Anatomy of a Merger:

Strategies and Techniques for Negotiating Corporate Acquisitions

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CHAPTER 7

Representations and Warranties

There are no known statistics on the subject, but I'm willing to bet my briefcase that lawyers spend more time negotiating "Representations and Warranties of the Seller" than any other single article in the typical acquisition agreement. It is a nit-picker's delight, a forum for expending prodigious amounts of energy in debating the merits of what sometimes seem to be relatively insignificant items. I don't mean to denigrate the important role which representations play in any acquisition, but there is a definite tendency on the part of lawyers and their clients to overreact in this area—at least partially as a result of their failure to analyze what is actually at stake. And so, before getting into a discussion of the specific representations, I think a few general observations are in order.[1]

1. See also the material on representations contained in Section 5.3.1.—*Representations*.

7.1. AN ANALYTICAL FRAMEWORK FOR NEGOTIATING REPRESENTATIONS

Let's assume that, representing the purchaser, you are about to receive comments on your draft of the agreement from the seller's lawyer. You anticipate that much of his assault will be aimed at your tough article on seller's representations. It might be useful to pause for a moment before entering the fray and reflect on just what you are attempting to accomplish.

7.1.1. Discerning the Purchaser's Purposes

From the purchaser's viewpoint, representations serve at least three distinct, although overlapping, purposes. First, they are useful as a device to obtain the maximum degree of disclosure about the acquired business *prior* to the purchaser undertaking a binding commitment to make the acquisition. In other words, representations constitute a systematic smoke-out of the data about the seller which the buyer feels is important. They are a means of forcing the seller to focus on significant aspects of his business, in a way he has probably never previously attempted, in order that important information can be formally transmitted to the purchaser.

I should stress that this purpose is not only important with respect to a seller you don't really trust and want to pin down, but also with a disorganized or forgetful seller, who is acting in good faith but whose memory needs to be jogged by reference to the categories of information sought in the representations. Moreover, there may be matters of which the seller is aware that don't appear as problems to him, but that are troublesome to the purchaser—perhaps because the latter is a more astute or experienced businessman, or because the subject matter conflicts with other segments of the purchaser's business. This focusing aspect of representations can often alert the purchaser to questionable areas for more detailed investigation, and may even provide ammunition for use in renegotiating the price or other terms of the deal.

The second general purpose of representations, from the purchaser's viewpoint, is to set the stage for the purchaser to walk away from the deal if facts develop that make it unwise to consummate the acquisition. Although in most cases the purchaser has been able to make a preliminary investigation prior to signing the agreement and has relied on certain data supplied to him by seller, purchaser's *definitive* investigation—the opening up of all seller's doors and drawers—usually takes place *after* the agreement has been signed.[2] If the agreement did not contain detailed representations by the seller, the subsequent discovery by the purchaser of adverse facts not rising to the level of fraud or clear materiality—for example, the unearthing of an innocently overlooked $50,000 contingent liability in a $1,000,000 deal—might not relieve the purchaser of his obligation to close. The presence of multiple representations (including one specifically covering contingent liabilities), coupled with the typical condition to purchaser's obligation to close which restates the representations as true at the closing,[3] will provide the purchaser with an out under the agreement in the case of the example—or if one or more other significant representations prove to be incorrect.

The third purpose of representations is to lay the groundwork for indemnification, should it develop after the transaction has been closed that a representation was untrue. If that $50,000 contingent liability were not discovered prior to the closing but reared its ugly head three months later, the purchaser would have an indemnifiable claim against the seller—in effect, he is entitled to be held harmless should the contingent liability come to pass. If the specific representation regarding contingent liabilities had been omitted from the agreement, the purchaser might have difficulty proving his reliance on a particular list of disclosed liabilities and his consequent right to indemnification. Keep in mind, how-

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2. This is particularly true if seller is a public company, if its business is competitive with purchaser's, or if purchaser is a potential entrant into seller's field—in which cases seller may be understandably leery about baring business secrets to purchaser in the absence of a contractual commitment on purchaser's part to make the acquisition.

3. See Sections 5.3.1.—*Conditions* and 5.3.3. But note that a materiality criterion may be introduced by the parties into either the condition or the representation; see Section 7.3.1.

ever, that (as previously discussed[4]) if the acquired company is publicly-held, the seller's representations typically do not survive the closing, and accordingly this purpose would not apply.

7.1.2. Evaluating Objections in Terms of Purpose

When you're negotiating representations on behalf of the purchaser, it's crucial to keep these three purposes in mind. For instance, let's say that the seller objects to representing that all his operating equipment is in a good state of repair and refuses to warrant that all of the items of furniture listed on a particular schedule can actually be found in his various branch offices.[5] Your reaction might vary considerably, depending on the circumstances.

Take one extreme: the seller is a public company, so that there will be no post-closing indemnification provisions; the buyer is enamored of the deal, with no intention of backing out of the agreement unless a catastrophe occurs prior to the closing; and his people, who have performed a very thorough investigation of the seller prior to signing the agreement, are satisfied that the business is relatively clean. Well, in this case you might be perfectly willing not to insist on these representations if seller's lawyer takes a hard line. After all, the smoke-out feature is somewhat insignificant (if you're interested, you can take a look at the machinery and desks); your client would never use a misrepresentation on this subject as the basis for walking away; and he won't be able to claim indemnification in any event.

Ah, but what if the situation is quite different? The seller, privately-held, has played his cards close to the vest. Your client has not been given an opportunity to investigate and believes there may be plenty of skeletons in seller's closet. As a matter of fact, the purchaser doesn't really know if he wants to go through with the deal, and would like the closest thing to an option that you can provide. Concerned over paying too high a price, he is determined to be indemnified in full for every little thing that bobs to the surface after the closing. Under those circumstances, your

4. See Section 5.3.1.—*Indemnification*.
5. Asset representations are discussed in Section 7.4.4.

posture on the equipment and furniture representations might resemble that of an Army mule.

Of course, most actual situations fall somewhere between these extremes, but your negotiating conduct can often be guided by your balancing of the purposes to be served.[6]

7.1.3. Helping Seller Over the Hump

Now let's examine the subject of representations from the vantage point of the seller. I think the most important single thing a seller's lawyer can do at the outset is to keep his client from getting uptight about full disclosure. The seller's negative reaction is understandable; after all, he has presumably never sold his business before, and is not necessarily familiar with that half-inch, three pound acquisition agreement so much in vogue today. Initially recoiling from the sheer girth and heft of the document, he proceeds to flip through pages and pages of his warranties until the inevitable explosion: "It's just not fair!" he screams, "they're trying to put me on the rack!"

In my opinion, a seller's attorney who enforces this erroneous belief and joins in the display of outraged indignation does his client a real injustice. The proper course is to calm the seller down; assure him that this is standard operating procedure in acquisitions; and point out to him that, although there is certainly room for negotiation on specific issues, in general the purchaser is entitled to full disclosure—even if that means a lot of work for seller in dishing up the facts.

Sometimes, unfortunately, seller's counsel doesn't do his job in this respect, and the task devolves upon the buyer's lawyer. This usually takes place at the first meeting with seller and his attorney, after they have received your draft of the agreement. Although you have to be very careful bypassing seller's lawyer, it's usually possible to get a gentle message across to seller and calm him down. Remind him that the sting of each representation is eased

6. For a related bit of analysis, see the discussion concerning materiality caveats in Section 7.3.1.

by the "except as set forth in the disclosure schedule" phrase[7] which precedes the operative language. The purchaser isn't asking the seller to represent anything that he is incapable of stating truthfully; if there is an exception to the terms of the representation, all he has to do is set it forth in the disclosure schedule and he's fully protected.

I might mention, in passing, that occasionally a seller's violent reaction to detailed representations is simply a calculated ploy on his part[8]—either to lay the groundwork for breaking off negotiations that he has decided to discontinue for other reasons, or to use as a wedge for renegotiating some other vital terms of the deal. The purchaser's attorney should be alert to this possibility and inform the client of his suspicions at the earliest possible moment, in order to avoid wasting time in useless disputation and to be prepared for what might be forthcoming when the diatribe is finally over.

7.2. THE UBIQUITOUS DISCLOSURE SCHEDULE

7.2.1. Backbone of the Representation Process

Concentrating for the moment on the informational aspects of representations, the typical means by which a purchaser formally obtains data from the seller is through the use of schedules or lists (which I am referring to in these pages as a "disclosure schedule"). For example, a typical representation would state that, except as set forth in an attached schedule, the seller has no subsidiaries. The representation might then go on to confirm that the schedule contains the states of incorporation of all seller's subsidiaries, the number of shares outstanding, etc. The attached schedule would then set forth, possibly in tabular fashion, the names of the various subsidiaries, as well as their jurisdictions, capital structure, and so on. This is certainly preferable to cluttering up the acquisition

7. Disclosure schedules are discussed in Section 7.2.
8. Overheated reactions are covered in Section 2.3.7.

agreement with such details. Of course, the agreement should always contain a provision stating that the disclosure schedule is made part and parcel of the representations, both for purposes of the closing conditions and for indemnification.[9]

Aside from its use in streamlining the acquisition agreement, the device of the referenced disclosure schedule sometimes serves the incidental purpose of enabling the parties to avoid baring their souls in public. If the seller is publicly-held, a copy of the agreement is annexed to the proxy statement which seller sends to its stockholders, but the disclosure schedule is almost never included. I can conceive of a situation, for example, where a former employee has made a claim against the seller for compensation due, which the seller is contesting as invalid. The claim is not material enough to warrant a footnote in the financial statements, but the seller feels he must disclose its existence to the purchaser—if not to preclude indemnification (since the representations will probably terminate at the closing in any event), or to deprive the purchaser of a basis for seeking an out upon discovery (since there will probably be a materiality standard in the applicable conditions), then perhaps simply because full disclosure is the proper and honest course.[10] If the seller were to dignify the claim by a specific reference in the agreement attached to the proxy statement, an observant claimant might be provided with more hope for success than he would otherwise have. It is much preferable that the claim be buried away in the disclosure schedule, which the claimant will probably never get his hands on.

For mechanical reasons, I prefer that all representations in the agreement refer to a single "disclosure schedule," which can then contain headings indicating the applicable sections of the repre-

9. Typically, the disclosure schedule is delivered prior to the agreement being signed. For a discussion of the situation where the disclosure schedule is delayed until after the signing, see Section 5.3.5. On the important question of whether the ongoing representations surviving the closing refer to the disclosure schedule as originally delivered, or as supplemented prior to the closing, see Sections 5.3.2. and 5.3.3.
10. In this regard, see Chapter 14, pp. 533 *et seq*.

sentations article.[11] Other attorneys prefer the separate representations to refer to "schedule 1," "schedule 2," and so on; i.e., each item having its own numbered schedule or list. Either way is acceptable substantively, but I find the second method sometimes gets a little messy, especially where you eliminate an inapplicable schedule (because, for example, the first draft of the representation makes reference to a schedule listing patents, and this particular seller doesn't have any) or add a new one as information develops—the numbering sequence always seems to get fouled up.

I want to warn you about one potential problem in connection with disclosure schedules. As purchaser's counsel, you must make sure that an item disclosed by the seller in a schedule for one purpose is *not* deemed disclosed for another purpose unless specifically so stated. Otherwise, you can get booby-trapped.

Assume, for example, that the agreement contains a representation to the effect that the disclosure schedule lists all contracts with suppliers and customers that run for more than one year or involve amounts in excess of $50,000.[12] In response to that item, the seller has listed seven contracts in the disclosure schedule. Now, further assume that there is a separate representation, in another section of the agreement (as might well be the case), stating that except as set forth in the disclosure schedule, the seller is not aware of any contracts which upon performance will result in a loss to the seller. No contracts are recorded in the disclosure schedule specifically referring to the latter representation. As it happens, however, one of the contracts listed in response to the first representation involved a serious error in judgment on the seller's part and will result in a substantial loss, although this fact is not apparent on the face of the contract.

Sixty days after the closing, the purchaser discovers the problem and makes a claim for indemnification against the seller for

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11. Remember also the device (referred to in Section 5.1.4.) for keeping the representations in the agreement minimal—by having them spelled out in the disclosure schedule itself.
12. Representations regarding contracts are discussed in Section 7.4.5.

not disclosing the potential loss. Seller replies that he certainly did disclose the existence of the unprofitable contract in the disclosure schedule, that purchaser had every opportunity to examine it and ask questions—and the fight is on. To avoid this situation, it's always a good idea to insert a provision in the agreement or in the disclosure schedule acknowledging that an item is only deemed disclosed in connection with the specific representation to which it is explicitly referenced.

You would think that this next point is so obvious as not to require mention, but for some reason it's not. The disclosure schedule transmitted by the seller must be read by the purchaser's businessmen and financial people. They are the ones who are in a position to appraise the significance of the matters disclosed. The lawyer can't handle the job alone; in fact, he is often the least knowledgeable person in this regard. But somehow, because the schedule is considered part of the agreement, it often lies ignored until the lawyer insists that it be closely perused. To be sure, many of the items have legal significance; and therefore the best procedure is for the lawyer, the businessmen and the financial people to review the schedule jointly.[13]

One final word. It is essential to dig *behind* the items disclosed. If a contract or lease is mentioned, look at a copy. If a lawsuit is referred to, examine the litigation file. You are held to the knowledge you would have obtained by doing this, so you may as well get your money's worth.

7.2.2. From the Seller's Viewpoint

If you represent the seller, the main question involving the disclosure schedule is just how detailed it should be. The answers range all over the lot. In some deals, the disclosure is agonizingly verbose, wending its way for pages and pages; in others, the listings are remarkably cryptic. In my view, the best approach is to strike a fair balance—so that the purchaser either receives the

13. This teamwork is also referred to in Section 2.3.8; coordinating the post-signing investigation is explored in Section 12.1.1.

necessary information in the schedule or is referred to documents which will give him that information—with no misleading statements or omissions.

Take the situation of disclosing the existence of a lawsuit against the seller.[14] I would suggest stating the name of the case, the court, the general nature of the claim (e.g., breach of contract), the amount sought, the present status of the case, the name of the lawyer handling the matter, and, if he has opined as to the likely outcome, the gist of his opinion. This provides the purchaser with sufficient information to decide if he wants to pursue the matter further, by asking for the court papers or interviewing the lawyer retained. If the purchaser is not really interested (because, for example, the amount claimed is only $5,000), the seller has satisfied his obligation.

One safe (although somewhat unwieldy) technique for the seller is to attach to the disclosure schedule copies of relevant documents. This obviates the risk of inadequately summarizing their principal contents, and the purchaser is in no position to balk since full disclosure is being made. In general, however, both seller and purchaser should recognize a rule of reason here. If, for example, disclosure is required with respect to the fixed assets utilized in seller's business, it would seem that rather than list each desk and chair in the office (assuming these items are insignificant in relation to the overall transaction), a miscellaneous furniture account can be set up with an aggregate dollar figure provided. Then if more details are sought, seller can furnish them upon request; but he shouldn't have to go to all that trouble in the first instance.

Seller and his attorney must proceed on the assumption that a careful purchaser will probe most of the items referred to in the disclosure schedule. There is nothing more calculated to upset a deal and professionally embarrass seller's counsel than for the purchaser's investigation to reveal that the seller has not been altogether candid.

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14. The litigation representation is covered in Section 7.4.7., the litigation opinion in Section 8.4.3.

Assume, for instance, that the agreement contains a general representation regarding backlog, with a reference to specific sales contracts in the disclosure schedule. Upon investigation, it turns out that prior to delivering the schedule, seller had received a letter from one of the customers listed, indicating a strong probability that three-quarters of his order will be cancelled. Seller's face will be several shades of crimson. As I see it, seller's lawyer should never have allowed this to happen. It is his job to cross-examine seller's business people on their disclosures, just as he would do if he were preparing a prospectus. The doubtful nature of this particular portion of the backlog should have been specifically noted.[15]

The preparation of the disclosure schedule ought to be a joint enterprise, involving seller's counsel and management. The lawyer's role is two-fold: he must first ascertain whether a requirement for specified disclosure exists under the agreement, and he should also be responsible for the nuances of how the disclosure is handled, which in certain circumstances can be very important.

To illustrate this latter point, let's suppose that in an assets-type transaction[16] there is one particularly significant contract, which seller will be assigning but which is itself silent on the subject of assignment. Under the applicable law, in the absence of an express provision to the contrary, the contract would probably (but not certainly) be held to be assignable without the consent of the other contracting party. Nevertheless, in order to cement good ongoing business relations, the seller does intend to ask the other party to consent. If for any reason the other party refuses, then the seller will simply assign the contract anyway, relying on the law of the jurisdiction.

The acquisition agreement contains the typical representation that, except as set forth in the disclosure schedule, no consents are required to the sale or assignment of the rights and properties

15. And by the way, just as in the realm of prospectus-writing, when you have a specific problem like this, it is *not* sufficient to state in general terms that customers have the right to cancel their orders.

16. Such transactions are analyzed in Section 4.6.

being transferred. Seller's controller, who is aware of this particular problem, references the applicable contract in the portion of the disclosure schedule keyed to this representation, without any qualification.

You know the rest of the story. The other party doesn't consent, seller assigns, the other party sues, and the disclosure schedule is introduced in evidence by the plaintiff as an admission by seller that consent was required. What ought to have happened, of course, was that any reference to this contract in the disclosure schedule should have been qualified by a caveat that although consent would be sought, it was not legally required.

Some sellers' lawyers will blandly negotiate the representations article of the acquisition agreement prior to becoming informed as to what specific matters the seller will be forced to include in the disclosure schedule. I'm not sure this is wise. For example, if the lawyer knows in advance that seller has a substantial number of minor contracts containing a sixty-day cancellation clause, the listing of which would not be particularly meaningful to the purchaser but would represent a great deal of work for seller, counsel can ask for an exception to the contracts representation, eliminating the requirement for specific disclosure of contracts terminable on less than three months' notice; but if he only discovers this after the negotiations are concluded, it may be too late.

7.2.3. The Schedule-less Acquisition

Every once in a while, the acquisition agreement for a transaction between two public companies will not call for detailed representations by either side, and will accordingly omit the necessity for a disclosure schedule. Typically, this occurs in situations where: (i) speed is important—for some reason or other, it is crucial that the acquisition agreement be signed as quickly as possible; (ii) the companies are of roughly equal size, so that the transaction is more a true combination than an outright acquisition and any detailed representations would likely be pretty much reciprocal; and (iii) an SEC proxy or registration statement is required in the transaction, which can be used as the basis for a catch-all representation.[17]

The rationale of this kind of deal is simple. Since both companies are already public, it can be assumed that their corporate lives have been relatively open books, with no major unpleasant surprises. Since the representations do not survive the closing in any event, there is no concern about using specific warranties as the basis for indemnification. And if a preliminary proxy statement (or comparable disclosure document) is in existence at the time of signing, it can serve as the basis for giving each of the parties an out if subsequent investigation reveals a drastically different state of affairs.[18]

If no comprehensive disclosure document is available prior to the agreement date, then I would hesitate in advising my purchaser client to sign an agreement without specific representations, unless there is a provision which in effect gives him the right to walk away if the definitive proxy statement or his investigation reveals *any* adverse information not previously publicly disclosed.[19] Such right can be for a certain period of time after completion of the document and investigation, so that the seller is not on pins and needles right up to the closing. Surprisingly, some sellers are willing to give the purchaser this right. These are generally sellers for whom the signing of the acquisition agreement has not involved a substantial change of position, who are cocky that your client's investigation will only strengthen his resolve to do the deal, who have been sweet-talked, and who are not particularly well-advised!

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17. To the effect that the proxy statement is accurate, complete and does not omit to state any material facts, and the included financial statements fairly present the financial condition and results of operations of the respective parties.

18. The importance of early preparation of the proxy statement is discussed in Section 12.2.2.

19. For an analogous situation, refer to the question of the delayed disclosure schedule discussed in Section 5.3.5.

7.3. EVERY SELLER'S FAVORITE CAVEATS

There are two recurrent themes sounded by every seller's attorney who ever negotiated the representations article of an acquisition agreement. One is materiality and the other is knowledge. Some bitter pitched battles have been fought over these innocuous-sounding concepts, to which we now turn.

7.3.1. Materiality is in the Eye of the Beholder

First, materiality.[20] The seller's attorney argues that he should only be required to list *material* contracts, not every insignificant commitment. He wants the representation to read that the seller has no *material* liabilities other than those set forth on the balance sheet; or that the seller is not a party to any *material* litigation, except as set forth in the disclosure schedule; and so forth. A typical colloquy on the subject runs as follows:

Seller's Attorney: [*off-handedly*]	"I would like the word 'material' inserted ahead of the word 'litigation' in paragraph 3(h)."
Purchaser's Attorney: [*with a knowing smile*]	"No dice, Harry. I want to know about *all* your litigation; then I'll decide what *is* material and what isn't."
Seller's Attorney: [*feigning irritation*]	"Look, Joe, in the ordinary course of business we have a bundle of small litigation, penny ante stuff. It's handled by twenty-five different lawyers, all over the country. I'm not sure we could even compile a list of every matter."

20. On the subject of negotiating a materiality caveat in the condition repeating representations at the closing, see Section 2.3.6.; see also Section 5.3.3.

Purchaser's Attorney: *[ignoring the last remark]*	"Anyway, Harry, what is the test of materiality? Sure, you have a big company here, but if there's a multiplicity of litigation, it might have significance in the aggregate—and perhaps it will educate us on some risks in your business—and maybe some of it involves basic principles, although miniscule dollars. So I want to know all about it."
Seller's Attorney: *[adopting tone of weary sophistication]*	"Come on, Joe, you're going to make this deal for the same price whether you have all these details or not. And I don't want you tracking down the seller three months after the closing because I forgot to include some two-bit claim in the schedule."

All right, both sides have now staked out their position. The seller's counsel has done his job in raising and arguing the point; the purchaser's lawyer has performed yeoman service in resisting the change. How is the issue to be won, lost or compromised?

There are no comprehensive guidelines for dealing with the seller's desire for materiality caveats in representations. It usually comes down to a question of identifying and attempting to satisfy, by one means or another, the real objectives of the parties (or rather their attorneys, since it is the lawyers who usually play this materiality game), without giving up what are considered vital protections.

To get at this question more analytically, let's oversimplify the motives of the purchaser's attorney in resisting materiality caveats by dividing them into one or more of three categories: P-1, he wants to unearth information; P-2, he wants to lay the basis for his client to walk away if things are not as represented; and P-3, he wants to set his client up for indemnification if there are any unpleasant surprises after the closing. The seller's attorney, on the other hand, usually has one or more of these reciprocal concerns: S-1, he might want to conceal unpleasant information[21] or simply avoid certain tedious tasks involving what he considers to be essentially trivia; S-2, he is not willing to furnish purchaser with an out over a minor misrepresentation, in the event that purchaser turns luke-warm on the deal and needs an excuse to call it off; and S-3, he is trying to guard against purchaser going after his client for indemnification down the road.

Now let's examine the subject of the prior dialogue in light of these considerations. Assume in the first case that purchaser's attorney is interested in complete information [P-1] while seller's attorney is worried about small claims [S-3]. Well, the usual compromise here is to require seller to list *all* litigation, not just *material* lawsuits—but to provide in the indemnification section of the agreement for a "basket" or "cushion";[22] i.e., a provision to the effect that the purchaser is only entitled to be indemnified if the aggregate of the items seller has failed to disclose or otherwise misrepresented reaches a certain prescribed level.

Take a different case. Assume that purchaser's lawyer wants his full pound of flesh under the indemnification provisions [P-3]; that seller's counsel is not concerned about *that* problem, but is really bothered by the prospect that purchaser will use the omission of some trivial litigation (including lawsuits brought against seller between signing and closing)[23] as the pretext for breaking off the agreement at the last moment because, for example, market conditions change [S-2]; and that purchaser has told his attorney that he fully intends to close this deal, come hell or high water. What you work out here generally is the required listing of *all* litigation, with a flat indemnification against any omissions, but the inclusion of a provision in the conditions section to the effect that only a misrepresentation which has a material adverse effect on

21. My experience is that this is not true of most seller's lawyers who, *if* not always moved as one might hope by ethical considerations, take the practical view that it is better to disclose now—since the adverse fact is likely to come out later to his client's financial discomfort.
22. See Section 10.2.1.
23. See Sections 5.3.2. and 5.3.3.

the financial condition or results of operations of the seller can furnish the purchaser with an out.[24]

Or assume a situation where seller's attorney is truly troubled by the prospects of assembling a host of insignificant data [S-1], while purchaser's lawyer, concerned that his investigation will uncover items which are ambiguous in terms of materiality, does not want to abdicate the right to decide what is sufficiently material to permit purchaser to walk away [P-3]. This kind of impasse comes up at numerous points in the representations article,[25] as well as in those dealing with covenants and conditions. Whenever the parties are either unwilling or unable to decide between materiality and non-materiality, the usual solution is to fix an objective standard as the criterion for disclosure (and thus for indemnification and other purposes). So in this case, the compromise might be for the representation to require a listing of each item of litigation against the seller involving a claim in excess of, say, $10,000. If the purchaser really isn't interested in the "small stuff," why put the seller to the trouble of compiling a useless dossier of immaterial litigation? As a further precaution, to guard against a great number of individually insignificant small claims which are substantial in the aggregate, the purchaser could insist upon receiving a representation that the aggregate of the litigation omitted by reason of this exclusion does not exceed the sum of, say, $50,000.

Three final points on materiality. If, representing the purchaser, you have acceded to a provision in the conditions article limiting the purchaser's termination right to misrepresentations having a material adverse effect upon the seller, while at the same time in the representations article you have permitted the seller numerous materiality caveats, then you run the risk of double materiality—i.e., the aggregate total of omitted information which does *not* constitute misrepresentations can be quite large without acting as a partial trigger to the condition. If you find over the course of negotiating several representations that seller's attorney is a bug

24. See Sections 5.3.3. and 7.3.1.
25. See various of the subsections of Section 7.4.

on materiality, you can suggest that, instead of negotiating this matter with respect to each representation, you will simply put that "material adverse effect" language into the condition section. Or, if he is worried about indemnification, you should hint at the strong possibility of a basket, the size of which will be determined "after I've heard all your problems."[26]

Second, you must remember to be precise grammatically in your use of the word "material." It is one thing for the seller to represent that "there has been no material breach of any agreement" and quite another for him to say "there has been no breach of any material agreement." In the former case, the discovery of a substantive breach of a minor contract could lead to dire consequences, while in the latter, although only major agreements are involved, even a technical breach would present problems. Seller's counsel may well try to double up and ask for "no material breach of any material agreement."

Finally, whatever the concept of materiality may mean, at the very least it is always relative to the situation. I remember well one particular day a number of years ago in which I was both assisting in negotiating a quite sizeable merger in one room and involved in a run-of-the-mill acqujsition of a private company that was going on in another. The insurance company we represented in the large deal was concerned that, if it were called upon to pay a substantial claim prior to closing, *that* might constitute a material adverse event giving the other party an out. I raised the point. Counsel for the other side asked, "What is your largest single policy?" Our client replied that it involved certain atomic energy coverage. "How big a loss could you suffer?," queried the other lawyer. Our client pondered this for a moment, and then answered that it could be in the neighborhood of $10,000,000. "Aha," said opposing counsel, "that simply would not be material." And, in the context of the numbers in that deal, he was absolutely right! Later in the day I joined the other negotiation, and participated for two hours in a vociferous fight over an addi-

26. For an example of these techniques, see Chapter 14, p. 517.

tional $5,000 of salary for seller's president. To *him*, it was extremely material; and I can't say that I disagree.

7.3.2. A Little Knowledge is a Dangerous Thing

Turning now to the knowledge caveat, it is obvious that the seller would prefer every one of his representations to be qualified "to the best of his knowledge"—the theory being that, although he would still be on the hook for items he knew about but failed to disclose, he would escape liability for undisclosed matters concerning which he had no actual knowledge. For example, if seller's prior management had given a mortgage on certain corporate property, but for some reason the instrument did not appear in the corporate records and the mortgagee had never recorded the lien, seller would not be liable if he had represented that, to his knowledge, there were no such mortgages. Without the knowledge caveat, he would be stuck.

From the viewpoint of purchaser's attorney, I think there is a common sense rule to be followed in this type of situation: the only time that you should voluntarily accept a knowledge caveat from seller is in a situation where, if seller does not in fact possess the information, he should not be required to stand behind the representation. The distinction can be seen in the usual litigation representation, where seller is asked to describe both pending and threatened lawsuits.[27] The pending portion is almost always unqualified, but the seller is certainly entitled to a knowledge caveat with respect to threats; the fact that the potential plaintiff has been boasting of his litigious intentions at the neighborhood tavern shouldn't matter a whit. Another example involves the sometime representation that there is no event or condition pertaining to the business or assets of seller that may materially adversely affect such business or assets; the best seller can really say is that he doesn't *know* of any problems along these lines.

Or take, for instance, the representation that the seller's use of a particular trade name does not violate the rights of any third

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27. See Section 7.4.7.

party. Now, assuming that seller has been using this name for a good while, and assuming that he is not aware of any other company using the name, and assuming that no third party has ever made any claim of violation (i.e., brought the matter to seller's knowledge), and assuming that the trade name is not *that* vital to the seller's business, it would not be inappropriate to accept a knowledge caveat from the seller in that situation.

On the other hand, in the usual case the purchaser is simply looking for a guarantee, and it becomes immaterial whether the seller actually has or hasn't the requisite knowledge. In these situations, the purchaser's attorney should refuse to permit the knowledge caveat to create ambiguity in the legal relations existing between the parties. For example, the purchaser should never allow the seller's representation that his accounts receivable are current and collectible[28] to be made to the best of his knowledge. The purchaser wants to be indemnified if those receivables turn out to be bad. The seller might well have no idea that the receivables will ultimately be worthless, and yet the risk of loss should fall upon the seller in that case. In more complex areas, such as unknown liabilities, unless there is a particular rationale to the contrary, I take the view that generally the seller (who is presumed to know his business better than purchaser) should bear the risk—and thus the purchaser should not agree to a knowledge caveat.[29]

7.4. SPECIFIC REPRESENTATIONS OF THE SELLER

We are now in a position to examine some of the more common representations and warranties required of the seller in the acquisition agreement. For purposes of analysis, I have attempted to organize these into broad general categories, a format not necessarily reflected in the typical agreement.

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28. See Section 7.4.4.
29. See Section 8.4.2. for a somewhat more generous reaction to requests for knowledge caveats in connection with attorneys' opinions.

7.4.1. Corporate and Stock Matters

This category embraces a variety of representations relating to the corporate organization and capitalization of the seller and its subsidiaries, good title to shares, and the taking of requisite corporate action.

The seller or its stockholders are invariably asked to represent that the seller is a corporation duly organized, validly existing and in good standing under the laws of its state of incorporation, with the corporate power and authority to carry on its business as presently conducted. Similar representations are sought regarding subsidiaries of the seller. The copies of the certificate of incorporation and by-laws of the seller, which have been furnished to the purchaser, are warranted to be complete and correct.[30] There is almost never any negotiation on these matters.

In any transaction involving the seller's stock (including, of course, any merger), seller is asked to make certain representations concerning its capitalization. This includes a declaration as to the number of shares of stock of different classes authorized and presently outstanding; a statement that all outstanding stock is validly issued, fully paid and non-assessable; in the case of a close corporation, an affirmation that all of the outstanding stock is owned by the stockholders who are signing the agreement, in the respective amounts set forth in the agreement or an attached schedule; a warranty that at the closing the purchaser will acquire good and valid title to all of the seller's shares, free and clear of all liens, options, proxies, charges or encumbrances of any nature; and a representation that there are no convertible securities, options or warrants outstanding (except as disclosed) and no other agreements extant with respect to the issuance of stock by the seller. The idea here, of course, is that the purchaser

30. For some reason, however, there is usually no representation with regard to other records of the seller, such as minutes of the meetings of its Board of Directors and stockholders. Under certain circumstances, these could be just as important as the charter and by-laws; and if your investigation reveals such a situation, you should probably get a representation or at least a separate certificate from the officers of the seller as to the accuracy of such documents.

is entitled to assurances that he will end up owning *all* the stock of the seller, which is what he is paying for.

Keep in mind, however, that in a stock purchase transaction, if an outstanding option to purchase shares of the seller in fact exists (which the seller fails to disclose, whether through fraud or inadvertence), the optionee (assuming *his* hands were clean) might well be able to force the company to issue him his stock—in which case, although the purchaser would presumably have rights of indemnification against the selling stockholders, he would not own 100% of the company. If, as purchaser's counsel, you are concerned about that possibility, you might want to structure the transaction as a merger, to preclude any minority shares from rising up to haunt you at a later date.[31]

In an acquisition of stock, the purchaser is likely to ask seller's stockholders[32] to represent that they have good title to the shares being sold, free and clear of all liens, claims and encumbrances. It sometimes happens that, at the time of signing the agreement, a particular stockholder does not have unencumbered title to the shares. They may be pledged to a bank to secure loans made to the corporation (which he has personally guaranteed) or to himself individually; or they may be subject to a stockholders' buy-sell agreement. Typically, the bank lien will not be released prior to the closing, at which time the bank is either paid off or accepts stock of the purchaser in exchange for the seller's shares. Similarly, the parties to the buy-sell agreement will not want to terminate their agreement irrevocably until the closing is actually taking place.

In these cases, the representation of seller's stockholder should state that he has good title to the stock, free and clear of all liens,

31. I am assuming that, either through operation of law or provisions in the plan of merger or option itself, the sole right of the undisclosed optionee after the merger would be to obtain the same consideration per optioned share that seller's stockholders received for each of their shares. If there were contrary provisions in the option agreement, hopefully these would only give rise to a damage claim by the optionee, as to which the purchaser would be held harmless by the seller.
32. See Section 10.2.6. for a discussion of the role of seller's stockholders in the representation process.

claims and encumbrances, *except* the lien of the bank which will be released at the closing, or *except* for the effect of the buy-sell agreement which will be terminated at closing. To enable him to give this warranty without undue risk, the selling stockholder should obtain, prior to signing the agreement, a written commitment from the bank that the lien will be removed at the closing; or, in the case of the buy-sell agreement, the parties should sign a termination document at the same time they sign the acquisition agreement, which document declares that it takes effect upon the closing of the acquisition.[33]

I might say that, representing the seller, I prefer a simpler form of representation—namely, that at the closing the purchaser will acquire good title to the shares, free and clear, etc. My argument to the purchaser is straightforward: since the only way to perfect a security interest in shares under the Uniform Commercial Code is through physical possession, any other security interest that might exist with respect to the shares prior to that time will be cut off by delivery at the closing. But the purchaser's attorney has been known to counter that (i) he wants to know if there are liens on the stock at the time of signing the agreement, so as to be in a position to assess any possible problems this might cause at the closing; and (ii) the delivery might not cut off other encumbrances to clear title that don't rise to the level of a security interest.[34]

33. A similar situation can arise in the case where the seller has, as of the agreement date, outstanding stock options which will be terminated prior to the closing. The seller should be careful to recite the present existence of such options, and then warrant that they will no longer be in existence at the closing.

34. Whether encumbering interests such as irrevocable proxies or voting trust agreements are cut off by transfer of the stock certificates evidencing such shares depends on local corporate law, which of course varies from state to state. The rule in New York is that a proxy may be revoked, notwithstanding a provision making it irrevocable, by a purchaser of shares without knowledge of the proxy's existence unless the proxy and the fact of its irrevocability is noted conspicuously on the face of the certificate representing such shares. N.Y. Bus. Corp. Law § 609(h), (McKinney, Supp. 1974). The question is not settled under

Where the purchaser is acquiring seller's assets, representations concerning seller's capitalization and stock ownership are not particularly significant. The buyer might still want to receive certain representations, however, to assure himself that the people with whom he has been dealing own all of the significant interests in the seller. The idea is to avoid someone coming out of the woodwork at a later date, claiming that his vote was needed to authorize the transaction at the corporate level, or that he is entitled to share in part of the proceeds—and that the purchaser has been a party to a conspiracy to defraud him.

If the seller conducts a multi-state business, one of the more troublesome representations involves qualification to do business as a foreign corporation in all jurisdictions where it is required. Many companies simply do not bother to qualify in certain states, where the necessity for such authorization is at least questionable. Their position is that they are taking a calculated business risk; since the criteria are not clear, and since qualification would subject them to state jurisdiction and taxation, they intend to delay until they are told by the state that they must qualify.

If, representing the purchaser, you sense that the other side is squeamish on this point, it generally pays to have your client make a speech along the following lines;

> "Gentlemen, since we are acquiring your company, we have a common interest here in cooperating. We will probably continue to take the same tack you have been taking in the past, assuming it can be justified, All we want to know are the various factors that have entered into your decision, and an approximation of the possible liabilities involved. Then we will make a judgment. What we *don't* want is to find out after the fact that some existing problems were not disclosed."

Delaware law although at least one commentator has predicated that a Delaware court would probably "improvise along the lines of the New York Statute." E. Folk, The Delaware Corporation Law 234 (1972).

My experience is that if you can get the seller's counsel to talk freely about the problem, the two of you can usually frame a compromise proposal.

The appropriate solution, of course, depends on the specific facts of the situation and upon your client's willingness to acquiesce in the posture traditionally adopted by the seller. The purchaser's principal concerns are that no sizeable past tax liability will surface and that no significant contract will be rendered unenforceable—the inconvenience and future expense of actually having to qualify are a standard risk of the business. One type of compromise is for the seller to warrant that he is qualified to do business in all states in which he owns or leases property or has personnel stationed. This tends to put the matter on a materiality basis and has the effect of excluding the ambiguous states. Another intermediate position that is sometimes taken involves the seller's representation that it can *become* qualified in all jurisdictions where it might need to, without any significant expense or loss to the seller. Neither of these, however, protect the purchaser against the possible unenforceability of contracts. If sales contracts are made outside the seller's home office, or for other reasons the ability to enforce a material contract may depend on qualification in a foreign jurisdiction, the purchaser should obtain a representation that the failure to qualify does not affect the enforceability of any material contract.[35]

In an acquisition involving corporate action on the part of the seller, there is always a representation that the agreement and the acquisition transaction itself have been authorized by all necessary corporate action.[36] Of course, if the seller is publicly-held

35. In any event, you will want to avoid any listing in the agreement or the schedules of the states considered troublesome, which would constitute an open invitation to regulation.

36. If there is any doubt in your mind as to whether seller's counsel knows exactly what corporate action must be taken, then it might be well to spell out in the representation the actual steps involved (*e.g.*, that it has been approved by two-thirds in interest of the seller's stockholders) along with the conclusory statement itself. See also Section 8.4.4. with respect to the attorney's opinion on this and other subjects.

and the agreement is signed prior to the requisite stockholder vote, the representation is made *subject to* that approval.[37] But as a general rule, you should never let the agreement be subject to *Board* approval, since this in effect gives the seller an option; and where the seller is closely-held and has the ability to get both Board *and* stockholders' approval prior to the time the agreement is signed, both should be obtained to avoid the option problem. Typically, there is very little negotiation over this section, since it is obvious to both sides that the transaction must be duly authorized.[38]

7.4.2. Financial Statements and Bring-Down

I have this recurring fantasy—evidently harking back to the days when I underwent constant preparation just in case someone were to ask me: Who is your favorite third baseman? What male vocalist do you like best?—in which my purchaser client says: "We're doing this acquisition, but I've made a deal with the seller that he will only give us *one* representation. Which do you want?" Appropriately forewarned and forearmed, I blurt out my answer with no hesitation: "The financial statements, of course." And I think most acquisition lawyers would agree that this is the key warranty, not only because of the intrinsic importance of the operating results and net worth which the financial statements portray, but also because many of the other representations are subsumed to greater or lesser degrees somewhere in the figures and footnotes. To be sure, we ask for and receive elaborate special warranties regarding liabilities, tax matters, accounts receivable, outstanding shares and so on—but the essence of most of them is right there in the financials.[39]

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37. See Section 8.2.3. for a discussion of the seller's covenant in connection with obtaining such approval, and Section 8.3.2. with regard to the applicable condition.
38. The representation (often thought of as the correlative of authority) that the transaction is not violative of law, charter or agreement is discussed in Section 7.4.7.
39. See, however, the discussion in Section 7.4.3. as to just what additional comfort the specific representations with respect to liabilities and taxes add to that provided by the financial statements.

The language of this representation has become rather stereotyped. In essence, it provides that specified financial statements of the seller as of certain dates and for particular periods, some or all of which have been certified by independent accountants, have been delivered to purchaser; that these financial statements have been prepared in accordance with generally accepted accounting principles, consistently applied; that the balance sheets fairly present the financial condition of the seller as of their respective dates; and that the income statements fairly present the results of operations of the seller for their respective periods.

That is the basic representation which, except in unusual circumstances, every purchaser is entitled to receive. Only rarely does a situation arise where the financial statements have less relevance and the representation can accordingly be more limited. One such instance would be when (i) the purchaser is buying substantially less than all the assets and operations of a division; (ii) the only existing financial statements relate to the entire division; (iii) the accountants claim they can't go back and separate out the figures for the transferred assets; and (iv) everyone says that the overall divisional figures distort what the purchased assets are capable of earning.[40]

Occasionally, the purchaser will ask the seller to represent that the financial statements not only constitute a fair presentation but are "true and correct," or other such terms. My accountant friends have counseled me to resist this language when representing sellers. The auditor's standard of accuracy for financial statements is fair presentation, which I gather may not always rise to the level of truth and other eternal verities. When representing the seller, I always frame my argument on this point in terms of what the accountants have advised; and, rather than quarrel with the

40. In this kind of situation, the purchaser must be aware that the difficulty of creating a viable audit trail for a material acquisition will present problems with the SEC in connection with any registration statement the purchaser may be contemplating during the next several years. See also the analogous problem often present in the purchase of a division of a public company, discussed in Section 13.1.3.

pronouncements of an entire profession, the purchaser's attorney will usually agree to delete the additional language.

Speaking of auditors, the question may well be asked: if you are receiving certified financial statements, with a reputable accounting firm putting its name and reputation (as well as its considerable financial resources and malpractice insurance policy) on the line, why do you need this representation from the seller? The short answer is that if the financial statements are incorrect but the auditors have performed their duties in non-negligent fashion, your only recourse will be against the seller—and thus the necessity for obtaining the requisite warranties.

If for any reason seller's financial statements have deviated from generally accepted accounting principles or have not partaken of the virtue of consistency, the seller must allude to that fact. The qualification can either be set forth in the representation itself or incorporated by reference to the accountants' report.[41] The seller's attorney should always check the accountants' report against the precise language of the representation to determine whether the seller is in a position to make the statements required of him.

Difficult questions are sometimes raised when certain financial statements have not been completed at the signing, but will be delivered prior to the closing. One aspect of this—the interaction with the condition section—has been previously discussed.[42] A different problem is caused when there is a requirement that the financial statements to be delivered must be audited. If this is simply phrased in terms of the financial statements being certified[43] or accompanied by an accountant's report or opinion, seller would be in a good position to argue that the delivery of even a seriously qualified report by the auditors fulfilled the requirement.

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41. For an illustrative negotiation where such a qualification is in issue, see Section 2.3.8. With respect to the subject of qualified options, see H. Sellin, ATTORNEY'S HANDBOOK OF ACCOUNTING (1-34)–(1-41) (1971).
42. See Section 5.3.4.
43. Most accountants nowadays reject the "certified" language (although lawyers continue to use it) in favor of such terms as "reported on" or references to their "opinion."

:cordingly, from the purchaser's viewpoint, the agreement should ɜarly state that what he is expecting is a clean opinion; i.e., an ıqualified report, containing no "except for" or "subject to" servations on fairness of presentation, the use of generally ac- pted accounting principles, or consistency.[44] If the report then ımes in with a qualification, the warranty stating that an un- ıalified report will be delivered is not satisfied, which (depending ı the criteria of the conditions section) may give the purchaser ı out.[45]

Representing the seller, particularly one who has never been ıdited before, you should carefully question the seller's ac- ıuntants in advance to see if they anticipate any problem. If, r example, the seller is the defendant in a substantial lawsuit ıat may cause the accountants to render a "subject to" opinion, is simple enough to spell out that specific qualification in the presentation. The purchaser will presumably not balk, since he ıows all about the lawsuit anyway; and the seller will have ʼoided giving the purchaser the right to terminate when the re- ɔrt comes in qualified, as predicted.

The real negotiating problems arise in connection with un- ıdited financial statements. In some acquisitions, unaudited atements are all you get; in others, there is a mix (e.g., where ıe most recent six months are unaudited, although all prior an- ıal periods are audited). At times, unaudited statements are de- ʋered before the agreement is signed, with audited statements ı follow prior to the closing. Or, the audited statements may be elivered prior to the signing, with an unaudited stub period to be ıpplied before closing. The key question in all such cases is: what

l. In this regard, see also the discussion of accountants' comfort letters in Section 8.3.3.

ɔ. Since this commitment to deliver is usually set forth in the representations section, failure to provide the unqualified report could also theoretically be regarded as a breach of contract entitling the purchaser to damages. For some reason, sellers rarely ask for the obligation to be shifted to a best efforts covenant (see Section 8.2.1.) which (coupled with an appropriate condition) would still furnish the purchaser with an out for non-delivery but would not give rise to a damage action.

representations should be made with respect to the unaudited statements?[46]

I think it is entirely proper for the purchaser to ask the seller, in the first instance, for exactly the same representations with respect to the unaudited statements that he is seeking with respect to the audited reports. It is then up to the seller's counsel to review his client's unaudited statements with his accounting personnel and outside auditors to determine what can safely be said about them.

As a threshold issue, in referring to unaudited statements covering less than a full year, most sellers will seek to include language indicating that the presentation is subject to year-end audit adjustments. From the purchaser's viewpoint, this opens the door much too wide. If he goes along with the concept of adjustments, the buyer should at least insist on adding a statement that any such adjustments would be of the normal, recurring type, and would not be material in the aggregate.

The real question for the seller, however, is whether it can properly be said that the unaudited statements (whether for a full fiscal year or a shorter period) fairly present the financial condition or results of operations of the company, and have been prepared on the basis of generally accepted accounting principles, consistently applied. If, for example, the unaudited statements do not contain the kind of intricate footnotes to balance sheets and income statements which appear in typical audited statements, I am always nervous about letting the seller make the full-blown representation—since accountants evidently deem such notes as essential to a fair presentation. Similarly, unless an outside auditor has been involved, there is always a question as to whether all proper accruals have been included.

Of course, the negative aspect of raising this issue from the seller's viewpoint is the possibility that it may alert the purchaser

46. In Section 5.3.4., there is a discussion of the interaction of representations regarding unaudited financial statements delivered prior to signing with audited statements delivered after signing, with particular reference to the conditions and indemnification articles of the agreement.

to problems which he might otherwise have overlooked—or, even worse, the apparent unreliability of the figures (as evidenced by the seller's concern with giving the usual warranty) could frighten the purchaser sufficiently to cause him not to proceed with the acquisition. So, the decision to tamper with this representation is not one the seller or his attorney should make frivolously, or simply to drive a hard bargain.

As purchaser's counsel, my view is that you can't ask the seller to represent more than he feels he can properly say. If his numbers are unreliable, and the seller tells you so, then you should not force him to warrant their reliability. It then devolves upon the purchaser's own financial people to satisfy themselves about the figures, through their own investigation. If they are not satisfied with what they find, then the transaction should probably be abandoned or at least postponed until an audit can be performed.

One thing the purchaser can always ask for, however, is protection against fraud. No matter how disorganized the numbers, the seller should be made to represent, as a bare minimum, that the figures in the financial statements have been taken from the books and records of the seller and represent actual, bona fide transactions. In addition, you can sometimes get piecemeal representations that may be helpful; e.g., that revenues from sales are as stated, or that overhead doesn't exceed a certain dollar limit.

Since the most recent financial statements referred to in the agreement are generally as of a date which is prior to the date of the agreement, the purchaser must ask the seller to make certain representations concerning the period between the latest balance sheet and the signing date.[47] At one extreme, some purchasers are satisfied with a general representation that, since the date of the financial statements, there has been no material adverse change in the financial condition or results of operations of the purchaser. Other purchasers, however, feeling that this is too vague a standard to be enforced, prefer to go into a great deal more detail, utilizing a multi-paragraph representation typically entitled "Absence of Certain Changes"—which states that, except as set forth

47. In this regard, see also Section 5.3.1.—*Representations*.

in the disclosure schedule, no events of certain kinds have occurred since the date of the latest audited financial statements. Usually, these are similar to the events proscribed by the article entitled "Covenants Pending the Closing,"[48] dealing with such matters (in addition to material adverse changes) as incurring material obligations or liabilities other than in the ordinary course of business, paying liens or encumbrances, permitting assets to be subjected to liens, cancelling debts, waiving rights, transferring any properties except in the ordinary course of business, granting general uniform increases in compensation of employees, making capital expenditures, paying dividends, redeeming stock, changing accounting practice, paying any amounts (other than salary) to the stockholders, or agreeing to take any of these actions. The only limitations on the litany of occurrences are the ingenuity and patience of buyer's lawyer.

Should you be precise or general? It really depends on what the purchaser wants to know and in how much detail. In most acquisitions of private companies, purchasers' lawyers tend to ask for the works, while in larger public deals a more restrained approach is often in evidence—although neither of these reactions is invariable. The main factor in the decision might be the period of time that has elapsed since the last audited financial statements; the longer it is, the more the purchaser probably needs the itemized information.

If the representation is kept simple, it should still cover two different aspects: (i) that since the balance sheet date there has been no material adverse change in specified categories (such as financial condition, results of operations, assets, liabilities, business and—if you can get away with it—prospects), with perhaps some quantification and specificity as to certain changes that you deem automatically materially adverse (e.g., any fiscal quarter in which a loss is incurred); and (ii) that since such date there have not been *any* changes in such categories except in the ordinary course of business or as disclosed in the schedule (or proxy statement, if applicable). In this way, the buyer is more likely to dis-

48. See Sections 5.3.1.—*Covenants* and 8.2.3.

cover non-recurring and extraordinary items, even if they don't rise to the level of being materially adverse.

One final aspect of this point. The phrasing of both the detailed and the simple representation ought to be that "since December 31, 1972, seller has not" done or experienced these things; it should *not* read "since December 31, 1972 and up to the date of the agreement. . . ." Inasmuch as this representation is updated as a condition of closing, it follows that by not inserting a current cut-off date, the entire period up to the time of closing is subsumed —so that an event occurring after the agreement date might still trigger the purchaser's closing condition.[49]

7.4.3. Liabilities and Taxes

Most acquisition agreements contain specific representations regarding liabilities and taxes of the seller, even though the financial statement warranty covers much of the same ground. The purpose of these representations is to provide an extra degree of comfort in two troublesome areas where a careless purchaser can get taken to the cleaners.

The representation concerning liabilities usually states in substance that except to the extent reflected, reserved against or given effect in the latest balance sheet, or as set forth in the disclosure schedule, the seller had no liabilities of any nature as of the date of the balance sheet, whether absolute, accrued, contingent or otherwise; and that since the date of the balance sheet, the seller has incurred no liabilities other than in the ordinary course of business and consistent with past practice. If a balance sheet is

49. If the event is one within the control of the seller (such as the payment of a proscribed dividend), then its occurrence will presumably also constitute a violation of a covenant pending closing—which in turn will violate the condition to the purchaser's obligation that all such covenants shall have been complied with prior to the closing (see Section 5.3.1.—*Conditions*). If it is not within seller's control, however (such as the rendering of a judicial judgment against the company), then it may not be picked up in the covenants section and accordingly would probably not contravene a condition to purchaser's obligation (other than through the bring-down provision) unless specifically referred to in the conditions article.

to be delivered subsequent to signing the agreement, the representation should add that all liabilities incurred and not paid prior to the date of that balance sheet will be reflected in it.

In many cases, there is simply no negotiation over this basic provision. At other times, sellers attempt to introduce materiality and knowledge caveats,[50] an approach which usually leads to some lively discussion; the "basket" provision,[51] eliminating from indemnification small claims under a certain aggregate figure, will often emerge as a compromise solution. For their part, purchasers' attorneys can generate a great deal of heat if they append a representation that the seller's stockholders know of no basis for the assertion against the seller of any liabilities or obligations not adequately reflected or reserved against in the balance sheet or set forth in the disclosure schedule.

I'm not sure I know why sellers and their attorneys sometimes oppose this letter clause so vigorously, when the entire provision is designed to go one step beyond that and hold the seller responsible for an *unasserted* liability relating to the period prior to the balance sheet, whether or not the seller knows of *any* basis for its assertion at the time he signs the agreement.[52] This, after all, is the principal respect in which the liabilities representation supplements the balance sheet warranty; that is to say, a balance

50. See Section 7.3.
51. See Section 10.2.1.
52. In this connection, if appropriate in the particular deal, you should consider including a specific clause on the potential liability of the seller for warranties it has made on goods previously sold. This can be handled in various ways: a representation by seller that its reserves for warranty claims in the balance sheet are adequate to cover all potential claims; a representation, referring to the disclosure schedule, that to its knowledge only the disclosed claims have been asserted against seller for breach of warranty; or perhaps an agreement by seller to indemnify the purchaser for all warranty claims in excess of a certain amount. In negotiating on these points, purchaser should keep in mind that, with respect to the claimant, purchaser will probably attempt to satisfy all claims to preserve the goodwill of the ongoing business, notwithstanding the arrangement between seller and purchaser. The related subject of product liability is usually handled by making sure there is adequate insurance to cover all possible claims. See Business Acquisitions, at 155-56.

sheet which does not reflect a claim that has not yet been made and which the company has no basis to believe will be asserted, presumably fairly presents the company's financial condition. Nevertheless, if seller has in mind a particular liability that could conceivably be asserted by a third party, his attorney might want to delete this portion of the representation so as to obviate the need for pre-signing disclosure and to eliminate the possibility that, if the claim were to be asserted prior to the closing, its non-disclosure (regardless of its ultimate merits) would furnish the purchaser with an out.

In order to respond to this particular representation, the seller's counsel has to meet with seller's accounting personnel and independent auditors to ascertain if any liabilities—even immaterial, contingent ones—have been ommitted from the financial statements and footnotes. Any such omissions ought to be listed on the disclosure schedule, so that the purchaser will not be entitled to seek indemnification from the seller when the liabilities ultimately have to be paid. Items of obligation that don't quite rise to the stature of an "accrued liability" for balance sheet purposes, but which could be so deemed under a more generous interpretation, should also be listed.

Remember that in an assets ("C"-type) deal, where the purchaser is assuming only specified liabilities, there is less emphasis upon the seller's representation as to liabilities, and more concern with the purchaser's instrument of assumption.[53] If this undertaking document is properly limited in scope, the buyer will not be burdened with undisclosed liabilities, even where there has been a misrepresentation.[54]

A troublesome problem with both the representation as to liabilities and any undertaking is that awkward period *subsequent to* the latest balance sheet. There is really no systematic method of pinning down what happens during those crucial weeks and months, and unfortunately such phrases as "in the ordinary course

53. See Sections 4.6.1. and 11.1.3.
54. But see Section 4.6.1. for instances in which the purchaser of assets may be deemed to assume certain liabilities unwittingly.

of business"—even when narrowed by such caveats as "consistent with past practice"—can encompass a multitude of sins. It may be that the purchaser will want to introduce the concept of a dollar ceiling on liabilities incurred since the last balance sheet, or ask the seller to represent that the amount does not exceed those incurred during the comparable period of the prior year, in order to limit the purchaser's risk.

The tax representation sought by the purchaser, in acquisitions where he is buying stock or otherwise falling heir to seller's tax problems, usually calls for statements along the following lines: seller had duly filed all tax returns required to be filed; he has paid all taxes due or claimed to be due from federal, state or local taxing authorities (including taxes on properties, income, franchises, licenses, sales and payrolls); seller's Federal income tax returns have been audited by the IRS through a certain date; all taxes determined or claimed to be due with respect to such periods have been paid and all tax liabilities to which the properties of seller may be subject have been discharged; the results of such audits are properly reflected in the financial statements; the reserves for taxes contained in the latest balance sheet of seller are adequate to cover his tax liabilities as of that date; there are no tax liens upon any of seller's property; there are no pending tax examinations nor tax claims asserted, and (if you can get it) there is no basis for any claim; seller has not granted any extension of the limitation period applicable to tax claims; and (in an acquisition of stock) seller has never filed a consent under section 341(f) of the Code relating to collapsible corporations.

Well, if this all sounds like so much overkill, the purchasers' attorneys can be forgiven. Let's face it, in the event the seller has a skeleton to hide, it's a good bet that here is the closet.

If you start with the view that the seller is responsible for what has occurred prior to the transaction and is supposed to deliver a company with no hidden liabilities,[55] then you can see what a disadvantage seller's counsel is usually at in negotiating the basic substance of the tax representation with any real fervor. Yet if

55. See the discussion in Section 5.4.

he does nothing, the seller is, in effect, a guarantor of all prior tax liabilities under the broad language of the representations sought by the purchaser. Accordingly, there are certain tactical decisions that the seller may have to consider.

Where the situation is that seller has not paid a clearly due tax, I believe that this must be disclosed to the purchaser, no matter how it is treated in the seller's financial statements; seller's counsel cannot put himself in the position of participating (even through acquiescence) in a deliberate deception of purchaser. Where there are current discussions being held with the IRS concerning outstanding problems, I feel that here too these issues should be disclosed to the purchaser, for practical as well as ethical reasons. It may be that a reserve will already have been set up for such matters in the financial statements; if not, once disclosed (and assuming they are not *too* material), seller can provide an appropriate reserve and insist that purchaser take subject to them. If, however, seller stays mum, purchaser has every right to seek indemnity when he discovers the problem (as he will) a few days after the closing.

More difficult questions are presented by the existence of potential tax problems which have not yet been raised by the Service and where the possible liability is unclear. A typical example is the seller's potential liability for the penalty tax on accumulated income[56] with respect to certain years which the IRS has not yet audited. On the one hand, you can say nothing to the purchaser and hope the IRS will never raise the point; but if a tax ultimately becomes due, it will then clearly be the seller's responsibility. On the other hand, you can bring the matter to the purchaser's attention, and adopt the posture that he will have to take his chances

56. Sections 531-537 of the Internal Revenue Code of 1954 impose a substantial additional tax on corporations used for the purpose of avoiding income taxes on their shareholders by accumulating earnings "beyond the reasonable needs of the business" instead of distributing them. The apparent position of the IRS is that the tax should be assessed if the amount of retained earnings exceeds the needs of the corporation in connection with specific projects plus the liquidity needed for one complete business cycle.

on this score; your risk here is not so much that the purchaser will nevertheless insist on indemnification[57] (since if you said nothing he would be entitled to it anyway), but that he will get cold feet for the deal as a result of the disclosure.

Representing the seller, my usual preference in the accumulated income situation is to take the latter course.[58] I find that the existence of this potential liability will almost never sour the deal, or even cause any renegotiation of the terms. Somehow the penalty nature of this tax, and the absence of any sense of wrongdoing with respect to the seller's conduct, make it easier to sell this approach to purchasers.[59] With other tax problems, however, there is no clear-cut answer. The decision usually turns on the apparent strength of the seller's bargaining position at that particular time, or the magnitude of the problem, or the likelihood of the IRS raising the point.

Some sellers take a different, bolder tack along the following lines:

> "Look, we've been taking a lot of edges in our income tax returns—on business entertainment, writing off expenses that arguably should have been capitalized, etc.—the same as you have and everyone else has. Presumably, you'll want to continue to take the same edges with our tax returns for periods after the acquisition. It's to everybody's advantage that we've done this in the past, and it would adversely affect your income if you tried to change the practice in years under your control. Here are our books; here are our tax returns; let your accountants look at them and satisfy yourself that we've done noth-

57. If this happens, you might still be able to swap that result for something else. See Section 4.8.2. with respect to the kind of problem that can be raised with respect to subsequent depreciation recapture.
58. This decision, however—as with all decisions to disclose matters that are not required to be disclosed by the agreement and which can have adverse consequences—should always be made by the client.
59. As a matter of face-saving, purchaser's experts will sometimes take the position that they recognized the problem all along, but weren't bothered by it.

ing really wrong. But you're going to have to acquire us subject to the possibility that the IRS will raise some questions down the road. We won't indemnify you."

'his approach, while possessing a certain refreshing candor, apparently enjoys only limited success.

Sellers' attorneys generally argue against inclusion in the tax epresentation of the clause stating that "there is no basis for any :laim" against seller. You almost never hear a really good, coierent argument on this point; it is simply (with a wave of the ıand): "Who knows what basis the IRS may assert for a claim? :t's simply not a fact within our knowledge. You look at our reurns and decide for yourselves." Since the warranty that the balınce sheet reserves are adequate to cover all tax liabilities makes :he seller, in effect, an absolute guarantor of prior taxes, the only purpose of excluding this "no basis" representation (as with the :omparable provision regarding liabilities discussed earlier in this section) is to avoid the necessity of disclosing the seller's fears about his past tax returns. But as the seller's lawyer, you should be aware that your negative reaction to this representation may well have the affect of arousing the purchaser's suspicions; and therefore it might be better not to raise the point unless your client does have some specific worries that he would rather not see publicly explored.

If there is an item of disclosed potential tax liability which the purchaser has agreed to take subject to, the question often arises of how to handle this in the agreement to avoid alerting the IRS to the problem (assuming, as you should, that the Service will obtain a copy of the agreement).[60] Some fertile minds have labored mightily over this sticky wicket, torn between not acting in an unethical fashion but at the same time not volunteering more information than is absolutely necessary. In the accumulated in-

60. If nothing is said, the seller has no protection against the purchaser later asserting a right of indemnity if and when the IRS raises the point. For a discussion of how taxes are handled generally in the indemnification article, see Section 10.2.2.

come tax situation, for example, it might be possible to limit the reference to tax liabilities (in the clause affirming that the tax reserves adequately cover such liabilities) to those imposed by Subchapters A and O of Chapter 1 of the Internal Revenue Code (the ordinary income and capital gains sections), thereby excluding by negative inference matters arising under the accumulated income penalty tax section without directly focusing on the problem.

There is one approach to this sort of problem that is sometimes utilized, where the attorneys for the respective parties exchange letters mutually interpreting the agreement on a particular point; e.g., that a certain arguable contingency is not intended to be covered by the applicable representation. They then take the position that these letters are not part and parcel of the agreement and thus, for example, need not be submitted to the IRS examiner. This presents legal, practical and ethical questions. It is certainly debatable whether the parties are legally bound by this exchange of lawyers' letters, and thus the use of this device ought to be limited in the first instance to situations where the parties trust each other's word and their lawyers enjoy mutual professional respect. Moreover, such an approach is proper only where the matter involved is truly ambiguous and subject to interpretation. It is definitely *not* appropriate for calling black "white" or for providing an exception where no interpretative question exists; in those situations, the exchange of letters could be considered to rise to the level of a *de facto* amendment of the agreement, which should then be produced to the examiner along with the agreement itself.

If you are purchasing assets of the seller, you obviously do not need all this detail concerning the seller's tax problems (although some purchasers' attorneys, out of habit, continue to ask for the same things). What you must principally be concerned about is that there is no transferee liability that the IRS can assert against the purchaser. Since there is no transferee liability without a tax lien,[61] your representation can be limited to the non-existence of

61. Int. Rev. Code of 1954, § 6323.

any such liens. You might also want to know whether there are any pending or threatened tax questions that may have the effect of reducing future income below the level reported in the seller's historical financial statements.

7.4.4. Asset Representations

The purchaser almost always asks for a series of warranties concerning the various assets of the seller—real property, machinery and equipment, inventory, accounts receivable, and intangibles such as patents, trademarks, trade names and copyrights. I don't intend to get into all the nuances of these representations, but some obvious points on which purchasers want assurances include: that the seller has good title to its real and personal properties, without any undisclosed liens or encumbrances (other than liens for current taxes not yet due, and perhaps minor imperfections of title or encumbrances that do not materially detract from the value of the property or impair operations); that the title insurance in force is adequate; that the carrying value of such assets on the balance sheet is not grossly overstated; that the seller has not received notification (nor has he knowledge) that he is in violation of building, zoning or other laws or regulations; that the inventory consists of a quality and quantity usable and saleable in the ordinary course of seller's business; that the accounts receivable are good; and that the intangibles are valid. If the seller is transferring assets, there must be appropriate warranties regarding the good title that purchaser will receive to all these assets at the closing.

On the subject of good title to property, the seller's attorney may well refuse to give you any legal opinions (stating that, with respect to real property, you should rely on title insurance, and as far as personal property is concerned, [*haughtily*] "I'm not in the habit of giving such opinions"), and you may well go along with him on that score[62]—but you must nevertheless insist on a flat representation. Don't let this become a "knowledge" situation. If there is a title impediment, the seller should bear the loss, regardless of whether he knew of the problem or not.

62. See Section 8.4.2.

On the other hand, sellers seem to have a good deal of success at introducing a "knowledge" criterion into the representations regarding intangibles. These usually get into the seller's competitive situation, and the purchaser likes to ask for assurances that no one can produce similar products, or use similar trade names, or restrain seller from any aspect of his business anywhere. I find that sellers and their attorneys can really wax emotional on this one: "Who knows what may be out there in the hinterlands, lying in wait for us? All I can tell you is, no one has ever given us the slightest amount of trouble." This often ends up in a compromise where the seller represents without qualification that he can continue to do what he's been doing where he's been doing it—but as far as third parties having any rights, the warranty is based on the seller's knowledge.

Sellers will often resist representations concerning the physical condition of fixed assets: "The machines are out there in the plant and they're running; you look at them and make up your own mind." The purchaser's reaction should depend on how important the equipment is to the business, and how expert an assessment he and his people are in a position to make.

The seller may be asked to represent that the fair market or replacement values of the various items of personal property are at least as great as their carrying values on the seller's balance sheet. This sometimes causes quite a squabble. Representing the seller, if you can't get the warranty deleted entirely, at least insist that it be made on an aggregate basis; your argument is that some assets may be overstated and some understated, but the purchaser should certainly be satisfied if the aggregate actual value exceeds the total book value.[63]

Inventory[64] is one item that the lawyer should not attempt to handle alone; he very definitely needs the inputs of the businessman and accountant. Such matters as inventory pricing, the method of accounting, the treatment of obsolescent items, the tax implications of these matters, the manner of handling finished

63. See Section 10.2.4. for a similar netting concept sellers sometimes attempt to introduce into the indemnification area.

64. See BUSINESS ACQUISITIONS, at 151.

and semi-finished goods, and the profit potential—these require an expert hand to frame the warranty to the existing situation.

The purchaser is entitled to a representation that the seller's accounts receivable are current and collectible at their recorded amounts, net of any reserve for doubtful accounts. As noted previously,[65] this representation should not be made "to the knowledge of the seller," but ought to be unqualified; if it turns out that some accounts prove uncollectible, the purchaser is entitled to indemnification. It has been suggested that merely to warrant the collectibility of the receivables may not be sufficient, and that the seller should be asked for a specific guarantee of their ultimate payment.[66] If, representing the purchaser, you decide to be verbose on this point, then you should provide that after a designated period of time the uncollected amount becomes automatically payable by the seller to the purchaser; that purchaser should not be required to institute legal proceedings to collect the receivables; and that purchaser should be empowered, in the exercise of his reasonable judgment, to settle or compromise accounts and charge seller with the difference.[67] My usual inclination is not to gild the lily here, but just try to slip the warranty through with as little fuss as possible.[68]

A representation geared to receivables on a three month-old balance sheet might not prove of much comfort to the purchaser. Many of the balance sheet receivables will have been collected by the time the agreement is signed, and more of them will no longer

65. See Section 7.3.2.

66. See Business Acquisitions, at 150. I gather the argument is that the warranty can be read to mean collectible on the date the representation is made—not the date when the receivable goes bad—a position to which I do not subscribe.

67. Buyer should also be willing to provide that any uncollected accounts (with respect to which seller's indemnity comes into play) should be turned over to seller (if he wants them) for collection, since he has, in effect, "bought" them.

68. Otherwise the seller is likely to be jogged into making the entirely reasonable (but unacceptable) argument that the reserve for uncollectible accounts, assuming it has been computed on a reasonable basis, should act as a substitute for the guarantee; i.e., a balance sheet approach.

exist by the time of the closing—while the post-balance sheet receivables to which purchaser actually succeeds at the closing may be seriously in default. If receivables loom large in the acquisition, you should consider the desirability of keying the warranty to those receivables which are in existence at the time of the agreement or the closing.

Where an unaudited balance sheet is furnished prior to the agreement, with an audited balance sheet (as of a subsequent date) to be delivered prior to the closing, the purchaser's attorney should try for the daily double; i.e., the receivables reflected in seller's unaudited balance sheet are, and those to be reflected in the audited balance sheet will be, current and collectible. The seller's lawyer will presumably try to keep the purchaser from having it both ways, and may suggest the following compromise: let the representation as to receivables on the unaudited balance sheet be usable by the purchaser as a condition of closing, but peg the ongoing representation (that survives the closing and furnishes the basis for indemnification) to the receivables in the audited balance sheet.[69] This might bother purchaser, though, since it furnishes seller with an incentive to increase his bad debt reserve in the post-signing audited balance sheet and thereby limit his potential liability. Accordingly, purchaser's attorney should insist on a proviso requiring the audited reserve to be consistent with past practice or not to exceed a certain dollar level; and to the extent it is inconsistent or excessive, full indemnification would come into play notwithstanding the increased reserve.

7.4.5. Leases, Contracts and Other Commitments

There are generally a series of seller's representations involving leases, contracts and the like. The purchaser, who wants to know what commitments he is inheriting when he buys the seller's stock or merges, asks the seller to make a list in the disclosure schedule, with enough descriptive material so that the purchaser can decide how much effort to expend on examining the actual

69. In Section 5:3.4. there is an analysis of a similar compromise with respect to financial statements generally.

documents. Then purchaser calls on the seller to represent that the leases and contracts are valid and in full force and effect, that neither party is in default, and that the instruments will continue to be binding in accordance with their terms after consummation of the acquisition.

These are the basic items, but the scope of representations regarding contractual matters can be quite broad, depending on the particular situation. As an example of the kind of information that it's possible to derive, the purchaser may ask for representations (i) that none of seller's agreements will result in a loss to the seller upon completion of performance, and (ii) that no purchase commitments are in excess of the normal requirements of the business or at an excessive price. This kind of warranty, however, really makes sellers' lawyers squirm, and such provisions cannot be expected to pass without comment.

From the seller's point of view, the principal negotiation in this area often revolves around whether some of the contracts can be ignored and not scheduled. The seller's counsel always pleads hardship: "He's got a million dinky little contracts in the file drawers; if I have to list and describe them all, we'll be here till Christmas." Purchaser's counsel should be prepared to adopt a reasonable position on this, consistent with not missing anything of real importance.[70] If, for example, there are numerous contracts involving small amounts, and the purchaser can satisfy himself as to their overall insignificance, a disclosure cut-off can be inserted in the representation—either in terms of the ability of the seller to cancel the contract on short notice, or in terms of the dollar amount involved, or both.

Seller sometimes argues: "I don't *think* there are any defaults under these agreements; I'm not aware of any; but I haven't checked through the terms of each one and the performance figures, so I couldn't swear to it." A compromise here, to which most sellers are agreeable, is to make some distinctions as to the possible defaults being covered. The seller should say that *he* is not in default, without any qualification; that to his knowledge,

70. In this regard, see the discussion in Sections 7.2.1., 7.2.2. and 7.3.1.

there is no basis for the other party to assert a default on the part of seller; and that to his knowledge, the other party is not in default.

Occasionally a seller's counsel will balk at allowing the seller to give a flat warranty that certain contracts are enforceable in accordance with their terms. In addition to the line of reasoning regarding the inapplicability of specific performance (discussed below[71]), the argument may be raised that whether or not a particular contract is enforceable is unclear due to the impact of, say, the anti-trust laws.[72] If there is a reasonable doubt, and the purchaser is prepared to accept the ongoing business risk, then the representation can be phrased in terms of the contract being enforceable to the best knowledge of the seller, based upon an appropriate opinion of counsel. The problem here is that if singling out a particular agreement or type of contract for such treatment were to become public knowledge, it might encourage the other party to the contract to evade his responsibilities. So you sometimes have to be a little devious in phrasing matters to avoid this spotlighting effect—perhaps referring to "certain contracts identified in a letter from seller's counsel."

The most abrasive questions can be raised about the business aspects of commitments; e.g., that they won't result in a loss, are not in excess of the company's normal requirements, etc. I generally step out of the way and let the businessmen slug these points out. But I must say that the insertion of such representations in the purchaser's first draft of the agreement—even if they ultimately disappear after extended negotiation—can be of great value in smoking out trouble spots on seller's business horizon.

7.4.6. Representations Concerning Employees

Most purchasers ask for certain representations covering seller's employees. One of the most significant of these, in the area of fringe benefit obligations of the seller, is the matter of pension

71. See Section 8.4.4.
72. This is an analogue to the question of possible violations of law, discussed in Section 7.4.7.

›lan liabilities and particularly any responsibility which the pur- :haser may be assuming for unfunded past service liability. This :an be an extremely complex subject, beyond the scope of the ›ook.[73] If there appears to be a problem in this area, it may be de- ;irable to consult an expert in the field to evaluate the risks for the ›urchaser and to help formulate the requisite representations. If the pension plan situation does not appear unusual, a repre- ;entation to the effect that the balance sheet accurately sets forth past service liability of the seller arising from any pension plans presently in operation may be sufficient.[74]

Other employee-related areas that might be covered by appro- priate representations include employment contracts, commission or bonus arrangements,[75] recent salary increases, loans to employ- ees, compliance with occupational safety laws, severence or ter- mination pay liabilities and other fringe benefit obligations. In this connection, make sure that *all* bonus and other employee fringe benefit plans or special deals—whether written or oral, whether legally binding or not—have been unearthed. Unlike other types of non-binding commitments which the purchaser can choose to ignore when he takes over, he will probably have to live up to the terms of these deals if he wants to retain the same employees without undue damage to morale.

With respect to labor relations, in addition to disclosure of the applicable union contracts (which ought to be reviewed by an attorney familiar with the issues of labor law), there should always be a representation as to the absence of any labor diffi-

73. See PRACTICE UNDER THE NEW PENSION REFORM LEGISLATION (M. Caplin, ed., New York Law Journal 1974).

74. The related question of compliance with the recently enacted Pension Reform Act of 1974 will likely be an issue in years to come. Because the Act establishes different compliance deadlines for various aspects of pension plans, all that a buyer can reasonably ask for at the present time is a warranty that neither the seller nor the plan is in violation of the Act at the date of closing. However, a thorough review of the seller's plan is necessary to insure that the buyer does not fail to take required actions under the Act subsequent to the closing.

75. In cases where there is a substantial number of sales agents, a lengthy list is sometimes avoided by requiring disclosure only of commission arrangements not cancellable on 30 days' notice.

culties in recent years. Not unreasonably, sellers sometimes ask for more precision in the language—limiting it to general strikes, large-scale grievances or alleged unfair labor practices—so as to exclude the occasional minor pecadillo. In cases where the seller is not a party to a labor agreement, purchaser may want to include warranties concerning the absence of labor organization activity and requests by employees for union representation.

If a purchaser of assets desires to avoid assuming a labor contract, he should obtain a representation from the seller to the effect that such contract will not be binding on the purchaser, either by its terms or by operation of law. In addition, of course, the sections of the acquisition agreement should expressely provide for the purchaser's non-assumption and for indemnification in the event an attempt is made by the union to saddle the purchaser with any such responsibility.

7.4.7. Litigation and Compliance With Law, Etc.

I am grouping together under this heading several separate but related concepts. In any acquisition, the purchaser is entitled to know (i) what litigation of the seller is pending or has been threatened, (ii) that the seller's business has been conducted in accordance with all legal requirements, (iii) whether anyone has brought or threatened any litigation over the pending acquisition, and (iv) that the acquisition won't violate any laws to which the seller is subject, or its charter, or any agreements by which it is bound.

We have already discussed how litigation is handled in the disclosure schedule,[76] and what happens when there is litigation occurring after the agreement but prior to the closing.[77] Seller usually takes the position that he cannot predict the outcome of litigation; he will disclose its existence, take a reserve for it on his financial statement if his auditors think it appropriate, and then let purchaser take subject to its outcome. In most cases, where the litigation is in the ordinary course, this is the way it goes. If,

76. See Section 7.2.2.
77. See Section 5.3.2.

however, there is some particular item of substantial litigation, the risk of which purchaser is not willing to assume, then purchaser might demand to be indemnified against an adverse result notwithstanding full disclosure.[78]

Purchaser usually asks the seller to warrant that he has complied with all aspects of applicable law (federal, state and local) in the conduct of his business. Seller often demurs on both a materiality and knowledge basis ("Oh, come on, everyone violates some minor law unknowingly once in a while; you should see all the regulations we're subject to. . . ."). The resulting representation can go four ways: (i) flat compliance with all laws, (ii) knowledge compliance with all laws, (iii) flat compliance with all material laws, or (iv) knowledge compliance with all material laws. Tenacity[79] and the ability to marshal arguments,[80] as well as the particular facts of the case, usually dictate the outcome.

Anti-trust considerations sometimes cause difficult problems, both in terms of the seller's business as conducted (for example, possible Robinson-Patman Act problems) and with respect to the consummation of the transaction (violation of the Clayton Act). If there is a serious anti-trust question, sellers often refuse to give these warranties in their broadest form. The seller argues (and with some merit, at least with respect to the acquisition aspect) that the purchaser is in possession of all the facts relevant to anti-trust (particularly facts regarding the purchaser *itself*, which the seller does not know), and should take the anti-trust risk rather than attempt to lean on the seller's representation.

The purchaser is usually agreeable to this, insofar as the acquisition itself is concerned; the main focus is on the terms of the condition to the parties' obligation to close.[81] With respect to past practice, though, the purchaser will often take a harder line—particularly where possible treble damage actions might result

78. See the discussion on this point in Sections 5.3.2. and 10.1.1. *See also* the analysis of the litigation opinion in Section 8.4.3.
79. See Section 2.3.1.
80. See Section 2.2.3.
81. In this regard, see the discussion of the attorney's litigation opinion in Section 8.4.3.

from the seller's conduct. The trick in either case is how to word the provision so that anti-trust is read out of the representation, without excluding important warranty aspects (such as compliance with other laws) *or* alerting the Justice Department or Federal Trade Commission to your sensitivity about the problem.[82]

In addition to no-violation-of-law, the seller is always asked to represent that the transaction will not controvert the seller's certificate of incorporation or by-laws, or breach any agreements to which it is a party or by which it is bound, or cause the acceleration of any of its indebtedness, and so forth. There is generally little negotiation here; the seller's lawyer usually saves his ammunition for the correlative legal opinion he will be called upon to render.[83] If consents are required to be obtained to avoid violating a certain agreement[84] (such as a bank loan), the purchaser is entitled to knowledge of these by means of the representation, in order to frame the requisite covenants and conditions[85] and to reach his own judgment as to the likelihood of the deal ultimately closing. So the representation is usually worded that, upon receipt of consents from ABC Bank and XYZ Vendor,[86] performance of the acquisition agreement will not constitute a violation of any contracts, etc.

7.4.8. A Mixed Bag of Warranties

In addition to the basic areas covered in the preceding sections, representations can and do cover a variety of other matters—those special concerns of the purchaser or his counsel. Does the seller have adequate insurance? Where are his bank accounts? Has he given any powers of attorney? And so on. In representing a par-

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82. See the analogous discussion with respect to taxes in Section 7.4.3.
83. See Section 8.4.2.
84. See Sections 5.3.1.—*Representations* and 12.3.
85. See Sections 8.2.1. and 8.3.1.
86. If these are numerous, or should you prefer not to use names in the agreement, reference can be made to the required consents listed in the disclosure schedule. In this regard, see Section 7.2.2.

ticular purchaser for the first time, it is wise to furnish him with your standard list of seller's represensations and inquire if there are any other areas in which he desires information or assurance.

Then there are certain warranties which are dictated by aspects of the particular deal. If, for example, a proxy statement or registration statement or other formal disclosure document is utilized, its contents should be covered by a no-misrepresentations, no-omissions warranty.[87] In addition, you are well advised to devise a special set of representations for certain types of companies being acquired, where important information may not be picked up by the usual provisions. For example, in a recent acquisition of an insurance company, our side requested very particularized warranties regarding such matters as the Annual Statements that insurance companies file with regulatory authorities, reports of examinations by the Commissioner and the company's response to asserted deficiencies, agents and the agency relationships, unpaid claims, reinsurance treaties, service contracts, statutory reserves and so forth.[88] The substance of these special items can best be developed in conjunction with your client or others possessing know-how in the field of seller's operations.

Always make sure to include a representation to the effect that the selling stockholders do not have any direct or indirect interest in any other companies which either compete with the seller,[89] or have had business dealings with the seller. Obviously you don't want to be facing competition from the seller's stockholders immediately after taking over their business. But the other part of the representation is equally important. If, for instance, the seller has been leasing space from a related corporation at a rental substantially below fair market value, this may have had the effect

87. See Sections 5.1.4., 7.2.3. and 12.2.2.
88. But don't forget to take all these one-shot warranties out of the form agreement when you're drafting for the next, non-insurance company deal—see Section 5.1.2.
89. You may want to word the representation broadly enough to require disclosure of any other business interests of seller's stockholders which may compete with other lines of business in which the purchaser is engaged.

of increasing historical earnings per share above what they should have been. When the lease runs out, the rent will presumably be increased, thus decreasing the net income of the business. The purchaser should know what he's getting into.

Finally, most purchasers' attorneys like to conclude with a representation containing Rule 10b-5 language; i.e., that no representation (including the information in the disclosure schedule) contains any untrue statement of material fact or omits to state a material fact necessary in order to make the statements made not misleading. Seller can't really object to this, since in effect he is deemed by the Rule to be making this representation in any transaction where the sale of a security is involved. There may also be a preamble in which the seller confirms that he has affirmatively disclosed to the purchaser all facts material to the assets, business, operations, financial condition and prospects of the seller. Some sellers balk at this, but I believe the buyer is entitled to it—at the very least, to the best of seller's knowledge. After seller initially balks, the dialogue usually runs as follows:

Purchaser:	"What do you have to hide?"
Seller:	"I can't predict everything that might happen."
Purchaser:	"We're just asking for those facts that are within your knowledge."
Seller:	"How do I know what will be deemed to be within my knowledge, on the basis of hindsight?"

After ten minutes or so, the seller usually caves in and supplies a list containing specific matters that could be deemed to affect the seller's business presently (such as interest rates) or have a future effect (such as a possible embargo, tariff increase, and the like). The word "prospects," however, usually gives sellers particular grief. Their argument is that they can represent the impact of events on historical financial results and assets, but "prospects" is too nebulous. I have to concede some sympathy with this point, while usually insisting on inclusion of the word.

7.5. THE PURCHASER'S REPRESENTATIONS

So much for the representations of the seller. Now, what about the purchaser? In the relatively rare case of a merger between two public companies of roughly equal size, the representations will be virtually the same for each party.[90] But in the typical transaction involving a large public buyer and a small private seller, the first draft of the acquisition agreement by purchaser's counsel will have fifteen to twenty pages of representations by the seller with only a few meager lines devoted to warranties of the purchaser—covering such uncontroversial matters as the purchaser's due organization and (where stock is to be issued) capitalization, the non-assessability of any issuable shares, the authority of the purchaser to do the deal and the binding nature of the agreement.[91]

7.5.1. Negotiating on the Seller's Behalf

Representing the seller and faced with such a weighted first draft, you must evaluate the situation before jumping in feet first to register your outraged demands. For instance, if the transaction is for cash, the seller doesn't need many representations. He will be walking away from the closing with the money in his hands, at which point his interest in the purchaser's continuing financial condition or prospects is relatively academic.[92] On the other hand, in a deal for stock of a relatively recent and somewhat shaky arrival on the public scene, the seller may want to find out as much about the purchaser as the latter knows about him. Your client is, in effect, a private placee,[93] and your inquiry should then be as

90. This situation is discussed in Section 7.5.2.
91. This is some indication that most acquisition lawyers share the "purchaser's bias" referred to in Section 5.4.
92. See Section 6.1.1. There are obviously certain exceptions to this point; e.g., the selling stockholder who is heavily dependent on an employment contract with the purchaser for his continuing livelihood, or who is sincerely concerned about his employees and customers "finding a good home."
93. See Section 6.2.1.

to what warranties an insurance company or other sophisticated investor would demand from a company which it is financing.

Most transactions, of course, fall somewhere in the middle. The purchaser is substantially larger than the seller and, although no General Motors, in seemingly satisfactory financial condition. You can anticipate that the purchaser would *not* take kindly to providing seller with the same detailed kind of representations sought from the seller. Nevertheless, your client will have at least part of his purchase price tied up in stock or notes, for which he is entitled to some protection.

The situation obviously calls for a compromise. It seems to me that, representing the seller, you should look for three types of assurance from the purchaser (in addition to the usual corporate boilerplate). First, the purchaser should represent the accuracy of its published financial statements for the most recent two or three fiscal years and any subsequent interim periods. There is absolutely no reason why a purchaser should balk at this request, since the financial statements are a matter of public record which the purchaser is holding out to the world at large as being correct. The purpose of including the representation in the agreement is to make it crystal clear that the seller is relying on these statements in making the deal. If the purchaser hesitates on this one, the seller is well advised to proceed with extreme caution.

Second, the purchaser ought to represent the substantial accuracy of the information concerning his business contained in filings with the SEC over a period of several years prior to the deal. Of course, if a merger proxy statement is being used in the transaction, or there is a recent prospectus of the purchaser, you can and should tie directly into that. The purchaser can warrant that such documents are accurate, complete and do not omit to state any material facts; and that (except as specifically disclosed to the seller) there have been no significant changes since the date of the last document. Again, it is difficult for a purchaser issuing securities to resist giving representations concerning filed information, particularly in view of recent developments concerning the important role such data plays in the private offering exemption.[94]

94. See Section 4.7.3.

Third, if there are any particular items that concern you or your client, it is sensible to focus on these with a view to some specific comfort. If the seller is taking non-subordinated promissory notes, by all means ask for representations regarding their ranking in the corporate debt hierarchy. If the purchaser is a defendant in some especially significant litigation, try for a representation that the outcome will not have a material adverse effect. Where the purchaser's patent position is crucial, that might call for a carefully framed warranty. If the ostensible facts appear alarming, you could request a representation that purchaser's business is being conducted in compliance with applicable law.

Obtaining protection for your client in these three areas will provide appropriate remedies in most cases against a purchaser who has been playing games. Of course, remedies are one thing and being made whole is quite another. Warranties are no substitute for an intelligent business evaluation of the purchaser's prospects by the seller or someone acting on his behalf.[95]

7.5.2. Symmetrical Schizophrenia

Let me briefly focus on that infrequent situation where the companies are roughly similar in size, and you anticipate virtually equivalent representations from both sides. All of a sudden, you are faced with the phenomenon I like to call "symmetrical schizophrenia." Forget the usual boilerplate; if you represent the purchaser in one of these foreseeably even-steven deals, you *must* consult with your own client before drafting the seller's representations. Why? Because you have to find out just what the *purchaser* is going to be able to represent without encountering difficulties.

If, for instance, the purchaser is having problems with his own receivables, and he knows enough to feel that seller's receivables are not a significant problem, then you might simply decide to omit the usual seller's representation regarding receivables. When

95. In this regard, see the discussion of offeree representatives in Section 4.7.3.

seller's counsel then asks you for "the same stuff you wanted us to give," perhaps receivables will conveniently be forgotten. Or, if purchaser can anticipate a problem scheduling dozens of minor contracts, a dollar cut-off can be built into the seller's representations, which will then also be applicable to purchaser.

The converse of this proposition is equally valid. In representing the seller in these transactions, you must make *your own* judgments as to what representations are required from purchaser —and not merely ask him to repeat those he has asked you for. At the same time, before you start bargaining for additions to purchaser's representations, you must make sure *your* client can live with the modifications. And if you bargain for caveats or other changes in the representations of seller proposed by purchaser, you have to keep in mind that any point you win will be correspondingly amended in purchaser's representation to you.[96] In short, there may be times when it's best to keep your big mouth shut.

96. See Section 13.3.3., for a discussion of the technique of combining representations used in transactions between related parties, in order to show fairness.