeds for the company's real estate, bills of sale for the company's major assts, encumbrances on company assets, and undoubtedly this will go back to some of your loan agreements, if there is any kind of a revolving credit facility, but there may be some mortgages on the real property, for example or UCC liens on some of the assets that aren't covered in other documents that you will need to review.

Moving out of the asset area of operations, you should next go to the labor relations area. Are relations with the labor or labor unions satisfactory at this time? Are there any labor agreements binding on the buyer? Do those agreements restrict the buyer? Is the target presently in violation of any of the terms of such agreement? Has there ever been a strike? Is it likely that a strike will occur in the future? Are existing employment contracts with management binding on the buyer or will they terminate at sale? What kind of benefits and severance agreements are in place with both management and other employees.

Under operation, there are two other areas of concern that will require you to ask a number of questions. Those are the areas of sales and the product information questions. When looking at the company's sales, you should ask the following questions.
What is the target's competitive position with regard to its sales?
Do the target's sales personnel perform to the goals met by the target's competitors?
Are the commissions and incentives paid to the target's personnel competitive in the marketplace?
Is advertising used by the target current and timely?
Where are the target's principal customers geographically located?
What are the percentage of sales attributable to each of the target's principal customers?
Does the target use market research in connection with its sales and marketing strategy?
With regard to the target's products, the buyer must obtain a description of all of the target's products, the volume sold of each product, and the backlog of orders of products. The buyer needs to evaluate the markups on each product and whether or not there are any patents and licenses and what kind of exclusivity and terms are connected to the licenses. Are the target's products competitive in the marketplace with regard to price, quality, and style? Is the target meeting present demand for its prod-

ucts and is there the potential to expand if production could be increased? What new markets are there for the company's products? What is the obsolescence factor with regard to the target's products? Does the target have an ongoing research and development strategy? What projects are being worked on and what is the size of the R & D budget? Is there much turnover in the research department? Is the target's R & D long term oriented or short term oriented? How does the target's budget for R & D compare with its competition? How does the target's budget over the last few years relate to its earnings then as compared to its earnings presently?

Assuming that the target is involved somehow in the manufacturing process, the buyer needs to evaluate the condition of the plant, machinery and other facilities. What is the market for raw materials? How have raw materials costs changed over the last five years and what is anticipated for raw materials expenses in the future? Does production per employee compare favorably with other companies in the same industry? Will the target have to relocate its facilities to increase efficiency? Are the target's manufacturing controls adequate? In the event that sales and business generally increase, can existing facilities accommodate such increases?

I'm going to tell you where to look when you are searching outside sources for information on your target, but before I do that, let me mention two operational areas of great concern, and I can't over emphasize their importance. The first area is the one of pending or threatened litigation against a target. When you are reviewing your insurance policies, they need to be reviewed with regard to what they cover and what they exclude, and if there is pending or threatened litigation, there must be an analysis done to determine exactly what kind and how much coverage you will have under your existing policies. As a buyer, if you are buying assets, and not stock, you generally would not have any liability for the debts for the torts of the seller. The word "general" is misleading, because in specific situations the buyer can be liable and those situations are where there has been an agreement to assume that liability in the acquisition agreement or if the buyer is deemed to be involved in a mere continuation of the predecessor, or if the transaction was created solely to avoid liability and could be set aside as fraudulent conveyance.

As a buyer, if you purchase assets but you keep all of the seller's employees, you will almost definitely be required to continue to recognize and bargain with the unions that are in place. If you are continuing to manufacture the same products, there is a good chance that you will be liable for product liability claims brought by individuals who are injured by a product manufactured by your predecessor. When you look at your insurance policies, you also need to determine if they are for claims made or occurrence. An occurrence type policy is one that continues after the cancellation or termination of the policy and is for claims that arose during the period of insurance coverage. So for example, if you have a policy with one company and it is in effect December 31, 2006, and a person is injured during that time period, but they don't report it until sometime in 2008 or 2009, and by then you have changed insurance companies, if that is an occurrence type policy, then the insurance that was in effect at the that time would cover the calm.

Recently, there have been a lot more of the claims made type policies issued and those are policies that cover only the claims actually made to the company during the term of the policy. If you have insurance of a claims made type in effect in 2009, and the claim is brought that year, that policy should cover that claim. You also need to see if the policies had what is commonly referred to as a tail, and that is a special policy that continues coverage that would otherwise be terminated. Policies and or state law may not permit coverage for putative or treble damages so the policies and the state law have to be reviewed with regard to those issues.

Any litigation that is ongoing should be reviewed by an experienced litigator or someone who is trained to analyze litigation. The target should provide you with a summary of all pending litigation which is not a status report of the litigation, but an outline of what relief is being sought by the plaintiffs, what insurance coverage is involved, an estimate as to the cost of the litigation, and a copy of any legal opinions that have been rendered concerning the actions involved in the litigation.

There are two specific areas in litigation analysis that are extremely important to your review of your target. First is in the area of severance plans. Severance plans have become important topics, because some recent court cases have held that they are in essence employee welfare benefit plans and that as such they are subject to the disclosure, reporting, and fiduciary requirements imposed by ERISA (the Employee Retirement Income Security Act).

The second area of major concern in litigation analysis in connection with mergers and acquisitions is the area of environmental law. Even if the business you are acquiring is not one that is traditionally thought of as having environmental problems, you should keep in mind that there are some non-traditional problem areas. These include fuel tanks that the target may use to fuel its vehicles or onsite generators or asbestos, which could be contained in the company structures, such as its warehouses or even its retail operations. Many facilities have electric transformers and PCBs are an environmental troublemaker. Because federal environmental law is so stringent, a buyer can be devastated by an environmental problem that is discovered after he closes on the target. If a target is only one of the companies that have contributed to pollution of a common site, they are still going to be held liable jointly and severally for cleanup cost. A buyer can even become liable if he purchases assets as opposed to stock, so an asset purchase won't protect you. Under the theory that you are continuing the same business as your predecessor, a buyer will typically be liable even though he didn't expressly assume the liability in his acquisition agreement. The major problems of environmental liability are that officers and directors and sometimes even shareholders can be held personally liable. Clean up costs are astronomical and with joint and several liability, can be far in access of the value of the target that has been purchased. Finally, it can take years before there is a final determination of the liability and that generally means years of litigation costs which in and of themselves can put you out of business.

My best advice to a buyer where there is a potential environmental problem is to first obtain an audit report from a qualified environmental analyst and then make sure that if you go through the transaction that the seller's warranties in his acquisition agreement are going to cover environmental liabilities and even liabilities that result in off-site pollution. You have to make sure that these warranties survive as long as possible because problems can come up long after your closing. That should tie into either some escrow provisions or some offset provisions if there is seller financing involved in the transaction. You should also try to have a provision in the acquisition agreement warranting against all actions which caused pollution whether or not those actions were illegal when they were taken. The reason for this is that federal environmental liability can be imposed for actions taken before the adoption of modern environmental protection laws. Many companies shipped environmental waste by unlicensed carriers and had waste delivered to unlicensed sites at a time when that activity in and of itself was not illegal. If such activity caused pollution, and the environmental regulators come after the target now, liability can be imposed for those prior actions.

Now before I go to the financial due diligence side, let me give you some tips on to where to look for information outside the target source. First of all, each state has its own agency where the state's corporations are incorporated. In Delaware and in most states it is usually the office of the Secretary of State, so you can obtain from them the certificate of incorporation or the articles of incorporation, whichever they call it in their state. There are also companies that will perform searches of public records for you and it is important that you use them to see if there are any uniform commercial code filings which would reflect any liens. Typically those liens are recorded at both the state and the local levels. You should also check with the U.S. Patent and Trademark office to see if there is the possibility of any products or names that the seller is using that may be infringing upon existing patents or trademarks.

Let's go now to the financial due diligence side. If the target is a public company, the first thing you will do will be to obtain copies of recent 10-K, 10-Q and 8-K filings, as well as any registration statements that have been filed by the target. When public companies are involved in mergers, and the filing of a registration statement is required, they use Form S-4 and in that form you will find historical financial information as well as pro forma financial information. So, if your target has been through a merger in recent years, you can and should look at that information. You will need to receive a copy of the most recent audited financial statement as well as the most recent un-audited financial statement. Management usually creates projections and that information should be obtained from management. Financial statements for the preceding five year period should be obtained and reviewed as well as schedules of bank balances reflecting both current and average balances over the preceding five year period should also be obtained. Usually lenders will require that a minimum cash balance be maintained by a debtor and any information regarding that kind of requirement should also be obtained. A credit report from credit reporting agencies such as Dun & Bradstreet should also be obtained. The tax status of the target: federal, state and local, should be reviewed. Are there any loss carry forwards? Are there any claims for refunds from taxing entities? Has the company been audited in recent years?

You need to obtain a specific breakdown of accounts receivable. I would review closely a detailed description of the general and administrative overhead expenses over the last five years. Review provisions that have been made in the financial statements for employee benefit plan obligations and whether or not those reserves are adequate. You should obtain a description of the company's intangible assets as well as descriptions of all of the companies long and short term debt. If any investments are reflected in the financial statements, the specific details of those investments must be obtained.

Read closely the notes to financial statements and make sure that you understand them fully. Any unique or unusual items are usually reflected and explained in these notes to the financial statements, so if the company is giving you a balance sheet and a statement of operations that just contains the numbers, make sure that you get the rest of the details. The following questions are ones that you typically would need to ask with regard to the company's financial condition and financial statements. What is the condition of the company's inventory? How much of it is obsolete? What effect will the value of the inventory have on the balance sheet if it is written down to its liquidation value? Is the seller willing to maintain ownership of the inventory, if you will buy it from him on a consignment basis, and agree to try to sell existing inventory first. What are the differences between the tax and the book basis for the fixed assets that are shown on the balance sheet? Are there any assets not recorded on the target's books? Have any items of previous tax returns been disallowed? Are any items subject to possible disallowance and if so, what effect would that have on the company's future financial position? Are the reserves for bad debts adequate? Are the target's credit lines sufficient if expansion is anticipated? How does the target record and determine cost of inventory?

Because of the variations contained in generally accepted accounting principles, the buyer must ascertain the method that the seller has used and the assumptions that have been made in accounting for each of the components on the target's income statement. The buyer's analysis will probably involve recasting the target's income statement so that it can be measured in different ways, or if the buyer seeks to marry the target to his existing operations, he'll need to recast the income statement, so that it is consistent with the method that the buyer is presently using.

The target's balance sheet would then be examined to determine the effect of the adjustment in earnings that would result from the recasting of the income statement and to determine the accuracy with which items such as taxes, contingent liabilities, fixed assets, inventory, receivables or expenses are reported. Again, this type of an analysis should be done by qualified accounting personnel who have substantial experience with the intricacies and variations contained in generally accepted accounting principles.

Let's summarize this section on the due diligence process:

Remember that the two initial purposes of the due diligence process are: 1) to find any problems that may kill the deal or affect the price and 2) to verify information to assist you in setting the price. Don't' forget to check the outside sources of information as well as the information you get from the target itself. Remember to break the process down to operational due diligence and financial due diligence. In your litigation analysis, don't overlook or be blindsided by either the severance plan issues or the environmental issues. And last, have your accountants recast the target's financials using different accounting methods for the inventory, depreciation, and the like.

Chapter 6

Structuring the Deal, Tax and Non-Tax Considerations

If you don't have an tax background, I would not advise that you skip this section, because you will obtain information here that you will definitely need in your merger and acquisition analysis.

There are numerous tax factors in connection with corporate mergers and acquisitions. Since this is an extremely important part of any merger or acquisition transaction, I will try to go slow and break this section down as much as possible. I think that before we talk about the specific types of mergers and acquisitions from a tax standpoint that we should analyze what the typical seller's tax motives are and what the typical acquirer's tax motives are.

In my opinion there are two generic tax structures. Under the federal tax laws, corporate acquisitions can be structured either as taxable sales or as tax free reorganizations. If the transaction is categorized as a sale, then the seller's gain or the seller's loss relating to the transaction is immediately recognized. The effect of the sale to the buyer is generally that a new basis is obtained by the buyer for the acquired assets or the acquired stock and that basis is equal to the amount that the buyer has paid for the stock or the assets.

An asset's basis is the value at which the asset is carried on the taxpayers balance sheet upon acquisition of an asset. The taxpayer pays value or cost for an asset and typically this is used as the original basis of the asset. That original basis is later subject to adjustments both up and down. The basis may be increased by capital expenditures or decreased by depreciation, amortization, or other items chargeable against the asset. The result is an adjusted basis in the asset.

When an owner of an asset sells or exchanges the asset, there is a gain or a loss for tax purposes. That gain or loss is measured by taking the difference between the amount obtained for the asset and the amount of the asset's adjusted basis at the time of the sale or the exchange. Consequently, the amount of the basis or the adjusted basis at the time of the owner's disposition of the asset, represents the amount that the owner can recover which will not be subject to taxation.

In a taxable sale transaction, the seller's basis in the property that it receives is equal to the property's fair market value. What this means is, that if the seller receives cash and stock, the stock would be valued at fair market value for purposes of the seller's basis. In a sale, both the seller's and the buyer's basis is frequently referred to as the cost basis.

If the transaction is able to qualify as a reorganization, the actual recognition of the seller's gain or the seller's loss in connection with the transaction will be deferred until some future taxable disposition occurs. Generally, due to this deferral of recognition, the buyer's basis in the acquired property would be the same as the seller's basis prior to the time that the reorganization occurred. In that situation, the buyer's basis would be generally referred to as a carryover basis. The basis that the seller has after reorganization, is usually called substituted basis because it is the same as the basis he had in the property that he transferred. So, if he had a million dollars basis in his assets, and he took some other property from the buyer in exchange for the property received by the buyer in the reorganization, then his basis in that property would also be a million dollars and he would have a substituted basis in the new property.

Generally speaking, a taxable sale is much easier to accomplish than a reorganization, since to qualify the transaction as a reorganization, there must be very strict compliance with numerous complicated tax regulations that we will touch on later. I will caution you, however, that there must be strict adherence to the statutory requirements because it is very easy to violate the statutory guidelines and to therefore fall outside the tax free reorganization protection that is afforded by these rules and regulations. The IRS does not like tax deferred transactions, simply because you are delaying the payment of tax to them, therefore, they will demand strict legal compliance in a tax deferred transaction.

Seller's Motives

Let's go into the motives that a seller will have in an acquisition transaction. We need to evaluate both the selling corporation and the selling shareholders' motives in connection with these transactions. We are going to look at four factors in motivation. The first is the timing of the recognition of the gain or the loss. The second is the nature of the gain or the loss as to whether it is "capital" or "ordinary", which is important for a number of reasons. The third is the timing of payment and the fourth is consideration involving acceptance of an acquirer's stock.

First of all, the buyer must know his seller as well as he possibly can. When you are involved in the due diligence process, you should try to determine the needs or the wants of the seller. This is obviously easier if you have got only one seller as opposed to fifty selling stockholders or a thousand selling stockholders, but you generally have to figure out the seller's perspective when you are trying to structure the transaction. If the seller is in a position where he is going to realize a large gain in connection with this transaction, and believe me, most sellers are going to want to realize a large gain, then the postponing of the recognition of that gain will probably be the seller's major consideration.

If you are dealing with a fire sale, however, and the seller anticipates that he is going to incur a loss in connection with the transaction he probably will prefer to arrange the transaction as a taxable sale, so that the loss can be deducted immediately subject, of course, to the limitations on the deductibility of capital losses. Those are the simple situations where you've have got just one or a few sellers and you can figure out pretty readily whether or not the seller is going to have a gain in connection with the transaction or a loss. But what about if you have a number of different stockholders, they all have a different basis in their stock and they all have different motivations? Well. in that situation, the potential conflict among the desires and the motives of the selling stockholders could be resolved by structuring the transaction to comply with the installment sale provisions of the Internal Revenue Code. If you are able to do that, then the sellers who have a loss on the sale would be entitled to recognize such loss in full in the year of the sale, despite the receipt of the sale proceeds on an installment basis. Sellers in an installment sale situation who would realize a gain would be permitted to report their gain ratably over the period in which the payments being made by the buyer are received by the selling stockholder.

As a buyer, you may want to also consider the possibility that if you have a manageable number of selling stockholders, you may wish to make immediate full payment to those stockholders who would be realizing a loss in connection with the transaction and pay those stockholders who would be receiving a gain on an installment basis. There are some serious securities law considerations with that kind of a transaction, however, and I think that it would only be viable if you had a very small group of people as selling stockholders, keeping in mind that you need to watch out for the registration requirements of the Securities Act and also the Tender Offer Rules. But, assuming you have a very small number of selling stockholders that kind of a structure could be worked out.

Timing of the gain, or loss, is important but it is not going to be the only consideration that a seller gives to the transaction. The second thing the seller is going to look at is the type of a gain, or loss, that is going to be realized, and by this I mean that whether or not these gains or losses will be categorized as capital or ordinary. The characterization of gain or loss as either ordinary or capital is important in a taxable asset acquisition because the parties can allocate the purchase price among the assets being sold so that the seller's gain, or loss, is established and the buyer's basis for depreciation and also for gain or loss on later disposition is established. The seller may have capital losses and capital losses can only be deducted immediately to the extent of capital gains, consequently the seller in such a situation will want to allocate the purchase price so that he can maximize his capital gain and minimize his ordinary income. In such a situation, the buyer is going to want to allocate as much of the purchase price as possible to fixed assets, or inventory, or receivables so that those items can be depreciated or amortized which will reduce future ordinary income for the buyer.

Generally speaking, the seller should not care how much of the purchase price the buyer allocates to fixed assets, inventory, or receivables if he doesn't need capital gains to deduct his capital losses.

The third area that motivates sellers is the area dealing with timing of the payments to be received from the buyer. Sellers may be willing to go forward with a taxable transaction and therefore incur substantial tax liability if they have serious doubts about the buyer's financial ability to get them paid out over a period of time. A seller may also need cash for reinvestment and a seller will also consider the cost of deferral of payment as against the amount of consideration in interest payments that are being received to determine if the interest received is adequate to offset the deferral. The doubt as to the buyer's financial ability to pay is usually a problem faced in financed buyout situations where the seller is asked to take some of the financing back in connection with the transaction. Again, if the seller needs the proceeds from this transaction for reinvestment purposes, the buyer needs to make that determination early on.

The fourth area of interest is where the buyer is trying to get the seller to take paper in the form of the buyer's securities. The seller is going to look at the present and future valuation of the buyer and he may want some kind of consideration that is tied to future developments. Those are usually the equity kickers that we have talked about in the financing section, that way the seller has the ability to cash in on the success of the venture if things go extremely well. In most situations where a buyer wants the seller to take securities, the seller will usually try to get the buyer to give registration rights as part of the acquisition agreement. Again these could either be demand registration rights or piggyback registration rights.

Motives of an Acquirer

Let's look briefly at the motives of the acquirer in connection with one of these transactions. The acquiring company's motives in structuring the transaction will be different because generally there is going to be no concern about recognition of gain or loss because no gain or loss is realized by the acquiring company when the deal closes unless the acquiring company is providing appreciated property as consideration in the transaction.

There are tax considerations, however, for the acquiring company and those are the retention of tax attributes of the target such as loss carryovers, earnings and profits. The acquiring company will also be concerned about the effect of the transaction on the basis of the property which is acquired in the transaction. If the transaction takes the form of a taxable purchase of assets, then the acquiring company will also be concerned about how the purchase price is to be allocated among the acquired assets. That may also be the case in certain stock purchases that are taxable transactions.

From a purely business standpoint, and not a tax standpoint, an acquiring company will also take into consideration things such as the availability of cash. While many acquiring companies like to use stock or other securities as consideration, because it alleviates the necessity to pay cash, an acquiring company also has to take into consideration what effect that issuance will have on its existing shareholders because that issuance will result in a dilution of the existing ownership as well as costs in the form of registration expenses if the securities have to be registered now or even if registration rights are granted and those expenses will have to be incurred in the future.

Obviously if debt instruments are issued, the acquiring company has to take into consideration what effect it is going to have on their debt to equity position and whether or not that may violate any of the acquiring company's existing lending arrangements. Usually the acquiring company will seek to structure the transaction as a tax free organization if there are valuable tax benefits in the selling corporation, such as, net operating loss carryovers, a high basis in the target's assets, deficits in earnings and or depreciation methods that provide for an acceleration of depreciation. The flip side of the coin is that an acquiring company will generally try to eliminate a negative tax situation that exists in a target by effecting a taxable asset acquisition. Those negative tax situations will include things such as large accumulated earnings or possibly a low basis in the target's assets.

With regard to the tax considerations made by the acquiring company, they will look at basis. In a taxable transaction, the acquiring company's basis in the property that it acquires generally is equal to the purchase price that it pays, as we have discussed before. In a tax free reorganization, the basis of the acquired assets generally carries over from the seller to the acquiring company, but is increased by any gain that the seller recognizes. This basis is obviously important because it becomes the measure whereby the gain or the loss at some time in the future will be determined and depreciation deductions will be calculated based on the basis that results from the transaction.

It's very important to note that if the seller's basis is in excess of the fair market value of the assets, then the acquiring company will most probably want a tax free reorganization so it can take on the seller's high basis. If, on the other hand, the fair market value of the assets that are being acquired exceeds the seller's basis, than the buyer is going to want to obtain a stepped up basis which is equal to what it costs the buyer for the assets. The buyer wants a higher basis for his depreciable assets because his depreciation is based upon the tax basis of the assets and not necessarily the purchase price. If the buyer intends to flip or sell some of the assets after the acquisition, and the buyer also wants as high a basis as possible, because that in turn would reduce the buyer's gain since the gain is calculated on the excess over the assets basis.

The allocation of the purchase price is another serious tax consideration for the buyer in the event that the transaction is structured as a taxable sale. The buyer wants as much of the purchase price as possible allocated to depreciable or amortizable property such as buildings, equipment, or covenants not to compete. Items such as land or goodwill are not depreciable assets and consequently the buyer is not going to want to allocate very much of the purchase price to those items.

I should mention here that with regard to goodwill the buyer won't get any current or future ordinary deductions in connection with his purchase of goodwill, but can use that additional basis provided by goodwill to reduce any resulting gain on the ultimate sale towards this position of his business so that when the buyer sells the business, he will actually get some benefit from having paid a fairly high basis for the goodwill in the form of what he is going to save because he's got a higher basis in the assets than he would otherwise have. So all of these items are the basic tax issues that motivate both sellers and acquirers and should be considered when you are planning your structuring. For example, if a taxable sale of assets has been agreed upon and the seller knows an allocation of the purchase price to more depreciable items will be of no determent to him, he may use that as a bargaining chip to trade with the buyer for something that he wants in the transaction, and even if he doesn't get the additional item he is looking for he really hasn't lost anything by allocating the purchase price the way the buyer wants it allocated.

Choice of Entity

We are moving into the area now known as the choice of entity issue. An important consideration in planning an acquisition is what is known as the choice of entity issue.

By this I mean the determination of what kind of an entity is going to acquire the target. There are three generic types of entities and those are C corporations, S corporations and partnerships, and there are two subcategories of partnerships – they can either be general partnerships or limited partnerships. These entities fall into two different types of categories for tax purposes. The first category is the tax paying entity and the second category is the pass through entity. A C corporation is a tax paying entity. When earnings are generated by a C corporation they are taxed to the corporation or taxed at the corporate level when they are earned. When those earnings are then distributed to the C corporation's shareholders, the earnings are taxed again at the shareholder level. S corporations and partnerships, whether they be general or limited, are not tax paying entities in and of themselves, because their earnings are taxed directly to their shareholders, if they are an S corporation, or the partners, if they are a partnership, and this is whether or not they are distributed to those partners or shareholders. In other words, they are not taxed at the S corporation or partnership level and then taxed again at the shareholder or partner level.

Since S corporations and partnerships pass tax liabilities directly through to their owners whether they be shareholders in the case of an S corporation or partners in the case of a partnership, these entities are generally referred to as "pass through entities." To complicate matters further there are circumstances when a C corporation can be a pass through entity and that is generally when a C corporation files a consolidated tax return with its corporate parent.

Sometimes you'll run into layers of ownership and even though pass through entities should only be subject to single taxation, there are circumstances where they run into a double taxation problem. For example, if a C corporation is a partner in a partnership and the partnership has earnings, there would be no taxation at the partnership level, but taxation of those earnings at the C corporation level and then if they were distributed to the shareholders of the C corporation, there will be taxation at that level. That's one of the reasons that you will sometimes see corporate partners of a partnership but those corporations will usually be S corporations so that the partnerships earnings are passed through to the S corporation and then passed through the S corporation to its shareholders, resulting in only one or a single layer of taxation.

You should be aware of the fact that there are four basic sets of guidelines or sets of rules that govern this pass through aspect. The first of these are the principles governing the pass through of income and loss which are designed to make sure that the income or loss of the entity is allocated to the shareholders or the partners of the entity to insure this single taxation level. The second are the basis adjustment principles which govern the increase or decrease of the basis in a shareholder's or partner's interest in the pass through entity to the extent of the income or loss of the entity recognized by those shareholders or partners. The result of adjusting the basis this way is that the income or loss of the pass through entity is not included in the income or loss of the partner or shareholder again upon distribution or sale of the partner's interest in the entity.

Third are the principles governing distribution which interplay with the basis adjustment principles to allow earnings to be distributed from the pass through entities to a shareholders or partners tax free. And number four, the loss limitation principles that place a maximum on the amount of pass through losses that a shareholder or partner can recognize with regard to the shareholder or partner's interest in the pass through entity. These loss imitation rules limit the deductibility of losses generated by pass through entities by three sets of rules, and those are the basis limitation rules, the at risk rules, and the passive loss rules.

The basis rules just generally say that the deductibility of the pass through losses is limited to the basis of the partner or the shareholder's interest in the entity. The at risk rules generally place a limitation on the loss the shareholder or partner can recognize to the amount that that person has put at risk economically. And the passive loss rules generally prohibit deductibility of passive losses unless there are offsetting passive gains. The purpose of the passive rules was to limit the numerous tax shelter abuses that were floating around in the 70's and 1980's. After these passive losses limitations are passed, many tax shelter salespeople switched to selling what they called "PIGS", which stood for passive income generators, which could be used by all those people who had passive losses that they then could not use to offset their regular income.

For a number of reasons pass through entities are more popular in small deals than in large ones, and some of the reasons for that are primarily due to the liquidity of the securities involved in the transaction. There is not much trading in partnership interest even if they are public limited partnerships. In S corporations, because of the limitations placed on the type of shareholders that they can have and the number of shareholders that they can have, just do not lend themselves to larger deals. If you are involved in a smaller acquisition, however, you should fully investigate the use of a pass through entity because the tax advantages that can be inherent in such a deal can make it very advantageous.

3 Transaction Forms

Next we want to talk about the forms that a transaction can take. The three basic forms are 1) asset purchases 2) stock purchases and 3) merger of the buyer or a subsidiary with a target. Combinations of those forms are also seen. For example it is fairly typical to see a stock purchase followed by a merger.

In an asset purchase the target's assets are acquired by the buyer including hard assets like equipment, inventory and real estate as well as intangible assets such as accounts receivable, leases, patents, trademarks, and various other types of contract rights. In an asset purchase, specific documents of conveyance are signed for each asset such as deeds in connection with real estate, bills of sale in connection with hard assets, and assignments of certain rights such as accounts receivable and other contract rights. The acquisition agreement governs with regard to the assumption of liabilities by the buyer. In other words, the buyer only gets the liabilities that are agreed to in the acquisition contract. Like every rule, there are exceptions, but the general rule is that any liabilities that are not specified in the acquisition agreement are not assumed by the buyer and remain as liabilities of the target corporation.

The second general type of transaction is the stock purchase and this is simply when the seller transfers its shares of stock in the target corporation to the buyer in exchange for either cash, debt, personal property, real estate, or some other form of consideration. In public company acquisitions, this is frequently done by tender offer and in those cases, the purchaser may be acquiring less than all of the stock of the target. Typically in a private company acquisition all of the stock of the target is acquired. In some private company deals, you will see stock either retained or transferred to management personnel as part of the deal.

The third type of transaction, a merger, is simply a statutory transaction where the buyer or an affiliate of the buyer merges with the target and one of those companies disappears. The parties to a merger are typically referred to as the "constituent corporations", the company that disappears is frequently called the "absorbed corporation" and the corporation that is left is referred frequently to as the "surviving corporation" or the "survivor."

In a merger transaction the assets and the liabilities of the absorbed corporation become part of the surviving corporation by operation of law and no separate documents need to be executed to transfer the specific assets of the absorbed corporation other than the filing of the merger agreement with the appropriate state authorities.

Advantages and Disadvantages of 3 Transaction Forms

What are the advantages and disadvantages of each of those forms of transaction? First of all, in an asset acquisition, the buyer will generally be the beneficiary of an increased basis in the assets acquired and consequently will receive tax benefits during the time that it owns the acquired assets because it can take advantage of depreciation of those assets which will offset its earnings from operations during that time period. In addition, upon a sale of those assets, the buyer would be taxed on the gain which would be the excess received over the basis of the assets. Generally speaking the seller will realize taxable gain from the sale of the assets assuming that his basis in the assets is lower than the purchase price. While that is a disadvantage to the seller, there are some ways to remedy that, which will be reviewed below.

As far as disadvantages are concerned, there appear to be many with regard to an asset sale. The first, and best known, of which are the increased tax cost of doing an asset transaction in many cases since passage of the Tax Reform Act of 1986. The Tax Reform Act of 1986 repealed what had been known as the general utilities rule. Basically, the general utilities rule was an exception to the double taxation system. The general utilities rule permitted non-recognition of gain to corporations upon distributions to shareholders in certain circumstances when appreciated property was distributed. Since corporate earnings are taxed at the corporate level when the sale occurs and then at the shareholder level at distribution of the net proceeds, the general utilities rule was useful in eliminating one level of taxation. Since the repeal of the general utilities rule, asset purchase transactions have been drastically reduced in number. Another disadvantage of an asset purchase is that it is generally more expensive and more time consuming to prepare all of the documents transferring each of the separate assets. Deeds to real estate have to be recorded and recording fees and transfer fees have to be paid to various state and local agencies. Consents have to be obtained on transfer of leases. Local licenses may have to be changed. If franchise agreements are involved, the franchisor would have to consent to the transfer and numerous other technical headaches arise in the appropriate legal transfer of all assets, particularly if various assets are owned or held in different state jurisdictions.

In a stock purchase transaction, a seller will find it advantageous to have the buyer purchase stock because the buyer then takes the corporation's business subject to all of its liabilities. In that case, my advice to a buyer is to be sure that the indemnification provisions in your acquisition agreement are strong so that there is some recourse against a seller in the event of undisclosed liabilities. One disadvantage of a stock transaction for a buyer involves the mechanics of acquiring stock from a number of different stockholders. In many cases, a buyer wants to acquire one hundred percent of the stock of the target so that he can use the target's assets as leverage in connection with his acquisition. In such a case, the entire deal can be thwarted by one stockholder. Most states have a short form merger provision that says that if you obtain ninety percent of the stock of the company, you can approve a merger transaction without the other ten percent approval and even without a formal meeting, but you have to give dissenters' rights to those shareholders who were not in favor of the merger. This is typically referred to as a "force out merger" and is used in a situation where there are a small number of holdouts who are acting as an impediment to an acquisition transaction. These people have the right to go into court and have their shares appraised and the buyer must pay them usually the fair market value of their shares on the date just prior to the time that the acquisition was to occur.

One area that needs to be looked at closely when you are doing a stock transaction is the change of control provisions in loan agreements, leases, and other binding contracts of a target. In recent years, lenders and leasors have inserted provisions requiring that they consent when there is a change in the control of the target corporation much like the standard provision that have been used for years in leases that requires consent for an assignment to a third party.

Another area of concern is where there are tax disadvantages that would be connected with a standard stock purchase transaction. In such a situation it may be possible to use Section 338 of the Internal Revenue Code. If a Section 338 election is made, the stock purchase is treated for federal income tax purposes as an asset acquisition and we will discuss that more in a few moments. As far as mergers are concerned, there are a number of different types of merger transactions and you will frequently hear the terms "reverse merger", "forward merger" or "subsidiary merger" mentioned.

Let's define those transactions. In a forward merger, the target mergers into a buyer corporation. The target shareholders exchange their stock for some purchase price which could be cash or securities or debt or some other form of consideration. The result of a forward merger is that the buyer corporation owns all the assets and liabilities of the target and the target as the absorbed corporation legally disappears. For tax purposes, a transaction of this type is treated as if the target had sold its assets for the purchase price and then liquidated and distributed the proceeds of that sale to the shareholders of the target as liquidation distribution. Since the target disappears in a forward merger, and the assets and liabilities of the target end up in a different corporation, such a transaction could violate contractual agreements that the target had in place prior to the merger. This depends on the jurisdiction or jurisdictions involved and the law of the state governing each contractual agreement must be reviewed to determine if a forward merger would violate any such agreements.

In a reverse merger, the buyer merges into the target and the target is the surviving corporation. The buyer's stockholders would receive stock in the target and the target's stockholders would receive the purchase price which again would either consist of cash or some other form of consideration. Frequently, a reverse merger is treated like a stock purchase for federal tax purposes. A subsidiary merger is simply either a forward or reverse merger which includes the use of a subsidiary that was formed solely for the acquisition transaction. For example, a reverse subsidiary merger is a transaction where the buyer incorporates the subsidiary and that subsidiary merges into the target with the target being the surviving corporation and the acquisition's subsidiary disappears. In a forward subsidiary merger, the target is merged into the acquisition subsidiary and the target disappears and the acquisition subsidiary is the surviving corporation.

Tax Free vs. Taxable Transactions

Next we want to discuss some of the differences between tax free acquisitions and taxable acquisitions. You will frequently hear the term "tax free acquisition" thrown around and it is really a misnomer because such a transaction is truly a deferral of taxation and just puts off the day of reckoning so that a seller's taxable gain or loss would not immediately be recognized.

The three most commonly used tax free transactions are 1) statutory mergers or consolidations 2) an exchange of voting stock of an acquiring company or its parent for a controlling stock interest in another corporation and 3) an exchange of voting stock of an acquiror or it's parent for substantially all of the properties of another corporation. You will hear these transactions referred to by the letter of the subparagraph under Internal Revenue Code Section 368(a)(1)(A), for example, a statutory merger or consolidation, is commonly referred to as an "A reorganization"; a stock for stock exchange is frequently referred to as a "B reorganization"; and an exchange of stock for assets is commonly referred to as a "C reorganization".

There are about ten different types of reorganizations under Section 368 when you take into consideration the variations, combinations and permutations that can be thought up to fit under Section 368. In addition, Internal Revenue Code Section 351 also provides for tax free transaction status. Section 351 is simply a method for one or more persons to get non-recognition treatment when they transfer cash or other property to a corporation in exchange for substantially all of the corporation's stock.

As for the Section 368 reorganizations, sometimes a tax free acquisition will appear to fit into more than one of the different reorganization categories. In some circumstances, the Internal Revenue Code provides where one of the types will prevail over the other even though in some cases the bottom line effect of the two reorganization sections may be the same. There are variations, however, in what kind and how much consideration can be paid and the extent to which certain liabilities must be assumed by the acquiror.

Let's review briefly these tax free transactions and then later we will talk about the hybrid situation. A statutory merger qualifies as an "A reorganization" and occurs when two or more corporations combine with one being absorbed and disappearing and the other being the survivor and consisting of all the assets of both of the pre-merger corporations. To the extent that the target's shareholders receive stock of the surviving corporation, the transactions will be tax free to them. If the target's shareholders receive cash or other property in exchange for their stock, they are taxed to the extent of the gain that they will realize in connection with their receipt of such cash or property. One of the paramount reasons that mergers or consolidations are so popular, is their flexibility with regard to the kind of consideration that can be given to the target's shareholders, particularly the fact that consideration is not limited to voting stock alone. The target's shareholders can get voting or non-voting stock, other types of securities or cash or other property. The only limitation that is placed on the target's shareholders is that they have to receive some minimum amount of equity consideration which gives them a continuing proprietary interest in the acquiror. You may hear this referred to as the doctrine of continuity of interest, which is generally a requirement of all reorganizations.

Some of the advantages of a merger or a consolidation are the things that we have talked about frequently before such as the direct acquisition of the absorbed company's assets by operation of law without any need to transfer each asset separately. Additionally existing contacts of the absorbed company would generally pass to the acquiror without the need to obtain consents from third parties. That, of course, is a general statement and may vary depending on the contacts that are in place. There are variations among the different state merger laws and sometimes those variations create disadvantages in merger transactions. If the acquiror and the target are in an unrelated business, some state laws would preclude their merger. The way that this is usually dealt with is that the company that is incorporated in the state with the offensive law is usually reincorporated in a state that would permit the merger, but again this takes time and runs into additional expense.

Another impediment that is frequently involved is that the target's stockholders have what is commonly referred to as dissenters' right under most state merger laws. This means that if they dissent from the transaction they have the right to demand payment in cash for their shares. This usually involves some form of an appraisal and if agreement cannot be reached between the dissenting stockholders and the company, then a state court usually decides the value of those shares. If a substantial number of the shareholders dissent and demand cash payment, then the financial burden of the transaction can kill the deal.

Different state laws also require different levels of approval whether it is majority or two thirds of the stockholders of the participating corporations. Usually if an acquirer is a public company, or company with a large shareholder base, it simply incorporates a subsidiary and merges the target with the subsidiary. By using that method, then approval of shareholders only has to take place within the target corporation. There are also numerous state anti-takeover laws that have been put into place, and in a situation involving a hostile transaction, they can be used as a defense. We will talk later in our chapter dealing with take over defenses about these state anti-takeover laws.

B reorganizations

A "B reorganization" consists of an exchange solely for voting stock of the acquiring corporation of the stock of the target directly from the target shareholders. The acquiring corporation can only use its voting stock or the voting stock of its parent corporation as consideration and cannot use cash or any other type of property as payment to its targets stockholders. The acquiring corporation must obtain control of the target and control is defined as owning at least eighty percent of the total combined voting power of all classes of the target's stock that are entitled to vote and at least eighty percent of the total number of shares of each other class of the target's stock. So, for example, if the target had one hundred thousand shares of common stock that was voting stock which was outstanding and one hundred thousand shares of preferred stock that was outstanding which had no voting rights and the acquiring company would be required to buy and own at the end of the transaction at least eighty thousand shares of the target's common stock and eighty thousand shares of the target's preferred stock. You should note that the only exception for cash payments to the target's stockholders is that cash may be issued instead of issuing fractional shares. What that means is that if you have a conversion ratio for example of one share of the acquiring company's stock for every 1.2 shares of the target's stock, and you have a selling shareholder with 1,000 shares of the target's stock, he or she would be entitled to 833.3 shares of stock of the acquiring company. That means that the acquiring company can issue 833 shares of stock and pay the target's stockholder for one third of one share of stock and that payment can be in cash.

You should keep in mind that it is necessary to follow the strict, rigid, statutory requirements for reorganizations. An example of how to kill a tax free reorganization occurred in one case where voting stock was issued as well as warrants to acquire additional shares of voting stock. The United States Supreme Court says that warrants are not voting stock even though they are a right to acquire voting stock and your reorganization will be disqualified if warrants are issued in connection with what was originally planned to be a "B reorganization". I mention that primarily because of the popularity of the use of warrants in today's marketplace.

Now sometimes "B reorganizations" don't happen all at once and by that I mean the end result of a series of transactions can qualify as a "B reorganization" if those transactions take place over a fairly short period of time. Let me clarify something that I just said so that it is not misinterpreted. If you have a B reorganization and you issue stock that is not eighty percent of the voting stock and you are counting on the warrants to increase the percentage beyond eighty percent, that is where you run into a problem using warrants and assuming that they are the same as voting stock.

There are some advantages to acquiring an ongoing corporation through a B reorganization and those are the standard ones that we talked about previously such as keeping existing contracts, licenses or possibly franchises in place without disrupting the corporate entity itself or having to have the company qualify to do business in various states since the existing entity is already in position to do so. The disadvantages, however, seem to be many. When the target becomes a subsidiary of the acquiring company, the previous tax attributes including loss carryovers would generally be unavailable to the acquiring company. Another big problem area is where the target company's stock is widely held. This creates two distinct difficulties for the acquiror. First of all the acquiring company would have to register its shares with the SEC to exchange them with the target's stockholders. This again is a very expensive process and involves a substantial time delay. The considerations also go beyond the federal securities laws into the state's blue sky laws because registration may be required under the laws of the states where the target's stockholders are residing. In a widely held corporation this could involve twenty, thirty or more states.

The other problem created by having the target's stock widely held is that the acquiring company will probably have difficulties in determining and establishing the basis of the acquired shares. This is important because the acquiring company gets the basis of the selling stockholder so there is a carryover basis in the stock of the target. If the stock is widely held, then the many stockholders of the target will have acquired their shares at different times for different prices. Most acquirors make obtaining this information a condition or requirement before issuing shares of the acquiring company in exchange for target shares. This is done by having the target's shareholders indicate the basis that they have in their shares on the form that they use when they request and exchange of the target's shares for the acquiring company's shares. There is one more thing that an acquiring company does not really like and that is a group of unhappy, disgruntled, disruptive, minority stockholders and one of the best ways that I can think of to get such a group into your company is to do a "B reorganization".

C reorganizations

In a "C reorganization" the acquiror must exchange its voting stock for substantially all of the properties of another corporation. Once again, the law says that the consideration to be paid must be solely voting stock of the acquiror or its parent, but unlike a "B reorganization" there are some exceptions to this rule. And it is not quite as rigid as the requirements under the "B reorganization". The Internal Revenue Service has set forth some guidelines for purposes of issuing advance rulings which indicate that the "substantially all" requirement will be met if the acquiror ends up with 90% of the value of the target's net assets and 70% of the value of its gross assets upon consummation of the transaction. This doesn't mean that some lower percentage will never satisfy the substantially all requirements but for advance ruling purposes and for safety when it comes to planning, you should count on the 90/70 standards.

There are two exceptions to the standard that the acquiror must transfer only voting stock. The first is that the acquiror can assume the target's liabilities or can obtain the target's properties subject to liabilities and such assumption of liabilities will be disregarded in determining whether the exchange is solely for voting stock. Second, the acquiror can give property other than its voting stock as long as at least 80% of the value of all assets of the target including those that the target retains after the transaction is consummated, are acquired in exchange for voting stock. When you apply the 80% test, the assumption of liability or the acceptance by the acquiror of property subject to liabilities is treated as property other than voting stock. Therefore, if the acquiror assumes liabilities of the target or takes property of the target subject to liabilities are in excess of 20% of the gross value of the target's assets, then voting stock will be the only consideration that is permissible under those circumstances.

The basis that the target had in its properties carries over to the acquiror in a "C reorganization" increased by any gain that is recognized by the target. The target's basis for the stock it receives from the acquiror for its assets is equal to the combined basis of the transferred property subject to some adjustments. The tax attributes of the target will generally carryover to the acquiror although there may be some limitations on some of those tax attributes such as net operating loss carryovers. Generally speaking what occurs in a "C reorganization" is that after the deal has been closed, the target is liquidated and the consideration that it received in connection with the transaction is distributed to its stockholders. When the target's stockholders get the stock of the acquiror after the target has been liquidated, their basis in the acquiror's stock is the same as the basis they had in their stock of the target.

One of the most important benefits or advantages to the acquiror in using a "C reorganization" is that the acquiror can avoid assuming the target's liabilities. Again, that is a general statement and can vary under circumstances where there are product liability or environmental type problems that surface after closing. One disadvantage that we have also mentioned before is that as a tax free asset acquisition, a "C reorganization" will require the specific transfer of each asset as opposed to a transfer of all of the assets by operation of law. Another disadvantage is that because the law indicates that the acquiror must obtain substantially all of the properties of the target, then the acquiror may end up with some assets that it really doesn't want in order to preserve the tax free status of the transaction.

We have mentioned briefly the use of triangular acquisitions. A triangular structuring of acquisition is expressly permitted by the Internal Revenue Code and an A, B or C reorganization can be structured such that a there is a subsidiary of the acquiror used in the transaction. The following are the principle advantages of using a triangular structure.

The parent corporation is generally isolated from the liabilities of the target.
The obtaining of approval from the parent corporation's shareholders prior to the acquisition, is not necessary.
The continued separation of the business operations of the newly acquired business from the parent corporation core business.
There are some additional statutory requirements in order for a triangular acquisition to qualify as tax free. They are as follows:

Forward triangular mergers where the target merges into the acquiror's subsidiary must meet these requirements:

1. Substantially all of the assets of the target must be acquired by the acquiror's subsidiary;
2. The target must be merged into the acquiror's subsidiary;
3. A merger would have qualified as an "A reorganization" had the target;

merged directly with the acquirer;

4. No part of the consideration provided to the target's stockholders in the merger consists of stock in the acquiror's subsidiary

You should note here that when they are talking about the requirement that the reorganization would have to qualify as an "A reorganization", what they mean is that it has to satisfy the doctrines of continuity of propriety interest that we talked about briefly before, continuity of business enterprise and business purpose.

A reverse triangular merger occurs when an acquiror's subsidiary is merged into the target corporation and the target's shareholders exchange their shares for shares of the acquiror. To qualify as a tax free reorganization, the following requirements have to be met.

1. Following the merger, the target must hold substantially all of the assets of both corporations.

2. A sufficient number of the target's shareholders must exchange their stock for stock of the acquiror parent so that the acquirior has control of the target according to Section 368(c), and

3. at least 80% of the target's stock must be acquired for voting stock of the acquiror parent.

There are two other triangular transactions: the triangular "B reorganization" and the triangular "C reorganization". The triangular "B reorganization" involves the subsidiary of the acquiror acquiring stock of the target. This can be done either through an agreement with the target's management or through individual negotiations with each shareholder of the target or by means of a hostile tender offer. The target's shareholders get voting stock of the acquiror parent in an exchange. The target's stock, in such a situation, can be exchanged for either the parent's stock or the stock of the subsidiary, but it can't be exchanged for both and if an exchange is structured so that the target's stockholders get both, the transaction would be disqualified as a tax free transaction. In a triangular "C reorganization", the acquiror's subsidiary ends up with possession of substantially all of the target's assets. This can be done in one of three ways:

1. The acquiror can directly acquire the target's assets in exchange for its voting stock and subsequently transfer the assets to a subsidiary

2. The target can transfer its assets directly to the acquiror's subsidiary and receive voting stock of the acquiror directly from the acquiror as consideration for the transaction.

3. The target can transfer its assets to the acquiror's subsidiary and receive voting stock of the acquiror from the subsidiary. The target will receive stock that was previously contributed by the acquiror to its subsidiary for the purpose of providing the payment or consideration for the contemplated transaction.

We previously mentioned three doctrines that have been used to deny tax free status to transactions, and let me just briefly explain those. For a transaction to be qualified as tax free, it has to meet the strict literal statutory requirements that are contained in the Internal Revenue Code. In addition to those statutory requirements, there are four doctrines that the courts look at to determine if the transaction in substance as well as in form, has significance apart from simply the tax avoidance aspects. The first of these is the business purpose requirement and this simply means is there some business purpose for this transaction aside from the tax avoidance? Was the transaction contrived merely to take advantage of the tax laws and aside from that tax avoidance, is there economic reality? Most of the cases that have applied this doctrine and denied the benefits of tax free reorganization have involved corporations whose ownership was interrelated prior to the transactions and the result of the transaction had no effect on the underlying ownership of the corporations.

The second doctrine is the continuity of the business enterprise requirement which requires the acquiror to either continue the business that the target has historically been involved in or to use a substantial part of the target's assets in the acquiror's existing business. The third is the continuity of interest requirement which requires that the former owners of the target continue to own a propriety interest in the acquiror after the reorganization is consummated. The fourth doctrine is the step transaction doctrine. Under this doctrine a series of transactions will be examined to see if more than one transaction should be combined or grouped with other transactions to give the overall picture of what the underlying economic realities are in that case. In other words, the focus shifts from the specific isolated event of the reorganization to a focus on contemporaneous business occurrences relating to the parties. For example, if a target sells some of its assets and soon thereafter enters into a "C reorganization" with an acquiror, the IRS may look at the transaction and say that the assets that were sold first where assets that the acquiror really didn't want and were sold off so that a tax free reorganization with the acquiror could be accomplished and that the first sale of the unwanted assets really was inseparable from the transfer of the assets that the acquiror wanted, and consequently the acquiror did not buy substantially all of the target's properties and therefore the "C reorganization" should not be a tax free transaction.

Taxable acquisitions which are either sales of stock or assets.

Basically in the stock transaction gain or loss is recognized according to its character and is then determined by taking the difference between the seller's basis of the stock and the amount that the seller received upon the sale of the stock. In an asset sale, the gain or loss is determined by taking the difference between the amount received and the seller's basis and also taking into consideration the nature and the holding period of the property that has been sold.

In the stock purchase, as we have discussed earlier in this chapter, a seller recognizes gain or loss at the time of the sale and that gain or loss is measured by taking the difference between the seller's basis and the amount that the seller receives from the stock. In a taxable sale of stock, the sale can be arranged as an installment sale to help the seller defer at least a portion of his gain. If at least one payment is received in the taxable year after the year of sale, the profits on the sale must be spread ratably over the period in which the payments are received unless the seller elects not to be covered by the installment of sales provisions. The seller must report as income in any taxable year, the proportion of the payments received which equals the ratio between the total profit to be realized on the sale and the sales price.

For an acquiror, the result of a taxable stock purchase is the same as it would be for the tax free stock acquisition with the exception of the acquiror's basis in the stock which would be its cost in a taxable transaction as opposed to the seller's carryover basis in a tax free stock acquisition. There are some potential problems in the event that a Section 338 election is made, which we will address after we focus generally on taxable asset acquisitions.

The target corporation or its shareholders gain or loss in a taxable asset acquisition, is determined by taking the difference between the tax basis in the assets and the amount of consideration received in the sale. If the target sells a capital asset, the sale will result in either a capital gain or a capital loss. If inventory or property that is held primarily for resale to customers is sold by the target, ordinary income or ordinary loss will arise. If the asset that is being sold is depreciable, and is sold at a gain, ordinary income may rise to the extent that excess depreciation is recaptured. When a target sells all of its assets or part of its assets, it has to determine the loss or gain on each of the assets separately. This is usually done by allocating the purchase price among the assets according to their respective fair market values. One of the main problems with the taxable sale of assets, is that the gain or loss is realized by the corporation when the sale takes place and then at the second level gain or loss is realized by the stockholders upon liquidation of the target and distribution of its assets. I previously alluded to the general utilities doctrine and the fact that it no longer is in effect and that now we have a double taxation situation.

Accounting Methods

From an accounting standpoint, there used to be two basic methods of providing for mergers and acquisitions. The purchase method and the pooling of interests method. Very generally speaking, the purchase method accounts for the transaction as the acquisition of one entity by another. What this means is that the purchase price is allocated to all of the assets and any excess is recorded as goodwill. The prior balance sheet and financial statements of the target are of little or no significance. If a pooling of interests method was achieved under prior law, then the result from an accounting standpoint would be different. In this method the result does not look like there has been an acquisition of one company or entity by another but the assets and liabilities and other tax attributes of each company are simply carried forward at their previous amount. There is in essence a combination of the operations and the operating results of the two entities and they are treated as though they had always had been together.

In June 2001, FASB issuing FASB Statement No. 141 Business Combinations which changed the method of accounting for business acquisitions by adopting the acquisition (purchase) method and eliminating the pooling of interests as an alternative. In December 2007, FASB issued a revised standard, SFAS 141 (R), Business Combinations, and SFAS 160, Non-controlling Interests in Consolidated Financial Statements. Purchase accounting recorded all assets and liabilities at their estimated fair values. When the price exceeded the sum of the fair values for individual, identifiable assets, the excess was attributed to goodwill. Prior to July 2001, goodwill was amortized up to 40 years. With the issuance of FASB Statement No. 142, Goodwill and Other Intangible Assets, goodwill is no longer amortized. It is now tested for, and if necessary, adjusted for impairment.

Because all assets and liabilities were transferred to the acquiring company at existing book values under the pooling method, no goodwill could be created. Pooling was a preferred method by many acquirors, and the use of this method became problematic with widespread abuse. The Financial Accounting Standards Board held that fair values should be used in all combinations. The lack of comparability due to financial statement distortions, which resulted from companies using alternative methods, could no longer be tolerated. The financial statement advantages created by the pooling method were eliminated by the issuance of FASB Statement No. 141.

Important Tax Provisions

There are a couple of tax code sections and tax issues that I want to mention and some of these may get a little more complicated than the matters that we have already discussed, but it is important that you are at least aware of these potential issues and potential problem areas.

The first of these I want to talk about is Section 338 of the Internal Revenue Code. Section 338 sets forth a procedure whereby an acquiror can elect to have a stock purchase transaction treated as an asset purchase transaction. One of the main requirements of the election is that the acquiror must receive at least 80% of the stock of the target. When all of the requirements of Section 338 are met, the target is treated as having sold its assets to the acquiror in a single, taxable transaction on the date that the acquiror purchased the target company's stock and the target corporation is treated as a new entity that purchased all of its assets on the following day. The sales price is treated as being basically equal to the fair market value of the assets of the target, which is determined by the sum of the purchase price of the target's stock and the liabilities that are in the target, which includes the tax liability on the assumed asset sale. Now you have to understand that this is a fictional transaction that is set up for tax purposes only. The deal is really structured as a stock acquisition. Since the end result is that the deal is treated as an asset acquisition and the target company ends up with the tax liability, why would a Section 338 election be made? The answer is that there are two scenarios that can make a Section 338 election advisable.

The first such scenario is where the taxable gain that is triggered by the fictional sale of the target's assets is offset by net operating losses and the increase in the tax basis of the target's assets is viewed by the acquiror as being more valuable to the acquiror than the carryover of the target's net operating losses. To try to explain a little more fully, for example, the target, we'll use "ABC Company" as its name, has half a million dollars of net operating losses. Section 338 is elected so that the stock sale to the acquiror, who we'll call "XYZ Corporation", is treated as an asset sale and we'll say that that sale is for one million dollars. The company's gain would be a half a million dollars because the other half a million dollars is offset by the net operating losses. XYZ Corporation, as the acquiror, pays a million dollars and therefore it gets a one million dollar basis that it can use for depreciation purposes. XYZ Corporation for independent reasons would prefer to have an asset with a million dollar basis that it can depreciate than a company with a half a million dollar net operating loss. Consequently the Section 338 election makes sense in that situation.

The second situation where the Section 338 election is often used is where the acquiror and the seller jointly make an election under Section 338(h)(10). A 338(h)(10) election also creates a fictional transaction for federal tax purposes only. Section 338 (h)(10) says that if the target corporation is a member of an affiliated group of corporations and that affiliated group of corporations files a consolidated federal income tax return, and in addition the acquirior makes a Section 338 election with regard to the acquisition of the target's stock, then the acquiror and the seller of the stock can jointly elect to treat the target corporation as a member of the selling consolidated group with respect to the stock sale that is being treated as an asset sale.

The end result of a 338(h)(10) election is that there is no recognition of gain on the actual sale of the stock of the target by the consolidated group in which the selling shareholder and the target were members at the time of the sale. Here's what happens in a 338(h)(10) election.

The target corporation is deemed to have sold all of its assets and that sale is treated as a taxable asset sale.
Any gain or loss that results from the sale of the target's stock, and remember the target's stock is being treated as a sale of assets, is reported on the consolidated tax return for the affiliated group and remember that the affiliated group includes both the target corporation and the corporations that sold the target's stock to the acquiror. In other words, there were some parent subsidiary relationships there or other affiliated relationships and the target's stock was owned by another corporation.
The target corporation is then treated as having been liquidated tax free after the stock sale that has been deemed to be an asset sale so that the target corporation's tax attributes carry over into the affiliated selling shareholder corporation.
The affiliated selling corporation does not recognize any gain or loss on the sale of the stock of the target corporation. Without Section 338(h)(10), the result would be triple taxation and by that I mean that there is taxation at the target corporation level on the deemed sale of assets, which again is really a stock sale, a second level or layer of taxation to the shareholders of the target corporation on the sale of the target's stock, and remember here that these shareholders are corporate shareholders that are corporations. And so then there is a third layer or level of taxation that would kick in when the sale proceeds ended up in the hands of the shareholders who were shareholders of the selling corporation. So in other words, by the time that the actual sale proceeds had filtered down to the individuals involved in the transaction, there would have been three layers or levels of taxation. When the acquiror and the seller of the target's stock have determined that it should be structured as an asset sale but for reasons other than tax reasons, such as simplicity of transfer of assets like we talked about previously, they would prefer to have effectuate the transaction through a sale of the target's stock, then a Section 338(h)(10) election would be appropriate. The acquiror and the seller will of course all also analyze any potential benefit of using the two alternatives of either a straight sale of assets or a forward merger. But I think that it is important that you are aware of the fact that a 338(h)(10) election is available under certain circumstances to permit a stock sale to be treated as an asset sale for tax purposes only. Again, don't be confused by the fictional tax transaction because the actual documentation and the structure is a stock sale. I should also mention here that at some states have state income tax provisions and whether or not any particular state would recognize a 338 election or a 338(h)(10) election will depend on the state.

Additional tax code sections that sometimes come into play.
Section 304
Section 304 of the Internal Revenue Code is usually seen in connection with a target corporation that is acquired in a leveraged buyout. Section 304 was originally put in place to plug a hole in the tax code that permitted tax avoidance resulting from a sale of stock in one related corporation to a second related corporation.

If John Smith owned a hundred shares of ABC Corporation and also a hundred shares of XYZ Corporation, those being all of the issued and outstanding shares of those corporations and he sold half of his ABC Corporation stock to XYZ Corporation for one hundred thousand dollars, he probably would have a capital gain on the sale of his stock when in reality, the end result did not change his beneficial ownership in the stock of the two corporations. Under those circumstances, Section 304 would recharacterize the entire transaction and treat it as though John Smith received a dividend from XYZ Corporation accompanied by a taxable contribution of ABC stock to XYZ, instead of just a sale of ABC stock that would qualify for capital gains treatment.

There is a lot more to Section 304 although that was what it was originally passed to address and now in leveraged buyout situations it becomes important because Section 304 is broad enough to include any situation where there is either direct or indirect control by the selling shareholder of the stock of both the acquiring corporation and the target corporation. Under the statute, control would be defined as either fifty percent of the voting power or fifty percent of the value of the corporation's stock which includes preferred stock.

When you are dealing with a leveraged buyout it is not unusual for the value of both the target and the acquiring corporation to be extremely low when viewed on a book value basis. The target has been burdened substantially by debt acquired in the leveraged buyout and the acquiror is usually nothing more than a shell that is used as an acquisition vehicle only, it has little or no book value prior the transaction. In such a situation, a seller who may be taking back preferred stock in a leveraged buyout transaction could conceivably cause the seller to have more than fifty percent of the value of the acquiring corporation. I am assuming that he also as the selling shareholder of the target's stock owns more than fifty percent of the value of the target's stock. If such is the case, than Section 304 becomes relevant and if Section 304 applies the sale proceeds received by the selling shareholders are treated as proceeds of a stock redemption. If such is the case, then the selling shareholders must look to Section 302 of the Code to see if this redemption should be treated as a sale of stock or as a dividend.

One of the problems is that if Section 304 kicks in, a Section 338 election that we just talked about could not be used, if this redemption was treated as a dividend. It could only be used if the transaction was treated as a sale. You should know that this applies not only when there is one selling shareholder, but could apply to a group as a whole. In such a case, where there is a potential problem with Section 304, the seller can accept some form of a debt instrument, such as a subordinated debenture. Another alternative would be to find a third party purchaser for the preferred stock. This is a complex area and I am only mentioning it to alert you to the issue.

Section 306

You may also here reference to Section 306 stock. If a corporation distributes preferred stock under certain circumstances on a tax free basis to its stockholders, that preferred stock could be characterized as Section 306 stock, which means that a shareholder would have ordinary income treatment upon the subsequent sale or redemption of the stock. It generally does not arise in a case where a seller sells his common stock, but retains preferred stock and does not arise where preferred stock is acquired for cash.

Section 279

Section 279 provides generally that interest deductions in excess of five million dollars per year will not be allowed on debt that is used to finance an acquisition to the extent that the company's interest deductions are attributable to what the IRS calls "corporate acquisition indebtedness". Corporate acquisition indebtedness means debt incurred to acquire stock or at least two thirds of the assets of another corporation, if it meets the specifics of the statute. Consequently, if a debt instrument of any kind is used in your acquisition, tax counsel must pass on the wording of the instrument to make sure that you have not subjected yourself to Section 279. In addition, Section 279 does not apply to repurchases of a company's own stock and has been interpreted not to apply to deals where the target's assets secure the loan so a leveraged buyout where the target is the resulting borrower will usually avoid Section 279 because Section 279 creates such an oppressive burden if it applies, you will need to rely heavily on your tax counsel to advise you in this area.

Original Issue Discount

Next let me mention some issues regarding what are known as the OID rules. OID stands for Original Issue Discount. When you are involved in issuing a debt instrument that has not equity features to it, in other words, a promissory note or a bond that doesn't have any warrants attached to it or it doesn't have any equity kickers and is not convertible to equity, then you need to be aware of the OID rules. Generally speaking, the IRS will view interest as accruing on debt whether or not there is actually a payment of interest made. Some loan documents and debt instruments will have provisions which will permit the deferral of interest payments by a borrower for some period of time. For example, the debt instrument might have a grace period to a borrower of say eighteen months, and defer the payment of interest on the loan for that time period to the end of the term of the loan. What the OID rules say generally is that if that happens, the borrower must still take a deduction for imputed interest that should have been paid during that time period conversely the lender has to book taxable income for that eighteen month time period when in fact, there actually was no payment made. If the lender is a pension fund or some other tax exempt type lender, this will have little effect on the transaction, but if the lender is a more typical tax paying entity, it generally will have the disadvantage of not getting any cash payment for a time period but having to book taxable income which obviously its not going to be very happy about. In financed buyouts we frequently see situations where there are grace periods and the business reason for the grace period is usually that the company needs all its cash right away for working capital and until they can get their cash flow straightened out they don't want to be burdened with excess payments that can make their deal fail in a short period of time.

The reason for these grace periods is generally not because of any tax advantage that might be involved since there is generally speaking a tax disadvantage to the lender as is typical in such a situation an adjustment is usually made. That adjustment is usually in the form of an increase in the interest rate that is payable to the lender. In other words, even though the lender is not getting anything out of the borrower on a short term, he is making up for it on the long term. The OID rules are very complicated and I haven't even touched their complexity here, but you need to be aware of the fact that original issue discount consideration come into play in any debt financing.

Summary

With regard to tax motivations of sellers, know your seller and his tax position to determine if this transaction will represent a tax gain or a tax loss to him. Give consideration to the timing of the gain or the loss and structure accordingly. Will the gain or the loss be capital or ordinary? Will the seller take back some of the financing? With regard to the buyer's motives in an acquisition, the buyer will look at the effect of the transaction on the acquired properties tax basis. If it is a taxable asset purchase, the buyer will be concerned over how the purchase price is allocated. If there are valuable tax benefits in the target, the buyer will generally want the deal structured as a tax free reorganization. If there are negative tax situations, the buyer will generally want a taxable asset acquisition.

If you are a buyer, be sure that you are familiar with the choice of the entity issue. Remember that there are three basic forms that a transaction can take - asset purchase, stock purchase and/or merger. Remember that most tax free transactions are accomplished under one of the subparagraphs of Section 368 of the Internal Revenue Code, most commonly the A, B and C reorganizations. Remember that there are procedures whereby a stock purchase can be treated for tax purposes as an asset sale and this fictional tax transaction may facilitate your particular needs. Watch out for Section 304 of the code in financed buyout situations. Be careful of Section 279, its effects can be devastating to your deal. And last, if you are involved in issuing debt instruments, be aware of the original issue discount rules.

Chapter 7

Securities Law Considerations in Acquisitions

In this chapter we are going to discuss how the federal and state securities laws apply to acquisitions including a discussion of when the securities issued in connection with an acquisition must be registered under the Securities Act of 1933 as well as a discussion of the tender offer rules and the rules governing proxy contests.

The sale of securities is regulated on two levels. The first being the federal level and the second being the state level. When you are involved in any transaction where securities are being sold or exchanged, you have to be careful to comply with both federal and the applicable state laws because there exists what is known as concurrent jurisdiction, which simply means that they both have the right to regulate these transactions. The specifics of registering securities, particularly with regard to initial public offerings, is beyond the scope of this book, so we won't go into the specifics in depth at this point, but you must be aware of the most important aspects of the application of the securities laws to acquisition transactions. When you have any kind of a corporate combination which involves exchanges of securities such as the stock for stock transactions that we discussed in the structuring chapter, your deal then involves the "sale" of securities because an exchange is defined as a sale under the securities laws. Consequently, your deal is subject to the registration requirements of the Securities Act of 1933 and any of the applicable state blue sky laws, unless there is an exemption from registration with which you can comply.

Federal Law

The way the Securities Act of 1933 is organized, all securities must be registered unless the securities, or the transaction to which they relate, is specifically exempted from the registration requirements. I like to tell my clients that this is one of the inverted laws in the American legal system because as an issuer, you are basically guilty until proven innocent, and by that I mean the way the federal and state securities laws are drafted, the person who claims an exemption from registration has the burden of proving that the exemption applies to him.

Consequently, if you as an issuer are ever challenged (by that I mean, if a regulator or someone who got your securities files a lawsuit against you), all they really have to do is allege that you sold them a security and it wasn't registered and that is all that they have to prove, if they are alleging the sale of unregistered securities against you. You must then pick up the ball and carry it and must be able to prove to the court that the exemption that you are relying upon applies specifically to your deal. That is why there is almost as much paperwork involved in a private placement of securities as there is in a public offering so that the issuer, if ever challenged, can prove that it complied with all of the laws.

When you talk about the federal laws and the federal exemptions under the securities laws, there are some exemptions that are provided for right in the 1933 Act, and then there have been a series of rules that have been passed under the authority of the Act, which set forth some other exemptions. Specifically, under the '33 Act, the rules I am referring to are what is called Regulation D.

The most commonly seen exempt transactions are those that are done under Regulation D and also those that rely on Section 4(2) of the '33 Act. Section 4(2) of the '33 Act simply says that securities are exempt from regulation that are issued in transactions by an issuer "not involving any public offering."

The idea behind both Sections 4(2) and Regulation D is that the burdensome registration process can be avoided in small business transactions under certain conditions. Very generally, the factors that indicate the availability of the Section 4(2) exemption are 1) the number of offerees, 2) the size and the manner of the offering, 3) the sophistication from a financial standpoint of the investors, 4) the relationship of the investors to the issuing entity, 5) the material information that has been disclosed to the investors, and 6) restrictions on the transferability or the resale of the securities that have been sold.

Early judicial decisions in this area focused to a great deal on the number of offerees involved in a transaction and you will frequently hear people who aren't very familiar with the process say things or ask questions like "as long as I keep it under 35 investors, I'm ok, right?" The important thing to remember is that the answer to that question is "No, you're not all right, that there is a lot more to it than just a number's game," but again, very generally speaking, the smaller the number, the better the chance that a Section 4(2) exemption will be available to you. Again, that is just one factor, and it's not the deciding or determining factor.

The factors of size and manner of offering relate to what kind of a process is involved in raising the funding, for example, is there an investment banker involved? Or is there an underwriter or some other professional money raiser who takes part in the transaction?

A Section 4(2) exemption does not permit any general solicitation which has frequently been interpreted to mean that there can be no advertising or other marketing designed to reach huge numbers of people through mass media. The financial sophistication aspect speaks for itself, because the law generally views the experienced investor as being able to take care of himself or herself and might not generally need the protection afforded by the disclosure requirements of registration. The relationship between the investors and the issuer is important because long time friends and business associates are typically assumed to have greater ability to obtain material information from an issuer.

Information actually provided to the investors is important because it also may show if the investors have been treated fairly in what they have been told and last of all restrictions on transferability or resale, which affect the liquidity of a security, indicate that generally for the longer period of time that an investor is tied to the investment, the greater the chances that this is purely a private offering and not a public one. For these reasons you will see some of the investment representations made in private placement subscription agreements that indicate that the investor knows that the investment is illiquid and will have to be held for a substantial period of time.

Because Section 4(2) is so broad in its statutory form, it is subject to change based upon the judicial decisions that have come out which interpret the section. Many issuers don't want to take the risk that the exemption won't apply to them because the area is fairly murky when it comes down to specifics. As a result of that situation, the SEC passed Regulation D which sets forth a much more clear standard that can be followed and relied upon by an issuer. You have undoubtedly heard the term "accredited investor" and the concept of an accredited investor is something that comes directly from Regulation D.

Regulation D is a series of rules, the three substantive ones being Rule 504, Rule 505 and Rule 506. Generally Rules 505 and 506 are the most used rules and they very generally exempt the deal from registration when sales are made to no more than thirty five non-accredited investors. There is no general solicitation or advertising and all investors receive disclosure of the same kind of information that would be included in a registration statement. Where this fits in an acquisition transaction is that an acquiror can issue stock and/or debt instruments under a Regulation D offering to a target's shareholders if there are a small enough number of shareholders of the target, and the other requirements of Regulation D can be met, the most stringent of which involves the giving of various audited financial information.

By using the Regulation D exemption, an acquiror can avoid substantial expense and delay in connection with an acquisition, because if you can't fit within one of the exemptions, the acquiror will have to file a registration statement on Form S-4 and register the securities that it intended to exchange with the target's stockholders.

Additional Federal Exemptions

There are some other exemptions from registration under the federal law that I want to just mention in passing so that you are aware of them. One is the Section 1145 exemption under the U.S. Bankruptcy Code, which exempts securities that are involved in an exchange that has been judicially or administratively approved. This is most frequently seen when a company is coming out of bankruptcy pursuant to a plan that is approved by the bankruptcy court.

Another exemption that is used is contained in Section 3(a)(11) of the '33 Act and is know as the intrastate offering exemption, which provides that securities are exempt from registration if they are part of a issue that is offered and sold only to persons who reside in a single state where the issuer is a corporation, incorporated in that state. This is a very difficult exemption to take advantage of because if even one of the offerees is a non-resident, then the exemption is not available. There is also the problem of what the SEC calls the offering coming to rest, and what that means is that if a resident of a single state resells the security to a non-resident within a short period of time, the SEC could argue that the offering had not been completed and the securities had not come to rest until such time as they were in the hands of the non-residents and consequently the intrastate offering exemption would not be available. Again this is a very tough exemption to use although in some specific particular circumstances it might be one that you could use.

Again, generally speaking you should be aware of the fact that Rule 145 exists. Rule 145 extends all of the disclosure requirements that are involved in the original issue of securities to merger and acquisition transactions as well as various asset transfers and reclassifications. The law before 1973 was that a merger or other business combination did not involve a sale of securities and consequently the registration provisions would not apply to such a transaction. When the SEC passed Rule 145, it was doing nothing more than verifying that if an exemption from registration were not available, than a merger or consolidation or even certain asset transfers would need to involve the filing of a registration statement which today is done under a form that is known as Form S-4.

Tender Offers and Proxy Contests

The other two areas that involve SEC matters are the areas of tender offers and of proxy contests. Very basically, a tender offer is nothing more than an offer being made by a person or an entity that is know as a bidder to purchase stock of a target corporation from its shareholders. Tender offers are made for cash or securities such as stock, warrants, debentures, or bonds or they are made from some combination of the two. If the bidder is offering any type of securities to the shareholders of the target, then the registration provisions of the securities laws that we have just talked about come into play and the bidder will be required to not only comply with all of the tender offer rules but also the registration provisions of the federal and state securities laws.

In a cash tender offer the bidder must comply with the tender offer rules only and since he is offering cash, he will not have the restraint placed upon him that is inherent in registering securities. Of course, it is possible in a situation involving less than thirty five non-accredited investors to issue either stock or some form of a debt instrument from the bidder and I have been involved in those situations so I know that it is possible even in a substantially sized company. But let's go back again briefly to the definition of a tender offer, because I want to mention the fact that the SEC proposed a definition of a tender offer, which was neither adopted nor withdrawn which defined a tender offer as including both 1) one or more offers to purchase or solicitations of offers to sell securities of a single class made during a 45 day period to more than 10 persons and seeking the acquisition of more than 5 percent of the class of securities of the target and 2) an offer to purchase disseminated in a wide spread manner providing for a premium over the market price in excess of 5 percent or two dollars, whichever was greater, and made without providing a meaningful opportunity to negotiate price and other terms. Again, this is what the SEC at one point and time said they thought was a tender offer, and again, the rule was not adopted, but it was also not withdrawn.

There is a fair amount of case law on this point and the cases seem to say that there are approximately eight situations that indicate that a stock purchase program is a tender offer and they are as follows:

1. Active and widespread solicitation of public shareholders for the shares of an issuer.

2. Solicitation made for a substantial percentage of the issuer's stock.
3. An offer to purchase made at a premium over the prevailing market price.
4. The terms of the offer are firm rather than negotiable.
5. The offer is contingent on the tender of a fixed number of shares, often subject to a fixed maximum number to be purchased.
6. The offer is open only for a limited period of time.
7. Offerees are subject to pressure to sell their stock.
8. Public announcement of a purchasing program concerning the target company precedes or accompanies the rapid accumulation of a large amount of the target company's securities.

The reason I outlined this for you is because you are going to want to know when your active securities purchase in the marketplace becomes viewed as a tender offer, and not just open market purchases. Let me make some very general suggestions that will not apply to every case. The first is that you are going to pay a premium over the market price, don't make it a substantial premium and make it in terms of a negotiable offer, not a firm price. Second, don't actively solicit a large group of shareholders. Keep your solicitations to a minimum and make sure that the people that you are contacting are sophisticated investors. Third, don't set a specific time limit and fourth, be careful that you are not violating Rule 10(b)(13), which prohibits a person who is making a tender offer from making any formal or informal arrangements to purchase any stock after the termination of a formal tender offer. The effect of such an agreement could be to treat differently or unequally holders of securities of the same class which is not permitted. This doesn't mean, however, that you can't make arrangements prior to a tender offer, and those arrangements are disclosed in the tender offer. What it means is that you can't make any arrangement once the tender offer has begun until such times as it has been concluded.

The technical mechanics of a tender offer are sufficiently complicated to take up a number of hours just in just their basic explanation, but let's try to hit the highlights here and talk about some of the advantages and disadvantages of tender offers as part of your merger and acquisition strategy.

The advantages of tender offers

The first advantage is that this is an offer to a target's stockholders and the target company's management and board of directors is not required to vote on or approve the bidder's offer. If the shareholder's tender their stock they are entering into a contract with the bidder directly and the target company itself is not a party itself to that contract. This is probably to your biggest advantage if this tender offer will be deemed to be a hostile tender offer because it permits a method by which you can acquire the target company against the wishes and desires of the target company's management.

Tender offers are regulated by what is known as the Williams Act. The Williams Act does require that a target's board of directors must meet and take a position on the tender offer and disclose that position to its shareholders. The target's shareholders then have the right to make up their own mind after taking into consideration the arguments that have been made by both the target's management and by the bidder.

Secondly some boards while they would not negotiate a merger with an acquiring company may not openly oppose a tender offer and thus without either the active support of the target's management or a hostile reaction to the tender offer, an acquisition may be made when it could not be made through negotiation with the company's management. Third, depending upon the situation, it may be cheaper for an acquiror to buy most of the stock of the target than to purchase that corporation's assets in a negotiated transaction with its management. Fourth, if management negotiates with an acquiror, it runs the risk that a court sometime in the future will determine that the price that management accepted was not adequate or not fair for the shareholders. In a tender offer where there is no competing bid, that situation is less likely to occur. In a merger transaction, a shareholder after the fact may decide that the exchange ratio really was not good enough and may bring an action against the board, but if the shareholder has accepted the tender himself, without there having been any board approval, it obviously becomes more difficult for a shareholder to blame that situation on the target's management. And fifth, the great advantage of the relatively short period of time that it takes to consummate a tender offer makes the process very popular. This is particularly true in a cash tender offer because there is no SEC pre-clearance of the documents. By that I mean that as soon as the bidder is ready to commence its tender offer, it does so under its own timetable and doesn't need to file any documents with the SEC until the offer is commenced. That is not the case where you have a proxy solicitation and it is also not the case where you have to file an administration statement in connection with issuing securities pursuant to either a tender offer or a merger. You must keep in mind that the SEC requires a minimum twenty business day offering period for a tender offer so conceivably for a cash tender offer the acquisition can be completed within twenty days. Because of the things the usually occur during the pendency of a tender offer, however, it is somewhat unusual to see one conclude that quickly.

Disadvantages of tender offers.

The first is that the bidder must offer a premium over the market price of the securities to attract the target's shareholders, and that is only the beginning. In addition there are investment banking fees, attorney's fees, accountant's fees, costs of publicity, fees connected with printing, and dissemination of all the information to the target's shareholders. On top of that there is the risk of litigation that is involved in a tender offer. Management may decide to fight the bidder and drag the bidder into costly litigation which adds to the bottom line cost of the shares if the tender is successful.

The second problem is one of due diligence, or I should say lack of due diligence. In many tender offer situations, the bidder must rely upon public filings to get the background information that it needs on the target and no matter what they say about the full disclosure requirements of the securities laws, you just can't get all the detailed information that you really should have to do a good due diligence background investigation of the target without the cooperation of the target. Third, in a more traditional merger or acquisition that is negotiated, an acquiror will have the benefit of representations and warranties that are contained in the acquisition agreement and can have the right to go after the selling stockholders if certain things are not as represented. In a tender offer there is no such benefit. It is usually an "as is" purchase and what you see or really what you don't see, is what you get. Fourth, if you don't buy all of the stock of the target, you may end up with minority stockholders and the bidder will have to deal with those minority stockholder and their interests which is frequently problematic. And fifth, there are state anti-takeover statutes which provide another layer of regulation in addition to the federal layer of regulation under the Williams Act.

Basic requirements of a tender offer

There are a number of ways that a bidder can commence a tender offer. The bidder can either publish a long form advertisement in the newspaper, it can publish a summary advertisement in the newspaper, or it can publish or send to shareholders of the target copies of the tender offer materials. There is also something known as the five day business rule. If a bidder makes a public announcement that identifies the bidder and the target as well as the number of shares that the bidder will seeking, and the price or range of prices that will be offered and the SEC says that a tender offer has been commenced and within five days of that announcement the bidder either has to publicly announce its decision not to proceed with the tender offer, or it has got to file and distribute its tender offer documents.

The date of commencement is important because as we mentioned previously there is a minimum twenty business day offering period so the bidder is usually very careful to go by the book when it comes to commencement of the offerings so that there is no question later as to whether or not the offer had been open for a minimum of twenty days. The most commonly used method of commencing an offering is by summary advertisement and you can frequently open the Wall Street Journal and find a summary advertisement for a tender offer.

On the day that the tender offer commences, or within in five days after under the five day business rule, the bidder has to file what is known as a Schedule 14(d)(1). This is a document that outlines the information about who the bidder is, who the target is, how much is being offered for the securities and in what manner, how long the offer is open for, and other information that is required to be disclosed by the rules. The Schedule 14(d)(1) gets filed with the SEC, copies are sent to the target and any stock exchange on which the company's securities are traded. If a tender offer is already in progress by another bidder, the new bidder must send a copy of his Schedule 14(d)(1) to the other bidder or bidders that are involved in competing tender offers. If material changes occur, that would change any of the information contained in the Schedule 14 (d)(1), the bidder is required to amend his documents. The Schedule 14(d)(1) is a technical document that is usually produced in what is known as a wraparound fashion. By that I mean that most of the information that is required by the rules is really set forth in the exhibits to Schedule 14(d)(1) and it is those exhibits for the most part that are sent to shareholders and they are specifically a document known as an offer to purchase and another document which is known as a letter of transmittal.

The offer to purchase is just that. It tells the target's shareholders what the deal is and the letter of transmittal is the method by which the target stockholders can tender their shares. Any shares that are tendered can be withdrawn by a stockholder at any time during the pendency of the tender offer. If the tendered shares have not been purchased within sixty days from the date of the original offer, then a stockholder may also withdraw his shares under those circumstances. The tender offer rules require that a bidder must either promptly pay the consideration offered or return the tendered shares. The withdrawal provisions I just talked about would come into play where the tender offer period has ended and the bidder's depositary and other agents are verifying that they have all the appropriate documentation to transfer the shares to the bidder before actually paying for them and during this period sixty days have run since the beginning of the tender offer, then the tendering shareholders would have the right to withdraw those shares if they had not obviously withdrawn them during the time that the tender offer was open.

As I mentioned before, a bidder cannot directly or indirectly purchase or arrange to purchase any securities of the target during the time that the tender offer is open other than pursuant specifically to the tender offer itself. In other words, the bidder cannot go into the marketplace and buy more stock at the market rate during the time that he has got a tender offer pending and he also can't privately negotiate any purchases of stock until the tender offer has either been withdrawn or the offering period has expired. SEC rules provide that if a bidder is offering to purchase less than all the outstanding stock of the company and more shares are tendered then the bidder has offered to purchase, then the bidder must buy those shares on a pro rata basis. This situation led to an abuse know as short tendering which means that a stockholder would tender more shares than he actually owned in hopes of increasing the pro rata amount that would be accepted. The law provides that a stockholder cannot tender a security unless that at the time of the tender and at the time of the pro ration period, they own the security that was tendered. It is also improper for a stockholder to engage in hedged tendering which means that he tenders to more than one bidder or he tenders in the tender offer and also sells his securities in the open market.

Proxy Solicitation Rules

Another area of concern, related to the securities law, are the proxy solicitation rules that govern proxy contests. Solicitation of proxies by person other than incumbent management has been an area that was virtually ignored years ago with a few well known exceptions. Takeover artists found it relatively easy to launch hostile tender offers and takeover attempts by the use of all cash tender offers with financing provided by huge pools of cash raised by the sale of junk bonds. By making offers directly to a target's shareholders in the form of cash at a premium over the market price, corporate raiders found ready and willing sellers and consequently the tender offer was used as the most efficient means of taking control of the company. Because hostile tender offers generated so much outrage, inevitably Congress as well the numerous state legislatures began to get involved in the process. As we have alluded to before, a large number of state legislatures have adopted state anti-takeover provisions in their state corporate laws.

In addition, Congress made changes in the tax laws that reduced the tax benefits of junk bonds and other financed acquisitions. If you recall back in the tax section under the chapter relating to structuring the deal, we discussed the fact that a general utilities stock has been abolished and this also acts as an impediment in takeover situations. Congress also passed a provision in the Internal Revenue Code which imposes a fifty percent tax penalty on green mail profits by hostile bidders in tender offer situations. All of these circumstances reduced the tender offer as a viable takeover tool and because of these restrictions, the result has been that corporate raiders have looked once again to proxy contests as a method to acquire control of a target companies. So the greatest benefit to an acquiror of all of these statutory provisions that are detrimental to and discourage tender offers, is that they don't prevent proxy contests.

When you look at the viability of a proxy contest, you have to take into consideration that if there is a shareholder's rights plan, or a poison pill, as those plans have been frequently called, then you will find that usually a proxy contest will not trigger poison pill defenses. When it comes down to the cost effectiveness of a proxy contest, that also becomes an advantage for an acquiror because it is much less expensive than purchasing a controlling interest in a company. When you look at the proxy contests that have occurred in the last few years, you find that they are not just made up of the disgruntled shareholder's attempts to unseat the board of directors of a target company but they are also increasingly consisting of attempts to invalidate any takeover defenses, including poison pills and other corporate policies that may discourage takeovers, and in the eyes of disgruntled shareholders, limit shareholder value. It is not unusual now to see unhappy shareholders use Rule 14(a)(8) to have their proposals included in proxy statements distributed by the target company and these shareholder proposals frequently consist of attempts to get shareholder authorization for recapitalizations, restructuring, or changes in other ways that the target company does business. In past years, the likelihood of a proxy contest being successful were minimal, but in today's active marketplace, the institutional investors and other owners of large blocks of stock, are taking a more and more active role in the activities of their companies. In the past, there was a tendency for large shareholders to vote with their feet, and by that I mean that they would just get up and leave if they didn't like the way things were going. They'd just sell their shares and move on to some other investment, but more and more we are seeing that insurance companies and other large institutions are not only more and more willing to listen to the dissonance, but may in fact be the ones leading the charge.

Let's talk briefly about the law with regard to proxy solicitation. The Securities Exchange Act of 1934 under Section 14(a) of that Act governs the solicitation of proxies and makes it unlawful for any person by use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise in contravention of rules and regulations prescribed by the SEC to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security other than an exempt security registered pursuant to Section 12 of the '34 Act, and generally speaking Section 12 of the '34 Act deals with companies that are governed by the reporting requirements of the '34 Act which is all Nasdaq companies as well as all companies listed on both the American and the New York Stock Exchange. The term "solicit" and the term "solicitation" are defined to include any request for a proxy whether or not accompanied by or included in a form of proxy and any request to execute or not execute or to revoke a proxy or the furnishing of a form of proxy or other communication to stockholders under circumstances reasonably calculated to result in the procurement, withholding, or revocation of a proxy.

The term "solicit" or "solicitation" does not apply to the furnishing of a form of proxy to a stockholder upon the unsolicited request of that stockholder or by the giving of information required by Rule 14(a)(7) to stockholders by the issuer. With regard to what gets filed in a proxy contest, there is something called a Schedule 14a, which sets forth the information that is required in a proxy statement and all proxy materials are filed with the SEC in a preliminary form in triplicate at least five business days before definitive copies are sent out to stockholders. The reason that Rule 14(a)(1) uses the language "communication to a security holder under circumstances reasonably calculated to result in a procurement, withholding, or revocation of a proxy", is so that all of the communications that are part of the continuous plan ending in solicitation are governed by the proxy rules, otherwise it would be easy for a group of stockholders that was unhappy with management to get around the law by spreading misinformation or even lies as a way of softening up the shareholders and getting them ready for a successful proxy solicitation. Why this is important to you, as either management or part of an insurgent group, is that you have to be careful regarding what discussions or other communications take place prior to the soliciting of proxies to make sure that you don't violate the proxy rules.

What kind of communications or meetings can take place without any violation of the proxy rules? The answer obviously depends on the facts and the situation, but generally speaking, meetings and discussions that are held by a committee of unhappy shareholders among themselves is generally alright and will not violate the proxy rules. Cases that involve the soliciting of funds to finance litigation that is designed to remove members of the board has been held by courts to be proxy solicitations. Also, if unfavorable newspaper advertisements are mailed to shareholders which also contain an appeal for funds to support a committee of shareholders to remove the present board, that would constitute a solicitation.

There is case law to the effect that if management communicates with shareholders wherein they report some significant corporate development soon after that development happens and far in advance of a formal proxy solicitation for an annual meeting, then such communication has been held not to be a solicitation or a violation of the proxy rules. There is little doubt that in a proxy contest, management will bring legal action against the shareholders committee that is seeking to oust them and consequently, any meetings or communications that have occurred before the time for the formal proxy solicitation will be looked at very carefully by management when they are seeking to bring this action against the insurgent group.

Now let me talk briefly about one of the other proxy rules that is important and that is Rule 14(a)(11) which relates to requirements that are placed upon participants in a solicitation. Certain filing requirements and other requirements are placed upon participants in connection with solicitation that are designed to elect or remove directors at any annual or special meeting. The definition of "participant" under the rules is what is important and it is very broad. The definition includes all of the people you would expect it to include and in addition, anyone who is involved in the organizing or directing of any group or committee even if they are not named as a potential director of the company and any person who finances or helps finance the solicitation of proxies with the exception that if you don't contribute more than five hundred dollars, and you are not otherwise a participant, it wouldn't apply to you. It also covers anyone who lends money or furnishes credit for the purpose of financing the proxy contest, except banks and other institutional lenders who are in the business of lending money in the ordinary course of their business.

The reason that you need to determine whether or not any person is a participant is because a statement on what is known as Schedule 14B must be filed on behalf of each participant in a proxy contest. This filing is also one that falls under the requirement of pre-clearance by the SEC and filing with the national securities exchanges upon which the securities of the target are listed. An example of the type of information that must be in Schedule 14B aside from the name and business address of the participant are the principle occupation of the participant, a ten year history of the participant's material occupations and other employments, a description of prior proxy contests in which the participant has been involved in the last ten years. A description of any convictions for criminal prosecutions in the last ten years, the amount of securities that the participant owns in the target, when he bought them, if he borrowed money to buy them, who he borrowed from and how much, whether or not there are any other contracts or arrangements regarding these securities such as any voting trust agreement or things of that nature and just about anything else that would constitute a participant's life story. So it is important that before you become a participant, even unwillingly, that you make the decision that you want to go through all of that because I can guarantee you that whatever you disclose will be looked at very closely by the other side and if, God forbid, there is something that you don't disclose, it will certainly be found out during the course of the proxy contest and all of the related litigation.

Now with regard to Schedule 14A, which we talked about briefly before, a proxy statement that is prepared in connection with the proxy contest will have all of the same type of information that is involved in a proxy statement where a proxy contest is not involved and in addition there are other specifics that will need to be disclosed if a proxy contest is going on. Those include such things such as detailed information regarding the persons employed or retained to solicit the proxies, the total estimated costs of the solicitation, the identification of who will bear the cost of this solicitation, and whether or not reimbursement will be sought from the target company. If reimbursement will be sought from the target, you must disclose whether or not a vote of security holders will be taken on the reimbursement. If a solicitation is terminated pursuant to a settlement with the other side, then a description of the terms of the settlement will also have to be disclosed. One other thing that is important that would need to be disclosed is if the insurgent group has plans to sell assets or stock after they would take control of the company and plans to distribute as a dividend to stockholders any amount realized by such a sale, then they have to include in their proxy statement information regarding the basis for and the limitations on the projected realizable values. Although it is very subjective, the SEC has taken the position that where there is a material contingency or any kind of material limitation on these values, then for the insurgents to include an amount that they are calling the realizable value, that the inclusion of that material is unreasonable and is in violation of the proxy rules. A good example of such a situation is where a public company owns a division and an insurgent group determines that if they took control of the company they would sell off that division. Taking the example one step further, the division might have something to do with say, hazardous waste, for example and because of the potential liability involved in such an operation, there is a material contingency on the value of that division. In other words, if the environmental problems are too large, they may not be able to sell the division at all, or if they can, they may not realize anything near what they think it is worth. In such a situation, the SEC would argue that to include a specific dollar value in the proxy statement that is more or less promised to be distributed to shareholders as a dividend after the insurgents take over and sell the division, that such a promise is unreasonable.

Let's mention one other schedule and SEC filing that comes into play in proxy contests. Under Rule 13(d)(1), any person or group of persons who acquires more than five percent of any security registered under Section 12 of the '34 Act, has to file a statement containing the information specified in Schedule 13D with the SEC and copies have to be sent to the issuer of the securities and the exchange on which the securities are traded. Under present law, this has to be filed within ten days after the person or group acquires the five percent interest. As an aside, this is typically what happens when people are gathering stock in an effort to then start a tender offer. They may go up to the 4.9% amount by accumulating stock over a period of time in the market, and then exceed the five percent, file their Schedule 13D, and soon after launch a tender offer. Why this is important in a proxy contest is because of the activities of a group of stockholders who are acting together or acting in concert who in the aggregate own more than five percent of the securities of the target. If they intend to conduct a proxy contest, and are acting together, they could trigger these reporting requirements under Section 13(d)(1), because the rules provide that if securities are owned by two or more persons, they will be aggregated for purposes of computing the beneficial ownership of a group if such persons agree to act together for the purpose of acquiring, holding, voting or disposing of securities of an issuer. Because of the requirements placed upon persons deemed to be participants in a proxy contest under Schedule 14B, and because of the disclosure requirements in Schedule 14A, and because of the potential for the requirement of filing a Schedule 13D, it is important to involve counsel for an insurgent group as early as possible so that violations of the proxy rules or of 13(d)(1) don't take place.

Let me also mention that if an insurgent is involved in a transaction where he ends up with fifty percent of the stock of the company or securities valued in excess of fifteen million dollars, he may be required to make the pre-merger notification filing with the Federal Trade Commission and the department of justice and you may have to observe a waiting period which is required by the Hart Scott Rodino Anti-Trust Improvements Act of 1976. For the law to apply to your tender offer or other acquisition, there are certain thresholds relating to the value of the transaction and the size of the parties involved. If you fit in this category, the filing fee alone in substantial, ranging from $45,000 to $280,000, depending upon the size of the transaction. Those specifics are a little beyond the scope of this course, but you should be aware of the fact that they are considerations that must be reviewed.

A famous corporate activist and takeover participant, Carl Icahn, recently wrote a short article describing what he believes to be the unfair advantage of incumbent management as it relates to a potential proxy contest. Mr. Icahn argues that proxy contests are littered with what he calls "inane technicalities." The first problem that he describes is the acquisition of the shareholders list by the insurgent group. He argues that companies play a game with the insurgents by charging an excessive amount, typically in the tens of thousands of dollars. Instead of directly denying the access to the list, the target company simply put an excessive charge on the process to discourage the insurgents from obtaining the list of shareholders. The insurgents can either pay the price or sue the company for the list, both of which are expensive alternatives. Shareholders with a substantial ownership position in a company have a right to obtain a list of shareholders, but few state laws directly address the way they can be charged for the list.

The second unfair advantage that Mr. Icahn describes is the use by management of shareholder money to mount a "defense" against an insurgent shareholder who wishes to seek a seat on the board of directors. Using the company's money, which is indirectly the shareholders' money, management hires a host of professionals such as multiple law firms, investment banking firms, proxy solicitation firms, public relations firms, printing companies, and other professionals. Frequently, this cost can run into the millions of dollars, all in an effort to prevent a shareholder from becoming a member of the board of directors against the will of management. Mr. Icahn provides an interesting analogy, by saying this would be like having a convenience store manager raid the cash register and use the money to hire security guards to keep the owner from coming into the store and offering suggestions on how to run the business.

The third unfair advantage described by Mr. Icahn is what he calls the "monopolization of professionals." This is simply the indirect threat by a target company against professional firms that help an insurgent investor group. The insurgent group must spend their own money to hire competing top professionals. Because this is a nasty competition, they let the insurgent's professional know behind the scenes that they won't ever be hired to do anything for the company in the future if they help the insurgent group. In my opinion, this last complaint is much less critical than the first two, simply because threatening professionals usually gets them to want to represent the opposition even more.

Summary

Remember that in a transaction where the acquiror is issuing stock or debt securities to a target's shareholders, a registration statement with the SEC will be required to be filed unless an exemption from registration is available. Also remember that you need to review each Blue Sky law of each of the states that are involved in your transaction.

Tender offers involve filings with the SEC and have certain advantages and disadvantages. The advantages of a tender offer include the fact that no approval is necessary from the target's board of directors, it is sometimes cheaper to buy stock than to acquire an assets, there is less chance that the deal will be overturned by a court in the future as being inadequate if there are no competing bids, and a tender offer can be accomplished relatively quickly. The disadvantages of a tender offer include the fees, costs, and premium over market price that can make it a very expensive proposition. There is usually an inadequate due diligence review as a result of a tender offer particularly where it's a hostile tender offer. It is in "as is" purchase without representations or warranties that are usually contained in a document if it is a negotiated transaction and you may end up with minority stockholders that remain involved in the company's business.

With regard to proxy contests, proxy contests have increased in numbers in recent years. They are less expensive than buying a controlling interest in a target company and sometimes don't trigger the standard poison pill defenses that many companies have put in place. The state anti-takeover provisions are generally ineffective against proxy contests. You don't want to become a participant in a proxy contest unless you are aware fully of what it is you are getting yourself into. Be sure that you get lots of competent advice as to what actions will constitute proxy solicitation, whether you are a part of the management group or a part of an insurgent group.

Chapter 8

Takeover Defenses

The purpose of this chapter is to deal with takeover defenses and to give you some basic information about what the typical defenses are and generally how they work without getting into the lengthy legal intricacies of the defenses because, again, we could do an entire course on each one of these specific defensive measures. There are, generally speaking, five generic categories of takeover defenses and they are as follows:

1. Restructuring Defenses
2. Defensive Acquisitions
3. Poison Pills, or more properly Shareholder's Rights Plans
4. Charter and Bylaw Amendments
5. The Effect of State Anti-Takeover Statutes

Restructuring Defenses

The first of these, the restructuring defenses, are a category that deals with a substitution of debt or some other securities for the common stock held by a target's stockholders. The most simplistic of the restructuring defenses is a recapitalization that is done by the target company distributing its cash and/or borrowed money to distribute to its stockholders as a dividend. Additionally, a target company can institute a stock repurchase program which consists of a tender offer for its own stock. A tender offer can again be funded by the cash that the target has in the company or it can rely upon borrowing money and incurring debt to buy back securities. Once again, a tender offer for the company's own stock is popular because it is a transaction that can be completed rather rapidly and generally does not require a vote of the company's stockholders, although this may depend upon the state law of the state where the company is incorporated.

Another restructuring method can be an exchange of debt securities and cash or just debt securities for common stock of the company and that can usually be accomplished without filing a registration statement because there is an exemption in the 1933 Act which permits the exchange of securities with existing stockholders, where no commission is paid to any independent third party for soliciting the exchange. The result of an exchange by the public stockholders for cash or debt for their common stock is that usually management and other corporate insiders end up with a greater percentage of the company because the number of outstanding shares decreases as they are acquired by the company.

Some companies have tried to restructure by using an employee stock option plan to purchase stock either in the open market or directly from the company. One of the problems with ESOPs is that the trustees of the ESOP are usually the same as the company's directors and if an ESOP purchase plan is instituted to fend off a hostile takeover, then you can rest assured that the issue of conflict of interest will be raised by the hostile bidder. Since the trustees of an ESOP have a duty to act in the best interest of the beneficiaries of the ESOP, or the employees, they have to be in a position to show that the actions that they have taken are more beneficial to the company's employees than permitting the sale of the company to the hostile bidder. One of the other problems with recapitalization is that if too much debt is incurred it can place the company in a more precarious financial position and in the event that the company fails, it will undoubtedly face the issue of whether or not the recapitalization plan was a fraudulent conveyance.

I should also mention here that after T. Boone Pickens launched a tender offer for Unocal, Unocal responded with a self tender that sought to purchase the shares of all stockholders except those shares owned by Pickens. As a result of that case, the SEC in 1986 passed a rule that prohibits discriminatory self-tenders that simply says you can not exclude a hostile bidder or anyone else from a tender offer.

Defensive Acquisitions

What about defensive acquisitions and defensive mergers? A defensive acquisition may be made by a target company which could result in making the target undesirable to the original bidder. One example would be for the target to create anti-trust problems for the bidder by acquiring a company that competes directly with the bidder. Management has to be careful, however, because at least one case a defensive acquisition that created an anti-trust problem for the bidder was held to violate the anti-fraud provisions of the tender offer regulations, because the sole primary and controlling purpose of the acquisition was to thwart the bidder's tender offer, and consequently in that case the court's enjoined the target from the defensive acquisition.

In a defensive merger, what happens is a target finds an original bidder to be undesirable for any one of a number of different reasons and consequently seeks to negotiate a friendly merger with a party that it views as a more favorable partner. This friendly third party, who is viewed as being a more palatable partner is commonly referred to as a "white knight". What usually happens is the white knight knows what the terms of the hostile tender offer are and then offers terms that may be more favorable to the target's stockholders. The original bidder can then do one of three things. It can either stand by its original tender offer, secondly, it can raise the price of its tender offer, or third it can propose that the target merge directly with the bidder and can have that proposal considered at the same time as the white knight's merger proposal. The bottom line is that in such a situation, the target's shareholders will make the ultimate decision as to which offer they choose to accept.

Shareholder's Rights Plans or Poison Pills

The first and most important thing to keep in mind with regard to a poison pill defense is that it is not just any one specific plan, but numerous different types of shareholder's rights plans have been devised, some of which are incredibly complex and others of which are simplistic. The gist of all poison pill defenses is that there is a triggering mechanism, the occurrence of which results in the issuance of certain rights to all shareholders of the target. One typical example is that if any one person or entity acquires twenty percent of a target's company's stock and institutes a tender offer, then "rights" are distributed to all shareholders that entitle them to purchase additional shares of common stock of the target at a price that is well below the current market price. As of 2008, industry experts estimate that 1,500 U.S. companies have some form of poison pill in place.

Some plans are designed so that if a merger has been consummated between the target and a bidder or one of its subsidiaries, the plan would entitle the target shareholders to purchase shares of common stock of the bidder at a discount. Usually the rights that may be attached to the shares that are held by the entity responsible for triggering the poison pill are not exercisable by that entity but become invalid.

A shareholder's rights plan that permits the purchase of stock of the resulting or surviving corporation is commonly referred to as a flip over plan. Other types of plans are called back end plans and typically those permit the target's stockholders to receive a right for each share owned and entitles them to exchange each share for a short term debt instrument upon the occurrence of a certain event or trigger. The purpose of a back end plan is not necessarily to prevent a takeover but to make sure that the shareholders of the target receive a fair value for their stock.

There are literally hundreds of variations of poison pill or poison debt type plans which trigger the issuance of additional stock or additional debt upon the occurrence of a triggering event and again the triggering event is usually something like when a single person or entity crosses some ownership threshold, most typically twenty percent. Because a poison pill or a poison debt plan is an extraordinary measure the courts have reviewed these plans very closely to make sure that they don't violate any state corporate laws and also to make sure that directors of the target corporation have not violated any of their fiduciary duties to the target's stockholders in adopting these shareholder's rights plans. The board of directors of a target company must therefore be very careful when it adopts a plan of this type because the courts generally view these plans as depriving shareholders of the opportunity of maximizing value by precluding participation in a hostile tender offer. Once again, the shareholder's right plan is one of those subject areas that could be discussed at length and the intricacies of which are beyond the scope of this book.

Charter and Bylaw Amendments which can act as defensive measures

The term "shark repellent" is the vernacular that is used to describe changes in a target company's bylaws or its articles or charter of incorporation. One of the most common charter or bylaw amendments that is made is the approval by a super majority, which means that if a merger or a sale of substantially all of a target's assets is contemplated with a shareholder who owns a large block of the company stock, say five or ten percent, then a large number of shareholders not including the interested shareholder, such as eighty percent, need to approve such a transaction. This is somewhat similar to the control share acquisition provisions of some of the state anti-takeover laws.

Another popular charter provision is the fair price provision which basically says that a shareholder that owns more than the specified percentage, again an interested shareholder probably something like ten percent of the voting stock of the company, can't effect a transaction with the company that would result in the elimination of the remaining shareholders at a lower price than the shareholder involved in the transaction paid for its shares. The exception would be that a supermajority could accept such a deal and invalidate the fair price provision. The purpose of the fair price provision was to avoid a technique that was frequently used in takeovers, and that was acquiring a controlling interest in a target company for cash and then forcing the other shareholders to sell their stock at a lower price or for a less desirable type of consideration such as stock or debt in the acquiror. The fair price provisions and variations of these fair price provisions are also typically found in some of the state anti-takeover statutes.

Many corporations have instituted a staggered board of directors, and by that we are talking about election of directors to the target company for different terms of office. For example, if a company had five directors, it may elect two of the directors for three year terms, two of the directors for two year terms and one director of a one year term so that not all of the directors would come up for election at the same time and thus it would be more difficult to obtain control of a company's board of directors. Occasionally staggered board provisions are used in connection with what has come to be known as contingent cumulative voting. Cumulative voting itself is simply a method by which a stockholder is permitted to vote the number of shares that he owns, times the number of directors being elected so that a shareholder can aggregate all of his votes for one director to insure that minority stockholders have the right to elect at least a portion of the board of directors. Cumulative voting is not overly popular and under many state corporate laws a corporation must specifically adopt a provision permitting cumulative voting. Contingent cumulative voting would be a charter provision which would trigger the right to cumulative voting upon the acquisition by a single person or an entity of a specified percentage of the company's stock. For example, if one person or one company acquired twenty five percent of a corporation, then cumulative voting might go into effect at that time, but if there is no single owner of such a block then cumulative voting would not take place and consequently, if there were no cumulative voting, the majority owners of the shares will elect the entire board of directors. Used in conjunction with a staggered board of directors, contingent cumulative voting creates a method whereby minority stockholders can stymie the election of the entire slate of a bidder's directors.

Additional defensive tactics

One defensive tactic has come to be known as the Pac-Man defense, and this is simply that a target company when it learns it has become the subject of a tender offer, turns around and responds by launching a tender offer of its own for the stock of the hostile bidder. This is also known as a counter-tender offer. The best known example of this situation was when Bendix Corporation launched a hostile takeover attempt of Martin-Marrietta in the early 1980s, and Martin-Marietta's response was to start acquiring Bendix stock in an attempt to take control of Bendix. It is not a very commonly used defense because there are numerous legal issues relating to conflict of interest and breach of fiduciary duty that can be raised.

Another term that you will hear thrown around is the crown jewel defense and by this is meant that the target company sells off its most attractive assets to discourage a bidder from continuing in its takeover efforts. Because this defense usually has the effect of not only warning off the unwanted hostile tender offer, but the effect of injuring the company by sale of its most important asset, it is not a very popular defense either with the courts or with shareholders.

You may also hear the term "White Squire" in connection with defensive measures and this refers to friendly investor that is not viewed by the target company as a threat to its continued existence. The White Squire is similar to the White Knight, but where the White Knight acquires a controlling interest in the target, the White Squire acquires a lesser interest. The target company may sell a large block of its stock to this friendly investor and to keep the white squire from becoming a problem or a hostile bidder, the sale may be done simultaneously with a stand still agreement which places limitations on the resale by the white squire and or the voting rights associated with the block of stock. If the sole purpose of this sale is viewed by the courts as being to maintain existing management, it may not hold up.

State Anti-Takeover Statutes

This discussion really should begin with a short explanation of the fact that there was a first generation of anti-takeover statutes, all of which fell after the Supreme Court invalidated the Illinois Business Takeover Act as unconstitutional in 1982. The first generation statutes were held to be invalid because they preempted the Williams Act and violated the Commerce Clause of the U.S. Constitution.

The second generation of anti-takeover statutes began to be passed soon thereafter and in 1987 the Indiana Control Share Acquisition Act of 1986 was upheld by the United States Supreme Court. That opened the floodgates for the rest of the states to start passing similar laws. Basically, these anti-takeover statutes for the most part provide that if an acquiror purchases a specified percentage of the outstanding stock of a target, and in many cases this is twenty percent, then the acquiror can only vote those shares if a majority of disinterested shareholders permit the vote and approve the voting of the shares owned by the acquiror. What this does is prohibit a purchaser from acquiring a controlling block of stock and voting that block of stock in favor of a merger with itself, its subsidiary, or other affiliated entity unless a majority, or super-majority, of the disinterested shareholders approved the proposed transaction.

There are variations in these anti-takeover statutes, some of which give cash out options which are similar to dissenters' rights, and other that provide that the acquiror must hold its stock for a specified period of time, such as three years, before it is permitted to vote the stock. These laws apply to corporations organized within the state where the statute is in effect. Some of these laws attempt to permit extra-territorial jurisdiction, and by that I mean they are trying to apply to corporations that may not be incorporated in their state, but may have a certain percentage such as ten percent, of the shareholders of the target corporation residing in their state. Industry experts usually list the states with the strongest anti-takeover statutes as Pennsylvania, Ohio, Massachusetts and Wisconsin. While Delaware is known as a management friendly state, and is on the list of strong anti-takeover statutes, it is usually viewed behind the four states mentioned above.

A target corporation that is analyzing all of the defensive measures that are available to it should look first to the anti-takeover provisions of the state in which they were incorporated and, second, to the states where their shareholder's reside and or a substantial amount of their assets are located to determine if the anti-takeover provisions of any of those states will apply to their situation. After an analysis of that type, they can move on to analyzing the desirability of charter and bylaws provisions, poison pills, and all of the other defensive measures that we have discussed.

EPILOGUE

We are at the forefront of an industry that will reshape America over the next twenty years, in much the same way as the interstate highway system, telecommunications, and the Internet have done in the past.

Literally thousands of small companies have sprung up in the past few years to address the energy needs of America, and the world. The movement encompasses all industries, as diverse as construction and automobile manufacturing. Energy efficiency and energy production as clearly the basis for the prosperity of humanity. More people see this today than ever before.

The frenzied activity in this sector will generate more merger and acquisition action than has ever been seen. As a participant in this industry, it is important that you educated yourself to understand the process involved in the combination of companies.

I also urge you to obtain a copy of *The Energy Revolution— 277 Things Every American Needs to Know About the New Energy Paradigm.* A copy of this publication can be downloaded for free at www.alternativeenergyassn.com

I wish you luck as you experience the growth phase of the industry that will have the greatest impact upon the world in the 21th Century.

Appendix A

DUE DILIGENCE CHECKLIST

Please provide copies of the following documents relating to the Company for our due diligence review. Please organize such documents according to the list below, and cross reference the appropriate items if duplicative.

CORPORATE LEGAL MATTERS

Copies of the Company's and each subsidiary's Articles of Incorporation, and all amendments thereto, and By-laws, as currently in effect.

Copies of the minute books of the Company and each subsidiary including minutes of all Board meetings, all meetings of each committee of the Board, and all meetings of stockholders, as well as written consents in lieu of such meetings, for the last three years).

Copies of the stock ledgers and records of the Company and each subsidiary.

Copies of all documentation authorizing and governing the issued stock of the Company and each subsidiary.

Copies of all stockholder agreements, voting agreements or trust agreements binding upon the stockholders of the Company and any subsidiary.

A list of all subsidiaries or affiliates of the Company or any subsidiary.

A schedule of assumed, fictitious or other business names under which the Company or any subsidiary have conducted business and the jurisdictions in which those names are registered, pending registration, applied for or otherwise protected.

A list of the states in which the Company and each subsidiary conduct business, have offices used in connection with its business, file tax returns, have registered trade names, maintain property, or have an agent who is a resident in the jurisdiction in which he or she solicits customers for the Company's or any subsidiary's business, whether or not the Company or any subsidiary is qualified to conduct business in any such jurisdiction, specifying with respect to each such jurisdiction the nature of the Company's or any subsidiary's activities, together with a list of each jurisdiction in which the Company and any subsidiary are qualified to conduct business.

Copies of all minority interests owned by the Company or any subsidiary in any entity and any partnership or joint venture, showing investment, other investors, respective investment amounts and major covenants of relevant agreements and all documents relating thereto.

Copies of any other material and reports that describe the history, present operations and business, or present corporate structure and management of the Company and each subsidiary.

REGULATORY AND OTHER LEGAL MATTERS

List and copies of all notices, information requests, material filings, permits, licenses, approvals and certificates obtained or required to be obtained from federal, state, local or foreign governmental authorities or agencies held or required to be held in connection with the Company's or any subsidiary's business.

Indicate the extent to which any of the permits, licenses, approvals and certificates referred to under 2.1 above will be affected by the contemplated transaction.

Summary of any allegation or claim that the Company or any subsidiary is acting in violation of any law, regulation, ordinance or other requirement of any governmental authority, including, but not limited to, the SEC, FDA, the DEA, OSHA or the EEOC or any antitrust, zoning, environmental, controlled substance or tax laws, whether federal, state or local or foreign, as well as any statute or regulation governing the labeling, testing, safety, storage, record keeping, approval, advertising or promotion of the Company or any subsidiary products.

Copies of all reports filed and significant correspondence between the Company or any subsidiary and any state or federal regulatory agency during the past five years.

Summary of, and copies of all documents and correspondence relating to, any pending or threatened SEC, FDA, DEA, OSHA, EPA or Department of Labor investigations, inquiries, warnings or proceedings and copies of all such items which occurred during the last five years.

FINANCIAL AND TAX MATTERS

Copies of the Company's and each subsidiary's audited and/or unaudited financial statements for the last five years.

the Company's and each subsidiary's monthly and quarterly unaudited financial statements during each of the last twelve months and each of the last four quarters, respectively.

Copies of historical audited financial statements, actual verses budget by product line for 2006, 2007 and YTD 2008.

Copies of quarterly financial projections for 2008, 2009 and 2010.

Copies of all foreign, federal, state and local income, sales, excise and franchise tax returns or assessments of the Company and each subsidiary for the last five years.

Copies of all correspondence, including, without limitation, applications for private letter rulings and opinions of counsel, regarding the tax treatment of any transaction to which the Company or any subsidiary is a party.

Summary and copies of all consents and agreements with any tax authority executed by the Company or any subsidiary.

Discussion of recent tax audits at the federal and state level, if any.

Summary of a pending or threatened disputes between the Company or any subsidiary with any tax authorities and copies of all relevant documents and correspondence related thereto.

Description of any intercompany transactions and accounts involving the Company or any subsidiary.

Copies of all written tax sharing or tax benefit agreements involving the Company or any subsidiary.

Latest available aging of accounts receivables for the Company and each subsidiary, including collections since aging date.

Description of other current and non-current asset accounts, including calculations of valuation allowances, at the end of the most recent month and at the end of the last fiscal year for the Company or any subsidiary with back up.

Schedules detailing the composition of prepaid and deferred expenses of the Company and each subsidiary with back up.

Description of sales, monthly, by product line for 2007 and YTD 2008.

Detailed aged accounts payable listing at the end of the most recent month and at the end of the last fiscal year and the Company and each subsidiary.

Schedules detailing the computation of accrued liability accounts at the end of the most recent month and the end of the last fiscal year for the Company and each subsidiary.

Description of all contingent liabilities whether included in the financial statements or not) of the Company and each subsidiary, including all agreements guaranteeing, indemnifying or otherwise becoming liable for the obligations or liabilities of another.

Copies of all auditors' letters relating to the Company and each subsidiary during the last five years.

Copies of all auditors' inquiry letters and replies thereto relating to the Company and each subsidiary during the last five years.

Description of significant account policies adopted by the Company or any subsidiary, including those adopted with respect to depreciation and the establishment of bad debt reserves and any other reserves.

Description of any change in accounting policies or procedures adopted by the Company or any subsidiary during the past five years.

Name of accountants, length of relationship with accounts, and description of any interest in, or position held by such accountants with respect to the Company and each subsidiary.

Internal financial, operating, management and similar reports or memoranda relating to operations of the Company and each subsidiary, including budgets and projections and marketing and strategy reports.

Summary of bad debt expense policies and detail for 2006, 2007 and YTD 2008.

REAL PROPERTY

List of all real property owned by the Company or any subsidiary, together with a description thereof.

For each item of real property listed in response to item 4.1 above, copies of deeds, title policies, title opinions, mortgages and sales contracts, appraisals, surveys, approved zoning site plans, schedule of accumulated depreciation, list of encumbrances and copies of any other documents relating to such real property.

List of all leases or licenses of, or permits to use, real property to which the Company or any subsidiary is a party and a description thereof, including: parties to and date of each such lease, location, leasehold amortization rates, total current amortization, Unamoritized cost, property and other taxes paid or assessed but unpaid, and appraised value. Please indicate each such lease, license or permit that is an oral agreement.

List all capital expenditures over the last six months, and provide a detailed capital expenditure budget for the balance of 2008.

Describe any idle assets and/or passive investments

For each real property lease, license and permit listed in response to item 4.3 above, copies of the lease agreement including all amendments thereto), title policies, title opinions, mortgages, assignment and sublease contracts, insurance policies, appraisals and any other documents relating to such leased property, including a summary of key lease or ownership terms, by facility.

Description of all material zoning, building, environmental and similar laws, ordinances and regulations to which any of the properties referred to under items 4.1 and 4.3

above are subject, together with a list of all variances and conditional or special use permits granted with respect to such properties.

Specify if the transfer of the real property disclosed in response to item 4.1 above or the real property leases disclosed in response to item 4.3 above will affect the rights of the transferee in respect of such real property or real property leases, or will require the consent of any landlord, mortgagee, lender, lessee or other person having an interest in such real property or real property leases.

Copies of all real estate tax bills for the past five years relating to the property listed in items 4.1 and 4.3 above.

Description of any other real property used by the Company or any subsidiary in connection with the operation of their respective businesses, together with a description of the Company's or such subsidiary's legal right to use such real property.

Copies of all legal opinions relating to real property, including, but not limited to, the sale, financing or zoning or real property.

PERSONAL PROPERTY

List of machinery, equipment and other tangible personal property with an original cost of $1,000 or more), owned by the Company or any subsidiary including administrative equipment and leasehold improvements) and a description thereof, including: date of acquisition, original cost, depreciation reserve, method of depreciation, estimated remaining useful life and appraised value. For vehicles and other registered equipment, the description also should include the state of registration, registration number, year and model.

List of all machinery, equipment and other tangible personal property leased by the Company or any subsidiary and a description thereof, including: age, method of amortization, amortization reserve, remaining term, annual payments, option, if any, to purchase the property at expiration of term, and indication of the assignability of the leases without consent, together with a copy of all such leases.

Specify whether of not any of the assets listed in 5.1 or 5.2 above are subject to any liens, claims, mortgages, pledges, leases, restrictions or other encumbrances or charges. Furnish copies of any such restrictions or encumbrances that are in writing, and fully describe all others.

Summary and list of other tangible assets of the Company and each subsidiary not previously disclosed.

INTELLECTUAL PROPERTY

Copies of all Internet/Website Related Agreements/Items, including:

Software development agreements, including website development.
Website related agreements, such as website hosting, linking and framing, banner advertising and click☐through revenue sharing agreements.
Database, processing and outsourcing services agreements.
Technology, know☐how, and research and development agreements.
Partnership, joint venture, strategic alliance and teaming agreements.
Government grants and related agreements.
Source code escrow agreements
Non☐compete and non☐solicitation agreements.

List of all patents and applications pending, held or being prosecuted by the Company or any subsidiary in the United States or elsewhere, with descriptive titles, numbers, jurisdiction, and copies of all correspondence to or from examining authorities or other parties regarding such patents and patent applications.

List of all copyright registrations and applications pending, held or being prosecuted by the Company or any subsidiary in the United States or elsewhere, with descriptive titles, numbers, jurisdiction and a list of all unregistered copyrighted materials of the Company's or any subsidiary's business for which there is no copyright application pending.

List of all trademarks, registered or unregistered, used in connection with the business of the Company or any subsidiary, whether or not such trademarks are owned by licensed to the Company or any subsidiary with a description of products or services associated therewith, and numbers, jurisdiction, and status of any registration or pending applications, if any.

List of proprietary products under development and the status of such products.

Copies of all license, option to license or sublicense agreements pursuant to which the Company or any subsidiary licenses intellectual property rights to or from third parties. Description of license agreements by product.

Copies of all agreements pursuant to which the Company or any subsidiary have assigned any intellectual property rights to, or obtained any intellectual property rights from, third parties.

Copies of all agreements pursuant to which any products owned or licensed by the Company or any subsidiary are distributed or marketed by third parties.

Copies of all agreements pursuant to which the Company's or any subsidiary's products are manufactured by, or pursuant to which the Company or any subsidiary acquires products or components for products from, third parties.

Copies of all research and development/product development agreements to which the Company or any subsidiary is a party.

Copies of all other agreements relating to intellectual property that are material to the business of the Company or any subsidiary.

List of employees, including, but not limited to, programmers and engineers, who have participated or contributed in a material way to the development of the Company's or any subsidiary's intellectual property, a brief description of their roles, and copies of their resumes or other evidence of previous job history.

Copies of all standard form agreements used by the Company or any subsidiary regarding confidentiality, non-disclosure, and assignment of inventions, and a list of all persons who have executed each of such forms, and a list of all persons who do business with the Company or any subsidiary who have not executed the applicable standard form.

Copies of confidentiality, non-disclosure and assignment of invention agreements between the Company and any subsidiary and any other person, the contents of which differ from those set forth in the standard form.

Copies of all other documents, company memoranda, policies and the like relating to the Company's or any subsidiary's written policies on intellectual property or trade secrets.

Copies of all security agreements pursuant to which a lender or creditor has taken a security interest in specific intellectual property assets or "general intangibles" of the Company or any subsidiary.

Copies of Uniform Commercial Code filings, or other state and federal filings, that relate in any way to any of the Company's or any subsidiary's intellectual property.

Copies of all documents, correspondence, pleadings, memos, notes and other papers relating to any pending or threatened intellectual property litigation or claim against the Company or any subsidiary or any other assertion, suggestion, or inquiry by a third party that the Company or an subsidiary is infringing upon its intellectual property rights.

Copies of all documents, correspondence, pleadings, memos, notes and other papers relating to any pending or threatened intellectual property litigation to which the Company or any subsidiary is a party. Describe any perceived violation of the intellectual property rights of the Company or any subsidiary by a third party and provide any copies of documents, correspondence, memos, notes or other papers relating to the perceived infringement.

BUSINESS MATTERS

Organization chart for the Company and each subsidiary.

Describe the Company's and each subsidiary's product lines, including the respective amount each such product line has contributed to gross sales in each of the past three years.

List of customers, including those with sales over 5 percent of total sales.

List of the Company's and each subsidiary's top 10 customers and suppliers including addresses and telephone numbers, if possible), and, if available, a breakdown by revenue per customer and purchase volume for supplier.

Copies of all standard forms of customer lease, sale and service contracts and invoices used by the Company and each subsidiary, together with a list and copies of all lease, sale and service contracts, invoices and arrangements that deviate from the standard forms, indicating the contract value of each such contract, invoice or arrangement.

Copies of all warranties other than those included in standard form contracts supplied in response to item 7.6 above) made with respect to any products sold or services provided by the Company or any subsidiary.

Description of customary sales or service credit terms and credit control procedures and policies used by the Company and each subsidiary.

Copies of all outstanding agreements between the Company and any subsidiary and their respective customers relating to annual sales or rentals in excess of $50,000.

List each agreement or commitment to which the Company or any subsidiary is a party for the purchase or acquisition of materials, supplies, merchandise, equipment or services which requires performance by the Company or any subsidiary or any other party thereto more than six months from the date of such agreement.

Copies of all distribution agreements, and all agreements with independent agents, salesmen or others involving the payment of commissions or other consideration or discounts, to which the Company or any subsidiary is a party.

Copies of all joint venture and partnership or other similar agreements to which the Company or any subsidiary is a party and any documents summarizing the terms of any such agreements.

Copies of any contracts restricting the ability of the Company or any subsidiary to compete in any line of business with any person or entity, or committing the Company or any subsidiary to continue in any line of business.

If any significant portion of the assets of the Company or any subsidiary were acquired from a third party, copies of the acquisition agreements and any related agreements and schedules.

Copies of all advertising agreements or arrangements binding the Company or any subsidiary.

Copies of all agreements pursuant to which the Company or any subsidiary has granted any person a right of first refusal or similar right to acquire any of their assets and all other agreements that restrict the ability of the Company or any subsidiary to sell or otherwise dispose of their assets.

Copies of any barter arrangements in existence binding the Company or any subsidiary.

Copies of all agreements binding upon the Company or any subsidiary involving aggregate payments of more than $50,000, or describe any such contracts currently in the process of negotiation.

Copies of all contracts, agreements, understandings and commitments of the Company or any subsidiary not of the type requested above if oral, description of key terms) binding on the Company or any subsidiary.

Summary of any existing or threatened circumstances which may give rise to the cancellation of, or claims for damages of loss under, any of the agreements or understandings referred to herein.

Descriptive literature concerning the Company or any subsidiary and their respective business and products, including advertising and marketing programs, strategic marketing plans, business plans, customer lists, catalogs, brochures, flyers, etc.

Summarize and list the process by which materials are ordered, purchased and paid.

Summarize the process for order entry and customer service, including cancellation.

List of the computer systems and computer equipment and gross and net book value of such equipment.

SECURITIES MATTERS

Copies of all agreements, instruments, private placement memoranda, prospectuses or offering circulars relating to sales or attempted sales of equity or debt securities of the Company or any subsidiary within the past five years, including, without limitation, all agreements relating to registration rights and copies of any written proposals and memoranda of any oral proposals for the acquisition of the Company's or any subsidiary's securities within the past five years. Such agreements should include all previous Preferred and Common Stock placements and warrants or debentures issued by the Company or any subsidiary to others.

Copies of all material correspondence between the Company or any subsidiary and the Securities and Exchange Commission and/or any state securities office during the last three years.

A schedule of all outstanding warrants, options and conversion privileges granted by the Company or any subsidiary, including date of issuance, exercise or conversion prices and amount exercised.

Current list of all shareholders, including options granted, issued, exercised and canceled, including exercise price and exercise date information).

Copies of preferred stock purchase agreements.

Copies of all material communications between the Company and any subsidiary and their respective shareholders during the past five years.

Copies of all permits to issue securities within the past five years granted to the Company or any subsidiary, including copies of the applications for all permits, whether or not a permit was issued with respect to such application and all federal securities filings.

BANK AND CREDIT ARRANGEMENTS

Description of all indebtedness and guarantees incurred by the Company or any subsidiary and copies of all loan agreements, guarantees, indentures, conditional sales contracts, chattel mortgages, accounts receivable financing agreements, factoring agreements and other relevant documents. The description should include the I) name of lender and borrower, ii) amount outstanding as of a recent date, iii) collateral or property mortgaged and iv) repayment terms, rate of interest and when payment due.

Copies of all instruments and related financing statements) any mortgage, security interest, lien or any other encumbrance on any of the assets of the Company or any subsidiary.

Copies of all correspondence with the lenders who are parties to the debt instruments listed in 9.1 above.

List of all bank accounts and safe deposits and authorized signatories used by the Company or any subsidiary.

Description of export credit arrangements, if any, to which the Company or any subsidiary is a party.

EMPLOYEES AND COMPENSATION; UNION AGREEMENTS

A list of all employees of the Company or any subsidiary, together with a schedule setting forth, with respect to each such employee, his or her name, date of hire, position, current compensation and most recent compensation increase, background, qualifications and experience both within and prior to joining the Company or any subsidiary. Include number of full time employees by functional area and list any with PhDs.

List and copies of all welfare plans and arrangements covering any employee of the

Company or any subsidiary, including life, health and disability insurance, severance and Section 501c) trust plans.

List and copies of all pension plans and arrangements covering any employee of the Company or any subsidiary, including retirement, profit-sharing, thrift and savings plans.

With respect t each plan listed in response to items 10.2 and 10.3 above, a) the most recent annual actuarial valuation report, if any the last filed Form 5500 or 5500-C and Schedules A and B thereto, the most recent annual and periodic accounting of related plan assets, all rulings of the Internal Revenue Service IRS) and the most recent IRS determination letter and b) a description of any changes which are being made to these plans or which are under consideration.

Copies of all compensation plans, including bonus, deferred compensation, stock option, stock purchase and annuity plans of or covering any employee of the Company or any subsidiary.

List of all employees of the Company or any subsidiary receiving long or short term disability payments, and a description of any arrangements for salary continuance currently in place.

Description of the Company's and each subsidiary's policy with respect to accrued vacations and sick leave for employees and the provisions for the payment thereof.

Description of all other benefits not included above, involving any employee of the Company or any subsidiary.

Copies of all handbooks and employee manuals relating to the Company's and each subsidiary's benefit plans or compensation policies.

Description and copies of all written and oral employment agreements other than union contracts) between the Company or any subsidiary and any employee of the Company or any subsidiary.

Copies of all consulting and management agreements, arrangements and understandings to which the Company or any subsidiary is a party.

Copies of all union contracts and collectible bargaining arrangements covering any employee of the Company or any subsidiary.

Description and copies of any pending or threatened arbitration, grievance proceeding or labor dispute involving any employee of the Company or any subsidiary.

List of any unusual labor relationships, strikes or work stoppages during the past three years involving any employee of the Company or any subsidiary.

Copies and/or description of any other relevant matter with respect to the employees of the Company or any subsidiary.

Copies of all EEOC compliance files for the last three 3) years and a description of any violation under any laws relating to EEOC or any other employment related or anti-discrimination laws during the last three years involving any employee or the Company or any subsidiary.

INSURANCE

Copies and description of all policies of insurance held by or maintained for the benefit of the Company or any subsidiary, including, without limitation, insurance for property, fire, officers' liability, fidelity, workers' compensation, products liability and any other types of insurance, together with a schedule setting forth with respect to each such policy the name of the insurance company, policy number, property or risk covered, appraised value of covered property where appropriate), extent of coverage, annual premium, insurance brokers and all endorsements. Description of all self-insurance programs or policies maintained by V.

Copies of all key person life insurance policies relating to any employee or the Company or any subsidiary,

Summary of all insurance claims of the Company or any subsidiary for the past three years, including date of claim, nature of loss, payment or reserve, and description of expenses under worker's compensation, including cost.

Summary of any claims or lawsuits pending or contemplated by the Company or any subsidiary and the extent of insurance coverage.

LITIGATION

List and summary of each pending or threatened litigation, claim, arbitration proceeding or investigation relating to the Company or any subsidiary, whether or not covered by insurance which occurred at any time during the last three years, together with copies of all material documents relating to such actions, including a) litigation involving alleged violations of laws or regulations relating to the protection of the environment or the health or safety of employees or others and b) governmental or administrative proceedings. Describe any allegations of unfair labor practices and any suits or administrative proceedings instituted by any employee of the Company or any subsidiary within the past five years.

List and summary of all judgments, decrees and order to which the Company or any subsidiary is presently or during the past five years has be subject in connection with its operation of their respective business. Exclude monetary judgments which have been satisfied and which were in an amount not exceeding $5,000.00 unless such judgment was in the nature of a fine or penalty, in which case specify the nature of such fine or penalty.

Summary of all product liability claims pending or threatened against the Company or any subsidiary during the last six years indicating the disposition thereof.

Copies of any and all court papers filed in connection with any of the foregoing.

AFFILIATED TRANSACTIONS

If any director, officer, employee or stockholder of the Company or any subsidiary or a member of his or her immediate family has an interest in any of the assets of the Company or any subsidiary or is a party to any contract with respect of the Company or any subsidiary, provide a brief description thereof an a copy of any agreement binding on the Company or any subsidiary.

Statement of amounts and other essential terms of any indebtedness or other obligations of or to the Company or any subsidiary to or from any officer, director, stockholder or employee of the Company or any subsidiary.

ENVIRONMENTAL MATTERS

Copies of all existing licenses, registrations, governmental approvals and permits related to the environment or to environmental matters issued to or on behalf of the Company or any subsidiary or regarding each property listed in item 4.1 or 4.3 at any time by a foreign, federal, state or local authority.

Copies of the applications pursuant to which the licenses, registrations, governmental approvals and permits were issued to the Company or any subsidiary.

Copies of all pending applications for foreign, federal, state or local licenses, registrations, governmental approvals and permits related to the environment or to environmental matters with respect to the Company or any subsidiary.

Copies of all compliance schedules, consent orders, judgements, waivers or variances associated with compliance with any program related to the environment or to environmental matters for the Company or any subsidiary.

Copies of all notices, citations and fines for, and civil or criminal suits associated with, any actual or alleged violation related to the environment or to environmental matters by the Company or any subsidiary.

Copies of all written communications, and documents memorializing oral communications between the Company or any subsidiary or any stockholder of the Company or any subsidiary and any governmental body foreign, federal, state or local) regarding or in connection with compliance with laws related to the environment, alleged or actual violations of laws related to the environment, including, without limitation, discharges, spills, leaks or releases – such communications, include, without limitation, data, reports, inspection reports, test results, correspondence and memoranda.

Copies of all documents related to or referring to any generation, transportation, storage, treatment or disposal of industrial, toxic or hazardous substances or solid or hazardous wastes by the Company or any subsidiary.

A copy of each spill control plan maintained by the Company or any subsidiary.

A copy of all written notices to governmental agencies and third parties relating to the Company or any subsidiary respecting, without limitation, the presence and emission of hazardous and toxic chemicals and substances known to cause cancer or reproductive toxicity.

A copy of the process layout for the facility of the Company or any subsidiary please include past process layouts, if different).

A copy of all environmental audit or assessment reports for a facility of the Company or any subsidiary prepared for any purpose, including internal, insurance or governmental.

APPENDIX B

PLAN AND AGREEMENT OF MERGER

THIS PLAN AND AGREEMENT OF MERGER dated _______, 2008, by and between ABC, INC., a Florida corporation ("ABC") and XYZ, INC., a Georgia corporation ("XYZ"), ABC and XYZ hereinafter being sometimes referred to as the "constituent corporations."

W I T N E S S E T H:

WHEREAS, the Boards of Directors of ABC and XYZ deem the merger of XYZ with and into ABC on the terms herein set forth (the "Merger") to be desirable and in the best interests of their respective shareholders, and have adopted and approved this Plan and Agreement of Merger ("Agreement"); and

WHEREAS, The Boards of Directors of XYZ and ABC have directed that this Agreement and the merger contemplated hereby be submitted to their respective shareholders for approval in accordance with the applicable laws of the State of Florida, and the State of Georgia.

NOW, THEREFORE, in consideration of the mutual covenants, agreements, warranties and representations contained in this Agreement and in order to consummate the transactions described above, XYZ and ABC agree as follows:

ARTICLE I

THE MERGER

1. Merger. The parties agree that XYZ shall be merged into ABC, as a single corporation, upon the terms and conditions of this Agreement and that ABC shall continue under the laws of the State of Florida as the Surviving Corporation (the "Surviving Corporation"), and they further agree as follows:

(a) Articles of Incorporation. The purposes, the registered agent, the address of the registered office, number of directors and the capital stock of the Surviving Corporation shall be as appears in the Articles of Incorporation of ABC on file with the office of the Secretary of State of the State of Florida on the date of this Agreement. From and after the Effective Date and until further amended, altered or restated as provided by law, the Articles of Incorporation separate and apart from this Agreement shall be and may be separately certified as the Articles of Incorporation of the Surviving Corporation.

(b) Bylaws. The Bylaws of ABC in effect on the Effective Date shall be the Bylaws of the Surviving Corporation until they shall be altered, amended or repealed.

(c) Directors. The persons who upon the Effective Date shall constitute the Board of Directors of the Surviving Corporation shall be the persons constituting the Board of Directors of ABC and the Board of Directors of XYZ on the Effective Date, consisting of John Smith, Bill Smith, Jim Smith, Tom Jones and Joe Jones. If on the Effective Date any vacancy exists on the Board of Directors of the Surviving Corporation, that vacancy may be filled in the manner provided in the Bylaws of the Surviving Corporation.

(d) Officers. The persons who upon the Effective Date shall constitute the officers of the Surviving Corporation shall be the persons constituting the officers of ABC on the Effective Date, subject to the addition of officers as hereinafter provided. The officers of the Surviving Corporation shall be John Smith, President and Chief Executive Officer, Bill Smith, Executive Vice President Administration, Secretary and Treasurer, Jim Smith, Executive Vice President Technlogy, Tom Jones, Executive Vice President Service Operations and Joe Jones, Executive Vice President Customer Development and General Manager XYZ services.

2. Submission to Shareholders. This Agreement shall be submitted to the shareholders of XYZ for their consent and approval by July 30, 2008, in accordance with the Georgia Business Corporation Act, and shall be submitted to the shareholders of ABC for their consent and approval by July 30, 2008, in accordance with the Florida Business Corporation Law, or such later date as the Boards of Directors of XYZ and ABC shall mutually approve, and, if it is adopted and approved in accordance with the laws of Georgia, as promptly as practicable thereafter, the fact that this Agreement has been adopted and approved as above provided shall be certified by their respective secretaries, and this Agreement and appropriate Articles of Merger shall be signed and acknowledged or sworn pursuant to the laws of Florida, and the laws of Georgia.

3. Effective Date. The Merger of XYZ into ABC shall become effective upon filing of the Articles of Merger with the State of Florida and the State of Georgia. The date on which the merger of XYZ into ABC becomes effective is referred to in this Agreement as the "Effective Date".

4. Effect of Merger. On the Effective Date, the separate existence of XYZ shall cease and XYZ shall be merged into ABC in accordance with this Agreement, and the Surviving Corporation shall continue unaffected and unimpaired by the merger and shall possess all of the rights, privileges, powers, franchises, patents, trademarks, licenses and registrations, both of a public and private nature, and shall be subject to all the restrictions, disabilities and duties, of each of the constituent corporations so merged, and all the rights, privileges, powers, franchises, patents, trademarks, licenses, and registrations of each of the constituent corporations; and all property, real, personal and mixed, and all debts to either of the constituent corporations on whatever account as well as for stock subscriptions and all other things in action or belonging to each of the constituent corporations shall be vested in the Surviving Corporation; and all property, rights, privileges, powers, franchises, patents, trademarks, licenses and registrations and every other interest thereafter shall be effectively the property of the Surviving Corporation as they were of the respective constituent corpo-

rations, and the title to any real estate, whether vested by deed or otherwise in either of the constituent corporations under the laws of the State of Florida or the State of Georgia, or any other state where real estate may be located, shall not revert or in any way be impaired by reason of the merger, provided that all rights of creditors and all liens upon the property of any of the constituent corporations shall be preserved unimpaired; and all debts, liabilities and duties of the constituent corporations shall then attach to the Surviving Corporation and may be enforced against it to the same extent as if those debts, liabilities and duties had been incurred or contracted by it.

5. Designation of Agent for Service. As of the Effective Date, ABC hereby agrees that it may be sued in the State of Georgia for any prior obligation of XYZ and for any obligation thereafter incurred by the Surviving Corporation (including any obligation to dissenting shareholders), and ABC hereby irrevocably appoints the Department of the State of the State of Georgia, as its agents, to accept service of process in any action, suit or proceeding for the enforcement of any such obligations for which the Surviving Corporation is liable under the Georgia Business Corporation Act.

6. Conversion Ratio. The manner and basis of converting and exchanging the shares of common stock of XYZ into common stock of ABC shall be as follows:

(a) Ratio. On the Effective Date, each share of common stock, no par value, of XYZ issued and outstanding immediately before the Effective Date, by virtue of the Merger and without any action on the part of the holder of any share of XYZ Stock, shall be converted into ABC Stock (as defined below), based upon the following formula:

The total number of shares of ABC Stock to be issued to XYZ shareholders in exchange for their 10,000 shares of XYZ stock shall be 233,136 or 22.57% of the total shares outstanding of ABC after the Effective Date per the calculation shown on Exhibit A to this Agreement.

The valuation of XYZ is agreed between the parties to be $2,070,888, or $207.0888 per share. The valuation of ABC is agreed between the parties to be $7,106,212, or $8.8828 per share. The total valuation for ABC and XYZ combined is agreed between the parties to be $9,177,100 (per the valuation dated February 3, 2008 and attached as an Exhibit hereto). The value of XYZ divided by the total value of the combined companies is equal to a percentage of 22.57%.

For all purposes of this Agreement, the term "ABC Stock" shall mean fully paid and nonassessable common stock of ABC, par value $0.001 per share, and all securities or property (including cash) issued or exchanged with respect thereto from and after the date of this Agreement upon any reorganization, recapitalization, reclassification, merger, consolidation, spin-off, partial or complete liquidation, stock dividend, split-up, sale of assets, distribution to shareholders, or combination of such stock or any change in the capital structure of ABC. In the event of any such change, the number of shares of ABC Stock into which XYZ Stock is to be converted pursuant to Section 6(a) hereof shall be appropriately adjusted.

(b) Fractional Shares. No certificates or scrip representing fractional shares of ABC Common Stock shall be issued upon surrender for exchange of certificates representing XYZ stock. In the event that the calculation of the exchange would result a XYZ shareholder being entitled to a fractional share, if such number is equivalent to .5 or more of a share, the number of shares due the shareholder will be rounded up to the next whole number of shares. In the event that the calculation of the exchange would result a XYZ shareholder being entitled to a fractional share, if such number is less than .5 of a share, the number of shares due the shareholder will be rounded up to the next whole number of shares.

7. Exchange of Certificates.

(a) Generally. As soon as practicable after the Effective Date, each holder of an outstanding certificate or certificates representing XYZ stock shall surrender the same to Desantis, Gaskill, Smith & Shenkman, P.A., Exchange Agent, for all such holders (the "Exchange Agent"), and such holders shall be entitled upon such surrender to receive in exchange a certificate representing the number of shares of ABC Stock into which those shares of XYZ stock previously represented by the certificate or certificates so surrendered shall have been converted as above stated. Until so surrendered, each outstanding certificate that, before the Effective Date, represented shares of XYZ Stock shall be deemed for all corporate purposes, other than the payment of dividends, to evidence ownership of the respective shares of ABC stock into which they shall have been converted. Unless and until an outstanding certificate that, before the Effective Date, represented shares of XYZ Stock shall be surrendered, no dividends payable to the holders of record of XYZ Stock as of any date subsequent to the Effective Date shall be paid to the holder of such outstanding certificate, but upon surrender of the outstanding certificate there shall be paid to the record holder of the certificate for shares of ABC Stock into which those shares shall have been converted the amount of dividends that previously were payable from the Effective Date with respect to those shares of ABC Stock.

(b) Specific Procedure. Prior to the Effective Date, ABC shall prepare certificates representing the shares of ABC Stock into which XYZ Stock shall be converted (the "ABC Certificates"). Promptly after the Effective Date, ABC or the exchange agent shall deliver to each record holder, as of the Effective Date, of an outstanding certificate or certificates which immediately prior to the Effective Date represented XYZ stock (the "XYZ Certificates") a form of letter of transmittal (which shall specify that delivery shall be effected, and risk of loss and title to the XYZ Certificates shall pass, only upon proper delivery of the XYZ Certificates to the Surviving Corporation) and instructions for use in effecting the surrender and exchange of the XYZ Certificates. Upon surrender to the Surviving Corporation or its designated agent of a XYZ Certificate or Certificates, together with such letter of transmittal duly executed, ABC or Exchange Agent shall promptly deliver to the recordholder of such XYZ Certificate or Certificates, in exchange therefor, ABC Certificates representing an aggregate number of shares of ABC Stock to which such holder is entitled pursuant to Section 6 above, plus any cash payment to which such holder is entitled pursuant to Section 6(b) above and such XYZ Certificate or Certificates shall forthwith be cancelled. If ABC Certificates are to be issued to a person or entity other than the person or entity in whose name the XYZ Certificate or Certificates surrendered is registered, it shall be a condition of delivery of ABC Certificates and cash payments for fractional shares in such other person's or entity's name that (i) the XYZ Certificate or Certificates so surrendered shall be properly endorsed or accompanied by a properly executed stock power or powers for transfer and (ii) such other person or entity shall pay any transfer or other taxes required by reason of the issuance to a person other than the registered holder of the XYZ Certificate or Certificates surrendered or shall establish to the satisfaction of the Surviving Corporation that such tax has been paid or is not applicable.

(c) No Transfers After Effective Date. At and after the Effective Date, there shall be no transfers of XYZ Stock which were outstanding immediately prior to the Effective Date on the stock transfer books of XYZ. If, after the Effective Date, XYZ Certificates are presented to the Surviving Corporation, they shall be cancelled and exchanged for ABC Certificates as provided in this Article II. At the close of business On the Effective Date, the stock transfer books of XYZ shall be closed.

(d) Stock Options and Related Matters. Except as XYZ and any holder of an option to purchase XYZ Stock may otherwise agree with the consent in writing of ABC, each holder of such an option that was granted by XYZ prior to the date hereof will continue to be entitled at and immediately after the Effective Date to acquire ABC stock in accordance with the terms and conditions of such holder's option, subject to the conversion ratios set forth in Section 6(a).

8. Shareholders' Rights. All shares of ABC Stock for and into which shares of XYZ Stock shall have been converted and exchanged pursuant to this Agreement shall be fully paid and nonassessable and shall be deemed to have been issued in full satisfaction of all rights pertaining to the converted and exchanged shares. Unless the Merger is abandoned, the holders of XYZ Certificates shall cease on the Effective Date to be shareholders of XYZ and shall have no rights with respect to XYZ Stock except the rights to receive the consideration set forth in Section 6 above.

9. Compliance with Laws. XYZ and ABC shall each take all appropriate corporate action to comply with the applicable laws of the State of Florida, the State of Georgia and the United States in connection with the contemplated Merger.

10. Transfer Books. At the close of business on the Effective Date, the transfer books of XYZ shall be closed and no transfer of shares of XYZ Stock shall be made or consummated thereafter.

11. Further Assurances. Prior to and from and after the Effective Date, the constituent corporations shall take all actions necessary or appropriate in order to effectuate the merger. In case at any time after the Effective Date the Surviving Corporation shall determine that any further conveyance, assignment or other document or any further action is necessary and desirable to vest in the Surviving Corporation full title to all properties, assets, rights, privileges and franchises of XYZ, the officers and directors of the constituent corporations shall execute and deliver all instruments and

take all action the Surviving Corporation may reasonably determine to be necessary or desirable in order to vest in and confirm to the Surviving Corporation title to and possession of all those properties, assets, privileges and franchises, and otherwise to carry out the purposes of this Agreement.

ARTICLE II

REPRESENTATIONS AND WARRANTIES OF XYZ

1. XYZ's Representations and Warranties. Except as set forth in the XYZ Merger Disclosure Statement previously furnished to ABC by XYZ (the "XYZ Disclosure Statement"), XYZ and its Shareholders represent and warrant to and agree with ABC as follows:

(a) Corporate Organization and Good Standing. XYZ is a corporation duly organized, and validly existing under the laws of the State of Georgia, and has full corporate power and authority to carry out its business as it is now being conducted and to own and lease property, and is duly qualified or authorized to do business and is in good standing in each jurisdiction in which the character and location of the properties owned or leased by it or the nature of business transacted by it makes those qualifications or authorizations necessary, except for jurisdictions in which the failure to be so qualified or authorized or to be in good standing would not, individually or in the aggregate, have a material adverse effect on the business or financial condition of XYZ. XYZ is not presently being challenged as to its right to do business as presently conducted in any jurisdiction. The copies of the articles of incorporation, as amended to date, and the Bylaws, as amended to date, of XYZ previously delivered to ABC are true, correct and complete copies as now in full force and effect. No provision of those instruments prohibits, limits or otherwise affects the right, power and authority of XYZ to enter into this Agreement or to cause consummation of the merger.

(b) Capitalization. The authorized capitalization of XYZ consists of 1,000,000 shares of common stock, no par value per share, of which 10,000 shares are presently issued and outstanding, (500 of which are held as Treasury Shares) all of which are validly issued, fully paid and nonassessable. Except as set forth on the XYZ Disclosure Statement, there are no existing options, warrants, convertible securities or similar rights granted by XYZ, or any commitments or agreements of a similar nature to which XYZ is a party, relating to the authorized or issued stock of XYZ.

(c) Subsidiaries. XYZ presently has no subsidiaries.

XYZ does not (a) own of record or beneficially, directly or indirectly, (i) any shares of capital stock or securities convertible into capital stock of any other corporation or (ii) any interest in any partnership, joint venture or other non-corporate business entity or (b) control, directly or indirectly, any other entity.

(d) Authorization. The execution, delivery and performance of this Agreement has been duly and effectively adopted and authorized by the Board of Directors of XYZ and will be submitted to the shareholders of XYZ for approval under applicable provision of the Georgia Business Corporation Act.

(e) Financial Statements. XYZ has delivered to ABC the unaudited balance sheets of XYZ as of March 31, 2008, December 31, 2008, 2007 and 2006, and the unaudited statement of operations and cash flows of XYZ for the fiscal years then ended. These financial statements fairly present, in conformity with generally accepted accounting principles applied on a consistent basis, the financial position of XYZ as of the date of the balance sheets and the results of the operations of XYZ for the periods covered by the statements of operations.

(f) No Violation. Except as set forth in XYZ Disclosure Statement, XYZ is not, and by the execution and performance of this Agreement, will not be, in breach of any term or provision of or in default under, and no event has occurred that with the lapse of time or action by a third party could result in a default under, any outstanding indenture, mortgage, contract or agreement to which XYZ is a party or to which XYZ may be subject, or under any provision of its articles of organization or Bylaws, except for possible defaults that individually or in the aggregate would not have any materially adverse effect on the business of XYZ. Provided the shareholders of XYZ have approved the transaction, the execution and performance of this Agreement by XYZ will not violate any order, injunction, decree, statute, rule or regulation applicable to XYZ or any of its properties or assets.

(g) Lists of Properties, Contracts, Etc. The XYZ Disclosure Statement, contains a list of the following:

(1) Real Property. All real property owned, leased or otherwise used or occupied by XYZ with book value or market value (whichever is greater) of $10,000.00 or more.

(2) Patents, Etc. XYZ has no United States or foreign patent, trademark and trade name registrations, or applications pending on this date for any patent, trademark, trade name or copyright registrations;

(3) Insurance. All policies of insurance in force with respect to XYZ including, without restricting the generality of the foregoing, those covering its officers, properties, building, machinery, equipment, furniture, fixtures, products and operations, as referred to in subparagraph (v) below;

(4) Employees. The names of, and salary (including commissions and bonuses) paid in the fiscal year ended December 31, 2008, and 2007, respectively, to all of the officers, directors and employees of XYZ whose aggregate compensation during those periods exceeded $60,000.00, as referred to in subparagraph (aa) below;

(5) Permits. A list of all franchises, licenses, permits, consents, approvals and authorizations of or from any public or governmental agency, trade names and copyright registrations, used in or otherwise necessary for the conduct of

their businesses;

(6) Banks. The name of each bank in which XYZ has an account or safe deposit box and the names of all persons authorized to draw on or have access to them;

(7) Powers of Attorney. The names of all persons, if any, holding a power of attorney from XYZ; and

(8) Litigation. A complete list and description, regarding all actions, suits, claims or legal, administrative or arbitration proceedings or investigations (whether or not the defense thereof or liabilities in respect thereof are covered by policies of insurance), pending or threatened against XYZ, or any of the properties or assets of any XYZ Company, or to which any XYZ Company is a party or a target, and all outstanding orders, writs, injunctions or decrees of any court, governmental agency or arbitration tribunal against XYZ or to which any XYZ Company is a party or a target.

True and complete copies of all of the patent, trademark, tradename and copyright registrations, applications pending for patent, trademark, trade name and copyright registrations and contracts and commitments; policies of insurance; and other documents referred to in the XYZ Disclosure Statement have been delivered to or made available for inspection by ABC.

(h) Title. XYZ owns good and merchantable title free and clear of any liens, claims, encumbrances, options, charges or assessments to all of its properties and other assets used in connection with its business, including, but not limited to, those reflected in the balance sheet of XYZ as of March 31, 2008, except: (1) personal property disposed of since March 31, 2008, in the ordinary course of business; (2) liens set forth on the balance sheet or in its notes or in this Agreement; (3) liens in connection with leaseholds or statutory liens (including liens for taxes not yet due and payable) not yet delinquent; and (4) minor defects and irregularities in the title to any real property, and encumbrances relating to any real property, that do not detract materially from the value and marketability of the property or impair the use of the property for the purpose for which it is held by XYZ or otherwise impair the business operation of XYZ ; and (5) as set forth on the XYZ Disclosure Statement. XYZ carries such insurance with reputable insurers in respect of its properties and businesses as is customary for similar businesses and as is adequate for the business conducted by XYZ. XYZ has received no notice of any violation of and is not in violation of any applicable zoning regulation, health or safety regulation, ordinance or, to the best of its knowledge, other federal, state or local law, order, regulation or requirement relating to its operations, products or its owned or leased properties, except for possible violations that individually or in the aggregate would not have a material adverse effect on the assets, operations or business of XYZ taken as a whole.

(i) Litigation, Actions, and Proceedings. Other than those listed and described on the XYZ Disclosure Statement, as of the date hereof there are no actions, suits, claims or legal, administrative or arbitration proceedings or investigations (whether or not the defense thereof or liabilities in respect thereof are covered by policies of insurance), pending or threatened against XYZ, or any of the properties or assets of any XYZ Company, or to which any XYZ Company is a party or a target, and there are no outstanding orders, writs, injunctions or decrees of any court, governmental agency or arbitration tribunal against XYZ or to which any XYZ Company is a party or a target, and there are no facts or circumstances known to XYZ which would constitute a valid basis for any such action, suit, claim or legal, administrative or arbitration proceeding or investigation which in any such case, if there were an adverse outcome, would have a material adverse effect on the XYZ taken as a whole. XYZ is not in default with respect to, nor in violation of, any regulation, order or decree of any court or of any governmental agency or instrumentality.

(j) Patents, Trademarks, Etc. XYZ has no patents, patent rights, patent applications, trademarks, trademark applications, service marks, service mark applications, trade names and copyrights, or applications for such which are in the process of being prepared, owned by or registered in the name of XYZ.

(k) Capital Stock: Options, Dividends, Etc. Except as otherwise contemplated by this Agreement or as set forth in the XYZ Disclosure Statement, since March 31, 2008, XYZ has not: (1) issued or agreed to issue any options to purchase or rights to subscribe to, or securities convertible into, any additional shares of XYZ stock; (2) entered into any transaction outside the ordinary course of business, or suffered any material adverse change in its financial position, assets, liabilities or business; (3) declared or paid any dividends or authorized or made any distribution upon or with respect to its capital stock or purchased or agreed to purchase any shares of its capital stock; (4) made any loans or advances or payments of any kind to any person, except (a) payments made in the ordinary course of business, (b) payments of amounts due on indebtedness incurred in the ordinary course of business or in respect of indebtedness reflected in the consolidated balance sheet of XYZ and subsidiaries; (5) mortgaged or pledged any of its assets or properties or incurred any indebtedness, for money borrowed or otherwise, or other liabilities, contingent or otherwise, other than liabilities incurred in the ordinary course of business; (6) sold, exchanged or otherwise disposed of any of its capital assets, except in the ordinary course of business; or (7) increased the salaries of its officers, directors or employees (making over $60,000.00 per annum) or paid or incurred any obligation to pay any bonus or other compensation, directly or indirectly, to its officers, directors or employees, other than salaries, wages and commissions at the rates being paid on March 31, 2008.

(l) Brokers. All negotiations relative to this Agreement and the transactions contemplated by it have been carried on by XYZ directly with ABC without the intervention of any person in a manner that gives rise to any valid claim against any of the parties to this Agreement for a brokerage or similar commission.

(m) Tax Returns. XYZ has filed all United States, foreign, state, county, local and other tax and duty returns and reports required to be filed and has paid all income, franchise, property, sales, employment, ad valorem and other taxes and duties required to be paid in respect of the periods covered by those returns, and has set up reasonable and adequate reserves, which are reflected in the financial statements referred to in subparagraph (e) of this paragraph for all taxes required to be accrued under generally accepted accounting principles as of the date of the balance sheet referred to in subparagraph (e) of this paragraph. All taxes (including, without limitation, income, accumulated earnings, property, sales, use, franchise, value added, fuel, employees' income withholding and social security taxes) which have become due or payable or required to be collected by XYZ or are otherwise attributable to any periods ending on or before December 31, 2008 and all interest and penalties thereon, whether disputed or not, have been paid in full or adequately provided for by reserves shown on the December 31, 2008 balance sheet of XYZ. All deposits required by law to be made by XYZ with respect to employees' withholding taxes have been duly made. The XYZ Shareholders agree to file a final return for the period ended June 30, 2008, and shall be responsible for payment of all taxes relating to such filing. Except as set forth on the XYZ Disclosure Statement no extension of time for the assessment of deficiencies in respect of federal, state, local or foreign income taxes for any year nor any waiver by XYZ of the statute of limitations with respect to any federal, state, local or foreign taxes is in effect. No deficiency or adjustment in respect of federal, state, local or foreign income taxes has been assessed against XYZ and remains unpaid, nor except as set forth on the XYZ Disclosure Statement has XYZ received any notice of audit for any tax for any period ending subsequent to June 30, 1997. XYZ has previously delivered to ABC true and complete copies of all federal, state, local and foreign income tax returns for its tax years ended December 31, 2007, 2006 and 2005 for XYZ, and all reports and results of federal, state, local and foreign income tax audits, if any, of XYZ since and including the tax year ended December 31, 1997.

(n) Inventories. All of the inventories which are reflected in the March 31, 2008 balance sheet of XYZ were purchased or acquired in the ordinary course of the business of XYZ as and in a manner consistent with the regular inventory practices relating to such businesses and have been or are anticipated to be used or sold in the ordinary course of such businesses and in a manner consistent with their regular inventory practices; on the date of such balance sheet, all of the inventories which are reflected in such balance sheet were valued at an amount no greater than the lower of cost (on a first-in, first-out basis) or market, and were (as to classes of items, inventories and methods of accounting and pricing) determined in a manner consistent with prior years; and all inventories which have been purchased or acquired by XYZ for it's business since March 31, 2008 were purchased or acquired in the ordinary course of business and in a manner consistent with XYZ's regular inventory practices and have been or are anticipated to be used or sold in the ordinary course of such businesses and in a manner consistent with their regular inventory practices. Subject to reserves therefor set forth in the March 31, 2008 balance sheet, of XYZ to the best of XYZ's knowledge, all inventories of XYZ are of usable and merchantable quality and contain no material amount of non-current items.

(o) Accounts Receivable. All of the accounts, notes and other receivables which are reflected in the March 31, 2008 Balance Sheet of XYZ were acquired in the ordinary course of business; and, except to the extent reserved against in such balance sheet, all of the accounts, notes and other receivables which are reflected in the March 31, 2008 Balance Sheet of XYZ have been collected in full, or, to the best of XYZ's knowledge, are good and collectible, in the ordinary course of business; and all of the accounts, notes and other receivables which have been acquired by XYZ since

March 31, 2008 were acquired in the ordinary course of business and have been collected in full, or, to the best of XYZ's knowledge, are good and collectible, subject to an appropriate reserve determined in a manner consistent with past practices of XYZ in the ordinary course of business.

(p) Labor and Employee Relations. XYZ is not a party to any collective bargaining agreement with any labor organization, group or association covering any of its employees and there are no charges (by employees, their representatives or governmental authorities) of unfair labor practices or of employment discrimination or of any other wrongful action by XYZ, or its officers, employees or agents with respect to any aspect of employment of its employees pending or threatened before, and to the best of XYZ's knowledge, no union representation elections relating to employees of XYZ have been scheduled by any governmental agency or authority, no organizational effort is being made with respect to any of its employees, and there is no investigation of any of XYZ's employment policies or practices by any governmental agency or authority pending or threatened. Except as set forth in the XYZ Disclosure Statement XYZ is not currently, nor within the last three years have any of them been, involved in labor negotiations with any unit or group seeking to become the bargaining unit or any employees of XYZ and there have been no work stoppages at any XYZ facility during the last three years, and to the best of XYZ's knowledge, no work stoppage is planned at any XYZ facility.

(q) Proprietary Information of Third Parties. No third party has claimed or has reason to claim that any person employed by or affiliated with XYZ has (a) violated or may be violating any of the terms or conditions of such person's employment, non-competition or non-disclosure agreement with such third party, (b) disclosed or may be disclosing or utilized or may be utilizing any trade secret or proprietary information or documentation of such third party, or (c) interfered or may be interfering in the employment relationship between such third party and any of its present or former employees, and no third party has requested information from XYZ which suggests that such a claim might be contemplated. No person employed by or affiliated with XYZ has employed any trade secret or any information or documentation proprietary to any former employer and, no person employed by or affiliated with XYZ has violated any confidential relationship which such person may have had with any third party, in connection with the development, manufacture or sale of any product or proposed product or the development or sale of any service or proposed service of XYZ, and XYZ has no reason to believe there will be any such employment or violation. None of the execution or delivery of this Agreement, or the carrying on of the business of XYZ as officers, employees or agents by any director, officer or key employee of XYZ, or the conduct or proposed conduct of the business of XYZ, will conflict with or result in a breach of the terms, conditions or provisions of or constitute a default under any contract, covenant or instrument under which any such person is obligated.

(r) Permits. XYZ owns or has the right to use in accordance with the terms thereof all franchises, licenses, permits, consents, approvals and authorizations of or from any public or governmental agency, patents, trademark registrations, service mark registrations, trade names and copyright registrations, used in or otherwise necessary for the conduct of their businesses, without any known conflict with the rights of others and subject to no claim, and in each case valid and in full force and effect, except for those the absence or unavailability of which do not or could in the future reasonably be expected not to have a material adverse effect on the business of XYZ.

(s) Certain Practices. Neither XYZ nor any of it's respective officers or employees have, during the last three years, in connection with the conduct of its business, directly or indirectly, given or agreed to give any significant rebate, gift or similar benefit to any supplier, customer, governmental employee or other person who was, is or may be in a position to help or hinder the business of XYZ (or assist in connection with any actual or proposed transaction) which (i) could subject XYZ to any damage or penalty in any civil, criminal or governmental litigation or proceeding, or (ii) if not continued in the future, could have a material adverse effect on the business conducted in any state by XYZ.

(t) Compliance With Laws. In all material respects, XYZ is in compliance with and is not in violation of, and all of its assets are owned, leased and utilized in compliance with and not in violation of, all laws, ordinances, requirements, rules regulations, decrees or orders applicable to its business, except for any failure or failures to comply, or violation or violations which, individually or in the aggregate, is or are not having, or could in the future reasonably be expected not to have, a material adverse effect on the assets, liabilities, operations, business or prospects of the XYZ. XYZ is not subject to any judgment, order, writ, injunction or decree which, individually or in the aggregate, materially and adversely affects or could in the future reasonably be expected to materially and adversely affect the assets, liabilities, operations, business or prospects of XYZ.

(u) Outstanding Commitments. The XYZ Disclosure Statement sets forth each existing material contract, agreement, instrument, franchise, mortgage, indenture, and other commitment, whether written or oral, to which XYZ is a party or by which any of its assets may be subject and which in each case is material to XYZ. Except as set forth in the XYZ Disclosure Statement, XYZ has satisfied in all material respects its liabilities and obligations which have become due and payable thereunder, and are not in material default under any of them. To the best knowledge of XYZ no other party to any such contract, agreement, instrument, franchise, mortgage, indenture, or commitment is in material default thereunder, and no event has occurred or circumstance exists which with the giving of notice or the passage of time or otherwise would constitute such a material default by XYZ or any other party thereto.

(v) Insurance. XYZ is adequately insured with responsible insurers in respect of its properties, assets and businesses against risks normally insured against by companies in similar lines of business under similar circumstances. The XYZ Disclosure Statement correctly describes (by type, carrier, policy number, limits, premium and expiration date) the insurance coverage carried by XYZ. XYZ has not failed to give any notice or present any claim under any such policy or binder in due and timely fashion, has not received notice of cancellation or non-renewal of any such policy or binder, is not aware of any threatened or proposed cancellation or non-renewal, has not received notice of any insurance premiums which will be materially increased in the future, nor is aware of any insurance premiums which will be materially increased in the future. There are no outstanding claims under any such policy which have gone unpaid for more than 45 days, or as to which the insurer has disclaimed liability.

(w) Loans and Advances. Except as set forth in the XYZ Disclosure Statement, XYZ does not have any outstanding loans or advances to any person and is not obligated to make any such loans or advances, except, in each case, for advances to employees of XYZ in respect of reimbursable business expenses anticipated to be incurred by them in connection with their performance of services for the company.

(x) Assumptions, Guaranties, Etc. of Indebtedness of Other Persons. Except as set forth in the XYZ Disclosure Statement, XYZ has not assumed, guaranteed, endorsed or otherwise become directly or contingently liable on any indebtedness of any person (including, without limitation, liability by way of agreement, contingent or otherwise, to purchase, to provide funds for payment, to supply funds to or otherwise invest in the debtor, or otherwise to assure the creditor against loss), except for guaranties by endorsement of negotiable instruments for deposit or collection in the ordinary course of business.

(y) Significant Customers and Suppliers. No customer or supplier which was material to XYZ during the period covered by the XYZ Financial Statements or which has been material to XYZ thereafter, has terminated, materially reduced or threatened to terminate or materially reduce its purchases from or provision of products or services to XYZ, as the case may be. Set forth in the XYZ Disclosure Statement is a list of the ten largest customers and ten largest suppliers of XYZ for the fiscal year ending December 31, 2008, together with the amount of sales or purchases attributable to such customers and suppliers expressed in dollars and as a percentage of total sales or purchases, as the case may be.

(z) Approvals. No registration or filing with, or consent or approval of or other action by, any federal, state or other governmental agency or instrumentality or other third party is or will be necessary for the valid execution, delivery or performance by XYZ of this Agreement other than pursuant to the Georgia Business Corporation Act, the Florida Business Corporation Law.

(aa) Employees and Employment Agreements. Set forth in the XYZ Disclosure Statement is a list of the names of the officers of XYZ and any other employee of XYZ with base compensation at a rate in excess of $60,000 for the current fiscal year, together with the title or job classification of each such person and the total compensation anticipated to be paid to each such person by XYZ in the current fiscal year. Except as set forth in the XYZ Disclosure Statement, none of such persons has an employment agreement or understanding, whether oral or written, which is not terminable on notice by XYZ without cost or other liability to XYZ. Except as previously disclosed to ABC in writing, no member of XYZ's senior management has indicated that he intends to terminate his employment with XYZ or seek a material change in his duties or status.

(bb) Transactions With Affiliates. Except as set forth in the XYZ Disclosure Statement, no director, officer or employee of XYZ, or member of the family of any such person, or any corporation, partnership, trust or other entity in which any such person, or any member of the family of any such person, has a substantial interest or is an officer, director, trustee, partner or holder of more than five percent (5%) of the outstanding capital stock thereof, is a party to any contract, agreement or other arrangement with XYZ providing for the employment of, furnishing of services by, rental of real or personal property from or otherwise requiring payments or involving other obligations to, any such person or firm.

(cc) Environmental Matters.

(1) Environmental Substance Liability. Except as set forth in the XYZ Disclosure Statement, no event has occurred that could give rise to material liability on the part of XYZ or any of it's subsidiaries, for any losses, liabilities, damages (whether consequential or otherwise), settlements, penalties, interest and expenses (including any such liability on account of the right of any governmental or private entity or person, and including closure expenses, costs of assessment, containment, or removal (other than transportation or disposal of materials required to be transported or disposed of in the ordinary course of business, remedial work, or monitoring) arising under any presently enacted and applicable federal, state, or local statute, or any regulation that has been promulgated pursuant thereto, or common law, as a result of or in connection with, or alleged to be as a result of or in connection with, the following:

(i) the handling, storage, use, transportation or disposal of any Substances (as hereinafter defined) in or near or from XYZ's facilities or plants, by XYZ, its subsidiaries, or its predecessors;

(ii) the handling, storage, use, transportation or disposal of any Substances by XYZ, its subsidiaries, or its predecessors which Substances were a product, by-product or otherwise resulted from the operations conducted by or on behalf of XYZ, its subsidiaries or its predecessors;

(iii) any intentional or unintentional emission, discharge or release of any Substances in or near or from XYZ's facilities or plants into or upon the air, surface water, ground water or land or any disposal, handling, manufacturing, processing, distribution, use, treatment, or transport of such Substances in or near or from XYZ's facilities and plants by or on behalf of XYZ, its subsidiaries or its predecessors; or

(iv) the presence of any toxic or hazardous building materials (including but not limited to asbestos or similar substances) in any facility or plant of XYZ or its subsidiaries, including but not limited to the inclusion of such materials in the exterior and interior walls, floors, ceilings, tile, insulation or any other portion of building structures.

(v) With regard to any matter set forth in the XYZ Disclosure Statement in response to this Section 1(cc)(1) of Article II, XYZ has included in the XYZ Disclosure Statement information regarding the type and amount of substances involved, the estimated cost of treatment, the federal and/or state agencies involved, a description of the circumstances, and copies of any reports prepared which purport to evaluate the material facts, circumstances and/or solutions.

As used in this Section (cc), the term "Substances" shall mean any pollutant, hazardous substance, hazardous material, hazardous waste or toxic waste, as defined in any presently enacted and applicable federal, state or local statute or any regulation that has been promulgated pursuant thereto.

(2) Environmental Permits. XYZ and its subsidiaries have obtained and hold all material registrations, permits, licenses, and approvals issued by or on behalf of any federal, state or local government body or agency ("Environmental Permits"), that are required in connection with the discharge or emission of Substances from their facilities or plants or the generation, treatment, storage, transportation, or disposal of any such Substances. Such Environmental Permits, which are described in the XYZ Disclosure Statement, are currently effective and sufficient for the ownership and operation of the plants and facilities and the operations of XYZ as currently conducted.

(dd) Employee Benefits.

(a) Employee Benefit Plans. XYZ has no "employee benefit plan" (as defined in Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA")) covering any present or former employee of XYZ and such other plan or arrangement providing for severance benefits, deferred compensation, fringe benefits, insurance benefits or any similar type of benefit or compensation covering any present or former XYZ employee (an "Employee Plan"), whether or not such Employee Plan has been terminated.

(b) Pension Plans. XYZ has no Employee Plan which is intended to be qualified under Section 401(a) of the Internal Revenue Code ("Pension Plan") and no Employee Plan which is an "employee pension benefit plan" (as defined in Section 3(2) of ERISA).

Welfare Plans. XYZ has no Employee Plan which is an employee welfare benefit plan (as defined in Section 3(1) of ERISA)("Welfare Plan").

(ee) Full Disclosure. This Agreement and all documents, schedules and certificates required to be delivered by XYZ to ABC pursuant to this Agreement do not contain any untrue statement of a material fact and do not omit to state any material fact necessary to make the statements contained herein and therein, in light of the circumstances in which made, not misleading.

ARTICLE III

REPRESENTATIONS OF ABC

Representations and Warranties of ABC. Except as set forth in the ABC Disclosure Statement, ABC represents and warrants to and agrees with XYZ as follows:

(a) Corporate Organization and Good Standing. ABC is a corporation duly organized, validly existing and in good standing under the laws of the State of

Florida, and has full corporate power and authority to carry out its business as it is now being conducted and to own and lease property, and is duly qualified or authorized to do business and is in good standing in each jurisdiction in which the character and location of the properties owned or leased by it or the nature of business transacted by it makes those qualifications or authorizations necessary when failure to qualify would have a material and adverse effect on the business of ABC. ABC is not presently being challenged as to its right to do business as presently conducted in any jurisdiction. The copies of the Articles of Incorporation, as amended to date, and the Bylaws, as amended to date, of ABC previously delivered to XYZ are true, correct and complete copies as now in full force and effect. No provision of those instruments prohibits, limits or otherwise affects the right, power and authority of ABC to enter into this Agreement or to cause consummation of the merger.

(b) Capitalization. The authorized capitalization of ABC consists of 10,000,000 shares of common stock, par value $0.001 per share, of which 800,000 shares are presently outstanding, and all of which shares are validly issued, fully paid and nonassessable. There are also outstanding a total of 90,000 options to acquire 90,000 shares of common stock of ABC. There are no other existing options, warrants, convertible securities or similar rights granted by ABC, except as set forth on the ABC Merger Disclosure Statement (the "ABC Disclosure Statement") or any commitments or agreements of a similar nature to which ABC is a party, relating to the authorized or issued stock of ABC.

(c) Subsidiaries. ABC has no subsidiaries.

Except for those referred to in the ABC Merger Disclosure Statement, ABC does not (a) own of record or beneficially, directly or indirectly, (i) any shares of capital stock or securities convertible into capital stock of any other corporation or (ii) any interest in any partnership, joint venture or other non-corporate business entity or (b) control, directly or indirectly, any other entity.

(d) Authorization. The execution, delivery and performance of this agreement by ABC have been duly and effectively authorized by the Board of Directors of ABC. This Agreement is subject to approval of the shareholders of ABC under the Florida Business Corporation Law, and it will be submitted to the shareholders for approval.

(e) Shares to be Issued. The shares of ABC Stock to be issued and delivered pursuant to this Agreement have been duly authorized for issuance by the Board of Directors of ABC and when so issued and delivered upon conversion will be validly issued and outstanding, fully paid and nonassessable.

(f) Financial Statements. ABC has delivered to XYZ the unaudited balance sheet of ABC as of December 31, 2008, and the statements of earnings and cash flows of ABC for the year ended December 31, 2008, with the related notes and schedules, all as compiled by Pereira and Associates, CPA, independent certified public accountants. All these financial statements (including in each case the related schedules and notes) fairly present in accordance with generally accepted accounting principles applied on a consistent basis the financial condition of ABC as of the date of the balance sheet and the results of its operations for the period covered by the statement of income and retained earnings. Interim financial statement as of March 31, 2008 have been delivered to XYZ. Since December 31, 2007, and up to the Effective Date there has been no material adverse change in the financial condition of ABC or any transaction outside the ordinary course of business.

(g) No Violation. ABC is not, and by the execution and performance of this Agreement, will not be, in breach of any term or provision of or in default under, and no event has occurred that with the lapse of time or action by a third party could result in a default under, any outstanding indenture, contract or agreement to which it is a party or to which it may be subject, or under any provision of its Articles of Incorporation or Bylaws, except for possible defaults that individually or in the aggregate would not have any materially adverse effect on the business of ABC. The execution and performance of this Agreement by ABC will not violate any order, injunction, decree, statute, rule or regulation applicable to ABC or any of its properties or assets.

(h) Brokers. The negotiations relative to this Agreement and the transactions contemplated by it have been carried on by ABC directly with XYZ, without the intervention of any person in a manner that gives rise to any valid claim against any of the parties for a brokerage or similar commission.

(i) Lists of Properties, Contracts, Etc. The ABC Disclosure Statement contains a list of the following:

(1) Real Property. All real property owned, leased or otherwise used or occupied by ABC with book value or market value (whichever is greater) of $10,000.00 or more.

(2) Patents, Etc. All United States and foreign patent, trademark and trade name registrations, unexpired as of this date, all United States and foreign applications pending on this date for any patent, trademark, trade name or copyright registrations and all trademarks and trade names in use on this date by ABC, or any of its subsidiaries, all of the foregoing being owned on this date by ABC, and all licenses granted by or to ABC, and all other material agreements to which ABC is a party, which are in force as of this date and relate in whole or in part to any items of the categories mentioned in this subparagraph, or relate to inventions, discoveries, improvements, processes, formulas, proprietary rights, trade secrets, ideas or other know-how, whether owned by ABC or otherwise, all of which are referred to in subparagraph (j) below;

(3) Contracts. All presently existing contracts and commitments (including mortgages, leases, deeds of trust, loan and credit agreements, employment contracts or deferred compensation, pension, profit-sharing or retirement plans, instrument, franchise, indenture, and contracts or commitments for the purchase or sale of products or services), whether written or oral, to which ABC is a party or by which any of its assets may be subject and which in each case is material to ABC.

(4) Insurance. All policies of insurance in force with respect to ABC including, without restricting the generality of the foregoing, those covering its officers, properties, building, machinery, equipment, furniture, fixtures, products and operations, as referred to in subparagraph (v) below;

(5) Employees. The names of, and salary (including commissions and bonuses) paid in the fiscal year ended December 31, 2008, to all of the officers, directors and employees of ABC whose aggregate compensation during those periods exceeded $60,000.00, as referred to in subparagraph (bb) below;

(6) Permits. A list of all franchises, licenses, permits, consents, approvals and authorizations of or from any public or governmental agency, trade names and copyright registrations, used in or otherwise necessary for the conduct of their businesses, ;

(7) Banks. The name of each bank in which ABC has an account or safe deposit box and the names of all persons authorized to draw on or have access to them; and

(8) Powers of Attorney. The names of all persons, if any, holding a power of attorney from ABC.

(9) Litigation. A complete list and description, regarding all actions, suits, claims or legal, administrative or arbitration proceedings or investigations (whether or not the defense thereof or liabilities in respect thereof are covered by policies of insurance), pending or threatened against ABC, or any of the properties or assets of ABC, or to which ABC is a party or a target, and all outstanding orders, writs, injunctions or decrees of any court, governmental agency or arbitration tribunal against ABC or to which ABC is a party or a target,

True and complete copies of all of the patent, trademark, tradename and copyright registrations, applications pending for patent, trademark, trade name and copyright registrations and contracts and commitments; policies of insurance; and other documents referred to in the ABC Merger Disclosure Statement have been delivered to or made available for inspection by ABC.

(j) Title. ABC owns good and merchantable title free and clear of any liens, claims, encumbrances, options, charges or assessments to all of its properties and other assets used in connection with its business, including, but not limited to, those reflected in the balance sheet as of December 31, 2008, except: (1) personal property disposed of since December 31, 2008, in the ordinary course of business; (2) liens set forth on the balance sheet or in its notes or in this Agreement; (3) liens in connection with leaseholds or statutory liens (including liens for taxes not yet due and payable) not yet delinquent; and (4) minor defects and irregularities in the title to any real property, and encumbrances relating to any real property, that do not detract materially from the value and marketability of the property or impair the use of the property for the purpose for which it is held by ABC or otherwise impair the business operation of ABC. ABC carries such insurance with reputable insurers in respect of its properties and businesses as is customary for similar businesses and as is adequate for the business conducted by ABC. ABC has received no notice of any violation of and is not in violation of any applicable zoning regulation, health or safety regulation, ordinance or other federal, state or local law, order, regulation or requirement relating to its operations, products or its owned or leased properties.

(k) Litigation, Actions, and Proceedings. Other than those listed and described on the ABC Disclosure Statement, as of the date hereof there are no actions, suits, claims or legal, administrative or arbitration proceedings or investigations (whether or not the defense thereof or liabilities in respect thereof are covered by policies of insurance), pending or threatened against ABC, or any of the properties or assets of any ABC Company, or to which any ABC Company is a party or a target, and there are no outstanding orders, writs, injunctions or decrees of any court, governmental agency or arbitration tribunal against ABC or to which any ABC Company is a party or a target. ABC is not in default with respect to, nor in violation of, any regulation, order or decree of any court or of any governmental agency or instrumentality.

(l) Patents, Trademarks, Etc. Set forth in the ABC Disclosure Statement is a list of all patents, patent rights, patent applications, trademarks, trademark applications, service marks, service mark applications, trade names and copyrights, and all applications for such which are in the process of being prepared, owned by or registered in the name of ABC is a licensor or licensee or in which ABC has any right, and in each case a brief description of the nature of such right. ABC own or possess (subject only to the obligations set forth in the ABC Disclosure Statement) adequate licenses or other rights to use all patents, patent applications, trademarks, trademark applications, service marks, service mark applications, trade names, copyrights, manufacturing processes, formulae, trade secrets and know-how (collectively, "Intellectual Property") necessary to the conduct of their businesses as currently conducted and as proposed to be conducted, and no claim is pending or, to the best of ABC's knowledge, threatened to the effect that the operations of ABC infringe upon or conflict with the asserted rights of any other person under any Intellectual Property, and to the best of ABC's knowledge, there is no basis for any such claim (whether or not pending or threatened), nor to the best of ABC's knowledge, threatened to the effect that any such Intellectual Property owned or licensed by ABC or any of its subsidiaries, or which any of them otherwise have the right to use, is invalid or unenforceable by ABC, and there is no basis for any such claim.

(m) Capital Stock: Options, Dividends, Etc. Except as otherwise contemplated by this Agreement, since March 31, 2008, and up to the Effective Date, ABC has not: (1) issued or agreed to issue any options to purchase or rights to subscribe to, or securities convertible into, any additional shares of ABC stock; (2) entered into any transaction outside the ordinary course of business, or suffered any material adverse change in its financial position, assets, liabilities or business; (3) declared or paid any dividends or authorized or made any distribution upon or with respect to its capital stock or purchased or agreed to purchase any shares of its capital stock; (4) made any loans or advances or payments of any kind to any person, except (a) payments made in the ordinary course of business, (b) payments of amounts due on indebtedness currently incurred in the ordinary course of business or in respect of indebtedness reflected in the balance sheet of ABC as of March 31, 2008; (5) mortgaged or pledged any of its assets or properties or incurred any indebtedness, for money borrowed or otherwise, or other liabilities, contingent or otherwise, other than liabilities incurred in the ordinary course of business; or (6) sold, exchanged or otherwise disposed of any of its capital assets, except in the ordinary course of business.

(n) Tax Returns. ABC has filed all United States, foreign, state, county, local and other tax and duty returns and reports required to be filed, with the exception of the period ending December 31, 2008 which return has been placed on extension, and has paid all income, franchise, property, sales, employment, ad valorem and other taxes and duties required to be paid in respect of the periods covered by those returns, and has set up reasonable and adequate reserves, which are reflected in the financial statements referred to in subparagraph (f) of this paragraph for the payment of all taxes or duties required to be paid or anticipated to be required to be paid in respect of the periods subsequent to the last of those periods covered by the returns and prior to the Effective Date. All taxes (including, without limitation, income, accumulated earnings, property, sales, use, franchise, value added, fuel, employees' income withholding and social security taxes) which have become due or payable or required to be collected by ABC or are otherwise attributable to any periods ending on or before December 31, 2008 and all interest and penalties thereon, whether disputed or not, have been paid in full or adequately provided for by reserves shown on the December 31, 2008 ABC Balance Sheet. All deposits required by law to be made by ABC with respect to employees' withholding taxes have been duly made. No extension of time for the assessment of deficiencies in respect of federal, state, local or foreign income taxes for any year nor any waiver by ABC of the statute of limitations with respect to any federal, state, local or foreign taxes is in effect. No deficiency or adjustment in respect of federal, state, local or foreign income taxes has been assessed against ABC and remains unpaid, nor has ABC received any notice of audit for any tax for any period ending subsequent to December 31, 2000. ABC has previously delivered to XYZ true and complete copies of all federal, state, local and foreign income tax returns for its tax years ended December 31, 2008, 2007 and 2006 for ABC, and all reports and results of federal, state, local and foreign income tax audits, if any, of ABC since and including the tax year ended December 31, 2000.

(n) Inventories. All of the inventories which are reflected in the March 31, 2008 ABC balance sheet were purchased or acquired in the ordinary course of the business of ABC as and in a manner consistent with the regular inventory practices relating to such businesses and have been or are anticipated to be used or sold in the ordinary course of such businesses and in a manner consistent with their regular inventory practices; on the date of the ABC Balance Sheet, all of the inventories which are reflected in such Balance Sheet were valued at an amount no greater than the lower of cost (on a first-in, first-out basis) or market, and were (as to classes of items, inventories and methods of accounting and pricing) determined in a manner consistent with prior years; and all inventories which have been purchased or acquired by ABC for it's business since the date of the March 31, 2008 Balance Sheet were purchased or acquired in the ordinary course of business and in a manner consistent with ABC's regular inventory practices and have been or are anticipated to be used or sold in the ordinary course of such businesses and in a manner consistent with their regular inventory practices. Subject to reserves therefor set forth in the March 31, 2008 Balance Sheet, to the best of ABC's knowledge, all inventories of ABC are of usable and merchantable quality and contain no material amount of non-current items.

(o) Accounts Receivable. All of the accounts, notes and other receivables which are reflected in the March 31, 2008 ABC Balance Sheet were acquired in the ordinary course of business; and, except to the extent reserved against in such Balance Sheet, all of the accounts, notes and other receivables which are reflected in the March 31, 2008 Balance Sheet have been collected in full, or, to the best of ABC's knowledge, are good and collectible, in the ordinary course of business; and all of the accounts, notes and other receivables which have been acquired by ABC since the date of the March 31, 2008 ABC Balance Sheet were acquired in the ordinary course of business and have been collected in full, or, to the best of ABC's knowledge, are good and collectible, subject to an appropriate reserve determined in a manner consistent with past practices of ABC in the ordinary course of business.

(p) Labor and Employee Relations. ABC is not a party to any collective bargaining agreement with any labor organization, group or association covering any of its employees. There are no charges (by employees, their representatives or governmental authorities) of unfair labor practices or of employment discrimination or of any other wrongful action by ABC, its subsidiaries, or its officers, employees or agents with respect to any aspect of employment of its employees pending or threatened before, and to the best of ABC's knowledge, no union representation elections relating to employees of ABC have been scheduled by any governmental agency or authority, no organizational effort is being made with respect to any of its employees, and there is no investigation of any of ABC's employment policies or practices by any governmental agency or authority pending or threatened. ABC is not currently, nor within the last three years have any of them been, involved in labor negotiations with any unit or group seeking to become the bargaining unit or any employees of ABC and there have been no work stoppages at any ABC facility during the last three years, and to the best of ABC's knowledge, no work stoppage is planned at any ABC facility.

(q) Proprietary Information of Third Parties. No third party has claimed or has reason to claim that any person employed by or affiliated with ABC has (a) violated or may be violating any of the terms or conditions of such person's employment, non-competition or non-disclosure agreement with such third party, (b) disclosed or may be disclosing or utilized or may be utilizing any trade secret or proprietary information or documentation of such third party, or (c) interfered or may be interfering in the employment relationship between such third party and any of its present or former employees, and no third party has requested information from ABC which suggests that such a claim might be contemplated. No person employed by or affiliated with ABC has employed or proposes to employ any trade secret or any information or documentation proprietary to any former employer and, no person employed by or affiliated with ABC has violated any confidential relationship which such person may have had with any third party, in connection with the development, manufacture or sale of any product or proposed product or the development or sale of any service or proposed service of ABC, and ABC has no reason to believe there will be any such employment or violation. None of the execution or delivery of this Agreement, or the carrying on of the business of ABC as officers, employees or agents by any director, officer or key employee of ABC, or the conduct or proposed conduct of the business of ABC, will conflict with or result in a breach of the terms, conditions or provisions of or constitute a default under any contract, covenant or instrument under which any such person is obligated.

(r) Permits. ABC owns or has the right to use in accordance with the terms thereof all franchises, licenses, permits, consents, approvals and authorizations of or from any public or governmental agency, patents, trademark registrations, service mark registrations, trade names and copyright registrations, used in or otherwise necessary for the conduct of their businesses, without any known conflict with the rights of others and subject to no claim, and in each case valid and in full force and effect, except for those the absence or unavailability of which do not or could in the future reasonably be expected not to have a material adverse effect on the business of ABC.

(s) Certain Practices. Neither ABC nor any of it's respective officers or employees have, during the last three years, in connection with the conduct of its business, directly or indirectly, given or agreed to give any significant rebate, gift or similar benefit to any supplier, customer, governmental employee or other person who was, is or may be in a position to help or hinder the business of ABC (or assist in connection with any actual or proposed transaction) which (i) could subject ABC to any damage or penalty in any civil, criminal or governmental litigation or proceeding, or (ii) if not continued in the future, could have a material adverse effect on the business conducted in any state by ABC.

(t) Compliance With Laws. In all material respects, ABC is in compliance with and is not in violation of, and all of its assets are owned, leased and utilized in compliance with and not in violation of, all laws, ordinances, requirements, rules regulations, decrees or orders applicable to its business, except for any failure or failures to comply, or violation or violations which, individually or in the aggregate, is or are not having, or could in the future reasonably be expected not to have, a material adverse effect on the assets, liabilities, operations, business or prospects of the ABC. ABC is not subject to any judgment, order, writ, injunction or decree which, individually or in the aggregate, materially and adversely affects or could in the future reasonably be expected to materially and adversely affect the assets, liabilities, operations, business or prospects of ABC.

(u) Outstanding Commitments. The ABC Disclosure Statement sets forth each existing material contract, agreement, instrument, franchise, mortgage, indenture, and other commitment, whether written or oral, to which ABC is a party or by which any of its assets may be subject and which in each case is material to ABC. ABC has satisfied in all material respects its liabilities and obligations which have become due and payable thereunder, and are not in material default under any of them. To the best knowledge of ABC no other party to any such contract, agreement, instrument, franchise, mortgage, indenture, or commitment is in material default thereunder, and no event has occurred or circumstance exists which with the giving of notice or the passage of time or otherwise would constitute such a material default by ABC or any other party thereto.

(v) Insurance. ABC is adequately insured with responsible insurers in respect of its properties, assets and businesses against risks normally insured against by companies in similar lines of business under similar circumstances. The ABC Disclosure Statement correctly describes (by type, carrier, policy number, limits, premium and expiration date) the insurance coverage carried by ABC. ABC has not failed to give any notice or present any claim under any such policy or binder in due and timely fashion, has not received notice of cancellation or non-renewal of any such policy or binder, is not aware of any threatened or proposed cancellation or non-renewal, has not received notice of any insurance premiums which will be materially increased in the future, nor is aware of any insurance premiums which will be materially increased in the future. There are no outstanding claims under any such policy which have gone unpaid for more than 45 days, or as to which the insurer has disclaimed liability.

(w) Loans and Advances. ABC does not have any outstanding loans or advances to any person and is not obligated to make any such loans or advances, except, in each case, for advances to employees of ABC in respect of reimbursable business expenses anticipated to be incurred by them in connection with their performance of services for the company.

(x) Assumptions, Guaranties, Etc. of Indebtedness of Other Persons. ABC has not assumed, guaranteed, endorsed or otherwise become directly or contingently liable on any indebtedness of any person (including, without limitation, liability by way of agreement, contingent or otherwise, to purchase, to provide funds for payment, to supply funds to or otherwise invest in the debtor, or otherwise to assure the creditor against loss), except for guaranties by endorsement of negotiable instruments for deposit or collection in the ordinary course of business.

(y) Significant Customers and Suppliers. No customer or supplier which was material to ABC during the period covered by the ABC Financial Statements or which has been material to ABC thereafter, has terminated, materially reduced or threatened to terminate or materially reduce its purchases from or provision of products or services to ABC or any of its subsidiaries, as the case may be. Set forth in the ABC Disclosure Statement is a list of the ten largest customers and ten largest suppliers of ABC for the fiscal year ending December 31, 2008, together with the amount of sales or purchases attributable to such customers and suppliers expressed in dollars and as a percentage of total sales or purchases, as the case may be.

(z) Approvals. No registration or filing with, or consent or approval of or other action by, any federal, state or other governmental agency or instrumentality or other third party is or will be necessary for the valid execution, delivery or performance by ABC of this Agreement other than pursuant to the Georgia Business Corporation Act, the Florida Business Corporation Law and state securities laws.

(aa) Employees and Employment Agreements. Set forth in the ABC Disclosure Statement is a list of the names of the officers of ABC and any other employee of ABC with base compensation at a rate in excess of $60,000 for the current fiscal year, together with the title or job classification of each such person and the total compensation anticipated to be paid to each such person by ABC in the current fiscal year. None of such persons has an employment agreement or understanding, whether oral or written, which is not terminable on notice by ABC without cost or other liability to ABC. Except as previously disclosed to XYZ in writing, no member of ABC's senior management has indicated that he intends to terminate his employment with ABC or seek a material change in his duties or status.

(bb) Transactions With Affiliates. Except as disclosed on the ABC Disclosure Statement, no director, officer or employee of ABC, or member of the family of any such person, or any corporation, partnership, trust or other entity in which any such person, or any member of the family of any such person, has a substantial interest or is an officer, director, trustee, partner or holder of more than five percent (5%) of the outstanding capital stock thereof, is a party to any contract, agreement or other arrangement with ABC providing for the employment of, furnishing of services by, rental of real or personal property from or otherwise requiring payments or involving other obligations to, any such person or firm.

(cc) Environmental Matters.

(1) Environmental Substance Liability. Except as disclosed on the ABC Disclosure Statement, no event has occurred that could give rise to material liability on the part of ABC or any of it's subsidiaries, for any losses, liabilities, damages (whether consequential or otherwise), settlements, penalties, interest and expenses (including any such liability on account of the right of any governmental or private entity or person, and including closure expenses, costs of assessment, containment, or removal (other than transportation or disposal of materials required to be transported or disposed of in the ordinary course of business, remedial work, or monitoring) arising under any presently enacted and applicable federal, state, or local statute, or any regulation that has been promulgated pursuant thereto, or common law, as a result of or in connection with, or alleged to be as a result of or in connection with, the following:

(i) the handling, storage, use, transportation or disposal of any Substances (as hereinafter defined) in or near or from ABC's facilities or plants, by ABC, its subsidiaries, or its predecessors;

(ii) the handling storage, use, transportation or disposal of any Substances by ABC, its subsidiaries, or its predecessors which Substances were a product, by-product or otherwise resulted from the operations conducted by or on behalf of ABC, its subsidiaries or its predecessors;

(iii) any intentional or unintentional emission, discharge or release of any Substances in or near or from facilities or plants into or upon the air, surface water, ground water or land or any disposal, handling, manufacturing, processing, distribution, use, treatment, or transport of such Substances in or near or from facilities and plants by or on behalf of ABC, its subsidiaries or its predecessors; or

(iv) the presence of any toxic or hazardous building materials (including but not limited to asbestos or similar substances) in any facility or plant of ABC or its subsidiaries, including but not limited to the inclusion of such materials in the exterior and interior walls, floors, ceilings, tile, insulation or any other portion of building structures.

As used in this Section (dd), the term "Substances" shall mean any pollutant, hazardous substance, hazardous material, hazardous waste or toxic waste, as defined in any presently enacted federal, state or local statute or any regulation that has been promulgated pursuant thereto.

(2) Environmental Permits. ABC and its subsidiaries have obtained and hold all material registrations, permits, licenses, and approvals issued by or on behalf of any federal, state or local government body or agency ("Environmental Permits"), that are required in connection with the discharge or emission of Substances from their facilities or plants or the generation, treatment, storage, transportation, or disposal of any such Substances. Such Environmental Permits, which are described in the ABC Disclosure Statement, are currently effective and sufficient for the ownership and operation of the plans and facilities and the operations of ABC as currently conducted.

(dd) Employee Benefits.

(a) Employee Benefit Plans. ABC has no "employee benefit plan" (as defined in Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA")) covering any present or former employee of ABC and such other plan or arrangement providing for severance benefits, deferred compensation, fringe benefits, insurance benefits or any similar type of benefit or compensation covering any present or former ABC employee (an "Employee Plan"), whether or not such Employee Plan has been terminated.

(b) Pension Plans. ABC has no Employee Plan which is intended to be qualified under Section 401(a) of the Internal Revenue Code ("Pension Plan") and no Employee Plan which is an "employee pension benefit plan" (as defined in Section 3(2) of ERISA).

Welfare Plans. ABC has no Employee Plan which is an employee welfare benefit plan (as defined in Section 3(1) of ERISA)("Welfare Plan").

(ee) Full Disclosure. This Agreement and all documents, schedules and certificates required to be delivered by ABC to XYZ pursuant to this Agreement do not contain any untrue statement of a material fact and do not omit to state any material fact necessary to make the statements contained herein and therein, in light of the circumstances in which made, not misleading.

(ff) Tax Matters.

(i) ABC is aware of no plan or intention on the part of any XYZ shareholders to dispose of ABC Stock to be received in connection with the Merger such that, following any such disposition, the aggregate fair market value of ABC Stock (measured as of the Effective Date) retained by former XYZ shareholders would be less than 50% of the aggregate fair market value of XYZ Stock immediately prior to the Merger.

(ii) ABC has no plan or intention to reacquire any of the ABC Stock issued in connection with the Merger.

(iii) ABC has no plan or intention to sell or otherwise dispose of any of the assets of XYZ to be acquired in the Merger, except for dispositions made in the ordinary course of business or transfers described in Section 368(a)(2)(C) of the Code.

ARTICLE IV

COVENANTS OF ABC AND XYZ

1. No Change in Conduct of Business. Except as contemplated by this Agreement or as consented to in writing by the parties to this agreement, during the period from the date of this Agreement to the Effective Date, ABC and XYZ shall conduct their respective operations and affairs according to their ordinary and usual courses of business consistent with past practices. The businesses of XYZ shall be conducted only in the normal, usual and ordinary course; and XYZ will use its best efforts to preserve those business organizations intact and to keep available to the Surviving Corporation the services of XYZ's present officers and XYZ employees and to preserve for the Surviving Corporation the goodwill of XYZ's suppliers, customers and others having business relations with XYZ. Without limiting the generality of the foregoing, and except as otherwise expressly provided in this Agreement or as consented to in writing by the parties to this agreement, prior to the Effective Date, neither ABC nor XYZ shall, except as specifically outlined in the ABC Disclosure Statement, or the XYZ Disclosure Statement, (i) issue, sell or pledge, or authorize or propose the issuance, sale or pledge of (A) additional shares of capital stock of any class or securities convertible into any such shares (other than ABC Stock or XYZ Stock issuable upon the exercise of currently outstanding options which by their terms are exercisable), or (B) any rights, warrants or options to acquire any such shares or other convertible securities, or grant or accelerate any right to convert or exchange any securities for shares of capital stock; (ii) redeem, purchase or otherwise acquire, or propose to redeem, purchase or otherwise acquire, any of its outstanding securities; (iii) declare, set aside, make or pay any dividend or distribution (whether in cash, stock or property) on or in respect of any shares of capital stock; (iv) except for sales and purchases of inventory in the ordinary course of business, make any acquisition of assets or securities, any disposition of assets or securities or any change in capitalization; (v) enter into any contract or release or relinquish any contract or other rights in excess of $25,000 in amount; (vi) except for any refinancing of existing indebtedness, incur any long-term debt for borrowed money or any short-term debt for borrowed money other than in the ordinary course of business consistent with past practice in excess of $25,000 in amount; (vii) propose or adopt any Charter or By-Laws amendments; (viii) other than as con-

templated or permitted by this Agreement, enter into any new employment agreements with any directors, officers or employees or grant any increases in the compensation or benefits to, or agree to pay any bonus, severance or termination payment or other special compensation to, directors, officers and employees other than scheduled merit increases in the ordinary course of business consistent with past practice; (ix) make any loan or advance to any of its directors, officers, employees, consultants, or agents or to any member of their families or any other loan or advance otherwise than in the ordinary course of business consistent with past practices; (x) make or incur any charitable contributions or any nonbusiness expense except in accordance with past practice and not exceeding $2,500; or (xi) agree in writing or orally to take any of the foregoing actions or any other action which would make any representation or warranty in this Agreement untrue on the date hereof or on the Effective Date.

2. No Solicitation or Discussion. Except for the transactions contemplated by this Agreement, XYZ shall use its best efforts to cause its directors, officers, employees, representatives, agents and affiliates not to, directly or indirectly, encourage solicit, initiate or participate in any way in discussions or negotiations with, or knowingly provide any information to, any person (other than the parties to this Agreement or any affiliate thereof) concerning any merger, purchase or sale of asset, purchase or sale of securities, exchange offer, consolidation, combination or similar transaction involving XYZ, during the term of this Agreement.

3. Access to Information.

(a) Between the date of the Agreement and the Effective Date, each party shall (i) give to the other and its authorized representatives access during regular business hours upon reasonable notice to such party's offices, warehouses and other facilities and to all of its books and records, (ii) permit the other and its authorized representatives to make such inspections as it may require, (iii) cause its officers to furnish the other and its authorized representatives with such financial and operating data and other information with respect to its business and properties as such party any from time to time request, (iv) furnish such party promptly with a copy of each report, schedule and other documents filed or received by it pursuant to federal or state securities law, if any, and (v) notify the other promptly in writing of the occurrence of any event or the existence of any circumstance which would have made any of its representations and warranties set forth herein untrue. No information provided pursuant to this Article IV, Section 3 or otherwise, nor any investigation by any party, shall affect or be deemed to modify any representation or covenant herein contained.

(b) ABC and XYZ agree that, in the event that the transactions contemplated hereby shall not be consummated, each will treat in confidence all documents, materials and other information which either shall have obtained during the course of the negotiations leading to this Agreement, the investigation of the other party hereto and the preparation of this Agreement and other documents relating to this Agreement, and shall return to the other party all copies of non-public documents and materials which have been furnished in connection therewith.

4. Reasonable Best Efforts. Subject to the terms and conditions hereof, each of the parties hereto agrees to use its reasonable best efforts to take, or cause to be taken, all appropriate action, and to do, or cause to be done, all things necessary, proper or advisable under applicable laws and regulations to consummate and make effective the transactions contemplated by this Agreement. In case at any time after the Effective Date any further action is necessary or useful to carry out the purpose of this Agreement, the parties shall use their reasonable best efforts to cause their respective proper officers, employees and representatives to take all such necessary action.

5. Shareholders Meetings.

(a) XYZ shall, as soon as practicable, take all action necessary in accordance with the Georgia Business Corporation Act, its Articles of Incorporation and By-Laws and the resolution of its Board of Directors with respect to obtaining approval of the Merger by holders of a majority of the XYZ Stock entitled to vote in person or by proxy at a meeting to be convened on the earliest practicable date for the purposes of considering and voting on the Merger. The Board of Directors of XYZ shall recommend that XYZ's shareholders vote to approve the Merger, and this Agreement, shall use its best efforts to solicit from shareholders of XYZ proxies in favor of the Merger and shall take all other action in its judgment reasonably necessary and appropriate to secure the vote of shareholders required to effect the Merger. Without limiting the generality of the foregoing, if, at the meeting, holders of less than the number of shares of XYZ Stock required to duly approve the Merger are voted in favor of such proposals, and a number of shares are not voted which, if they were present and voted in favor of the Merger, together with the shares voted in favor of such proposals, such proposals would be duly approved, at the request of ABC or at its own instance, XYZ will adjourn the meeting on one or more occasions to a convenient date within no more than forty-five days and will continue to solicit proxies until such date; provided that adjournment and solicitation comply with all applicable laws.

(b) ABC shall, as soon as practicable, take all action necessary in accordance with the Florida Business Corporation Law, its Articles of Incorporation and By-Laws and the resolution of its Board of Directors with respect to obtaining approval of the Merger by holders of a majority of the ABC Stock entitled to vote in person or by proxy at a meeting to be convened on the earliest practicable date for the purposes of considering and voting on the Merger. The Board of Directors of ABC shall recommend that ABC’s shareholders vote to approve the Merger, and this Agreement, shall use its best efforts to solicit from shareholders of ABC proxies in favor of the Merger and shall take all other action in its judgment reasonably necessary and appropriate to secure the vote of shareholders required to effect the Merger. Without limiting the generality of the foregoing, if, at the meeting, holders of less than the number of shares of ABC Stock required to duly approve the Merger are voted in favor of such proposals, and a number of shares are not voted which, if they were present and voted in favor of the Merger, together with the shares voted in favor of such proposals, such proposals would be duly approved, at the request of XYZ or at its own instance, ABC will adjourn the meeting on one or more occasions to a convenient date within no more than forty-five days and will continue to solicit proxies until such date; provided that adjournment and solicitation comply with all applicable laws.

6. Notification of Certain Matters. XYZ and ABC will each give prompt notice to the other after it has knowledge of (i) the occurrence, or failure to occur, of any event which occurrence or failure would or would be likely to cause any of their respective representations or warranties contained in this Agreement to be untrue or incorrect in any material respect at any time from the date hereof to the Effective Date and (ii) any failure on the part of XYZ or ABC, as the case may be, or on the part of any of the officers, directors, employees, representatives or agents of such parties to comply with or satisfy in any material respect any covenant, condition or agreement to be complied with or satisfied by them under this Agreement; provided, however, that no such notification will alter or otherwise affect such representations, warranties, covenants, conditions or agreements, or the information set forth on the respective Disclosure Statements of the parties.

7. Public Announcements. ABC and XYZ shall, to the fullest extent practicable, consult with one another before issuing any press release or otherwise making any public statement with respect to the Merger and shall not issue any such press release or make any such public statement prior to such consultation, except as may be required by law after consultation with counsel.

ARTICLE V

CONDITIONS TO OBLIGATION TO CONSUMMATE THE MERGER

1. Conditions to Obligations of XYZ. All obligations of XYZ under this Agreement are subject to the fulfillment, prior to the Effective Date, of each of the following conditions (any one or more of which, in the absolute discretion of XYZ, may be waived in writing by XYZ):

(a) Representations and Warranties. XYZ shall not have discovered any material error, misstatement or omission in the representations and warranties made by ABC in Article III, of this Agreement or any material adverse change in the business, operations or properties of ABC after the date of this Agreement. The representations, warranties and agreements of ABC contained in this Agreement shall be deemed to have been made again at and as of the Effective Date (but the representations, warranties and agreements may reflect the consummation of any transactions consented to or approved in writing by XYZ) and shall then be true in all material respects; ABC shall have performed and complied with all agreements and conditions required by this Agreement to be performed or complied with by it prior to or at the Effective Date; and XYZ shall have been furnished with a certificate of the president or vice president of ABC, dated the Effective Date, certifying in such detail as XYZ may request to the fulfillment of the foregoing conditions.

(b) Opinion of Counsel of ABC. There shall have been delivered to XYZ the opinion, dated the Effective Date and addressed to XYZ and its shareholders, of DeSantis, Gaskill, Smith & Shenkman, P.A., attorneys for ABC, to the effect that:

(1) ABC is a corporation duly organized, validly existing and in good standing under the laws of the State of Florida with full corporate power to carry on its business as then conducted and is duly qualified to do business and is in good standing in each jurisdiction in which the character and location of the properties owned by it or the nature of the businesses transacted by it makes that qualification necessary when failure to qualify would have a material and adverse effect on the business of ABC. For the purposes of determining jurisdictions in which ABC is required to qualify as a foreign corporation, those attorneys may rely as to matters of fact upon certificates of officers of ABC.

(2) ABC authorized capital stock consists of 10,000,000 shares of common stock, par value of $.001 per share, of which 800,000 shares are presently outstanding, all of which are validly issued, fully paid and nonassessable. Other than the 90,000 options to acquire 90,000 shares of ABC stock, there are no options, warrants or other rights to purchase securities of ABC are outstanding, except as set forth in this Agreement and on the ABC Disclosure Statement. For the purpose of determining the existence of such options, warrants or other rights to purchase, those attorneys may rely on the books, records and minutes of ABC and upon certificates of officers of ABC.

(3) The execution, delivery and performance of this Agreement by ABC has been duly authorized and adopted by all requisite action of the Board of Directors of ABC and by the shareholders of ABC; and no consent or approval by any state or municipal agency is required under the Florida law; this Agreement has been duly executed and delivered by ABC and constitutes a valid and legally binding obligation of ABC enforceable in accordance with its terms, except as limited by equitable remedies, securities laws regarding indemnification, and bankruptcy, insolvency or other laws affecting the enforcement of creditors' rights; and when the Articles of Merger are filed pursuant to Florida law, and Georgia law the merger of XYZ into ABC shall become effective as contemplated in this Agreement.

(4) The shares of ABC Stock to be issued and delivered pursuant to this Agreement have been duly authorized and when issued and delivered will be validly issued, fully paid and nonassessable, free from preemptive rights.

(c) Corporate Authorization. XYZ shall have received copies of the resolutions adopted by the directors and shareholders of ABC, certified to be true and correct by the secretaries of the respective corporations.

(d) The shareholders of XYZ shall have duly approved this Agreement and the transactions contemplated hereby by requisite vote.

(e) All consents, permits and approvals of, or filings with, any government body or agency, or of any third party under any agreement, contract or document, necessary or appropriate for the consummation of the Merger shall have been obtained or made.

(f) There shall not be entered by any court or governmental, regulatory or administrative agency or instrumentality any order, injunction or decree that prohibits, restricts or delays consummation of the Merger.

2. Conditions to Obligations of ABC. All obligations of ABC under this Agreement are subject to the fulfillment, prior to the Effective Date, of each of the following conditions (any one or more of which, in the absolute discretion of ABC, may be waived in writing by ABC):

(a) Representations and Warranties. ABC shall not have discovered any material error, misstatement or omission in the representations and warranties made by XYZ in Article II of this Agreement or any material adverse change in the business, operations or properties of XYZ after the date of this Agreement. The representations, warranties and agreements of XYZ contained in this Agreement shall be deemed to have been made again at and as of the Effective Date (but the representations, warranties and agreements may reflect the consummation of any transactions consented to or approved in writing by ABC) and shall then be true in all respects; XYZ shall have performed and complied with all agreements and conditions required by this Agreement to be performed or complied with by it prior to or at the Effective Date; and ABC shall have been furnished with a certificate of the president of XYZ, dated the Effective Date, certifying in such detail as ABC may request to the fulfillment of the foregoing conditions.

(b) Corporate Authorization. The execution, delivery and performance of this Agreement and the Merger shall have been duly and effectively adopted and approved by the shareholders of XYZ in accordance with the Georgia Business Corporation Act, ABC shall have received copies of the resolutions adopted by the directors and shareholders, certified to be true and correct by the secretary of XYZ.

(c) Opinion of XYZ's Counsel. ABC shall have been furnished with an opinion, dated the Effective Date, of ____________attorneys for XYZ, to the effect that:

(1) XYZ is a corporation duly organized, and validly existing under the laws of the State of Georgia, has the corporate power to carry on its business as it is then being conducted and is duly qualified to do business and is in good standing in each jurisdiction in which the character and location of the properties owned by it or the nature of the businesses transacted by it makes that qualification necessary except for jurisdictions in which the failure to be so qualified or authorized or to be in good standing would not, individually or in the aggregate, have a material adverse effect on the business or financial condition of XYZ. For the purposes of determining jurisdictions in which XYZ is required to qualify as a foreign corporation, those attorneys may rely as to matters of fact upon certificates of officers of XYZ.

(2) XYZ's authorized capital stock consists of 1,000,000 shares of common stock, no par value per share, of which 10,000 shares are issued and outstanding, all of which are validly issued, fully paid and nonassessable. No options, warrants or other rights to purchase securities of XYZ are outstanding, except as set

forth on the XYZ Disclosure Statement. For the purpose of determining the existence of such options, warrants or other rights to purchase, those attorneys may rely on the books, records and minutes of XYZ and upon certificates of officers of XYZ.

(3) The execution, delivery and performance of this Agreement by XYZ have been duly authorized, adopted and approved by all requisite action of the Board of Directors and shareholders of XYZ in accordance with the Georgia Business Corporation Act, and no consent or approval by any state or municipal agency under the laws of the State of Georgia is required; which has not been obtained and this Agreement has been duly executed and delivered by XYZ and constitutes a valid and binding obligation of XYZ enforceable in accordance with its terms, except as limited by equitable remedies, securities laws regarding indemnification, and bankruptcy, insolvency or other laws affecting the enforcement of creditors' rights; and when the Articles of Merger are filed pursuant to Florida law, and Georgia law the merger of XYZ into ABC shall become effective as contemplated in this Agreement.

(d) Absence of Litigation. At the Effective Date no suit, action or other proceeding shall be pending or threatened before any court or other governmental agency in which it is sought to restrain or prohibit or to obtain damages or other relief in connection with this Agreement or the consummation of the contemplated transactions.

ARTICLE VI

TERMINATION

1. Termination. Anything in this Agreement to the contrary notwithstanding, this Agreement may be terminated and abandoned at any time prior to the Effective Date:

(a) By mutual consent of the Board of Directors of XYZ and ABC; or

(b) By the Board of Directors of XYZ or ABC if the Closing of the Merger shall not have occurred by July 30, 2008.

ARTICLE VII

MISCELLANEOUS

1. Survival of Representations and Warranties. All representations and warranties contained in this Agreement or in any certificate or other writing delivered pursuant hereto shall survive the Closing until the second anniversary of the Effective Date. Any representation and warranty herein or in any such certificate or writing shall be deemed to have been relied upon by the party or parties to which made, notwithstanding any investigation or inspection made by or on behalf of such party or parties and shall not be affected in any respect by any such investigation or inspection.

2. Effect of Termination. In the event of the termination of this Agreement pursuant to Article VI, this Agreement shall forthwith become void and of no further effect, without any liability on the part of any party or its directors, officers, shareholders or representatives (except for the provisions of Article IV, Section 3(b); Article VII, Section 2; Article VII, Section 3; and Article VII, Section 6, which shall remain in effect). Nothing in this Article VII, Section 2 shall relieve any party to this Agreement of liability for breach of this Agreement.

3. Post Termination Agreement. For a period of one year from the date of any termination of this Agreement, without the prior written consent of ABC, XYZ will not (a) acquire, offer to acquire, or agree to acquire by purchase or otherwise, beneficial ownership of any voting securities convertible into or with appertaining rights to acquire voting securities), of ABC; (b) make any solicitation of proxies to vote, or seek to advise or influence any person, entity or group with respect to the voting of, any voting securities of ABC; (c) form, join or in any way participate in, or in any manner provide any form of assistance to, a group with respect to any voting securities of ABC; or (d) otherwise act to seek to, assist or encourage any other person, entity or group in seeking to, control or influence the management, Board of Directors or policies of ABC or propose to effect any form of business combination with ABC or any restructuring, recapitalization or similar transaction with respect to ABC.

4. Amendment and Modification. Subject to applicable law, this Agreement may be amended, modified or supplemented only by written agreement of XYZ and ABC at any time prior to the Effective Date with respect to any of the terms contained herein except that after the approval by shareholders of XYZ contemplated herein, the amount or form of consideration to be received by the holders of XYZ Stock in the Merger may not be decreased or altered without the approval of such holders.

5. Extension; Waiver. At any time prior to the Effective Date, ABC, on the one hand, and XYZ, on the other hand, may (i) extend the time for the performance of any of the obligations or other acts of the other, (ii) waive any inaccuracies in the representations and warranties contained herein by the other or in any document, certificate or writing delivered pursuant hereto by or on behalf of the other or (iii) waive compliance with any of the agreements or conditions of the other contained herein, if permitted by applicable law. Any agreement on the part of any party to any such extension or waiver shall be valid only if set forth in an instrument in writing signed on behalf of such party by its duly authorized representative.

6. Expenses. Except as otherwise expressly provided herein, XYZ and ABC shall separately pay all expenses incurred by them in connection with the transactions contemplated by this Agreement.

7. Entire Agreement. This Agreement embodies the entire agreement between the parties. There have been and are no agreements, covenants, representations or warranties between the parties other than those expressly stated or expressly provided for in this Agreement.

8. Notices. All notices, requests, demands and other communications shall be in writing and shall be deemed to have been duly given if delivered or mailed, registered or certified postage prepaid:

a. If to XYZ, to:

With a copy to:

b. If to ABC, to:

With a copy to:

5. Agreement Binding. This Agreement is made pursuant to and shall be construed under the laws of the State of Florida. It shall inure to the benefit of and be binding upon XYZ and ABC, and their respective successors and assigns.

6. Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

IN WITNESS WHEREOF, XYZ, a Georgia corporation, ABC, a Florida corporation, acting through their duly authorized officers, all parties to this Agreement, this _____ day of ______________, 2008 have signed this Plan and Agreement of Merger.

XYZ, INC., a
Witnesses: Georgia corporation

BY:

Its:

As to XYZ, Inc., a
Georgia corporation

XYZ, INC. SHAREHOLDERS:

Tom Jones

Joe Jones

ABC, INC., a Florida corporation

BY:

Its: President

As to ABC, Inc.,
a Florida corporation

STATE OF
COUNTY OF

The foregoing instrument was acknowledged before me this day of , 2008, by ___________________, as _______________of XYZ, Inc., a Georgia corporation, on behalf of the corporation.

I am a Notary Public of the State (NOTARY SEAL) of Georgia and my commission
expires:
County of Residence:

STATE OF FLORIDA
COUNTY OF _________

The foregoing instrument was acknowledged before me this day of , 2008, by __________________, as ______________of ABC, Inc., a Florida corporation, on behalf of the corporation.

I am a Notary Public of the State (NOTARY SEAL) of Florida and my commission
expires: