



viewPOINTS

MERGERS,  
ACQUISITIONS,  
AND THE  
THEORY OF  
THE LINE





## Part 1: The Line

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You're a seller 24 hours from closing a \$50 million transaction. The deal has edged right up to the brink several times, leaving nerves – and relationships – frayed.

But you're past all that.

Then the buyer says, "There was an unexpected license transfer fee of \$5,000." Even though you think that expense should arguably be theirs, you agree to split the cost, to which the buyer responds, "No, we think you should bear it all."

To the buyer, it shouldn't be a big deal for the seller; just another \$2,500.00.

But it's not.

Because to the seller, it's much more than \$2,500.00<sup>1</sup>.

**You see, the buyer crossed The Line (capital 'T', capital 'L').**

Invisible? Yes.

But it is there. And tiptoeing over it could cost them.

Because instead of a happy seller with \$50 large in the bank, you have a seller with financial security and the memory of a final indignity.

- A seller that might swallow hard on what otherwise would have been a full-throated endorsement of the buyer to his staff.
- A seller that might be just a tad more feisty when the inevitable post-deal disagreement surfaces (and it will).
- A seller that might clip his response when asked to be a reference for the buyer in their next deal.

Same holds true for sellers.

If he or she overstays their negotiating welcome? They might make it through the letter of intent. The problem is sellers mistakenly believe that once the primary business issues have been settled – price, structure, disposition of assets and liabilities, non-compete, and more – that they're essentially done. The rest is just details, so they spend what remains of their "negotiating currency," e.g. transactional goodwill, getting to a signed LOI.

What they don't know, or don't pay attention to, is that there's a whole lot of negotiating still to be done, leaving buyers with more than enough opportunities to even the score – and more (see Part 2).

"But wait," you say, "in the end, won't the parties defer to the Excel gods and their dispassionate worksheets to make a final decision? You know, to do what's in their economic best interests? After all, it's business, nothing personal." And in most situations, at some point in a difficult negotiation, this kind of thinking will eventually make an appearance.

Or not.

### The Magnitude of Emotion in M&A

There are systemic reasons why deal-making can bring out the worst in us.

You see, most business deals aren't for a product in which the seller has devoted much of their life and passion.

Most business deals don't have the financial future of the seller and their family and employees at stake. And, oh yeah, their legacy as well.

Most business deals do not require an individual buyer and an individual seller (you know, humans) to go mano y mano negotiating a litany of deal points over what can easily take four, five, even six months to reach the dotted line.

**So, emotions can pinball back and forth until the deal ultimately tilts.**

That's why one of the most important – and overlooked – reasons to engage an intermediary is to, well, **intermediate** communications between parties; re-packaging a "they're out to nail me" into a dulcet "we have concerns regarding valuation."

So, in many situations, the parties may have a king's banquet of emotions to swallow to close a transaction.

Some will.

But many won't.

**All of which brings us to The Theory of The Line.**

Quite simply, it goes like this:

Buyers and sellers should negotiate heartily right up to the point where they find themselves only a metaphorical inch or two **before** they get to **The Line** because the emotional toll that last inch or more may take is going to cost a lot. And almost assuredly, far more than it's worth. Worse yet, you likely won't know when the bill comes due or even how much you had to pay.

Got it.

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<sup>1</sup> \$2,500.00 in addition to the \$2,500.00 the seller was willing to pick up.



But where exactly is this line we speak of?

When the tenor of negotiations moves from surely to surly. When responsiveness goes from PDQ to long overdue. When concession requests morph from hefty to petty. Unless your sensitivity level hovers around “brick,” you’ll know when you’re getting close.

## Part 2: Opportunities for Redress

Imagine that your counterpart has crossed the line.

Where can you go to get back some of the give backs you gave to get the deal to a GO?

**Sidebar:** *The scenarios below come from the perspective of a miffed buyer. So, their tactics might make them as if they are spawn of Machiavelli and Cruella DeVille. Nothing can be further from the truth. First, in our examples, their actions are a reaction to a **seller** stepping over the line. That’s why they’re miffed. Second, just as the seller’s job is to extract as much value from the buyer, the buyer’s is to buy as cheaply as possible; neither can lay claim to the moral high ground. Third, these things can go both ways, placing the black hat squarely upon a miffed seller.*

### Quality of Earnings – predominately an opportunity for buyers

As part of the due diligence process, buyers are increasingly obtaining quality of earnings reports. More than just verifying that the financials presented are thorough and accurate, the so-called “Q of E” is intended to give the buyer a window into the earnings before interest, taxes, depreciation, and amortization that they can anticipate **going forward**.

For example, in addition to verifying the appropriateness of any add-backs a seller might have claimed, a Q of E might reflect a highly anticipated reimbursement change, investments in personnel, technology, and other infrastructure that may be long past due, or anticipated changes in wages and benefits necessary to conform with the buyer’s human resources policies.

With any reductions in EBITDA often (a) somewhat subjective and (b) a gilded invitation to renegotiate price, a buyer with PTSD (post-transaction stress disorder) will be sorely tempted to use the quality of earnings report to chip away at EBITDA.

### Working capital – an opportunity for buyers and sellers

This one seems so simple.

Virtually every letter of intent comes with a proviso that the deal includes “adequate” working capital – a figure that will be determined prior to close, and “squared-up” within 90 days thereafter.

Innocent enough.

Except when you consider that calculating “adequate” working capital is about as precise as a shotgun blast (the variables that inform the end results can be extremely subjective – especially if the company is growing – or declining).

When you toss in the fact that any shortfalls in working capital are taken against the purchase price<sup>2</sup>, it doesn’t take much for a disgruntled buyer to nudge up the working capital target to a level that assures them a tidy claw back.

And rest assured.

This happens.

A lot.

### Indemnification – mostly, but not exclusively a buyer opportunity

One of the most significant items that must be negotiated post-LOI are indemnification provisions.

As a refresher, particularly in health care where there is substantial exposure to third party claims from government or private payors, sellers must **indemnify** buyers from the consequences of any wrongdoings, **intentional or not**, that occurred during the seller’s “watch.”

While wholly appropriate, sellers loath even the possibility of having to pay back any of their hard-won purchase price.

The good news is that buyers are often willing to limit indemnification in terms of dollars, time, or both.

But as you would rightly guess, an unscathed buyer will be more amenable to such limitations than one that felt they had to crawl through broken glass to get to the dotted line.

### Escrow – an opportunity for buyers and sellers

Related to indemnification, how much escrow will a buyer require to secure unknown liabilities and a portion of the indemnification?

A happy buyer might agree to, say 10% of the purchase price, and release a third of it at 6 months, 12 months, and finally 18 months after closing.

<sup>2</sup> To be sure, in most situations, this provision cuts both ways: working capital “long-falls” above the established target are typically **added** to the purchase price.



An unhappy buyer? 20% released in a lump sum after 18 months. “After all, if you’re confident that there aren’t any gremlins lying about and the escrow is in an interest-bearing account, there shouldn’t be a problem.”

**Employment or transitional agreements, scope of non-competes – an opportunity for buyers and sellers**

The cost – or value – of a deal to a buyer or seller isn’t solely limited to the price paid for the business. There’s the matter of salary, benefits, duration, and other terms related to employment or consulting agreements, if applicable. Then there’s the non-compete to consider. How long? What geography? What products and services?

**Wait, there’s more.**

While the above might be the juiciest areas buyers can tap into to squeeze sellers that may have “crossed the line,” they are by no means the only ones.

Think about all the details buyers will check up on, and all the items that go into a definitive purchase agreement. Now think about how many shades of grey there are in health care. Items that can balance on the head of a pin as to whether they fall in the “good” box, or the “not so good” box.

- Regulatory compliance: where exactly is the line of demarcation between an honest mistake, which likely has no impact on the deal, and disorganization that very well could?

- Background checks: how much should the buyer be concerned about some minor infraction that happened 30 years ago but remains a footnote in your “permanent record?” Or worse yet, any “iffy” things entombed in an ever-expanding digital footprint (know this: buyers Google).
- Chart reviews: is a representative sample good enough or will the buyer request the Full Monty and review them all?
- Human Resources audit: how might a buyer react if otherwise **appropriate** services were delivered by a caregiver whose license had inadvertently lapsed for a week but has since been adjudicated?

Any one of these items by themselves could be grounds for some kind of post LOI renegotiation. But put two or three together? Now you have the makings of an increase in risk, which could easily slice a turn or two off the multiple of EBITDA that informed the initial valuation.

The bottom line is that negotiators that are top line know it’s not a line that the right line is the fine line right before The Line, and if you lollygag past the line, you can land on a dotted line that at the end of the line is well out of line with the deal you landed when you took a hard line.

Clear enough.

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