That was a complicated one. Some questions are very simple. What would you do in this case? You represent T, which is negotiating to be acquired by P. T is the subject of certain messy litigation, involving allegations that (unfairly, in your view) cast the principals of T in a very unfavorable light. T's principals do not feel that they have done anything wrong, but they would prefer that P not dig too deeply into this litigation and lose heart for the deal as a consequence.

I'll tell you what I might do in this one, all other things being equal. I would suggest that T propose, right from the outset, that the transaction be structured as an *assets* deal, with *no* assumption of liabilities; i.e., where T agrees to remain responsible for all of its own liabilities, including litigation, and to retain (without distributing to stockholders) sufficient funds from the purchase price to accomplish this. Since P will not have to assume any T litigation liabilities, P's lawyer is much less likely to conduct as thorough an investigation of the lawsuit as he otherwise might feel compelled to do.[161]

161. On the other hand, P might just fool you and decide that he needs to run down the particulars of the lawsuit to get a better feel for the business he's acquiring, or because of some concern about possible transferee liability.

CHAPTER 5

An Overview of the Acquisition Agreement

Once the parties have reached an agreement in principle and decided on the basic structure of the deal, the next step is the preparation of the acquisition agreement.

5.1. A BRIEF ESSAY ON FORMS

As mentioned earlier,[1] it is the purchaser's prerogative to draft the acquisition agreement, and his attorney cannot afford to pass up the opportunity. Some journeymen lawyers seem to think that this consists simply of reviving a trusty form of agreement utilized in the past, inserting some new names, dates and basic terms, and

1. See Section 2.3.2.

shipping it out. For the careful practitioner, however, the process is not quite so mechanical.

5.1.1. A Form in Every File Cabinet

In the first place, the acquisition agreement differs considerably from a document such as a corporate bond indenture which has become highly stylized through constant repetition by a relatively small number of draftsmen, the necessity to comply with the provisions of a statute (in that case, the Trust Indenture Act of 1939), and the introduction of a recommended model indenture. In contrast, acquisition agreements are resolutely non-uniform, varying considerably with the whims and skills of the draftsman.

To be sure, most agreements utilized in the merger and acquisition field do manage to cover pretty much the same ground and contain relatively similar provisions. I'll go further; there are abundant instances of nearly identical words, phrases and clauses, suggesting that respectful plagiarism is indeed the order of the day.[2]

Nevertheless, no two law firms seem to use the same form of acquisition agreement. As a matter of fact, quite often within firms (including my own) more than one form of agreement is utilized, as individual partners express their own preferences. To carry the matter one step further, many lawyers (including myself) do not use the same form all the time, even for similar transactions; there is a tendency to develop customized forms to suit the particular needs or desires of individual clients. And finally, a single client will sometimes wish to employ more than one form of agreement, depending on the size and nature of the particular transaction.

Having stressed all this diversity, I will now proceed to shift ground and recommend to counsel for any company likely to undertake several acquisitions that a basic form of acquisition agreement be developed. It saves time for the associates in a law

2. I freely confess, in small point, to having lifted from the drafts of my friends and adversaries a number of valuable nuggets for future utilization.

firm who are charged with preparing initial drafts of agreements; marking up an old document is obviously a more expeditious process than creating a new one. It's easier on the partner who has to review the associate's draft, since he can place at least partial reliance on the form's successful prior utilization. And the client, without serious pangs of guilt, is liberated from poring over boilerplate which tracks the previous deal.

More significantly, the use of a basic form ensures that any particular needs of the client which have been reflected in past agreements will not be overlooked. For example, the acquiring company may operate in an industry where patent protection is quite important and where, as a result, the businessmen and lawyers have developed provisions for insertion in seller's patent representations that go substantially beyond the usual skeletal verbiage. Both the client and the lawyer should enjoy a measure of confidence that this language will once again find its way into the draft.

5.1.2. The Cardinal Sins of Form Abuse

But the converse proposition is equally important. Nothing is less professional than a first draft of agreement that cries out: "I am a mark-up of the last acquisition, conceived in ignorance and dedicated to the proposition that my draftsman simply refused to think through the differences in the two deals." The client is embarrassed, the lawyer chagrined.

You must recognize that each transaction has its own individualized thumbprint. Last year's agreement might serve as a useful starting point, but you ought to progress from there on the basis of the particular facts before you. For instance, if the last company acquired owned no real estate, obviously no representations in that area would have been required; on the other hand, if the new acquisition involves substantial real property, you cannot neglect to devise a thoroughgoing realty representation to protect your client. Similarly, complex warranties dealing with the ceding of reinsurance, which were utilized in connection with the purchase of an insurance company, are clearly out of place in the subsequent acquisition of a manufacturing operation and must be deleted. In utilizing a form, the attorney should constantly question the applicability of particular language to the present transaction, and consider the advisability of inserting additional provisions to meet current needs.

I want to call special attention to one cardinal sin that I find young (and often mature) lawyers commit time and again. The ABC deal comes in to the office. The partner evaluates it, calls in an associate, gives him the facts, and tells him to prepare a draft "modeled on the XYZ acquisition that we did in January." The associate goes to the shelf, pulls down the thick black binder on the XYZ deal, makes a photocopy of the agreement and proceeds to mark it up for the ABC deal. Fatal, fatal error. Do you know why?

The reason is that the XYZ agreement which found its way into that binder was the final, executed, *negotiated* agreement. Using it as the model for a first draft bequeaths to the ABC lawyer, gratis, the work product of the XYZ lawyer. All of the provisions that you struggled so hard to resist and finally compromised—the additional purchaser's representations, the "materiality" limitations, the "knowledge" caveats—are fixed firmly in place. What the associate should have done, of course, was to go back to the *first draft* of the XYZ deal in the files, and mark that up. But believe me, this happens over and over, and you don't always catch it before the draft agreement is delivered to the other side.

5.1.3. Riding the Coattails

In this same vein, if you represent a company that has been making a number of similar acquisitions, you should try to guard against each new seller obtaining copies of the final agreements with previous sellers. Presumably each seller has extracted certain concessions from you in the course of negotiations, which you would prefer not to surrender in the first instance. If the current seller is in possession of the other contracts, he will know what you have been willing to concede in the past; and since each agreement probably contains a number of different seller's points,

he will undoubtedly try to shoot for the best of all possible worlds. When he requests certain language to be inserted and you resist, he will pounce on the fact that you gave a similar clause to XYZ, which is a difficult gambit to counter.

I always keep a copy of the *least* negotiated prior deal handy, so that if the seller or his lawyer ask for one of the purchaser's agreements, I can hand that one over. But since acquisition agreements are often filed with the SEC or the stock exchanges as public documents, this problem is not always avoidable.[3] In that case, I suggest you use either of the following tactics.

You can say, if it is true, that the circumstances in the XYZ deal were different, which was what led to the particular concession. So, for example, if XYZ escaped with no substantial representations regarding leases, this may have been because XYZ had no material leases—whereas ABC does have them, and you need the additional protection. If this tack is not available, however, and you don't want to give in without a fight, then you should point out to ABC that each deal has to stand on its own two feet; that there were other aspects of that old XYZ acquisition, *more* favorable to your client, which are not present in the ABC deal. A little half-facetious bluff such as, "We'd be happy to give you the indemnity proviso that XYZ had, but in return we want you to agree to a purchase price based on six times earnings (as the XYZ deal was) instead of the seven multiple we're offering you . . ." neatly illustrates the point for ABC, and sometimes closes off debate on the subject.

On occasion, it's possible for the purchaser to turn the public record aspect of his acquisition agreements to his advantage. This is the old "Waiter-there's-a-fly-in-my-soup"—"Shut-up-or-everyone-will-want-one" routine. When the seller asks for a certain concession, the purchaser is sympathetic but uncooperative, on the ground that once the agreement containing this provision be-

3. This point actually deserves to be reversed and stated in the affirmative: if you represent a seller being acquired by a publicly-owned purchaser who has made prior acquisitions, by all means take a trip to the SEC or the stock exchange to examine previously negotiated agreements and collect appropriate bargaining ammunition.

comes public he will be forced to yield the same point to all prospective acquirees (and perhaps retroactively to some prior sellers).

Incidentally, watch out for this one, which sounds apocryphal but actually happened to one of my partners. He was representing the purchaser in the acquisition of a company blessed with apparently unsophisticated counsel. My partner delivered his usual tough first draft of acquisition agreement. The seller's comments took a long time coming back. When they did, they were very detailed and surprisingly professional. My partner later found out what had happened. In the interim, the seller's lawyer had been asked to represent another company which was making an acquisition; he apparently copied our purchaser's form of agreement and sent it to the seller in that other transaction; *that* seller was represented by an experienced merger lawyer, who came up with the detailed comments; and *those* comments were used as the basis for what my partner received. Some unsophisticate!

5.1.4. Cheaper by the Pound

Most acquisition lawyers, at one time or another, have heard the following admonition from their purchaser clients: "Please—please—don't give this guy a fifty page contract. It will scare him to death and we'll lose the deal. I *know* his business is clean; all I want are the minimal protections." Forgive me for sounding cynical, but I guarantee that if you take your client's advice, three months after the deal is completed everything will turn sour, and your client will undoubtedly have forgotten ever making such a statement (or, if he manages to remember it, will remark icily: "Sure I said that, but it was *your* job as my attorney to protect me against myself.")

By the way, I happen to agree with that last remark of your client. You should never deceive yourself that you are off the hook in that kind of situation, or that the client is somehow assuming the risk. There is more than one way to skin a cat, and methods do exist to cut down on the document's girth without abandoning any essential protection.

Let's face it, the outside world tends to regard lawyers as verbose creatures, many of whom are constitutionally incapable of making a point with one word where three will suffice. Some clients claim this is because we charge by the pound. The plain fact is, however, that it is much easier to run on for several pages than to endure the discipline of condensing the same material into a single paragraph. I am no apologist for brevity when it interferes with substance, and the acquisition area is certainly replete with delicate nuances; but to the extent that a matter can be adequately handled in fewer words, it usually works to everyone's benefit.

Suppose your client is acquiring a public company. He and you are reasonably confident about its business, the character of its management, and the thoroughness and integrity of its lawyers and accountants. You intend to conduct a vigorous business and legal investigation prior to the closing. In such a case, it is sometimes sufficient to limit the substantive representations you seek from the seller to the fair representation of its financial statements and the completeness and accuracy of the material about the company set forth in its proxy statement covering the acquisition.[4] Since the representations generally do not survive the closing for indemnification purposes where a public company is being acquired,[5] and because it will usually require a material misrepresentation for the purchaser to be able to walk away from the deal,[6] your client is reasonably protected;[7] and the bulkiness of the acquisition agreement will be considerably slimmed.

But to be realistic, the purchaser is unlikely to make his "keep it short" speech about *that* kind of acquisition candidate. So what do you do? A gimmick that I have occasionally used to confront this problem involves omitting from the agreement proper the

4. This abbreviated procedure is discussed in Section 7.2.3. Material on proxy statements is contained in Section 12.2.
5. See Section 5.3.1.—*Indemnification*.
6. See Sections 2.3.6., 5.3.1.—*Conditions* and 7.3.1. But see also the discussion in Section 7.2.3. about the need to have virtually absolute walkaway rights where no comprehensive disclosure document has been made available prior to signing.
7. To say nothing of the protection afforded your client by Rules 10b-5 and 14a-9 under the Exchange Act.

mass of business representations relating to real estate, leases, contracts and the like,[8] and simply stating in the draft that these are being handled by a disclosure schedule, which document the seller represents is true and complete and does not omit any necessary fact. This can shave about fifteen pages worth off the agreement. Then, *next week*, you send the seller your proposed form of disclosure schedule, which incorporates in the preambles to each category the specific representations generally contained in the agreement; e.g., "This list sets forth the basic terms of all the leases to which the company is a party, each of which is in full force and effect, none of which is in default," etc. The legal effect is exactly the same, but somehow it doesn't seem to offend sellers as badly as when the detailed language is contained in the acquisition agreement itself.

If you are confident that the seller will not try anything questionable between the signing and the closing, and you have good "walkaway" conditions, most of the covenants pending closing[9] (which often run on for a number of pages) can be eliminated, and the seller simply restricted from engaging in any business out of the ordinary course or inconsistent with past practice—without seriously endangering your client's interests. Documents to be exchanged at the closing can be omitted in favor of a proposed closing memorandum. The language of the lawyers' opinions can either be keyed in to specific representations or reference made to an exhibit to be subsequently furnished, in either case with considerable saving of agreement pages. I could go on in this vein, but by now you must have the general idea.

One more thought on brevity. Although lawyers delight in anticipating potential problems, you can and usually should resist dealing with far-out hypothetical situations. I have been furnished agreements in which there were entire sections setting forth in detail the responsibilities of the parties in the event that the Securities Act of 1933 were to be repealed! You do have to keep abreast of developments, but a sense of moderation should prevail.

8. Specific representations of the seller are covered in Section 7.4.
9. Discussed in Sections 5.3.1.–*Covenants* and 8.2.3.

5.2. THE ANATOMY OF THE AGREEMENT

5.2.1. A Skeletal Outline

Although acquisition agreements differ in details, most examples of the genre share a basic structure. It might be useful at this point to outline the various articles of the typical agreement (which do not necessarily appear in this order):

1. The operative terms of the transaction.[10]. This includes identification of the assets or stock to be transferred, the consideration to be paid, and the mechanics of the transaction.[11]
2. Other terms or transactions, if any, relating or ancillary to the principal transaction. For example, if the purchase price is to be earned out,[12] the procedural details can be handled here. This would also be the place for provisions regarding the financing of the transaction, for a reference to employment contracts,[13] for non-competition covenants[14] and the like.
3. If the purchase price is payable in stock or other securities of the purchaser, this article would contain (i) for a closely-held seller, investment representations and any registration rights with respect to the shares, or (ii) for a public

10. I always like to have these key provisions contained in the first article of the agreement, so that the reader can come right to the heart of the matter without having to wade through voluminous boilerplate. Many lawyers begin their acquisition agreements with pages and pages of representations, covenants and conditions, with the basic terms hidden back at page 46. The legal effect is exactly the same, but for some reason the all-provisions-are-equal viewpoint implicit in that indirect approach offends my sensibilities.
11. If the transaction involves a statutory merger, the mechanics may be contained in an attached Agreement of Merger or similar document required under state law, which would be incorporated by reference into the acquisition agreement. See Sections 4.5.2. and 11.1.3.
12. See Section 6.3.
13. See Section 11.2.
14. See Section 11.2.7.

seller, matters relating to registration of the securities being issued.[15]

4. The representations and warranties of the seller.[16]
5. The representations and warranties of the purchaser.
6. The covenants of the seller (and in some cases, the purchaser) pending the closing, i.e., those items that the seller either agrees to do or refrain from doing in the period between the signing of the agreement and consummation of the transaction.[17]
7. Conditions precedent to the purchaser's obligation to close.[18]
8. Conditions precedent to the seller's obligation to close.
9. Closing and termination provisions.[19]
10. Where appropriate, provisions regarding indemnification by the seller of the purchaser (and perhaps vice versa).[20]
11. Miscellaneous matters, such as finders' fees, expenses, and some boilerplate of the trade.[21]

5.2.2. Simultaneous vs. Deferred Closings

One of the first decisions to make in drafting an acquisition agreement, assuming it has not been resolved in the preliminary negotiations, is whether to have a simultaneous agreement and closing (i.e., where title to the stock or assets is transferred and the purchase price paid at the same time that the agreement is signed) or a deferred closing (i.e., where the agreement is signed first, with the closing of the transaction to take place at some point in the future).

The preponderance of significant acquisition transactions employ the deferred closing method. In some cases, there is no real

15. See Sections 4.7.2. and 4.7.3. and Chapter 9.
16. Representations and warranties are discussed in Section 5.3.1.–*Representations* and Chapter 7.
17. See Sections 5.3.1.–*Covenants*, 8.1. and 8.2.
18. Conditions are discussed in Sections 5.3.1.–*Conditions*, 8.1. and 8.3.
19. See Section 8.5.
20. See Section 5.3.1.–*Indemnification* and Chapter 10.
21. See Sections 11.1.1. and 11.1.2.

choice in the matter, since this is the only conceivable way that the deal can be accomplished. Take, for instance, the merger of a publicly-held seller. The typical procedure under applicable state law calls for the directors to approve an agreement of merger, which is then executed by the parties and submitted to stockholders for their approval. The SEC requires a detailed proxy statement to be furnished to stockholders before they can be allowed to vote.[22] Since the merger cannot be consummated until stockholders' approval is received, and inasmuch as the companies have to sign the agreement prior to mailing the proxy statement, there must of necessity be a deferred closing.

In other instances, a deferred closing is a practical necessity. This is true, for example, where receipt of a tax ruling[23] is a prerequisite to consummation of the transaction. Rulings normally take as much as three or four months to obtain, and the parties do not like to sit for that length of time without an agreement; besides, the IRS will want to see the signed agreement prior to issuing its ruling, in order to be able to pass on the exact terms of the deal. So the parties enter into an agreement calling for a deferred closing, with the receipt of the tax ruling as one of the conditions of closing. Even where no outside approvals are required, the purchaser often has a strong desire to tie the seller up contractually as soon as possible, particularly where there is a competing bidder for the seller's business—without the delay attendant upon whipping into shape a host of closing documents, and without risking the deal-breaking tensions and emotions of a closing at a time when no one is legally bound.

From time to time, however, you will find yourself involved in a transaction which can be consummated contemporaneously with the signing of the agreement; and if this is possible, it may well be preferable. The simultaneity obviates the need for a good many of the provisions in the typical acquisition agreement. Covenants pending the closing and conditions of the closing can both be

22. This requirement applies to companies registered under the Exchange Act. Proxy statements are discussed in Section 12.2.
23. See Section 4.3.4.

eliminated, since the closing is then taking place. No elaborate delineation of the prospective language of legal opinions, comfort letters and so on is necessary, since these are already in hand. Only those representations which are intended to survive the closing need be included. Painstaking formulae to arrive at the number of purchaser's shares to be issued[24] can be dispensed with, and the actual number simply plugged in. This in turn does away with a substantial amount of negotiation, particularly the frustrating and often abrasive bargaining associated with attempts to provide for the possible occurrence of unlikely events.

Three caveats, however. First: generally speaking, because of the complex paperwork that is usually involved in an assets transaction, a simultaneous agreement and closing works best when stock is being transferred. Second: since the simultaneous procedure will often take longer to complete than merely signing an agreement for a deferred closing, there should probably be a signed letter of intent[25] representing an interim moral obligation. Third: unfortunately, simultaneous closings can present some tantalizing disclosure problems under the Federal securities laws.[26]

While we're discussing the timing of the transaction, I should mention that it is good practice in every acquisition for the purchaser's attorney to prepare at the outset a timetable setting forth the actions that must take place, a proposed schedule of dates for accomplishing each matter, and an indication of the persons responsible for particular events.[27] This usually has a beneficial focusing effect on all concerned. I must caution, however, that for some lawyers the schedule (painstakingly fashioned in incredibly precise terms) begins to take on a life of its own, injecting undesirable overtones of rigidity and pressure into the proceedings. At best, the timetable can only serve as a rough guideline that should be adapted with considerable flexibility to changing conditions.

24. See Section 6.2.
25. See Section 3.3.
26. See Section 3.4.
27. See, *e.g.*, Bangser, "Specimen Work Schedule and Timetable; Balance Sheet," in ACQUISITIONS 1973, at 65-72 (J. Herz, ed., P.L.I. 1973).

5.2.3. The Simultaneous/Deferred Decision in the Negotiating Process

This decision as to whether to have a simultaneous or deferred closing can enter into the negotiating process in a number of ways. We have already seen[28] how it can be utilized to mask the purchaser's concern over the rising price of his stock. In a similar vein, the seller's decision on this subject may be influenced by an appraisal of his likely earnings for the current period and his prognosis as to what the buyer will require in the way of a representation regarding these earnings. Where the purchaser is a potential competitor of the seller, the latter may be reluctant to allow the purchaser to investigate the seller's affairs unless there exists a signed agreement obligating the purchaser to acquire the business if he finds nothing amiss. The desire of the seller to be negotiating with more than one potential buyer at the same time—and the purchaser's natural inclination that the seller not be permitted to do this—can also be reflected in this decision.

To illustrate this further, let's look at two examples, one from the seller's viewpoint and the other from the purchaser's. Assume that the seller is engaged in a line of business whose future prospects are threatened by a pending development outside the seller's control; e.g., an upward revision in tariff rates that will make a certain imported product too expensive for the seller to use, thereby forcing him to find an alternate domestic source of supply and cutting deeply into his profit margins. The seller is aware that this subject is scheduled to come up in Congress within the next month, but he doesn't know how it is going to be resolved. The seller fully intends to disclose this information to the purchaser, but the question is one of timing.

The seller knows that if he signs an agreement now for a deferred closing, he will be asked to represent formally that he knows of nothing which could mar the immediate prospects of his business;[29] at that point, he would feel honor bound to disclose

28. Section 2.4.2.
29. See Section 7.4.8.

the pending tariff revision. The effect of this might be to cause a timorous buyer to rethink the entire deal and, if he has substantial other reservations, to decide to back out. Then, even if it turned out ultimately that the tariff was not modified, the seller would have lost his purchaser.

If, on the other hand, the parties do not enter into an agreement but simply work toward a simultaneous agreement and closing, the seller might feel justified in not disclosing this possible adverse event until it has either ripened or the parties are ready to close.[30] If the rate changes, or it remains threatened at the closing, he will disclose it and take his chances with the purchaser—but remember, the purchaser would presumably have retained the right to walk away on this basis even if an agreement had been signed. If, however, Congress fails to act and the old tariff rate is retained, the seller will not have to make any adverse disclosure to the purchaser, and he will presumably have his deal.

Second example. The purchaser knows that he will probably declare a 3% stock dividend in the next month. If he signs an agreement now to acquire the seller in 60 days for a specific number of shares of purchaser's stock, he anticipates that seller's lawyer will require the agreement to provide an anti-dilution adjustment to give effect to just such a stock dividend prior to the closing,[31] with the result that the seller will end up with 3% more shares than anticipated. Because of this, and all other things being equal, the buyer might prefer not to enter into an agreement at this point, but simply work toward a simultaneous closing. Along the way, he would pay his stock dividend. If the price of his stock were not affected (which is often the case with that sort of dividend), he may well be able to maintain constant the number of shares that he previously agreed in principle to issue.

30. Some sellers, to be sure, would be uncomfortable in this situation and might prefer to discuss the situation immediately with the buyer—particularly in view of the fact that, although no one is bound until the closing, the buyer is spending time and money on the deal prior to that time.

31. See Section 6.2.3.

5.3. THE INTRICATE INTERACTION OF THE VARIOUS ARTICLES

A properly drafted acquisition agreement is a rather delicate mechanism. There is a structure and symmetry among its principal articles that must be understood and constantly reviewed in order to conclude successful negotiations. The critical sections for purposes of this analysis are those involving representations, covenants, conditions, and indemnification. These contractual four horsemen function together as a unit, serving different but complementary purposes. As issues arise in negotiating the transaction, one of the first steps in problem-solving is to identify all of the specific areas affected. A change in a particular representation might impinge upon a certain condition or covenant, or neutralize indemnification, thus requiring further tinkering to avoid unintended results. The intelligent negotiator should always be aware of the tricky interworkings of these sections.

5.3.1. The Four Horsemen: A Statement of Purpose

Let's begin by reviewing briefly the varying purposes that these four articles of the acquisition agreement serve.

REPRESENTATIONS.[32] The representations (or, as they are usually referred to, the representations and warranties[33]) are a way of the seller (or buyer) saying: "Here is what my business is all about, at this particular moment in time." In the vernacular of financial statements, representations constitute essentially a static, balance sheet approach, as contrasted with the motion implicit in a statement of income showing results of operations; the photographic analogy would be to a snapshot, as distinguished from a movie.

32. Representations are discussed in detail in Chapter 7.

33. Some commentators (*e.g.*, BUSINESS ACQUISITIONS, at 147) have pointed out a distinction between representations and warranties, in that representations are limited to statements as to existing circumstance, while warranties may also cover future situations. Unless specifically distinguished in the text, however, I intend to use the two terms interchangeably.

Many of the representations require references to other documents: "Here is a list of all our subsidiaries; here is a schedule of each patent we own."[34] A number of them are keyed to the most recent financial statements of the company. Since typically the representations are intended to reflect the situation that exists on the day that the agreement is signed (i.e., *Today*, we have no pending litigation), a bring-down provision is often required.

For example, it is inaccurate for a seller to represent on February 1 that he *then* has no liabilities except for those set forth in his December 31 balance sheet, since he has presumably incurred additional liabilities in the intervening month. So a phrase such as "and except for those incurred since December 31 in the ordinary course of business and consistent with past practice" is usually added to the warranty. From the purchaser's point of view, this is preferable to a representation by the seller on February 1 that *as of December 31* he had no liabilities other than those set forth in the December 31 balance sheet, since this would create a gap period (January 1 to February 1) regarding which the purchaser would be completely unprotected.[35]

Occasionally, there is a "here is how it *will be* at the closing" type of warranty.[36] For example, if the seller's loan agreement requires the bank's consent to the acquisition, (which has not been obtained at the time the agreement is signed, the seller could hardly represent that, *as of the agreement date,* consummation of the transaction will not violate any of the seller's contracts. The purchaser, on the other hand, may be unwilling to sign an agreement binding himself to the transaction if the bank approval is treated merely as a condition to the parties' obligations to close; in the purchaser's cynical view, (i.e., malleable bank colluding with disillusioned seller to withhold approval for the deal) this

34. The use of a separate disclosure schedule, incorporated by reference into the various representations, is discussed in Section 7.2.1.
35. The concepts of disclosing all liabilities and bringing down representations are discussed in Sections 7.4.3. and 7.4.2., respectively.
36. This is to be contrasted with the typical *condition* (discussed below in this Section) bringing down all the representations and warranties to the closing, solely for purposes of giving the parties an out.

effectively transforms the seller's obligation into an option. Assuming that the bank approval cannot be received in advance of signing the agreement, one solution is for the seller to warrant that, *as of the closing* (when the bank's consent will presumably be in hand), consummation of the transaction will not violate any of the seller's agreements. This obligates the seller contractually to secure the consent; but assuming preliminary contacts with the bank have bolstered his confidence that it will be forthcoming, he many feel justified in undertaking the business risk in order to get the acquisition agreement signed.[37]

COVENANTS.[38] In contrast to a representation, a covenant is a promise or agreement on the part of a party which relates to a period of time (the movie rather than the snapshot). Covenants are a way of saying: "Here is what we commit ourselves to do, and here is what we promise not to do, during the period between the date the agreement is signed and the closing." They relate to the future,[39] whereas the usual representation relates to the present or the past.

The typical agreement contains a good illustration of this distinction. Inasmuch as the date of the seller's last balance sheet is almost always prior to the date of the agreement, there is gen-

37. On this topic, see Sections 7.4.7. and 12.3.1.
38. Covenants are discussed in detail in Sections 8.1. and 8.2.
39. The normal covenants article deals with matters *pending* the closing, and accordingly cuts off at that time. This makes sense in the typical merger or stock transfer, where the seller is either disappearing in the transaction or its control is being transferred to the purchaser. There may, of course, be certain covenants in other parts of the acquisition agreement that extend beyond the closing, such as the agreement on the purchaser's part to register the stock it is issuing to the seller (see Chapter 9). In an assets transfer, where the selling corporation remains in existence after the closing, it is typical for the purchaser to obtain a generalized covenant of further assurances, covering any necessary actions on the part of the seller that may be required to bring the transferred assets more fully into the control and possession of the purchaser after the closing—and there may also be specific post-closing obligations covering such items as the use or revision of the corporate name. The agreement may also contain covenants binding the stockholders of the seller after the closing, particularly provisions regulating competition with the purchaser (see Section 11.2.7.).

erally a *representation* to the effect that, from the date of the balance sheet to the date of the agreement, the seller has not taken certain specific actions (such as paying a dividend or making any significant capital expenditures).[40] Virtually the same items also appear in the *covenants* article of the agreement, where they constitute the seller's promise that he will not pay a dividend, make a significant capital expenditure or take other specified actions between the date of the agreement and the closing.

Most prohibitive covenants are phrased in terms of actions that cannot be taken "without the consent of the other party," so that as a practical matter the seller may be able to justify a particular action (e.g., the making of a proscribed capital expenditure) prior to closing and obtain the necessary permission from the purchaser. For purposes of this analysis, however, the covenants are treated as absolute obligations, which is the way you should view them when negotiating their content.

The agreement usually contains both negative and affirmative covenants. The negative ones, such as the prohibition against paying dividends, restrict action. Of course, if a party can determine in advance of signing the agreement that he will be taking a certain action prior to closing which would otherwise violate a particular covenant, he should disclose this to the other side and negotiate a specific exception to the covenant so as to permit such action. The affirmative ones, requiring performance on the part of the seller, include such matters as the obligation to submit the transaction to a vote of stockholders, to prepare and mail proxy material, to apply for a tax ruling, to permit the other party to investigate, and the like. Some of these, involving matters not wholly within the party's control, are phrased in terms of his using his "best efforts" to achieve the desired result, without mandating its eventual accomplishment.[41]

The main brunt of the covenants usually falls upon the seller. There may, of course, be affirmative covenants on the part of the purchaser, such as cooperating in obtaining a tax ruling, permitting the seller access to information about the purchaser's business, listing any stock to be issued, and the like. But where a large public corporation is acquiring a small private one, the purchaser is unlikely to consent to being restricted by any negative covenants pending the closing. For instance, the purchaser would probably be unwilling to agree to refrain from making any other acquisitions during this period without the consents of the seller, on the grounds that a public company cannot afford to tie its hands if opportunities present themselves. On the other hand, where the companies are more closely related in size and bargaining position, the seller might insist on certain reciprocal negative covenants from the purchaser.

40. See Section 7.4.2.
41. The elusive concept of "best efforts" is treated in Section 8.2.1.

CONDITIONS.[42] The conditions article is a way of saying: "Here is what you are entitled to get from me (or from others) at or prior to the closing. If you don't get it, you can walk away from the deal without any recourse on my part." These are conditions precedent, as contrasted with conditions subsequent. A typical condition to the obligation of the purchaser to close is the receipt of a "comfort letter" from the seller's independent accountants.[43] A typical condition to the obligation of the seller to close is the receipt of a favorable tax ruling from the Internal Revenue Service.[44] By specifying in the agreement what events constitute conditions precedent to a party's obligation, lawyers avoid a jurisprudential miasma of contract law.[45]

For purposes of this analysis, the principal conditions with which we are concerned are: (i) the ubiquitous one stating that all representations and warranties made by the other side will be true at the closing as if they had been made at that date, that all covenants of the other side will have been performed by the closing, and that the other side will furnish an officers' certificate

42. Conditions are discussed in detail in Sections 8.1. and 8.3.
43. See Section 8.3.3.
44. See Section 4.3.4.
45. I am referring to the distinction between conditional and independent performance, treated in *Restatement of Contracts*, §§ 266-290; see also *Restatement (Second) of Contracts*, §§ 250-255 (Tent. Draft No. 7, 1972).

to those effects at the closing; and (ii) the receipt of legal opinions on a variety of matters, usually covered also by specific representations, but where the lawyers' particular brand of comfort appears desirable.[46]

It is not merely coincidental or redundant that these two conditions overlap to some degree. Thus, if the seller's lawyer is unable to opine that the selling corporation is in good standing under the laws of its state of incorporation, the purchaser can validly decline to consummate the transaction. This right to walk away might also be justified through the device of the condition updating to the closing the seller's good standing representation. In the absence of the requisite formal legal opinion, however, it is at least possible that the seller and his counsel might have failed to focus on the good standing infirmity, and the closing would have proceeded in ignorance.[47]

Let's take this example a step further. If the seller's good standing representation had been untrue at the time it was initially made (i.e., when the agreement was signed), the purchaser might also have an action against the seller for damages.[48] The purchaser's argument would be that if he had known of the lack of good standing at the date of the agreement, he would not have proceeded with the deal and thus would not have incurred various expenses (such as for proxy solicitation) or experienced other adverse changes of position between the time of the agreement and the closing. On the other hand, if the seller's good standing representation was true when made, but an event outside the seller's control had occurred in the period between the signing and the closing to make it untrue, the purchaser would presumably *not* have a good cause of action against the seller for damages. This is because the reiteration of seller's representation at the closing (as well as any legal opinion then delivered) is *only* for purposes of the condition which gives the purchaser an out; it is not intended to impose liability on the seller for events occurring

46. Legal opinions are discussed in detail in Section 8.4.
47. The purposes of receiving a legal opinion are further explored in Section 8.4.2.
48. This subject is further discussed in Section 10.1.1.

after he has warranted his "balance sheet," snapshot view of the business.[49] But if the event causing the representation to be untrue at the closing resulted from some action or inaction by the seller which violated one of his covenants pending closing (e.g., if he failed to pay franchise taxes when due, which he had promised to do faithfully and in a timely manner), then the purchaser would not only have an additional out (on the grounds that the seller had not performed all his covenants), but would also have a damage claim because of the breach of an express agreement.

Even in the absence of an explicit conditions article in the agreement, a party might have the right to withhold performance if the other party breached one of his representations or covenants. This would require, however, a legal determination as to whether the breach was material[50] or was a condition precedent to the closing obligation. The conditions article is intended to resolve in advance these areas of potential dispute. Note, however, that as discussed elsewhere,[51] the parties themselves may choose to introduce an express materiality standard into various conditions sections.

INDEMNIFICATION.[52] The fourth section to bear in mind is indemnification, which says, in effect: "Here is what we will pay you if it turns out we have breached one of our representations." As contrasted with covenants (which cover the pre-closing period) and conditions (which apply at the closing), indemnification provisions come into play *after* the closing. For example, the seller represents that he has good title to all his assets, subject to no encumbrances. The transaction closes on that assumption. Two weeks later, the purchaser discovers the existence of a lien on one parcel of seller's land in the amount of $100,000. The purchaser is entitled to indemnification from the seller for the $100,000 that

49. However, as noted in Section 5.3.2., the seller could have problems if he failed to advise the purchaser promptly after discovery of the good standing infirmity.
50. See *Restatement of Contracts*, §§ 275 *et seq.*; see also *Restatement (Second) of Contracts*, § 266 (Tent. Draft No. 8, 1973).
51. See Sections 2.3.6., 5.3.3. and 7.3.1.
52. Indemnification is discussed in detail in Chapter 10.

he will have to pay to remove the lien and restore unencumbered title, plus any expenses which he incurs in accomplishing this.

Even without a specific indemnification section, the purchaser would presumably be entitled to collect from the seller for a breach of representation which damages the purchaser. There are, however, a number of purposes served by the indemnification section, including the following: (i) to eliminate any ambiguity as to whether the representations are intended to survive the closing; (ii) to make it clear that *all* misrepresentations are indemnifiable, thereby rebutting in advance any argument by the seller that a particular breach was unintentional or not sufficiently significant to require the purchaser being made whole; (iii) to provide that the expenses (such as attorneys' fees) incurred by the buyer in connection with the misrepresented item fall into the protected area; (iv) to frame particular remedies, and perhaps liquidate or provide a formula for damages; (v) to set forth specific terms and procedures for indemnification to avoid future argument (e.g., who is responsible for defending a third party lawsuit); (vi) to include breaches of covenants and other agreements as indemnifiable claims; and (vii) to pick up matters that do not constitute misrepresentations but as to which the buyer has nevertheless insisted on protection (e.g., seller's income taxes attributable to the period through the closing date, or a *disclosed* lawsuit that the parties agree will be the seller's responsibility).

Generally speaking, there is no indemnification section in acquisition agreements between two public companies, inasmuch as the agreement usually states that the respective representations and warranties terminate upon the closing. This is a critical distinction between acquisitions of public and private companies. In acquiring a private company, if your pre-closing investigation is not sufficiently thorough but your contract is tough enough, you can still be made whole down the road through the indemnification provisions. But in acquiring a public company, your investigative prowess must be exhibited *prior* to the closing, so that you are in a position to use the reiteration of the representations as the basis for an out; if you do not catch the misrepresentation before you close, you may well lack recourse.

The rationale behind the distinction is that where public stockholders of the acquired company are concerned, the transaction must be complete at the closing. The public stockholders will generally not be amenable to a holdback of part of the consideration they have coming to them in order to enforce indemnification;[53] and once the full purchase price has reached their hands, the purchaser will not be able to chase them down to enforce his claim. In certain deals, however, where the acquired public company has one or more dominant stockholders, the buyer may be able to obtain an indemnification agreement from them.[54] And of course, if there were fraud in the transaction, or other conduct on the part of the seller that would constitute a violation of Rule 10b-5 under the Exchange Act or the SEC proxy rules,[55] the purchaser would have some recourse after the closing. There might also be personal liability on the part of officers, directors, accountants, or even (perish the thought!) attorneys involved in the transaction.[56]

5.3.2. The Case of the Late-Blooming Lawsuit

With that as background, let's now analyze some hypothetical negotiating situations in terms of the interaction among the various provisions discussed. Assume that the agreement to sell a privately-held business is signed on January 1, with the closing set for March 1. The agreement contains a representation that no sig-

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53. Occasionally, the terms of a transaction involving a public seller will call for a deferred distribution of part of the purchase price, against which claims can be made—but this is relatively rare, usually limited to troubled companies.
54. See Section 10.2.6.
55. Section 14 of the Exchange Act, and the Rules promulgated pursuant to that Section.
56. In this regard, see EXPANDING RESPONSIBILITIES UNDER THE SECURITIES ACTS (J. Flom & L. Loss chairmen, 1972); Jacobs, "Role of Securities Exchange Act Rule 10b-5 in the Regulation of Corporate Management," 59 *Cornell L. Rev.* 27 (1973); Lowenfels, "Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priority of Duties," 74 *Colum. L. Rev.* 412 (1974); and Sonde, "Responsibility of Professionals Under Federal Securities Laws—Some Observations," 68 *Nw. U.L. Rev.* 1 (1973).

nificant litigation exists affecting the seller,[57] which is in fact true as of the signing date, January 1. Then on February 1, well prior to the closing, a substantial lawsuit is commenced against the seller by a third party, seeking damages of $1,000,000.

The acquisition agreement should (but often does not) contain a covenant obligating the seller to update his disclosure schedule promptly if new events occur prior to the closing that would have mandated disclosure at the time of signing had they then existed. Even in the absence of such a covenant, contractual mechanics exist to necessitate disclosure of the late-blooming lawsuit, in the form of (i) the certificate that the principal officers of the seller will be required to furnish the purchaser at the closing, to the effect that all representations are true at that time, and (ii) the closing opinion of the seller's attorney, which usually touches on litigation.[58] Nevertheless, there are at least two advantages to the purchaser in insisting upon the covenant to supplement.

In the first place, if (notwithstanding the existence of such a covenant in the agreement) the purchaser is never notified about the lawsuit and closes, the resulting violation will clearly give rise to indemnification rights for the purchaser, since the typical indemnification provision covers not only misrepresentations but also breaches of covenants. In the absence of the covenant, however, although the purchaser might well have a rescission remedy and other rights under Rule 10b-5 (as well as personal claims against the fraudulent officer and the negligent attorney), the purchaser's right to indemnification under the agreement is questionable—since the representation was true when made, and the lawyer's opinion, the officer's certificate, and the reiteration of representations are all merely closing conditions serving a different purpose in the overall scheme of things. In the second place, even if the purchaser is assured of finding out about the lawsuit at the closing through the certificate and opinion, he has an interest in learning of its existence as soon after February 1 as possible, in

57. See Section 7.4.7.
58. The litigation opinion is discussed in Section 8.4.3.

order to save himself expenses he would otherwise incur during February in expectation of a closing that now may never take place.

Let's suppose that, covenant or not, the seller notifies the purchaser of the lawsuit immediately. The litigation will give the purchaser an out under the conditions section of the agreement, because the representation regarding litigation will not be true at the closing.[59] But the purchaser is not entitled to any damages from the seller, who was unaware of the suit at the time of signing and thus couldn't be charged with a misrepresentation.[60] This is another way of saying that the representations are *not* repeated at the closing for the purpose of imposing additional liabilities on the seller, but simply to furnish the purchaser with an excuse for not consummating the deal.

Now, what if the purchaser still feels that the acquisition is a good one, and would like to close in spite of the lawsuit? Who should bear the risk of this new contingent liability? In the absence of a specific provision on the subject contained in a supplement to the acquisition agreement, the answer is not always clear. If the agreement contains a clause (which the seller should always ask for) stating that, upon the transaction closing, the seller's disclosure schedule *as supplemented prior to the closing* will form the basis for indemnification, then the updating of the disclosure schedule to reveal the lawsuit will have cured any deficiency and the buyer will bear the risk. Even without such a

59. In the hypothetical situation under discussion, the $1,000,000 lawsuit is assumed to be clearly material. If, on the other hand, a $1,000 lawsuit had been brought against seller in the interim between signing and closing, one would scarcely expect this to create an opportunity for the purchaser to avoid his obligation. However, unless either the condition repeating seller's representations at the closing or seller's litigation representation itself is qualified by a materiality standard, this could happen—thereby highlighting the importance of negotiating for such a provision. In this regard, see Sections 5.3.3. and 7.3.1.
60. It should be noted that the usual litgation representation, discussed in Section 7.4.7., refers to both pending lawsuits and litigation which, to seller's knowledge, is *threatened*. Accordingly, if seller had known of the threat of the suit on January 1 and had failed to disclose its existence to purchaser, there *would be* an actionable misrepresentation.

clause, the seller could argue that the purchaser's implicit waiver of the representation-repeating condition in proceeding to consummate the deal constitutes acceptance of the burden of the disclosed litigation.

So, if the purchaser wants to close with the contingent liability of the lawsuit remaining on *seller's* shoulders, the purchaser has to exact this as the price for yielding his right to walk away. As distinguished from other situations where renegotiation possesses certain shady connotations, this is a perfectly proper negotiating point for the purchaser to raise. His argument is that at the time he made the deal, he knew nothing of this contingency; if he had, it would have entered into his decision on the purchase price. Should the purchaser prove successful in upholding this position, a specific supplemental agreement ought to be signed, extending the reach of the indemnification section to any liability arising out of the named lawsuit plus the accompanying legal expenses.

But what if the seller is unwilling to carry the burden of the lawsuit? He might argue that the purchaser is supposed to be buying the business, warts and all. The seller wants a clean break; once the deal closes, the seller doesn't want to have anything—even an unmeritorious lawsuit—hanging over his head indefinitely.[61] This is a hazardous bargaining position for the seller to assume with too much rigidity, since the buyer may simply decide to walk away from the deal entirely.

But often this posture on the part of seller will lead to a different kind of solution, where the purchaser assumes the risk and expenses of the lawsuit in return for a revised purchase price, reduced by some negotiated fraction of the potential maximum litigation exposure. Of course, the purchaser's attorney would then have to make his own independent analysis of the merits and costs of the lawsuit, which is difficult to accomplish under the time pressure of the closing and prior to any pre-trial discovery in the case. As a result, it may prove more practical to frame the compromise in terms of dividing the ultimate risk (whatever it may be, but perhaps with certain built-in maximum exposure limits) between seller and buyer.

61. In this connection, see the discussion in Section 4.6.1.

5.3.3. The Neurotic Seller and the Pound of Flesh

Now, let's view this interaction of contractual provisions from a slightly different perspective. Assume that you represent a seller who doesn't mind indemnifying the purchaser fully against any and all misrepresentations, but is positively neurotic about the possibility that the purchaser might walk away at the closing. The seller calls you in and declares, with a great deal of emotion:

> "Look, I've checked over everything, and I'm reasonably sure that the representations we're making are correct. On the other hand, this is a complicated business and there might be some little things that I've overlooked. But I'm worried to death that this guy will be able to use some of those minor matters for an out in case he changes his mind about the deal."

The seller may be uptight, but he knows what he's talking about. I firmly believe that, representing the seller, you must always operate under the assumption that the purchaser will be predisposed to wiggling out of the agreement at the closing. This attitude is basic to the adoption of a proper negotiating stance. The sweeter a purchaser talks, the more you must force yourself to envision him two months from now, completely soured on the deal, searching for a legal means of disengaging himself. Perhaps he will discover some new, adverse facts about the seller's business that dry up his enthusiasm, or new developments at purchaser's own shop might cause a re-evaluation, or economic conditions could change—or the buyer may just become crotchety over a persistent ache in the muscles of his lower back. If I ever have trouble picturing the turnabout, I can always resort to the relatively safe assumption that the seller's operating results for the most recent period prior to the closing will be dismal, reflecting the diversion of everyone's energies from production and marketing to involvement in the acquisition itself.[62]

62. A phenomenon which is explored further in Chapter 14, pp. 505, 530-531.

This problem is usually handled by asking the purchaser to qualify various of the seller's representations, or the closing condition reiterating the representations, with a materiality concept.[63] Thus, if your client is concerned that there may be one or more minuscule contractual obligations that he has overlooked, you would ask that the language in the agreement require the seller only to disclose *material* contracts—or, if quantification seems appropriate, obligations in excess of, say, $10,000.[64] Then, in the event he misses an immaterial contract, it has no legal effect.

If the purchaser does not permit you to qualify seller's specific representations in this fashion ("I want to know about *all* your contracts; *I'll* decide which ones are material!"), you should then request language to the effect that, in order to furnish the purchaser with an out at the closing, the seller's aggregate misrepresentations must be of such a nature as to have a material adverse effect on the overall business, earnings or financial position of the seller. With this protection, a minor misrepresentation, an overlooked item, an insignificant event occurring subsequent to signing, or some technical non-compliance would not give the purchaser—who might otherwise want an excuse to avoid his contractual obligation—the right to do so.

In analyzing these problems, keep in mind that the practical resolution is often a renegotiation of the terms of the deal by the disillusioned purchaser. The seller's strength in these bargaining sessions might well turn on whether or not the purchaser has a legal out under the terms of the agreement. For example, assume that (i) the seller's current operating results (which in the particular agreement are not the subject of any specific representation) flatten out, but not sufficiently to represent a material adverse change;[65] and (ii) the buyer discovers in the course of his investigation an undisclosed, pre-existing $2,000 liability of the seller (which was required to be listed in a schedule to the agreement). If the conditions section limits the purchaser's right to

63. The concept of materiality is discussed in Section 7.3.1.
64. Disclosure of contractual obligations is covered in Section 7.4.5.
65. This bring-down type of representation is discussed in Section 7.4.2.

walk away to misrepresentations whose effects are materially adverse, neither the mediocre numbers nor the $2,000 misrepresentation will furnish purchaser with an out. If that materiality language is absent from the conditions section, however, the $2,000 error will give the purchaser the technical right to walk away, even though the earnings disappointment does not. Now, the buyer would probably not be such a cad as to terminate on the basis of the $2,000 alone, but the fact that he has that *right*, plus the negative aspects of the flat earnings, may well spell trouble for seller in the renegotiating sessions.[66] On the other hand, if the purchaser did not have the absolute right to walk away, he might be loath to bring up the subject of renegotiation at this point.

But back to the case of the neurotic seller. Let us further assume that this particular purchaser's attorney wants his pound of flesh. He won't give you a single materiality caveat in the representations; if you've forgotten something, that's your tough luck and the seller will have to pay. He won't permit a materiality standard in the conditions section, because his resulting inability to terminate means he would have to take subject to all the misrepresentations (not material in the aggregate) he anticipates discovering prior to the closing. He is not even willing to give you the usual "basket"[67] against minor indemnification claims. It begins to look as if your client is going to be put in the unenviable position of sweating it out through the closing, in constant anguish that an insignificant breach might furnish the purchaser with a way out.

One method of handling this dilemma is to work out the following compromise with the purchaser's attorney. You begin by expressing your fear that a minor misrepresentation could, under the language of his draft of the agreement, give the purchaser an out. Use an absurd example[68]—a minor easement, for instance, that

66. An example of this "aggregation" concept is contained in Chapter 14, pp. 533-536.
67. See Section 10.2.1.
68. The use of this tactic is discussed in Section 2.3.6.

only slightly mars good title to some insignificant real property. Hopefully, the purchaser's attorney will reply: "Oh, come on, we obviously wouldn't want to get out of the deal for those kinds of things—only for something substantial."

At that point, you have him. He's now on record as only worried about *indemnification*. You're worrying about *conditions*. The compromise is obvious. If *he* makes it clear in the argreement that only substantial misrepresentations will give the purchaser an out at the closing, *you* will make it clear that the little (or big) misrepresentations discovered prior to the closing *will* give rise to indemnification which survives the closing. In other words, the purchaser will not be forced to make a decision to close in spite of these items; he will get his pound of flesh, but the seller will have his peace of mind. To put it still another way (in terms previously discussed), indemnification will flow from the *initial* disclosure schedule, *not* from the disclosure schedule as supplemented.

5.3.4. The Problem of the Tardy Financial Statements

One of the most difficult issues in this interaction area arises when, at the point the parties sign an agreement for a deferred closing, the seller's audited year-end financial statements are not yet available.[69] Assume the agreement is signed January 1, with the closing scheduled for March 1. Prior to the signing, the purchaser has been furnished with the seller's financial statements for the nine months of the preceding year ending September 30. The December 31 year-end financials, certified by the seller's independent accountants, will not be ready until late February. You represent the purchaser. How do you handle this situation?

First of all, from the purchaser's point of view it is essential that *the seller's audited financial statements disclose a certain* minimum level of earnings (or perhaps net worth), as a condition to the purchaser's obligation to close. If the agreement merely called for the seller to deliver his audited financial statements prior

69. The seller's representation regarding his financial statements is analyzed in Section 7.4.2.

to the closing, without more, the purchaser would be allowing the seller to write himself a blank check; i.e., the purchaser would be committing that familiar but unforgiveable blunder of acquisition negotiations—taking subject to a document, the contents of which he doesn't know at the time he agrees to accept it.[70]

At this point, one might ask: if the seller's earnings for the preceding year are mediocre, wouldn't that give the purchaser an out anyway as constituting a material adverse change? Possibly, yes; but the seller will undoubtedly argue that the downturn is not really material; and he might even take the position (*if no earlier point of reference is established*) that, *since* the financial statements merely reflect a state of affairs which was in fact historical at the time of the signing (the relevant year having been completed, although not yet reported on), it does not constitute a material adverse change in seller's business *since* the signing; and you will go round and round. For the sake of certainty, you ought to have a ready means of measuring the level of performance or position which the year-end figures will show.

In addition, there should be a tie-in between the audited financials and the unaudited statements received prior to signing. This is frequently cast *in terms of the audited financials not reflecting* any material adverse change (or perhaps *any* negative change) from the unaudited. At least in terms of income, measuring such erosion is easier when the unaudited and audited figures cover the same period; the process is trickier where, as in the example given, the unaudited statement is for nine months while the audit covers the full year.[71] Still, the provision is worthwhile having, particularly to guard against new adverse items cropping up in the audited balance sheet or its footnotes.

When audited financial statements are being delivered subsequent to the date of the agreement, you have to be particularly careful with respect to representations that tie in to the financials. In the usual case where the audited financials are in hand prior

70. This important point is also treated in Sections 5.3.5. and 7.4.2.
71. In this connection, see the discussion of the *National Student Marketing* case in Section 12.4.3.

to signing and the seller represents that he had no liabilities as of their date except as set forth in the balance sheet,[72] the purchaser can look at the balance sheet and know exactly what he is getting. If any undisclosed liabilities which existed as of the balance sheet date later come to light, the purchaser has the right not to close if the omission is significant enough to violate one of the conditions to his obligation—or, if the closing has already taken place, he will probably be in a position to seek indemnification.

If, however, the representation asserts that the seller has no liabilities except as may be set forth in the audited financial statements to be delivered prior to the closing, and the purchaser has not seen these financials at the time he signs the agreement, he is leaving himself wide open. There may be a significant contingent liability or an additional tax accrual contained in the audited balance sheet, which are not in the unaudited statements prepared by seller's internal accountants; the purchaser will have to swallow them whole. I can't tell you how many draft acquisition agreements I have seen which are phrased in precisely those terms.

To protect himself in this situation, the purchaser must key such representations as those regarding liabilities into the unaudited balance sheet that he has in hand at the time of signing. That way, at least he can see what responsibilities he will be assuming. But the seller is then likely to argue, with some justice, that *he* can't live with such a provision; that he would be exposing himself to serious indemnification problems, since the internally-prepared unaudited statements might well fail to reflect the proper tax accruals, contingent liabilities, etc. The seller wants his future obligations keyed to those *certified* financial statements—the ones he is paying his auditors so handsomely to do right!

There is at least one way to resolve this issue, which generally minimizes the problems of both parties. The agreement is worded so as to relate the seller's *continuing* representations (that survive

72. Since the balance sheet will invariably be as of a date prior to signing, a bring-down representation (see Sections 5.3.1.—*Representations* and 7.4.2.) is usually appended to account for this interim period—a practice which we will ignore for purposes of this illustration.

the closing for indemnity purposes) to the audited financial statements. But for purposes of the buyer's closing conditions, the representations are tied into the unaudited statements that have been delivered at the time of signing the agreement. Thus, where a substantial contingent liability that did not appear in the unaudited statements comes to light in the certified statements, the purchaser can walk away. If he chooses to close, however, and does not attempt to renegotiate,[73] then he takes subject to that contingent liability (since it has been disclosed in the audited financial statements that form the basis for the seller's ongoing representations) and cannot use it as grounds for indemnification.

5.3.5. Reacting to the Delayed Disclosure Schedule

There is one further aspect of this matter that I want to discuss briefly. In contrast to the usual case where the purchaser receives the seller's disclosure schedule before signing the agreement, I have participated in a few acquisitions where the parties have signed the agreement prior to delivery of the disclosure schedule. This occurs when everyone is anxious to get the ball rolling, and the parties refuse to let "legalistic Mickey Mouse" stand in their way.

If you represent a purchaser who pushes you into this position, make sure that the agreement provides for the seller to deliver the disclosure schedule by a specific date, and grants the purchaser the right to walk away within a given period of time thereafter if there is *anything* in the schedule that he doesn't like. If the purchaser chooses not to walk away within the prescribed time period, then he takes subject to the disclosure schedule; and, of course, to the extent that the schedule is correct, there is no indemnification.

I feel that wide-open discretion to back out on the part of buyer is the only manageable way to handle this kind of a transaction. If you attempt to tie the purchaser's ability to terminate the deal into his prior knowledge (i.e., restrict the operation of the pro-

73. *See, e.g.*, Section 5.3.2.

vision to negative information appearing in the disclosure schedule of which the purchaser was not previously aware), you have entered a never-never land guaranteed to provoke disputes and possibly litigation. Who knows what the purchaser may have been told orally at some early point in the negotiations, and whether he received sufficient details to be able to spot the problem at that time? Unless the purchaser has a complete out, he will be taking subject to any number of items he may be learning about for the first time. With the discretionary condition, the deal is more like an option, and the purchaser can live with it.[74]

As for the seller, if he is anxious to sign, convinced that his company is clean and certain that the buyer is enamored of the deal, he may not mind giving seller a "free look." His lawyer, however, can be expected to throw up his hands in horror, advising the seller to resist such a contractual imbalance—or at least to try for something of value in consideration of the option. Practically speaking, a not uncommon denouement to this particular scenario is for the signing to be deferred for a few sleepless days and nights pending delivery of an accelerated disclosure schedule.

5.4. THE BUILT-IN PURCHASER'S BIAS

So much for the interaction of the various contractual provisions. I feel obliged to state at this point that I usually carry with me into the negotiating room a certain bias[75]—perhaps stemming from more frequent representation of purchasers than sellers—which can be stated as follows: once agreement in principle has

74. Note that the purchaser's untrammeled ability to walk away might raise a legal question of consideration for the seller's obligation to perform. In some states (New York, for example), no consideration is required for a written irrevocable offer—which, at the very least, the agreement still is. In other jurisdictions, some additional formality is required as a substitute for consideration—perhaps a seal (Massachusetts) or a statement of intention to be legally bound (Pennsylvania). Purchaser's lawyer should be alert to this kind of problem, so as to avoid giving the seller the right to renege.

75. A bias which is hopefully well-concealed when representing the seller.

been reached on basic matters and the discussion has turned to the rest of the details forming the fabric of an acquisition agreement, the purchaser should be in the driver's seat.

In effect, the purchaser is saying something along these lines to the seller:

> "I agree to buy your business at the price and upon the other terms we have agreed to, *provided* that: (i) you tell me everything there is to know about your business, because that state of affairs forms the basis on which I am willing to pay this price; (ii) you promise not to do anything prior to the closing that would adversely disturb this state of affairs, and in fact everything is the same or better at the time that we actually close; (iii) you let me investigate you to my heart's content; (iv) you deliver me good title to what I am getting; and (v) you stand behind what you tell me in case something negative comes up later on."

In other words, most of the provisions in an acquisition agreement are designed to satisfy the purchaser's need for assurance that what he actually receives is what he thinks he has bought. There is usually a real disparity in the relative protection for the two parties in the agreement, especially where the buyer is paying cash. In point of fact, cash is cash, and there is not much the seller has to know about that;[76] his main concern is that the purchaser appear at the closing to hand the money over, without somehow weaseling out of the agreement. Practically everything else the seller does is defensive, warding off the demands for information, restrictions, conditions and so on imposed by the purchaser.

Of course, where the purchaser is paying in stock, the seller's interest does take on more of an "offensive" character; and, depending upon the relative size of the companies, the seller might insist on a degree of comfort rivaling that sought by the purchaser

76. Cash acquisitions are discussed in Section 6.1.1.

—a subject we will be coming to later.[77] But even here, particularly where the seller is a privately-held company whose affairs are being subjected to the harsh light of outside investigation and analysis for the first time, it is the purchaser who not only has the most to lose but the best chance of losing it—unless his attorney obtains for him an adequate level of contractual protection.

77. See Sections 6.2.1. and 7.5.

CHAPTER 6

Purchase Price Considerations

Negotiations touching upon the purchase price always rank high on the critical list. In spite of all the legalistic paraphernalia of modern acquisitions—the pursuit of eventual recovery through indemnification, the stress on magical solutions occurring on the eve of closing—the purchase price remains the most venerable indicium of a gratifying deal.

In this chapter, we will begin with a few comments on the principal forms the purchase price is likely to take—cash; stock which may be either common or preferred; and debt, evidenced by notes or debentures—and the differing negotiating considerations that hinge on the form. Then, we will analyze three specific recurring problems that every acquisition lawyer is called upon to face: first, the valuation of stock when the purchase price is payable in shares; second, the contingent purchase price, where a portion of the cash or stock to be paid is dependent upon the