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REPRESENTING THE SELLERS IN A MERGER OR ACQUISITION

James J. Hanks, Jr.†

From the moment owners decide to sell their business, corporate counsel is confronted with many unique planning opportunities. In negotiating with the buyer, the sellers' counsel must consider the tax, accounting and securities consequences of the sale's structure. The author examines these and other considerations that should be addressed in planning the transaction from the decision to sell to the final drafting of the contract.

Although the pace of business combinations has apparently slowed since its heyday in the late 1960's and early 1970's, the expansion of business enterprises through acquisitions of other businesses remains an important feature of the economic picture of the United States. Moreover, the transfer of the ownership of business enterprises not involving combinations with previously existing businesses is not likely to disappear even in an uncertain economy. Certainly, many of the traditional motivations for selling or merging a business enterprise continue to exist. The principal focus of this article is on the problems faced by the sellers of a privately-owned business; however, for comparative reasons and other purposes, there are occasional discussions of certain objectives and problems faced by buyers.

DECIDING TO SELL

There can be any number of reasons why the owners of a privately-held business may desire to sell their company to other owners or to merge it with another company. Among the most common are a desire to increase the liquidity of their investment by exchanging their interest in a small, privately-held company for cash or for securities of a larger, perhaps publicly-owned corporation; advancing age of the principal owners and a desire to retire and have the business continue in secure hands; need for additional capital to finance new facilities or expansion into new areas; and competition. Frequently, a healthy, growing business will reach a "critical mass" point at which it has become a leader in its own field or geographical area but the increasing requirements of its customers indicate that it will either have to associate itself with a larger company or face the loss of important customers. Whatever the reason, the owners of the business

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should undertake a careful analysis not only of their personal financial positions but also of the present and likely future position of their company. No business is too small to suffer from a periodic review of its situation and projections for the future.

Generally, the owners of a business will not come to counsel until they have already decided that they want to sell and, frequently, not until they have reached an agreement with a prospective buyer. This order of events, of course, often means that the sellers have not taken into account various matters which could have a material effect on the economics of the deal if counsel had been consulted earlier. Accordingly, it is wise to advise clients to consult with counsel as early as possible in considering whether to sell their company. At whatever point counsel is eventually consulted, however, he should first review with his clients the reasons which are leading them to consider selling their company.

Once the owners have decided that they do want to sell their company, they should be encouraged to gather as much information as will be helpful in attracting the most suitable buyer. The single most important information will be audited financial statements for the past several years. At a minimum, these documents should include balance sheets and income statements. If it is more than six months since the date of these financial statements, an interim balance sheet and income statement should be prepared. The owners should also put in order and have information available with respect to customers, suppliers, employees, company organization, backlog of orders, the industry, geographical area and future projections.

Not only should the sellers assemble all of the relevant information about their own company but also they should obtain as much information as possible about the prospective buyer. This information is useful for two purposes: first, to discover, if possible, the economic terms of any other mergers and acquisitions which the buyer may have undertaken recently; and, second, to evaluate the financial condition of the buyer. If the sellers are seeking only a straight 100% cash-at-closing deal for their company, they are not really concerned with the financial condition of the buyer after closing. (Of course, if there is to be any significant period between the execution of the agreement and closing, the sellers should be concerned with the buyer's ability to pay the purchase price at closing.) To the extent that the sellers are receiving anything other than cash at closing—e.g., stock, notes, promises to pay based upon future earnings—they must be concerned, however, with the buyer's financial condition and its ability to meet its commitments and to produce a satisfactory return on the investment which the sellers will be making in the buyer. If the buyer is a publicly-held company, there are many sources of information available. The sellers should seek and obtain copies of the buyer's annual reports (which will include its financial statements) for the past five years. These reports, especially the financial statements, should be analyzed carefully by both the sellers and their counsel for signs of weaknesses or problems of the buyer. It is also wise to turn over copies of the buyer's financial statements

to the sellers' accountants for their evaluation. Among the key pieces of information to be abstracted or computed from the financial statements are net sales, net profit percentage (net profit divided by sales), net working capital (current assets less current liabilities), current ratio (current assets divided by current liabilities), inventory turnover (gross sales divided by inventory) and the capitalization ratios (the proportion of total capital represented by each kind of security issued by the buyer). All of these items should, of course, be compared to the same items for prior years to determine the direction in which the buyer is moving.

Other sources of information about publicly-held companies include Dun and Bradstreet, Standard and Poor, Moody, Value Line and brokerage firm research reports. The sellers should obtain all of the recent filings of the company with the Securities and Exchange Commission (the "SEC"). These filings are a particularly valuable source of information because copies of the documentation for prior material acquisitions by the buyer will be included as exhibits and thus the sellers will not only be able to discover the economic terms of previous deals made by the buyer but also sellers' counsel will be able to learn what the buyer has sought and conceded in such important areas as sellers' representations and warranties, indemnification, non-competition covenants, and registration rights.

All of this information should be evaluated carefully. Weak points and problem areas should be noted not only to obtain additional information but also to negotiate better economic terms. Too many sellers are so awed or impressed by the fact that a prospective buyer is a large public company that they fail to investigate as fully as they should. If the prospective transaction with the buyer involves a merger of the sellers' company into the buyer with the sellers remaining as employees, the sellers should ask the buyer if it has any objection to the sellers talking to the principals of prior mergers about whether they have been satisfied with their association with the buyer.

If the prospective buyer is not a publicly-held company, many of the sources of information mentioned above will be unavailable. The sellers should still ask, however, for audited financial statements of the buyer for the past several years. If the transaction involves notes of the buyer, the sellers also should obtain credit reports of the buyer and possibly speak with the lending officers at the buyer's banks. If the notes are to be guaranteed by individual principals of the buyer, personal financial statements and credit reports should be obtained on each of them. In addition, consideration should be given to backing up the individual guarantees with life insurance on each of the guarantors.

NEGOTIATING THE DEAL

Pro Forma

In the typical acquisition, the buyer's first step in determining the price which it wants to offer for the sellers' company is to prepare a pro forma

income statement—commonly known as a "pro forma"—showing the profit which the sellers' company can be expected to return to the buyer. The pro forma is a projection of future profits based upon the prior performance of the sellers' company. The buyer generally prepares the pro forma from the selling company's recent income statements. For negotiating purposes, the buyer will try to be as conservative as possible in estimating the profit to be realized from the sellers' company because a lower profit projection will justify a lower offering price. Income will be minimized and expenses maximized in the hands of whomever is preparing the buyer's pro forma. Many buyers prepare two pro formas: one for use as a negotiating tool with the sellers and the other for confidential use as the buyer's actual valuation of the business.

Although few sellers take the trouble to do it, there is no reason why they should not prepare (with the assistance of their accountants) their own pro forma of their company for use in negotiating with the buyer. Whether or not the sellers prepare their own pro forma, the buyer's pro forma should not be accepted without question but it should be carefully scrutinized in order to determine if income has been understated and expenses overstated, thus minimizing the profit to be realized. Every additional dollar of profit which can be successfully added to the pro forma will generally have a multiplier effect worth several additional dollars in the purchase price.

In preparing their own pro forma or in reviewing the buyer's pro forma, there are certain problems which confront the sellers. First, if the sellers are planning to remain as employees of the buyer, they must give careful consideration to the salaries which they want to receive. Every additional dollar of salary will be one less dollar of pro forma profit; and, the lower the pro forma profit, the lower the purchase price the buyer will be willing to pay. Frequently, it is better to provide for lower salaries in the pro forma not only to maximize pro forma profit but also in the expectation that in a year or two after the acquisition the principals may be able to negotiate higher salaries with their new employer.

Second, in the case of key employees of the selling company who are not principals of the company, it may be necessary to provide for salary increases in order to assuage any apprehension or fear on the part of these employees about their future under a new employer, especially if the buyer is a larger company.

Third, items such as travel and entertainment, club dues, and automobile expenses may have been inordinately high in prior years. The sellers then will be in the position of trying to convince the buyer that not all of these expenses were really necessary to the business and could easily be reduced or eliminated, a position which will undoubtedly be at some variance with that previously taken with the Internal Revenue Service (the "Service").

Fourth, any goodwill which the company is presently amortizing (e.g., as a result of prior acquisitions by it) must continue to be amortized by the buyer in accordance with its prior amortization practices (but in no event

over a period of more than 40 years),[1] and may not be deducted for purposes of determining pro forma taxes.

PRICE

There are several formulae for valuing a business. One of the most common is a multiple of gross income times gross income. In some industries, a certain multiple of gross sales is traditionally recognized as yielding an acceptable valuation of the company. For example, in the insurance agency field, 1.5 times gross commissions has generally been accepted as a fair valuation of the agency. Another common formula for valuing a business is a multiple of earnings times earnings. Both an income multiple and an earnings multiple are arbitrary factors and will always be the subject of negotiation up and down, even after agreement upon pro forma earnings has been reached.

A third formula which buyers frequently use in determining what they are willing to pay for a company is earnings divided by the desired return on investments. Suppose, for example, that the earnings of the sellers' company are $100,000 and that the buyer desires a return on an investment of 10%. This would mean a purchase price of $1,000,000 ($100,000 divided by .10). If the parties are thinking about a transaction involving the buyer's stock, the same concept can be expressed in terms of the number of shares to be issued to the sellers by dividing earnings by the desired earnings per share of stock issued. For example, if earnings are $100,000 and the buyer wants earnings of at least $2.00 per share from the sellers' company, this goal would indicate a purchase price of 50,000 shares of the buyer's stock ($100,000 divided by $2.00). If the buyer's stock is selling at more than $20.00 per share, a 50,000-share deal could be better than a $1,000,000 cash transaction, especially if structured as a tax-free reorganization.[2]

As indicated above, if the buyer is a publicly-traded company, recent SEC filings will be extremely useful in exploring what the buyer has paid for other companies. In any event, the sellers should work through all of the foregoing equations, both in valuing their own company and in weighing various offers made by the buyer. If one equation yields a particularly low price, then the sellers should try to guide the negotiations along the lines of the other equations. The astute buyer, of course, will try to do the opposite. Frequently, a buyer will negotiate only on the basis of a multiple which allegedly has been accepted in the industry or followed by the buyer in prior acquisitions. It is surprising how many sellers are lured into negotiating only on this basis and fail to compute the actual return on investment or earnings per share which the buyer will be realizing. Obviously, no matter how tantalizing a multiple the buyer may be offering, if the sellers can show that their company would return 20% per year on the purchase price when

1. *See* ACCOUNTING PRINCIPLES BOARD, OPINION NO. 17, ¶¶ 27–31 (1970) [hereinafter cited as OPINION].
2. See pp. 294–99 *infra*.

the buyer itself is only showing a 10% return, the sellers will have a persuasive argument for a higher purchase price.

All parties to the negotiation expect that the initial valuation by each party is subject to some adjustment, but the amount of any such increase or decrease will depend upon the facts and circumstances of each company. Some of the factors which could justify significant increases in the buyer's original valuation include: exceptionally high past profitability; superior employees; and, a new geographical or product market for the buyer. Some of the factors which might mitigate against any significantly higher valuation include: absence of past growth; high percentage of income concentrated in only a few customers; increasing competition; and, elderly employees.

After determining the cash value for their business, the sellers must determine whether they want the purchase price to be paid entirely in cash at closing or are willing to accept some consideration other than immediate cash, such as stock, notes or future cash payments keyed to earnings. Of course, such a judgment involves weighing the certainty of cash at closing against the greater risk, but perhaps higher price, of stock or deferred payments. If the buyer is unwilling to pay all of the purchase price in cash at closing, the sellers should seek additional consideration. Frequently, the total dollars to be realized from the sale can be increased by structuring the transaction as a "tax-free" reorganization under Section 368 of the Internal Revenue Code of 1954 (the "Code") or as an installment sale under Section 453.[3]

Net Assets

Generally, the value of the company's net assets is determined separately from the valuation of the business as a going concern. What this approach means is that the parties usually reach agreement on the purchase price for the company using variations of the formulae suggested above and then add to that figure the value of the company's net assets (total assets minus total liabilities) as shown on the balance sheet. In making this valuation, goodwill and other similar intangible items generally will be excluded and assets generally will be valued at their cost less depreciation.

If the purchase price is to be paid for in stock of the buyer, the sellers should be certain that they are not contributing more to the buyer in net assets per share of stock received than the buyer's stock itself is actually worth in net assets per share. For example, if the balance sheet of the sellers' company shows total assets of $500,000 and total liabilities of $300,000 and the sellers are receiving 50,000 shares of the buyer's stock for their company, they are contributing to the buyer $4.00 in net assets for each share of stock which they are receiving ($500,000 minus $300,000 equals $200,000, divided by 50,000 shares, equals $4.00 per share). If the net assets of the buyer divided by the total number of outstanding shares of

3. See p. 293 *infra*.

the buyer's stock yields net assets per share of less than $4.00, the sellers should negotiate for additional shares of stock in order to compensate them for the uplifting effect which the addition of their net assets will have on the buyer's total net assets per share. Moreover, if the buyer excludes goodwill and other intangible items in its computation of the net assets of the sellers' company, the sellers should be certain to exclude any such items appearing on the buyer's balance sheet in determining the buyer's net assets per share. Once again, the importance of carefully analyzing all of the available information about the buyer is emphasized, especially its financial statements.

Employment Contracts

If the principals of the selling company are to become employees of the buyer, separate employment contracts should be negotiated and executed. In the case of a tax-free reorganization, care should be taken that these employment contracts do not provide for unreasonably high compensation because this could be construed by the Service as additional consideration (known as "boot") for the sale of the business, thus vitiating the tax-free treatment of the acquisition.[4] Likewise, if the buyer is planning to account for the transaction as a pooling of interests,[5] excessive compensation arrangements must be avoided.[6]

Non-Competition Covenants

In a business where much of the value of the company lies in a reservoir of goodwill built up over the years with its customers, the company employees who deal with these customers are an essential part of the business. For this reason, many buyers want to retain the continued services of the sellers' principals or at least insure that these individuals will not enter into competition with the buyer after selling their company. Accordingly, the buyer may insist upon the sellers agreeing to refrain from engaging in the same or similar business (except as employees of the buyer) within a certain geographic area and to refrain from soliciting customers of the selling company for a certain minimum period of time.

As is well known, non-competition covenants are the subject of recurring litigation and must be negotiated with a view not only to what can be obtained but also to what could be enforced. Generally, the courts are somewhat more favorable to non-competition covenants which are part of the sale of a business than to non-competition covenants which are part of employment contracts. The theory, of course, is that the buyer does have a legitimate interest in protecting itself against the loss of its investment in an acquisition by the immediate re-entry of the sellers into competition with the buyer.

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4. *Accord*, ABA Section of Taxation, *Points to Remember*, 22 Tax Law. 193, 196–97 (1968).
5. See pp. 299–304 *infra*.
6. *See* Opinion No. 16, ¶ 48(b) (1970).

Deferred Compensation

Sometimes, principals of the selling company may desire some form of deferred compensation arrangement, such as payment of a fixed sum upon termination of employment until their death or that of their widows. Buyers are frequently receptive to such arrangements, but the full value of the compensation package (with some discount for future payment) is generally deducted from the total purchase price, unless it is agreed upon as part of a reasonable compensation package. If the sellers are seeking to dispose of their business in a tax-free reorganization, an exceptionally generous deferred compensation arrangement as part of an employment contract would vitiate tax-free treatment; and, as already noted, an excessive deferred compensation package could prevent the acquisition from being accounted for as a pooling of interest.

Compensation to Non-Stockholders

As mentioned above, there frequently will be key employees of the sellers' business who are not stockholders. In such cases, the buyer will often try to retain the services of these individuals by increasing their salaries and thus giving them a sense of having benefited from the transfer of the business. In addition, the selling stockholders may feel some moral obligation to insure that such key employees receive some sort of compensation for their prior services in building the business over the years. These objectives can be accomplished in at least two ways. First, the employees involved can be made stockholders of the business prior to acquisition. In order to insure that the acquisition is treated as a pooling of interest, any stock of the agency which is transferred in contemplation of the acquisition must be transferred, either by sale or gift, by an existing stockholder and not be issued directly by the company itself.[7] Second, the selling stockholders can agree to transfer some of the purchase price which they receive to key employees subsequent to the acquisition. This arrangement is of no concern to the buyer, although there are income and gift tax problems involved to the selling stockholders and the employees.

Escrow Agreements

To insure that the buyer will be indemnified against any undisclosed liabilities or other misrepresentations or breach of warranties, the buyer frequently insists upon escrowing a certain percentage of the purchase price for a period of time. The most negotiated issues in escrow agreements are the amount and duration. Anywhere from 10% to 20% of the purchase price is a common amount to be placed in escrow, although special circumstances might justify higher or lower percentages if an escrow is to be established. The period of escrow certainly should be at least as long as necessary for the

7. See pp. 300-03 *infra*.

buyer to become familiar with the operation of the business, including a post-closing audit. Frequently, buyers will argue for at least a year or longer on the ground that the escrow should be at least one complete fiscal year or business cycle. In extreme situations, the length of the escrow is sometimes tied to the applicable statute of limitations.

The person who will act as escrow agent is also commonly an issue. Although it may be desirable to have a completely neutral third party act as escrow agent, this choice can entail a substantial fee and, often, protracted bargaining over exculpatory provisions and other collateral matters in the escrow agreement. For some reason, lawyers for either the buyer or the sellers frequently act in this capacity despite the obvious potential for conflict of interest. Nevertheless, it is usually cheaper and easier to establish an escrow with a lawyer rather than with a third party. On occasion, an officer of the buyer (e.g., the corporate secretary) is designated as the escrow agent. This selection may be the most efficent manner of handling the situation, particularly if such an individual is currently acting as escrow agent for other acquisitions. Even though he is employed by the buyer, and presumably not unresponsive to the buyer's desires, such an individual will have independent, legally enforceable fiduciary obligations to both the buyer and the sellers.

Another occasional issue is who should receive earnings from the escrow fund. If there are no claims against the fund, any interest or dividends should clearly go to the sellers because the fund belongs to them. On the other hand, if there are claims against the fund, should any earnings go back into the fund to be available for claims, or should they be paid to the buyer? If the amount of claims against the fund equals or exceeds the amount of the fund, there is a good argument that, because the fund will belong to the buyer if the claims are made out, any earnings should go to the buyer. Perhaps the most logical compromise is to provide that a proportion of periodic earnings will be retained in the fund equal to that proportion of the entire fund represented by claims against the fund at the time the earnings are received. As these claims are disposed, the earnings will be paid to the buyer or sellers depending upon whether the claim is upheld.[8]

Stock Restriction Agreements

In the event that the purchase price for the sellers' company is to paid in whole or in part in stock, the buyer may ask that the sellers agree to hold the stock for a specific period of time. Typically, these agreements provide that a certain amount of the stock may be sold immediately or in a short time after closing, while various percentages of the remainder of the stock may be sold after the passage of staggered periods of time. Apart from the requirements of the securities laws,[9] this type of stockholders' agreement is

8. For a recent statement of the Service's position with respect to advance rulings in allegedly tax-free acquisitions under Int. Rev. Code Of 1954, § 368(a), (1), where escrow agreements are involved, see Rev. Rul. 75-11, 1975 Int. Rev. Bull. No. 8, at 26.
9. See pp. 304-08 *infra*.

generally desired by buyers in order to discourage large blocks of their stock from being dumped on the market at one particular time, thereby depressing the market price of the stock. Also, if the sellers are to become employees of the buyer, the buyer will frequently prefer that its new employees retain their equity investment in the buyer for at least a minimum period of time as an incentive to performance.

Aside from attempting to negotiate early releases of the stock, counsel to sellers should be satisfied that the agreement contains the following provisions: first, in the event of the stockholder's death, all restrictions should be removed immediately. Second, the agreement should contain exceptions for transfers by way of gift and for pledges as collateral for borrowing, provided, of course, that the stock in the hands of donees or lenders will remain subject to the same restrictions as would have applied if the stock had not been given or pledged. Third, there should be an exception in the event that the stockholder suffers some sort of adverse change of circumstances giving rise to a need for immediate cash. (The standard governing such a change of circumstances could be the same as that which presently permits the early lifting of restrictions on sales under SEC Rule 144).[10] Fourth, sellers who receive only a small number of shares (e.g., less than 10% of the number of shares transferred) or who do not become employees of the buyer should not be required to sign the stockholders' agreement or, in the alternative, should be given more liberalized treatment.

Fringe Benefits

Any fringe benefits or other perquisites which the sellers are presently receiving from the company, such as automobiles and club memberships, should be the subject of negotiation with the buyer. Frequently, a buyer will state that it has "firm" company policies with respect to such matters which cannot be altered without alienating the existing employees. In such event, the sellers should insist upon increasing their annual compensation, or the purchase price, to account for these expenses previously paid by the company.

Letter of Intent

Once an agreement in principle has been reached on all of the significant terms and conditions, the parties generally execute a letter of intent. The purpose of this letter is to insure that both parties agree upon the economic basis and other premises of the deal. Defining the principal terms in a letter of intent helps to disclose any misunderstanding before further time, money and effort is expended and before any public announcement is made. A letter of intent also helps to guide counsel in drafting the necessary documents.

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10. 17 C.F.R. § 230.144 (1975).

It is unwise to attempt to include every detail of the transaction in the letter of intent because the negotiations can frequently be protracted and the enthusiasm of the parties dampened. For example, the precise terms of such provisions as representations and warranties, indemnities, escrows and other similar collateral provisions are best left to negotiation by counsel. Although a letter of intent is generally not legally binding, it should contain an affirmative statement to this effect.[11]

In most cases, it is wise not to publicize that a deal has been made, or is being considered, until the letter of intent has been executed. Premature announcements often can have an unsettling effect on customers and employees and can be embarrassing in the event the deal is not consummated. Moreover, once it becomes public knowledge that the sellers' company is for sale, the bidding price almost inevitably goes down with each successive deal not concluded.

TAX CONSIDERATIONS

Taxable Transactions

If a business is operated in non-corporate form, the sale of the business will be treated as a sale of the individual assets which comprise the going business, and the gain realized on the sale of each asset will be taxed at ordinary income or capital gain rates depending upon the nature of each asset which is sold. The gain realized is determined by subtracting the sellers' adjusted basis in each asset from the amount realized for each asset sold.[12] The amount realized by the owners for each asset is equal to the money or fair market value of the property received in exchange for the asset.[13] The sellers' basis in the assets is generally equal to their capital investment less certain adjustments such as depreciation.

When a business is operated in corporate form, there are three ways that a stockholder can dispose of the business and obtain cash from the sale. He can sell his stock; the corporation can sell its assets and then distribute the proceeds of the sale to him in liquidation; or, the corporation can distribute all of its assets in liquidation to the stockholders, who will then make the sale. While the results are similar, i.e., the buyer has acquired the seller's business, and the seller has received cash, the tax effects of each method can vary.

The sale by a stockholder of stock in a corporation is a transaction which gives rise to capital gain or loss. Such a sale offers the advantages of allowing the election of the installment method of reporting gain[14] and relieving the selling stockholder of the responsibility of satisfying or providing for corporate liabilities and disposing of any assets not wanted by the buyer.

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11. *See, e.g.*, Pepsico, Inc. v. W.R. Grace & Co., 307 F. Supp. 713 (S.D.N.Y. 1969).
12. Int. Rev. Code of 1954, § 1001(a).
13. *Id.* § 1001(b).
14. *Id.* § 453.

If a potential buyer desires to acquire assets rather than stock, he may purchase the assets from the corporation. The corporation's sale of its assets will give rise to taxable income measured by the difference between the amount received and the adjusted basis of such assets in its hands.[15] When the stockholders subsequently liquidate the corporation to obtain the cash received from this sale, the stockholders will realize and recognize gain measured by the difference between the amount received in liquidation and their adjusted basis in the stock.[16] This transaction, therefore, is subject to tax at both the corporate and stockholder levels.

If, rather than allowing the corporation to sell its assets, the stockholder liquidates the corporation and sells the assets to the buyer, the tax effects are decidedly different. In such event, the stockholders will realize and recognize gain on the liquidation measured by the difference between the fair market value of the assets received in liquidation and their adjusted basis in the stock.[17] The subsequent sale of assets by the stockholders to the buyer, while a taxable event, should not result in additional taxable income because the stockholders' adjusted basis in the assets received upon liquidation will be equal to their fair market value[18] which, in turn, should be equal to the price paid by the buyer.

The disparate tax results between these two alternatives was a "trap for the unwary" and led to the enactment of Section 337 of the Code. Section 337(a) provides, in part, that if a corporation adopts a plan of complete liquidation, and, within twelve months of the adoption of the plan, distributes all of its assets (less those retained to meet claims) in complete liquidation, the corporation will not recognize any gain or loss from the sale or exchange of its assets within that period. The stockholders, as in any other liquidation,[19] recognize gain on the excess of the fair market value of the assets distributed in liquidation (which presumably are the proceeds of the sale) over the stockholders' basis in their stock. Thus there is only one tax—to the stockholders, on the excess of the proceeds of the sale plus the fair market value of any unsold assets over their adjusted basis in their stock. This result is the same whether the stockholders had sold the stock to the buyer or had liquidated the corporation and then sold the assets, the only tax being on the stockholders in the amount of the excess of the sale price (which is presumably equal to the fair market value of the underlying assets) over the stockholders' adjusted basis in the stock. The double tax—on the corporation when it sells the assets and on the stockholders when the corporation distributes the sale proceeds to them in liquidation—is avoided.

In any taxable sale of a business, an important item of negotiation should be treatment of that part of the agreed sales price which is over and above the value of the actual assets sold. The seller will contend that the excess

15. *Id.* § 1001(a).
16. *Id.* § 331(a).
17. *Id.* § 1001(a).
18. *Id.* § 334(a).
19. *Id.* § 331(a).

represents payment for goodwill (which will give rise to capital gain to the seller and will be nondeductible to the buyer), while the buyer will contend that the excess represents additional payment for the assets (which will give the buyer a higher basis for depreciating the assets, if they are depreciable) or payment for the covenant not to compete (which will give rise to ordinary income to the seller and is deductible by the buyer over the term of the covenant). As a general rule, the parties will compromise on such allocation, the agreement of the parties usually being accepted by the Service.

If the buyer and the seller do not allocate the purchase price among the assets of the business which are being sold, the Service will undertake the task for them. Such allocation will be based upon the relative fair market value of the assets purchased. Because there can exist a wide range and difference of opinion as to the fair market value of tangible personal property and/or real estate, licenses, permits, goodwill and other business assets, the seller should take an active role in the allocation of the purchase price and insist that the amount allocable to those assets which give rise to capital gain adequately reflect the value of those assets and that such allocation become a part of the final written agreement between the parties.

Even if the sale is a taxable transaction, recognition of the gain can often be deferred by the use of an installment sale. Under Section 453, if the seller receives no more than 30% of the purchase price in the year of sale, he can report his gain on the sale in the same proportion each year that his total gain bears to the total purchase price. The remainder of each payment represents return of capital. In other words, if X owns all of the stock of XYZ with a basis of $10,000 and sells the stock to ABC for $100,000, with $25,000 to be paid at closing and $25,000 in each of the next three years, X will have realized a gain of $90,000 ($100,000–$10,000) but will only have to report the gain at the rate of $22,500 ($25,000 ÷ $100,000 × $90,000) each year for four years. If, however X received $40,000 in the year of sale and $30,000 each of the next two years, he would recognize the full gain of $90,000 in the first year, but would have received only $40,000 in cash with which to pay the tax on the gain. Obviously, any future payments should be represented by notes and these notes should specifically provide that any prepayment privilege cannot be exercised in the year of sale if the effect would be to push the payments received by the seller in that year over the 30% limit. There are many other problems in the installment sale area including disposition of notes representing future payments, difficulty in computing the 30% limit if the purchase price is contingent on future events and imputed interest on future obligations if none is provided.[20]

Another potential problem area in taxable transactions is the "collapsible corporation."[21] A collapsible corporation is generally one which is used by

20. *See generally* INT. REV. CODE OF 1954, § 483.

21. INT. REV. CODE OF 1954, § 341. *See generally* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 12.01-.09 (3d ed. 1971).

its stockholders to purchase property and then cause or permit the property to appreciate in value, after which the stockholders sell their stock or liquidate the corporation, in either event paying only a capital gains tax, rather than the corporation paying tax (probably at ordinary rates) on the gain which it would have realized on the sale of the appreciated property. The collapsible corporation had its origin in the motion picture industry but is most frequently a problem today in the real estate area where a corporation may purchase land for development and then immediately before selling the land (the gain from which would be ordinary income), it liquidates or its stockholders sell their stock, hopefully paying only a capital gains tax. Section 341(a) eliminates this device by providing that any gain from the sale of stock or liquidation of a collapsible corporation will be taxed at ordinary rather than capital gains rates. Section 341 is not without its partial escape hatches; however, it is a statute of such complexity that it should be carefully read in each instance to avoid its penalty provisions.

Tax-Free Acquisitions

In the event that the sellers' company is operating as a corporation and was incorporated for some legitimate business purpose other than the avoidance of taxes,[22] the exchange of its business, whether on the corporate (asset) level or the stockholder (stock) level, for stock of the buyer may constitute a "tax-free" reorganization.[23] Any gain realized by the corporation or its stockholders on receipt of the buyer's shares in exchange for the business of the company will not be recognized at the time of the acquisition but will be deferred. This deferral is accomplished by "substituted" basis provisions[24] which provide that, upon receipt of stock of an acquiring corporation by stockholders of an acquired corporation as the result of a tax-free reorganization, the stockholders will receive the buyer's stock at the same basis as the stock surrendered. If and when the stockholders sell their stock in the buyer, the full amount of their gain, plus any additional gain arising out of an increase in the market price of the buyer's stock between the date of the acquisition and the date of sale, will be taxed.

Thus, suppose X owns 50 of the 200 shares of XYZ Company and his total basis for these 50 shares is $5,000. XYZ Company then sells its business to ABC for a total purchase price of 10,000 ABC shares worth $440,000. X receives 2,500 shares of ABC worth $110,000. The gain realized by X is $110,000 minus $5,000, his basis in his XYZ stock. The capital gain tax on this gain of $105,000, if recognized (assuming a 25% rate), would be $26,250. If the acquisition of XYZ by ABC has qualified under Section 368 of the Code as a "reorganization," this gain will go unrecognized at the time of acquisition. Suppose that five years later, X's 2,500 ABC shares have appreciated in value from $110,000 to $220,000 and he then sells them. At

22. *See generally* Int. Rev. Code of 1954, § 269.
23. Int. Rev. Code of 1954, § 368.
24. *Id.* § 358.

this time, the full amount of his gain will be recognized. Thus X will have to pay a capital gains tax on $220,000, minus the substituted basis of $5,000, the basis in his old XYZ stock at the time he surrendered it.

Suppose, however, that five years after the acquisition of XYZ by ABC, X dies. His heirs then will receive the 2,500 ABC shares at a "stepped-up" basis.[25] That is, the basis at which they hold the ABC shares will be equal to $220,000, the value of the ABC shares at the date of X's death. Thus, suppose that two years after X's death, his former 2,500 ABC shares now held by his heirs are worth $250,000 and his heirs decide to sell them. They will be taxed only on the gain represented by the amount realized by them at the time of the sale ($250,000) minus the stepped-up basis at which they hold the ABC shares ($220,000). Thus his heirs will pay a capital gains tax on only $30,000 and both X and his heirs will have escaped any tax at all on the gain of $215,000, the difference between the fair market value of the ABC stock at the date of X's death ($220,000) and his basis in his old XYZ stock ($5,000).

An acquisition which qualifies under Section 368 has two key advantages: (1) deferral of tax by each stockholder of the seller until the time of his sale of the buyer's stock; and, (2) elimination of tax if the stockholder dies still holding his shares in the buyer.

As mentioned above, in order to obtain these tax benefits, the selling company must be doing business as a corporation. Moreover, the company must have been incorporated for some business purpose other than availing itself of a tax-free acquisition. It is generally thought that at least one year should pass between incorporation and acquisition in order to avoid the Service taking the position that the corporation, and hence the tax-free acquisition, should be ignored for tax purposes, i.e., that the corporation was formed for the sole purpose of availing itself of a tax-free reorganization.

Even this period of time would not prevent the Service from questioning the motives for incorporation, especially if there were evidence that the purpose was tax avoidance. Conversely, if a company could prove that it incorporated for non-tax-avoidance reasons without regard to a future acquisition, conceivably it could be acquired tax-free within a year after incorporation.

There are basically three types of acquisitions which can qualify for tax-free treatment (although mergers are treated as asset acquisitions for tax purposes, they will be considered separately here):

1. *"C" Reorganization.* Acquisition of all or substantially all of the *assets* of the selling corporation solely in exchange for voting stock of the buyer.[26]

2. *"B" Reorganization.* Acquisition of at least 80% of the *stock* of the sellers' corporation solely in exchange for voting stock of the buyer.[27]

3. *"A" Reorganization. Merger* of the selling corporation directly into the

25. *Id.* § 1014(a).
26. *Id.* § 368(a)(1)(C).
27. *Id.* § 368(a)(1)(B).

buying corporation or *consolidation* of the buying corporation and selling corporation into a third corporation.[28]

"C" REORGANIZATIONS

Buyers generally prefer this type of acquisition. In a typical C Reorganization, the buyer acquires all or substantially all of the cash (except cash retained for expenses of the sale), accounts receivable, inventories, fixed assets, prepaid expenses, goodwill and books and records of the company. For purposes of issuing an advance ruling that a transaction qualifies as a C Reorganization, the Service has ruled that "substantially all" of the assets generally means at least 90% of net assets and 70% of the gross assets (based on fair market value).[29] For purposes of satisfying the "substantially all" test, the assets of the acquired company include intangibles, such as goodwill, even if not shown on the balance sheet.[30] The more assets retained by the selling corporation, however, the greater the risk that the Service will claim that the seller transferred less than "substantially all" of its assets to the buyer and thus did not enter into a tax-free C Reorganization. Following the exchange of its assets for stock of the buyer, the selling corporation usually liquidates, distributing the buyer's stock to the stockholders in cancellation and redemption of its own capital stock, although liquidation is not required.

The major advantages of a C Reorganization to the buyer are:

(a) The buyer acquires only those liabilities which it specifically assumes (there is no specific limit on the amount of liabilities which a buyer assumes so long as *no* consideration other than voting stock of the buyer is transferred to the selling corporation).[31]

(b) Assuming that the requisite number of stockholders of the selling company approves the transaction, the minority shareholders, if any, have no dissenters' rights, except in a state which recognizes the de facto merger doctrine.

(c) The approval of the buyer's stockholders is unnecessary.

The principal advantages of a C Reorganization to the selling corporation are:

(a) The selling principals can retain the corporate shell of their company as a receptacle for any unrelated assets which are not transferred to the buyer within the limitations of the 70%–90% test. (In order for the acquisition to be accounted for as a pooling of interests,[32] however, the buyer's stock which is received by the selling corporation must be distributed to the latter's stockholders).

(b) Any consideration received by the sellers in addition to the buyer's stock will not vitiate the tax-free nature of the acquisition provided that

28. *Id.* § 368(a)(1)(A).
29. Rev. Proc. 74-26, 1974 INT. REV. BULL. No. 36, at 19.
30. Schuh Trading Co. v. Commissioner, 95 F.2d 404 (7th Cir. 1938).
31. INT. REV. CODE OF 1954, § 368(a)(2)(B).
32. See pp. 300-03 *infra*.

this additional consideration, when added to any liabilities assumed by the buyer, does not exceed 20% of the value of the selling company's assets. (As noted above, however, liabilities assumed by the buyer are not included in this 20% if no consideration other than the buyer's voting stock is paid for the assets of the selling company).[33]

(c) The selling company's legal, accounting and other expenses connected with the acquisition can be paid by the selling company rather than by the selling stockholders.[34]

Finally, the assets of the selling company may also be acquired by a subsidiary of the buyer solely in exchange for the buyer's voting stock.[35]

"B" REORGANIZATIONS

The use of B Reorganizations (stock for stock) is less favored by buyers. The major disadvantages of a B Reorganization to a buyer are: the buyer acquires the sellers' corporation intact, with all of its liabilities, whether disclosed or undisclosed (this, obviously, is an advantage to the sellers); and as a subsidiary of the buyer, the acquired corporation will require certain bookkeeping and maintenance expenditures. To the individual sellers, a B Reorganization is disadvantageous in that they can receive as consideration only the voting stock of the buyer.

The major advantage to both parties in a B Reorganization is that if the acquired company has unrelated assets which its stockholders wish to retain and which constitute more than an insubstantial amount of its assets (thus making a C Reorganization unavailable), the corporation may, prior to acquisition by the buyer, distribute these unrelated assets to the stockholders as a dividend without losing the tax-free status of the acquisition by the buyer.[36] In contrast, the buyer may desire a B Reorganization if the selling corporation has some valuable licenses or non-assignable contracts (e.g., a favorable lease) which the buyer could not otherwise obtain.

Another theoretical advantage of a B Reorganization is that, because the acquisition is between buyer and the individual stockholders, the buyer can make a separate deal with each stockholder without regard to that stockholder's proportionate equity ownership in the acquired corporation. This approach seldom occurs and, moreover, would prevent treatment of the acquisition as a pooling of interests.[37] Another possible advantage is that the buyer need acquire only 80% of the selling company's stock to have a valid B Reorganization. Nevertheless, most buyers will not agree to a B

33. *See* INT. REV. CODE OF 1954, § 368(a)(2)(B).
34. Rev. Rul. 73-54, 1973-1 CUM. BULL. 187, provides that the buyer can pay valid reorganization expenses such as legal and accounting fees, appraisal fees, transfer taxes, etc., of the selling corporation in a C Reorganization or of the selling stockholders in a B Reorganization.
35. INT. REV. CODE OF 1954, § 368(a)(1)(C).
36. See Rev. Rul. 56-184, 1956-1 CUM. BULL. 190.
37. See pp. 300-03 *infra*.

Reorganization unless all of the stockholders of the target corporation agree to sell their stock; buyers generally prefer to own companies in which there are no minority stockholders.

Finally, as in C Reorganizations, a B Reorganization may be carried out by using a subsidiary of the buyer to acquire the selling stockholders' stock in exchange for voting stock of the parent.[38]

"A" Reorganizations

A "straight" A Reorganization, the merger of the acquired corporation into the acquiring corporation or a consolidation into a newly organized corporation, is impracticable to most buyers because it almost always requires the specific approval of stockholders of both corporations. If the buyer is a publicly-held company, its stockholders will typically meet only once a year. Moreover, in a merger the acquiring corporation would be directly liable for all of the liabilities of the acquired corporation.

A corporation can merge into a subsidiary of the buyer and thus "solve" the problem and expense involved in calling a meeting of stockholders.[39] This type of acquisition is known as a "triangular merger" and would be desirable where, for example, the acquired corporation wants to distribute a not insubstantial amount of unrelated assets to its stockholders (which would be impermissible in a C Reorganization) or where the stockholders want to receive consideration from the buyer in addition to the buyer's stock (which would be impermissible in a B Reorganization). In addition, it is possible to create a new subsidiary of the buyer, fund it solely with stock of the buyer and then merge it into the target corporation.[40] The result of this type of acquisition, which is known as a "reverse triangular merger," is that the buyer ends up owning all the stock of the target corporation and the former stockholders of the latter wind up with stock of the buyer in return—the same result as in a B Reorganization. A reverse triangular merger avoids some of the disadvantages of a B Reorganization. For example, consideration other than solely voting stock of the buyer can be received by the selling stockholders. Because state law governs the validity of all mergers, the laws of the state in which either of these types of mergers is contemplated should be reviewed to ascertain whether the desired type of merger is permitted.

Aside from the technical requirements involved with respect to each type of acquisitive reorganization, sellers should be aware of the general judicial doctrine of continuity of interest which will preclude tax-free reorganization treatment where the stockholders of the acquired corporation, as a group, receive less than a substantial amount of the consideration in the form of an equity interest in the reorganized corporate entity.[41] For purposes of the

38. *See* Int. Rev. Code of 1954, § 368(a)(1)(B).
39. Int. Rev. Code of 1954, § 368(a)(2)(D).
40. *Id.* § 368(a)(2)(E).
41. *See* Pinellas Ice Co. v. Commissioner, 287 U.S. 462 (1933); Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932).

Service's advance ruling requirements, this "substantial" requirement is 50%.[42]

ACCOUNTING CONSIDERATIONS

There are two generally accepted methods of accounting for business combinations—as a "purchase" or as a "pooling of interests." These methods are mutually exclusive and non-divisible. That is, a business combination must be treated for accounting purposes either as a purchase or as a pooling of interests—not both, and not part one and part the other. It is important to note that whether an acquisition is accounted for as a pooling or as a purchase is independent of whether it is tax-free or taxable.

Comparison of Purchase and Pooling of Interests.

Suppose that ABC desires to acquire XYZ in exchange for 15,000 ABC shares, with a market value at the date of acquisition of $40.00 per share. Net assets of XYZ (assets minus liabilities) are $100,000 at the date of acquisition. Pro forma net income is $40,000 per year. Prior to the acquisition, the balance sheet of XYZ is as follows:

Assets		Liabilities	
Cash	$ 50,000	Payables	$100,000
Receivables	150,000	Capital Stock	10,000
		Retained Earnings	90,000
	$200,000		$200,000

If the acquisition must be treated as a purchase, then the effect of the acquisition of XYZ on the books of ABC will be as follows:

Assets		Liabilities	
Cash	$ 50,000	Payables	$100,000
Receivables	150,000	Capital Stock	600,000
Goodwill[1]	500,000	(15,000 × $40 per share)	
	$700,000		$700,000

[1] Excess of market value of ABC stock, $600,000 (15,000 × $40.00 per share), over net assets acquired ($200,000 - $100,000).

Thus, under the present example, if the acquisition were to be treated as a purchase, ABC would have to set up an item of $500,000 on its books as goodwill attributable to the purchase of XYZ. Opinion No. 17 of the

42. Rev. Proc. 74-26, 1974 Int. Rev. Bull. No. 36, at 19; *see* Rev. Rul. 66-224, 1966-2 Cum. Bull. 114.

Accounting Principles Board (the "APB") of the American Institute of Certified Public Accountants requires that goodwill be amortized on the books of the acquiring corporation over a period of not more than 40 years. Moreover, no tax deduction is permitted for this charge. Thus, if the amortization policy of ABC is 20 years, dividing the $500,000 goodwill item by 20 years would yield an annual charge of $25,000 against the post-tax earnings of ABC.

If this $25,000 charge is allocated to the $40,000 pro forma annual income of XYZ, the net pro forma income for this acquisition would be reduced to $15,000 per year. Because ABC exchanged 15,000 of its shares for the business of XYZ, ABC would be receiving only $1.00 per share in pro forma net earnings of XYZ. If ABC's earnings are, for example, $1.50 per share, then accounting for the acquisition of XYZ as a purchase would dilute rather than increase ABC's earnings.

If, on the other hand, the combination can be treated as a pooling of interests, the effect of the acquisition on the books of ABC will be as follows:

Assets		Liabilities	
Cash	$ 50,000	Payables	$100,000
Receivables	150,000	Capital Stock	10,000
		Retained Earnings	90,000
	$200,000		$200,000

In other words, the effect of the acquisition on ABC's books as a pooling of interests is exactly the same as if each item on the books of both XYZ and ABC had simply been added together item-by-item. Moreover, these adjustments will be made not only to the books of ABC for the present period but also for all prior periods during which both companies were operating. Likewise, the earnings histories of the companies are combined as if they had always operated as one.

The most important fact about the treatment of the combination as a pooling of interests is that there is no item for goodwill set up on the books of ABC to be amortized over a 20-year period. There is no charge for goodwill against the $40,000 pro forma income of XYZ and the full $40,000 is available to ABC as earnings. When $40,000 is divided by the 15,000 shares paid by ABC, the result is that ABC is receiving $2.67 in earnings for the acquisition of XYZ. Clearly, accounting for the acquisition in this fashion has an uplifting rather than dilutive effect on ABC's $1.50 per share earnings. Although the economic realities of the acquisition are exactly the same, treating the combination as a purchase yields only $1.00 in earnings for each ABC share exchanged, but treating the combination as a pooling of interests yields $2.67 in earnings for each ABC share exchanged.

Qualification as a Pooling of Interests

The basic concept of the pooling of interests method of accounting for business combinations is that the two stockholder groups of their respective

companies pool resources and risks to form a new entity to carry on, in combination, the previously separate enterprises, and to unite in one company the previously separate earnings streams.

Unlike qualifying for a tax-free reorganization, an acquired company need not be a corporation in order to qualify the acquisition for treatment as a pooling of interests. The company may be a sole proprietorship or a partnership.[43]

To qualify for treatment as a pooling of interests, a combination must meet all twelve conditions specified in Opinion No. 16 of the APB. If the acquisition fails to meet any one of these conditions, it must be treated as a purchase and not as a pooling of interests. These conditions as they affect typical acquisitions are as follows:

1. *The acquired company is autonomous and not a subsidiary or a division of another company at any time within two years prior to the initiation of the plan of combination.* Thus, a company which is the subsidiary of a larger company cannot be pooled by a buyer. This condition does not apply, however, to a company which was a subsidiary with at least 20% outside ownership prior to October 31, 1970, the date on which Opinion No. 16 became effective. This rule also does not apply to a subsubsidiary or division which is ordered to be divested from its parent company pursuant to an order of a court or governmental agency. A plan of combination will be "initiated" on the date of the agreement in principle.

2. *Both the acquired and the acquiring companies have been independent of each other.* This condition means that neither combining company may own more than 10% of the outstanding voting common stock of any other combining company.

3. *The combination is effected in a single transaction or is completed in accordance with a specific plan within one year after the plan is initiated.* In other words, the transaction should be consummated within a reasonable period of time. If consummation is delayed, however, for some reason beyond the control of the combining companies (e.g., governmental proceedings, litigation, etc.), this condition would not necessarily be violated.

4. *The buyer offers and issues only common stock with rights identical to those of a majority of its outstanding voting common stock in exchange for substantially all of the stock or assets of another company.* If, for example, the buyer agreed to an exceptionally generous deferred compensation arrangement for one or more agency stockholders, then such an arrangement might vitiate treatment as a pooling of interests.

In an acquisition of the assets of a company, the requirement of "substantially all" of the assets or stock of the acquired company has the same purpose and effect as the "substantially all" requirement of the Code for C Reorganizations. In the acquisition of the company's stock, this condition means 90% or more. The acquired company may retain cash,

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43. It is important to understand that whether an acquisition is accounted for as a purchase or a pooling of interests has no bearing on whether it is a non-taxable transaction.

receivables or securities under certain conditions to settle contingencies, disputed items, legal and accounting expenses and taxes.

5. *Neither the acquiring nor the acquired company changes the equity interest of its voting common stock in contemplation of the acquisition either within two years prior to the initiation of the combination or between the initiation and the consummation of the acquisition.* A change in equity interest in contemplation of the combination may include extraordinary distributions to stockholders and additional issuances, exchanges and retirements of securities. Distributions to stockholders, however, which are no greater than normal dividends do not violate this condition. Normality of dividends is determined by earnings during the period, and by the previous dividend policy and record.

Questions frequently arise concerning the application of this condition to an acquisition of a sole proprietorship, partnership or Subchapter S corporation. Because the proprietors of these entities are taxed on earnings without regard to distribution, it probably would be considered normal to distribute all of the earnings of such an entity prior to acquisition.

Although this condition prohibits a change by a combining company in its equity interest, it does not prohibit a change of equity interest resulting from dealings by the stockholders individually. Thus in a typical situation where the sole stockholder of a company about to be acquired wishes to make stockholders of two or three key employees, to permit them to receive some of the buyer's stock, it would be permissible for the sole stockholder to give some of *his* stock to these employees, but it would be impermissible for the corporation to issue this stock to them *directly* (e.g., as compensation for services rendered to the corporation).

6. *If either the acquiring or the acquired company reacquires shares of its voting common stock, it must be for some purpose other than the combination of the two companies or any other prospective combination.*

7. *The ratio of the equity interest of each individual common stockholder of the acquired company to the interests of the other common stockholders in the company remains the same as the result of the combination.* This condition means that each individual common stockholder of the selling company must receive a voting common stock interest in the buyer exactly in proportion to his relative voting common stock interest in the company. For example, if an individual owns 80% of the selling company, he should receive 80% of the stock of the buyer which is issued in connection with the acquisition. Any change in ratio would constitute a reshuffling of the stockholders' equity interests in connection with the acquisition, rather than a pure combining of interests.

8. *The voting rights of the common stock ownership in the buyer after the acquisition are fully exercisable by the stockholders.* Thus, neither the stock of the buyer to be issued in connection with an acquisition nor the stock of an acquired company can be placed in a voting trust. Such an arrangement would violate the spirit of the pooling of interests concept, namely, to pool resources and to share risks and earnings. This condition is not violated by the typical escrow agreement because the escrowed shares are issued in the

names of the individual stockholders who are fully entitled to exercise all voting rights with respect to such shares during the escrow period.

9. *The combination is resolved at the date of consummation and there are no provisions relating to the subsequent issuance of securities or other consideration.* Thus arrangements by which additional stock would be issued contingent upon future earnings of the acquired company (sometimes known as "earn-outs") are prohibited. Likewise, there can be no provisions for the return of already-issued stock if the subsequent earnings attributable to the acquired company fail to reach certain levels. This prohibition reflects the previously discussed view of the APB that a pooling of interests is appropriate only where there is a genuinely proportionate sharing in the combined company. If additional stock could be issued or forfeited in the future, there would not be a true sharing of risks and rewards. Moreover, the APB was anxious to guard against the possibility of an immediate distortion of earnings per share of the acquiring company, since initial per share earnings would not reflect the ultimate issuance of additional shares. The number of shares of the buyer's stock issued to effect an acquisition may be revised for the later settlement of a contingent liability in a different amount than that recorded by the acquired company. This objective is, of course, the purpose of escrow agreements.

10. *The buyer does not agree to retire or reacquire any of its common stock issued in connection with the acquisition.*

11. *The buyer does not enter into any other financial arrangements for the benefit of former stockholders of an acquired company (such as a guarantee of loans secured by the buyer's stock issued in the acquisition) which in effect negate the exchange of the buyer's stock.*

12. *The buyer does not intend or plan to dispose of a significant part of the assets of the combining companies within two years after the acquisition, other than disposals in the ordinary course of business or to eliminate duplicate facilities or excess capacity.*

When Not to Pool

Despite the many attractions of treating an acquisition as a pooling of interests, there are situations in which a buyer might not want to pool. For example, if a target company has been operating at a loss, pooling for all prior periods would have a depressing effect on the buyer's prior earnings for these periods. Superficially, this result might not be undesirable because a reduction in prior years' earnings would increase the growth in earnings from prior years to present and future years. Overindulgence in such a ploy, however, which alert investment analysts are quick to pick up, will severely tarnish a company's financial reputation. So, if a target company has a loss history, treating the acquisition as a purchase might well be more desirable than treating it as a pooling of interests. Of course, beginning with the date of acquisition, any goodwill attributable to the acquisition would have to be annually amortized and charged against earnings. If the company has been operating at a loss for some while, it is possible that the purchase price

(based on the market value of the buyer's stock) which the buyer would pay would not be much above the value of the net assets and thus very little goodwill would be created. Moreover, there may be a net operating loss carry-forward available to cover at least part of the charge against earnings.

This consideration raises another highly theoretical situation in which a buyer might not want to pool. Where the acquisition would create negative goodwill, i.e., where the purchase price paid by the buyer is actually less than the value of the net assets, the buyer would have to amortize and deduct a negative figure from earnings, thus increasing earnings.

The preceding examples have been situations in which a buyer might not want to pool because pooling would actually have an adverse effect either on prior periods or on future earnings. There are additional situations in which a buyer might be willing to forego the benefits of pooling to take advantage of some device not permitted by the pooling rules. For example, if by using cash to purchase a company, the buyer could obtain a higher return than by leaving the same funds in a time deposit, it might well be advisable to use cash rather than stock even though it means giving up a pooling of interests. The projected return which a buyer might realize on a cash-purchased company would have to include an allowance for whatever amortized charge against the buyer's earnings would be created by treating the acquisition as a purchase. Another situation in which the buyer might be willing to forego a pooling would be when future earnings of the seller are so speculative that it would be impossible to fix a purchase price except as based on subsequent earnings. Because earn-outs and contingent stock are prohibited by the pooling rules, such an acquisition would have to be treated as a purchase.

SECURITIES CONSIDERATIONS

The purpose of the Securities Act of 1933[44] (the "Act") is to provide full and fair disclosure of all material facts to a prospective buyer of a security. Section 5 of the Act[45] prohibits the use of interstate commerce or the mails (1) to sell or transmit a security, unless a registration statement is effective as to the security, or (2) to transmit a security, unless it is accompanied or preceded by a prospectus which complies with Section 10 of the Act,[46] or to transmit the prospectus itself, unless it complies with Section 10. An acquisition for consideration other than cash clearly involves the sale of a "security,"[47] as that term has been defined by Congress and interpreted by the Supreme Court. Thus, unless a specific exemption is available under the Act with respect to the type of transaction involved, the registration and prospectus requirements of Section 5 will apply to the issuance and to the resale of such securities.

44. 15 U.S.C. § 77a (1970).
45. *Id.* § 77e.
46. *Id.* § 77j.
47. *Id.* § 77b(1).

ISSUANCE OF SECURITIES IN AN ACQUISITION

Under Section 4(2) of the Act,[48] the issuance of securities in any transaction, including an acquisition, "not involving any public offering" is exempt from the registration and prospectus requirements of Section 5. Thus, the question becomes: What is a "public offering" of securities? SEC Rule 146[49] indicates that, if there are no more than 35 individuals who will receive securities of the buyer in the acquisition and certain other conditions are met, the acquisition will be deemed to be a transaction "not involving any public offering within the meaning of Section 4(2) of the Act."[50] Among the other conditions which must be met are the following: no general solicitation or advertising may be used by the issuer;[51] each offeree must have a certain level of business sophistication and be able to bear the economic risk of the sale;[52] and the same kind of information which would otherwise be set forth in a prospectus must be made available to each offeree.[53] Although SEC Rule 146 is not the exclusive route to obtaining the benefit of the Section 4(2) exemption, all of the conditions to the rule must be satisfied in order for it to be available,[54] and all of these requirements, of course, are obligations of the buyer. If it results that the buyer issued securities in a transaction which was a "public offering," and no other exemption was available, the recipients of the buyer's securities (in return for the stock or assets of the selling corporation) would have a cause of action against the buyer for having failed to comply with the registration and prospectus devlivery requirements of Section 5. In addition, the buyer might be subject to criminal liability.

If the buyer is engaged in a continuing series of acquisitions in which the same type of security is issued in each instance, all of the acquisitions face possible "integration" and may be held to constitute a single "private offering."[55] If an aggregate of more than 35 persons received securities of the buyer in an integrated series of acquisitions, SEC Rule 146 would be unavailable, thus the buyer might be unable to avail itself of the Section 4(2) exemption.[56] In such a case, unless some other exemption were

48. *Id.* § 77d(2).
49. 17 C.F.R. § 230.146 (1975). *See also* SEC Securities Act Release No. 5487 (April 23, 1974).
50. SEC Rule 146(b), 17 C.F.R. § 230.146(b) (1970).
51. *Id.*, 146(c), 17 C.F.R. § 230.146(c).
52. *Id.*, 146(d), 17 C.F.R. § 230.146(d).
53. *Id.*, 146(e), 17 C.F.R. § 230.146(e).
54. SEC Rule 146, 17 C.F.R. § 230.146 (1975), Preliminary Note 3.
55. *Id.*; Shapiro & Sachs, *Integration Under the Securities Act: Once an Exception, Not Always*...., 31 MD. L. REV. 1 (1971). The Rule provides, however, that:
> [A]n offering shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by Section 3 or Section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six-month period immediately preceeding or after the six-month period immediately following any offers, offers for sale or sales pursuant to this rule, *Provided*, that there are during neither of said six-month periods any offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

SEC Rule 146(b)(1), 17 C.F.R. § 230.146(b)(1) (1975).
56. SEC Rule 146(g), 17 C.F.R. § 230.146(g) (1975).

available, the buyer would have to register the securities under Section 5 and deliver a valid prospectus to all of the sellers who receive the buyer's securities in any acquisition. As indicated above, however, all of these matters are problems for the buyer to resolve.[57]

In addition to exempting acquisitions which do not involve a public offering of the buyer's securities, the Act also exempts an "intrastate offering," i.e., where securities are offered and sold by the issuer only to persons resident within the same state in which the issuer, assuming it is a corporation, is incorporated and doing business.[58] According to SEC Rule 147,[59] which was promulgated in 1974, the intrastate offering exemption is "intended to apply only to issues genuinely local in character, which in reality represent local financing by local industries, carried out through local investment."[60] The rule sets forth certain objective standards which a local buyer may use in claiming the intrastate offering exemption.[61] Even if an exemption from the registration and prospectus requirements of Section 5 is available, however, the buyer is not exempted from the anti-fraud provisions of both the Act and the Securities Exchange Act of 1934 whenever interstate commerce or the mails is used to sell or deliver the securities.

At the state level, the Maryland Securities Commissioner has recently adopted a new Rule S-7,[62] which is closely patterned after SEC Rule 146. Rule S-7 specifically provides that compliance with SEC Rule 146 will be deemed to be compliance Rule S-7.

Resale of Securities of the Buyer Following an Acquisition

Probably of more immediate concern to the sellers is what they can do with the buyer's securities after the acquisition. Under Section 4(1) of the Act, "transactions by any person other than an issuer, underwriter or dealer"[63] are exempted from the registration and prospectus requirements of Section 5. Thus, if the individual selling stockholder is not an issuer, underwriter or dealer, he need not comply with the requirements of Section 5 upon reselling his stock in the buyer after the acquisition. The stockholder is not an issuer of the buyer's securities and presumably he is not a "dealer"[64] or an "underwriter,"[65] as these terms are commonly used.

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57. The antifraud provisions of the Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j (1970), however, apply to the seller as well as the buyer. Accordingly, sellers' counsel should assist his clients in assuring that the latter make full disclosure of all material facts.
58. Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970).
59. 17 C.F.R. § 230.147 (1975). *See generally* SEC Securities Act Release No. 5450 (Jan. 7, 1974).
60. SEC Rule 147, 17 C.F.R. § 230.147 (1975), Preliminary Note 3.
61. These objective standards include tests for determining whether in fact the issuer is "doing business" within the state. *See* SEC Rule 147(c), 17 C.F.R. § 230.147(c) (1975).
62. 2 Blue Sky L. Rep. ¶ 23, 615.
63. 15 U.S.C. § 77d(1) (1970).
64. Securities Act of 1933, § 2(12), 15 U.S.C. § 77b(12) (1970).
65. *Id.* § 2(11), 15 U.S.C. § 77b(11) (1970).

Section 2(11) broadly defines, however, the term "underwriter" to include any person who has purchased a security from an issuer with a "view" to the "distribution" of the security or who offers or sells for the issuer "in connection with" the distribution of the security.

If, in reliance upon Section 4(2) of the Act, the securities issued by the buyer in an acquisition have not been registered, the sellers may not resell their securities until the passage of a sufficient amount of time to indicate that they acquired the securities for investment purposes rather than for purposes of further distribution. After this period of time has passed, the securities will be considered to have come to rest in the hands of the investing public and "distribution" of the securities will have ended. Accordingly, the holder of the securities at that time will not be deemed an "underwriter" and the exemption of Section 4(1) will apply.

What period of time is necessary for the holder of unregistered securities received in an acquisition to wait before reselling them? For sometime it was thought that one or two years was sufficient. Then, three years seemed to be necessary. In April, 1972, the SEC promulgated Rule 144[66] which states that two years is long enough provided certain other conditions are met. Among these other conditions are a limitation on the amount of securities which may be sold in any six month period; a requirement that the securities be sold in "brokers' transactions," within the meaning of Section 4(4) of the Act;[67] filing of a notice of intent to sell; and the availability of adequate current public information with respect to the buyer who issued the securities. A key point in acquisitions involving stock which is to be resold under the rule is whether all of the consideration has been paid two years prior to resale of the stock. The sellers should always determine in advance that an earn-out, price support provision or employment agreement will not give rise to an argument that the entire consideration was not paid at closing.

Usually, the selling stockholders who receive unregistered securities of a buyer in an acquisition will want the buyer to facilitate resales of the securities subsequent to the acquisition. Accordingly, the sellers should require the buyer to agree to fully satisfy the requirements of SEC Rule 144, as they relate to the issuer, to permit resale of the securities issued in the acquisition. This obligation should be a continuing one for as long as SEC Rule 144 would apply. For purposes of facilitating sales under the rule, the buyer should be required to furnish to the selling stockholders, from time to time, upon written request, any and all information necessary to enable the selling stockholders to comply with the rule. Of course, the resale provisions of the rule are not helpful to the reselling stockholders if there is no market or only a very thin market for the buyer's stock. Especially if the buyer's stock is not listed on a national stock exchange, it is important to check the

66. 17 C.F.R. § 230.144 (1975). *See generally* SEC Securities Act Release No. 5306 (Sept. 26, 1972).
67. 15 U.S.C. § 77d(4) (1970).

nature of the market for the stock to determine whether it would even be possible to make unsolicited sales.

In addition to requiring the buyer to satisfy the provisions of SEC Rule 144 relating to issuers, the sellers may also want the buyer, under certain conditions, to agree to register the securities received in the acquisition to permit later resales which would be impermissible without registration. Typically, such registration rights are either "mandatory" or "piggyback." In the former, the buyer agrees to file a registration statement at the request of the sellers regardless of whether the buyer would otherwise have filed one. In the second type of right, the buyer simply agrees to include the securities issued to the selling stockholders in any registration statement which the buyer may subsequently file. As a part of their registration rights, the selling stockholders should also require the buyer to do whatever is necessary or at least to use its best efforts to qualify the securities under the securities laws of a reasonable number of states as requested by the selling stockholders. In negotiating registration rights, an important question will be who will bear what part of the registration costs. The legal, accounting and other expenses of a registration statement can often be more than those involved in the acquisition itself.

If the buyer's securities being delivered in the acquisition have been registered under the Act, it is generally unnecessary for a selling stockholder to wait any particular period of time before reselling as long as he receives less than ten percent of the total number of shares covered by the registration statement. In such a case, the securities are considered to have come to rest in the hands of the investing public and the "distribution" completed. Even if a selling stockholder receives registered securities of the buyer with a view to immediate resale, he will not be considered an underwriter under the Act because he will not be participating in a distribution of the securities. Accordingly, any resale of the buyer's securities by such a stockholder would be exempted by Section 4(1) from the registration and prospectus requirements, without the necessity of waiting for the expiration of any period of time.

If, however, a stockholder receives ten percent or more of the shares covered by the registration statement, the staff of the SEC takes the position that the shares have not yet come to rest in the hands of the public and thus the "distribution" has not been completed. In such a case, the stockholder is considered an underwriter and the exemption of Section 4(1) would be unavailable. Thus, such a stockholder would have to comply with both the registration and prospectus requirements of Section 5 of the Act. This compliance can ordinarily be achieved by filing an amendment to the registration statement designating any such stockholder as an underwriter and indicating that the prospectus may be used by him in making resales. If any one of the selling stockholders in an acquisition would receive more than ten per cent of the securities covered by the registration statement, the buyer should be required to agree to make such an amendment to the registration statement or to provide registration rights for future registration, as discussed above.

DRAFTING THE CONTRACT

All of the careful evaluation, tenacious negotiation and imaginative structuring of a potential sale of a business can be for naught if the contract is not properly drafted so as to reflect the seller's objectives. Generally, the buyer's counsel will prepare the first draft of the contract. If, however, the seller's counsel can obtain this responsibility himself, he should do so. There is a significant advantage in being able to prepare the first draft of any legal instrument since the burden of requesting and demonstrating the need for changes is then shifted to the other side. It is surprising how often lawyers are willing to yield the responsibility (and the advantage) of preparing the first draft.

The following discussion of the various parts of a typical acquisition contract is not meant to be exhaustive but merely to suggest a basic list of items which should be covered and certain problem areas which may be encountered.

PREAMBLE

In a sale of assets, the selling company always will be a party to a contract; frequently, however, the buyer will insist upon the stockholders of the selling company also being made parties for purposes of making them liable under the representations and warranties, the non-competition covenants and the indemnification provisions. Sometimes, this issue can be resolved by having only the principal stockholders or only those stockholders who are actively engaged in the operation of the business become parties to the contract. In a sale of stock, the selling stockholders will have to be parties and there will be no reason for the selling company to be a party since it will continue in existence as a subsidiary of the buyer. If the structure of the transaction involves purchase through a subsidiary of the buyer, the sellers should insist upon both the parent and the subsidiary being parties to the contract.

As in every contract, all of the parties should be identified with sufficient precision so as to avoid any confusion. Corporations should be identified with their exact corporate names and a reference to the state in which they are incorporated. Individuals should be identified by reference to their place of residence or to their capacity as stockholders of the seller.

The "whereas" clauses are useful to describe the business in which each of the parties is presently engaged and the objectives to be achieved by the contract. They should make reference at least once to each of the parties and the role of that party in the acquisition.

DEFINITIONS

It is generally desirable to have a separate section for the definition of terms which will be frequently used in the contract. This section is most helpful when located at the beginning of the document. Among the terms

which should be considered for definition at the outset are the following:

Closing Date: ———, 197 , at ———i.m., or such other date and time as may be mutually agreed upon by the parties hereto.

Closing: The acts and events which occur on the Closing Date for the purpose of consummating this Agreement.

XYZ Stock: All of the issued and outstanding capital stock of XYZ, owned by Stockholders as set forth in Schedule I attached hereto.

ABC Stock: Shares of the voting common stock of ABC, without par value.

ABC Notes: A series of negotiable promissory notes of ABC, each substantially in the form of Exhibit ___ attached hereto, in an aggregate principal sum of $———, guaranteed by ———, to be delivered pursuant to paragraph ___.

Representations and Warranties of Sellers

The buyer is certainly entitled to representations and warranties from the sellers with respect to the corporate status, capitalization and stock ownership of the selling corporation. The sellers also should be prepared to represent and warrant that the most recent year-end financial statements of the company are in accordance with its books and records, present fairly the financial position of the company and its results of operations, and have been prepared in accordance with generally accepted accounting principles applied on a consistent basis. The buyer may also insist upon interim financial statements, especially if several months have passed since the fiscal year-end. The buyer will, in addition, undoubtedly seek affirmative representations and warranties that, except as reflected on the financial statements, the selling corporation had no outstanding liabilities for any period prior to the date of the financial statements or arising out of transactions entered into or any state of facts existing prior to that time. In any representation and warranty which the sellers make with respect to the absence of undisclosed liabilities, they should be certain to specifically except those reflected on the latest balance sheet, those referred to or arising under any agreements or commitments listed or described in any attached exhibits or schedules, and those incurred since the date of the latest balance sheet in the ordinary course of business. The buyer may also desire a separate representation and warranty that the net worth of the seller will not be less than a certain figure as of closing date.

The buyer will also usually seek a representation and warranty that, since the date of the last year-end financial statements, none of the following events have occurred: any material adverse change in the financial condition, assets or liabilities of the selling; any declaration or payment of any dividend or distribution in respect of the sellers' stock or any redemption, purchase or other acquisition of such stock; or the execution of or any change in any material agreement or instrument binding the selling company. If interim financial statements are to be used, the sellers should insist that, because they are representing and warranting such in-

terim statements as of the date thereof, the date for material adverse changes should be moved up to the date for the interim financial statements.

The buyer will also generally seek representations and warranties as to the good and marketable record title and the zoning classification of any real property. Similar title assurances will typically be sought concerning the ownership and condition of personal property.

Among other subjects for which the buyer may seek assurances by representations and warranties of the sellers are the absence of litigation, validity and enforceability of leases, collectibility of receivables, customer lists, material contracts and commitments, compliance with law, prior tax returns, adequacy of insurance coverage, non-competitive interests of stockholders, patents, trademarks and copyrights, backlog of orders and due authorization of the acquisition. The buyer may, in addition, seek a representation and warranty with respect to the absence of any "pending or threatened" litigation against the selling company. This representation and warranty should be limited to "material" litigation. Further, "pending" should be limited litigation in which notice or service of process has been received, and "threatened" should be limited to claims which have actually been asserted or suggested by way of demand upon or other notice to the sellers. Obviously, the sellers should not have to represent and warrant as to the absence of any threats of litigation which have not actually been communicated to them.

If the acquisition is to be accounted for as a pooling of interests, the buyer may seek representations and warranties that the seller (1) has not been a subsidiary or division of any other corporation within two years prior to the date of the contract; (2) has not, within two years prior to the agreement in principle, changed the equity interest of its voting common stock for the purpose of affecting the acquisition; or (3) reacquired any shares of its voting common stock for the purpose of affecting the transactions contemplated by the agreement.

Generally, there will be a provision that all representations and warranties of the sellers not only will be true as of the date of the agreement and at closing, but also will survive closing and any audit or investigation by the buyer. Of course, any such survival provision should be made applicable to representations and warranties of the buyer as well as those of the sellers.

Representations and Warranties of the Buyer

As indicated earlier, to the extent that the buyer is paying cash at closing for the business of the sellers, it is not necessary for the sellers to conduct an exhaustive analysis of the buyer's financial condition or to receive assurances in the form of representations and warranties as to the business of the buyer. In such a case, about the only representations and warranties which the sellers should seek would be as to the corporate status of the buyer and the due authorization of the agreement. To the extent, however, that the purchase price is some form of non-cash consideration, such as notes or stock, or if there is to be any substantial period of time between the

execution and consummation of the agreement, the sellers may want additional representations and warranties from the buyer. Paramount among these, of course, would be a representation and warranty as to the buyer's financial statements. The language of such a representation and warranty should parallel that given by the sellers with respect to their own financial statements. If the buyer is a large, publicly-traded corporation, however, it may take the position that it should represent and warrant only as to the "substantial" accuracy of its financial statements on the ground that while it is acquiring the business of the sellers on the dollar-for-dollar basis, the sellers are only interested in the substantial creditworthiness or financial condition of the buyer. The sellers in a non-cash deal should also be entitled to receive representations and warranties from the buyer as to the absence of material adverse changes and litigation. If the acquisition involves issuance of a publicly-traded buyer's stock, then the buyer should represent and warrant that the shares will be issued pursuant to an effective registration statement under the Act, that the registration statement and accompanying prospectus conform to the requirements of the Act and the rules and regulations of the SEC, that neither the registration statement nor the prospectus contains any untrue statement or omission of a material fact and that there have been no material adverse changes to the buyer since the date of the prospectus.

Terms of the Acquisition

The heart of the agreement lies here and it is frequently helpful to divide this section into two parts—(1) the obligations of the sellers and what they are expected to deliver at closing and (2) the obligations of the buyer and what it is expected to deliver at closing. If assets are being sold, a bill of sale and/or deed should be referred to as a separate instrument. If stock is being sold, the stock certificates should be delivered, with stock powers attached and endorsed by each stockholder in blank. Generally, the buyer will require that each stockholder's signature on the stock powers be guaranteed by a bank or trust company. If the purchase price is to be paid in cash, the agreement should specify whether cash, certified checks, bank cashier's checks or federal funds will be used. If notes are part of the purchase price, they should be drafted separately as exhibits and attached to the agreement. If the notes of the buyer are to be guaranteed by another person, separate guarantees should be drafted and referred to in the contract.

If the stock of the buyer is part of the purchase price, then the agreement should specify the number of shares to be delivered and provide that this figure will be appropriately adjusted to take into account any stock split, stock dividend, reverse stock split or other change in the buyer's stock occurring between the date of the agreement and closing, with the exception of the issuance of shares pursuant to existing stock option plans or other acquisitions for which the buyer receives full value. If the buyer's stock is listed on a stock exchange, the buyer should be required to list any shares delivered to the sellers and any shares underlying any warrants or

options. If stock options or warrants are part of the purchase price, the buyer should be required to maintain a sufficient number of shares of the underlying stock validly authorized and not otherwise committed so that if any option or warrant is exercised the buyer will be able to issue immediately the requisite number of shares.

As indicated earlier, the parties may wish to allocate the purchase price between the assets of the selling company and covenants not to compete. The buyer also may want to make an allocation between depreciable and nondepreciable assets.

If the buyer is acquiring the company's assets, there should be a separate section with respect to what liabilities, if any, the buyer is assuming.

Non-Competition Covenants

Naturally, the buyer will have the greatest interest in the most careful drafting of the non-competition covenants so as to make them legally valid and enforceable. The sellers' counsel should try to reduce the geographical area and the period of such covenants, even if applicable state law permits judicial reduction of such terms to reasonable limits. It is more desirable to limit the scope of the covenants at the time of the agreement than to argue at a later time over what is reasonable. The sellers' counsel should also resist the inclusion of any provision to the effect that the geographical area and length of time of the covenants will be reduced to the maximum permitted by the law applied to determine the validity of the covenants because the buyer should be permitted to provide only for what the law allows. Including such a provision only encourages a buyer to try to get away with as much as possible rather than trying to reach agreement on what is reasonable under the law.

The sellers' counsel may further want to suggest that the scope of non-competition covenants for minor stockholders should not be as broad as for larger stockholders.

Conditions to Closing—Buyer

The obligation of the sellers to close should be made subject to the occurrence or satisfaction by the buyer of certain conditions. First, all of the representations and warranties of the buyer must be true as of closing date and the buyer must have performed all agreements or conditions required by the agreement to be performed by it prior to closing. Second, the sellers should receive an opinion of buyer's counsel to the effect that the representations and warranties by the buyer as to its corporate status and due authorization of the acquisition are true and correct. In addition, in an acquisition involving notes or stock of the buyer, the buyer's counsel should give his opinion with respect to the absence of material litigation, the due execution (including the incumbency of the executing officers of the buyer) and delivery of the agreement and any notes, stock or warrants. If the sellers are receiving publicly-traded stock, the buyer's counsel should opine that

the registration statement and the prospectus comply with the Act and the rules and regulations of the SEC, that there has been no amendment to the registration statement or supplement to the prospectus, that there is no stop order in effect and that, to the best of counsel's knowledge, neither the registration statement nor the prospectus contains any material misstatements or omissions. Third, if the sellers are seeking a revenue ruling on the tax treatment of the acquisition, the receipt of a favorable ruling should be a condition to the sellers' obligation to close.

Conditions to Closing—Sellers

The buyer should insist that its obligation to close be conditioned upon the satisfaction by the sellers of certain conditions. First, all of the representations and warranties of the sellers must be true as of Closing Date and the sellers must have performed all agreements or conditions required by the agreement to be performed by them prior to Closing. Second, the sellers should deliver a good standing certificate dated shortly prior to Closing. Third, if the buyer is acquiring stock, the sellers should deliver their minute book, stock ledger, corporate seal and signed, undated letters of resignation by all directors and officers. Fourth, the buyer will sometimes insist upon a letter from each holder of an unpaid note or mortgage of the sellers' company which confirms the unpaid principal balance and the date to which interest has been paid. Fifth, the buyer may also require general releases by the selling stockholders of any claims against the corporation. Sixth, if the deal is an acquisition of assets or a merger, the buyer may require certified copies of resolutions of the board of directors and stockholders of the selling company and consents of landlords to the assignment to the buyer of leases to which the selling company is a party. Finally, the buyer will almost inevitably require an opinion of the sellers' counsel as to the corporate status of the company and the due authorization of the acquisition, the absence of any material litigation or breach of any other agreement and validity and enforceability of the agreement in accordance with its terms. The buyer also may require that the sellers' counsel opine as to the due authorization and issuance of the selling company's stock and the lack of required consent of any other person to the agreement.

Indemnification

In any indemnification provision, the buyer will be seeking compensation from the sellers for losses arising out of (1) misrepresentation or breaches of warranties, (2) undisclosed liabilities, (3) acts occurring prior to closing and (4) uncollectible accounts receivable. There are several things which the sellers' counsel can do to limit the impact of indemnification provisions. First, there should be some sort of "deductible" on the indemnification obligation, *i.e.*, the selling stockholders will not be liable until and only to the extent that losses exceed some minimum sum. This sum should

approximate an amount which, if deducted prior to Closing from the net worth of the seller, would still not deter the buyer from going through with the deal at the same price. Second, there should be a maximum limit on the indemnification liability of the sellers, certainly no more than the fair market value of the consideration which they are receiving. Third, the sellers should not be charged with any liability which is covered by insurance. Fourth, any income tax benefit received by the buyer should be deducted from the indemnification liability of the seller.

Fifth, there should be a time limit on the liability of the sellers. Sixth, the indemnification liability of any individual seller should not exceed the pro rate percentage of the purchase price received by him. Finally, the buyer should permit the indemnifying sellers to appoint counsel or otherwise participate in the defense of any claim which may give rise to an indemnifiable loss and should agree not to settle any such claim without the consent of the stockholders.

Miscellaneous Provisions

The contract should also provide for such items as confidentiality of information, absence of finders, payment of expenses, governing law and all of the other customary provisions.

CONCLUSION

The imaginative sellers' counsel will not restrict himself simply to the preparation of legal documents. He will assist his clients in determining whether to sell, in preparing material likely to be sought by a prospective buyer and in gathering and analyzing information about the buyer. He will participate in the negotiating process and will help to structure an acquisition with the greatest tax advantages to his clients. He will advise them as to the applicable securities considerations and will have at least a working knowledge of the relevant accounting issues. Only then will he finally arrive at the more traditional task of document drafting. The sellers' counsel is probably the one individual who is able to perform or at least assist in all of the foregoing roles; and in the best interests of his clients, he should not shrink from doing so.