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Asset Acquisitions: a Colloquy

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ASSET ACQUISITIONS: A COLLOQUY

BYRON F. EGAN, H. LAWRENCE TAFE, III, AND
SAMUEL C. THOMPSON, JR.

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I. INTRODUCTION

This article first discusses some of the basic principles involved in the drafting of acquisition agreements. The focus is on asset acquisitions, including the Model Asset Purchase Agreement, which was recently published by the American Bar Association ("ABA").¹ The article then presents the transcript of a *Mock Negotiation of an Asset Acquisition*, which was presented at the University of Miami School of Law's *Fifth Annual Institute on Mergers & Acquisitions: Corporate, Securities & Related Aspects*. The authors participated in that negotiation.

Section II introduces the three principal structures for effectuating a sale of a business; Section III addresses the issue of whether an acquisition should be structured as an asset acquisition; and Section IV discusses a key issue in any asset acquisition: the potential that the buyer may have successor liability for liabilities of the seller that are not explicitly assumed. Section V addresses ethical issues that can arise in asset acquisitions, and Section VI discusses the organization of the Model Asset Purchase Agreement. Section VII presents the transcript of the *Mock Negotiation of an Asset Acquisition*, and the Appendices contain the sections (without the commentary) of the draft of Model Asset Purchase Agreement that are discussed in the Mock Negotiation.

¹ American Bar Association, Section of Business Law, Model Asset Purchase Agreement With Commentary (2001)[hereinafter the "*Model Asset Purchase Agreement*"]. As a basis for the bulk of the materials included herein, the authors have utilized portions of a draft of the Model Asset Purchase Agreement and certain other materials prepared for programs of the Negotiated Acquisitions Committee. The authors express appreciation to the many members of the Asset Acquisition Task Force whose contributions have made these materials possible. These materials, however, are solely the responsibility of the authors and have not been reviewed or approved by either the Negotiated Acquisitions Committee or its Asset Acquisition Agreement task force.

All of the issues discussed in this article are explored in greater detail in the Model Asset Purchase Agreement, which every business lawyer should have in his or her library.

II. ALTERNATIVE STRUCTURES FOR SALES OF BUSINESSES

The actual form of the sale of a business can involve many variations. Nonetheless, there are many common threads involved for the draftsman. The principal segments of a typical agreement for the sale of a business include:

- Introductory material (i.e., opening paragraph and recitals);
- The price and mechanics of the business combination;
- Representations and warranties of the buyer and seller;
- Covenants of the buyer and seller;
- Conditions to closing;
- Indemnification;
- Termination procedures and remedies; and
- Miscellaneous (boilerplate) clauses.

There are many basic legal and business considerations for the draftsman involved in the preparation of agreements for the sale of a business. These include federal income taxes; state sales, use and transfer taxes; federal and state environmental laws; federal and state securities laws; the accounting treatment; state takeover laws; problems involving minority shareholders; the purchaser's liability for the seller's debts and contingent liabilities; insolvency and creditors' rights laws; problems in transferring assets (mechanical and otherwise); state corporation laws; stock exchange rules; pension, profit-sharing and other employee benefit plans; antitrust laws; foreign laws; employment, consulting and non-compete agreements; union contacts and other labor considerations; the purchaser's security for breach of representations and warranties; insurance; and a myriad of other considerations.

There are three basic forms of business acquisitions:

1. Statutory business combinations (e.g., mergers, consolidations and share exchanges);
2. Purchases of shares; and
3. Purchases of assets.

A. Mergers and Consolidations

Mergers and consolidations involve a vote of shareholders, resulting in the merging or disappearance of one corporate entity into or with another corporate entity. Mergers and consolidations can be structured to be taxable or non-taxable for federal income tax purposes. Simply stated, if stock is the consideration for the acquisition of the non-surviving corporation, the merger can qualify as an *A* reorganization under Section 368(a)(1)(A) of the Internal Revenue Code of 1986, as amended (the "Code").² Thus, a shareholder of the target corporation receives stock in the purchasing corporation wholly tax-free. However, a shareholder of the target company who receives only boot (i.e., consideration other than purchaser's stock or other purchaser securities under certain circumstances) is normally taxed as if the shareholder had sold his stock in the target corporation in a taxable transaction. Generally stated, a shareholder who receives both stock and boot is not taxed on the stock received but is taxed on the boot. The boot is taxed either as a dividend or as a capital gain, but not in excess of the gain which would have been realized if the transaction were fully taxable.

B. Purchases of Shares

Purchases of shares of the target company can likewise be handled on a taxable or non-taxable basis. In a voluntary stock purchase, the acquiring corporation must generally negotiate with each selling shareholder individually. An exception to this is a mechanism known as the share exchange permitted by certain state business corporation statutes³ under which the vote of holders of the requisite percentage (but less than all) of shares can bind all of the shareholders to exchange their shares pursuant to the plan of exchange approved by such vote.

Generally speaking, if the purchasing corporation acquires the stock of the target corporation solely in exchange for the purchaser's voting stock and, after the transaction the purchasing corporation owns stock in the target corporation possessing at least 80% of the target's voting power and at least 80% of each class of the target corporation's non-voting stock, the transaction can qualify as a tax-free *B* reorganization.⁴

Note that one disadvantage of an acquisition of the target corporation's stock is that the purchasing corporation does not obtain a step-up in the basis

² I.R.C. § 368(a)(1)(A) (2001).

³ See, e.g., Tex. Bus. Corp. Act. Ann. Art. 5.02 and 5.06 (Vernon 2000).

⁴ See I.R.C. § 368(a)(1)(B) (2001).

of the target corporation's assets for tax purposes. If the stock acquisition qualifies as a qualified stock purchase under Section 338 of the Code (which generally requires a taxable acquisition by a corporation of at least 80% of the target corporation's stock within a 12-month period), an election may be made to treat the stock acquisition as a taxable asset purchase for tax purposes. However, after the effective repeal of the *General Utilities*⁵ doctrine, discussed *infra*, Section 338 elections are seldom made unless the target is a member of a group of corporations filing a consolidated federal income tax return (or, since 1994, an S corporation) and the seller(s) agrees to a Section 338(h)(10) election which causes the seller to bear the tax on the deemed asset sale, since the present value of the tax savings to the buyer from a stepped-up basis in target's assets is less than the corporate-level tax on the deemed asset sale.

C. Asset Purchases

Generally speaking, asset purchases feature the advantage of specifying the assets to be acquired and the liabilities to be assumed. A disadvantage involved in asset purchases in recent years, however, has been the repeal, pursuant to the Tax Reform Act of 1986, of the so-called *General Utilities* doctrine. Prior to then, the Code generally exempted a C corporation from corporate-level taxation (other than recapture) on the sale of its assets to a third party in connection with a complete liquidation of the corporation and the distribution of the proceeds to its shareholders. After the effective repeal of the *General Utilities* doctrine, a C corporation generally recognizes full gain on a sale of assets even in connection with a complete liquidation. Thus, if a purchasing corporation buys the target's assets and the target corporation liquidates, the target pays a corporate-level tax on its full gain from the sale of its assets (not merely the recaptured items). The shareholders of the target are taxed as if they had sold their stock for the liquidation proceeds (less the target's corporate tax liability). Absent available net operating losses, if the sale is a gain, the *General Utilities* doctrine repeal thus makes an asset sale less advantageous for the shareholders.

Generally speaking, for a non-taxable acquisition of assets, the purchaser must acquire substantially all of the target's assets *solely* in exchange for the voting stock of the purchaser.⁶ Basically, a C reorganization is disqualified unless the target distributes the purchaser's stock, securities and other

⁵ Gen. Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

⁶ See I.R.C. § 368(a)(1)(C) (2001).

properties it receives, as well as its other properties, in pursuance of the plan of reorganization.

There are a number of other tax requirements applicable to tax-free and taxable reorganizations, too numerous to cover in this article.

III. WHETHER TO DO ASSET PURCHASE

An acquisition might be structured as an asset purchase for a variety of reasons. It may be the only structure that can be used when a noncorporate seller is involved or where the buyer is only interested in purchasing a portion of the company's assets or assuming only certain of its liabilities. If the stock of a company is widely held or it is likely that one or more of the shareholders will not consent, a sale of stock (except perhaps by way of a statutory merger or share exchange) may be impractical. In many cases, however, an acquisition can be structured as a merger, a purchase of stock or a purchase of assets.

As a general rule, often it will be in the buyer's best interest to purchase assets but in the seller's best interest to sell stock or merge. Because of these competing interests, it is important that counsel for both parties be involved at the outset in weighing the various legal and business considerations in an effort to arrive at the optimum, or at least an acceptable, structure. Some of the considerations are specific to the business in which a company engages, some relate to the particular corporate or other structure of the buyer and the seller, and others are more general in nature.

Set forth below are some of the more typical matters to be addressed in evaluating an asset purchase as an alternative to a stock purchase or a merger or a share exchange ("statutory combination").

A. *Purchased Assets*

Asset transactions are typically more complicated and more time consuming than stock purchases and statutory combinations. In contrast to a stock purchase, the buyer in an asset transaction will acquire only the assets described in the acquisition agreement. Accordingly, the assets to be purchased are often described with specificity in the agreement and the transfer documents. The usual practice, however, is for buyer's counsel to use a broad description that includes all of the seller's assets, while describing the more important categories, and then to specifically describe the assets to be excluded and retained by the seller. Often excluded are cash, accounts receivable, litigation claims or claims for tax refunds, personal assets and certain records pertaining only to the seller's organization. This puts the burden on the seller to specifically identify the assets that are to be retained.

A purchase of assets also is cumbersome because transfer of the seller's assets to the buyer must be documented, and separate filings or recordings may be necessary to effect the transfer. This often will involve separate real property deeds, lease assignments, patent and trademark assignments, motor vehicle registrations and other evidences of transfer that cannot simply be covered by a general bill of sale or assignment. Moreover, these transfers may involve assets in a number of jurisdictions, all with different forms and other requirements for filing and recording.

B. Contractual Rights

Among the assets to be transferred will be the seller's rights under contracts pertaining to its business. Often these contractual rights cannot be assigned without the consent of other parties. The most common examples are leases that require consent of the lessor and joint ventures or strategic alliances that require consent of the joint venturer or partner. This can be an opportunity for the third party to request confidential information regarding the financial or operational capability of the buyer and to extract concessions in return for granting its consent. While sometimes this can be avoided by a purchase of stock or statutory combination, many leases and other agreements require consent to any change in ownership or control. Many government contracts cannot be assigned and require a novation with the buyer after the transaction is consummated. This can pose a significant risk to a buyer.

Asset purchases also present difficult questions about ongoing coverage for risks insured against by the seller. Most insurance policies are, by their terms, not assignable and a buyer may not be able to secure coverage for acts involving the seller or products it manufactures or services it renders prior to the closing.

C. Governmental Authorizations

Transfer of licenses, permits or other authorizations granted to a seller by governmental or quasi-governmental entities may be required. In some cases, an application for a transfer or, if the authorization is not transferable, for a new authorization, may involve hearings or other administrative delays in addition to the risk of losing the authorization. Many businesses may have been grandfathered under regulatory schemes, and are thereby exempted from any need to make costly improvements to their properties; the buyer may lose the grandfather benefits and be subject to additional compliance costs.

D. *Assumed Liabilities*

An important reason for structuring an acquisition as an asset transaction is the desire on the part of a buyer to limit its responsibility for liabilities of the seller, particularly unknown or contingent liabilities.

Unlike a stock purchase or statutory combination, where the acquired corporation retains all of its liabilities and obligations, known and unknown, the buyer in an asset purchase has an opportunity to determine which liabilities of the seller it will contractually assume. Accordingly, one of the most important issues to be resolved is what liabilities incurred by the seller prior to the closing are to be assumed by the buyer. It is rare in an asset purchase for the buyer not to assume some of the seller's liabilities relating to the business, as for example the seller's obligations under contracts for the performance of services or the manufacture and delivery of goods after the closing. Most of the seller's liabilities will be set forth in the representations and warranties of the seller in the acquisition agreement and in the seller's disclosure letter or schedules, reflected in the seller's financial statements or otherwise disclosed by the seller in the course of the negotiations and due diligence. For these known liabilities, the issue as to which will be assumed by the buyer and which will stay with the seller is reflected in the express terms of the acquisition agreement.

For unknown liabilities or liabilities that are imposed on the buyer as a matter of law, the solution is not so easy and lawyers spend significant time and effort dealing with the allocation of responsibility and risk in respect of such liabilities. Many acquisition agreements provide that none of the liabilities of the seller, other than those specifically identified, are being assumed by the buyer and then give examples of the types of liabilities not being assumed (e.g. tax, products and environmental liabilities). There are, however, some recognized exceptions to a buyer's ability to avoid the seller's liabilities by the terms of the acquisition agreement, including the following:

- Bulk sales laws permit creditors of a seller to follow the assets of certain types of sellers into the hands of a buyer unless specified procedures are followed.
- Under fraudulent conveyance or transfer statutes, the assets acquired by the buyer can be reached by creditors of the seller under certain circumstances. Actual fraud is not required and a statute may apply merely where the purchase price is not deemed fair consideration for the transfer of assets and the seller is, or is rendered, insolvent.

- Liabilities can be assumed by implication, which may be the result of imprecise drafting or third-party beneficiary arguments that can leave a buyer with responsibility for liabilities of the seller.
- Some state tax statutes provide that taxing authorities can follow the assets to recover taxes owed by the seller; often the buyer can secure a waiver from the state or other accommodation to eliminate this risk.
- Under some environmental statutes and court decisions, the buyer may become subject to remediation obligations with respect to activities of a prior owner of real property.
- In some states, courts have held buyers of manufacturing businesses responsible for tort liabilities for defects in products manufactured by a seller while it controlled the business. Similarly, some courts hold that certain environmental liabilities pass to the buyer that acquires substantially all the seller's assets, carries on the business and benefits from the continuation.
- The purchaser of a business may have successor liability for the seller's unfair labor practices, employment discrimination, pension obligations or other liabilities to employees.
- In certain jurisdictions, the purchase of an entire business where the shareholders of the seller become shareholders of the buyer can cause a sale of assets to be treated as a *de facto merger*. This theory would result in the buyer assuming all of the seller's liabilities.

None of these exceptions prevents a buyer from attempting to limit the liabilities to be assumed. Thus, either by compliance with a statutory scheme (e.g., the bulk sales laws or state tax lien waiver procedure) or by careful drafting, a conscientious buyer can take some comfort in the fact that most contractual provisions of the acquisition agreement should be respected by the courts and should protect the buyer against unforeseen liabilities of the seller. However, courts have adopted a number of theories of successor liability which can override the express terms of the contract. See Section IV below.

It is important to recognize that in a sale of assets the seller retains primary responsibility for satisfying all its liabilities, whether or not assumed by the buyer. Unlike a sale of stock or a statutory combination, where the shareholders may only be liable to the buyer through the indemnification provisions of the acquisition agreement, a creditor still can proceed directly against the seller after an asset sale. If the seller is liquidated, its shareholders may remain subject to claims of the seller's creditors under statutory or common law principles, although this might be limited to the proceeds received on liquidation and expire after a period of time. Under some state

corporate law statutes, a seller's directors may become personally liable to its creditors if the seller distributes the proceeds of a sale of assets to its shareholders without making adequate provision for its liabilities.

In determining what liabilities and business risks are to be assumed by the buyer, the lawyers drafting and negotiating the acquisition agreement need to be sensitive to the reasons why the transaction is being structured as a sale of assets. If the parties view the transaction as the acquisition by the buyer of the entire business of the seller, as in a stock purchase, and the transaction is structured as a sale of assets only for tax or other technical reasons, then it may be appropriate for the buyer to assume most or all liabilities, known and unknown. If instead the transaction is structured as a sale of assets because the seller has liabilities the buyer does not want to assume, then the liabilities to be assumed by the buyer will be correspondingly limited.

A buyer may be concerned about successor liability exposure and not feel secure in relying on the indemnification obligations of the seller and its shareholders to make it whole. Under these circumstances, it might also require that the seller maintain in effect its insurance coverage or seek extended coverage for preclosing occurrences which could support these indemnity obligations for the benefit of the buyer.

E. Income Taxes

In most acquisitions, the income tax consequences to the buyer and to the seller and its shareholders are among the most important factors in determining the structure of the transaction. The shareholders will prefer a structure that will generate the highest after-tax proceeds to them, while the buyer will want to seek ways to minimize taxes after the acquisition. The ability to reconcile these goals will depend largely on whether the seller is a C or an S corporation or is an entity taxed as a partnership.

In a taxable asset purchase, the buyer's tax basis in the purchased assets will be equal to the purchase price (including assumed liabilities). An important advantage to the buyer of an asset purchase is the ability to allocate the purchase price among the purchased assets on an asset-by-asset basis to reflect their fair market value, often increasing the tax basis from that of the seller. This step-up in basis can allow the buyer greater depreciation and amortization deductions in the future and less gain (or greater loss) on subsequent disposition of those assets. (In the case of an S corporation, the same result may be achieved by a buyer purchasing stock and making a joint

election with the selling shareholders under Section 338 of the Code to treat the purchase of stock as a purchase of assets).⁷

A significant disadvantage of an asset sale to a C corporation and its shareholders results from the repeal, as of January 1, 1987, of the so-called *General Utilities* doctrine. This doctrine had exempted a C corporation from corporate-level taxation (other than recapture) on the sale of its assets to a third party at a gain followed by a complete liquidation and the distribution of the proceeds to its shareholders. With the repeal of the *General Utilities* doctrine, a C corporation will generally recognize gain on a sale of assets to a third party or on the in-kind distribution of its appreciated assets in a complete liquidation. Thus, if a buyer purchases assets and the seller liquidates, the seller will recognize gain or loss on an asset-by-asset basis, which will be treated as ordinary income or loss or capital gain or loss, depending on the character of each asset. However, corporations do not receive the benefit of a lower rate on long-term capital gains, and the gains can be taxed at a rate as high as 35%. Its shareholders then will be taxed as if they had sold their stock for the proceeds received in liquidation (after reduction by the seller's corporate tax liability). Gain or loss to the shareholders is measured by the difference between the fair market value of the cash or other assets received and the tax basis of the shareholders' stock.

Absent available net operating losses, the repeal of the *General Utilities* doctrine can make an asset transaction significantly less advantageous for the shareholders of a C corporation. A sale of stock would avoid this double tax. However, a buyer purchasing stock of a C corporation will obtain a stepped up basis only in the stock, which is not an asset it would be able to amortize or depreciate for tax purposes, and the buyer generally would not want to succeed to the seller's presumably low tax basis in the acquired assets.

The tax treatment to the seller and its shareholders in an S corporation's sale of assets will depend upon the form of consideration, the relationship of the tax basis in the seller's assets (the inside basis) to the tax basis of its shareholders in their stock (the outside basis), whether there is built-in gain (*i.e.*, fair market value of assets in excess of tax basis at the effective date of the S corporation election), and whether the seller's S status will terminate. Generally, the amount and character of the gain or loss at the corporate level will pass through to the shareholders and be taken into account on their individual tax returns, thereby avoiding a double tax. However, the purchase price will be allocated among the S corporation's assets and, depending on the relationship of the inside basis and the outside basis, the amount of the gain or loss passed through to the shareholders for tax purposes may be more

⁷ See I.R.C. § 338(h)(10) (2001).

or less than if the same price had been paid for the stock of the S corporation. An S corporation that was formerly a C corporation also must recognize built-in gain at the corporate level, generally for tax years beginning after 1986, on assets that it held at the time of its election of S status, unless ten years have elapsed since the effective date of the election.

The preceding discussion relates to federal income taxes under the Code. Special consideration must be given to state and local tax consequences of the proposed transaction.

F. *Transfer Taxes*

Many state and local jurisdictions impose sales, documentary or similar transfer taxes on the sale of certain categories of assets. For example, a sales tax might apply to the sale of tangible personal property, other than inventory held for resale, or a documentary tax might be required for recording a deed for the transfer of real property. In most cases, these taxes can be avoided if the transaction is structured as a sale of stock or a statutory combination. Responsibility for payment of these taxes is negotiable, but it should be noted that the seller will remain primarily liable for the tax and that the buyer may have successor liability for them. It therefore will be in each party's interest that these taxes are paid on a timely basis.

State or local taxes on real and personal property should also be examined, because there may be a reassessment of the value for tax purposes on transfer. However, this can also occur in a change in control resulting from a sale of stock or a merger.

G. *Employment Issues*

A sale of assets may yield more employment or labor issues than a stock sale or statutory combination, because the seller will typically terminate its employees who may then be employed by the buyer. Both the seller and buyer run the risk that employee dislocations from the transition will result in litigation or, at the least, ill will of those employees affected. The financial liability and risks associated with employee benefit plans, including funding, withdrawal, excise taxes and penalties, may differ depending on the structure of the transaction. Responsibility under the Worker Adjustment and Retraining Notification Act⁸ ("*WARN Act*") can vary between the parties, depending upon whether the transaction is structured as an asset purchase, stock purchase or statutory combination. In a stock purchase or statutory

⁸ See 29 U.S.C. §§ 2101(a)-2101(b) (1988).

combination, any collective bargaining agreements generally remain in effect. In an asset purchase, the status of collective bargaining agreements will depend upon whether the buyer is a successor, based on the continuity of the business and work force or provisions of the seller's collective bargaining agreement. If it is a successor, the buyer must recognize and bargain with the union.

IV. SUCCESSOR LIABILITY

A. Background

In any acquisition, regardless of form, one of the most important issues to be resolved is what liabilities incurred by the seller prior to the closing are to be assumed by the buyer. Most of such liabilities will be known - set forth in the acquisition agreement and in the exhibits thereto, or otherwise disclosed by seller to buyer in the course of the negotiations and due diligence in the acquisition. For unknown liabilities, the legal presumption as to who bears the risk differs markedly depending upon which of the three conventional acquisition structures has been chosen by the parties.

- In a stock acquisition transaction, since the acquired corporation simply has new owners of its stock and has not changed in form, such corporation retains all of its liabilities and obligations, known or unknown, to the same extent as it would have been responsible for such liabilities prior to the acquisition. In brief, the acquisition has had no effect whatsoever on the liabilities of the acquired corporation.
- In a merger transaction, where the acquired corporation is merged out of existence, all of its liabilities are assumed, as a matter of state merger law, by the corporation which survives the merger. Unlike the stock acquisition transaction, a new entity will be responsible for the liabilities. However, the practical result is the same as in a stock transaction; i.e. the buyer will have assumed all of the preclosing liabilities of the acquired corporation as a matter of law.
- By contrast, in an asset purchase, the contract between the parties is expected to determine which of the assets will be acquired by the buyer and which of the liabilities will be assumed by the buyer. Thus, the legal presumption is very different from the stock and merger transactions: the buyer will not assume liabilities of the selling corporation which the buyer has not expressly agreed to assume by contract.

There are a number of business reasons for structuring an acquisition as an asset transaction rather than as a merger or purchase of stock. Some are driven by the obvious necessities of the deal; *e.g.*, if less than all of the assets of the business are being acquired, such as when one acquires a division of a large corporation. However, there is probably no more important reason for structuring an acquisition as an asset transaction than the desire on the part of the buyer to limit by express provisions of a contract the liabilities - particularly unknown or contingent liabilities - which the buyer does not intend to assume.

There have been some recognized exceptions to the buyer's ability to avoid seller's liabilities by the terms of a contract between the seller and the buyer:

- Bulk sales laws have permitted creditors of the seller to follow the assets into the hands of the buyer if the bulk sales law procedures are not complied with.
- Fraud - if the deal is really a sham and not a *bona fide* arm-length transaction, or if seller is insolvent and inadequate consideration is paid by the buyer, under the fraudulent transfer statutes.
- Implied Assumption - really a matter of sloppy drafting coupled with some third-party beneficiary arguments which leave the buyer with an unexpected problem.
- Tax liens - some state tax statutes provide that taxing authorities can follow the assets to recover taxes owed by the selling company; generally a waiver from the state or other accommodation can resolve.

None of these exceptions prevents a buyer from limiting the liabilities to be assumed from a selling company. By compliance with a statutory scheme (*e.g.*, the bulk sales laws, state tax lien waiver procedure, etc.) or by careful drafting (implied assumptions, representations and structures that negate the elements of a fraudulent transfer), a buyer could structure an asset purchase transaction to protect the buyer against liabilities of the seller that the buyer does not intend to assume under the terms of the asset purchase agreement.

B. *Successor Liability Doctrines*

During the past two decades, the buyer's level of comfort in asset purchase transactions has dropped somewhat. During that period, courts have developed some theories which require buyers to be responsible for seller preclosing liabilities even in the face of express contractual language in the asset purchase agreement to the contrary. In addition, since the early

1980's federal and state statutes have imposed strict liability for certain environmental problems on parties not necessarily responsible for causing those problems. These developments, particularly in the areas of product liability, labor and employment obligations and environmental liability have created problems for parties in asset purchase transactions. The remainder of this section will briefly describe the principal theories of successor liability and will address some of the techniques which lawyers have used to deal with those problems.

1. DE FACTO MERGER

Initially, the *de facto* merger theory was based upon the notion that, while a transaction had been structured as an asset purchase, the result looked very much like a merger. The critical elements of a *de facto* merger were that the selling corporation had dissolved right away and that the shareholders of the selling corporation had received stock in the buying corporation. These two facts made the result look very much like a merger. The theory was applied, for example, to hold that dissenters' rights granted by state merger statutes could not be avoided by structuring the transaction as an asset sale. While this may have pushed an envelope or two, the analysis was nonetheless framed within traditional common law concepts of contract and corporate law. However, the *de facto* merger doctrine was expanded in 1974 to eliminate the requirement that the corporation dissolve and, more importantly, to introduce into the equation the public policy consideration that if successor liability were not imposed, a products liability plaintiff would be left without a remedy. In balancing the successor company's interest against such a poor plaintiff, the plaintiff wins.⁹

The elements of a *de facto* merger were set forth about ten years after the *Knapp* case in *Hercules*:¹⁰

- (1) There is a continuation of the enterprise of the seller corporation, so that there is a continuity of management, personnel, physical location, assets and general business operations.
- (2) There is a continuity of shareholders which results when the purchasing corporation pays for the acquired assets with shares of its own stock, this stock ultimately coming to be held by the shareholders of the seller corporation so that they become a constituent part of the purchasing corporation.

⁹ *Knapp v. N. Am. Rockwell Corp.*, 506 F.2d 361 (3d Cir. 1974).

¹⁰ *Philadelphia Elec. Co. v. Hercules*, 762 F.2d 303 (3d Cir. 1985).

- (3) The seller corporation ceases its ordinary business operations, liquidates and dissolves as soon as legally and practically possible.
- (4) The purchasing corporation assumes those obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operation of the seller corporation.

In 1995 the United States District Court for the Eastern District of Pennsylvania applied the doctrine of *de facto* merger to find successor liability for environmental costs.¹¹ The Court indicated that all four elements of *de facto* merger set forth in *Hercules* did not have to be present (although in this case all four factors were found). In addition the Court determined that Pennsylvania law does not require that the seller's former shareholders take control over the buyer in order to satisfy the continuity of a shareholder factor above-mentioned. The Third Circuit reversed the District Court in this case and held that the *de facto* merger doctrine would not apply in the circumstances of this case. The facts of *SmithKline Beecham* were somewhat unusual. Beecham had bought assets of a company from Rohm and Haas in 1978. Rohm and Haas had given an indemnification to Beecham for all liabilities prior to the closing and Beecham indemnified Rohm and Haas for liabilities following the 1978 transaction. Rohm and Haas in turn had bought the company in 1964 - also in an asset transaction. The District Court had held that the 1964 transaction satisfied the *de facto* merger rule which meant that Rohm and Haas would be liable for the prior owner's unknown liabilities and therefore those pre-1964 liabilities would be swept up in the indemnification which Rohm and Haas had given to Beecham fourteen years later. On appeal the Third Circuit determined that in the 1978 indemnification provision, Rohm and Haas did not intend to include liabilities prior to its ownership in its indemnification of Beecham.¹² Thus the Third Circuit made the following determinations:

In this case, the parties drafted an indemnification provision that excluded successor liability. SKB and R & H chose to define 'Business' and limit its meaning to New Whitmoyer. Under these circumstances, we believe it was not appropriate for the district court to apply the *de facto* merger doctrine to alter the effect of the indemnification provision.

¹¹ *SmithKline Beecham Corp. v. Rohm and Haas Co.*, 1995 WL 117671 (E.D. Pa. Mar. 17, 1995).

¹² *SmithKline Beecham Corp. v. Rohm and Haas Co.*, 89 F.3d 154 (3rd Cir. 1996).

But where two sophisticated corporations drafted an indemnification provision that excluded the liabilities of a predecessor corporation, we will not use the *de facto* merger doctrine to circumvent the parties' objective intent.

The Third Circuit's reasoning suggests that if two parties intend that successor liability shall not obtain, the Court will respect those intentions. If this is so, the opinion seriously undermines the very basis of the *de facto* merger doctrine — that a court will use the doctrine to impose liability on the successor in spite of the express intentions of the parties in an asset purchase agreement to the contrary.¹³

Some states have endeavored to legislatively repeal the *de facto* merger doctrine. See, for example, Texas Business Corporation Act Article 5.10B, which provides that in relevant part that “[a] disposition of any, all, or substantially all, of the property and assets of a corporation . . . (1) is not considered to be a merger or conversion pursuant to this Act or otherwise; and (2) except as otherwise expressly provided by another statute, does not make the acquiring corporation, foreign corporation, or other entity responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation, foreign corporation, or other entity did not expressly assume.”¹⁴

2. CONTINUITY OF ENTERPRISE

As above noted, the *de facto* merger doctrine has generally involved a transaction which looks like a merger in which the selling corporation has gone out of existence and its stockholders have received stock of the buyer. In 1976 the Michigan Supreme Court took the *de facto* merger doctrine a step further and eliminated the continuing stockholder requirement. In *Turner v. Bituminous Casualty Co.*, the Court was dealing with a transaction in which the consideration was cash, rather than stock, and the Court concluded that this fact alone should not produce a different result from that which would obtain under a *de facto* merger analysis if the consideration had been stock.¹⁵ Under this continuity of enterprise test successor liability can be imposed upon findings of: 1) continuity of the outward appearance of the enterprise, its management personnel, physical plant, assets and general business

¹³ See H. Lawrence Tafe, III, *The de facto Merger Doctrine Comes to Massachusetts Wherein the Exception to the Rule Becomes the Rule*, Boston Bar Journal (November/December 1998).

¹⁴ See Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation – Texas versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249, 288-290 (Winter 2001).

¹⁵ *Turner v. Bituminous Cas. Co.*, 244 N.W.2d 873, 883 (Mich. 1976).

operations; 2) the prompt dissolution of the predecessor following the transfer of assets; and 3) the assumption of those liabilities and obligations necessary to the uninterrupted continuation of normal business operations. These are essentially the same ingredients which support the *de facto* merger doctrine - but without the necessity of showing continuity of shareholder ownership.

3. PRODUCT LINE EXCEPTION

In 1977 California took a slightly different tack in holding a successor liable in a products liability case. In *Ray v. Alad Corp.*, the buyer had acquired essentially all of the seller's assets including plant, equipment, inventories, trade name, goodwill, etc. and had also employed all of its factory personnel.¹⁶ The buyer continued to manufacture the same line of products under the seller's name and generally continued the seller's business as before. Successor liability was found by the California Supreme Court:

A party which acquires a manufacturing business and continues the output of its line of products under the circumstances here presented assumes strict tort liability for defects in units of the same product line previously manufactured and distributed by the entity from which the business was acquired.

The rationale for this doctrine had moved a long way from the corporate statutory merger analysis of the *de facto* merger doctrine. The Court determined that the plaintiff had no remedy against the original manufacturer by reason of the successor's acquisition of the business and consequent ability of the successor to assume the original manufacturer's risk. The Court also determined that the responsibility of the successor to assume the risk for previously manufactured product was essentially the price which the buyer had paid for the seller's good will and the buyer's ability to enjoy the fruits of that good will.¹⁷

4. CHOICE OF LAW

Of those states which have considered the issues directly, many more have rejected the product line exception than have embraced it. However, because choice of law principles, especially in the area of product liability,

¹⁶ *Ray v. Alad Corp.*, 560 P.2d 3 (Cal. 1977).

¹⁷ *See also Ramirez v. Amsted Indus., Inc.*, 431 A.2d 811 (N.J. 1981).

may find the law of a state in which an injury occurs to be applicable, the reach of those states which have embraced either the product line exception or the narrower continuity of interest doctrine may be beyond their respective borders.

5. ENVIRONMENTAL STATUTES

In 1980 the federal Superfund law was enacted - Comprehensive Environmental Response, Compensation And Liability Act Of 1980 ("CERCLA").¹⁸ In the years since the enactment of that statute, environmental issues have become a central - and often dominant - feature of acquisitions. Moreover, in creating liability of a current owner for the costs of cleaning up contamination caused by a prior owner, the statute effectively preempted the ability of a buyer to refuse to accept liability for the sins of the seller or seller's predecessor. Unlike the theories discussed above which might impose successor liability on a buyer if certain facts appeal to certain courts, CERCLA determined that every buyer would be liable for certain environmental liabilities regardless of the provisions of any acquisition agreement or any common law doctrines or state statutes.

In addition to CERCLA, a number of states have enacted Superfund-type statutes with similar provisions to CERCLA. Further, as indicated above, the *de facto* merger and continuity of enterprise doctrines have been applied in environmental cases in states where courts have adopted one or more variations of those themes.

C. Some Suggested Responses

1. ANALYSIS OF TRANSACTION

The first step in determining whether a proposed asset purchase will involve any substantial risk of successor liability is to analyze the facts involved in the particular transaction in light of the developments of the various theories of successor liability above discussed. It is clear that product liability and environmental liability pose serious threats as many of the significant developments in the law of successor liability seem to involve either product liabilities or environmental liabilities.

¹⁸ 42 U.S.C. §§ 9601-967 (1980).

a. Product Liability

It may well be that the company whose assets are the subject of the transaction will not have any product liability problem by reason of the nature of its business. Moreover, even if the company to be acquired does sell products which create some potential liability issues, in the course of due diligence the buyer may be able to make some reasonable judgments with respect to the potential for problems based upon the past history of the selling company. Obviously one can also rely on insurance, on an occurrence basis if previously carried by the seller and on a claims-made basis in respect of insurance to be carried by the buyer. It may also be possible to acquire a special policy relating only to products manufactured by the seller prior to the closing and to build in the cost of that policy to the purchase price.

b. Environmental

On the environmental front a similar analysis must be made. There are obviously some types of businesses which present very high-risk situations for buyers. As above noted there are both federal and state statutes which will impose liabilities on successors regardless of the form of the transaction. At the same time, the *SmithKline Beecham* case confirms that the doctrine of *de facto* merger may well cause a successor to be subject to much greater liability than would be imposed directly by CERCLA or other statutes. Accordingly, the due diligence on the environmental front, in addition to all of the customary environmental analyses done in any asset purchase, may well require an analysis of prior transactions and prior owners.

c. Applicable Laws

In addition to analyzing the particular facts which might give rise to successor liability for either products or environmental concerns, one should obviously also review the laws which might be applicable if a successor liability issue were to arise. The more expansive doctrines of successor liability above mentioned have been adopted by a relatively small number of states, and it may be that in a particular transaction one can determine that the risk of such doctrines applying in the aftermath of a particular acquisition transaction is very low.

2. STRUCTURE OF TRANSACTION

If a transaction is likely to be subject to one or more of the doctrines of successor liability, it might be possible to structure the asset purchase in the manner which avoids one or more of the factors upon which courts rely in finding successor liability. In all likelihood the business considerations will dictate most of the essential elements of how the transaction will be put together - and in particular how the business will be run by the buyer in the future. However, since continuity of the seller's business into the buyer's period of ownership is a common theme in all of the current successor liability doctrines, it may be possible for the buyer to take steps to eliminate some of the elements upon which a successor liability case could be founded. Thus continuity of management, personnel, physical location, trade names and the like are matters over which the buyer has some control after the asset purchase and might be managed in a way to reduce the risk of successor liability in a close case.

3. ASSET PURCHASE AGREEMENT PROVISIONS

a. Liabilities Excluded

If the buyer is to have any hope of avoiding unexpected liabilities in an asset transaction, the contract between the buyer and the seller must be unambiguous as to what liabilities the buyer is and is not assuming. In any transaction in which a buyer is acquiring an ongoing business, the buyer is likely to be assuming certain of the seller's liabilities, especially obligations incurred by seller in the ordinary course of seller's business. Indeed, it is likely to be very important to the buyer in dealing with the seller's creditors, vendors, customers, etc. that the asset purchase be viewed in a seamless process in which the buyer hopes to get the benefit of seller's goodwill for which the buyer has paid. Under these circumstances however, it is most important that the contract be very clear as to which liabilities the buyer is expressly not assuming. See Section 2.4 in Appendix A to this article.

b. Indemnification

As a practical matter, probably the most effective protection of a buyer against successor liability is comprehensive indemnification by the seller, particularly if indemnification is backstopped by a portion of the purchase price held in escrow. See Section 11 in Appendix H to this article.

4. SELLING CORPORATION – SURVIVAL

The dissolution of the selling corporation is a factor which the courts have consistently taken into account in successor liability cases. While it may be placing form over substance, if the seller's dissolution were delayed, one of the elements of the successor liability rationale would at least be in doubt.

5. LIMITATION ON ASSETS

In creating a corporate structure for the asset purchase, buyer should keep in mind the desirability of limiting the assets of the acquired enterprise which might be accessible to a plaintiff in a future successor liability case. Thus, if in the last analysis the buyer is to be charged with a liability created by the seller or a predecessor of the seller, it would be helpful to the buyer if assets available to satisfy that claim were limited in some manner. There may be no way as a practical matter to achieve this result in a manner consistent with the business objectives of the buyer. However, if, for example, the particular line of business with serious product liability concerns were acquired by a separate corporation and thereafter operated consistent with principles which would prevent veil-piercing, at least the buyer would have succeeded in placing a reasonable cap on the successor liability exposure.

V. ETHICAL CONSIDERATIONS

An asset acquisition is like many other legal transactions involving multiple parties with potentially different goals and interests.

The *Model Asset Purchase Agreement* and commentary refer to the Buyer and Seller as single entities. In the fact pattern of the *Model Asset Purchase Agreement* the Seller will be joined by significant shareholders of Seller in its representations, warranties and indemnification obligations. While a seller and its shareholders may share a uniform interest in the sale, they also will typically have differing interests in the transaction (e.g., post-closing employment by the Buyer, noncompetition agreements and whether and how much separate consideration will be received by an individual shareholder for his or her agreement to be employed or not to compete, which typically comes out of the overall amount the Buyer is willing to pay for the Seller's assets; and arrangements for sharing indemnification responsibilities among one or more principals of the Seller, to mention but a few).

Often all of the parties related to the seller will ask that one lawyer represent the entire group, especially if the deal is not large and the seller is closely held. Such a situation requires careful consideration by the lawyer to identify each of the potential multiple clients and to evaluate potential and actual conflicts of interest that may exist or arise among these group members, or between any one or more of them and other clients or former clients tangentially related to the transaction (e.g., landlords, lien holders, guarantee holders, etc.). Evaluating potential conflicts can require significant due diligence by the lawyer to identify not only those conflicts apparent at the beginning of the transaction, but also those which may become evident as the transaction progresses.

In determining the appropriateness of representing multiple clients, the substantive and procedural implications of Rule 2.2 of the ABA Model Rules of Professional Conduct should be considered. These include consultation with each individual client about the effect on client-lawyer confidentiality and the attorney-client privilege. Written consent after consultation may be required. Furthermore, once the attorney-client relationship has been established with each member of the group, each client has the right to loyal and diligent representation with the right to discharge the lawyer as stated in Rule 1.16, and the protection of Rule 1.9 concerning obligations to a former client. Under Rule 2.2 the lawyer must withdraw from the representation if any one of the multiple clients so requests, or, if one or more of the clients denies the lawyer the authority to disclose certain information to any of the remaining clients, thereby preventing the lawyer from being able to discharge the lawyer's duties to the remaining clients. Furthermore, absent unusual circumstances upon withdrawal from representation of any one client, the lawyer may not proceed with the representation of any of the remaining clients, including the seller, unless each of the multiple clients and former clients after consultation consents in writing to the continued representation. Rules 1.6, 1.8(b), 1.9 and 1.10 protect the interests of the former client. Therefore, the lawyer must be mindful that, if the common representation fails, the result can be significant additional cost, embarrassment and recrimination with the potential for considerable harm to the interests of one or more of the clients.

VI. ORGANIZATION OF MODEL ASSET PURCHASE AGREEMENT

A. Structure

The structure of the *Model Asset Purchase Agreement* follows current practice:

Article 1 contains a glossary of defined terms, as well as general guides to construction and interpretation. This article enhances ease of usage and organization of the acquisition agreement and includes cross-references to definitions in various places in the agreement.

Article 2 contains the economic and operative terms of the acquisition, including the assets to be acquired, the consideration to be paid, and the basic mechanics of the closing.

Articles 3 and 4 are the representations and warranties of the Seller and the Buyer, respectively. The representations and warranties are statements of fact that exist or will exist at the time of the Closing. The Seller's representations and warranties, which contain detailed statements about its business, are much more comprehensive than the Buyer's and include extensive provisions regarding matters such as environmental problems, employee benefits, and intellectual property that could result in significant liabilities for the Buyer after the Closing if not covered by adequate representations and warranties (and the corresponding indemnification obligations) by the Seller and its principal shareholders. The Buyer's representations and warranties deal mainly with the Buyer's ability to enter into the acquisition agreement and to consummate the acquisition.

Articles 5 and 6 contain covenants in which the parties commit to perform (affirmative covenants) or not to perform (negative covenants) certain acts in the period between signing the acquisition agreement and closing the acquisition. The main burden of the covenants falls on the Seller, which must take organizational steps toward consummating the acquisition and operate its business in the manner provided after signing the agreement and before the closing.

Articles 7 and 8 contain conditions precedent to the obligations of the Buyer and the Seller, respectively, to consummate the acquisition. These sections specify what each party is entitled to expect from the other at the Closing. If a condition is not satisfied by one party, the other party may be able to elect not to complete the acquisition.

Article 9 outlines the circumstances in which each party may terminate the acquisition agreement and the effects of such termination.

Article 10 contains certain additional covenants of the parties.

Article 11 contains indemnification provisions giving each party specific remedies for the other's breach of certain obligations under the acquisition agreement. These provisions cover matters such as calculation of damages, recovery of expenses and costs (including legal fees) in addition to damages (a right that may not exist absent an indemnification provision), and procedures for claiming damages.

Article 12 contains comprehensive confidentiality and access to information provisions, which are applicable both prior to and after the

closing and supersede the confidentiality agreement previously entered into between the parties.

Article 13 contains general provisions such as notice, severability, and choice of law.

B. *Letter of Intent*

In some transactions, the parties do not sign a binding agreement until the closing. If a letter of intent has been executed that includes a no-shop provision and gives the buyer adequate opportunity to conduct due diligence, the buyer may resist becoming contractually bound until it is ready to close. Conversely, the seller has an interest in not permitting extensive due diligence until the buyer is contractually bound. This is especially so in circumstances in which the buyer is a competitor or in which the seller is concerned that the due diligence process will necessitate or risk disclosure to employees, customers or competitors that the business is for sale.

C. *Gap Between Signing and Closing*

Occasionally it is the seller that is reluctant to sign before the closing. This may be the case, for example, if the seller has announced that the business is for sale, has several potential buyers and does not want to preclude talking to alternative buyers until the seller is certain that the transaction will close.

Sometimes a simultaneous signing and closing occurs because the transaction simply evolves that way. The parties may be negotiating an agreement that contemplates a period between signing and closing, but the due diligence may proceed more rapidly than the negotiations, and it may develop that a waiting period would be pointless or even harmful to the transaction. In such circumstances, counsel should consider whether it is appropriate to remove from the agreement the pre-closing covenants, conditions to the parties' obligations to close, and other provisions rendered unnecessary by the decision to sign and close simultaneously. Care should be taken to ensure that no contractual obligation applicable post-closing is affected by such changes.

IV. TRANSCRIPT OF MOCK NEGOTIATION OF AN ASSET ACQUISITION¹⁹

Introduction

DENNIS HERSCH: Welcome to our program, *Mock Negotiation of an Asset Acquisition*. On the panel today, we have Vice Chancellor Jack Jacobs of the Delaware Chancery Court; next to him, Frank Balotti of Richards Layton & Finger in Wilmington. They will act as commentators on various points raised in the negotiation. Sam Thompson will act as moderator, and our negotiators are Larry Tafe, a partner in the Boston office of Day, Berry & Howard, who will represent the target, and Byron Egan, a partner of Jackson Walker in Dallas, who will represent the acquiror. For the last five years, Byron and Larry have spent a good deal of time as Co-Chairs of the Task Force of the ABA Negotiated Acquisitions Committee drafting a Model Asset Acquisition Agreement, which will be published by the ABA within the next few months. If it is a success, we may try and turn it into a movie. We haven't cast Larry yet, but I think Anthony Hopkins will do Byron just great.

LARRY TAFE: I'll take Robert Redford.
(Target Counsel)

DENNIS HERSCH: You got it. Gentlemen, the floor is yours.

Background

SAMUEL THOMPSON: Okay, we are going to ask Larry to give us the background of this transaction, which starts out as a stock acquisition and then moves to an asset acquisition. Larry.

¹⁹ Introduction by Dennis S. Hersch, Davis Polk & Wardwell, New York.

LARRY TAFE:
(Target Counsel)

Thank you, Sam and Dennis. As Dennis indicated, Byron and I have spent a fair amount of time together over the last five or actually approaching six years as we have co-chaired a task force at the ABA which has been working on the Model Asset Acquisition Agreement,²⁰ which you mentioned. And this was really the second big project of our ABA Committee, the first being the Model Stock Purchase Agreement,²¹ which some of you may, I hope, own in your libraries. It has been great fun working on these projects.

As Sam indicated, the way we are going to go about this is to have Byron and I do a negotiation on behalf of a seller and a buyer in what we think will be an asset transaction and to highlight some of the issues in the asset world. We are going to assume that this transaction was initially structured as a stock transaction and then was converted into an asset transaction. We hope we can draw some comparisons and parallels and differences. We are starting off with a publicly held conglomerate, which we will refer to as Parent. The business being sold by "Parent" has been operated primarily as a subsidiary, which we will refer to as "Target". We have discovered since the transaction was initially structured as a stock deal that there may well be some assets outside of Target and held by Parent that may also have to be transferred in the transactions. Parent may also license the use of certain intellectual property.

As I indicated, initially we structured the deal as a stock transaction. Target accounts for a substantial part of the business of the Parent company, and in round numbers, we have figured that the percentage of assets that the parent will be selling, including the sub assets

²⁰ *Model Asset Purchase Agreement, supra*, note 1.

²¹ American Bar Association, Model Stock Purchase Agreement (1995).

would be 55 percent, but that it does contribute upwards of 80 percent of the Parent profits. Finally, we should tell you as indicated, it is a management buyout and that indeed, the chief executive officer of Parent (the "CEO") is on both sides of the deal. That is, he is going to go with the management buyout team and the financial people that are acquiring Target.

I will represent the selling entity, Parent and Target, and Byron will represent the buying entity, which we will refer to as "Buyer". All the corporations are Delaware corporations. Sam will moderate, and Frank and Jack will pipe in on some issues of Delaware law as we go along. As a final background fact, it has been determined that there are assets of Parent not inside Target that have to be transferred either by outright transfer or by license or something else to Target. On the other side of it, Buyer has become concerned about exposure in the intellectual property area. So the Buyer is talking now about doing an asset transaction, pursuant to which it would acquire the assets of Target and related assets held by Parent. So with that background, I would ask Byron to talk a little bit about some of the issues that we may be discussing.

Stock Acquisition Converted Into Asset Acquisition

BYRON EGAN:
(Acquiror Counsel)

Thank you, Larry. We did do a term sheet early in this deal that contemplated that we would be buying the stock of this subsidiary because we thought that was where all of the business that we were buying really was. That is the way they have been operating. But as the due diligence proceeded after we signed a confidentiality agreement, we found that in fact there were assets in Parent and employees of Parent that are properly associated with the business of Target. We also found that there were technology licenses held by Target that have some

problems. We have got some infringement claims that are out there, patent infringement claims running against Target, and we are worried about successor liability. We are worried that if we buy the stock of Target, we are going to be buying liabilities that we did not plan on. So what we would like to propose, Larry, is that this is a classic case for doing an asset transaction. We could get the assets we need by buying the assets of Target and then buying the piece of Parent that goes along with Target's assets. We would buy assets from both Parent and Target, and we would assume those liabilities that we need, including certain contracts. We will leave you with these liabilities that we are concerned with. We also have the issue of employees. Some of the employees we want are in Target and some are in Parent, and we would ask you to just terminate all these people and let us pick who we want. We believe that we can do that under applicable state law. There may be a couple of union contracts we have got to work, with but I think we can solve that. So Larry, I would like to propose to you that we structure the transaction as an asset purchase. I realize that there are some theories of successor liability and it may be that we cannot absolutely be sure that there will not be any liabilities, but that will give our litigators something to fight about. So in the hope that you would go along with us in this transaction and do an asset acquisition, I sent over last night to you my standard form of asset purchase agreement. It is a reasonable buyer's first draft based on the ABA Negotiated Acquisition Committee's Model Asset Acquisition Agreement, and so I do not think you will have any problem. And what I would like to do is work through some of the provisions with you. To begin this process, what we probably ought to do is look at what I call "wockitywock" section — the section of the

agreement that is probably the most important because it defines what assets are being sold or retained and what liabilities are being assumed or retained.

LARRY TAFE:
(Target Counsel)

What is that again?

Negotiation of Assets to be Acquired

BYRON EGAN:
(Acquiror Counsel)

It is the section that is most important.

LARRY TAFE:
(Target Counsel)

Wockitywock?

BYRON EGAN:
(Acquiror Counsel)

That is right. It is the engine – it specifies the assets that are going to be transferred and the assets that are not going to be transferred, and the liabilities that are going to be assumed by Buyer, and the assets and the liabilities that are going to be retained by Seller. And so we begin with Article 2, which is set out in Appendix A to this article.

Larry, as I said, this is my standard form agreement. This was drafted by the ABA Committee in the context of the acquisition of a closely held corporation. Here, however, we are in essence buying a division and we are going to need to make some modifications. So what I would like to do is run through the provisions with you in a hurry. You do not have to agree with everything right now. This is not carved in stone, although I will admit that hammer and the chisel are in hand. Let us just run through it. Section 2.1 is entitled “Assets to be Sold” and it sets out the assets to be sold. Section 2.1 says we will buy from Target all of the assets of every kind of Target, except the “Excluded Assets.” Then we have a laundry list of the assets that we are going to try to get, which will necessitate lots of schedules and lots of details about the assets

that we are buying. This is important. Where the lawyers make the money for their clients is by being sure that in an asset deal, the client gets all the assets that produce the revenue stream that it thinks it is buying. On the other side, it is important to exclude whatever liabilities the buyer does not want.

LARRY TAFE:
(Target Counsel)

Could I just pipe in and say that transferring all of the assets of the Target is fine. We were going to do that when we are doing the stock deal, but we are obviously not selling all of the assets of Parent. So we are talking about two sellers essentially, one of which would be selling in asset transaction all of the assets of Target, but Parent would be selling only some assets that are necessary to make Target's whole business operate.

BYRON EGAN:
(Acquiror Counsel)

You are absolutely right. Since the definition of Seller in the Model Agreement is the selling corporation, we are going to have to change the definition a little bit. Here we will have two sellers and we need to consider using a defined term of "Business" here, as is frequently done in the context of the division acquisition. In fact, most asset purchase agreements you will see will include a definition of Business, which is intended to pick up the segment that includes the revenue stream that the buyer thinks it is buying. In the Comment to Section 2.1, you have a definition of "Business" that I would propose to use here. The definition would include basically all of the assets of Target, and it would also include all of the assets of Parent that relate to this particular line of business.

LARRY TAFE:
(Target Counsel)

Byron, on the issue of the definition of Business, I think you are right. I probably do need a definition of Business, but I am also going to be careful about how it is used. This Business has been primarily operated as a subsidiary. We did

not need a definition of Business when we were talking about simply selling the stock of the entity. If you sell the stock of the entity, the business goes with it. If we are going to define Business in this agreement, we will include not only acquired assets of Target but other related assets including intellectual property assets held by Parent.

BYRON EGAN:
(Acquiror Counsel)

Larry, you are right. This is one of those areas where the difference between the right word and the almost right word is the difference between lightning bolt and lightning bug.

LARRY TAFE:
(Target Counsel)

That was pretty good.

BYRON EGAN:
(Acquiror Counsel)

Excluded assets are also important. If you are the seller, you know that the buyer is paying for certain things, but you find you are not getting any value for certain other things, so what you try to do is carve out and retain those assets you are not getting any credit for in the purchase price.

Negotiation of Liabilities to be Assumed

BYRON EGAN:
(Acquiror Counsel)

Then we move to Section 2.4 that has a simple caption: "Liabilities". This is another definition that is critical. As the buyer, we are going to do this real simple. We will take trade payables that are on the balance sheet and arise in the ordinary course of business, and we will take liabilities under scheduled contracts and other scheduled liabilities. If a liability is not on a schedule, we are not going to take it. We are particularly going to be careful to identify a number of specific liabilities that we are not taking. We are not going to take any tax liabilities. We are not going to take any liabilities relating to the operation to the business prior to the closing time. So it is real simple. We will take

scheduled liabilities and will leave the rest with you.

LARRY TAFE:
(Target Counsel)

That brings us to our first issue of contention. When we determined that we would go from a stock transaction to an asset transaction, we did so for a couple of reasons: first, these additional assets which have to somehow be dealt with in order for you to get the business you want; and second, your concern about a particular area of exposure which Target has in the world of intellectual property and whether there would be some potential infringement claims and whatnot. However, but for that one area of concern, and in my view you are overly concerned about it, in the transaction that we had before you were going to buy the stock of Target and take all the liabilities with it. Now obviously, we were going to have to make representations and warranties about Target.

We were going to have to indemnify you if things came out of the woodwork that we had not told you about and we are still prepared to do that. But I do not know why, simply because we have gone from a stock form to an asset form, we have to then start with essentially Buyer not assuming any liabilities of a going concern unless they are on a list somewhere. We have a full set of representations and warranties and you have done a fair amount of due diligence in the earlier stages of this transaction in which you really know what Target does and what it does not do. And the bottom line is that your liabilities approach is a change in substance in the deal rather than simply a change in form to accommodate one problem.

BYRON EGAN:
(Acquiror Counsel)

We would go back and forth on the issue of assumed liabilities in a real deal because this is a value point for the clients and the right words here are critical. But at the end of the day, I am

going to be very insistent that we take only scheduled liabilities and the rest must remain with the sellers. I am simply going to say: do not cry down my back, you'll rust my spurs.

LARRY TAFE:
(Target Counsel)

You see what I have to put up with it? This is six years. You know how many of those I have heard in six years?

SAMUEL THOMPSON:
(Moderator)

Byron, your client presumably priced the stock deal under the assumption that all the liabilities were going to come over to buyer. Now you are insisting that certain liabilities stay back. Now, might you be willing to increase the purchase price to compensate for the fact that you are now only taking certain specified liabilities.

LARRY TAFE:
(Target Counsel)

Thank you, Sam.

BYRON EGAN:
(Acquiror Counsel)

The problem is the risk of the unknown. In our purchase price, we did not factor in anything for the risk of the unknown, and so we are leaving the risk of the unknown with who is in the best position to know it.

SAMUEL THOMPSON:
(Moderator)

When you originally structured the purchase price for the stock deal, you had to price it on certain unknown potential liabilities that were coming over. But now you are not taking certain liabilities. So it seems to me that you ought to at least be able to ratchet up purchase price.

BYRON EGAN:
(Acquiror Counsel)

I ought to, but I would say to that: If wishes were horses, beggars would ride. And then we would move on to the next issue.

LARRY TAFE:
(Target Counsel)

Okay, on that note.

SAMUEL THOMPSON: Does that mean Byron won?
(Moderator)

LARRY TAFE: You can out number him, but you can't beat him.
(Target Counsel)

Negotiation Over Sale of Substantially All the Assets

LARRY TAFE: I want to talk to you, Byron, about a few of the
(Target Counsel) representations and warranties in the agreement. I realize this is a first draft and I realize it is designed as a form that is used primarily in the context of the sale of an entire business. Even with those caveats and even though you only gave it to me last night at 10:00 which did not give me a chance to read it very closely, I have some initial problems.

BYRON EGAN: What I gave you is a standard form of agreement.
(Acquiror Counsel) You ought to know what is in it.

LARRY TAFE: Section 3.2 (see Appendix B) is a pretty standard
(Target Counsel) provision regarding the due execution of the agreement by seller and its enforceability, and I do not have problems with the better part of it. It does suggest that you are looking for a vote by the shareholders of Parent. As you know, Parent is a publicly held company listed on the New York Stock Exchange and this transaction involves about 55% of Parent's assets going and 80% of its profits. Parent will still have a couple of viable businesses left after the sale, and one of the reasons for this sale is to get some cash so Parent can beef up its own business and do some things. Parent does not want to bother with proxy statements and shareholder votes in order to do what is essentially a deal that is designed to get it more strategically positioned in businesses that it is not now in.

BYRON EGAN:
(Acquiror Counsel) Well, Larry, I will want that representation, plus the opinion of Frank Balotti, as Delaware counsel, that shareholder approval is not required.

FRANK BALOTTI:
(Commentator) What are you willing to pay for it?

BYRON EGAN:
(Acquiror Counsel) Well, it depends on whether you give me a clean opinion or whether you have one of those chatty opinions that reads sort of like a novel. You know, he has these long opinions that go on and on.

LARRY TAFE:
(Target Counsel) I am glad he is picking on somebody else.

BYRON EGAN:
(Acquiror Counsel) Frank's opinions do not reach a plain English conclusion. His opinions talk about a lot of cases and say some of them go this way and some of them go that way, and I always vote with the cases.

FRANK BALOTTI:
(Commentator) And you will get the long one. It will be a novella, it will cost you a tidy sum and it may come out the other way. Are you willing to risk that?

BYRON EGAN:
(Acquiror Counsel) Please give us some color on that.

FRANK BALOTTI:
(Commentator) Okay, the Delaware law basically is that a Board of Directors may sell, lease, or transfer all or substantially all of the property of a corporation as approved by the shareholders.²² In other words, if you are selling all or substantially all of the assets, a shareholder vote is required. There is not a definition in the statute of what is substantially all. However, Delaware case law,

²² See Del.Gen.Corp.Law § 271 (2001).

the case law Byron does not want to read about, has developed a two-pronged test to help those in need of guidance come to a conclusion as to whether or not a shareholder vote is required. The first part of the test is what's called a qualitative test, in which you look at the assets being sold to try and determine whether they are the long time assets of the company. You ask: Is it the business the company has been in forever? Are you changing the business of the company?

The second part of the test is the quantitative test, which tries to measure the percentage of the assets being sold as against the entire asset base of the company. In this instance, we have 55% of the fair market value of the assets being sold. That is a gray area. It is not absolutely clear one-way or the other in the minds of most people whether or not 55% constitutes substantially all or something less than substantially all. So you look elsewhere. And the elsewhere we have in this fact pattern is the assets being sold generate 80% of the income of the company. That certainly tips in favor of these assets being substantially all and in this instance, I would recommend that a shareholder vote be obtained.

But that does not end the inquiry because you need to determine which shareholder vote is required, that of Parent or of Target. Let us ignore the assets of Parent which are coming along with this transaction and concentrate on the fact that Target, a subsidiary of Parent, is selling all of its assets. It is easy to obtain the vote of the stockholder of the subsidiary, because the stockholder of the subsidiary is Parent. Under Delaware law, when a subsidiary sells all or substantially all of its assets, the vote that is required is the vote of the parent, not the public stockholders of the parent. But things are not quite that simple because those assets had to get to the subsidiary somehow some time. If the assets were dropped down from the parent level

to a subsidiary level without a vote of the parent shareholders, it would cause questions to be raised.

You have to look back and see how the assets came to be in the subsidiary. There is a difference in opinion among Delaware practitioners of whether a vote is required in all instances when assets are dropped down. If a parent drops down substantially all of its assets to a subsidiary, some firms take the view that there are circumstances in which a vote is not required. Other law firms, such as ours, take the view that if you drop down all or substantially all of the assets to a subsidiary, a vote of the parent stockholders is required. Now in this instance, if the assets were dropped down originally without a vote, then we may tell you that despite the fact there are assets of the subsidiary being sold, you might now need the vote of the parent public stockholders.

VICE CHANCELLOR JACOBS: I would like to add one thing to what Frank said to put the issue in perspective. The question is why would the buyer care if the seller has a problem with its stockholders; that is if the stockholder vote would be needed in order to authorize the sale? And the answer is, at least in Delaware, and I think in some other jurisdictions, is that if under the corporate statute of the seller's jurisdiction, a shareholder vote is required and it is not obtained, then the sale is void. So your client, the buyer, is going to be party to a void sale and subject to having the assets that it purchased recaptured in some way, which you certainly do not want for your client. However, it is also correct to say that the law as to whether or not a shareholder vote is required varies greatly from jurisdiction to jurisdiction, as Larry and Byron will explain in a minute.

- SAMUEL THOMPSON:
(Moderator) Frank, if I understood your analysis of Delaware law, it would lead me to conclude that if this were a sale by Parent of the stock of its subsidiary, Target, then a shareholder vote would be required at the Parent company level.
- FRANK BALOTTI:
(Commentator) Correct, because the Parent is then selling all or substantially all of its assets measured on a fair market basis, i.e., the stock of the sub.
- SAMUEL THOMPSON:
(Moderator) But when the sub, which is the wholly owned sub of the Parent, sells its assets, the transaction is not deemed to be a sale of the Parent of its assets.
- FRANK BALOTTI:
(Commentator) That is correct.
- SAMUEL THOMPSON:
(Moderator) The economic substance of those two transactions is the same. The Parent ends up with cash.
- FRANK BALOTTI:
(Commentator) You cannot overlook the doctrine of independent legal significance in Delaware. If it is the subsidiary that is selling assets, in theory it receives the cash and dividends up or distributes the cash up to the Parent. You cannot re-characterize the transaction to be a sale by the Parent of its assets because that is not the transaction.
- SAMUEL THOMPSON:
(Moderator) There is no uncertainty in Delaware law on that issue?
- FRANK BALOTTI:
(Commentator) There is not a Supreme Court decision that definitively sets all this out so yes, there is some uncertainty. There are several Chancery Court decisions that tell you that the vote required when you sell assets of a subsidiary is the vote of the Parent, not the Parent's stockholders. There is not a decision that goes on and talks about the drop down issue. That is lore that has been

developed by the lawyers in Delaware because we get that question frequently.

LARRY TAFE:
(Target Counsel)

But you would really have form over substance if you had an honest-to-God holding company that held nothing but stock in five subs which is not an unusual operating arrangement in some circumstances, and decide to sell out. I gather you are saying that if they sell the stock of all of its subs, Parent has to go to its shareholders because it is clearly selling all of its assets. If they decide to structure those deals the way Egan wants everything structured so he is not going to get hit by any lawsuits or anything and they sell assets of all those subs, there is an argument that they can do that and not have to go to the shareholders of the parent.

FRANK BALOTTI:
(Commentator)

Correct. In theory, if the assets have been dropped down from the holding company to the subs, the shareholders have voted on it at some point on the drop down, knowing the consequences of that drop down.

BYRON EGAN:
(Acquiror Counsel)

Larry, he who lives by the sword, dies by the sword. You can change the character of a corporation's business simply by leveraging up, by adding assets and incurring debt. So why not look at this issue in a simple fashion and say if a corporation is going to continue in business after the transaction, just a different form of business, then shareholders should not have a vote on it because that is ordinarily within the preview of the board of directors. There is nothing in Delaware law that says if you change your business, you have got to have shareholder approval, so why should this little segment of a change, called a sale of assets, require shareholder vote? So our view in Texas, and the Texas Business Corporation Act now says, that if you are going to continue in any business no

shareholder vote is required.²³ For instance, if you sell your manufacturing business and continue as a holding company doing investments, shareholder approval is not required. Larry, has the Model Business Corporation Act taken a similar approach?

LARRY TAFE:
(Target Counsel)

Yes, they have. As long as there is a continuing substantial business, that is the way they deal with it.

SAMUEL THOMPSON:
(Moderator)

I think that under the Model Business Corporation Act if the selling company does not continue a significant business a shareholder vote is required.²⁴ The Model Act no longer uses the concept of substantially all the assets. I would think that in this context, where Parent retains 45% of its assets and 15% of its revenues, assuming the assets and revenues reflect an ongoing business, a shareholder vote would likely not be required under the Model Act.

FRANK BALOTTI:
(Commentator)

So under almost any jurisdiction's law, except perhaps Texas, there is a lot of slicing and dicing and careful analyzing that the lawyer for the seller needs to do and the lawyer for the buyer is going to be equally concerned about.

BYRON EGAN:
(Acquiror Counsel)

Well, we could move on past this by simply pointing you to the commentary to Section 3.2 in the ABA Model Asset Purchase Agreement.

Negotiation Over Sufficiency of Assets Representation

LARRY TAFE:
(Target Counsel)

Let me go on to some other representations here that I think need some attention. In Section 3.6 (see Appendix C) there is what looks like a

²³ Tex. Bus. Corp. Act. Art. 5.09 (2001); see Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation – Texas versus Delaware: Is It Now Time to Rethink Traditional Notions?*, 54 SMU Law Review 249, 287-290 (Winter 2001).

²⁴ Model. Bus. Corp. Act. § 12.02 (1999).

perfectly benign statement that says in substance that there are sufficient assets here to run the business as we have been running it. And obviously, we have no problem with that when we were talking about the assets of a subsidiary, although I am not even sure that the representation would have been appropriate if we were selling stock of a subsidiary. But I do want to be sure that we do not have a trap here where we define a business and then tell you that you are not going to have to do anything more than we are now doing in order to run that business. It may well need some new technology. It may well need a lot of things and the vagueness of your new idea of having a definition of business gives me some concern with this representation that I might not otherwise have, particularly since your guys, including the CEO who is going over to Buyer in the transaction, know more about this damn thing than the rest of the people in Parent.

BYRON EGAN:
(Acquiror Counsel)

Well, Larry, I am going to send you a bottle of Gelusil at the end of the day, but I need Section 3.6 because I need to know that my client is getting all the assets that it needs to produce that stream of revenues that it formulated its purchase price on. That is what Section 3.6 is intended to do. So Larry, you ought to be satisfied.

SAMUEL THOMPSON:
(Moderator)

Byron, let me ask you a question. How is Larry supposed to know what assets you formulated your price on since he was not in the room when you formulated your price?

BYRON EGAN:
(Acquiror Counsel)

He gave my client some division financial statements that included revenues from the business being sold. I want to be sure that my client gets all the assets that produced that stream of revenues.

- SAMUEL THOMPSON:
(Moderator) Okay, including interest on cash on deposits?
- BYRON EGAN:
(Acquiror Counsel) We are not buying cash.
- SAMUEL THOMPSON:
(Moderator) Then you are not getting all of the assets which produce the revenues. But there is an exception. Section 3.6 provides "Except as disclosed in Part 3.6."
- BYRON EGAN:
(Acquiror Counsel) That is exactly right, Sam.
- SAMUEL THOMPSON:
(Moderator) So it is up to him to list what does not come over.
- BYRON EGAN:
(Acquiror Counsel) Absolutely!
- SAMUEL THOMPSON:
(Moderator) Not fair.
- LARRY TAFE:
(Target Counsel) You know, it is worse than not fair. It is totally irrelevant.

Negotiation Over No Undisclosed Liabilities

- LARRY TAFE:
(Target Counsel) Let us talk about no the undisclosed liabilities representation, which is Section 3.13 (see Appendix D). That is a representation that in substance I do not have any problem with except that we are now talking about the sale to the extent that the representation applies to Parent. You do not need Section 3.13 because Buyer is not going to assume any of those liabilities anyway unless they are on a list of Assumed Liabilities. So whether there exist other liabilities in Target or whether there are other liabilities in Parent, you should not give a hoot because you just said back in Section 2.2(a) that

if you do not see that liability on my list of Assumed Liabilities, I do not assume it.

BYRON EGAN:
(Acquiror Counsel)

Folks, I do care and I care for two reasons. This is a due diligence function. As you know, representations and warranties have two functions: one is shifting responsibility and the other is due diligence. And in Section 3.13, I am trying to find out, and perhaps shift some responsibility in the process, whether this business produces liabilities that my client does not know about that it is not assuming, because liabilities of that kind may recur in the future and may be a cost item for my client in the future. Secondly, I am leaving liabilities with Larry's client and I am going to make various efforts to be sure that his client keeps money in the corporation to satisfy those liabilities. At the end of the day, there is a possibility that his client will not be able to satisfy them and the creditors will come after my client. So I want to know what liabilities exist. That knowledge will give my client a chance to structure a deal where my client will be protected.

FRANK BALOTTI:
(Commentator)

Do you buy that Larry?

LARRY TAFE:
(Target Counsel)

No. I think it is customary to give the representation and warranty, but I am not sure that it is necessary.

Negotiation Over the Taxes Representation and Warranty

LARRY TAFE:
(Target Counsel)

Let us talk about the taxes representation and warranty, which is Section 3.14, (see Appendix E). That gets even further afield. You certainly do not need Parent to tell you that Parent has paid all its taxes. I understand that there may well be some local or state taxes which may constitute liens on assets which get triggered by the transfer. We will certainly represent to you

that the assets your client buys will be free and clear of liens, and we will take whatever steps are required to get releases of those liens from the state or other authorities. In terms of the overall tax history of Parent and indeed Target, which you are not buying, you do not need to know a damn thing about our taxes. You can take all of Section 3.14 and get rid of it because you are going to take assets into a new entity. You are going to start with clean slate. You are going to set up your books. That entity is not going to owe 15 cents of taxes to anybody on day 1. And your client certainly is not going to owe any of ours. So I do not want to go through these pages and pages of representations and warranties about taxes which should be of no concern to you.

BYRON EGAN:
(Acquiror Counsel)

Sam, do you want to explain to him why we need this.

SAMUEL THOMPSON:
(Moderator)

Larry, first with respect to state sales taxes, there could be successor liability here in that they could carry over under state statutes. For example, in Florida, right here in this state, any unpaid state taxes would simply carry over to the acquiring company.²⁵ So there is a strong incentive for the acquiring company to make sure that the target company's state taxes have been paid. While you are right that the federal income tax liability from the sale is not going to carry over, it is possible, that there could be encumbrances on the assets from federal tax liens. For this reason, we have in Section 3.14(a) a representation that there are no such encumbrances arising from prior federal tax liability.

Furthermore, we want to understand this business, and one of the ways to understand this

²⁵ Fla. Stat. Ann. § 212.10 (2001).

business is to look at the returns you have filed with the various tax authorities that set forth the tax positions you have taken with respect to this business. This will give us a better fundamental understanding of the business and will identify tax issues that we are likely to face in the future. So this is standard. We are asking that the tax returns that were required to have been filed were filed and that the taxes were paid. We want copies of those returns. We want to know that there were proper accruals. In particular, we want to know whether there have been any tax sharing or similar arrangements between Parent and Target. These things will give us a way of verifying some of the fundamental economic assumptions we have made about this transaction. So I think it is a situation where we are protecting ourselves and not hurting you.

LARRY TAFE:
(Target Counsel)

I guess that you are probably right, although if it becomes a due diligence function, strictly an informational tool, I want to be sure before we sign off on these representations and warranties that we do not have any liability. If I am right that you are not going to have any liability, putting aside the things that might carry over, then I guess the question for me is why not just give the representation and not worry about it, because Parent is never going to have to answer to it. But I do not think that is a constructive way to go about representations and warranties. If you need the representation and warranty in order to be protected if I breach it, it is because you have some concern that there would be liability running to you if it were breached. And if the answer is: there is no any way with respect to federal tax liability that you are ever going to bear any responsibility for it whether I breach the representation or not, then it seems a little silly.

Negotiation Over 10b-5 Representation

- LARRY TAFE:
(Target Counsel) Let us turn to Section 3.33, which is what I call the “10b-5 rep” (see Appendix F). The first thing this says is that everything else said in the representations and warranties is not untrue. And I love that because at the law school I went to, when you make representations, you do not have to say at the end of every representation and that it is the truth. What the hell does it add to anything to say that all the statements in here are not untrue?
- BYRON EGAN:
(Acquiror Counsel) I think it does. And furthermore, why do you have any trouble reaffirming that you have told us everything?
- LARRY TAFE:
(Target Counsel) I knew you were going to ask me that.
- BYRON EGAN:
(Acquiror Counsel) Further, we are talking about an asset deal, and securities laws are not applicable to asset transactions unless there is a security involved. So by buying assets instead of the stock of a subsidiary, my client does not have the benefit of SEC Rule 10b-5 since I do not have Rule 10b-5 protection so I try to get it contractually. This is a bit broad, but I think it’s a valid provision.
- LARRY TAFE:
(Target Counsel) Well, the more troublesome part of this representation is the part dealing with the statement that there are no material facts omitted that are necessary in light of, and all that good stuff that we know and love. And it seems to me that you have served up an agreement that has thirty-three representations and warranties, umpteen covenants, forty-two closing conditions, and sixty-two indemnifications and the agreement will run a couple of hundred pages when we are all done here and really what you want me to say is that I will warrant to you here that you have not forgot to ask for

something. You have full access to the company to do all your due diligence and ask any questions you want to ask. You have got representations here that overlap each other fourteen ways to Sunday. There is nothing left that you can ask about this company and the notion that I would give you what I would loosely characterize as a gotcha provision that says that essentially that if you have forgotten to ask something, my client is going to fill the gap when your client screws the company up and it goes down the tubes. On the street I grew up on, they would have called that chutzpa.

BYRON EGAN:
(Acquiror Counsel)

But we are moving on.

*Discussion of Fiduciary Duty Issues with Delaware Counsel and the Vice
Chancellor*

LARRY TAFE:
(Target Counsel)

Next we want to talk about the issues that arise in view of the fact that we have a management buyout. We have an internal conflict of interest since the CEO of Parent is a shareholder of the Buyer. We need help from our brethren from Delaware, Frank Balotti and Vice Chancellor Jack Jacobs.

FRANK BALOTTI:
(Commentator)

I will seek an advisory opinion from the Judge.

VICE CHANCELLOR JACOBS:
(Commentator)

I just wanted to tell all of you candidly that I am finding it very difficult to be the straight man in this group of comics. And I want to assure you that when I was a lawyer, I used to have a sense of humor. And before I became a Judge, I was even allowed to display it. Having said that, we all know that an asset sale is primarily a creature of commercial law, and it is necessary to take account of fraudulent conveyance acts and to factor in the impact of the Bankruptcy Code and so forth. However, there are parts of the process

where the corporation law of the state governing buyer and/or the seller may apply, and so you have to be mindful of that. You certainly have that in this situation where you have got a management buy-out with a CEO being on the seller's side and on the buyer's side. There are a number of questions that come up. One of them is what fiduciary duties apply to the directors of Parent and Target and whether they agree not to provide information to any other bidder or consider the merits of any competing transaction.

BYRON EGAN:
(Acquiror Counsel)

Please look at Section 5.6, where I have served up for Larry, what I consider a very simple, straight forward, no negotiation provision (see Appendix G). It says Parent will not discuss, negotiate with, provide any non-public information to or consider the merits of, any inquiries or proposals from any person. I want this deal adequately protected and, of course, Larry, I want you to give me a Frank Balotti opinion to the effect that this provision can be enforced in accordance with its terms.

LARRY TAFE:
Target Counsel)

We are talking about deal protection.

FRANK BALOTTI:
(Commentator)

Let us start with the basic obligation of the seller. The seller is obligated to obtain the best price available for the assets. That's normal sale of asset law going back ten, twenty, thirty, forty years. In fact, *Revlon*²⁶ and those cases that deal with the sale of the entire enterprise, started from the law dealing with sale of assets. However, there are not any cases on deal protection in sale of assets as far as I know in Delaware. It seems as if our sale of asset law stopped developing about the time the sale of the

²⁶ *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A.2d 173 (Del. 1986).

enterprise law started to develop under *Van Gorkom*,²⁷ *Revlon*, and all those cases that you know and love. But, to start with a basic proposition: How is it that the seller knows that it is obtaining the best price available when it deals exclusively with one buyer? That is a difficult question. Our facts do not mention the presence of an investment banker who advised the seller on price or anybody who advised the seller on the fair market value of the asset. So, you have some fiduciary problems because there is no method by which the seller can have assurance that the assets being sold are being sold for the best price available. One can make a pretty decent argument that if you buy *Revlon* and *QVC*²⁸ as applying to a sale of assets, then Parent's directors here have not fulfilled their responsibility of insuring that they are obtaining the best price reasonably available.

LARRY TAFE:
(Target Counsel)

Suppose we have an investment banker. In that case you would be able to give Byron the opinion he wants?

FRANK BALOTTI:
(Commentator)

Not necessarily. However, a stockholder vote should do it in my mind if there is disclosure to the shareholders that the board dealt exclusively with one buyer, did not afford any other buyers the opportunity to review these assets, and these are the terms under which we ask you to approve this transaction. That should be very helpful. It may, in fact, extinguish arguments under a *Revlon* analogy. That is not case law, but I think that is the best side of the argument.

BYRON EGAN:
(Acquiror Counsel)

Frank, suppose that your client is in extremis. We are talking about the age of insolvency coming on, your client is not in very good shape

²⁷ Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

²⁸ Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34 (Del. 1994).

and you do not have time to go get a sanitizing shareholder vote. You do not have time to go out and do an extensive auction. My client is here with cash and is willing to bail you out. Now, can you take that into account?

FRANK BALOTTI:
(Commentator)

I think you can take that into account, but I am not sure you can take it into account in the analysis I went through before on whether or not a shareholder vote is required under Section 271 of the Delaware General Corporation Law, because again, we do not have the case that says you do not need to live up to that statutory provision if the corporation is in extremis. I think the buyer and the seller are going to be concerned that once a proxy statement goes out, a shareholder will come out of the woodwork, file an action in court and try to enjoin the sale on the grounds that the assets are not being sold for the highest available price. You then get into the question of whether the *Revlon* line of cases applies in a situation like this or whether we are talking about business judgment rule analysis, which I think is the question that Larry was asking.

BYRON EGAN:
(Acquiror Counsel)

In this particular transaction, we have the CEO of Parent as a controlling shareholder of Buyer. So, we have a situation where we have an interested party on both sides of the transaction.

FRANK BALOTTI:
(Commentator)

That is true.

SAMUEL THOMPSON:
(Moderator)

Now, so even if we get a shareholder vote, Frank, and the transaction is challenged, what is the standard of review? Is it business judgment rule, is it enhanced scrutiny under *Unocal*²⁹ or is it entire fairness?

²⁹ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

FRANK BALOTTI:
(Commentator)

It is probably entire fairness and with a shareholder vote with appropriate disclosure, you would shift the burden to the plaintiff to show that the transaction is not entirely fair. This should be contrasted with the normal burden on the defendant to show that the transaction is entirely fair.

SAMUEL THOMPSON:
(Moderator)

Let me make sure I understood you. So you think that entire fairness standard would apply to Parent's board? And the question is whether the burden is going to be on the board or the burden is going to be on the plaintiff? And if you have a fully informed shareholder vote, perhaps following action by an independent board or an independent committee of the board, then you would have the burden shifted to the plaintiff. Is that right?

FRANK BALOTTI:
(Commentator)

That is one way to look at it. On the other hand, assume that you have an interested transaction where you have a board of directors say of ten people and one of them is dealing with the corporation and the other nine independent directors review the transaction. In that instance, entire fairness does not apply. Entire fairness does not apply to every transaction. I would have thought that a transaction of the type that I just described would be one reviewed under the business judgment rule. We do not know in this case how many members of the board in addition to the CEO are part of the buying group. So, I think you need to look at the make-up of the board and who is involved before you reach a final decision on business judgment or entire fairness.

LARRY TAFE:
(Target Counsel)

Frank, I cannot imagine that, if there was a question as to whether shareholder approval was required because it was all or substantially all the assets, a buyer would accept anything less than shareholder approval. Extremis or whatever is

no defense to not getting shareholders to approve the transaction.

FRANK BALOTTI:
(Commentator)

What buyers occasionally accept is the opinion of counsel as to whether or not a shareholder vote is required. It happens many times when speed is of necessity and the deal has to close as in Byron's example, and if the lawyer is of the opinion that a shareholder vote is not required. In such cases many buyers close based on that opinion.

LARRY TAFE:
(Target Counsel)

Yes, but under the hypothetical of more than fifty percent of the assets and virtually all of the operating income, I do not think your firm would give me that opinion.

FRANK BALOTTI:
(Commentator)

You probably would not get that opinion from a reputable Delaware firm. You might get it from Texas firm. Let me draw a distinction here between the situation that we are talking about in this case, and the fact pattern in a closely held situation. If you have all the shareholders of the target company agreeing to the transaction, then these issues do not arise.

LARRY TAFE:
(Target Counsel)

That is exactly what the assumptions are in the Model Asset Purchase Agreement. The contract is by and among a selling company and its major shareholders, not all of them, but its major shareholders that constitute well over what is necessary to satisfy any shareholder vote problem. So the issue disappears in such case.

Negotiation of Indemnification Provisions

BYRON EGAN:
(Acquiror Counsel)

Moving onward, assume that we have gotten past the corporate hurdles and we are down to negotiating the simple provisions relating to indemnification. Turn to Article 11 (see Appendix H). Section 11.2 basically says that Seller is going to indemnify Buyer for any

liability arising out of the ownership or operation of the assets prior to the effective time. Larry, do you have any problem with that?

LARRY TAFE:
(Target Counsel)

Well, I do not have any problem with that. Let me talk just a little bit and go out of the negotiating mode for a minute because I think it works better. Byron and I cannot really fight about the rules of successor liability. They are what they are.

BYRON EGAN:
(Acquiror Counsel)

And that is what Section 11.2 is intended to deal with.

LARRY TAFE:
(Target Counsel)

One of the nice things about going through the experience that we have had with this asset acquisition agreement project over the last several years is that you actually learn something. The most significant bit of new knowledge that I have acquired is the extent to which various and sundry doctrines of successor liability have eroded what I grew up thinking was an inviolate principle: namely that in an asset acquisition, unlike a stock or merger deal, the contract would, in fact, control what liabilities the buying party is stuck with. And if you draft it carefully enough and you make very clear that, as between buyer and seller, the buyer is not assuming liabilities as Byron has suggested in his review of the Section 2 provisions, it works and, of course, is respected. We all know that there have always been some sort of traditional exceptions to that rule. Sam has mentioned tax liens. There were statutes like the bulk sales and fraudulent transfer statutes.

There have been exceptions for fraud issues. But those are all well-known and recognized exceptions that we all know and love and can deal with. You can really deal with tax liens. You can deal with, at least to some extent, fraudulent conveyance issues if you can do financial analysis and solvency analysis and that

sort of thing. More recently we have had some environmental statutes that have imposed strict liability, and there is no way any contract can override them. But all those things are there and we deal with them and we know them. What we have not had to deal with until recent years is a number of doctrines that have been adopted in one way or another by a number of states that really do say that if the transaction falls into this sort of category, the court will, in fact, impose liability on a buyer for a seller's liability, even though the contract says in bold, clear, black and white terms that the parties intended otherwise. Section IV of this article surveys various and sundry theories of successor liability. And there are some that are kind of far out. California, as you might expect, has one that is kind of far out and is a strict liability tort doctrine. It is the same doctrine that says that if the seller's gone, which is generally the case (otherwise there is no reason to chase the buyer), and a guy's leg is cut off, then the guy can recover from the buyer. It is dressed up in somewhat fancier language than that, but that is really the bottom line.

SAMUEL THOMPSON:
(Moderator)

By the way, that doctrine has not been accepted in Florida.

LARRY TAFE:
(Target Counsel)

Indeed the doctrine has been expressly disavowed in probably twenty-five or thirty states and has been accepted only in two or three. What is by no means a far out doctrine, is the de facto merger principle. And, you know, the courts will begin by recognizing the conventional rule and, then they will say, but, of course, there is an exception if there's a de facto merger. And there are four factors that can bring about a de facto merger in the view of the court. First, the enterprise continues with substantially the same form, the same management, the same locale, the same product, the same

facilities and so forth. Second, the seller goes out of business, liquidates, dissolves, ceases its operations, which would not be the case we are posing here, but it would be under the facts on which the Model Asset Acquisition Agreement is based. Third, buyer assumes the ordinary course liabilities of the selling enterprise. Those three factors are not exactly extraordinary items in a typical sale of all of the assets of an enterprise. The fourth factor is not quite as common, and is whether the shareholders or a shareholder of the seller wind up with some equity interest in the buyer. And that goes back to the origins of the de facto merger doctrine, which I believe were in Pennsylvania 40 years ago which dealt with some appraisal rights cases.³⁰

BYRON EGAN:
(Acquiror Counsel)

Larry, in Texas we got confused again with all those theories and we simply amended our statute, the Texas Business Corporation Act, to provide that the doctrine of de facto merger is dead, and we tried to drive a stake through its heart and all of the progeny that Larry's been talking about in asset deals.³¹ Now, the issue of course is where does the claim arise and will it arise in a state that is user friendly for those doctrines and where the Texas statute is not respected, and that is an issue for another day.

VICE CHANCELLOR JACOBS:
(Commentator)

One quick comment about the successor liability issue because there are some important points that I think you need to keep in mind. Larry talked about the de facto merger concept as being the approach that has been taken by Massachusetts and perhaps other states as the doctrinal basis for successor liability. Byron suggested that would not be the result in Texas

³⁰ Farris v. Glen Alden, 143 A.2d 25 (Pa. 1958).

³¹ Tex. Bus. Corp. Act. Art. 5.10 (2001); see Byron F. Egan and Curtis W. Huff, *Choice of State of Incorporation – Texas versus Delaware: Is It Now Time to Rethink Traditional Notions?*, 54 SMU Law Review 249, 288-290 (Winter 2001).

because Texas has abolished de facto mergers. Well in Delaware, we have decisional laws that declare that Delaware does not recognize de facto mergers either. Thus, we would come out in Delaware the same way that Texas comes out. However, a few minutes in the library convinced us otherwise because there are cases, a district court case followed by state court decisions that do adopt successor liability based on the de facto merger doctrine. So what we have is a peculiar situation in which for purposes of corporate law, that is applying the Delaware corporate statute, there is no such animal as de facto merger, but for purposes of successor liability there may be. And those of you who are from states that proclaim not to follow a de facto merger theory should be careful and research that area carefully in the context of the successor liability concept before you draw any untoward conclusions.

BYRON EGAN:
(Acquiror Counsel)

We are coming to the end of our time, but we would like to call your attention and Judge Jacobs' attention to Section 11.11 in your materials. It provides for indemnification in the case of strict liability of the indemnitee or indemnitee negligence. All this is in bold face, and my friends from New York say that bold face type looks funny. They have probably seen it in some deals where they think it is unnecessary. The provision basically says that the indemnification provisions that are elsewhere in the agreement are going to be applicable irrespective of whether the liability arises out of the negligence of the indemnitee or arises out of a strict liability doctrine imposed on the indemnitee. And there is a Fifth Circuit case, *Fina*,³² that explains that a general "indemnity provision [similar to Section 11.2,

³² *Fina, Inc. v. ARCO*, 200 F.3d 266 (5th Cir. 2000).

see Appendix H] is not enforceable under Texas law as applied to strict liability."³³ The Fifth Circuit reasoned: "Texas law requires that each type of claim be separately referenced by an indemnity provision: 'Indemnification against strict liability is an exception to usual business practices in the same manner as indemnifying against someone else's negligence. . . . [F]airness dictates against imposing liability on an indemnitor unless the agreement clearly and specifically expresses the intent to encompass strict liability claims."³⁴ Now, we have the Judge and I would like him to tell us whether the Fifth Circuit got it right. Is the express negligence doctrine something that you recognize in Delaware?

VICE CHANCELLOR JACOBS: It is recognized in Delaware. It is legally all right to have an indemnification clause where an indemnitee can be indemnified against the consequences of its own negligence provided that is clearly and expressly stated in the indemnification provision of the contract. If that is what the Fifth Circuit held, then that is consistent with our rule. Whether it is right or not is not for me to say.

SAMUEL THOMPSON: Judge, thank you very much for that very important point. We have come to the end of our program and I want to thank you all again for coming. I also want to thank our speakers, and I want to give a particular thanks to our co-chairs Dennis and Harvey for their great service on behalf of the University of Miami School of Law.

³³ *Id.* at 274.

³⁴ *Id.*

**APPENDIX A. SECTION 2, ASSETS ACQUIRED AND
LIABILITIES ASSUMED**

2. SALE AND TRANSFER OF ASSETS; CLOSING

2.1 ASSETS TO BE SOLD

Upon the terms and subject to the conditions set forth in this Agreement, at the Closing, but effective as of the Effective Time, Seller shall sell, convey, assign, transfer and deliver to Buyer, free and clear of any Encumbrances other than Permitted Encumbrances, and Buyer shall purchase and acquire from Seller, all of Seller's right, title and interest in and to all of Seller's property and assets, real, personal or mixed, tangible and intangible, of every kind and description, wherever located, including the following (but excluding the Excluded Assets):

- (a) all Real Property, including the Real Property described in Parts 3.7 and 3.8;
- (b) all Tangible Personal Property, including those items described in Part 2.1(b);
- (c) all Inventories;
- (d) all Accounts Receivable;
- (e) all Seller Contracts, including those listed in Part 3.20(a), and all outstanding offers or solicitations made by or to Seller to enter into any Contract;
- (f) all Governmental Authorizations and all pending applications therefore or renewals thereof, in each case to the extent transferable to Buyer, including those listed in Part 3.17(b);
- (g) all data and Records related to the operations of Seller, including client and customer lists and Records, referral sources, research and development reports and Records, production reports and Records, service and warranty Records, equipment logs, operating guides and manuals, financial and accounting Records, creative materials, advertising materials, promotional materials, studies, reports, correspondence and other similar documents and Records and, subject to Legal Requirements, copies of all personnel Records and other Records described in Section 2.2(g);
- (h) all of the intangible rights and property of Seller, including Intellectual Property Assets, going concern value, good-will, telephone, telecopy and e-mail addresses, websites and listings and those items listed in Part 3.25(d), (e), (f) and (h);

- (i) all insurance benefits, including rights and proceeds, arising from or relating to the Assets or the Assumed Liabilities prior to the Effective Time, unless expended in accordance with this Agreement;
- (j) all claims of Seller against third parties relating to the Assets, whether choate or inchoate, known or unknown, contingent or non-contingent, including all such claims listed in Part 2.1(j); and
- (k) all rights of Seller relating to deposits and prepaid expenses, claims for refunds and rights to offset in respect thereof which are not listed in Part 2.2(d) and which are not excluded under Section 2.2(h).

All of the foregoing property and assets are herein referred to collectively as the "Assets".

Notwithstanding the foregoing, the transfer of the Assets pursuant to this Agreement shall not include the assumption of any Liability in respect thereof unless the Buyer expressly assumes such Liability pursuant to Section 2.4(a).

2.2 EXCLUDED ASSETS

Notwithstanding anything to the contrary contained in Section 2.1 or elsewhere in this Agreement, the following assets of Seller (collectively, the "Excluded Assets") are not part of the sale and purchase contemplated hereunder, are excluded from the Assets, and shall remain the property of Seller after the Closing:

- (a) all cash, cash equivalents and short term investments;
- (b) all minute books, stock Records and corporate seals;
- (c) the shares of capital stock of Seller held in treasury;
- (d) those rights relating to deposits and prepaid expenses and claims for refunds and rights to offset in respect thereof listed in Part 2.2(d);
- (e) all insurance policies and rights thereunder (except to the extent specified in Section 2.1(i) and (j));
- (f) all of the Seller Contracts listed in Part 2.2(f);
- (g) all personnel Records and other Records that Seller is required by law to retain in its possession;
- (h) all claims for refund of Taxes and other governmental charges of whatever nature;
- (i) all rights in connection with and assets of the Employee Plans;
- (j) all rights of Seller under this Agreement, the Bill of Sale, the Assignment and Assumption Agreement, the Promissory Note and the Escrow Agreement; and

- (k) property and assets expressly designated in Part 2.2(k).

2.3 CONSIDERATION

The consideration for the Assets (the "Purchase Price") will be (i) \$_____ plus or minus the Adjustment Amount and (ii) the assumption of the Assumed Liabilities. In accordance with Section 2.7(b), at the Closing the Purchase Price, prior to adjustment on account of the Adjustment Amount, shall be delivered by Buyer to Seller as follows: (i) \$_____ by wire transfer; (ii) \$_____ payable in the form of the Promissory Note; (iii) \$_____ paid to the escrow agent pursuant to the Escrow Agreement; and (iv) the balance of the Purchase Price by the execution and delivery of the Assignment and Assumption Agreement. The Adjustment Amount shall be paid in accordance with Section 2.8.

2.4 LIABILITIES

(a) *Assumed Liabilities.* On the Closing Date, but effective as of the Effective Time, Buyer shall assume and agree to discharge only the following Liabilities of Seller (the "Assumed Liabilities"):

- (i) any trade account payable reflected on the Interim Balance Sheet (other than a trade account payable to any Shareholder or a Related Person of Seller) which remain unpaid at and are not delinquent as of the Effective Time;
- (ii) any trade account payable (other than a trade account payable to any Shareholder or a Related Person of Seller) that have been incurred by Seller in the Ordinary Course of Business between the date of the Interim Balance Sheet and the Closing Date which remains unpaid at and are not delinquent as of the Effective Time;
- (iii) any Liability to Seller's customers incurred by Seller in the Ordinary Course of Business for non-delinquent orders outstanding as of the Effective Time reflected on Seller's books (other than any Liability arising out of or relating to a Breach which occurred prior to the Effective Time);
- (iv) any Liability to Seller's customers under written warranty agreements in the forms disclosed in Part 2.4(a)(iv) given by Seller to its customers in the Ordinary Course of Business prior to the Effective Time (other than any Liability arising out of or relating to a Breach which occurred prior to the Effective Time);
- (v) any Liability arising after the Effective Time under the Seller Contracts described in Part 3.20(a) (other than any Liability arising

under the Seller Contracts described on Part 2.4(a)(v) or arising out of or relating to a Breach which occurred prior to the Effective Time);

(vi) any Liability of Seller arising after the Effective Time under any Seller Contract included in the Assets which is entered into by Seller after the date hereof in accordance with the provisions of this Agreement (other than any Liability arising out of or relating to a Breach which occurred prior to the Effective Time); and

(vii) any Liability of Seller described on Part 2.4(a)(vii).

(b) *Retained Liabilities.* The Retained Liabilities shall remain the sole responsibility of and shall be retained, paid, performed and discharged solely by Seller. "Retained Liabilities" shall mean every Liability of Seller other than the Assumed Liabilities, including:

(i) any Liability arising out of or relating to products of Seller to the extent manufactured or sold prior to the Effective Time other than to the extent assumed under Section 2.4(a)(iii), (iv) or (v);

(ii) any Liability under any Contract assumed by Buyer pursuant to Section 2.4(a) which arises after the Effective Time but which arises out of or relates to any Breach that occurred prior to the Effective Time;

(iii) any Liability for Taxes, including (A) any Taxes arising as a result of Seller's operation of its business or ownership of the Assets prior to the Effective Time, (B) any Taxes that will arise as a result of the sale of the Assets pursuant to this Agreement and (C) any deferred Taxes of any nature;

(iv) any Liability under any Contract not assumed by Buyer under Section 2.4(a), including any Liability arising out of or relating to Seller's credit facilities or any security interest related thereto;

(v) any Environmental, Health and Safety Liabilities arising out of or relating to the operation of Seller's business or Seller's leasing, ownership or operation of real property;

(vi) any Liability under the Employee Plans or relating to payroll, vacation, sick leave, worker's compensation, unemployment benefits, pension benefits, employee stock option or profit-sharing plans, health care plans or benefits, or any other employee plans or benefits of any kind for Seller's employees or former employees, or both;

(vii) any Liability under any employment, severance, retention or termination agreement with any employee of Seller or any of its Related Persons;

- (viii) any Liability arising out of or relating to any employee grievance whether or not the affected employees are hired by Buyer;
- (ix) any Liability of Seller to any Shareholder or Related Person of Seller or any Shareholder;
- (x) any Liability to indemnify, reimburse or advance amounts to any officer, director, employee or agent of Seller;
- (xi) any Liability to distribute to any of Seller's shareholders or otherwise apply all or any part of the consideration received hereunder;
- (xii) any Liability arising out of any Proceeding pending as of the Effective Time, whether or not set forth in the Disclosure Letter;
- (xiii) any Liability arising out of any Proceeding commenced after the Effective Time and arising out of, or relating to, any occurrence or event happening prior to the Effective Time;
- (xiv) any Liability arising out of or resulting from Seller's non-compliance with any Legal Requirement or Order of any Governmental Body;
- (xv) any Liability of Seller under this Agreement or any other document executed in connection with the Contemplated Transactions; and
- (xvi) any Liability of Seller based upon Seller's acts or omissions occurring after the Effective Time.

APPENDIX B. SECTION 3.2, ENFORCEABILITY REPRESENTATION

3. REPRESENTATIONS AND WARRANTIES OF SELLER AND SHAREHOLDERS

Seller and each Shareholder represent and warrant, jointly and severally, to Buyer as follows:

3.2 ENFORCEABILITY; AUTHORITY; NO CONFLICT

(a) This Agreement constitutes the legal, valid, and binding obligation of Seller and each Shareholder, enforceable against each of them in accordance with its terms. Upon the execution and delivery by Seller and Shareholders of the Escrow Agreement, the Employment Agreement, the Noncompetition Agreement, and each other agreement to be executed or delivered by any or all of Seller and Shareholders at the Closing (collectively, the "Seller's Closing Documents"), each of Seller's Closing Documents will constitute the legal, valid, and binding obligation of each of Seller and the Shareholders a party thereto, enforceable against each of them in accordance with its terms. Seller has the absolute and unrestricted right, power and authority to execute and deliver this Agreement and the Seller's Closing Documents to which it is a party and to perform its obligations under this Agreement and the Seller's Closing Documents, and such action has been duly authorized by all necessary action by Seller's shareholders and board of directors. Each Shareholder has all necessary legal capacity to enter into this Agreement and the Seller's Closing Documents to which such Shareholder is a party and to perform his obligations hereunder and thereunder.

(b) Except as set forth in Part 3.2(b), neither the execution and delivery of this Agreement nor the consummation or performance of any of the Contemplated Transactions will, directly or indirectly (with or without notice or lapse of time):

- (i) Breach (A) any provision of any of the Governing Documents of Seller, or (B) any resolution adopted by the board of directors or the shareholders of Seller;
- (ii) Breach or give any Governmental Body or other Person the right to challenge any of the Contemplated Transactions or to

exercise any remedy or obtain any relief under any Legal Requirement or any Order to which Seller or either Shareholder, or any of the Assets, may be subject;

(iii) contravene, conflict with, or result in a violation or breach of any of the terms or requirements of, or give any Governmental Body the right to revoke, withdraw, suspend, cancel, terminate, or modify, any Governmental Authorization that is held by Seller or that otherwise relates to the Assets or to the business of Seller;

(iv) cause Buyer to become subject to, or to become liable for the payment of, any Tax;

(v) Breach any provision of, or give any Person the right to declare a default or exercise any remedy under, or to accelerate the maturity or performance of, or payment under, or to cancel, terminate, or modify, any Seller Contract;

(vi) result in the imposition or creation of any Encumbrance upon or with respect to any of the Assets; or

(vii) result in any shareholder of the Seller having the right to exercise dissenters' appraisal rights.

(c) Except as set forth in Part 3.2(c), neither Seller nor either Shareholder is required to give any notice to or obtain any Consent from any Person in connection with the execution and delivery of this Agreement or the consummation or performance of any of the Contemplated Transactions.

**APPENDIX C. SECTION 3.6, SUFFICIENCY OF ASSETS
REPRESENTATION**

3.6 SUFFICIENCY OF ASSETS

Except as disclosed in Part 3.6, the Assets (a) constitute all of the assets, tangible and intangible, of any nature whatsoever, necessary to operate Seller's business in the manner presently operated by Seller and (b) include all of the operating assets of Seller.

**APPENDIX D. SECTION 3.13, NO UNDISCLOSED LIABILITIES
REPRESENTATION**

3.13 NO UNDISCLOSED LIABILITIES

Except as set forth in Part 3.13, Seller has no Liability except for Liabilities reflected or reserved against in the Balance Sheet or the Interim Balance Sheet and current liabilities incurred in the Ordinary Course of Business of Seller since the date of the Interim Balance Sheet.

APPENDIX E. SECTION 3.14, TAXES REPRESENTATION**3.14 TAXES**

(a) *Tax Returns Filed and Taxes Paid.* Seller has filed or caused to be filed on a timely basis all Tax Returns and all reports with respect to Taxes that are or were required to be filed pursuant to applicable Legal Requirements. All Tax Returns and reports filed by Seller are true, correct and complete. Seller has paid, or made provision for the payment of, all Taxes that have or may have become due for all periods covered by the Tax Returns or otherwise, or pursuant to any assessment received by Seller, except such Taxes, if any, as are listed in Part 3.14(a) and are being contested in good faith and as to which adequate reserves (determined in accordance with GAAP) have been provided in the Balance Sheet and the Interim Balance Sheet. Except as provided in Part 3.14(a), Seller currently is not the beneficiary of any extension of time within which to file any Tax Return. No claim has ever been made or is expected to be made by any Governmental Body in a jurisdiction where Seller does not file Tax Returns that it is or may be subject to taxation by that jurisdiction. There are no Encumbrances on any of the Assets that arose in connection with any failure (or alleged failure) to pay any Tax, and Seller has no Knowledge of any basis for assertion of any claims attributable to Taxes which, if adversely determined, would result in any such Encumbrance.

(b) *Delivery of Tax Returns and Information Regarding Audits and Potential Audits.* Seller has delivered or made available to Buyer copies of, and Part 3.14(b) contains a complete and accurate list of, all Tax Returns filed since _____, 20___. The federal and state income or franchise Tax Returns of Seller have been audited by the IRS or relevant state tax authorities or are closed by the applicable statute of limitations for all taxable years through _____, 20___. Part 3.14(b) contains a complete and accurate list of all Tax Returns that have been audited or are currently under audit and accurately describe any deficiencies or other amounts that were paid or are currently being contested. To the Knowledge of Seller, no undisclosed deficiencies are expected to be asserted with respect to any such audit. All deficiencies proposed as a result of such audits have been paid, reserved against, settled, or are being contested in good faith by appropriate proceedings as described in Part 3.14(b). Seller has delivered, or

made available to Buyer, copies of any examination reports, statements or deficiencies, or similar items with respect to such audits. Except as provided in Part 3.14(b), Seller has no knowledge that any Governmental Body is likely to assess any additional taxes for any period for which Tax Returns have been filed. There is no dispute or claim concerning any Taxes of Seller either (i) claimed or raised by any Governmental Body in writing or (ii) as to which Seller has Knowledge. Part 3.14(b) contains a list of all Tax Returns for which the applicable statute of limitations has not run. Except as described in Part 3.14(b), Seller has not given or been requested to give waivers or extensions (or is or would be subject to a waiver or extension given by any other Person) of any statute of limitations relating to the payment of Taxes of Seller or for which Seller may be liable.

(c) *Proper Accrual.* The charges, accruals, and reserves with respect to Taxes on the Records of Seller are adequate (determined in accordance with GAAP) and are at least equal to Seller's liability for Taxes. There exists no proposed tax assessment or deficiency against Seller except as disclosed in the [Interim] Balance Sheet or in Part 3.14(c).

(d) *Specific Potential Tax Liabilities and Tax Situations.*

(i) *Withholding.* All taxes that Seller is or was required by Legal Requirements to withhold, deduct or collect have been duly withheld, deducted and collected and, to the extent required, have been paid to the proper Governmental Body or other Person.

(ii) *Tax Sharing or Similar Agreements.* There is no tax sharing agreement, tax allocation agreement, tax indemnity obligation or similar written or unwritten agreement, arrangement, understanding or practice with respect to Taxes (including any advance pricing agreement, closing agreement or other arrangement relating to Taxes) that will require any payment by Seller.

(iii) *Consolidated Group.* Seller (A) has not been a member of an affiliated group within the meaning of Code Section 1504(a) (or any similar group defined under a similar provision of state, local or foreign law), and (B) has no liability for Taxes of any person (other than Seller and its Subsidiaries) under Reg. Section 1.1502-6 (or any similar provision of state, local or foreign law), as a transferee or successor by contract or otherwise.

(iv) *S Corporation*. Seller is not an *S* corporation as defined in Code Section 1361.

ALTERNATIVE No. 1:

Seller is an *S* corporation as defined in Code Section 1361 and Seller is not and has not been subject to either the built-in-gains tax under Code Section 1374 or the passive income tax under Code Section 1375.

ALTERNATIVE No. 2:

Seller is an *S* corporation as defined in Code Section 1361 and Seller is not subject to the tax on passive income under Code Section 1375, but is subject to the built-in-gains tax under Code Section 1374, and all tax liabilities under Code Section 1374 though and including the Closing Date have on shall be properly paid and discharged by Seller.

INCLUDE WITH BOTH ALTERNATIVE No. 1 AND No. 2:

Part 3.14(d)(iv) lists all the states and localities with respect to which Seller is required to file any corporate, income or franchise tax returns and sets forth whether Seller is treated as the equivalent of an *S* corporation by or with respect to each such state or locality. Seller has properly filed Tax Returns with and paid and discharged any liabilities for taxes in any states or localities in which it is subject to Tax.

(v) *Substantial Understatement Penalty*. Seller has disclosed on its federal income Tax Returns all positions taken therein that could give rise to a substantial understatement of federal income Tax within the meaning of Code Section 6662.

APPENDIX F. SECTION 3.33, 10B-5 REPRESENTATION

3.33 DISCLOSURE

(a) No representation or warranty or other statement made by Seller or either Shareholder in this Agreement, the Disclosure Letter, any supplement to the Disclosure Letter, the certificates delivered pursuant to Section 2.7(b) or otherwise in connection with the Contemplated Transactions contains any untrue statement or omits to state a material fact necessary to make any of them, in light of the circumstances in which it was made, not misleading.

(b) Seller does not have Knowledge of any fact that has specific application to Seller (other than general economic or industry conditions) and that may materially adversely affect the assets, business, prospects, financial condition, or results of operations of Seller that has not been set forth in this Agreement or the Disclosure Letter.

APPENDIX G. SECTION 5.6, NO NEGOTIATION COVENANT

5.6 NO NEGOTIATION

Until such time as this Agreement shall be terminated pursuant to Section 9.1, neither Seller nor either Shareholder shall directly or indirectly solicit, initiate, encourage or entertain any inquiries or proposals from, discuss or negotiate with, provide any non-public information to, or consider the merits of any inquiries or proposals from, any Person (other than Buyer) relating to any business combination transaction involving Seller, including the sale by the Shareholders of Seller's stock, the merger or consolidation of Seller, or the sale of Seller's business or any of the Assets (other than in the Ordinary Course of Business). Seller and Shareholders shall notify Buyer of any such inquiry or proposal within twenty four hours of receipt or awareness of the same by Seller or either Shareholder.

APPENDIX H. SECTION 11.1, GENERAL INDEMNIFICATION PROVISION

11. INDEMNIFICATION; REMEDIES

11.1 SURVIVAL

All representations, warranties, covenants, and obligations in this Agreement, the Disclosure Letter, the supplements to the Disclosure Letter, the certificates delivered pursuant to Section 2.7, and any other certificate or document delivered pursuant to this Agreement shall survive the Closing and the consummation of the Contemplated Transactions, subject to Section 11.7. The right to indemnification, reimbursement, or other remedy based on such representations, warranties, covenants and obligations shall not be affected by any investigation (including any environmental investigation or assessment) conducted with respect to, or any Knowledge acquired (or capable of being acquired) at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of or compliance with, any such representation, warranty, covenant or obligation. The waiver of any condition based on the accuracy of any representation or warranty, or on the performance of or compliance with any covenant or obligation, will not affect the right to indemnification, reimbursement, or other remedy based on such representations, warranties, covenants and obligations.

11.2 INDEMNIFICATION AND REIMBURSEMENT BY SELLER AND SHAREHOLDERS

Seller and each Shareholder, jointly and severally, will indemnify and hold harmless Buyer, and its Representatives, shareholders, subsidiaries, and Related Persons (collectively, the "Buyer Indemnified Persons"), and will reimburse the Indemnified Persons, for any loss, liability, claim, damage, expense (including costs of investigation and defense and reasonable attorneys' fees and expenses) or diminution of value, whether or not involving a Third-Party Claim (collectively, "Damages"), arising from or in connection with:

- (a) any Breach of any representation or warranty made by Seller or either Shareholder in (i) this Agreement (without giving effect to any supplement to the Disclosure Letter), (ii) the Disclosure Letter, (iii)

- the supplements to the Disclosure Letter, (iv) the certificates delivered pursuant to Section 2.7 (for this purpose, each such certificate will be deemed to have stated that Seller's and Shareholders' representations and warranties in this Agreement fulfill the requirements of Section 7.1 as of the Closing Date as if made on the Closing Date without giving effect to any supplement to the Disclosure Letter, unless the certificate expressly states that the matters disclosed in a supplement have caused a condition specified in Section 7.1 not to be satisfied), (v) any transfer instrument or (vi) any other certificate, document, writing or instrument delivered by Seller or either Shareholder pursuant to this Agreement;
- (b) any Breach of any covenant or obligation of Seller or either Shareholder in this Agreement or in any other certificate, document, writing or instrument delivered by Seller or either Shareholder pursuant to this Agreement;
 - (c) any Liability arising out of the ownership or operation of the Assets prior to the Effective Time other than the Assumed Liabilities;
 - (d) any brokerage or finder's fees or commissions or similar payments based upon any agreement or understanding made, or alleged to have been made, by any Person with Seller or either Shareholder (or any Person acting on their behalf) in connection with any of the Contemplated Transactions;
 - (e) any product or component thereof manufactured by or shipped, or any services provided by, Seller, in whole or in part, prior to the Closing Date;
 - (f) any matter disclosed in Parts ____ of the Disclosure Letter;
 - (g) any noncompliance with any Bulk Sales Laws or fraudulent transfer law in respect of the Contemplated Transactions;
 - (h) any liability under the WARN Act or any similar state or local Legal Requirement that may result from an "Employment Loss," as defined by 29 U.S.C. Section 2101(a)(6), caused by any action of Seller prior to the Closing or by Buyer's decision not to hire previous employees of Seller;
 - (i) any Employee Plan established or maintained by Seller; or
 - (j) any Retained Liabilities.

11.11 INDEMNIFICATION IN CASE OF STRICT LIABILITY OR INDEMNITEE NEGLIGENCE

THE INDEMNIFICATION PROVISIONS IN THIS ARTICLE 11 SHALL BE ENFORCEABLE REGARDLESS OF WHETHER THE LIABILITY IS BASED ON PAST, PRESENT OR FUTURE ACTS, CLAIMS OR LEGAL REQUIREMENTS (INCLUDING ANY PAST, PRESENT OR FUTURE BULK SALES LAW, ENVIRONMENTAL LAW, FRAUDULENT TRANSFER ACT, OCCUPATIONAL SAFETY AND HEALTH LAW, OR PRODUCTS LIABILITY, SECURITIES OR OTHER LEGAL REQUIREMENT), AND REGARDLESS OF WHETHER ANY PERSON (INCLUDING THE PERSON FROM WHOM INDEMNIFICATION IS SOUGHT) ALLEGES OR PROVES THE SOLE, CONCURRENT, CONTRIBUTORY OR COMPARATIVE NEGLIGENCE OF THE PERSON SEEKING INDEMNIFICATION, OR THE SOLE OR CONCURRENT STRICT LIABILITY IMPOSED ON THE PERSON SEEKING INDEMNIFICATION.

