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Summary of Acquisition Agreements*

LOU R. KLING, EILEEN NUGENT SIMON AND MICHAEL GOLDMAN**

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I. INTRODUCTION

There are basically three different methods for acquiring the business of another corporation under state law: a stock purchase, an asset purchase, or a merger. Although each transaction differs significantly in structure, the same basic contractual provisions can be built into any of these methods. Provisions basic to any acquisition agreement include mechanical provisions, purchase price provisions, representations and warranties, covenants, conditions, indemnification provisions, termination provisions and provisions relating to expense reimbursement and fees, as well as a number of miscellaneous provisions.

Although these basic provisions are present in virtually all acquisition agreements, their relative importance can differ dramatically. This Article compares some of these differences by examining the operation of these provisions in public company acquisition agreements, private company acquisition agreements and leveraged buyout agreements.

In principle, public company acquisitions are no different from acquisitions of subsidiaries, divisions and private companies. In fact, the agreements are generally simpler than for other types of acquisitions. Public company acquisitions, however, do have their own unique problems. Two interrelated factors generally cause the greatest concern. First, shareholder approval for a public company acquisition does not occur until near the end of the acquisition process, long after public announcement of the transaction. Second, public company acquisitions suffer from an increased risk of third party competition. This can arise both prior to the execution of a definitive agreement and thereafter, until target shareholder approval is obtained or sometimes even until closing. A third, unrelated aspect of public company transactions is that, unless an escrow or similar holdback device is established, there is no way for the purchaser to obtain indemnification from public shareholders.

Private company transactions tend to have some of the same characteristics as public company transactions, but with a few significant differences. Private companies do not have the same reporting requirements as public companies, which creates a greater need for enhanced representations and warranties. Additionally, acquiring the principal stockholder's consent not to compete post-closing with the business sold to the acquiror may be significant in a private company acquisition.

A leveraged buyout has three distinct characteristics. First, it is an acquisition of all or a majority (or substantial) equity interest in an entire company or in a subsidiary, division or other portion of a company, by an investor group or entity. Second, the major portion of the purchase price is financed through the incurrence of debt. Finally, the credit

backing up such debt is (primarily) that of the entity or business being acquired.

II. OVERVIEW OF TYPICAL ACQUISITION AGREEMENT

Before discussing how specific provisions operate in each type of acquisition, it is important to note at the outset that most transactions have a period between the signing of the agreement—the time when the parties become legally obligated to effect the transaction—and the closing, which is when the acquisition actually occurs. A number of reasons explain the delay between signing and closing. Stockholder approval by the seller's shareholders (or the buyer's) may be required. There may be antitrust filings under the Hart-Scott-Rodino Antitrust Improvements Act of 1976¹ or other regulatory approvals necessary. Moreover, the buyer may need a period of time after the agreement has been signed to line up its financing. This delay necessitates a number of provisions, which will be discussed at length below.

A typical acquisition agreement consists of a number of parts. Of particular importance are the representations and warranties, covenants and closing conditions, which all work together and interrelate with each other. The representations and warranties consist of a number of statements about the seller (or buyer) and its business at the time the agreement is signed.² The covenants portion of the agreement deals with the period between signing and closing. As such, at the time of signing it is a forward looking set of provisions which obligate the parties to take, or refrain from taking, certain actions.

The conditions article will determine whether the parties are obligated to close the transaction. In a typical acquisition, a number of conditions will determine the parties' obligations to close. For example, any stockholder or governmental approvals necessary for the transaction will have to have been obtained. If they have not been, the parties may (or, in the case of stockholder approval, will) not be required to consummate the transaction.

Two key conditions relate to the representations and covenants discussed above. The first—the so-called “bring down” —states that the representations made when the agreement was signed about the seller and its business (or in the case of the seller's condition, the buyer's representations about itself) are still true at the time the parties are otherwise ready to consummate the transaction. The second condition is that

1. 15 U.S.C. §§ 15(c)-(h), 18(a), 66 (1994).

2. In certain instances, the statements may be made as of a prior date, such as the date of the most recent financial statements.

the other party shall have performed and complied with its covenants and agreements between signing and closing.

The indemnification article of the agreement deals with problems that arise or that the parties become aware of after the closing. If, for example, it turns out that one or more of the seller's representations was false, the buyer may be entitled to recover damages from the seller. Other circumstances include those where the parties agree that post-closing remedies be available for either of them.³ In the typical public company acquisition, no post-closing indemnification or similar remedy will be available for the buyer.

The acquisition agreement will also contain (critically important) provisions setting forth the purchase price to be paid, provisions describing the stock, assets and/or liabilities being acquired and miscellaneous provisions including those relating to termination rights and their consequences. A description of the purchase price to be paid can range from something quite simple, such as a flat, specified dollar amount, to the complex, involving formulas and all sorts of adjustments. The price may be payable in cash, securities of the buyer or an affiliate, or any other property. A key element of the purchase price description will be whether it is affected by the results of operation of the business being acquired during the period pending the closing. This will, in effect, determine whether the business is being run for the benefit of the buyer or the seller between signing and closing.

The mechanical and transfer provisions of an acquisition agreement are usually fairly simple and straightforward in mergers and stock purchase agreements. In asset transactions, however, where fewer than all assets and liabilities of a particular entity are to be acquired, the description of the assets and liabilities being transferred and assumed can be quite complex and have serious substantive implications for the parties.

III. SELLER REPRESENTATIONS AND WARRANTIES

A. *General Considerations*

The acquisition agreement is a negotiated document that in large part reflects how favorable the parties view their respective deals, the parties' relative bargaining power and other attendant circumstances (including time pressure). The representations article is often the first following the purchase price provisions in an acquisition agreement and thus often sets the tone for the entire agreement.

3. In the overwhelming majority of circumstances these provisions are for the benefit of the buyer.

The purpose of the seller's representations is to paint a picture of the business being acquired, generally as of the time that the parties become contractually bound. Equally important, the representations work together with the covenants to set forth a road map of many of the events that must occur between signing and closing.

Buyers generally require sellers to make representations and warranties for three reasons. First, the seller's representations assist the buyer in understanding the business it is acquiring and in doing its due diligence. Second, they allow the buyer to refuse to close the transaction if the representations are not true at closing. Finally, these provisions enable the buyer to recover damages if a representation turns out to have been false, whether or not the transaction closes.

The scope of the seller's representations is often a function of the specifics of the particular transaction. For example, a buyer may be paying a high price for a business, is unconcerned with outside competition either because there is none or the seller is "locked up," and is not faced with significant time pressures. If this is the case, the buyer may require the seller to make extensive representations. On the other hand, if a seller is conducting an auction, with several bidders offering approximately the same price, time pressure is created. In this instance, the buyer will not usually be able to obtain extensive representations.

B. *Specific Representations of the Seller*

Among the representations that buyers will typically insist be included in the acquisition agreement are a number of clauses relating to the seller's corporate organization and existence under state law, its powers and duties both to its stockholders and the state, its authority to entertain the acquisition, and its liabilities. This section examines a number of key provisions and issues that may arise during their negotiation.

Corporate Organization and Existence. Buyers are surely entitled to know that the entity it is purchasing is what it purports to be. Thus, sellers are almost invariably asked to represent that the company is a "corporation, duly organized, validly existing and in good standing under the laws of its jurisdiction of incorporation." As to "duly organized," the seller must represent that the incorporation of the company complied with the relevant state corporate law applicable at the time. As to "validly existing," the seller will represent that the company still exists as a corporation, ie. that it has not been merged or liquidated or dissolved out of existence. As to "good standing," here the seller will state that the company has performed whatever acts are required by its

state of incorporation to be performed so as to avoid the state being able to suspend or terminate the corporate charter.

The seller is also often asked to represent that the company has "full corporate power and authority to conduct its business in the manner in which it is conducted and to own and lease its properties." This representation relates to corporate authority and power as set forth in state corporate law and the certificate of incorporation and by-laws.

Good Standing as a Foreign Corporation. Companies are usually asked to represent that they are duly qualified and in good standing to conduct business in each jurisdiction where the nature of their business or their ownership or leasing of assets makes such qualification necessary. This representation, unlike the one dealing with good standing in a company's jurisdiction of incorporation, can lead to a fair amount of discussion. In many cases, it will be unclear whether qualification in any particular state is required, and the decision whether or not to qualify as a foreign corporation is often made on business grounds rather than according to legal concerns.

The buyer conversely has legitimate concerns relating to the failure of the seller's company to be duly qualified as a foreign corporation where required to be so. For example, since most states require foreign corporations doing business in the state to pay an annual tax, a company that failed to qualify will have a liability for unpaid taxes in addition to possible penalties. Failure to be in good standing can also lead to the company's not being able to use the state's courts to enforce contracts. The compromise often reached is to have the seller represent that its company is duly qualified and in good standing as a foreign corporation in all jurisdictions where qualification is required except for those jurisdictions where failure to be so qualified will not have a material adverse effect.

Capitalization and Title to Stock. The seller's representations regarding capitalization and title to stock will usually begin by covering the numbers of authorized and outstanding shares of each class of stock. In a stock purchase agreement, the buyer needs to be able to verify at closing that it has acquired all of the seller's outstanding shares. Additionally, if the transaction involves the amount paid being calculated on a per share basis, the exact number of shares outstanding will determine the aggregate cost to the buyer. If the company is closely held, the buyer will want to know who it is dealing with, the percentage of outstanding shares that such person(s) owns, and whether it is dealing with the holders of all the company's shares.

Public companies will often be unable to give a representation as of the date of the acquisition agreement regarding outstanding stock, but

will be able to give it as of the end of the prior month or quarter. This should be acceptable as long as the seller makes some additional representations. The seller must also state that the only stock issuances since such date were of certain limited types, such as issuances upon the exercise of options or warrants or the conversion of convertible debt securities which, in each case, were outstanding on such date. The seller must also indicate the amount of such options, warrants, convertible securities and rights that were outstanding on such date. Additionally, the seller must represent that no options, warrants, convertible securities or similar rights to acquire stock were issued since such date.

The capitalization representation usually includes assurances that the outstanding shares of company stock "were duly authorized, validly issued, fully paid and non-assessable, and not issued in violation of any preemptive rights." The only portion of this representation that ever causes much discussion is the part that concerns preemptive rights since, on occasion, it will turn out that a company has in fact previously issued stock in violation of preemptive rights (usually due to carelessness). The violation of preemptive rights can, however, represent a real money issue for the buyer. The buyer is clearly entitled to know all the facts in this circumstance.

Subsidiaries. Companies will commonly be asked to make separate representations concerning their subsidiaries if such entities are being directly or indirectly sold in the transaction or, sometimes, if the subsidiaries are selling assets in the transaction. Such representations will generally cover corporate organization and power, good standing, capitalization of the subsidiary and the parent company's title to stock in the subsidiaries. In addition, most of the other representations discussed below will routinely cover the company and its subsidiaries as a group. Buyers will want to know, not only that the parent company owns the subsidiary's stock free and clear of any liens, but that it owns all of the subsidiary's stock and that no other persons may acquire subsidiary stock through the exercise of options, warrants or preemptive rights.

The issue that receives the most attention relates to the definition of "subsidiary." Sellers do not want to have to cover every little subsidiary that may exist, particularly inactive ones. Buyers, however, are concerned about potential liabilities and a small subsidiary can still subject it to a large potential claim. There is also often a dispute as to whether joint ventures are included in the definition.

Due Authorization. The next representation the buyer will demand the seller make regards due authorization. The first part of this representation usually involves the company stating that it has corporate power and authority to execute and deliver the acquisition agreement and to

consummate the transactions contemplated thereby. Next, the representation is made that all corporate action necessary to approve the execution, delivery and performance of the acquisition agreement has been obtained. Buyers should not allow sellers to execute acquisition agreements subject to board approval since this would effectively give the seller an option to go forward or not.

The final portion of the due authorization representation deals with the acquisition agreement being a binding obligation of the company, enforceable against it in accordance with its terms. Companies sometimes try to request that this portion of the representation be made "subject to shareholder approval," if shareholder approval is necessary to consummate the transaction. Buyers often resist this qualification since critical aspects of the agreement are enforceable regardless whether shareholder approval is obtained.

One final qualification that sellers often try to include is a limitation on enforceability of the acquisition agreement. Sellers will often want to include a clause that states that enforceability is limited by "bankruptcy, insolvency, reorganization, moratorium or similar laws now or hereafter in effect affecting creditors' rights generally."

No Violations; Approvals. This representation is critical to the buyer. First, it informs the buyer of those instances following the closing where the company will be in breach, thereby risking potential liability and a loss of the anticipated benefits of an agreement. Second, the buyer might be concerned with being exposed to liability itself for causing the company to breach an agreement or to violate a law, whether or not the acquisition closes. Finally, the representation allows the buyer to figure out what it has to do and what problems it has to solve in order to close the transaction.

The first part of this representation deals with whether the execution, delivery and performance of the acquisition agreement will violate: (1) the company's certificate of incorporation or bylaws; (2) any agreement to which the company or any subsidiary is a party; or (3) any applicable law, rule, regulation, injunction or court order. The second part of the representation gives comfort as to the absence of governmental approvals or filings required in connection with the execution, delivery and performance of the acquisition agreement.

Financial Statements; Undisclosed Liabilities. Because the company's financial statements provide significant and complete information about the business being acquired, the financial statements and undisclosed liabilities provisions are key to the acquisition agreement. The important part of this representation is where the company warrants that the foregoing financial statements are "prepared from and in accord-

ance with the books and records of the company in accordance with generally accepted accounting principles ("GAAP") consistently applied (except as indicated in the notes thereto) and fairly present the financial condition, and results of operations of the company as of and for the periods indicated." This representation will not state that the financial statements are complete, accurate, not misleading or true and correct. Nor will it state that the financial statements do not contain any untrue statement of material fact or omit to state any material fact.

In the case of unaudited quarterly financial statements, the representation is often modified to add at the end "except that the above-mentioned quarterly financial statements were prepared in accordance with the accounting rules applicable to Reports on Form 10-Q under the Securities Exchange Act of 1934⁴ and, accordingly, do not contain all the footnotes required by generally accepted accounting principles." Buyers should not object to this.

The substantive content of the financial statement representation may differ from what has been described above when only a part of a business is being acquired. For example, financial statements of a division may not have been prepared in accordance with GAAP but, rather, in accordance with a set of internal accounting procedures. At a minimum, the buyer should insist that these internal statements be scheduled.

A representation about undisclosed liabilities is not necessarily present in every acquisition agreement. When present, the representation generally takes one of two forms. The first type will state that, as of the date of the company's most recent balance sheet, the company did not have any liabilities, whether absolute, contingent, known or unknown, that were not reflected in the balance sheet.

Because sellers often object that generally accepted accounting principles do not require that all liabilities be reflected in the balance sheet, a second form has also been used. In that case, the seller represents that there were no liabilities as of such date of a type required by GAAP to be reflected in a balance sheet that were not so reflected in the company's balance sheet as of such date. From a buyer's perspective, this second form adds nothing to the general financial statement representation. There are, however, possible compromises which include qualifying the first form by knowledge, adopting the first version but excluding those types of liabilities that are subject to other provisions in the agreements, or taking an exception for liabilities that arise in the ordinary course of business.

No Material Adverse Change. This representation concerns the

4. 15 U.S.C. §§ 78(a)-78(mm) (1994).

absence of any material adverse change in the company's business since the date of the most recent balance sheet. Sometimes the representation also includes a warranty that the company's business has been conducted in the ordinary course since such date. When this provision is being negotiated, several issues will usually arise. One relates to the date from which the representation should run—the most recent audited balance sheet or the more recent unaudited balance sheet. Another issue relates to whether or not the "prospects" of the company should be addressed. This is really an argument about whether or not the term "prospects" is too vague and hard to predict. Additionally, sellers will often ask for an exception to the representation based upon changes in general economic conditions. Buyers often agree to this, but are usually more resistant to exceptions requested based on changes in the company's industry generally.

Among the other things that a buyer might ask the company to represent have not occurred are: dividends, stock acquisitions, incurrence of liens on the company's assets or of additional debt assumption by the company, payment or prepayment of debt, compensation increases or benefit plan amendments, inventory or receivables write-offs, changes in accounting policies or practices, or settlements of litigation or material disputes.

Litigation. The seller's representations will also include a litigation provision. This representation can be drafted as either an informational or judgmental type of representation. The informational approach would involve having the company state that, except as disclosed on the disclosure schedule, "there is no litigation pending against it," with a possible exception for those which, if the relief requested were granted, would not have a material adverse effect. The other type of representation states that, except as set forth on the disclosure schedule, "there is no pending litigation against the company that (is reasonably likely to/in the company's reasonable judgment is likely to/will) have a material adverse effect on the company."

Compliance with Law: Environmental Matters. In addition to assuring the buyer that the company has operated its businesses in accordance with law, the compliance representation provides comfort that the company has all necessary permits to operate its businesses and that it is not in violation of any injunctions or orders.

The portion of this representation which is the most debated concerns environmental matters. From the buyer's perspective, the environmental representations should include specific provisions stating that the company's business has all of the required permits and authorizations. It should also include a representation that the business is conducted in

compliance with all applicable environmental laws, permits, and authorizations.

Further, the compliance representation may state that no environmental claims are pending or threatened against the business and that no actions, conditions, or circumstances pertaining to the business are present, that may give rise to any future environmental claims or clean-up obligations on the part of the company. Moreover, the buyer may require the seller to state that all locations on which the business may have conducted certain environmentally risky activities have been identified and that no consents or approvals for transfer of environmental permits or the business itself are required. Alternatively, this clause could state that any such consents and approvals can be obtained expeditiously without material cost. The seller will obviously have incentives to limit the extent of these representations and will probably try to do so through the use of materiality and knowledge qualifications.

Title to Assets. The seller's representation section of the acquisition agreement often includes a representation that the company has "good and marketable title" to its assets free and clear of all liens, title defects and encumbrances. Almost invariably, certain exceptions are needed to these representations, such as exceptions regarding scheduled liens, liens disclosed in the notes to the company's balance sheet, and liens and title defects which do not materially detract from the value of the property.

Taxes. The key aspect of the taxes representation is that all "tax returns" required to be filed with respect to the company and its affiliates are in all respects "true, complete and correct and have been duly filed in a timely manner." Additionally, the tax provision should state that all taxes attributable to the company and its affiliates that are or were due and payable have been paid and that the balance sheet reflects appropriate accruals for taxes for the current period.

Another important piece of information regarding the company's tax history involves audits. The company is often asked to represent that, except as set forth in the disclosure schedule, the statute of limitations for the assessment of federal, state, local and foreign income taxes has expired for all consolidated federal income tax returns of the consolidated group or that the consolidated federal income tax returns of the consolidated group have been examined by the IRS for all years through a specified date.

A broad tax representation should also include a provision on withholding which represents that the company and its affiliates have complied with all tax withholding provisions of applicable federal, state, local and foreign laws and have paid to the proper governmental authori-

ties all amounts required to be so withheld and paid over. Another representation sometimes included regards the filing obligations of the company in various states, and a statement regarding whether the company computes its state income taxes on an apportionment of business income under a unitary or combined method.

Finally, the buyer should consider getting representations about several additional matters. The buyer should have notice of any tax elections in effect which would affect the company and the company's allocable share of overall foreign losses. It should know about the potential liability for "recapture" of ordinary losses⁵ and the extent to which the company holds "tax-exempt use property" within the meaning of Section 168(h) of the IRC.⁶ The buyer may require further representations as to whether the company is a partner in any partnerships, whether the company is a party in any agreement that would require it to make any "excess parachute payment," and whether the company or any subsidiary has any tax liability with respect to other consolidated groups.

Employee Benefits Plans. The buyer will typically require a representation that all of the various types of employee benefits plans or arrangements which the seller or any "ERISA affiliate"⁷ of the company is contributing to, or maintaining for, its current or former employees are listed on a schedule to the purchase agreement. This representation is often not limited to formal or written plans and, as such, can pick up oral arrangements with a single employee. The buyer will also typically require the company to represent that pertinent documents relating to each of the listed plans have been delivered to the buyer in the course of the buyer's due diligence.

The buyer may seek representations regarding Title IV⁸ liability as well. These might include representations that no unsatisfied Title IV liability has been incurred by the company or any ERISA affiliate, and that there is no material risk that any such liability will be incurred, other than for premiums due the Pension Benefit Guaranty Corporation ("PBGC").⁹ Further, the buyer may require that the seller state that the PBGC has not instituted termination proceedings for any plan,¹⁰ and no material risk of such proceedings being instituted exists. Finally, the seller may be asked to represent that the plans are adequately funded to meet accrued benefit obligations.

The buyer will often seek a representation to the effect that the

5. See I.R.C. § 1231 (1994).

6. I.R.C. § 168(h) (1994).

7. See I.R.C. § 3121(l) (1994).

8. 42 U.S.C. §§ 2000a-2000h (1994).

9. See 29 U.S.C. § 1307 (1994).

10. I.R.C. § 4975(c) (1994).

company, its ERISA affiliates, and the plans subject to ERISA have not engaged in a "prohibited transaction."¹¹ The buyer will also commonly seek a representation to the effect that all payments required to be made to benefit plans have been made, and that no "accumulated funding deficiency" has been incurred. The buyer will often require a representation involving "multi-employer pension plans." However, not all of these representations will be appropriate where such plans are not assumed by the buyer in an asset purchase. The buyer will seek representations concerning post-retirement as well. Finally, the buyer will often seek a catch-all employee benefit representation to the effect that the company's plans are operated and administered in accordance with applicable law, including ERISA and the IRC, and that each plan intended to be tax-qualified under the Code is so qualified.¹²

No Misleading Statements. Buyers often ask companies to include a representation that the acquisition agreement does not "contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements contained in the acquisition agreement not misleading." Other, broader formulations will focus on the accuracy of all information supplied to the buyer (which can pick up projections) or supplied to the buyer pursuant to the acquisition agreement. Occasionally, a buyer will request a representation that all information material to the acquisition has been disclosed to it and is accurate in all respects.

Sellers often object to this representation in light of all the other detailed representations contained in the agreement. In addition, even when given, many sellers would not agree to the last formulation described above. Although the buyer has certain securities law remedies available to it regardless of this representation, the representation still adds something of value to the buyer (i.e., the buyer has to prove elements other than just a material misstatement under the securities laws).

Other Representations. Numerous other representations may be required, depending on the nature of the seller's business. These provisions are usually necessary to provide the buyer adequate assurances against future liability for particular aspects of the seller's business.

These provisions include a representation as to inventory and accounts receivable. In transactions where inventory and accounts receivable are a significant part of the total value of the company or of the assets being acquired, the buyer often asks for specific representations covering these assets. Such a representation, if not qualified by

11. See 29 U.S.C. § 1303 (1994).

12. See I.R.C. § 401 (1994).

reference to reserves, can result in unintended consequences for a seller, such as a guaranty of collectibility.

In an insurance provision, the buyer is looking for a list of the company's insurance policies and comfort that the company is adequately insured and that the transaction will not result in termination of the policies.

The representation regarding customers and suppliers can be both informational and directed to a substantive business concern. As such, it can involve very sensitive disclosures for the seller.

Regarding contracts and leases, the company is asked to assure the buyer that it is not in default under any of its agreements. This often ends up being limited by materiality.

Securities filings are extremely important in acquisitions involving public companies. A related provision is one regarding proxy statements issued by the seller. If a proxy statement is being used, the company will represent as to the accuracy of the information furnished by it for inclusion therein.

A representation as to the sufficiency of the seller's assets will be required if less than an entire corporate structure is being acquired. Here, the buyer may want the seller to represent that the assets being conveyed to it in the transaction are all the assets which are necessary or sufficient to run the business in the manner it has been operated or, perhaps, in the manner the buyer intends to run it.

A representation regarding intellectual property will depend on the type of business in which the company is engaged in general, and specifically, the importance the buyer has placed on intellectual property rights in determining a valuation of the company.

Finally, issues regarding affiliated transactions may require additional disclosure and representation. Sometimes the buyer will request that the seller disclose all of the transactions between the company and its subsidiaries on the one hand and the seller and its other subsidiaries or affiliated companies or insiders, on the other, which took place during a specified period and involved more than a specified amount.

IV. QUALIFICATIONS TO SELLER REPRESENTATIONS

A. *Knowledge Qualifications*

Knowledge qualifications are, in effect, allocations of risk between the buyer and seller. Sellers often refuse to make various representations on the grounds that they do not know, or have no basis for knowing, whether those representations are true or not. In addition to deciding whether a particular representation is to be qualified by a

knowledge limitation, another key issue is often whether the knowledge should be limited to that of a particularly specified group of individuals (e.g., senior management).

The knowledge qualification makes the biggest difference with respect to the buyer's ability to sue for damages, either in conjunction with terminating the agreement or pursuant to an indemnification right following the closing. If the representation is qualified by a knowledge limitation, the buyer, in order to recover damages, not only has to show that the underlying representation was false, but also that the seller knew it to be so.

Knowledge qualifications are less important to both parties in situations where no indemnification rights are given and where the likelihood of a significant lawsuit for a simple misrepresentation in the context of a terminated transaction is small, such as the typical acquisition of a public company. They are generally irrelevant with respect to closing conditions.

B. *Materiality Qualifications*

The materiality qualification is probably the most important way in which sellers limit the scope of their representations. The first important point to note is that the level of an item or problem which is material will vary significantly from transaction to transaction. Materiality is also by nature a very imprecise concept which will depend on the context, even when dealing with the same company. More so than with a knowledge qualification, the exact placement of the materiality limitation and what it modifies is important. In many instances, there may be several ways in which the materiality limitation can be used, each with different consequences.

The use of such limitations is in the final analysis a function of the basic bargaining power of the parties as well as the economics and other circumstances of the transaction. In a large transaction, the choice is often between the use of materiality exceptions and long disclosure schedules containing endless lists of exceptions to the representations.

The addition of a materiality standard to a representation is not necessarily fatal to any one of the three functions generally served by the representations.¹³ The only difference really is that the buyer's rights are not triggered unless there is a "material" problem. Certain representations are virtually never qualified by materiality limitations. These include representations as to due organization, capitalization, authority

13. See *supra* discussion Part III.A.

to do the transaction, and that the transaction does not violate the company's charter, by-laws or injunctions or decrees.

In some cases, the buyer may complain of double materiality. This means that the buyer believes that the seller is getting a windfall by obtaining twice the protection it needs or deserves. One common circumstance of double materiality is where the seller wishes to qualify the same representation with materiality limitations in two places. A second common example of double materiality is where a representation is not only qualified by materiality, but also by the bringdown condition. This use of double materiality occurs quite often in public company deals, and most buyers appear to accept it. A third and, in the authors' judgment, the most important, example of double materiality is where the representation is qualified by materiality and, in addition, there is a basket or threshold that must be exceeded before the buyer is entitled to be indemnified for losses. The buyer should be acutely aware of the effects of such limitations on its ability to seek redress after the acquisition agreement is executed.

V. BUYER REPRESENTATIONS

A. *General Considerations*

If the seller is being paid in the form of buyer securities, particularly common stock, then the seller will be interested in representations relating to the buyer's business. In other instances, the seller's prime motivation in obtaining representations from the buyer is to know who it is dealing with, to understand exactly what has to happen before the buyer can close the deal and to be as sure as possible that on the day of closing the buyer can actually come up with the purchase price. Thus the buyer's representations are generally more "transactional" in nature than those of the seller. The seller wants to know the buyer's ability to close the transaction before the seller signs on to the transaction.

B. *Specific Representations of the Buyer*

Buyer's Ability to Consummate the Transaction. If the purchase price is to be paid in cash, the buyer will generally represent to the seller a number of circumstances that go to the buyer's ability to do the deal "without a hitch." Such representations include those as to due organization and good standing, as well as due authorization to consummate the transaction.

Further, the buyer will represent that execution, delivery and performance of the acquisition agreement will not violate the buyer's governing documents, any agreement, injunction or decree to which it is a party or any law or regulation applicable to it. The buyer will also rep-

resent that delivery and performance of the acquisition agreement will not require a filing, consent or approval by any governmental or judicial entity or any third party.

Valuation of the Buyer's Equity. The most typical situation in which the buyer gives more than "bare bones" representations is where the purchase price paid is either entirely or partially in the form of securities of the buyer. However, it is important to note that if a significant percentage of the buyer's stock is to be issued to the seller, the seller may look for representations and warranties substantially identical to what it is giving to the buyer. In any case, the addition of several representations would, at a minimum, often be made by a buyer in a stock transfer situation.

First, the buyer will state that its financial statements have been prepared from and in accordance with the books and records of the buyer in accordance with GAAP. Second, the buyer will declare that it has not had a material adverse change in its business since the date of the most recent balance sheet delivered to the seller. Finally, it will state that no litigation is pending or threatened against the buyer that would have a material adverse effect on its business.

Financing Representations of the Buyer. An important representation the seller can request of the buyer is one as to its ability to pay the purchase price (unless the buyer is a large corporate entity). In its simplest form, this representation will state that "the buyer has the funds (or has available commitments from creditworthy financial institutions to provide the funds) required to pay the purchase price and consummate the transactions contemplated hereby."

Acquisition of Shares for Investment Purposes. If the buyer is purchasing stock (either through a merger or by direct purchase) in a non-registered transaction, it will usually further represent that it is acquiring the shares for investment purposes and not with a view to distributing them in violation of the securities laws.

VI. COVENANTS

The covenants section is the main vehicle used in getting the parties through the period between signing and closing. Certain covenants, like an obligation to provide post-closing service by the Seller, will be binding on the parties after the closing.

A. *Covenants Relating to the Transaction Process*

Covenants Generally Included. Many of the following covenants will be included in every acquisition agreement, unless irrelevant to the

particular transaction. Most will be agreements on the seller's part to take certain actions during the transaction process.

The first set of seller's covenants relate to due diligence during the course of the acquisition. The seller will usually agree, among other things, to give the buyer and its representatives full access to the company's physical plant as well as information concerning the company's business in the form of its books and records. The seller may also grant access to its representatives. All of these covenants enable the buyer to continue the due diligence process.

The next set of seller's covenants relate to actions necessary in anticipation of closing. These include an agreement on the part of the seller that it will use its best efforts to obtain the necessary consents of third parties to the consummation of the transaction, including its lenders, if applicable. The seller will also agree to take necessary actions to file applications or other documents with any number of applicable governmental entities, both U.S. and foreign. The seller will agree to prepare all documents necessary to effect the transfers called for in the transaction, particularly the transfer of assets of a division, as well as a covenant whereby the seller agrees to discharge all liens on the assets or stock being sold. This is often coupled with the so-called "further assurances" clause. This covenant states the seller's agreement to provide—even post closing—executed documents and to take actions (reasonably) necessary or appropriate to consummate the transactions contemplated by the acquisition agreement.

The seller will agree to continue to update the disclosure schedules which are part of the agreement or to otherwise continue to provide information about the company to the buyer after signing but prior to closing. These covenants almost always include a requirement to update the financial statements and other information previously provided to the buyer (but as of a later date) but often include other business information as well.

The covenants section will contain various provisions relating to employee benefit matters in connection with both the cessation or termination of existing employee benefit plans and the institution of new employee benefit plans to take effect post-closing. Other miscellaneous covenants include various provisions relating to the filing, payment and collection of refunds relating to taxes, primarily income taxes. Other provisions will relate to the delivery of the books and records relevant to the company.

Further covenants include an agreement by both parties that neither will make public announcements concerning the transaction without the approval of the other except as required by law and provisions relating

to the treatment of confidential or proprietary information obtained in the acquisition process.

Special Transaction Covenants. The covenants article is also the place for special arrangements and side deals that are present in virtually every transaction. Common areas for side deals include employee matters (such as severance matters or the transfer of assets out of a pension plan) and the separation of businesses from the (typically corporate) staff areas which support their activities.

Covenants Concerning the Buyer's Financing. It may make sense to include a covenant to set forth the steps the buyer will take to ensure that the financing condition is fulfilled. This is important because the buyer's commitment from its lenders will contain its own set of conditions, thus giving the buyer a potential back door ability to abandon its obligations under the acquisition agreement.

Covenants Relating to Stockholder Approval. In certain situations, approval of the transaction by the stockholders of either the buyer or the seller or both will be necessary in order to consummate the acquisition of the company. Thus, it may well be appropriate to be quite specific about the steps necessary to obtain such approval and to obtain the relevant party's specific obligation to perform or use its best efforts to ensure that each such step is performed.

Covenants Necessary in Acquisitions for Buyer Stock. Certain covenants will be included in a transaction in which acquisition consideration is in the form of the buyer's stock. These will relate to the registration process with the SEC (in the case of an acquisition that involves a public offering) and stock exchange listing if the issuer of such stock is a public company. If the buyer's stock is to be issued to the company's stockholders and the transaction does not qualify as one "not involving any public offering," the parties will include special representations and covenants so that the issuance and sale of such stock is in compliance with applicable securities regulations.

B. *Covenants Relating to the Operation of the Business*

An acquisition agreement will almost always obligate the seller between signing and closing to operate the business only "in the ordinary course" and not to undertake any actions not in the ordinary course without prior written consent of the buyer. With regard to this covenant, the buyer's concerns often are paramount (although the seller will argue that if the deal does not close, the seller will have to live with the consequences of how the Business was run during this period not the buyer), and so many parties will go further than the constraint above and agree

to a litany of specific actions which cannot be undertaken without the consent of the buyer.

C. *Post-Closing Covenants*

General Post-Closing Covenants. Almost all acquisition agreements include a "further assurances" covenant providing generally that the parties will cooperate with each other after the closing to take such steps and to execute and file such documents as are reasonably necessary to carry out the purposes and accomplish the intent of the agreement. A second general type of post-closing covenant relates to provisions which deal with the "splitting" of certain assets, liabilities or services.

Registration Rights. This covenant often appears in transactions in which the buyer's stock that is publicly traded is used as acquisition consideration. The acquisition agreement will contain covenants relating to circumstances under which the buyer, that is, the issuer of the securities in question, will agree to register post-closing some or all of such securities pursuant to the Securities Act.¹⁴

D. *"No-Shop" Provisions*

No-shop provisions first and foremost address the "competitor risk." The buyer wants to be able to negotiate and complete a transaction without the constant threat of interference from a competitor which may overbid his price or undercut his other contract demands by taking positions which are more palatable to the seller on matters like post-closing adjustments, closing conditions or representations and warranties.

In the purchase of a subsidiary or division (so long as it does not represent all or substantially all of a company's assets) or in the acquisition of a private company controlled by a few sophisticated stockholders, the buyer's risk ends at the signing of the acquisition agreement. From and after that time no board of director or shareholder approvals are left to be obtained on the seller's side of the table and the seller will not be able to terminate the agreement (or fail to approve it) in order to take another deal.

However, the situation is not so simple in the public company context. Stockholder approval cannot be obtained until at least two months after the agreement is signed and publicly announced. Absent the ability of a buyer to "lock up" the transaction by having a few shareholders who control a large block (e.g., 50% or more) of stock to commit to the

14. 15 U.S.C. § 78(a)-78(mm) (1994).

transaction, stockholder approval will not be a foregone conclusion and a third party bidder who offers more before the stockholder meeting will in all likelihood be able to bust-up the deal. Moreover, the seller's board of directors may be unable as a fiduciary duty matter to recommend the original deal at the time of mailing the proxy statement if a higher bid has emerged. In a public company acquisition, then, the buyer's goal is to minimize the likelihood of a third party bidder emerging after signing.

Buyers attempt to achieve this by getting the seller to agree to a "no-shop" provision. This provision is a covenant which prohibits the company and seller from "shopping" to get a competing bid. It will prohibit the seller from soliciting or encouraging a transaction with another bidder. It will often bind the seller's affiliates, including the company and, in many cases, the seller's officers, directors, and, perhaps, its representatives, such as investment bankers, attorneys and accountants. It will further prohibit the furnishing of confidential information about the company to a third party or negotiation with a third party. Indeed, sometimes the provision requires the seller/company to advise the buyer of any inquiry or competing bid.

Sellers and the company will often obtain a "fiduciary out" exception to the foregoing provisions that will allow negotiation with, and the furnishing of information to, a third party bidder if the seller's or company's board of directors fiduciary duties require them to do so. The fiduciary out provision does not typically apply to the no solicitation requirement.

E. *"Best/Reasonable Efforts" Obligations*

In acquisition transactions, the parties will generally provide for a "best efforts", "reasonable efforts", or "reasonable best efforts" standard for things outside of their control or those dependent upon the actions of third parties (i.e., obtaining shareholder approval). It is often unclear, however, how far a party must go in order to comply with a "best efforts" standard. Consequently, in recent years there has been increasing use of other standards.

VII. CONDITIONS

A. *The Bringdown; Compliance with Covenants*

In General. The condition that the other party's representations and warranties be true and correct at closing is generally the most significant condition for both buyers and sellers. This "bringdown" clause protects each party from the other's business changing or additional, unforeseen risks arising before closing. The operation of the bringdown condition will depend to a very large degree on the manner in which the

representations were drafted. For example, a representation that speaks as of a specified date, whether it be a date prior to the date of the agreement or the date of execution of the agreement, will still speak only as of such date even when it is "brought down."

Double Materiality. One important issue regarding conditions is whether the bringdown should require that each representation be "true and correct as of the closing" or "true and correct in all material respects as of the closing." There are clearly representations where a minor mistake should not give the other party a walk-right. But, by inserting a materiality qualification here, the negotiations concerning the materiality qualifications in the representations and warranties section may be undermined.

Another, more troublesome problem, one which is usually not addressed, is that there may be a number of immaterial problems in different representations, none of which results in any particular representation being false by reason of the materiality qualifications therein, but all of which problems in the aggregate might be material.

B. *Other Conditions*

Delivery of Officers' Certificate. A requirement should be included that a senior officer or officers of the representing party deliver a certificate stating that the representations are true at closing. The provision requiring the delivery of the officers' certificate, as well as the certificate itself, should track the language of the bringdown condition and compliance with the covenants provision.

Compliance with Covenants. This condition is closely related to the bringdown condition as it requires that the parties have performed and complied with all of their obligations and agreements in the acquisition agreement required to be performed and complied with prior to closing. Again, an officers' certificate as to satisfaction of this condition will normally be delivered.

Governmental and Third Party Consents. Agreements often include a condition that all required consents of third parties and governmental bodies to the consummation of the transaction have been obtained. It will normally be qualified by materiality. In this provision, two particularly important conditions are usually addressed. First, there will typically be a closing condition to the obligations of both parties that any required waiting period under the Hart-Scott-Rodino Act shall have expired.¹⁵ Second, certain states have environmental regulations which require filing and remedial measures be followed subsequent to a

15. 15 U.S.C. §§ 15(c)-(h), 18(a), 66 (1994).

change in control. In transactions where these regulations play a part, the buyer will need to have a firm condition that the applicable regulations have been complied with and all appropriate approvals have been obtained prior to closing.

Litigation. In many respects, litigation is the most difficult condition to negotiate. While both parties generally agree that immaterial litigation should not affect their obligations to close, materiality depends on the likelihood of an adverse outcome to litigation, as well as upon the relief sought. This is a very difficult assessment for either party to make.

The buyer can phrase the litigation condition in several different alternative ways, in addition to, or in lieu of, relying on the bringdown of the seller's litigation representation. The condition may state that the buyer need not close if any litigation is pending against the company. Alternatively, the condition may state that the buyer need not close if any litigation pending against the company which in the (sole/reasonable) judgment of the buyer makes it inadvisable to consummate the acquisition. As a third alternative, the buyer may state that it need not close if any litigation pending against the company which in the (reasonable) judgment of the buyer (will/might/could/is reasonably likely to) have a material adverse effect on the company. Another may state that the buyer need not close if any litigation is pending against the company unless company counsel delivers its opinion to the buyer that it (will not/is not reasonably likely to) have a material adverse effect on the company. An additional choice will state that any litigation pending against the company which (will/might/could/is reasonably likely to) have a material adverse effect on the company will permit the buyer to refuse to close. Finally, the condition may state that any litigation in which an injunction or restraining order against the transaction has been (issued and which is in effect/requested/requested by a governmental entity) will give the buyer the option to walk away.

Often, in light of the litigation representation and bringdown condition, the specific litigation condition chosen will be limited to litigation relating to the acquisition, with one of the foregoing formulations, as so limited, being used. However, the most difficult litigation problems are those regarding the risk of governmental antitrust actions challenging the transaction.

Shareholder Approval; Securities Law Matters. If the approval of a party's shareholders is required for consummation, it will be a condition to both parties' obligations. The parties sometimes include conditions requiring that dissenters' appraisal rights not be exercised with respect to more than a specified number of shares, since this can have a substantial

effect on both pooling and tax-free treatment. Another important reason for this condition is that the exercise of appraisal rights with respect to any shares means that the corporation will have to obtain cash to pay the fair value of such shares. The risk with this condition is that it might signify to a particular shareholder that it has the negotiating leverage to stop the deal.

If the seller is to receive securities in the acquisition and the company is publicly held, the securities to be issued, whether of the buyer or the company itself will have to be registered under the Securities Act of 1933.¹⁶ Thus, a condition will usually be added to both the buyer's and the company's obligations that an effective registration statement exists and that no stop order had been issued. A corresponding condition will often (although it might be only to the buyer's obligations) be included regarding state securities or blue sky laws.

If securities are to be issued in the transaction, and if they are of the same class as securities of the buyer, already listed on a national securities exchange, they must be approved for listing as well. The agreement will often include a condition to both parties' obligations that the securities be so listed.

If securities are to be issued in the transaction, affiliates of the company will be subject to limitations under Rules 144 and 145 promulgated under the Securities Act of 1933 on their ability to resell such securities.¹⁷ To insure compliance with such regulations, buyers often require as a closing condition to their obligations that such persons sign and deliver such letters. Special provisions must be included in these letters if the acquisition is to be accounted for as a pooling.

Accounting Conditions. If the transaction is intended to qualify as a pooling, the buyer will generally require as a condition to its obligations to close a letter from its public accountants to the effect that the acquisition will be so treated.

Further, letters from the parties' outside accountants may be required. These will provide comfort, in the form of negative assurances, on the parties' quarterly financial statements and for the period from the most recent quarterly to a few days before closing. The purpose of the comfort letter is one of due diligence. By covering changes since the most recent quarterly financial statements included in the proxy statement or prospectus, the letter will help the buyer determine whether there has been a material adverse change in the company's business, whether any of the company's representations are not true at closing or whether the company failed to comply with any of its covenants.

16. 15 U.S.C. §§ 77(a)-77(bbbb) (1994).

17. *Id.*

Obtaining comfort letters will also help to establish a due diligence defense (except for the buyer-issuer itself) with respect to the unaudited financial information in the registration statement and prospectus if there is ever any litigation against parties.

Tax Rulings and Opinions. It is almost universally the case in transactions that are designed to be tax free or partially tax free that the seller's or the company's obligations to close be conditioned upon receipt of an opinion of counsel or a ruling from the IRS to this effect.

Fairness Opinions. A fairness opinion is usually delivered prior to the execution of the acquisition agreement. The critical issue is often whether or not an updated opinion should be delivered. The two points in time when an updated fairness opinion can be required are prior to mailing a proxy statement and at the closing. Closing fairness opinions are not seen very often, in private or public deals. Fairness opinions at the time of the mailing of a proxy statement are somewhat more common, but they have recently become less frequent, at least insofar as the acquisition agreement is concerned. Parties sometimes include (particularly in leveraged buy-out situations) a closing condition for the seller or company that an opinion be delivered at closing, or much more commonly, that an earlier one not withdrawn.

Legal Opinions. The theory behind requiring a legal opinion is that it provides the recipient with additional assurances as to those aspects of the transaction or the other party which are being opined upon. The problem with requiring opinions is that they generally do not render a great deal of assurance (especially in relation to their cost) and better ways of obtaining the additional comfort are available.

Legal opinions are generally more appropriate to the extent that they deal with the effect of the transaction on a party than when they involve questions about the party which do not depend on the transaction itself. Typical opinions include due organization and existence, corporate power to conduct its business and enter into and consummate the acquisition agreement, due authorization and enforceability of the acquisition agreement, execution and performance of the acquisition agreement not violating law, charter and bylaws, injunctions and material agreements or required governmental consents or approvals.

Due Diligence Conditions. This is an extremely important, although relatively rare, condition which gives the buyer the right to refuse to close based on the results of its post-signing investigation of the seller or the company.

Miscellaneous Conditions. One miscellaneous condition is the "Book Value Test," a buyers' condition sometimes present, particularly in non-public transactions, which requires that the company have at least

a specified book value or level of working capital at closing. Additionally, execution and delivery of other documents and agreements may also be required as a condition to close. Further, assurances as to the absence of options or convertible securities which survive the closing may be added as conditions.

It is not uncommon in the case of leveraged buyouts for acquisition agreements to provide that the buyer's (and the seller's) obligations are conditioned upon financing. The inclusion of such a provision makes the agreement much more conditional and less likely to close. As a result, sellers often strongly resist such conditions.

Finally, no material adverse change conditions are often required. This condition will probably be necessary if the period from signing to closing is not covered in the seller's representations, thus, if the seller's representation states that there has been no material adverse change in the seller's business from an earlier date until the date of the agreement, rather than simply from the earlier date, this condition should be included.

VIII. INDEMNIFICATION

A. *General Considerations*

In an acquisition agreement, indemnification is generally drafted as a post-closing matter, with the parties tacitly agreeing to leave the resolution of pre-closing breach of contract in the event the deal does not close, and the appropriate measure of damages, to a court of competent jurisdiction. Whether indemnification is appropriate in any particular case will depend on how attractive the purchase price is, the parties' relative bargaining power and how concerned the buyer is about the seller's business and the accuracy of the seller's representations.

General liability issues are addressed in the indemnification provisions. These are comprised of statements as to the scope of indemnification. Various matters might be covered by general liability indemnification, including an agreement as to seller's indemnification of the buyer for breaches of representations and warranties, which is basically a matter of full and fair disclosure. Likewise, buyer may agree to indemnify the seller for breaches of representations and warranties, which is largely a question of reciprocity.

As to the buyer's post-closing activities, certain matters may be singled out and treated as specific items with respect to which the buyer will be indemnified. These areas often include particular pending litigations or pending or threatened claims which the seller has agreed to retain responsibility for, taxes due for periods prior to the closing, the

collectibility of accounts receivable and certain environmental matters, as well as indemnification for third party claims.

Indemnification for seller's pre-closing activities and the "unknown" may also be provided for. The seller may be responsible for actions taken before the closing which were not then known to form the basis for liability and which it was incapable of disclosing (and the buyer was incapable of discovering) before the closing. Indemnification as to these matters may be necessary if the situation warrants.

The question whether representations and warranties survive the closing or are merged into the sale of the company is not absolutely settled under contract law of all states. Thus, if it is the intention of the parties that the buyer may recover from the seller post-closing for a misrepresentation, they should specifically provide that the seller's representations survive the closing. Survival may be most likely for representations which refer to a post-closing event or circumstance. But most typical representations do not address post-closing matters. Unless the contract specifically provides otherwise, it is not clear that the representations survive closing.

If the representations do survive the closing, it will often be the case that they will survive until the expiration of the applicable statute of limitations for contracts. But it is not unusual for the parties to agree on a somewhat shorter period of time that the representations will survive and form the basis for a cause of action. Most representations will generally survive for one to two years, with those relating to taxes, employee benefits, environmental issues and due authorization of the transaction surviving significantly longer.

One advantage to including specific indemnification provisions is that the parties can specify the types of losses they expect to be able to recover for as between each other and, perhaps, the measure of damages to be applied upon such occurrence. The most frequently disputed areas are those of consequential damages and lost profits. Often, the agreement does not create specific inclusion or exclusion for these types of losses.

Unless the agreement specifically provides that the matters set forth in the indemnification provisions are to be the only matters for which the parties intend to be able to sue each other with respect to matters arising out of the acquisition agreement and the transaction, various other causes of action which, depending on the circumstances, may be available to the parties. It is the authors' experience, however, that most agreements provide that, absent fraud, the indemnification provisions are the exclusive remedy.

B. *Negotiating Issues in Indemnification Provisions*

Baskets, Ceilings and Thresholds. The rationale behind a basket or threshold is simple: the seller is taking the position that some minor mistakes or misstatements are bound to be in its representations and it should not suffer any indemnification burden until these problems exceed a certain amount. Whether the amount is a basket or a threshold varies from transaction to transaction, with the difference being the measure of a seller's liability once the amount has been reached. However, in the case of a "basket," indemnification is available only for the excess. Sellers may, as an alternative, argue for a ceiling on their liability. It has been the authors' experience that such provisions, even where the ceiling is substantially below (e.g. 10% of) the purchase price, have become increasingly common, particularly in large transactions and auction situations.

The Effect of Tax Benefits or Insurance on Indemnification. Indemnification provisions in many acquisition agreements will "tax effect" the damages suffered by buyer, in effect reducing the amount required to be paid by seller by the value of any tax deductions or benefits received by buyer by reason of having suffered damages. Indemnification provisions also often give the sellers credit for any insurance recoveries available to reduce the buyer's damages.

C. *Drafting Indemnification Provisions*

Use of Securities to Satisfy Indemnification Obligations. A seller who receives securities of the buyer in the acquisition will often request to have the ability to return such securities to the buyer in satisfaction of its indemnification obligations. If the buyer agrees to this type of provision, valuation questions must be answered.

Joint and Several Liability. If there is more than one seller, buyers will generally seek joint and several indemnification so that it can go against any seller for 100% of the damages. The buyer's position will be that the sellers can thereafter recover from each other so as to provide for an equitable allocation, but that that is not buyer's problem. Buyers are usually also willing to have one large seller assume the entire indemnification burden. This happens most often when such seller owns close to all of the company's stock (i.e. more than 80%).

Indemnification Procedures. These relate primarily to claims made by third parties against the buyer (or the acquired business) which the buyer believes it is entitled to be indemnified against by the sellers. Generally, the sellers will be entitled to assume the defense of the third party claim if they wish to do so although the buyer will normally also be entitled to participate at its own cost. Difficult questions (which are

usually not expressly dealt with) can arise if a "basket" has not yet been exceeded, or if a "ceiling" is close to being reached with respect to which party is entitled to control the litigation.

D. *Collectibility of Indemnification: Set-Offs and Escrows*

The practical aspects of indemnification, particularly the means by which a buyer can collect in respect of an indemnifiable claim, can be as important as the substantive rights. Two specific mechanisms, the set-off and the escrow, may assist the buyer in shifting bargaining power away from the seller and enable the buyer to minimize its risk.

In a transaction where a portion of the purchase price has been deferred, the buyer may be able to offset the amount of the alleged indemnity against the amount ultimately due on the notes. This gives a timing advantage to the buyer, although since it is unlikely that a seller will allow the buyer a unilateral right to offset, the advantage is certain to be temporary. Further, how satisfactory this solution is to the buyer will depend on the timing of the payments which it is able to withhold.

A solution that somewhat equalizes bargaining strengths in the event of a claim for indemnification is to create an escrow by delivering a portion of the purchase price, into escrow, to a third party. The escrow prevents the buyer from arbitrarily setting off amounts under an alleged indemnifiable claim and at the same time forces the seller to reach an accommodation with the buyer.

Among the issues which arise with respect to escrows are: (1) amount placed in escrow; (2) exclusivity of escrow — whether or not the indemnification rights of buyer are limited by the amount in escrow; (3) duration; and (4) treatment of interest or earnings on the escrow fund.

IX. TERMINATION; FEES AND EXPENSES

A. *Termination Provisions*

Virtually all agreements provide for an outside date at which either the agreement will automatically terminate or either party will have the unilateral ability to terminate it. Other termination rights arise if a final, non-appealable injunction against the transaction is obtained or if the conditions otherwise become impossible to satisfy.

In public company transactions, termination rights might also arise if third party bidders emerge or if the company's board of directors can no longer recommend the transaction to its shareholders. These provisions (together with the fee provisions resulting therefrom) have become the most hotly negotiated provisions in these acquisitions.

The key issue is often whether the company can terminate the agreement in order to accept a competing proposal. Another question that has prompted a great deal of discussion is whether the mere emergence of a third party bid or the furnishing of information to a third party should give the buyer a termination right even if the company wishes to stick with it.

B. *Fees and Expense Reimbursement Provisions*

In most transactions, the acquisition agreement will provide that, absent breach, each party pays its own expenses if the transaction does not close. Again, the situation becomes more complicated in public company transactions if a third party bidder has appeared. In such cases, the practice that has grown out of Delaware case law is that the fee can be as large as 2% of the transaction size (or slightly higher in smaller deals and lower in very large transactions), at least if there had not been a pre-signing auction. The circumstances where a fee would be payable are also highly negotiated.

X. PURCHASE PRICE CONSIDERATIONS—CASH TRANSACTIONS

A. *Fixed Price Transactions*

The simplest type of purchase price is a flat dollar amount. Since most agreements do not permit sellers to pay themselves dividends or otherwise make distributions to themselves between signing and closing, the earnings generated by the business being acquired will remain with it and, accordingly, be acquired also. Thus, during the period between signing and closing, the business is being run for the benefit of the buyer.

In public company cash transactions, there is almost always a flat purchase price, although its impact can be mitigated by providing for the accrual of interest on it until paid or permitting the payment of regular quarterly dividends between signing and closing. There may be practical difficulties with segregating the earnings of a division being acquired.

B. *Book Value and Working Capital Adjustments*

The two most common alternatives to a flat purchase price is one where a specified dollar amount is increased or decreased by changes in stockholders equity or working capital, as calculated on a balance sheet of the business being acquired prepared as of the closing date, relative to such amount as calculated on the pre-signing balance sheet on which buyer based its purchase price.

Such adjustments effectively give the sellers the benefit of any earnings between the pre-signing balance sheet date and closing (and conversely, the cost of any losses). The closing balance sheet will not be prepared until some time (usually a minimum of 30 days) following closing. As a result, the parties sometimes agree to have the payment at closing based on an estimate prepared by seller; the alternative is to have just the "flat" portion of the purchase price paid at closing with the full amount of the adjustment being paid post-closing.

Care has to be taken that income taxes are treated appropriately. For example, if the seller is responsible for all income taxes for the period prior to closing, the increase in purchase price for pre-closing increases in shareholders equity should arguably not be tax-effected (i.e. reduced for taxes).

Agreements will generally require that the closing balance sheet be prepared in a manner consistent with the pre-signing balance sheet and otherwise in accordance with generally accepted accounting principles. Parties sometimes negotiate additional, very detailed provisions regarding the policies to be used in preparing the closing balance sheet. There will normally be elaborate dispute resolution provisions applicable to disagreements relating to the closing balance sheet.

XI. ACQUISITIONS OF PUBLIC COMPANIES

Insofar as the acquisition agreement is concerned, public company transactions are generally simpler than other types of acquisitions. In a public company acquisition, there are generally no purchase price adjustments and indemnification is rarely available to protect the acquiror of a public company.

Certain trends have emerged in public company transactions as a result of the desire to avoid third party competition. The negotiation and pre-signing due diligence investigations have become much shorter and more streamlined. Purchasers have generally been willing to enter into less detailed acquisition agreements, particularly as to representations and warranties, and to conduct less extensive due diligence in order to obtain greater speed. Purchasers have also attempted to minimize the time period from the initial public announcement of a possible transaction until they have acquired control of the target company.

A. *Multi-Step Transactions*

Many acquisitions of public companies are now accomplished through a multi-step approach. This may be accomplished, for example, by a potential acquiror entering into a stock purchase agreement with major shareholders to acquire their stock for cash and a merger agree-

ment with the target providing for the immediate commencement of a cash tender offer for all outstanding shares of the target's stock and a second step cash merger, each at the same per share cash acquisition price as the stock purchase agreement. This transaction structure generally permits the entire process to occur far more rapidly.

There are two critical benefits obtained by the purchaser from such an agreement. First, by increasing the shares committed to the purchaser, stock purchase agreements with target shareholders make any attempt at competition less likely to occur or succeed. Second, while such an agreement does not raise the cost to a third party who chooses to compete, it may have the effect of lowering the cost to the initial purchaser of its raising its own price to defeat a third party that outbid the original transaction. However, the ability of purchasers to fully utilize the multi-step approach by entering into stock purchase agreements is limited in certain jurisdictions by control share statutes.

Stock purchase agreements are generally very simple. The representations and warranties are generally quite short, covering such matters as due authorization, no violation of injunctions, charter, bylaws or other governing documents and, on occasion, no violation of other agreements or laws. In addition, the sellers make representations as to their title to the stock to be transferred pursuant to the agreement. In most stock purchase agreements, the parties also covenant to use their best efforts to close the transaction, and the sellers grant the purchaser a proxy to vote their shares. The conditions to closing under most stock purchase agreements are also minimal.

Acquisitions by tender offer are designed to transfer control quickly to the purchaser. The tender offer allows the purchaser to acquire the entire company, not just the shares under contract. The tender offer contains conditions to the purchaser's obligation to purchase shares. If the conditions are not satisfied, the purchaser will not be obligated to purchase shares and will invariably be excused from having to close under the stock purchase agreements. The conditions contained in the tender offer are critical; once the tender offer is consummated the purchaser will have acquired the great bulk of the target's shares.

Where the acquisition is a merger, the purpose of the multi-step approach is to make the final step merger somewhat anti-climatic, but the purchaser will not obtain unfettered access to the target's cash flow, operations and assets until the final step merger. Once the tender offer has been completed, there will be virtually no meaningful conditions remaining to consummation of the merger.

B. *Public Company Merger Agreements*

The critical feature of public company merger agreements is their relative brevity. This occurs for the same reasons as are present in the multi-step context: the desire for speed and secrecy in the negotiating process; the absence of indemnification; the liberal use of materiality qualifications; the ability of the purchaser to derive comfort from the fact that the target is a public company subject to reporting and liability provisions of the federal securities laws; as well as the purchaser's ability to replace a number of different representations and warranties with a smaller number covering the accuracy of the target's financial statements and SEC reports. The merger agreement will provide for the first-step tender offer (if there is one) and will set forth the conditions to be included in the tender offer.

C. *Formula Priced Deals*

Formula pricing avoids the impact of fluctuations in the market price of the acquiror's stock, and the resulting changes in the acquisition price. Formula priced acquisitions are transactions where the parties agree that, rather than have each share of target stock converted into a number of shares of acquiror stock fixed in the merger agreement, each share of target stock will instead be converted into such number of shares of acquiror stock, unknown at the time of execution of the acquisition agreement, that have a specified trading price, determined at some time, or, more commonly, over some period in the future, but prior to consummation of the transaction.

Parties occasionally put limits (i.e. a "collar") on how much the exchange ratios may vary as a result of formula pricing relative to what it would have been if calculated at the time of signing the merger agreement. At the outer limits of the collar (or, alternatively, at other, wider limits), parties may have termination rights.

XII. LEVERAGED BUYOUTS

A. *Structure and Financing*

There are important complexities applicable to the structuring of a leveraged buyout resulting in large part from the purchase price being raised primarily through debt financing based upon the credit of the target company. Additionally there are several different methods whereby a group of investors could acquire a target company. Some of the different structures that can be utilized in a leveraged buyout are: stock purchase; stock purchase followed by merger; reverse subsidiary

merger; upstream guaranty; redemption by target; target loan to purchaser; asset purchase; and forward merger.

B. *The Acquisition Agreement in a Leveraged Buyout*

There may often be significant differences between leveraged buyout acquisition agreements and those for more "traditional" transactions. These generally derive from two factors, one found in most, and the other in all, leveraged buyouts: the participation of target management in the buyout group and the bulk of the purchase price being raised through debt financing.

One impact of these factors is the target's representations. The critical question is whether the purposes of having these representations are relevant in the leveraged buyout context. The target would argue they are not. The target's position is that, first, the presence of a separate financing condition renders the bringdown condition aspect of representations irrelevant. As to other purposes, the target could argue that the presence of management on the buy-side not only eliminates the need for the target to make detailed representations about its business, but that it cannot even do so.

But the target's position does not work if there is no financing condition or if the purchaser has legitimate reasons for not wishing to rely on it. And even if there is a financing condition, the purchaser might still be concerned about indemnification for misrepresentations that would otherwise be unavailable. There are some legitimate reasons for why indemnification might be reasonable. First, indemnification rights are generally assigned to the senior acquisition lenders and can form an important part of their collateral package. Thus they are the real beneficiaries of indemnification rights, not the buyout group. Second, target management may only be a small part of the buyout group.

Another aspect of the leveraged buyout acquisition agreement that is often different from a normal transaction is the inclusion of a financing condition. Except in those cases where indemnification is relevant, it would not be an exaggeration to say that the only really important provisions of an acquisition agreement in the leveraged buyout context are the deal price, the financing condition and the bust-up fee/expense reimbursement provision. A financing condition conditions the buyer's obligations to close the transaction on having concurrently received the proceeds necessary to consummate the transaction. Targets often take the position that this has the effect of turning the acquisition agreement into an option on the part of the purchaser. Purchasers, on the other hand, argue that the failure to obtain financing is in all likelihood due to the occurrence of an event over which they have little control, and thus

they should not have to risk being in breach of their obligations. Additionally, purchasers are "kept honest" by having paid substantial commitment and other fees for which they will often not be entitled to reimbursement if they fail to obtain financing.

The use of substantial third party debt financing impacts other parts of the acquisition agreement as well. Due to fraudulent conveyance concerns, target boards often ask buyers to represent that, as a result of the leveraged buyout, the company will not be rendered insolvent, have unreasonably small capital or be unable to pay its debts as they come due.

Expense reimbursement and termination/bust-up fee provisions are also commonly found in leveraged buyout acquisition agreements. Particularly in the public company context, these are extensively negotiated.