SPECIAL ISSUES IN ASSET ACQUISITIONS

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ATTACHMENTS:

NOTE:

AS A BASIS FOR THE BULK OF THE MATERIALS INCLUDED HEREIN, THE AUTHORS HAVE UTILIZED PORTIONS OF A PRE-PUBLICATION DRAFT OF THE MODEL ASSET PURCHASE AGREEMENT WITH COMMENTARY PREPARED BY THE ASSET ACQUISITION AGREEMENT TASK FORCE OF THE NEGOTIATED ACQUISITIONS COMMITTEE OF THE AMERICAN BAR ASSOCIATION, TOGETHER WITH CERTAIN OTHER MATERIALS PREPARED FOR COMMITTEE PROGRAMS. THE MODEL ASSET PURCHASE AGREEMENT, AS FIRST PUBLISHED IN MAY 2001 BY THE AMERICAN BAR ASSOCIATION, DIFFERS IN A NUMBER OF RESPECTS FROM THE DRAFT ON WHICH THESE MATERIALS WERE BASED. FURTHER, AS THE AUTHORS HAVE UPDATED THESE MATERIALS TO REFLECT EVENTS SUBSEQUENT TO THE PUBLICATION OF THE MODEL AGREEMENT, THE DIVERGENCE OF THESE MATERIALS FROM THE MODEL AGREEMENT HAS INCREASED. THE AUTHORS EXPRESS APPRECIATION TO THE MANY MEMBERS OF THE TASK FORCE WHOSE CONTRIBUTIONS HAVE MADE THESE MATERIALS POSSIBLE. THESE MATERIALS, HOWEVER, ARE SOLELY THE RESPONSIBILITY OF THE AUTHORS AND HAVE NOT BEEN REVIEWED OR APPROVED BY EITHER THE NEGOTIATED ACQUISITIONS COMMITTEE OR ITS ASSET ACQUISITION AGREEMENT TASK FORCE.

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I. INTRODUCTION

Buying or selling a business in uncertain times, including the purchase of a division or a subsidiary, revolves around a purchase agreement between the buyer and the selling entity and sometimes its owners. Purchases of assets are characterized by the acquisition by the buyer of specified assets from an entity, which may or may not represent all or substantially all of its assets, and the assumption by the buyer of specified liabilities of the seller, which typically do not represent all of the liabilities of the seller. When the parties choose to structure an acquisition as an asset purchase, there are unique drafting and negotiating issues regarding the specification of which assets and liabilities are transferred to the buyer, as well as the representations, closing conditions, indemnification and other provisions essential to memorializing the bargain reached by the parties. There are also statutory (e.g., bulk sales and fraudulent transfer statutes) and common law issues (e.g., de facto merger and other successor liability theories) unique to asset purchase transactions that could result in an asset purchaser being held liable for liabilities of the seller which it did not agree to assume.

These drafting and legal issues are dealt with from a United States (**"U.S."**) law perspective in the *Model Asset Purchase Agreement with Commentary*, which was published by the Negotiated Acquisitions Committee of the American Bar Association (***"ABA"***) in 2001 (the ***"Model Asset Purchase Agreement"*** or the ***"Model Agreement"***). In recognition of how mergers and acquisitions (**"M&A"**) have become increasingly global, the Model Agreement was accompanied by a separate ABA Negotiated Acquisitions Committee volume in 2001 entitled *International Asset Acquisitions*, which included summaries of the laws of 33 other countries relevant to asset acquisitions, and in 2007 was followed by another ABA Negotiated Acquisitions Committee book, which was entitled *International Mergers and Acquisitions Due Diligence* and which surveyed relevant laws from 39 countries.

A number of things can happen during the period between the signing of an asset purchase agreement and the closing of the transaction that can cause a buyer to have second thoughts about the transaction. For example, the buyer might discover material misstatements or omissions in the seller's representations and warranties, or events might occur, such as the filing of litigation or an

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assessment of taxes, that could result in a material liability or, at the very least, additional costs that had not been anticipated. There may also be developments that could seriously affect the future prospects of the business to be purchased, such as a significant downturn in its revenues or earnings or the adoption of governmental regulations that could adversely impact the entire industry in which the target operates.

The buyer initially will need to assess the potential impact of any such misstatement, omission or event. If a potential liability can be quantified, the analysis will be somewhat easier. However, the impact in many situations will not be susceptible to quantification, making it difficult to determine materiality and to assess the extent of the buyer's exposure. Whatever the source of the matter, the buyer may want to terminate the acquisition agreement or, alternatively, to close the transaction and seek recovery from the seller. If the buyer wants to terminate the agreement, how strong is its legal position and how great is the risk that the seller will dispute termination and commence a proceeding to seek damages or compel the buyer to proceed with the acquisition? If the buyer wants to close, could it be held responsible for the liability and, if so, what is the likelihood of recovering any resulting damage or loss against the seller? Will closing the transaction with knowledge of the misstatement, omission or event have any bearing on the likelihood of recovering?

The dilemma facing a buyer under these circumstances seems to be occurring more often in recent years. This is highlighted by the Delaware Chancery Court decisions in *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001), in which the Court ruled that the buyer did not have a valid basis to terminate the merger agreement and ordered that the merger be consummated (see Appendix C), and *Frontier Oil Corp. v. Holly Corp.*, CA No. 20502 2005, WL 1039027, (Del. Ch. Apr. 29, 2005), in which the Court ruled a target had not repudiated a merger agreement by seeking to restructure the transaction due to legal proceedings commenced against the buyer after the merger agreement was signed (see Appendix D). While these cases are each somewhat unique and involved mergers of publicly-held corporations, the same considerations will generally apply to acquisitions of closely-held businesses.[1] In the event that a buyer wrongfully terminates the purchase agreement or refuses to close, the buyer could be liable for damages under common law for breach of contract as is illustrated by the court's analysis in *Rus, Inc. v. Bay Industries, Inc. and SAC, Inc.*, 2004 WL 1240578 (S.D.N.Y. May 25, 2004), discussed below in the Comment to Section 11.4 of the Model Agreement. There is little case law dealing with these issues in the context of an acquisition because, more often than not, the parties will attempt to reach a settlement rather than resorting to legal proceedings.

The issues facing the parties in an asset purchase transaction will depend somewhat on the structure of the transaction and the wording of the acquisition agreement. Regardless of the wording of the agreement, however, there are some situations in which a buyer can become responsible for a seller's liabilities under successor liability doctrines. The analysis of these issues is somewhat more complicated in the acquisition of assets, whether it be the acquisition of a division or the purchase of

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1 *Nixon v. Blackwell,* 626 A.2d 1366, 1380-81 (Del. 1993) (en banc) (refusing to create special fiduciary duty rules applicable in closely held corporations); s*ee Merner v. Merner*, 2005 WL 658957 (9th Cir. (March 18, 2005)) (California would follow approach of Delaware in declining to make special fiduciary duty rules for closely held corporations); *but see Donahue v. Rodd Electrotype Co.,* 367 Mass. 578, 328 N.E.2d 505, 515 & n. 17 (Mass. 1975) (comparing a close corporation to a partnership and holding that "stockholders in the close corporation owe one another substantially the same fiduciary duty in the operation of the enterprise that partners owe to one another").

all the assets of a seller. The authors have therefore selected as the basis for the analysis a pre-publication draft of the Model Asset Purchase Agreement. The materials include:

(A) An overview of the three basic forms of business acquisitions:

(i) Statutory business combinations (e.g., mergers, consolidations and share exchanges);

(ii) Stock purchases; and

(iii) Asset purchases.

(B) Introductory matters concerning the reasons for structuring the transaction as an asset purchase.

(C) A discussion of the various successor liability doctrines and some suggested means of minimizing the risk.

(D) An initial draft of certain key provisions of an Asset Purchase Agreement which focuses on the definition and solution of the basic issues in any asset purchase: (1) what assets are being acquired and what liabilities are being assumed, (2) what assets and liabilities are being left behind, (3) what are the conditions of the obligations of the parties to consummate the transaction and (4) what are the indemnification obligations of the parties. While these matters are always deal specific, some generalizations can be made and common problems identified.

II. ALTERNATIVE STRUCTURES FOR SALES OF BUSINESSES

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

(1) Introductory material (i.e., opening paragraph and recitals);

(2) The price and mechanics of the business combination;

(3) Representations and warranties of the buyer and seller;

(4) Covenants of the buyer and seller;

(5) Conditions to closing;

(6) Indemnification;

(7) Termination procedures and remedies; and

(8) Miscellaneous (boilerplate) clauses.

There are many basic legal and business considerations for the draftsman involved in the preparation of agreements for the sale of a business. These include federal income taxes; state sales, use and transfer taxes; federal and state environmental laws; federal and state securities laws; the accounting treatment; state takeover laws; problems involving minority shareholders; the purchaser's liability for the seller's debts and contingent liabilities; insolvency and creditors' rights laws; problems in transferring assets (mechanical and otherwise); state corporation laws; stock exchange rules; pension, profit-sharing and other employee benefit plans; antitrust laws; foreign laws; employment, consulting and non-compete agreements; union contacts and other labor considerations; the purchaser's security for breach of representations and warranties; insurance; and a myriad of other considerations. See Byron F. Egan, *The Roles of an M&A Lawyer*, INSIDE THE MINDS: STRUCTURING M&A TRANSACTIONS (2007).

There are three basic forms of business acquisitions:

(i) Statutory business combinations (e.g., mergers, consolidations and share exchanges);

(ii) Purchases of shares; and

(iii) Purchases of assets.

A. Mergers and Consolidations

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

B. Purchases of Shares

Purchases of shares of the target company can likewise be handled on a taxable or non-taxable basis. In a voluntary stock purchase, the acquiring corporation must generally negotiate with each selling shareholder individually. An exception to this is a mechanism known as the "share exchange" permitted by certain state business corporation statutes (*see e.g.* Texas Business Corporation Act Articles 5.02 and 5.06) under which the vote of holders of the requisite percentage (but less than all) of shares can bind all of the shareholders to exchange their shares pursuant to the plan of exchange approved by such vote.

Generally speaking, if the purchasing corporation acquires the stock of the target corporation solely in exchange for the purchaser's voting stock and, after the transaction the purchasing corporation owns stock in the target corporation possessing at least 80% of the target's voting power and at least 80% of each class of the target corporation's non-voting stock, the transaction can qualify as a tax-free "B" reorganization. See §368(a)(1)(B) of the Code.

Note that one disadvantage of an acquisition of the target corporation's stock is that the purchasing corporation does not obtain a "step-up" in the basis of the target corporation's assets for tax purposes. If the stock acquisition qualifies as a "qualified stock purchase" under §338 of the Code (which generally requires a taxable acquisition by a corporation of at least 80% of the target corporation's stock within a 12-month period), an election may be made to treat the stock acquisition as a taxable asset purchase for tax purposes. However, after the effective repeal of the *General Utilities* doctrine, discussed *infra*, §338 elections are seldom made unless the target is a member of a group of corporations filing a consolidated federal income tax return (or, since 1994, an S corporation) and the seller(s) agree to a §338(h)(10) election, which causes the seller to bear the tax on the deemed asset sale since the present value of the tax savings to the buyer from a stepped-up basis in target's assets is less than the corporate-level tax on the deemed asset sale.

C. Asset Purchases

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

Generally speaking, for a non-taxable acquisition of assets, the purchaser must acquire "substantially all" of the target's assets solely in exchange for the voting stock of the purchaser. See §368(a)(1)(C) of the Code. Basically, a "C" reorganization is disqualified unless the target distributes the purchaser's stock, securities and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization.

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

III. WHETHER TO DO AN ASSET PURCHASE

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

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

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

A. Purchased Assets

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

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

B. Contractual Rights

Among the assets to be transferred will be the seller's rights under contracts pertaining to its business. Often these contractual rights cannot be assigned without the consent of other parties. The most common examples are leases that require consent of the lessor and joint ventures or strategic alliances that require consent of the joint venturer or partner. This can be an opportunity for the third party to request confidential information regarding the financial or operational capability of the buyer and to extract concessions in return for granting its consent. This might be avoided by a purchase of stock or a statutory combination. See *Branmar Theatre Co. v. Branmar, Inc.*, 264 A.2d 256 (Del. Ch. 1970) (holding that a sale of a company's stock is not an "assignment" of a lease of the company where the lease did not expressly provide for forfeiture in the event the stockholders sold their shares); *Baxter Pharmaceutical Products, Inc. v. ESI Lederle Inc.*, 1999 WL 160148 (Del. Ch. 1999) (nonassignability clause that does not prohibit, directly or by implication, a stock acquisition or change of ownership is not triggered by a stock purchase); *Star Cellular Telephone Co., Inc. v. Baton Rouge CGSA, Inc.*, 1993 WL 294847 (Del. Ch.), aff'd, 647 A.2d 382 (Del. Supr. 1994) (where a partnership agreement did not expressly include transfers by operation of law in its anti-transfer provision, court declines to attribute to contracting parties an intent to prohibit a merger and notes that drafter could have drafted clause to apply to all transfers, including by operation of law). However, some courts have held that a merger violates a nonassignment clause. *See, e.g., PPG Indus., Inc. v. Guardian Indus. Corp.*, 597 F.2d 1090 (6th Cir. 1979). At least one court held that such a violation occurred in a merger where the survivor was the contracting party. *See SQL Solutions, Inc. v. Oracle Corp.*, 1991 WL 626458 (N.D. Cal. 1991). Leases and other agreements often require consent of other parties to any change in ownership or control, whatever the structure of the acquisition. Many government contracts cannot be assigned and require a novation with the buyer after the transaction is consummated. This can pose a significant risk to a buyer.

Asset purchases also present difficult questions about ongoing coverage for risks insured against by the seller. Most insurance policies are, by their terms, not assignable and a buyer may not be able to secure coverage for acts involving the seller or products it manufactures or services it renders prior to the closing. *See, e.g., Henkel Corp. v. Hartford Accident & Indem. Co.,* 29 Cal. 4th 934 (2003), in which the California Supreme Court held that, where a successor's liability for injuries arose by contract rather than by operation of law, the successor was not entitled to coverage under a predecessor's insurance policies because the insurance company had not consented to the assignment of the policies. For an analysis of the *Henkel* decision and a discussion of decisions in other jurisdictions, see Lesser, Tracy and McKitterick, *M&A Acquirors Beware: When You Succeed to the Liabilities of a Transferor, Don't Assume (at Least, in California) that the Existing Insurance Transfers Too*, VIII Deal Points (The Newsletter of the ABA Bus. L. Sec. Committee on Negotiated Acquisitions) 2 (No. 3, Fall 2003), which can be found at http://www.abanet.org/buslaw/negacq/newsletter/2003/08_03.pdf.

C. Governmental Authorizations

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

D. Assumed Liabilities

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

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

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

- Bulk sales laws permit creditors of a seller to follow the assets of certain types of sellers into the hands of a buyer unless specified procedures are followed.

- Under fraudulent conveyance or transfer statutes, the assets acquired by the buyer can be reached by creditors of the seller under certain circumstances. Actual fraud is not required and a statute may apply merely where the purchase price is not deemed fair consideration for the transfer of assets and the seller is, or is rendered, insolvent.

- Liabilities can be assumed by implication, which may be the result of imprecise drafting or third-party beneficiary arguments that can leave a buyer with responsibility for liabilities of the seller.

- Some state tax statutes provide that taxing authorities can follow the assets to recover taxes owed by the seller; often the buyer can secure a waiver from the state or other accommodation to eliminate this risk.

- Under some environmental statutes and court decisions, the buyer may become subject to remediation obligations with respect to activities of a prior owner of real property.

- In some states, courts have held buyers of manufacturing businesses responsible for tort liabilities for defects in products manufactured by a seller while it controlled the business. Similarly, some courts hold that certain environmental liabilities pass to the buyer that acquires substantially all the seller's assets, carries on the business and benefits from the continuation.

- The purchaser of a business may have successor liability for the seller's unfair labor practices, employment discrimination, pension obligations or other liabilities to employees.

- In certain jurisdictions, the purchase of an entire business where the shareholders of the seller become shareholders of the buyer can cause a sale of assets to be treated as a "*de facto merger*." This theory would result in the buyer assuming all of the seller's liabilities.

None of these exceptions prevents a buyer from attempting to limit the liabilities to be assumed. Thus, either by compliance with a statutory scheme (e.g. the bulk sales laws or state tax lien waiver procedure) or by careful drafting, a conscientious buyer can take comfort in the fact that most contractual provisions of the acquisition agreement should be respected by the courts and should protect the buyer against unforeseen liabilities of the seller.

It is important to recognize that in a sale of assets the seller retains primary responsibility for satisfying all its liabilities, whether or not assumed by the buyer. Unlike a sale of stock or a statutory combination, where the shareholders may only be liable to the buyer through the indemnification provisions of the acquisition agreement, a creditor still can proceed directly against the seller after an asset sale. If the seller is liquidated, its shareholders may remain subject to claims of the seller's creditors under statutory or common law principles, although this might be limited to the proceeds received on liquidation and expire after a period of time. Under state corporate law statutes, a seller's directors may become personally liable to its creditors if the seller distributes the proceeds of a sale of assets to its shareholders without making adequate provision for its liabilities.

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

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

E. Income Taxes

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

In a taxable asset purchase, the buyer's tax basis in the purchased assets will be equal to the purchase price (including assumed liabilities). An important advantage to the buyer of an asset purchase is the ability to allocate the purchase price among the purchased assets on an asset-by-asset basis to reflect their fair market value, often increasing the tax basis from that of the seller. This "step-up" in basis can allow the buyer greater depreciation and amortization deductions in the future and less gain (or greater loss) on subsequent disposition of those assets. (In the case of an S corporation, the same result may be achieved by a buyer purchasing stock and making a joint election with the selling shareholders under Section 338(h)(10) of the Code to treat the purchase of stock as a purchase of assets.)

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

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

The tax treatment to the seller and its shareholders in an S corporation's sale of assets will depend upon the form of consideration, the relationship of the tax basis in the seller's assets (the "inside basis") to the tax basis of its shareholders in their stock (the "outside basis"), whether there is "built-in gain" (*i.e.*, fair market value of assets in excess of tax basis at the effective date of the S corporation election) and whether the seller's S status will terminate. Generally, the amount and character of the gain or loss at the corporate level will pass through to the shareholders and be taken into account on their individual tax returns, thereby avoiding a "double tax." However, the purchase price will be allocated among the S corporation's assets and, depending on the relationship of the inside basis and the outside basis, the amount of the gain or loss passed through to the shareholders for tax purposes may be more or less than if the same price had been paid for the stock of the S corporation. Since the character of the gain as ordinary income or capital gain is determined by the nature of the S corporation assets, the sale of assets by an S corporation may create ordinary income for the shareholders as compared to the preferred capital gain generated by a stock sale. An S corporation that was formerly a C corporation also must recognize "built-in gain" at the corporate level, generally for tax years beginning after 1986, on assets that it held at the time of its election of S status, unless ten years have elapsed since the effective date of the election.

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

F. Transfer Taxes

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

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

G. Employment Issues

A sale of assets may yield more employment or labor issues than a stock sale or statutory combination, because the seller will typically terminate its employees who may then be employed by the buyer. Both the seller and buyer run the risk that employee dislocations from the transition will result in litigation or, at the least, ill will of those employees affected. The financial liability and risks associated with employee benefit plans, including funding, withdrawal, excise taxes and penalties, may differ depending on the structure of the transaction. Responsibility under the Worker Adjustment and Retraining Notification Act (***"WARN Act"***) can vary between the parties, depending upon whether the transaction is structured as an asset purchase, stock purchase or statutory combination. In a stock purchase or statutory combination, any collective bargaining agreements generally remain in effect. In an asset purchase, the status of collective bargaining agreements will depend upon whether the buyer is a "successor," based on the continuity of the business and work force or provisions of the seller's collective bargaining agreement. If it is a successor, the buyer must recognize and bargain with the union.

IV. SUCCESSOR LIABILITY

A. Background

In any acquisition, regardless of form, one of the most important issues to be resolved is what liabilities incurred by the seller prior to the closing are to be assumed by the buyer. Most of such liabilities will be known -- set forth in the representations and warranties of the seller in the acquisition agreement and in the exhibits thereto, reflected in the seller's financial statements or otherwise disclosed by seller to buyer in the course of the negotiations and due diligence in the acquisition. For such known liabilities, the issue as to which will be assumed by the buyer and which will stay with the seller is resolved in the express terms of the acquisition agreement and is likely to be reflected in the price. For unknown liabilities, the solution is not so easy and lawyers representing principals in acquisition transactions spend significant time and effort dealing with the allocation of responsibility and risk in respect of such unknown liabilities.

While all of the foregoing would pertain to an acquisition transaction in any form, the legal presumption as to who bears the risk of undisclosed or unforseen liabilities differs markedly depending upon which of the three conventional acquisition structures has been chosen by the parties.

- In a stock acquisition transaction, since the acquired corporation simply has new owners of its stock and has not changed in form, the corporation retains all of its liabilities and obligations, known or unknown, to the same extent as it would have been responsible for such liabilities prior to the acquisition. In brief, the acquisition has had no effect whatsoever on the liabilities of the acquired corporation.

- In a merger transaction, where the acquired corporation is merged out of existence, all of its liabilities are assumed, as a matter of state merger law, by the corporation which survives the merger. Unlike the stock acquisition transaction, a new entity will be responsible for the liabilities. However, the practical result is the same as in a stock transaction (i.e. the buyer will have assumed all of the preclosing liabilities of the acquired corporation as a matter of law).

- By contrast, in an asset purchase, the contract between the parties is expected to determine which of the assets will be acquired by the buyer and which of the liabilities will be assumed by the buyer. Thus, the legal presumption is very different from the stock and merger transactions: the buyer will not assume liabilities of the selling corporation which the buyer has not expressly agreed to assume by contract.

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

As previously discussed in these materials, there have been some recognized exceptions to the buyer's ability to avoid seller's liabilities by the terms of an acquisition agreement between the seller and the buyer. One of the exceptions is the application of various successor liability doctrines that may cause a buyer to be responsible for product, environmental and certain other liabilities of the seller or its predecessors.

B. Successor Liability Doctrines

During the past two decades, the buyer's level of comfort has dropped somewhat. During that period, courts have developed some theories which require buyers to be responsible for seller preclosing liabilities in the face of express contractual language in the asset purchase agreement to the contrary. In addition, since the early 1980's federal and state statutes have imposed strict liability for certain environmental problems on parties not necessarily responsible for causing those problems. These developments, particularly in the areas of product liability, labor and employment obligations and environmental liability, have created problems for parties in asset purchase transactions. The remainder of this section will briefly describe the principal theories of successor liability and will address some of the techniques which lawyers have used to deal with those problems.

1. De Facto Merger

Initially, the *de facto* merger theory was based upon the notion that, while a transaction had been structured as an asset purchase, the result looked very much like a merger. The critical elements of a *de facto* merger were that the selling corporation had dissolved right away and that the shareholders of the seller had received stock in the buyer. These two facts made the result look very much like a merger. The theory was applied, for example, to hold that dissenters' rights granted by state merger statutes could not be avoided by structuring the transaction as an asset sale. While this may have pushed an envelope or two, the analysis was nonetheless framed within traditional common law concepts of contract and corporate law. However, the *de facto* merger doctrine was judicially expanded in one state in 1974 to eliminate the requirement that the corporation dissolve and, more importantly, to introduce into the equation the public policy consideration that if successor liability were not imposed, a products liability plaintiff would be left without a remedy. In balancing the successor company's interest against such a poor plaintiff, the plaintiff wins. *Knapp v. North American Rockwell Corp.*, 506 F.2d 361 (3rd Cir. 1974).

The elements of a *de facto* merger were set forth about 10 years after the *Knapp* case in *Philadelphia Electric Co. v. Hercules, Inc.*, 762 F.2d 303 (3rd Cir. 1985):

- There is a continuation of the enterprise of the seller corporation, so that there is a continuity of management, personnel, physical location, assets and general business operations.

- There is a continuity of shareholders which results when the purchasing corporation pays for the acquired assets with shares of its own stock, this stock ultimately coming to be held by the shareholders of the seller corporation so that they become a constituent part of the purchasing corporation.

- The seller corporation ceases its ordinary business operations, liquidates and dissolves as soon as legally and practically possible.

- The purchasing corporation assumes those obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operation of the seller corporation.

In 1995 the United States District Court for the Eastern District of Pennsylvania applied the doctrine of *de facto* merger to find successor liability for environmental costs. *SmithKline Beecham Corp. v. Rohm and Haas Co.*, No. 92 - 5394, 1995 WL 117671 (E.D. Pa March 17, 1995). The Court indicated that all four elements of *de facto* merger set forth in *Hercules* did not have to be present (although in this case all four factors were found). In addition the District Court determined that Pennsylvania law does not require that the seller's former shareholders take control over the buyer in order to satisfy the continuity of a shareholder factor above-mentioned. The Third Circuit reversed the District Court and held that the *de facto* merger doctrine would not apply in the circumstances of this case. The facts of *SmithKline Beecham* were somewhat unusual. Beecham had bought assets of a company from Rohm and Haas in 1978. Rohm and Haas had given an indemnification to Beecham for all liabilities prior to the closing and Beecham indemnified Rohm and Haas for liabilities following the 1978 transaction. Rohm and Haas in turn had bought the company in 1964 - also in an asset transaction. The District Court had held that the 1964 transaction satisfied the *de facto* merger rule which meant that Rohm and Haas would be liable for the prior owner's unknown liabilities and therefore those pre-1964 liabilities would be swept up in the indemnification which Rohm and Haas had given to Beecham 14 years later. On appeal the Third Circuit determined that in the 1978 indemnification provision, Rohm and Haas did not intend to include in its indemnification liabilities prior to its ownership of Beecham. *SmithKline Beecham Corp. v. Rohm and Haas Corp.*, 89 F.3d 154 (3rd Cir. 1996). Thus the Third Circuit made the following determinations:

> In this case, the parties drafted an indemnification provision that excluded successor liability. SKB and R & H chose to define 'Business' and limit its meaning to New Whitmoyer. Under these circumstances, we believe it was not appropriate for the district court to apply the *de facto* merger doctrine to alter the effect of the indemnification provision.
>
> But where two sophisticated corporations drafted an indemnification provision that excluded the liabilities of a predecessor corporation, we will not use the *de facto* merger doctrine to circumvent the parties' objective intent.

The Third Circuit's reasoning suggests that if two parties intend that successor liability shall not obtain, the Court will respect those intentions. If this is so, the opinion seriously undermines the very basis of the *de facto* merger doctrine — that a court will use the doctrine to impose liability on the successor in spite of the express intentions of the parties in an asset purchase agreement to the contrary. See Tafe, *The de facto Merger Doctrine Comes to Massachusetts Wherein The Exception to the Rule Becomes the Rule*, Boston Bar Journal (November/December 1998).

More recently, the U.S. Court of Appeals for the Second Circuit in *Cargo Partner AG v. Albatrans Inc.*, 352 F.3d 41, 2003 U.S. App. LEXIS 24692 (2d Cir. 2003), a case involving a suit over trade debt, ruled that, without determining whether all four factors discussed above need to be present for there to be a *de facto* merger, a corporation that purchases assets will not be liable for a seller's contract debts under New York law absent continuity of ownership which "is the essence of a merger." It cited a New York case, *Fitzgerald v. Fahnestock & Co.*, 286 A.D. 2d 573, 730 N.Y.S.2d 70 (2001), in which the court had stated that not all of the four elements are necessary to find a *de facto* merger.

Some states have endeavored to legislatively repeal the *de facto* merger doctrine. *See*, *for example*, Texas Business Corporation Act Article 5.10B, which provides that in relevant part that "[a] disposition of any, all, or substantially all, of the property and assets of a corporation . . . (1) is not considered to be a merger or conversion pursuant to this Act or otherwise; and (2) except as otherwise expressly provided by another statute, does not make the acquiring corporation, foreign corporation, or other entity responsible or liable for any liability or obligation of the selling corporation that the acquiring corporation, foreign corporation, or other entity did not expressly assume." In *C.M. Asfahl Agency v. Tensor, Inc.*, 135 S.W.3d 768, 780-81 (Tex.App.─Houston [1st Dist.] 2004), a Texas Court of Civil Appeals, quoting Tex. Bus. Corp. Act Ann. art. 5.10(B)(2) and citing two other Texas cases, wrote: "This transaction was an asset transfer, as opposed to a stock transfer, and thus governed by Texas law authorizing a successor to acquire the assets of a corporation without incurring any of the grantor corporation's liabilities unless the successor expressly assumes those liabilities. [citations omitted] Even if the Agency's sales and marketing agreements with the Tensor parties purported to bind their 'successors and assigns,' therefore, the agreements could not contravene the protections that article 5.10(B)(2) afforded Allied Signal in acquiring the assets of the Tensor parties unless Allied Signal expressly agreed to be bound by Tensor parties' agreements with the Agency." See Egan and Huff, *Choice of State of Incorporation --Texas versus Delaware: Is it Now Time to Rethink Traditional Notions*, 54 SMU Law Review 249, 287-290 (Winter 2001).

2. Continuity of Enterprise

As above noted, the *de facto* merger doctrine has generally been limited to instances where there is a substantial identity between stockholders of seller and buyer - a transaction which looks like a merger in which the selling corporation has gone out of existence and its stockholders have received stock of the buyer. In 1976 the Michigan Supreme Court took the *de facto* merger doctrine a step further and eliminated the continuing stockholder requirement. In *Turner v. Bituminous Casualty Co.*, 397 Mich. 406 (1976), the Court was dealing with a transaction in which the consideration was cash, rather than stock, and the Court concluded that this fact alone should not produce a different result from that which would obtain under a *de facto* merger analysis if the consideration had been stock. Under this "continuity of enterprise" test, successor liability can be imposed upon findings of (1) continuity of the outward appearance of the enterprise, its management personnel, physical plant, assets and general business operations; (2) the prompt dissolution of the predecessor following the transfer of assets; and (3) the assumption of those liabilities and obligations necessary to the uninterrupted continuation of normal business operations. These are essentially the same ingredients which support the *de facto* merger doctrine - but without the necessity of showing continuity of shareholder ownership.

3. Product Line Exception

In 1977 California took a slightly different tack in holding a successor liable in a products liability case. In *Ray v. Alad Corp.*, 560 P.2d 3 (Cal. 1977), the buyer had acquired essentially all of the seller's assets including plant, equipment, inventories, trade name, goodwill, etc. and had also employed all of its factory personnel. The buyer continued to manufacture the same line of products under the seller's name and generally continued the seller's business as before. Successor liability was found by the California Supreme Court:

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

The rationale for this doctrine had moved a long way from the corporate statutory merger analysis of the *de facto* merger doctrine. The Court determined that the plaintiff had no remedy against the original manufacturer by reason of the successor's acquisition of the business and consequent ability of the successor to assume the original manufacturer's risk. The Court also determined that the responsibility of the successor to assume the risk for previously manufactured product was essentially the price which the buyer had paid for the seller's goodwill and the buyer's ability to enjoy the fruits of that goodwill. *See also Ramirez v. Amsted Industries, Inc.*, 431 A.2d 811 (N.J. 1981).

4. Choice of Law

Of those states which have considered the issues directly, more have rejected the product line exception than have embraced it. However, under applicable choice of law principles (especially in the area of product liability), the law of a state in which an injury occurs may be found applicable and, thus, the reach of those states which have embraced either the product line exception or the narrower continuity of interest doctrine may extend beyond their respective borders. *See generally Ruiz v. Blentech Corporation*, 89 F.3d 320 (7th Cir. 1996); *Nelson v. Tiffany Industries*, 778 F.2d 533 (9th Cir. 1985).

Compounding the difficulties of predicting both what theory of successor liability might be imposed and what state's laws might be applicable to a successor liability claim under applicable choice of law principles, the choice of law provision in an asset purchase agreement may not govern the choice of law in a successor liability case. *See Berg Chilling Systems, Inc. v. Hull Corp.*, 435 F.3d 455 (3rd Cir., 2006) (contractual choice of law provision held inapplicable to successor liability claim, with the majority reasoning that the *de facto* merger doctrine looks beyond the form of the contract to its substance and that a claimant not a party to the contract should not be bound by its choice of law provision).

5. Environmental Statutes

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

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

6. Federal Common Law/ERISA; Patents

In *Brend v. Sames Corporation*, 2002 WL 1488877 (N.D.Ill. 2002), an asset purchase agreement expressly provided that the buyer was not assuming any liability under seller's "top hat" plan, an unfunded deferred compensation plan for selected executives of seller. Following federal common law rather than state law, the Court held that the buyer could be liable if (1) it knew of the claim (which was evidenced by the express non-assumption wording in the asset purchase agreement) and (2) there was substantial continuity of the business.

Both the buyer and seller were public corporations that continued to exist after the transaction, which involved the sale of a division of seller. No stock of buyer was issued to seller or its shareholders in the transaction, and no employee of seller became an officer or director of buyer. Seller ultimately commenced Chapter 7 bankruptcy proceedings. The former executives of seller sued on a successor liability theory seeking a judicial declaration that buyer was liable under the "top hat" contracts.

Although the "top hat" plan was exempt from most of the provisions of the Employee Retirement Income Security Act of 1974 (**"ERISA"**), the former executives sought to enforce their rights under ERISA since under Illinois common law "[t]he well-settled general rule is that a corporation that purchases the assets of another corporation is not liable for the debts or liabilities of the transferor corporation," subject to certain traditional exceptions. The Court noted that "[s]uccessor liability under federal common law is broader . . . . [and] allows lawsuits against even a genuinely distinct purchaser of a business if (1) the successor had notice of the claim before the acquisition; and (2) there was 'substantial continuity' in the operation of the business before and after the sale." In so holding, the Court followed decisions applying the federal common law of successor liability to multiemployer plan contribution actions. *See Upholsterers' Int'l Union Pension Fund v. Artistic Furniture*, 920 F.2d 1323 (7th Cir. 1990); *Moriarty v. Svec*, 164 F.3d 323 (7th Cir.1998). The opinion was rendered on cross motions for summary judgment by the former executives and buyer, and in denying both motions the court wrote:

> The evidence submitted precludes summary judgment *against* either party, but is insufficient to enter summary judgment *for* either party. It is undisputed that ITW [buyer] acquired "substantial assets" of Sames [seller]. But the evidence submitted by the parties does not tell us enough about what actually happened after the Purchase Agreement was executed to permit us to fully analyze whether ITW continued the operations of the Binks Business [the acquired division] "without interruption or substantial change." We know that the Purchase Agreement provided for ITW's hiring of former Sames employees, but we do not know how many or what percentage of former Sames employees became employees of ITW or whether these employees performed the same jobs, in the same working conditions, for the same supervisors. There is no evidence regarding the production processes or facilities, or whether ITW made the same products or sold to the same body of customers. Additional (absent) relevant evidence would address whether there was a stock

> transfer involving a type of stock other than common stock, and the exact makeup of the companies' officers and directors before and after the sale.

In *Mickowski v. Visi-Track Worldwide, LLC*, 415 F.3d 501, 510 (6th Cir. 2005), plaintiff obtained a patent infringement judgment against a corporation which subsequently sought protection under the Bankruptcy Code and sold substantially all of its remaining assets with Bankruptcy Court approval. The Bankruptcy Court later revoked its discharge of debtor liabilities without overturning the asset sale. The plaintiff then sued the asset purchaser, which had not assumed the patent infringement judgment, on the grounds that the purchaser was the successor to and a mere continuation of the bankrupt corporation, arguing that each of the officers and key employees became employees of the asset purchaser performing substantially the same duties and the website of the acquired business indicated it was the same company at a new location. Plaintiff argued that the federal "substantial continuity" test applied in age discrimination cases was applicable and was satisfied by continuation of these personnel. The Sixth Circuit held that the Ohio common law standard for successor liability was applicable to patent infringement cases and that under the Ohio standard for successor liability "'the basis of this [mere continuation] theory is the continuation of the corporate entity, not the business operation, after the transaction,' such as when one corporation sells its assets to another corporation with the same people owning both corporations."

C. Some Suggested Responses

1. Analysis of Transaction

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

(a) Product Liability

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

(b) Environmental

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

(c) Applicable Laws

In addition to analyzing the particular facts which might give rise to successor liability for either products or environmental concerns, one should obviously also review the laws which might be applicable if a successor liability issue were to arise. While choice-of-law problems may deny 100% comfort, it is a fact that the more expansive doctrines of successor liability above mentioned have been adopted by a relatively small number of states and it may well be that in any particular transaction one can determine that the risk of such doctrines applying in the aftermath of a particular acquisition transaction is very low.

2. Structure of Transaction

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

3. Asset Purchase Agreement Provisions

(a) Liabilities Excluded

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

(b) Indemnification

As a practical matter, probably the most effective protection of a buyer against successor liability is comprehensive indemnification by the seller, particularly if indemnification is backstopped by a portion of the purchase price held in escrow. See Section 11 of the Selected Asset Purchase Agreement Provisions *infra*.

4. Selling Corporation - Survival

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

5. Limitation on Assets

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

V. ETHICAL CONSIDERATIONS

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

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

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

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

VI. ORGANIZATION OF MODEL ASSET PURCHASE AGREEMENT

A. Structure

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

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

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

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

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

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

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

Article 10 contains certain additional covenants of the parties.

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

Article 12 contains comprehensive confidentiality and access to information provisions, which are applicable both prior to and after the closing and supersede the confidentiality agreement previously entered into between the parties.

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

B. Due Diligence

In the context of an M&A transaction, the term **"due diligence"** is used to describe the process that one of the parties undertakes to investigate the other party in order to make an informed business judgment whether to go forward with the transaction on the terms proposed. While the term most frequently is used in reference to the investigation made by the buyer, due diligence is also the concern of the target where the proposed transaction involves the seller receiving buyer securities or where the buyer's ability to perform is a concern. See ABA *Manual on Acquisition Review* (1995) and ABA *The M&A Process – A Practical Guide for the Business Lawyer* (2005).

C. The Confidentiality Agreement

A confidentiality agreement is the first stage for the due diligence process as parties generally are reluctant to provide confidential information to the other side without having the protection of a confidentiality agreement. The target typically proposes its form of confidentiality agreement, and a negotiation of confidentiality agreement ensues. A seller's form of confidentiality agreement is attached as Appendix F. See Article 12 of the Model Agreement, *infra*, and Appendix F, *infra*.

D. Letter of Intent

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

E. Gap Between Signing and Closing

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

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

VII. SELECTED ASSET PURCHASE AGREEMENT PROVISIONS

To illustrate and amplify the matters discussed above, there are set forth below the following selected provisions of a hypothetical Asset Purchase Agreement (the page number references are to pages herein) which are derived from a pre-publication draft of the Model Asset Purchase Agreement. The selected provisions below represent only certain parts of an Asset Purchase Agreement which are relevant to issues discussed herein and do not represent a complete Asset Purchase Agreement, the principal provisions thereof or even all of the provisions which distinguish an asset purchase from another form of business combination.

Asset Purchase Agreement

This Asset Purchase Agreement (**"Agreement"**) is made as of _________ ____ , 20___ by and among ___________, a ___________ corporation (**"Buyer"**); ___________, a ______________ corporation (**"Seller"**); ___________, a resident of ___________ (**"A"**); and __________, a resident of ___________ (**"B"**) (with A and B referred to herein as **"Shareholders"**).

COMMENT

The two principal shareholders are included as parties to the Model Agreement because they indemnify the Buyer and are responsible for certain of the covenants. Sometimes some or all of the shareholders are made parties to a separate joinder agreement rather than making them parties to the acquisition agreement.

RECITALS

Shareholders own ________ shares of the common stock, par value $___ per share, of Seller, which constitute ___% of the issued and outstanding shares of capital stock of Seller. Seller desires to sell, and Buyer desires to purchase, the Assets of Seller for the consideration and on the terms set forth in this Agreement.

COMMENT

While there is no legal requirement that an acquisition agreement contain recitals, they can help the reader understand the basic context and structure of the acquisition. Recitals are typically declarative statements of fact, but these statements normally do not serve as separate representations or warranties of the parties. The parties and their counsel should, however, be aware of the possible legal effect of recitals. *See, e.g.,* Cal. Evid. Code § 622 ("The facts recited in a written instrument are conclusively presumed to be true as between the parties thereto . . . .").

Agreement

The parties, intending to be legally bound, agree as follows:

1. DEFINITIONS AND USAGE

COMMENT

It is useful, both to reduce the length of other sections and to facilitate changes during negotiations, to have a section of the acquisition agreement that lists all defined terms appearing in more than one section of the agreement. A common dilemma in drafting definitions is whether to include long lists of terms with similar but slightly different meanings. If the goal is to draft a comprehensive, all-inclusive definition, the tendency is to list every term that comes to mind. If too many terms are listed, however, the absence of a particular term may be accorded more significance than intended, even if a phrase such as “without limitation” or a catch-all term beginning with “any other” is used. (The Model Agreement avoids repetitive use of such a phrase and contains a general disclaimer in Section 1.2(a)(vii) instead.) Also, long lists of terms with similar meanings perpetuate a cumbersome and arcane style of drafting that many lawyers and clients find annoying at best and confusing at worst. The Model Agreement resolves this dilemma in favor of short lists of terms that are intended to have their broadest possible meaning.

There are alternative methods of handling the definitions in typical acquisition agreements. They may be placed at the end of the document as opposed to the beginning, they may be placed in a separate ancillary document referred to in the agreement or they may be incorporated in the earliest section of the agreement where they appear followed by initial capitalization of those defined terms in the subsequent sections of the agreement. There are proponents for each of these alternatives and probably no one of them is preferable, although the drafters of the Model Agreement felt that reference would be easier if most of the principal definitions were in one place. However, it was also recognized that where relatively brief definitions are set out in one section of the Agreement and are not used outside of that section, those definitions generally would not also be listed in the Definitions in Section 1.1. Every definition, however, is listed in the Index of Definitions following the Table of Contents. The Model Agreement does not attempt to incorporate definitions from the various agreements and documents that are exhibits or ancillary to the Agreement.

1.1 DEFINITIONS

For purposes of this Agreement, the following terms and variations thereof have the meanings specified or referred to in this Section 1.1:

“Accounts Receivable” -- (i) all trade accounts receivable and other rights to payment from customers of Seller and the full benefit of all security for such accounts or rights to payment, including all trade accounts receivable representing amounts receivable in respect of goods shipped or products sold or services rendered to customers of Seller, and (ii) all other accounts or notes receivable of Seller and the full benefit of all security for such accounts or notes, and (iii) any claim, remedy or other right related to any of the foregoing.

“Adjustment Amount” -- as defined in Section 2.8.

"Assets" -- as defined in Section 2.1.

"Assignment and Assumption Agreement" -- as defined in Section 2.7(a)(ii).

"Assumed Liabilities" -- as defined in Section 2.4(a).

"Balance Sheet" -- as defined in Section 3.4.

"Best Efforts" -- the efforts that a prudent Person desirous of achieving a result would use in similar circumstances to achieve that result as expeditiously as possible, *provided, however,* that a Person required to use his Best Efforts under this Agreement will not be thereby required to take actions that would result in a materially adverse change in the benefits to such Person of this Agreement and the Contemplated Transactions, or to dispose of or make any change to its business, expend any material funds or incur any other material burden.

COMMENT

Case law provides little guidance for interpreting a commitment to use "best efforts." *See generally* Farnsworth, *On Trying to Keep One's Promises: The Duty of Best Efforts in Contract Law*, 46 U. Pitt. L. Rev. 1 (1984). Some courts have held that "best efforts" is equivalent to "good faith" or a type of "good faith." *See, e.g., Gestetner Corp. v. Case Equip. Co.*, 815 F.2d 806, 811 (1st Cir. 1987); *Western Geophysical Co. of Am. v. Bolt Assocs., Inc.*, 584 F.2d 1164, 1171 (2d Cir. 1978); *Kubik v. J. & R. Foods of Or., Inc.*, 577 P.2d 518, 520 (Or. 1978). Other courts view "best efforts" as a more exacting standard than "good faith." *See, e.g., Bloor v. Falstaff Brewing Corp.*, 601 F.2d 609, 615 (2d Cir. 1979) ([t]he requirement that a party use its best efforts does not prevent a party from giving reasonable consideration to its own interests"); *Grossman v. Lowell*, 703 F. Supp. 282, 284 (S.D.N.Y. 1989); *In re Heard*, 6 B.R. 876, 884 (Bankr. W.D. Ky. 1980). The standard is not definable by a fixed formula but takes its meaning from the circumstances. *See, e.g., Triple-A Baseball Club Ass'n v. Northeastern Baseball, Inc.*, 832 F.2d 214, 225 (1st Cir. 1987), *cert. denied*, 485 U.S. 935 (1988); *Joyce Beverages of N.Y., Inc. v. Royal Crown Cola Co.*, 555 F. Supp. 271, 275 (S.D.N.Y. 1983); *Polyglycoat Corp. v. C.P.C. Distribs., Inc.*, 534 F. Supp. 200, 203 (S.D.N.Y. 1982). In *Hermann Holdings Ltd. v. Lucent Technologies, Inc.,* 302 F.3d 522, 581-582 (5th Cir. 2002), the Court wrote that when determining whether a party has used its best efforts, the Court measures the party's efforts "…by comparing the party's performance with that of an average prudent comparable operator."

The Model Agreement definition requires more than good faith but stops short of requiring a party to subject itself to economic hardship. Because "Best Efforts" duties apply most often to the Seller, a high standard of what constitutes "Best Efforts" favors the Buyer. Some attorneys, particularly those representing a Seller, prefer to use the term "commercially reasonable efforts" rather than "best efforts". A sample definition of the former follows:

> For purposes of this Agreement, 'commercially reasonable efforts' will not be deemed to require a Person to undertake extraordinary or unreasonable measures, including the payment of amounts in excess of normal and usual filing fees and processing fees, if any, or other payments with respect to any Contract that are significant in the context of such Contract (or significant on an aggregate basis as to all Contracts).

The parties may wish to provide for a specific dollar standard, either in specific provisions where "Best Efforts" is required, or in the aggregate.

"Bill of Sale" -- as defined in Section 2.7(a)(i).

"Breach" -- any breach of, or any inaccuracy in, any representation or warranty or any breach of, or failure to perform or comply with, any covenant or obligation, in or of this Agreement or any other Contract, or any event which with the passing of time or the giving of notice, or both, would constitute such a breach, inaccuracy or failure.

"Bulk Sales Laws" -- as defined in Section 5.10.

"Business Day" -- any day other than (i) Saturday or Sunday or (ii) any other day on which banks in ________________ are permitted or required to be closed.

"Buyer" -- as defined in the first paragraph of this Agreement.

"Buyer Contact" -- as defined in the Section 12.2.

"Buyer Indemnified Persons"-- as defined in Section 11.2.

"Closing" -- as defined in Section 2.6.

"Closing Date" -- the date as of which the Closing actually takes place.

COMMENT

It is important to distinguish among the date on which the closing is scheduled to occur, the date on which the closing actually occurs (defined as the "Closing Date") and the time as of which the Closing is effective (defined as the "Effective Time"). See the definition of "Effective Time" and the related Comment and Sections 2.6 and 9.1 and the related Comments.

"Closing Financial Statements" -- as defined in Section 2.9(b).

"Closing Working Capital" -- as defined in Section 2.9(b).

"Code" -- the Internal Revenue Code of 1986.

"Confidential Information" -- as defined in Section 12.1.

"Consent" -- any approval, consent, ratification, waiver, or other authorization.

"Contemplated Transactions" -- all of the transactions contemplated by this Agreement.

"Contract" -- any agreement, contract, Lease, consensual obligation, promise, or undertaking (whether written or oral and whether express or implied), whether or not legally binding.

COMMENT

This definition includes all obligations, however characterized, whether or not legally binding. The Buyer may want to know about statements by the Seller to its distributors that the Seller will look favorably on a request for a return for credit of unsold products when the Seller introduces a replacement product. The Buyer may also want to encompass established practices of the Seller within this definition. Similarly, the Buyer may want the definition to encompass "comfort letters" confirming the Seller's intention to provide financial support to a subsidiary or other related person and assurances to employees regarding compensation, benefits, and tenure, whether or not such letters or assurances are legally binding.

"Damages" -- as defined in Section 11.2.

"Disclosing Party" -- as defined in Section 12.1.

"Disclosure Letter" -- the disclosure letter delivered by Seller and Shareholders to Buyer concurrently with the execution and delivery of this Agreement.

COMMENT

The form and content of the Disclosure Letter (sometimes called a disclosure schedule) should be negotiated and drafted concurrently with the negotiation and drafting of the acquisition agreement. The Disclosure Letter is an integral component of the acquisition documentation and should be prepared and reviewed as carefully as the acquisition agreement itself. The Buyer may prefer to attach multiple schedules or exhibits to the acquisition agreement instead of using a disclosure letter.

"Effective Time" -- [The time at which the Closing is consummated.] [__________ on the Closing Date.]

COMMENT

Under the Model Agreement, if the Closing occurs, the Effective Time fixes the time at which the transfer to the Buyer of the assets and the risks of the business and the assumption by the Buyer of liabilities are deemed to have taken place, regardless of the actual time of consummation of the transaction.

Normally the Effective Time will be the time when payment for the assets is made, at the consummation of the Closing. Sometimes acquisition agreements specify an effective time at the opening or closing of business on the closing date, or even (in the case of a business, such as a hospital, that operates and bills on a twenty-four hour basis) 12:01 a.m. on the Closing Date. This must be done with care, however, to avoid unintended consequences, such as the buyer having responsibility for an event that occurs after the Effective Time but before the Closing or the seller having responsibility for an event that occurs after the Closing but before the Effective Time.

Many drafters do not use a general definition of effective time and simply treat the closing as if it occurred at a point in time on the closing date. If the parties agree on an effective time for financial and accounting purposes that is different from the time of the closing, this can be accomplished by a sentence such as the following: "For financial and accounting purposes (including any adjustments pursuant to Section 2.8), the Closing shall be deemed to have occurred as of __________ on the Closing Date."

"Encumbrance" -- any charge, claim, community property interest, condition, equitable interest, lien, option, pledge, security interest, mortgage, right of way, easement, encroachment, servitude, right of first option, right of first refusal or similar restriction, including any restriction on use, voting (in the case of any security or equity interest), transfer, receipt of income, or exercise of any other attribute of ownership.

"Escrow Agreement" -- as defined in Section 2.7(a)(viii).

"Excluded Assets" -- as defined in Section 2.2.

"Exhibit" -- an exhibit to this Agreement.

"GAAP" -- Generally accepted accounting principles for financial reporting in the United States, applied on a basis consistent with the basis on which the Balance Sheet and the other financial statements referred to in Section 3.4 were prepared.

COMMENT

The American Institute of Certified Public Accountants defines GAAP as:

> a technical accounting term that encompasses the conventions, rules, and procedures necessary to define accepted accounting practice at a particular time. It includes not only broad guidelines of general application, but also detailed practices and procedures. . . . Those conventions, rules, and procedures provide a standard by which to measure financial presentations.

CODIFICATION OF ACCOUNTING STANDARDS AND PROCEDURES, *Statement on Auditing Standards No. 69*, § 2 (American Inst. of Certified Pub. Accountants, 1992).

The use of this term in an acquisition agreement is customary. Although the requirement that financial statements be prepared in accordance with GAAP provides some comfort to the buyer, the buyer should understand the wide latitude of accepted accounting practices within GAAP. GAAP describes a broad group of concepts and methods for preparing financial statements. GAAP thus represents a boundary of accepted practice but does not necessarily characterize a "good" financial statement.

GAAP is not a static concept — a financial statement will change as GAAP changes. The principal authority determining the "conventions, rules, and procedures" that constitute GAAP is the Financial Accounting Standards Board ("FASB"), although custom and usage also play a role. The FASB often issues Financial Accounting Standards ("FAS") bulletins that present guidelines for financial accounting in special circumstances or changes in accepted practices. The adoption of FAS 106, for example, changed the presentation of retiree health costs by requiring such costs to be recorded as a liability rather than expensed as incurred.

GAAP permits the exercise of professional judgment in deciding how to present financial results fairly. GAAP permits different methods of accounting for items such as inventory valuation ("FIFO," "LIFO," or average cost), depreciation (straight line or accelerated methods), and accounting for repairs and small tools. Changes in these alternative methods can substantially affect reported results even though there has been no change in the underlying economic position of the seller. The buyer may want to examine the seller's financial statements from previous years to ensure their consistency from year to year. The buyer also may want to determine whether there are any pending FAS bulletins that would require a change in the seller's accounting practices, and the buyer may want the seller to represent and covenant that there have been (within the past five years, for example) and will be (prior to the closing) no voluntary changes in the seller's accounting practices. For a further discussion of these issues, see the comment to Section 3.4.

Although GAAP is the standard used in the preparation of nearly all financial statements, the SEC reserves the right to mandate specific accounting methods for public companies. When dealing with financial statements of public companies, the Buyer may want to amend the definition of GAAP to include compliance with SEC accounting standards.

In international transactions, the parties should be aware that there are important differences between the GAAP standards and accounting standards used in other nations. The buyer sometimes requires that foreign financial statements be restated to conform to United States GAAP or accompanied by a reconciliation to United States GAAP.

"Governing Documents" -- with respect to any particular entity, (a) if a corporation, the articles or certificate of incorporation and the bylaws; (b) if a general partnership, the partnership agreement and any statement of partnership; (c) if a limited partnership, the limited partnership agreement and the certificate of limited partnership; (d) if a limited liability company, the articles of organization and operating agreement; (e) any other charter or similar document adopted or filed in connection with the creation, formation or organization of a Person; (f) all equityholders' agreements, voting agreements, voting trust agreements, joint venture agreements, registration rights agreements or other agreements or documents relating to the organization, management or operation of any Person, or relating to the rights, duties and obligations of the equityholders of any Person; and (g) any amendment or supplement to any of the foregoing.

"Governmental Authorization" -- any Consent, license, or permit issued, granted, given, or otherwise made available by or under the authority of any Governmental Body or pursuant to any Legal Requirement.

"Governmental Body" -- any:

(a) nation, state, county, city, town, borough, village, district, or other jurisdiction;

(b) federal, state, local, municipal, foreign, or other government;

(c) governmental or quasi-governmental authority of any nature (including any agency, branch, department, board, commission, court, tribunal or other entity exercising governmental or quasi-governmental powers);

(d) multi-national organization or body;

(e) body exercising, or entitled or purporting to exercise, any administrative, executive, judicial, legislative, police, regulatory, or taxing authority or power; or

(f) official of any of the foregoing.

"Ground Lease" -- any long-term lease of land in which most of the rights and benefits comprising ownership of the land and the improvements thereon or to be constructed thereon, if any, are transferred to the tenant for the term thereof.

"Ground Lease Property" -- any land, improvements and appurtenances subject to a Ground Lease in favor of Seller.

"HSR Act" -- the Hart-Scott-Rodino Antitrust Improvements Act of 1976.

"Indemnified Person" -- as defined in Section 11.9.

"Indemnifying Person" -- as defined in Section 11.9.

"Initial Working Capital" -- as defined in Section 2.9(a).

"Interim Balance Sheet" -- as defined in Section 3.4.

"Inventories" -- all inventories of the Seller, wherever located, including all finished goods, work in process, raw materials, spare parts and all other materials and supplies to be used or consumed by Seller in the production of finished goods.

"IRS" -- the United States Internal Revenue Service, and, to the extent relevant, the United States Department of the Treasury.

"Knowledge" -- an individual will be deemed to have "Knowledge" of a particular fact or other matter if:

(a) such individual is actually aware of such fact or other matter; or

(b) a prudent individual could be expected to discover or otherwise become aware of such fact or other matter in the course of conducting a reasonably comprehensive investigation regarding the accuracy of any representations or warranties contained in this Agreement.

A Person (other than an individual) will be deemed to have "Knowledge" of a particular fact or other matter if any individual who is serving, or who has at any time served, as a director, officer, partner, executor, or trustee of such Person (or in any similar capacity) has, or at any time had, Knowledge of such fact or other matter (as set forth in (a) and (b) above), and any such individual (and any individual party to this Agreement) will be deemed to have conducted a reasonably comprehensive investigation regarding the accuracy of any representations and warranties made herein by such Person or individual.

COMMENT

The seller will attempt to use the caveat of knowledge to qualify many of its representations and warranties. A knowledge qualification of representations concerning threatened litigation has become accepted practice. Otherwise, there is no standard practice for determining which representations, if any, should be qualified by the seller's knowledge. Ultimately, the issue is allocation of risk -- should the buyer or the seller bear the risk of the unknown? The buyer will often argue that the seller has more knowledge of and is in a better position to investigate its business and therefore should bear the risk. The seller's frequent response is that it has made all information about the seller available to the buyer and that the buyer is acquiring the assets as part of an on-going enterprise with the possibility of either unexpected gains or unexpected losses. Resolution of this issue usually involves much negotiation.

If the buyer agrees to a knowledge qualification, the next issue is whose knowledge is relevant. The buyer will seek to have the group of people be as broad as possible, to ensure that this group includes the people who are the most knowledgeable about the specific representation being qualified, and to include constructive and actual knowledge. The broader the group and the greater the knowledge of the people in the group, the greater will be the risk retained by the seller. An expansive definition of knowledge can return to haunt the buyer, however, if an "anti-sandbagging" provision is proposed by the seller and accepted by the buyer. This provision would preclude a buyer's claim for indemnity if it closes the transaction notwithstanding its knowledge of the inaccuracy of a representation by the seller (normally acquired between the signing of the definitive agreement and closing). See the Commentary to Section 11.1.

The final issue is the scope of investigation built into the definition. Some acquisition agreements define knowledge as actual knowledge without any investigation requirement. Others may require some level of investigation or will impute knowledge to an individual who could be expected to discover or become aware of a fact or matter by virtue of that person's position, duties or responsibilities. If the actual knowledge standard is used, the buyer may want to expand the scope to the actual knowledge of key employees of the seller and list the titles or names of these employees.

"Land" -- all parcels and tracts of land in which Seller has an ownership interest.

"Lease" -- any Real Property Lease or any lease or rental agreement, license, right to use or installment and conditional sale agreement to which Seller is a party and any other Seller Contract pertaining to the leasing or use of any Tangible Personal Property.

COMMENT

If the Assets to be acquired also include options to purchase or lease real property, the Buyer may wish to include the options in the definition of Land or Lease, respectively, in order to receive the benefit of the representations contained in Sections 3.7, 3.8 and 3.10, as applicable with respect to the option property as well as the assignment provisions of Section 2.7.

"Legal Requirement" -- any federal, state, local, municipal, foreign, international, multinational, or other constitution, law, ordinance, principle of common law, regulation, statute, or treaty.

"Liability" -- with respect to any Person, any liability or obligation of such Person of any kind, character or description, whether known or unknown, absolute or contingent, accrued or unaccrued, disputed or undisputed, liquidated or unliquidated, secured or unsecured, joint or several, due or to become due, vested or unvested, executory, determined, determinable or otherwise and whether or not the same is required to be accrued on the financial statements of such Person.

"Order" -- any order, injunction, judgment, decree, ruling, assessment or arbitration award of any Governmental Body or arbitrator.

"Ordinary Course of Business" -- an action taken by a Person will be deemed to have been taken in the "Ordinary Course of Business" only if that action:

(a) is consistent in nature, scope and magnitude with the past practices of such Person and is taken in the ordinary course of the normal day-to-day operations of such Person;

(b) does not require authorization by the board of directors or shareholders of such Person (or by any Person or group of Persons exercising similar authority) and does not require any other separate or special authorization of any nature; and

(c) is similar in nature, scope and magnitude to actions customarily taken, without any separate or special authorization, in the ordinary course of the normal day-to-day operations of other Persons that are in the same line of business as such Person.

COMMENT

When the acquisition agreement is signed, the buyer obtains an interest in being consulted about matters affecting the seller. However, the seller needs to be able to operate its daily business without obtaining countless approvals, which can significantly delay ordinary business operations. This tension is analogous to that found in other areas of the law that use the concept of "in the ordinary course of business":

1. Under bankruptcy law, certain transactions undertaken by the debtor "other than in the ordinary course of business" require approval of the Bankruptcy Court. *See* 11 U.S.C. § 363(b)(1) (1988).

2. Most states' general corporation laws require shareholder approval for a sale of all or substantially all of a corporation's assets other than in the regular course of business.

3. A regulation under the Securities Exchange Act of 1934 allows management to omit a shareholder proposal from a proxy statement "[i]f the proposal deals with a matter relating to the company's ordinary business operations." *See* 17 C.F.R. § 14a-8(i)(7) (1999).

An important consideration in drafting this definition is the relevant standard for distinguishing between major and routine matters: the past practices of the seller, common practice in the seller's industries, or both. In one of the few cases that have interpreted the term "ordinary course of business" in the context of an acquisition, the jury was allowed to decide whether fees paid in connection with obtaining a construction loan, which were not reflected on the seller's last balance sheet, were incurred in the ordinary course of business. *See Medigroup, Inc. v. Schildknecht*, 463 F.2d 525 (7th Cir. 1972). In *Medigroup*, the trial judge defined "ordinary course of business" as "that course of conduct that reasonable prudent men would use in conducting business affairs as they may occur from day to day," and instructed the jury that the past practices of the company being sold, not "the general conduct of business throughout the community," was the relevant standard. *Id.* at 529; *cf. In re Fulghum Constr. Corp.*, 872 F.2d 739, 743 & n.5 (6th Cir. 1989) (stating that, in the bankruptcy context, the relevant standard is "the business practices which were unique to the particular parties under consideration and not to the practices which generally prevailed in the industry," but acknowledging that "industry practice may be relevant" in arriving at a definition of "ordinary business terms"). *But see In re Yurika Foods Corp.*, 888 F.2d 42, 44 (6th Cir. 1989) (noting that it might be necessary to examine industry standards as well as the parties' prior dealings to define "ordinary course of business"); *In re Dant & Russell, Inc.*, 853 F.2d 700, 704 (9th Cir. 1988) (applying, in the bankruptcy context, a "horizontal dimension test" based on industry practices); *In re Hills Oil & Transfer, Inc.*, 143 B.R. 207, 209 (Bankr. C.D. Ill. 1992) (relying on industry practices and standards to define "ordinary course of business" in a bankruptcy context).

The Model Agreement definition distinguishes between major and routine matters based on the historic practices of both the Seller and others in the same industry and on the need for board or shareholder approval. The definition is derived primarily from the analysis of "ordinary course of business" in bankruptcy, which examines both the past practice of the debtor and the ordinary practice of the industry. *See, e.g., In re Roth Am., Inc.*, 975 F.2d 949, 952-53 (3d Cir. 1992); *In re Johns-Manville Corp.*, 60 B.R. 612, 616-18 (Bankr. S.D.N.Y. 1986). No standard can eliminate all ambiguity regarding the need for consultation between the buyer and the seller. In doubtful cases, the seller should consult with the buyer and obtain its approval.

The buyer should be aware that its knowledge of transactions the seller plans to enter into before the closing may expand the scope of this definition. One court has stated:

> If a buyer did not know the selling corporation had made arrangements to construct a large addition to its plant, "the ordinary course of business" might refer to such transactions as billing customers and purchasing supplies. But a buyer aware of expansion plans would intend "the ordinary course of business" to include whatever transactions are normally incurred in effectuating such plans.

Medigroup, 463 F.2d at 529. Thus, the buyer should monitor its knowledge of the seller's plans for operations before the closing, and if the buyer knows about any plans to undertake projects or enter into transactions different from those occurring in the past practice of the seller and other companies in the same industries, the buyer may want specifically to exclude such projects or transactions, and all related transactions, from the definition of "ordinary course of business."

Clause (b) of the definition has special significance in a parent-subsidiary relationship. State law does not normally require parent company authorization for actions taken by subsidiaries. Unless the certificate or articles of incorporation provide otherwise, most state laws require shareholder approval only for amendments to the charter, mergers, sales of all or substantially all of the assets, dissolutions, and other major events. Therefore, the Model Agreement definition excludes any action requiring authorization by the parent of a seller not only for subsidiary actions requiring shareholder authorization under state law, but also for subsidiary actions requiring parent authorization under the operating procedures in effect between the parent and the subsidiary.

A seller may object to clause (c) of the definition on the ground that it does not know the internal approval processes of other companies in its industries.

"Part" -- a part or section of the Disclosure Letter.

"Permitted Encumbrances" -- as defined in Section 3.9.

"Person" -- an individual, partnership, corporation, business trust, limited liability company, limited liability partnership, joint stock company, trust, unincorporated association, joint venture or other entity, or a Governmental Body.

"Proceeding" -- any action, arbitration, audit, hearing, investigation, litigation, or suit (whether civil, criminal, administrative, judicial or investigative, whether formal or informal, whether public or private) commenced, brought, conducted, or heard by or before, or otherwise involving, any Governmental Body or arbitrator.

"Promissory Note" -- as defined in Section 2.7(b)(ii).

"Purchase Price" -- as defined in Section 2.3.

"Real Property" -- the Land and Improvements and all Appurtenances thereto and any Ground Lease Property.

"Real Property Lease" -- any Ground Lease or Space Lease.

"Record" -- information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form.

"Receiving Party" -- as defined in Section 12.1.

"Related Person" --

With respect to a particular individual:

(a) each other member of such individual's Family;

(b) any Person that is directly or indirectly controlled by any one or more members of such individual's Family;

(c) any Person in which members of such individual's Family hold (individually or in the aggregate) a Material Interest; and

(d) any Person with respect to which one or more members of such individual's Family serves as a director, officer, partner, executor, or trustee (or in a similar capacity).

With respect to a specified Person other than an individual:

(a) any Person that directly or indirectly controls, is directly or indirectly controlled by, or is directly or indirectly under common control with such specified Person;

(b) any Person that holds a Material Interest in such specified Person;

(c) each Person that serves as a director, officer, partner, executor, or trustee of such specified Person (or in a similar capacity);

(d) any Person in which such specified Person holds a Material Interest; and

(e) any Person with respect to which such specified Person serves as a general partner or a trustee (or in a similar capacity).

For purposes of this definition, (a) "**control**" (including "**controlling,**" "**controlled by**" and "**under common control with**") means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a Person, whether through the ownership of voting securities, by contract or otherwise, and shall be construed as such term is used in the rules promulgated under the Securities Act, (b) the "**Family**" of an individual includes (i) the individual, (ii) the individual's spouse, (iii) any other natural person who is related to the individual or the individual's spouse within the second degree, and (iv) any other natural person who resides with such individual, and (c) "**Material Interest**" means direct or indirect beneficial ownership (as defined in Rule 13d-3 under the Securities Exchange Act of 1934) of voting securities or other voting interests representing at least 10% of the outstanding voting power of a Person or equity securities or other equity interests representing at least 10% of the outstanding equity securities or equity interests in a Person.

COMMENT

The main purpose of the representations concerning relationships with related persons is to identify "sweetheart" deals benefitting the seller (which may disappear after the closing), transactions with related persons on terms unfavorable to the seller (which the buyer may not be able to terminate after the closing), and possibly diverted corporate opportunities. Thus, the buyer will want a broad definition of "Related Persons." For individuals, the Model Agreement definition focuses on relationships with and arising from members of an individual's family; depending on the circumstances, a broader definition may be necessary to capture other relationships. In the definition of "Material Interest," the appropriate percentage of voting power or equity interests will depend on the circumstances. The objective is to identify the level of equity interest in a Related Person that may confer a significant economic benefit on a seller or a seller's shareholder; this may be an interest well short of control of the Related Person. Tax and accounting considerations may also be relevant to determining the appropriate percentage.

"Representative" -- with respect to a particular Person, any director, officer, employee, agent, consultant, advisor, accountant, financial advisor, legal counsel or other representative of that Person.

"Retained Liabilities" -- as defined in Section 2.4(b).

"Seller" -- as defined in the first paragraph of this Agreement.

"Seller Confidential Information" -- as defined in Section 12.1.

"Seller Contact" -- as defined in Section 12.2.

"Seller Contract" -- any Contract (a) under which Seller has or may acquire any rights or benefits, (b) under which Seller has or may become subject to any obligation or liability, or (c) by which Seller or any of the assets owned or used by Seller is or may become bound.

"Shareholders" -- as defined in the first paragraph of this Agreement.

"Space Lease" -- any lease or rental agreement pertaining to the occupancy of any improved space on any Land.

"Tangible Personal Property" -- all machinery, equipment, tools, furniture, office equipment, computer hardware, supplies, materials, vehicles and other items of tangible personal property (other than Inventories) of every kind owned or leased by Seller (wherever located and whether or not carried on Seller's books), together with any express or implied warranty by the manufacturers or sellers or lessors of any item or component part thereof, and all maintenance records and other documents relating thereto.

"Tax" -- any income, gross receipts, license, payroll, employment, excise, severance, stamp, occupation, premium, property, environmental, windfall profit, customs, vehicle, airplane, boat, vessel or other title or registration, capital stock, franchise, employees' income withholding, foreign or domestic withholding, social security, unemployment, disability, real property, personal property, sales, use, transfer, value added, alternative, add-on minimum, and other tax, fee, assessment, levy, tariff, charge or duty of any kind whatsoever, and any interest, penalties, additions or additional amounts thereon, imposed, assessed, collected by or under the authority of any Governmental Body or payable under any tax-sharing agreement or any other Contract.

COMMENT

In addition to the governmental impositions applicable to Seller's business, the term "Tax" includes fees and other charges incident to the sales taxes and other charges imposed on the sale of the assets. Such taxes are sometimes levied in the form of fees, which may be payable by buyer and measured by the value of particular assets being transferred, for the registration of the transfer of title to aircraft, vehicles, boats, vessels, real estate and other property. See Sections 7.4(f) and 10.2 and related Commentary.

"Tax Return" -- any return (including any information return), report, statement, schedule, notice, form, or other document or information filed with or submitted to, or required to be filed with or submitted to, any Governmental Body in connection with the determination, assessment, collection, or payment of any Tax or in connection with the administration, implementation, or enforcement of or compliance with any Legal Requirement relating to any Tax.

"Third Party" -- a Person that is not a party to this Agreement.

"Third-Party Claim" -- any claim against any Indemnified Person by a Third Party, whether or not involving a Proceeding.

1.2 USAGE

(a) Interpretation. In this Agreement, unless a clear contrary intention appears:

(i) the singular number includes the plural number and vice versa;

(ii) reference to any Person includes such Person's successors and assigns but, if applicable, only if such successors and assigns are not prohibited by this Agreement, and reference to a Person in a particular capacity excludes such Person in any other capacity or individually;

(iii) reference to any gender includes each other gender;

(iv) reference to any agreement, document or instrument means such agreement, document or instrument as amended or modified and in effect from time to time in accordance with the terms thereof;

(v) reference to any Legal Requirement means such Legal Requirement as amended, modified, codified, replaced or reenacted, in whole or in part, and in effect from time to time, including rules and regulations promulgated thereunder and reference to any section or other provision of any Legal Requirement means that provision of such Legal Requirement from time to time in effect and constituting the substantive amendment, modification, codification, replacement or reenactment of such section or other provision;

(vi) "hereunder", "hereof", "hereto" and words of similar import shall be deemed references to this Agreement as a whole and not to any particular Article, Section or other provision thereof;

(vii) "including" (and with correlative meaning "include") means including without limiting the generality of any description preceding such term;

(viii) "or" is used in the inclusive sense of "and/or";

(ix) with respect to the determination of any period of time, "from" means "from and including" and "to" means "to but excluding"; and

(x) references to documents, instruments or agreements shall be deemed to refer as well to all addenda, exhibits, schedules or amendments thereto.

(b) Accounting Terms and Determinations. Unless otherwise specified herein, all accounting terms used therein shall be interpreted and all accounting determinations thereunder shall be made in accordance with GAAP.

(c) Legal Representation of the Parties. This Agreement was negotiated by the parties with the benefit of legal representation and any rule of construction or interpretation otherwise requiring this Agreement to be construed or interpreted against any party shall not apply to any construction or interpretation hereof.

COMMENT

Clauses (v), (vii), (viii) and (x) of Section 1.2(a) are designed to eliminate the need for repetitive and cumbersome use of (i) the phrase "as amended" after numerous references to statutes and rules, (ii) the phrase "including, but not limited to," or "including, without limitation," in every instance in which a broad term is followed by a list of items encompassed by that term, (iii) "and/or" where the alternative and conjunctive are intended, and (iv) a list of all possible attachments or agreements relating to each document referenced in the Model Agreement. The REVISED MODEL BUS. CORP. ACT, Section 1.40(12) contains a similar definition: "'Includes' denotes a partial definition." In certain jurisdictions, however, the rule of *ejusdem generis* has been applied to construe the meaning of a broad phrase to include only matters that are of a similar nature to those specifically described. *See, e.g., Forward Industries, Inc. v. Rolm of New York Corp.*, 506 N.Y.S.2d 453, 455 (App. Div. 1986) (requiring the phrase "other cause beyond the control" to be limited to events of the same kind as those events specifically enumerated); *see also Buono Sales, Inc. v. Chrysler Motors Corp.*, 363 F.2d 43 (3d Cir.), *cert. denied*, 385 U.S. 971 (1966); *Thaddeus Davids Co. v. Hoffman-LaRoche Chemical Works*, 166 N.Y.S. 179 (App. Div. 1917).

2. SALE AND TRANSFER OF ASSETS; CLOSING

2.1 ASSETS TO BE SOLD

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

(a) all Real Property, including the Real Property described in Parts 3.7 and 3.8;

(b) all Tangible Personal Property, including those items described in Part 2.1(b);

(c) all Inventories;

(d) all Accounts Receivable;

(e) all Seller Contracts, including those listed in Part 3.20(a), and all outstanding offers or solicitations made by or to Seller to enter into any Contract;

(f) all Governmental Authorizations and all pending applications therefor or renewals thereof, in each case to the extent transferable to Buyer, including those listed in Part 3.17(b);

(g) all data and Records related to the operations of Seller, including client and customer lists and Records, referral sources, research and development reports and Records, production reports and Records, service and warranty Records, equipment logs, operating guides and manuals, financial and accounting Records, creative materials, advertising materials, promotional materials, studies, reports, correspondence and other similar documents and Records and, subject to Legal Requirements, copies of all personnel Records and other Records described in Section 2.2(g);

(h) all of the intangible rights and property of Seller, including Intellectual Property Assets, going concern value, good-will, telephone, telecopy and e-mail addresses, websites and listings and those items listed in Part 3.25(d), (e), (f) and (h);

(i) all insurance benefits, including rights and proceeds, arising from or relating to the Assets or the Assumed Liabilities prior to the Effective Time, unless expended in accordance with this Agreement;

(j) all claims of Seller against third parties relating to the Assets, whether choate or inchoate, known or unknown, contingent or non-contingent, including all such claims listed in Part 2.1(j); and

(k) all rights of Seller relating to deposits and prepaid expenses, claims for refunds and rights to offset in respect thereof which are not listed in Part 2.2(d) and which are not excluded under Section 2.2(h).

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

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

COMMENT

The identities of the specific assets to be transferred and the liabilities to be assumed (see Section 2.4) are the heart of an asset purchase transaction. The acquisition agreement and the disclosure letter should identify, with some degree of detail, those assets that are to be acquired by the buyer. The mechanism used for this identification will depend in part upon the amount of detail the parties desire, the nature of the assets involved, and the status of the buyer's due diligence at the time the acquisition agreement is finalized. The identification could be guided by a consideration of which assets listed on the balance sheet the buyer intends to purchase. The asset description could also be used as part of the buyer's due diligence investigation or to confirm that investigation. To this end, the buyer could give the seller an exhaustive list of assets and leave it to the seller to tailor the list to fit the assets the seller has and considers part of the assets being sold.

The Model Agreement initially describes the assets to be acquired in a general way, followed by a categorization into the groupings listed in Section 2.1. This general description is further supplemented, to the extent appropriate, by reference to Parts of the Disclosure Letter to list or describe particular items within certain groupings. This method works well when the buyer's due diligence is well under way at the time the acquisition agreement is finalized and allows the parties to specify, for example, which particular contracts buyer will acquire.

Alternatively, the parties might omit any specific identification or description and describe the acquired assets only by categorizing them into general groupings. Although the parties should always pay close attention to the definition of Excluded Assets, the mechanism by which the assets that are excluded from the transaction are described assumes even greater significance when the acquired assets are described in only a general way.

The interplay between the section listing purchased assets and the section listing the excluded assets also needs close attention. The Model Agreement specifically provides that the listing of Excluded Assets set forth in Section 2.2 takes priority over the listing of Assets set forth in Section 2.1. This priority is established both by the parenthetical at the end of the introductory paragraph of Section 2.1 and the language at the beginning of Section 2.2. As a result, particular care needs to be given to the listing of Excluded Assets as that list will control if a particular asset could be both an Asset and an Excluded Asset.

The categories of Assets in Section 2.1 are described using a combination of defined terms and specific description of the Assets. This represents a blend of two extremes, which are defining all terms elsewhere and using only the defined terms in Section 2.1 and placing the complete description of all assets in Section 2.1 with the definitions at the end of each category. In the Model Agreement, defined terms are used to cover categories of Assets where that defined term is used elsewhere in the Model Agreement (for example, in the representations section). Reference is made to the definitions of the various defined terms used in Section 2.1 and the Comments to those definitions for further description of the scope of those terms. If no defined term is needed elsewhere in the Model Agreement, a specific description of the category of Assets is used. Where defined terms are used, the definitions need to be carefully drafted to transfer only the Assets intended and to ensure that the defined terms need to be addressed consistently throughout the Agreement.

For example, the term "Tangible Personal Property" includes personal property owned or leased by the seller (see Section 2.1(b)). Therefore, since the buyer is purchasing all leased personal property, the associated lease contracts should be listed on the Part of the Disclosure Letter referred to in Section 2.1(e), should not be listed on Exhibit 2.2(f) pursuant to Section 2.2(f), which identifies excluded assets, and should be listed on the Part of the Disclosure Letter referred to in Section 2.4(a)(v).

Whether a defined term or a specific description is utilized, the Buyer can reduce the risk that an unlisted item will be excluded from the acquired assets by using language such as "including." Although the last sentence of Section 1.2(a)(vii) expressly recognizes that the word "including" does not limit the preceding words or terms, the rule of *ejusdem generis* has been applied to construe the meaning of a broad phrase to include only matters that are of a nature similar to those specifically described. See the Comment to Section 1.2.

If there are specific assets which are of significant importance to the buyer, the buyer may want to specifically list those assets instead of relying on the introductory "catch-all" phrase or any "including" clause listing assets of a similar type. For example, if the seller had subsidiaries, the buyer would want to include specifically stock of the subsidiaries as assets in Section 2.1. Similarly, if the seller owns or has access to certain business development assets, such as luxury boxes, event tickets or the like, the buyer would want to specifically identify those assets.

Under Section 2.1(i), all insurance benefits are transferred to the buyer unless expended in accordance with the terms of the Model Agreement. In most asset acquisitions, insurance policies are not transferred, primarily because such policies typically may not be transferred without the consent of the insurance company. Transferable policies may be purchased, however. This delineation would involve a review of the seller's policies to determine whether each is transferable. The approach taken in the Model Agreement is that the policies themselves stay with the seller but all unexpended benefits are transferred. Given this split and the typical non-transferability language in insurance policies, the buyer may need to utilize the further assurances clause set forth in Section 10.11 and rely on the seller to take certain actions on behalf of the buyer to receive any insurance proceeds. Note that only insurance benefits relating to the Assets and Assumed Liabilities are transferred. Therefore, life insurance under "key man" policies would not be transferred. Finally, the buyer would receive no rights under this section to the extent the seller self-insures with respect to a certain risk. However, the parties would need to adjust this provision if the seller has another variant of self-insurance where an insurance policy covers the risk at issue but the insured agrees to reimburse the insurance company dollar-for-dollar for any claims. Under Section 2.1(i), the benefits under that policy would transfer to the buyer and the seller would be left with the reimbursement obligation. Usually, the parties and their insurance consultants will be able to structure reasonable insurance backup mechanisms as joint protection for pre-closing occurrences or, failing that, the buyer may require a substantial escrow or set-off right to cover these risks. See Sections 2.7 and 11.8.

Section 2.1(k) provides that rights of the seller with respect to deposits and prepaid expenses, and claims for refunds and rights to offset relating thereto, are included in the Assets unless specifically excluded. The term "prepaid expenses" is an accounting term and is used in that sense. Therefore, accounting reference materials would be helpful in the application of this term. Finally, note that this section provides that it is the seller's rights which are being sold, rather than the actual deposits, prepaid expenses and related items.

In many asset purchase transactions the buyer is seeking to acquire a business and all of seller's operating assets necessary to conduct the business. Because the Model Agreement was drafted on the basis of a fact pattern that assumed the acquisition of all of seller's operating assets and in order to reduce the risk that buyer could be held liable for seller liabilities which it did not assume, the Model Agreement does not attempt to define the "business" being acquired or include in Section 2.1 a statement to the effect that the Assets include all of the assets of seller's business. But see the representation in Section 3.6.

Many drafters prefer to include a defined term "Business" and a catch-all statement to the effect that the Assets include all of the properties and assets of any kind or nature used in the Business. This approach is particularly useful (and may be necessary) in situations where the buyer is acquiring a division of the seller. If this approach were used, the lead-in to Section 2.1 could be revised, and a new subsection (l) could be added to Section 2.1, to read as follows:

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

> Seller and which relate to the business currently conducted by the __________ Division of Seller as a going concern, including the design, manufacture and sale of its products and the furnishing of advisory and consulting services to customers as well as any goodwill associated therewith (the "Business"), including the following (but excluding the Excluded Assets):
>
> * * *
>
> "(l) all other properties and assets of every kind, character and description, tangible or intangible, owned by Seller and used or held for use in connection with the Business, whether or not similar to the items specifically set forth above."
>
> See also Section 3.6 and the related Comment.

2.2 EXCLUDED ASSETS

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

(a) all cash, cash equivalents and short term investments;

(b) all minute books, stock Records and corporate seals;

(c) the shares of capital stock of Seller held in treasury;

(d) those rights relating to deposits and prepaid expenses and claims for refunds and rights to offset in respect thereof listed in Part 2.2(d);

(e) all insurance policies and rights thereunder (except to the extent specified in Section 2.1(i) and (j));

(f) all of the Seller Contracts listed in Part 2.2(f);

(g) all personnel Records and other Records that Seller is required by law to retain in its possession;

(h) all claims for refund of Taxes and other governmental charges of whatever nature;

(i) all rights in connection with and assets of the Employee Plans;

(j) all rights of Seller under this Agreement, the Bill of Sale, the Assignment and Assumption Agreement, the Promissory Note and the Escrow Agreement; and

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

COMMENT

As with the description of the assets to be acquired, the parties should always pay close attention to the identity of the assets to be excluded from the acquisition and therefore not transferred from the seller to the buyer. As with the acquired assets, the excluded assets could be described generally, identified specifically or described using some combination of the two. Whichever method of description is used, it is important that the method chosen be consistent with the description of the acquired assets.

In general, the Model Agreement uses general descriptions to categorize the Excluded Assets. One of these descriptions, Sections 2.2(e), is qualified by reference to the Assets to reflect the fact that, in general, this category of assets is being retained by the Seller but selected assets are being acquired by the Buyer. Two other sections, Sections 2.2(d) and 2.2(f), reflect the opposite approach. Each category of assets described in these sections is being acquired by the Buyer and only selected assets are being retained by the Seller. However, through Part 2.2(k), the Model Agreement also provides for the specific identification of certain assets to be retained by the Seller which do not fit within a general category and do not merit a special category or identification in the text of the Agreement.

The description of excluded assets needs also to mesh with the description of the assumed and excluded liabilities. For example, Section 2.2(i) of the Model Agreement provides that the Seller will retain all rights and assets relating to the Employee Plans. Correspondingly, Section 2.4(b)(vi) of the Model Agreement provides that the Seller retains all liabilities relating to those Employee Plans.

A number of the categories are designated as excluded assets because the Seller will continue as an independent company after the closing of the transactions contemplated by the Model Agreement. The Seller should retain all of its rights under the Model Agreement and related documents. Also in this category are the Seller's minute books, stock records and corporate seal, all of which are properly retained by the Seller in an asset purchase, and personnel records and other records the Seller is legally required to retain. However, the Buyer may want to ensure that it has access to these retained items and the ability to make copies to address post-closing matters. The Buyer should also specify where this inspection will occur as the Seller may liquidate and move the records to an inconvenient location. Finally, the Buyer may want the right to obtain these items if the Seller ever decides to discard them. The Model Agreement provides that the Buyer will receive a copy of certain of these items in Section 2.1(g). See Section 10.10 and accompanying Commentary.

Section 2.2(a) reflects the norm in asset purchase transactions that the buyer typically will not buy cash and cash equivalents. There usually is no reason to buy cash because this simply would have a dollar for dollar impact on the purchase price and excluding cash provides logistical simplicity. However, there may be situations when the purchase of cash should be considered. First, the logistics of the particular transaction may be such that purchasing cash is easier. For example, when purchasing a chain of retail stores, it may be easier to buy the cash in the cash registers rather than collecting all the cash and then restocking the registers with the buyer's cash. Second, the buyer may be able to buy cash for a note with deferred payments. This would provide the buyer with immediate working capital without requiring the infusion of additional capital - in essence, a form of seller financing.

At times, a buyer may include a category in Section 2.2 which would authorize the buyer, in its discretion, to designate certain of the seller's property or assets as Excluded Assets, often without altering the purchase price or other terms of the agreement. This right typically can be exercised from the signing of the agreement until shortly before closing. The buyer may request such right to allow the buyer the greatest benefit from its due diligence analysis (which typically continues up to the closing). The seller may desire to carefully review the breadth of this right because the buyer's decision to exclude assets may materially change the deal for the seller, particularly if the seller is exiting the business. For example, there may be assets which the seller would no longer want or which are worth less than the related operating costs or real estate which may be subject to environmental problems. If the seller agrees to this kind of provision, the seller may insist upon a right to renegotiate the purchase price depending on the assets left behind. As an alternative to the purchase price renegotiation, the seller may request limitation of the proposed exclusion right so that the buyer could not exclude certain assets, which could include assets that neither party wants. Whether the buyer will have the ability to insist on the inclusion of this provision is a matter of the parties' relative bargaining positions.

2.3 CONSIDERATION.

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

COMMENT

In Section 2.3 of the Model Agreement the consideration to be paid by the Buyer for the assets purchased includes both a monetary component and the assumption of specific liabilities of the Seller. In addition to the consideration set forth in Section 2.3, the Seller and the Shareholders may receive payments under noncompetition and employment agreements. If an earnout, consulting, royalty or other financial arrangement is negotiated by the parties in connection with the transaction, additional value will be paid.

The amount a buyer is willing to pay for the purchased assets depends on several factors, including the seller's industry, state of development and financial condition. A buyer's valuation of the seller may be based on some measure of historical or future earnings, cash flow, or book value (or some combination of revenues, earnings, cash flow, and book value), as well as the risks inherent in the seller's business. A discussion of modern valuation theories and techniques in acquisition transactions is found in Samuel C. Thompson, Jr., *A Lawyer's Guide to Modern Valuation Techniques in Mergers and Acquisitions*, 21 THE JOURNAL OF CORPORATION LAW, 457 (Spring 1996). The monetary component of the purchase price is also dependent in part upon the extent to which liabilities are assumed by the buyer. The range of liabilities a buyer is willing to assume varies with the particulars of each transaction and, as the Commentary to Section 2.4 observes, the assumption and retention of liabilities is often a heavily negotiated issue.

The method of payment selected by the parties depends on a variety of factors, including the buyer's ability to pay, the parties' views on the value of the assets, the parties' tolerance for risk, and the tax and accounting consequences to the parties (especially if the buyer is a public company). See Section III.E in the introductory text and the commentary to Section 10.2 for a discussion of the tax aspects of asset acquisitions and the Comment to Section 2.5 for a discussion of the allocation of the purchase price. The method of payment may include some combination of cash, debt, and stock and may also have a contingent component based on future performance. For example, if a buyer does not have sufficient cash or wants to reduce its initial cash outlay, it could require that a portion of the purchase price be paid by a note. This method of payment, together with an escrow arrangement for indemnification claims, is reflected in Section 2.3 of the Model Agreement. If the method of payment includes a debt component, issues such as security, subordination, and post-closing covenants will have to be resolved. Similarly, if the method of payment includes a stock component, issues such as valuation, negative covenants and registration rights must be addressed.

If a buyer and a seller cannot agree on the value of the assets, they may make a portion of the purchase price contingent on the performance of the assets following the acquisition. The contingent portion of the purchase price (often called an "earnout") is commonly based on the assets' earnings over a specified period of time following the acquisition. Although an earnout may bridge a gap between the buyer's and the seller's view of the value of the assets, constructing an earnout raises many issues, including how earnings will be determined, the formula for calculating the payment amount and how that amount will be paid (cash or stock), how the acquired businesses will be operated and who will have the authority to make major decisions, and the effect of a sale of the buyer during the earnout period. Resolving these issues may be more difficult than agreeing on a purchase price.

The Model Agreement assumes that the parties have agreed upon a fixed price, subject only to an adjustment based on the difference between the Seller's working capital on the date of the Balance Sheet and the date of Closing (see Sections 2.8 and 2.9).

2.4 LIABILITIES

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

(i) any trade account payable reflected on the Interim Balance Sheet (other than a trade account payable to any Shareholder or a Related Person of Seller) which remain unpaid at and are not delinquent as of the Effective Time;

(ii) any trade account payable (other than a trade account payable to any Shareholder or a Related Person of Seller) that have been incurred by Seller in the Ordinary Course of Business between the date of the Interim Balance Sheet and the Closing Date which remains unpaid at and are not delinquent as of the Effective Time;

(iii) any Liability to Seller's customers incurred by Seller in the Ordinary Course of Business for non-delinquent orders outstanding as of the Effective Time reflected on Seller's books (other than any Liability arising out of or relating to a Breach which occurred prior to the Effective Time);

(iv) any Liability to Seller's customers under written warranty agreements in the forms disclosed in Part 2.4(a)(iv) given by Seller to its customers in the Ordinary Course of Business prior to the Effective Time (other than any Liability arising out of or relating to a Breach which occurred prior to the Effective Time);

(v) any Liability arising after the Effective Time under the Seller Contracts described in Part 3.20(a) (other than any Liability arising under the Seller Contracts described on Part 2.4(a)(v) or arising out of or relating to a Breach which occurred prior to the Effective Time);

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

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

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

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

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

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

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

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

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

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

(viii) any Liability arising out of or relating to any employee grievance whether or not the affected employees are hired by Buyer;

(ix) any Liability of Seller to any Shareholder or Related Person of Seller or any Shareholder;

(x) any Liability to indemnify, reimburse or advance amounts to any officer, director, employee or agent of Seller;

(xi) any Liability to distribute to any of Seller's shareholders or otherwise apply all or any part of the consideration received hereunder;

(xii) any Liability arising out of any Proceeding pending as of the Effective Time, whether or not set forth in the Disclosure Letter;

(xiii) any Liability arising out of any Proceeding commenced after the Effective Time and arising out of, or relating to, any occurrence or event happening prior to the Effective Time;

(xiv) any Liability arising out of or resulting from Seller's non-compliance with any Legal Requirement or Order of any Governmental Body;

(xv) any Liability of Seller under this Agreement or any other document executed in connection with the Contemplated Transactions; and

(xvi) any Liability of Seller based upon Seller's acts or omissions occurring after the Effective Time.

COMMENT

The differences between asset and stock acquisitions is clearly seen in the area of liabilities. In a stock acquisition, the buyer, in effect, acquires all assets of the company subject to all its liabilities. In an asset acquisition, the buyer typically will not agree to assume all liabilities of the business being acquired, although some areas of liability may follow the assets in the hands of a successor. See the discussion of successor liability contained in Section IV above.

In an asset acquisition, the assumption and retention of liabilities is ordinarily a heavily negotiated issue, dependent in large part upon the economic agreement of the parties. The outcome of that negotiation will depend upon the results of the buyer's due diligence and negotiations between the parties on other economic matters.

As to approach, most buyers will desire to identify the liabilities they will assume with as much specificity as practicable to reduce the chance for unanticipated exposure and controversy. To protect itself after the closing, the buyer will want indemnification if for some reason it is forced to pay any liability retained by the seller. It will be important to the buyer to negotiate the indemnification provisions to reflect its agreement that retained liabilities remain the responsibility of the seller. Counsel to the buyer must be aware of this position in drafting limitations on the responsibility of the seller to indemnify, such as collars, baskets, limitation periods on the initiation of claims and exclusivity of the indemnification. Conversely, counsel to the seller needs to recognize that unlimited indemnification for retained liabilities, broadly defined, can facilitate an end run by the buyer around limitations on indemnification for breaches of representations and warranties. Finally, knowledge about liabilities the seller is to retain, whether determined or contingent as of the time of closing, may influence the buyer's decision to require an escrow of part of the purchase price, the amount to be held in escrow and its duration. See Article 11 (which provides for indemnification) and Section 2.7 (subsections (a)(vii) and (b)(iii) require execution of an escrow agreement).

The assumption and retention of liabilities set forth in the provisions of the Model Agreement is based upon the specific fact situation posited. Those provisions do reflect at least two general dividing lines which are likely to be the typical buyer's position. The first is that, except for specific liabilities arising before the closing which the buyer elects to assume, the buyer will expect the seller to continue to be responsible for and pay all liabilities of the seller's business which arise out of or relate to circumstances before the effective time. The second is that the buyer will only be willing to assume liabilities arising in the ordinary course of the business of the seller.

The division of liabilities along these lines requires understanding of the seller's business which may not be easily achieved. For example, dividing liabilities arising from nonserialized products, an artificial division based upon when the problem arises in relation to the effective time may be the only practical way to assign responsibility. In addition, the careful drafter will have to be concerned about consistency between the assumption and other provisions of the agreement, the completeness of coverage and the inevitable redundancies which may occur in specifically enumerating the liabilities the buyer will assume. As a case in point, compare Section 2.4(a)(vi), which deals with the assumption of liabilities under Seller Contracts (as broadly defined in Section 1.1 of the Model Agreement), with Sections 2.4(a)(ii) and (iii), which deal with the assumption of liabilities under trade accounts payable and work orders, all of which may fall within the definition of Seller Contracts.

The Model Agreement addresses the liabilities which the Buyer will assume in subsection 2.4(a). In defining the term "Assumed Liabilities," the Model Agreement provides that the Buyer will take on only specifically enumerated liabilities. Special care should be taken in areas where the description of liabilities to be assumed might be construed to encompass contingent liabilities. The importance of the primacy of this enumeration is demonstrated by the attention paid to avoid contrary indications in other provisions of the Model Agreement. For example, Section 2.1, listing the assets to be transferred, is qualified to indicate that the Buyer is not agreeing thereby to assume any liabilities of Seller unless expressly assumed under Section 2.4(a). In addition, the specificity required to limit the exposure of the Buyer is evident from analysis of the particular provisions of Section 2.4(a).

In clauses (i) and (ii) of Section 2.4(a), the Buyer's agreement to assume trade accounts payable is restricted to non-delinquent payables that are not paid before the Effective Time. If the Buyer assumed delinquent payables, the Seller would have an incentive to delay paying trade accounts. Payables not assumed must be paid by the Seller under Section 10.3. In clause (i) the liabilities are particularly described by reference to the Interim Balance Sheet which the Buyer has presumably received and examined before execution of the agreement. The Interim Balance Sheet rather than the last audited Balance Sheet (both of which are warranted by Seller under its representations) is used because it provides a more current listing of the Seller's trade accounts payable. As for trade accounts payable arising from the date of the Interim Balance Sheet to the Closing Date, the agreement of the Buyer is limited to liabilities arising in the Ordinary Course of Business. Finally, the Buyer's agreement to assume trade accounts payable does not include any such payable to a Related Person of the Seller. This position is taken in the Model Agreement because, at the time of a first draft, the Buyer may not know enough about such payables to know that the underlying transactions are arm's-length.

In Section 2.4(a)(iv), the Buyer only agrees to assume the warranty obligations of the Seller under specifically identified forms of agreements given by the Seller in the Ordinary Course of Business and does not assume any liability due to a breach before the effective time. The intent of this provision is to avoid assuming products liability risk for products manufactured or sold by the Seller before the closing. The allocation of product liability risk between a seller and a buyer is determined not only by the extent to which the buyer contractually assumes such risk, but also by the application of de facto merger and other theories of successor liability. See Section IV above. The buyer may wish to address this possibility through indemnification, taking into account the availability of existing and potential insurance coverage for the risk.

Under clauses (v) and (vi) of Section 2.4(a), the Buyer agrees to assume liabilities under Seller Contracts, but this assumption is limited in several respects. For Seller Contracts existing at the time the agreement is signed, the Buyer will assume only those liabilities and obligations arising under the specifically identified Seller Contracts listed in Part 3.20 of the Disclosure Letter and not arising out of any Breach of those Seller Contracts. As to Seller Contracts entered into between the date the agreement is signed and the Effective Time, the Buyer's assumption is further limited to those contracts which are entered into by the Seller in compliance with the terms of the Model Agreement, most importantly the Seller's covenants in Section 5.2 about how it will operate its business during that period. Because such covenants serve as the standard for determining the liabilities assumed under subsection (a)(vi), they should be scrutinized to avoid the Buyer's assumption of unanticipated liabilities.

In Section 2.4(b), the Model Agreement provides that if a liability is not specifically assumed by the Buyer it remains the responsibility of the Seller. Although the drafter must keep in mind the implications of the doctrine of *ejusdem generis* described elsewhere in this Comment (see the Comment to Section 1.2), the list of Retained Liabilities found in this subsection is intended to be illustrative of the types of liabilities retained but is not, by its terms, intended to be exclusive. The benefit of such a list is to focus the parties' attention on the division of liabilities between them. Of course, as in the description of the liabilities to be assumed and the coordination of that provision with other provisions of the Model Agreement, care should be taken to avoid implications and ambiguities which might raise questions about what liabilities the Buyer has agreed to assume. If there is concern about which party will bear responsibility for a specific liability or category of liabilities, it should be carefully addressed in the agreement. With regard to Section 2.4(b)(iii), note that some state statutes prohibit sellers and buyers from agreeing that the seller will pay sales taxes.

2.5 ALLOCATION

The Purchase Price shall be allocated in accordance with Exhibit 2.5. After the Closing, the parties shall make consistent use of the allocation, fair market value and useful lives specified in Exhibit 2.5 for all Tax purposes and in any and all filings, declarations and reports with the IRS in respect thereof, including the reports required to be filed under Section 1060 of the Code, if applicable, it being understood that Buyer shall prepare and deliver IRS Form 8594 to Seller within forty-five (45) days after the Closing Date if such form is required to be filed with the IRS. In any Proceeding related to the determination of any Tax, neither Buyer nor Seller or Shareholders shall contend or represent that such allocation is not a correct allocation.

COMMENT

From a federal tax perspective, a sale of the assets of a business is treated as if there were a number of sales of individual assets. Section 2.5 represents the agreement between the Buyer and the Seller as to how the aggregate purchase price is allocated among the specific assets being purchased. The purpose of this agreement is to assure that both the Buyer and the Seller are consistent in their reporting of the transaction for tax purposes. In general, an arm's-length agreement between the parties as to allocation of the purchase price will be given effect, unless the IRS determines that the allocation is inappropriate.

An agreement on allocation is important for, in most asset transactions involving the sale of an entire business, the parties will have to comply with Section 1060 of the Code. Pursuant to Section 1060, both the buyer and the seller must file Form 8594 (Asset Acquisition Statement under Section 1060) generally describing the allocation with their returns for the year in which there was a transfer of assets used in a trade or business if (i) any good will or going concern value could attach to any of the assets and (ii) the buyer's basis in the assets is determined wholly by the amount paid for the assets.

Compliance with Section 1060 will also require disclosure of the consideration paid for employment or consulting agreements with stockholders of the seller who previously were key employees. The IRS carefully monitors such arrangements and may recharacterize the amounts if there is not economic justification for such payments and the arrangements are not reasonable.

Section 1060 does not require the buyer and seller to agree on a purchase price allocation; and this agreement can be an unforeseen area of dispute between the parties because of the different tax effects an allocation may have. From the seller's perspective the allocation determines how much, and the tax character (which may result in a material differential in marginal rates) of, gain, loss or income the seller will recognize as a result of the asset sale. For the buyer, the allocation will determine what value the assets will have on its books for tax (and financial statement) purposes; and this determination will affect if and how it can depreciate or amortize that purchase price against its income. In addition, consequences other than direct income tax effects may give rise to controversy. For example, a substantial allocation to land being sold may give rise to material real estate transfer taxes and may affect future ad valorem property taxes. Also, different tax effects may have an unfavorable impact on the financial statements of the seller or buyer.

Nonetheless, parties often agree to file identical IRS Forms 8594 to reduce the likelihood that the IRS will scrutinize the allocation.

2.6 CLOSING

The purchase and sale provided for in this Agreement (the "**Closing**") will take place at the offices of Buyer's counsel at _________________, at 10:00 a.m. (local time) on the later of (i) ______________, ____, or (ii) the date that is five Business Days following the termination of the applicable waiting period under the HSR Act, unless Buyer and Seller agree otherwise. Subject to the provisions of Article 9, failure to consummate the purchase and sale provided for in this Agreement on the date and time and at the place determined pursuant to this Section 2.6 will not result in the termination of this Agreement and will not relieve any party of any obligation under this Agreement. In such a situation, the Closing will occur as soon as practicable, subject to Article 9.

COMMENT

Depending on the nature of the acquisition and the interest of the parties in completing the acquisition within a certain time frame, there are many ways to set the date of the closing. See Freund, *Anatomy of a Merger* 321-23 (1975). Section 2.6 of the Model Agreement provides that closing will take place on the later to occur of a specific date or five days after the satisfaction of a specific condition to closing unless Buyer and Seller agree otherwise. Buyer or Seller may want to add the right to postpone the closing for a specified period of time if it is unable to satisfy a condition. Note that the term "Contemplated Transactions" is not used in this Section 2.6 because some of the actions encompassed within that defined term will occur after the Closing.

By specifying a date in clause (i) of Section 2.6, the parties have fixed the earliest date that the closing may occur. This may be necessary in certain circumstances, such as when the buyer wants to complete its due diligence investigation, needs to obtain financing or will be required to give notice under the Worker Adjustment and Retraining Notification Act, 29 USC §§ 2101-2109 (the **"WARN Act"**), although these circumstances could also be addressed by making these types of events conditions to closing and determining the closing date by reference to their satisfaction. A party may wish to specify a particular closing date if it suspects that the other party may be motivated to delay the closing. For example, a buyer that uses a calendar year may not want to close in mid-December to avoid unnecessary costs, such as preparation of a short-period tax return or interim financial statements for an unusual period of time. Also, a seller may desire to close a transaction after the end of its current tax year to defer the tax consequences of the transaction.

The second clause of Section 2.6 of the Model Agreement determines a closing date by reference to a specific condition to the closing, in this case termination of the applicable waiting period under the HSR Act. Generally, this type of clause attempts to fix the date upon which closing will take place by reference to the condition to closing which the parties expect will take the longest amount of time to satisfy. Conditions that typically take a long time to satisfy include shareholder approval (in the case of a sale of all or substantially all of the assets of the seller, depending upon state corporate law requirements), termination of the waiting period under the HSR Act, expiration of the notice periods under the WARN Act, receipt of all regulatory approvals (if seller is in a regulated industry) and receipt of all (or certain specified) other third party consents (e.g., assignments of contracts or of industrial revenue bonds where the assets being sold include real estate). When there is doubt about which condition will take the most amount of time to satisfy, the parties might consider agreeing to close the transaction within so many days after the satisfaction of the last condition or certain specified conditions. The parties might keep in mind, however, that the satisfaction of some conditions may be influenced by a party, even though the agreement contains provisions (such as Sections 5.7 and 6.2 of the Model Agreement) requiring both parties to use their best efforts to satisfy all conditions to the closing of the transaction.

There are also tax, accounting, and other practical considerations in scheduling the closing. For example, if the buyer is paying the purchase price in funds that are not immediately available (see comment to Section 2.7), the seller may not want to close on a Friday (especially the Friday before a three-day weekend) because the seller would not have use of the funds over the weekend. If the buyer is paying the purchase price by a wire transfer of immediately available funds, the seller may want to determine the time by which its bank must receive the funds in order to invest the funds overnight. The amount the seller could lose as a result of not having use of the funds for a few days depends on the purchase price, but may be substantial in large transactions. Further, if a physical inventory will be performed shortly before closing, the parties may want to schedule the closing on a day and at a time to permit this physical inventory with little disruption of the business.

The next to last sentence of Section 2.6 establishes that failure to consummate the acquisition on the date and time and at the place specified does not relieve any party from its obligations under the acquisition agreement or give any party an independent right to terminate the acquisition agreement. The dates set forth in Section 2.6 should not be confused with the ability to terminate the agreement under Section 9. Because of Section 2.6 providing that failure to close does not terminate the acquisition agreement, the Model Agreement provides in Section 9.1(f) and (g) that either party may terminate the agreement if the Closing has not taken place by a specified "drop dead" date. The inclusion of a drop dead date assures the parties that they will not be bound by the acquisition agreement (and, in particular, by pre-closing covenants) for an unreasonably long period of time. This drop dead date could be placed in the closing section. It is typically placed in the termination provision, however, to keep all termination rights in a single section. Notably, if Section 2.6 states a specific closing date without reference to conditions that must be met, the effect of Sections 9.1(c) and 9.1(d) may be to give a party the right to terminate the agreement if the Closing does not take place on the date specified.

2.7 CLOSING OBLIGATIONS

In addition to any other documents to be delivered under other provisions of this Agreement, at the Closing:

(a) Seller and Shareholders, as the case may be, shall deliver to Buyer, together with funds sufficient to pay all Taxes necessary for the transfer, filing or recording thereof:

(i) a bill of sale for all of the Assets which are tangible personal property in the form of Exhibit 2.7(a)(i) (the **"Bill of Sale"**) executed by Seller;

(ii) an assignment of all of the Assets which are intangible personal property in the form of Exhibit 2.7(a)(ii), which assignment shall also contain Buyer's undertaking and assumption of the Assumed Liabilities (the **"Assignment and Assumption Agreement"**), executed by Seller;

(iii) for each interest in Real Property identified on Part 3.7(a) and (b), a recordable warranty deed, an Assignment and Assumption of Lease in the form of Exhibit 2.7(a)(iii) or such other appropriate document or instrument of transfer, as the case may require, each in form and substance satisfactory to Buyer and its counsel and executed by Seller;

(iv) assignments of all Intellectual Property Assets and separate assignments of all registered Marks, Patents and Copyrights, in the form of Exhibit 2.7(a)(iv) executed by Seller;

(v) such other deeds, bills of sale, assignments, certificates of title, documents and other instruments of transfer and conveyance as may reasonably be requested by Buyer, each in form and substance satisfactory to Buyer and its legal counsel and executed by Seller;

(vi) an employment agreement in the form of Exhibit 2.7(a)(vi), executed by [_______] (the **"Employment Agreement"**);

(vii) noncompetition agreements in the form of Exhibit 2.7(a)(vii), executed by each Shareholder (the **"Noncompetition Agreements"**);

(viii) an escrow agreement in the form of Exhibit 2.7(a)(viii), executed by Seller and the Shareholders and the escrow agent (the **"Escrow Agreement"**);

(ix) a certificate executed by Seller and each Shareholder as to the accuracy of their representations and warranties as of the date of this Agreement and as of the Closing in accordance with Section 7.1 and as to their compliance with and performance of their covenants and obligations to be performed or complied with at or before the Closing in accordance with Section 7.2; and

(x) a certificate of the Secretary of Seller certifying, as complete and accurate as of the Closing, copies of the Governing Documents of Seller, certifying all requisite resolutions or actions of Seller's board of directors and shareholders approving the execution and delivery of this Agreement and the consummation of the Contemplated Transactions and the change of name contemplated by Section 5.9 and certifying to the incumbency and signatures of the officers of Seller executing this Agreement and any other document relating to the Contemplated Transactions, and accompanied by the requisite documents for amending the relevant Governing Documents of Seller required to effect such change of name in form sufficient for filing with the appropriate Governmental Body.

(b) Buyer shall deliver to Seller and the Shareholders, as the case may be:

(i) $_________ by wire transfer to an account specified by Seller at least three (3) business days prior to Closing;

(ii) a promissory note executed by Buyer and payable to Seller in the principal amount of $__________ in the form of Exhibit 2.7(b)(ii) (the **"Promissory Note"**);

(iii) the Escrow Agreement, executed by Buyer and the escrow agent, together with the delivery of $_____________ to the escrow agent thereunder, by wire transfer to an account specified by the escrow agent;

(iv) the Assignment and Assumption Agreement executed by Buyer;

(v) the Employment Agreement executed by Buyer;

(vi) the Noncompetition Agreements executed by Buyer and $_________ by wire transfer to an account specified by each Shareholder at least three (3) days prior to the Closing Date;

(vii) a certificate executed by Buyer as to the accuracy of its representations and warranties as of the date of this Agreement and as of the Closing in accordance with Section 8.1 and as to its compliance with and performance of its covenants and obligations to be performed or complied with at or before the Closing in accordance with Section 8.2; and

(viii) a certificate of the Secretary of Buyer certifying, as complete and accurate as of the Closing Date, copies of the Governing Documents of Buyer and certifying all requisite resolutions or actions of Buyer's board of directors approving the execution and delivery of this Agreement and the consummation of the transactions contemplated herein and the incumbency and signatures of the officers of Buyer executing this Agreement and any other document relating to the Contemplated Transactions.

COMMENT

Because of the length and complexity of many acquisition agreements, and in particular asset acquisition agreements, some drafters attempt to list all of the documents that will be exchanged at the closing in a separate section so that the parties have a checklist, but this is often impracticable. In addition, such a list may expose a party to liability because of an obligation to deliver documents that must come from a non-party. To avoid unnecessary repetition and possible construction problems, the Model Agreement lists in this section only those deliveries which are within the control of the party obligated to deliver them.

In Section 2.7, the parties covenant to make certain deliveries. The parties should be aware of the distinction between (i) deliveries to be treated as covenants, the breach of which will give the non-breaching party a right to damages, and (ii) deliveries to be treated as conditions, the breach of which will give the non-breaching party the right to terminate the acquisition (that is, a "walk right") but not a right to damages. If the Seller fails to deliver a particular transfer document, for example, the Buyer can pursue its damage remedy. In contrast, if the Seller fails to deliver the legal opinion or consents (or other documents reasonably requested by the Buyer) contemplated by Article 7 (the Buyer's conditions), the Buyer would have the right to terminate the acquisition, but it would not have the right to damages unless the Seller breached its covenant in Section 5.7 to use its best efforts to obtain such documents. If, however, the Seller covenanted to deliver a particular consent (because, for example, the Seller or a party related to the Seller was the lessor under a lease which was to be transferred and that required a consent), the Seller's failure to deliver that consent (regardless of the efforts used) would give the Buyer a right to damages as well as the right to terminate the acquisition (see introductory comment to Article 7). Articles 7 and 8 of the Model Agreement provide that the deliveries required by this Section 2.7 are conditions precedent to the applicable party's obligation to consummate the contemplated transaction.

Parties' Closing Certificates. The reciprocal certificates required to be delivered at the closing in regard to the accuracy of each party's representations and warranties and the performance of its covenants provide a basis for the post-closing indemnification remedies under Sections 11.2(a) and (b) and 11.4(a) and (b). See Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions §* 14.02[5] (1998). See also Comment to Sections 7.1 and 8.1.

The parties may wish to specify by name or position the officers who are to execute the closing certificates on behalf of the seller and the buyer (e.g. the chief executive officer and the chief financial officer). The secretary will ordinarily be the officer executing certificates dealing with corporate proceedings and approvals.

Officers who are asked to sign closing certificates might express concern about their personal liability, particularly if they are not shareholders or otherwise benefiting from the transaction. The buyer might claim that, in addition to its right to indemnification, it relied on these certificates and was damaged to the extent that the statements made by the officers were inaccurate. While there is a dearth of authority dealing specifically with this issue, there have been instances where buyers have sought to recover directly against the officers signing officers' certificates based on theories of negligent misrepresentation and fraud. See, e.g., *Morgan Guar. Trust Co. of N.Y. v. Tisdale,* No. 95 Civ. 8023, 1996 WL 544240 (S.D.N.Y. Sept. 25, 1996).

The seller's counsel might attempt to minimize the officers' exposure by adding a knowledge qualification to the closing certificates and making it clear that the certificates are being signed by the officers in their corporate capacity and not as individuals. This might be objected to by the buyer's counsel, particularly the knowledge qualification, because of a concern over the effect it might have on the buyer's indemnification rights. However, that concern can be alleviated by adding to the certificate an express statement to the effect that the knowledge qualification will have no such effect. The officers' exposure might be less of a problem if the seller is successful in adding a clause to the effect that the indemnification provisions are the sole remedy for any claims relating to the sale.

Manner of Payment. The Model Agreement provides for payment by wire transfer because such transfers are the norm in most substantial transactions. In some circumstances, however, the parties may choose, for various reasons, including the size of the transaction, to have payment made by bank cashier's or certified check. While all three forms of payment are commonly used and should be acceptable to a seller, parties should be aware of certain differences in a buyer's ability to stop payment and in the availability of the funds for use by a seller.

A certified check is a check of the drawer that contains the drawee bank's certification on its face. As a result of the bank's certification, the drawee bank's liability is substituted for that of the drawer. A cashier's check is a check drawn by a bank on itself. Thus, a cashier's check is the primary promissory obligation of the drawee bank.

Once a certified check has been certified and delivered, and once a cashier's check has been delivered to the payee, the customer who procured the check has no right to stop payment. Although there have been a few cases involving banks that stopped payment on certified and cashier's checks at the request of customers, courts generally have held that the customer has no right to stop payment. See Clark, *The Law of Bank Deposits, Collections and Credit Cards* ¶¶ 3.06 (rev. ed. 1999) (citing cases).

Except for a wire transfer of federal funds, there is no difference among a cashier's check, a certified check and a wire transfer in terms of the availability of funds. For cashier's checks, certified checks, and wire transfers of clearinghouse funds, a bank into which such checks are deposited or into which such wire transfers are sent is required to make the funds available to the payee or beneficiary no later than the business day following the deposit or receipt of the transfer. For wire transfers of federal funds, a bank is required to make the funds available immediately on the date of receipt of the transfer. Therefore, if a seller wants immediate use of the funds, the acquisition agreement should specify that payment will be made by wire transfer of immediately available funds. See generally Clark, *The Law of Bank Deposits, Collections and Credit Cards* ¶¶ 7.01-7.25 (rev. ed. 1999). If a buyer is a foreign firm, a seller may want to specify that payments will be made in U.S. dollars.

<u>Promissory Notes</u>. Exhibit 2.7(b)(ii) to the Model Agreement contains a form of the Buyer's promissory note to be delivered to the Seller. This promissory note is subject to the rights of set-off in favor of the Buyer, which provide some security to the Buyer for the enforcement of the Seller's post-closing indemnification obligations. The promissory note bears interest, is subject to prepayment without penalty, and may be accelerated following the occurrence of an event of default.

The promissory note is neither subordinated to the rights of other creditors of the Buyer nor secured by a security interest in favor of the Seller. Whether such features are included depends on the proportion of the purchase price paid in cash at closing, the Buyer's need for third party financing, the financial strength of the party responsible for future payments, the length of the payout period, the guaranty of future payments by another, and the bargaining position of the parties.

When a promissory note is subordinated with regard to payment, the parties must determine the degree of subordination. A full subordination of payments prohibits any payment of interest or principal under the note until completion of payment of all senior debt. Alternatively, the parties may agree to prohibit subordinated payments only when an event of default has occurred or in the event of a bankruptcy or reorganization proceeding involving a buyer.

A seller in a strong bargaining position may demand collateral to secure a buyer's note, especially if the buyer is financially weak. The property to serve as collateral will vary, but typically will come from the assets sold. A seller may take a security interest in all of the assets sold, and in future replacements and substitutes for those assets, in order to be able to take back the business in case of default. A similar result is achieved if the assets when sold go into a newly formed entity and the seller takes the ownership interest in that entity as collateral. Alternatively, a seller may take a collateral interest in specific property which the seller believes is of sufficient value and readily marketable. To prevent the value of the collateral from being unduly diminished, a seller may also seek certain covenants from a buyer regarding the operation of the company after closing. In addition or as a substitute, a seller might obtain the guaranty of another party related to the buyer. A seller will desire to perfect whatever security interest is taken in order to take the most superior position possible as compared to other creditors, while a buyer may need to have that interest subordinated to the interests of some or all of its other creditors.

A detailed discussion of the technical aspects of taking a secured interest to protect a seller is beyond the scope of this Comment. However, if there is to be security for the buyer's note, the details of that understanding should be included in the agreement and the forms of security documents attached to it as exhibits.

The promissory note is nonnegotiable to protect the Buyer's set-off rights. See Comment to Section 11.8.

Escrow Agreement. Exhibit 2.7(a)(viii) contains a form of escrow agreement providing for an escrow of funds to assist the Buyer in realizing on any successful indemnification claims that it may have under the acquisition agreement (see Article 11). The escrow agreement may also be used to facilitate payment of the purchase price adjustment amount. Consideration should also be given to whether the Buyer wants both an escrow and a right of setoff. See the Comment to Section 11.8.

2.8 ADJUSTMENT AMOUNT AND PAYMENT

The **"Adjustment Amount"** (which may be a positive or negative number) will be equal to the amount determined by subtracting the Closing Working Capital from the Initial Working Capital. If the Adjustment Amount is positive, the Adjustment Amount shall be paid by wire transfer by Seller to an account specified by Buyer. If the Adjustment Amount is negative, the Adjustment Amount shall be paid by wire transfer by Buyer to an account specified by Seller. All payments shall be made together with interest at the rate set forth in the Promissory Note, which interest shall begin accruing on the Closing Date and end on the date that the payment is made. Within three (3) business days after the calculation of the Closing Working Capital becomes binding and conclusive on the parties pursuant to Section 2.9 of this Agreement, Seller or Buyer, as the case may be, shall make the wire transfer payment provided for in this Section 2.8.

COMMENT

The Model Agreement contains a purchase price adjustment mechanism to modify the purchase price in the event of changes in the financial condition of the Seller during the period between execution of the acquisition agreement and closing. Such a mechanism permits the parties to lessen the potentially adverse impact of a flat price based on stale pre-closing information. Through use of a purchase price adjustment mechanism, the parties are able to modify the purchase price to reflect more accurately the Seller's financial condition as of the closing date. Not all transactions contain purchase price adjustment mechanisms, however. Such mechanisms are complex in nature and are frequently the subject of contentious negotiations. As a result, in many cases the parties rely on other mechanisms, such as resorting to claims for breach of representations and warranties, indemnification rights and walk away or termination provisions to achieve their objectives.

In the absence of a purchase price adjustment mechanism such as the one employed in the Model Agreement, provision is frequently made for the proration of certain items (such as rent under leases included within the Assumed Liabilities and ad valorem taxes with respect to the Real Property and Tangible Personal Property) to ensure that the seller is responsible for such liabilities only to the extent they cover periods up to and including the date of closing and the buyer is responsible for such liabilities only to the extent they cover periods subsequent to the closing. A proration mechanism is rarely appropriate if the parties have agreed to such a purchase price adjustment mechanism. The following is a sample of such a provision:

ADJUSTMENTS TO PURCHASE PRICE

The Purchase Price shall be subject to the following credits and adjustments, which shall be reflected in the closing statements to be executed and delivered by Buyer and Seller as hereinabove provided:

(a) **Prorations.** Any rents, prepaid items and other applicable items with respect to the Assumed Liabilities shall be prorated as of the Closing Date. Seller shall assign to Buyer all unused deposits with respect to the Assumed Liabilities and shall receive a credit in the amount thereof with respect to the Purchase Price.

(b) **Ad Valorem Taxes.** Ad valorem real and tangible personal property taxes with respect to the Assets for the calendar year in which the Closing occurs shall be prorated between Seller and Buyer as of the Closing Date on the basis of no applicable discount. If the amount of such taxes with respect to any of the Assets for the calendar year in which the Closing occurs has not been determined as of the Closing Date, then the taxes with respect to such Assets for the preceding calendar year, on the basis of no applicable discount, shall be used to calculate such prorations, with known changes in valuation or millage being applied. The prorated taxes shall be an adjustment to the amount of cash due from Buyer at the Closing. If the actual amount of any such taxes varies by more than ______________ Dollars ($__________) from estimates used at the Closing to prorate such taxes, then the parties shall re-prorate such taxes within ten (10) days following request by either party based on the actual amount of the tax bill.

The type of purchase price adjustment mechanism selected depends on the structure of the transaction and the nature of the target company's business. There are many yardsticks available for use as the basis of a post-closing adjustment to the nominal purchase price. They can include, among others, book value, net assets, working capital, sales, net worth or stockholders' equity. In some cases it will be appropriate to adjust the purchase price by employing more than one adjustment mechanism. For example, in a retail sales business it may be appropriate to measure variations in both sales and inventory. Finally, the nominal purchase may be subject to an upward or downward adjustment, or both. The purchase price also may be adjusted dollar for dollar or by an amount equal to some multiple of changes in the yardstick amount.

Because the Model Agreement was drafted on the basis of a fact pattern that indicated that the Seller was a manufacturing concern with a full range of business activities, for purposes of illustration the Model Agreement provides for an adjustment to the purchase price based on changes in the Seller's working capital. Working capital of the Seller is determined as of the date of the Balance Sheet and the Closing Date and the nominal purchase price is adjusted either upward or downward based upon the amount of the increase or decrease in the level of the Seller's working capital. To lessen the opportunity for manipulation of the working capital amount during the measurement period, restrictions on the Seller's ability to manipulate its business operations and financial condition are set forth in the Seller's pre-closing covenants contained in Article 5.

The parties may also choose to place limits on the amount of the purchase price adjustment. Depending on the relative bargaining position of the parties, the acquisition agreement may provide an upper limit (a "cap" or "ceiling") to any adjustment amount the buyer will be obligated to pay the seller. As an alternative, the parties may agree upon an upper limit to any adjustment amount the seller will be obligated to pay or give back to the buyer after the closing, the effect of which is to reduce the final purchase price paid by the buyer to a specified "floor." The acquisition agreement may further provide for both a cap or ceiling and a floor (when used in such combination, a "collar") on the adjustment amount. The purchase price adjustment provision can also contain a de minimis "window" - i.e., a range within which neither party pays a purchase price adjustment amount.

2.9 ADJUSTMENT PROCEDURE

(a) **"Working Capital"** as of a given date shall mean the amount calculated by subtracting the current liabilities of Seller included in the Assumed Liabilities as of that date from the current assets of Seller included in the Assets as of that date. The Working Capital of Seller as of the date of the Balance Sheet (the **"Initial Working Capital"**) was _______________ Dollars ($_______).

(b) Buyer shall prepare financial statements (**"Closing Financial Statements"**) of Seller as of the Effective Time and for the period from the date of the Balance Sheet through the Effective Time on the same basis and applying the same accounting principles, policies and practices that were used in preparing the Balance Sheet, including the principles, policies and practices set forth on Exhibit 2.9. Buyer shall then determine the Working Capital as of the Effective Time minus accruals in accordance with GAAP in respect of liabilities to be incurred by Buyer after the Effective Time (the **"Closing Working Capital"**) based on the Closing Financial Statements and using the same methodology as was used to calculate the Initial Working Capital. Buyer shall deliver the Closing Financial Statements and its determination of the Closing Working Capital to Seller within sixty (60) days following the Closing Date.

(c) If within thirty (30) days following delivery of the Closing Financial Statements and the Closing Working Capital calculation, Seller has not given Buyer written notice of its objection to the Closing Working Capital calculation (which notice shall state the basis of Seller's objection), then the Closing Working Capital calculated by Buyer shall be binding and conclusive on the parties and be used in computing the Adjustment Amount.

(d) If Seller duly gives Buyer such notice of objection, and if Seller and Buyer fail to resolve the issues outstanding with respect to the Closing Financial Statements and the calculation of the Closing Working Capital within thirty (30) days of Buyer's receipt of Seller's objection notice, Seller and Buyer shall submit the issues remaining in dispute to ________________________, independent public accountants (the **"Independent Accountants"**) for resolution applying the principles, policies and practices referred to in Section 2.9(b). If issues are submitted to the Independent Accountants for resolution, (i) Seller and Buyer shall furnish or cause to be furnished to the Independent Accountants such work papers and other documents and information relating to the disputed issues as the Independent Accountants may request and are available to that party or its agents and shall be afforded the opportunity to present to the Independent Accountants any material relating to the disputed issues and to discuss the issues with the Independent Accountants; (ii) the determination by the Independent Accountants, as set forth in a notice to be delivered to both Seller and Buyer within sixty (60) days of the submission to the Independent Accountants of the issues remaining in dispute, shall be final, binding and conclusive on the parties and shall be used in the calculation of the Closing Working Capital; and (iii) Seller and Buyer will each bear fifty percent (50%) of the fees and costs of the Independent Accountants for such determination.

COMMENT

The specific terms of the business deal must be considered when developing a purchase price adjustment mechanism. For example, if the transaction contemplates an accounts receivable repurchase obligation requiring the Seller to repurchase all or a portion of its accounts receivable not collected prior to a certain date, the purchase price adjustment procedure must take such repurchases into account when determining the adjustment amount. The Model Agreement provides that the Buyer will prepare the Closing Financial Statements and calculate the Working Capital as of the Effective Time. To account for the effects of the underlying transaction, Working Capital is limited to the difference between the current liabilities of the Seller included in the Assumed Liabilities and the current assets of the Seller included in the Assets.

To minimize the potential for disputes with respect to the determination of the adjustment amount, the acquisition agreement specifies the manner in which the adjustment amount is calculated and the procedures to be utilized in determining the adjustment yardstick as of a given date. The Model Agreement addresses this objective by stating that the Closing Financial Statements shall be prepared on the same basis and applying the same accounting principles, policies and practices that were used in preparing the Balance Sheet, including the principles, policies and practices listed on Exhibit 2.9. Therefore, the buyer's due diligence ordinarily will focus not only on the items reflected on the Balance Sheet, but also on the accounting principles, policies and practices used to produce it, as it may be difficult for the Buyer to dispute these matters after Closing. For cost, timing and other reasons, the parties may elect to prepare less comprehensive financial statements for the limited purpose of determining the adjustment amount. Determination of the adjustment amount will depend upon the type of financial statements which have been prepared and special accounting procedures may need to be employed in calculating the adjustment components. Where the parties engage the accountant to issue a report of findings based upon the application of agreed-upon procedures to specified elements, accounts or items of a financial statement, such agreed-upon procedures should follow applicable statements on accounting standards and be clearly set forth in the acquisition agreement. See Statement on Auditing Standards No. 75, "Engagements to Apply Agreed-Upon Procedures to Specified Elements, Accounts, or Items of a Financial Statement," and Statement on Standards for Attestation Engagements No. 4, "Agreed-Upon Procedures Engagements." Unless consistent accounting principles, policies and practices are applied, the purchase price adjustment will not be insulated from the effects of changes in accounting principles, policies and practices. Since purchase price adjustment mechanisms rely heavily on the application of accounting principles and methods to particular fact situations, the input of the parties' accountants is important to the crafting of a mechanism which is responsive to the facts and workable and reflects the expectations and intentions of the parties in establishing the ultimate purchase price.

Provisions establishing dispute resolution procedures follow the provisions for the initial determination and objection. If the parties are unable to resolve amicably any disputes with respect to the Closing Financial Statements and the Closing Working Capital, Section 2.9(d) provides for dispute resolution by independent accountants previously agreed to by the parties. If the acquisition agreement does not specify who will serve as the independent accountants, the parties should establish the procedure for selection. Even if the independent accountants are named, it may be wise to provide replacement procedures in case a post-closing conflict arises with respect to the selection of the independent accountants (e.g., through merger of the independent accountants with accountants for the Buyer or the Seller).

The procedure to be followed and the scope of authority given for resolution of disputes concerning the post-closing adjustments vary in acquisition agreements. Section 2.9 provides that the Buyer will determine the Working Capital based on the Closing Financial Statements using the same methodology as was used to calculate the Initial Working Capital. The Closing Financial Statements and the Buyer's determination of the Closing Working Capital are then delivered to the Seller and, if the Seller has not objected within the requisite time period to the Closing Working Capital calculation (stating the basis of the objection), the calculation is "binding and conclusive on the parties." If the Seller objects and the issues outstanding are not resolved, the "issues remaining in dispute" are to be submitted to the accountants for resolution "applying the principles, policies and practices referred to in Section 2.9(b)." The determination by the accountants of the issues remaining in dispute is "final, binding and conclusive on the parties" and is to be used in the calculation of the Closing Working Capital.

The procedure set forth in Section 2.9 does not provide for the accountants to act as arbitrators, and there is no separate arbitration provision governing disputes under the Model Agreement. See the Comment to Section 13.4. However, Section 2.9 provides that the determination by the accountants is to be "final, binding and conclusive" on the parties. To what extent will this determination be binding on the parties, arbitrable or confirmable by a court? This is largely a question of state law, except that the Federal Arbitration Act will preempt any state law that conflicts or stands as an obstacle to the purpose of the Act to favor arbitration. The issue is often addressed in the context of a motion to compel arbitration by one of the parties to the acquisition agreement. The court in *Talegen Holdings, Inc. v. Fremont Gen. Corp.*, No. 98 Civ. 0366 (DC), 1998 WL 513066, *3 (S.D.N.Y. Aug. 19, 1998), dealt with such a motion as follows:

> In resolving a motion to compel arbitration under the Federal Arbitration Act . . . , a court must: (1) determine whether the parties agreed to arbitrate; (2) ascertain the scope of that agreement to see if the claims raised in the lawsuit fall within the terms of the agreement; (3) if federal statutory claims are asserted, decide whether Congress has deemed those claims to be nonarbitrable; and (4) if some, but not all claims are to be arbitrated, determine whether to stay the balance of the proceedings pending arbitration.

It then stated that "[c]ourts have consistently found that purchase price adjustment dispute resolution provisions such as the one at issue here constitute enforceable arbitration agreements." *Id.* The clauses providing for dispute resolution mechanisms need not expressly provide for arbitration in order for a court to determine that the parties have agreed to arbitration.

If a court determines that the parties agreed to arbitration, the extent to which arbitration will be compelled under the Federal Arbitration Act depends on whether the provision is broadly or narrowly drawn. A broad clause creates a presumption of arbitrability, whereas a narrow clause allows a court to consider "whether the claims fall reasonably within the scope of that clause." *Id.* Even with a narrow provision, "[b]ecause the [Federal Arbitration Act] embodies Congress's strong preference for arbitration, 'any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration.'" *Id.*; *see also Wayrol Plc v. Ameritech Corp.*, No. 98 Civ. 8451 (DC), 1999 WL 259512 (S.D.N.Y. April 30, 1999); *Advanstar Communications, Inc. v. Beckley-Cardy, Inc.*, No. 93 Civ. 4230 (KTD), 1994 WL 176981 at *3 (S.D.N.Y. May 6, 1994) (while a narrow clause must be construed in favor of arbitration, courts may not disregard boundaries set by the agreement).

The question of what comes within the arbitrable issues is a matter of law for a court. If the dispute arises over the accounting methods used in calculating the closing working capital or net worth, a court might compel arbitration as to those issues. *See Advanstar*, 1994 WL 176981 (clauses allowing arbitration of disagreements about balance sheet calculations "include disputes over the accounting methods used"). A court can disregard whether the claims might be characterized in another way. *See Talegen* at *17. On the other hand, some courts require that the provision include on its face the issue in dispute. In *Gestetner Holdings, Plc v. Nashua Corp.*, 784 F. Supp. 78 (S.D.N.Y. 1992), the court held that an objection to the closing net book value includes an objection about whether the closing balance sheet failed to comply with generally accepted accounting principles; however, the court did not rule on whether the initial balance sheet, for which the defendant argued that indemnification was the exclusive remedy, could also be considered an arbitrable dispute. *See also Gelco Corp. v. Baker Inds., Inc.*, 779 F.2d 26 (8th Cir. 1985) (clause covering disputes concerning adjustments to closing financial statements did not encompass state court claims for breach of contract); *Twin City Monorail, Inc. v. Robbins & Myers, Inc.*, 728 F.2d 1069 (8th Cir. 1984) (clause extended only to disputed inventory items and not to all disputes arising out of the contract); *Basix Corp. v. Cubic Corp.*, No. 96 Civ. 2478, 1996 WL 517667 (S.D.N.Y. Sept. 11, 1996) (clause applied only to well-defined class of disagreements over the closing balance sheet); *Stena Line (U.K.) Ltd. v. Sea Containers Ltd.*, 758 F.Supp. 934 (S.D.N.Y. 1991) (only limited issues concerning impact of beginning balance sheet on later balance sheet are arbitrable); *Medcom Holding Co. v. Baxter Travenol Lab., Inc.*, 689 F.Supp. 841 (N.D. Ill. 1988) (clause limited to accounts or items on balance sheet does not encompass objections to valuation of property or accounting principles by which property is valued).

The scope of the accountants' authority in Section 2.9(d) is expressly limited to those issues remaining in dispute and does not extend more broadly to the Closing Financial Statements or to the calculation of the Initial Working Capital or the Closing Working Capital. The authority cited above suggests that if there is a dispute over whether the financial statements from which the Initial Working Capital or the Closing Working Capital are calculated have been prepared in accordance with generally accepted accounting principles or reflect the consistent application of those principles, the Buyer may not be able to resolve the matter under the procedure established in Section 2.9(c) and (d). However, it might be able to make a claim for indemnification based on a breach of the financial statement representations and warranties in Section 3.4. If any of the items in the financial statements from which Initial Working Capital is computed are in error, the inaccuracy could affect the Adjustment Amount payable under Section 2.8. Again, the Buyer's recourse might be limited to a claim for indemnification. If the error is to the disadvantage of the Seller, it may not be able to restate the financial statements or cause the Initial Working Capital to be adjusted and therefore would have no recourse for its own error. *See Melun Indus., Inc. v. Strange*, 898 F.Supp. 995 (S.D.N.Y. 1992).

In view of this authority, the buyer may wish to weigh the advantages and disadvantages of initially providing for a broad or narrow scope of issues to be considered by the accountants. By narrowing the issues, it will focus the accountants on the disputed accounting items and prevent them from opening up other matters concerning the preparation of the financial statements from which the working capital calculation is derived. However, reconsideration of some of the broader accounting issues might result in a different overall resolution for the parties. The buyer might also consider whether to provide that the accountants are to act as arbitrators, thereby addressing the question of arbitrability, at least as to the issues required to be submitted to the accountants. This may, however, have procedural or other implications under the Federal Arbitration Act or state law.

The phrase "issues remaining in dispute" in the second sentence of Section 2.9(d) limits the inquiry of the independent accountants to the specific unresolved items. The parties might consider parameters on the submission of issues in dispute to the independent accountants. For example, they could agree that if the amount in dispute is less than a specified amount, they will split the difference and avoid the costs of the accountants' fees and the time and effort involved in resolving the dispute. The parties may also want to structure an arrangement for the payment of amounts not in dispute.

Purchase price adjustment mechanisms do not work in isolation and the seller may want to include in these provisions a statement to the effect that any liabilities included in the calculation of the adjustment amount will not give the buyer any right to indemnification. The rationale for such a clause is that the buyer is protected from damages associated with such claims by the purchase price adjustment. *See Brim Holding Company, Inc. v. Province Healthcare Company*, 2008 Tenn. App. LEXIS 325 (May 28, 2008), in which a stock purchase agreement indemnification section provision requiring seller to indemnify buyer for any losses from a specified proceeding was held to entitle the buyer to receive the entire amount paid in settlement of the case even though seller had pursuant to the working capital adjustment section reduced the purchase price by a portion of the amount paid in settlement (the seller's argument that the buyer was "double dipping" by getting both a working capital adjustment and an indemnification payment for the same amount was rejected by the Court).

2.10 CONSENTS

(a) If there are any Material Consents which have not yet been obtained (or otherwise are not in full force and effect) as of the Closing, in the case of each Seller Contract as to which such Material Consents were not obtained (or otherwise are not in full force and effect) (the **"Restricted Material Contracts"**), Buyer may waive the closing conditions as to any such Material Consent, and either:

(i) elect to have Seller continue its efforts to obtain the Material Consents, or

(ii) elect to have Seller retain that Restricted Material Contract and all Liabilities arising therefrom or relating thereto.

If Buyer elects to have Seller continue its efforts to obtain any Material Consents and the Closing occurs, notwithstanding Sections 2.1 and 2.4, neither this Agreement nor the Assignment and Assumption Agreement nor any other document related to the consummation of the Contemplated Transactions shall constitute a sale, assignment, assumption, transfer, conveyance or delivery, or an attempted sale, assignment, assumption, transfer, conveyance or delivery, of the Restricted Material Contracts, and following the Closing, the parties shall use Best Efforts, and cooperate with each other, to obtain the Material Consent relating to each Restricted Material Contract as quickly as practicable. Pending the obtaining of such Material Consents relating to any Restricted Material Contract, the parties shall cooperate with each other in any reasonable and lawful arrangements designed to provide to Buyer the benefits of use of the Restricted Material Contract for its term (or any right or benefit arising thereunder, including the enforcement for the benefit of Buyer of any and all rights of Seller against a third party thereunder). Once a Material Consent for the sale, assignment, assumption, transfer, conveyance and delivery of a Restricted Material Contract is obtained, Seller shall promptly assign, transfer, convey and deliver such Restricted Material Contract to Buyer, and Buyer shall assume the obligations under such Restricted Material Contract assigned to Buyer from and after the date of assignment to Buyer pursuant to a special-purpose assignment and assumption agreement substantially similar in terms to those of the Assignment and Assumption Agreement (which special-purpose agreement the parties shall prepare, execute and deliver in good faith at the time of such transfer, all at no additional cost to Buyer).

(b) If there are any Consents not listed on Exhibit 7.3 necessary for the assignment and transfer of any Seller Contracts to Buyer (the **"Non-Material Consents"**) which have not yet been obtained (or otherwise are not in full force and effect) as of the Closing, Buyer shall elect at the Closing, in the case of each of the Seller Contracts as to which such Non-Material Consents were not obtained (or otherwise are not in full force and effect) (the **"Restricted Non-Material Contracts"**), whether to

(i) accept the assignment of such Restricted Non-Material Contract, in which case, as between Buyer and Seller, such Restricted Non-Material Contract shall, to the maximum extent practicable and notwithstanding the failure to obtain the applicable Non-Material Consent, be transferred at the Closing pursuant to the Assignment and Assumption Agreement as elsewhere provided under this Agreement, or

(ii) reject the assignment of such Restricted Non-Material Contract, in which case, notwithstanding Sections 2.1 and 2.4 hereof, (A) neither this Agreement nor the Assignment and Assumption Agreement nor any other document related to the consummation of the Contemplated Transactions shall constitute a sale, assignment, assumption, conveyance or delivery, or an attempted sale, assignment, assumption, transfer, conveyance or delivery, of such Restricted Non-Material Contract, and (B) Seller shall retain such Restricted Non-Material Contract and all Liabilities arising therefrom or relating thereto.

<u>COMMENT</u>

Section 2.10 addresses the issue of how to handle situations where required third party consents are not obtained prior to the Closing. The Section provides for different approaches if the contracts are material or non-material.

This differentiation is made by use of Exhibit 7.3. On that Exhibit, the Buyer designates those contracts which are important enough that the Buyer reserves a right not to consummate the transaction if the required consents are not obtained. In preparing Exhibit 7.3, the Buyer should be careful so as not to omit non-material contracts if a group or significant number of them, each individually non-material, may be material when considered collectively.

If the Buyer does agree to close where a material consent has not yet been obtained, the Buyer has an election under Section 2.10. The Buyer can either have the Seller continue its efforts to obtain the consent or have the Seller retain the material contract.

A seller may object to the buyer's right to elect to have the seller retain a material contract after the business is sold. Under such circumstances, the seller may be in a difficult position to meet its obligations under the contract, particularly if it is exiting the business sold. The seller could also argue that such an election may materially alter its realization from the transaction and, therefore, its desire to sell. If the seller agrees to this kind of provision, the seller may insist on a right to renegotiate the purchase price depending on the material contract to be retained. As an alternative, the seller might negotiate a limitation on the application to specific material contracts. Whether the buyer will have the ability to insist on the inclusion of this provision is a matter of the parties' relative bargaining positions.

If the Buyer elects to have the Seller continue its efforts to obtain consent, Section 2.10(a) provides that (i) the contract is not yet assigned to the Buyer (because such a purported assignment might not be valid, and would be in violation of the assignment restrictions of the contract, and therefore the third party might attempt to cancel the contract or bring a claim for breach thereof), (ii) in the interest of leaving the parties as close as possible to the positions bargained for in the Model Agreement, the parties must do all they legally and reasonably can to procure for the Buyer the benefits the Buyer would have received had the contract been assigned at the Closing, (iii) the parties must continue after the Closing to attempt to obtain the missing consent (note that parties will sometimes negotiate the issue of how long these efforts must continue), and (iv) once the missing consent relating to a particular contract is obtained, that contract will be assigned to and assumed by the Buyer pursuant to a special-purpose assignment and assumption agreement which will generally follow the form of the assignment and assumption agreement attached as Exhibit 2.7(a)(ii). Parties might prefer to reach agreement on the form of the special-purpose assignment and assumption agreement in advance.

Section 2.10(b) deals with consent to non-material contracts. Examples of non-material contracts might be the lease of the office postage meter, the photocopier machine service agreement and the water cooler rental agreement. Often, such non-material contracts are cancelable by either party upon 30 days' notice, are contracts which simply provide for pay-as-you-go services, are contracts for which a substitute is readily available, or are contracts where the third party vendor is not likely to care who the contracting party is so long as the third party is paid in a timely manner.

Section 2.10(b) provides the Buyer at the Closing with an election as to each Restricted Non-Material Contract as to which a required consent has not been obtained by the Closing. The Buyer can choose to have the contract assigned to it even in violation of the contract's assignment provisions, figuring that (i) the risk of the third party canceling the contract or bringing a breach of contract claim if and when such third party becomes aware of the unauthorized transfer is not significant, or (ii) even if such cancellation of or claim under the contract is pursued by the third party, the amount of potential damages is minimal. Alternatively, the Buyer can elect not to take the contract, forcing the Seller to retain the contract and all the liabilities thereunder.

Arguably, it should be a buyer's decision whether to accept or reject non-material contracts where consents have not been obtained. After all, it is the buyer's post-closing operation of the business which will suffer if the contracts are not assigned, so a buyer should decide what contracts it truly needs. However, the seller may argue that it too can be held responsible if a contract is purportedly assigned in violation of the assignment restrictions of such contract, and therefore that the seller should have some say in whether or not such a contract is transferred to a buyer in violation of the assignment restrictions (or at least should be protected in some way, such as through indemnification, if the third party pursues a claim against the seller). The parties' negotiating positions and strengths will govern the outcome of this issue.

Sections 5.4, 5.7, 6.1 and 6.2 will have to be coordinated so as to clarify that the parties must cooperate to obtain both the Material Consents and the Non-Material Consents before the Closing.

3. REPRESENTATIONS AND WARRANTIES OF SELLER AND SHAREHOLDERS

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

COMMENT

The Seller's representations and warranties are the Seller's and the Shareholders' formal description of the Seller and its business. The technical difference between representations and warranties — representations are statements of past or existing facts and warranties are promises that existing or future facts are or will be true — has proven unimportant in acquisition practice. *See* Freund, *Anatomy of a Merger* 153 (1975). Separating them explicitly in an acquisition agreement is a drafting nuisance, and the legal import of the separation has been all but eliminated. *See Reliance Finance Corp. v. Miller*, 557 F.2d 674, 682 (9th Cir. 1977) (the distinction between representations and warranties is inappropriate when interpreting a stock acquisition agreement). The commentary to the Model Agreement generally refers only to representations.

Representations, if false, may support claims in tort and also claims for breach of an implied warranty, breach of an implied promise that a representation is true, or breach of an express warranty if the description is basic to the bargain. *Cf.* U.C.C. § 2-313. *See generally Business Acquisitions* ch. 31 (Herz & Baller eds., 2d ed. 1981). The Model Agreement, following common practice, stipulates remedies for breaches of representations that are equivalent to those provided for breaches of warranties (see Sections 1.1 (definition of

"Breach"), 7.1 and 7.2 (conditions to the Buyer's obligations to complete the acquisition), and 11.2(a) (the Seller's and the Shareholders' indemnification obligations)).

Purposes of the Seller's Representations: The seller's representations serve three overlapping purposes. First, they are a device for obtaining disclosure about the seller before the signing of the acquisition agreement. A thorough buyer's draft elicits information about the seller and its business relevant to the buyer's willingness to buy the assets. For example, because the Model Agreement was drafted on the basis of a fact pattern that assumed that the Seller has no subsidiaries, the representations in the Model Agreement reflect this assumption. If a seller has subsidiaries, the buyer's draft needs to elicit information regarding the subsidiaries.

The seller's representations also provide a foundation for the buyer's right to terminate the acquisition before or at the closing. After the signing of the acquisition agreement and before the closing, the buyer usually undertakes a due diligence investigation of the seller. Detailed representations give the buyer, on its subsequent discovery of adverse facts, the right not to proceed with the acquisition, even if the adverse facts do not rise to the level of common law "materiality" defined by judges in fraud and contract cases (see Section 7.1 and the related Comment).

Finally, the seller's representations affect the buyer's right to indemnification by the seller and the shareholders (and other remedies) if the buyer discovers a breach of any representation after the closing (see Section 11.2 and the related Comment). In this regard, the seller's representations serve as a mechanism for allocating economic risks between the buyer and the seller and the shareholders. Sellers often resist the argument that representations simply allocate economic risk on the basis that civil and criminal liabilities can result from making false statements. The buyer will typically request that the shareholders' indemnification obligations be joint and several; as to this and the allocation of responsibility among the shareholders, see the Comment to Section 11.2.

Scope of Seller's Representations: The scope and extent of the seller's representations and warranties largely will be dependent upon the relative bargaining power of the parties. Where there is competition for a seller or the acquisition presents a particularly attractive opportunity, the buyer might scale down the representations so as not to adversely affect its ability to make the acquisition. In scaling down the representations, consideration must be given to their relative benefit to the buyer in terms of the degree and likelihood of exposure and their materiality to the ongoing business operations.

The representations and warranties will also reflect particular concerns of the Buyer. In some cases, these concerns can be satisfied through the conduct of due diligence without having to obtain a specific representation. In other cases, the Buyer will insist upon additional comfort from the Seller through its representations backed up by indemnification.

The representations in the Model Agreement are based on a fact pattern which characterizes the Seller as a manufacturer with a full range of business activities, including advisory and consulting services provided to customers. The representations would look somewhat different if the Seller were strictly a service provider. Similarly, representations often are added to address specific concerns that pertain to the industry in which the seller operates. For example, representations concerning the adequacy of reserves would be appropriate for an insurance company and representations concerning compliance with certain federal and state food and drug laws would be appropriate for a medical device or drug manufacturer. If it were to have subsidiaries that are part of the Assets being acquired by the Buyer, the representations should be expanded to include their organization, capitalization, assets, liabilities and operations. An example of the incorporation of subsidiaries in the representations and in certain other provisions of an acquisition agreement can be found in the MODEL STOCK PURCHASE AGREEMENT WITH COMMENTARY. Similar changes should be made for any partnerships, limited liability companies or other entities owned or controlled by the Seller. The scope of the representations also changes over time to address current issues. Examples are the extensive environmental representations that began to appear in the late 1980s and the Year 2000 representations that were commonly sought by buyers in the late 1990s. See Section 3.26.

Considerations When Drafting "Adverse Effect" Language in Representations: The importance of the specific wording of the Seller's representations cannot be emphasized too much because they provide the foundation for both the Buyer's "walk rights" in Section 7.1 and the Buyer's indemnification rights in Section 11.2.

Consider, for example, the following simplified version of the litigation representation: "There is no lawsuit pending against Seller that will have an adverse effect on Seller." The phrase "that will have an adverse effect on Seller" clearly provides adequate protection to the Buyer in the context of a post-closing indemnification claim against the Seller and the Shareholders. If there is a previously undisclosed lawsuit against the Seller that has an adverse effect on the Seller (because, for example, a judgment is ultimately rendered against the Seller in the lawsuit), the Buyer will be able to recover damages from the and the Seller and the Shareholders because of the breach of the litigation representation (see subsection 11.2(a)). However, the quoted phrase may not adequately protect the Buyer if the Buyer is seeking to terminate the acquisition because of the lawsuit. To terminate the acquisition (without incurring any liability to the Seller), the Buyer will have to demonstrate, on the scheduled closing date, that the lawsuit "will have an adverse effect on Seller" (see Section 7.1). The buyer may find it difficult to make this showing, especially if there is doubt about the ultimate outcome of the lawsuit.

To address this problem, a Buyer might be tempted to reword the litigation representation so that it covers lawsuits that "could reasonably be expected to have" an adverse effect on the seller (as distinguished from lawsuits that definitely "will" have such an effect). However, while this change in wording clearly expands the scope of the Buyer's "walk rights," it may actually limit the Buyer's indemnification rights, because even if the lawsuit ultimately has an adverse effect on the Seller, the Seller and its shareholders may be able to avoid liability to the Buyer by showing that, as of the closing date, it was unreasonable to expect that the lawsuit would have such an effect.

To protect both its indemnification rights and its "walk rights" in the context of undisclosed litigation, the Buyer may propose that the litigation representation be reworded to cover any lawsuit "that may have an adverse effect" on the Seller (see Section 3.15(a)). If a seller objects to the breadth of this language, the Buyer may propose, as a compromise, that the litigation representation be reworded to cover lawsuits "that will, or that could reasonably be expected to," have an adverse effect on the seller.

Finally, an aggressive Buyer may propose to create "walk rights" for any litigation that "if adversely determined, could reasonably be expected to have a material adverse effect." A Seller should object to the breadth of this provision because, in addition to including the broad language referred to above, this provision permits the Buyer to presume an adverse outcome of the litigation. As a result, it materially expands the Buyer's "walk rights."

Considerations When Drafting Representations Incorporating Specific Time Periods: Representations that focus on specific time periods require careful drafting because of the "bring down" clause in Section 7.1 (the clause stating that the Seller's representations must be accurate as of the closing date as if made on the closing date). For example, consider the representation in Section 3.17(a)(iii), which states that the Seller has not received notice of any alleged legal violation "since" a specified date. Absent a cut-off date, this would require disclosure of all violations since the organization of the Seller. In some acquisition agreements, this representation is worded differently, stating that no notice of an alleged violation has been received at any time during a specified time period (such as a five-year period) "prior to the date of this agreement." If the representation were drafted in this manner, the Buyer would not have a "walk right" if the Seller received notice of a significant alleged violation between the signing date and the closing date — the representation would remain accurate as "brought down" to the scheduled closing date pursuant to Section 7.1(a), because the notice would not have been received "prior to" the date of the Agreement. In contrast, if the representation were drafted as in Section 3.17(a)(iii), the representation would be materially inaccurate as "brought down" to the scheduled closing date (because the notice of the alleged violation would have been received "since" the date specified in Section 3.17(a)(iii)), and the Buyer therefore would have a "walk right" pursuant to Section 7.1(a).

The Effect of "Knowledge" Qualifications in Representations: Sections 3.14, 3.16, 3.18, 3.20, 3.22, 3.23, 3.24, 3.25, 3.33 and 4.3 contain "knowledge" qualifications. The addition of knowledge qualifications to the representations in Article 3 can significantly limit the Buyer's post-closing indemnification rights (by shifting to the Buyer the economic risks of unknown facts). However, such qualifications should not affect the Buyer's "walk rights" under Section 7.1. If, before the Closing, the Buyer learns of a fact (not already known to the Seller) that is inconsistent with a representation containing a knowledge qualification, the Buyer should simply disclose this fact to the Seller. The Seller will thus acquire knowledge of the fact, and the representation will be inaccurate despite the knowledge qualification. For further discussion of knowledge qualifications, see the Comments to the definition of "Knowledge" in Section 1.1 and to the sections listed above.

The Absence of "Materiality" Qualifications: The Seller's representations in the Model Agreement generally do not contain materiality qualifications. Rather, the issue of materiality is addressed in the remedies sections. Section 7.1(a) specifies that only material breaches of representations give the Buyer a "walk right." Section 7.1(b) covers the few representations that contain their own materiality qualification (see the Comment to Section 7.1). The indemnification provisions replace a general and open-ended materiality qualification with a carefully quantified "basket" in Section 11.6 that exonerates the Seller and the Shareholders from liability for breaches resulting in damages below a specified amount. Alternatively, the Buyer could acquiesce to some materiality qualifications in Article 3 but eliminate or reduce the "basket" to prevent "double-dipping."

The Absence of a "Bring Down" Representation: For a discussion of the absence of a "bring down" representation in the Model Agreement, see the comment to Section 7.1.

3.1 ORGANIZATION AND GOOD STANDING

(a) Part 3.1(a) contains a complete and accurate list of Seller's jurisdiction of incorporation and any other jurisdictions in which it is qualified to do business as a foreign corporation. Seller is a corporation duly organized, validly existing, and in good standing under the laws of its jurisdiction of incorporation, with full corporate power and authority to conduct its business as it is now being conducted, to own or use the properties and assets that it purports to own or use, and to perform all its obligations under the Seller Contracts. Seller is duly qualified to do business as a foreign corporation and is in good standing under the laws of each state or other jurisdiction in which either the ownership or use of the properties owned or used by it, or the nature of the activities conducted by it, requires such qualification.

(b) Complete and accurate copies of the Governing Documents of Seller, as currently in effect, are attached to Part 3.1(b).

(c) Seller has no Subsidiary and, except as disclosed in Part 3.1(c), does not own any shares of capital stock or other securities of any other Person.

COMMENT

In an asset acquisition, the buyer's primary concern is that the business of the seller has been operated properly prior to the execution of the acquisition agreement and will continue to be so operated between the signing and the closing. Moreover, the buyer (or the subsidiary that will own the assets and conduct the business post-closing) may need to qualify to do business in each state where that business will be conducted. A list of all states where qualification of the seller is required gives the buyer a checklist of states where it must be qualified on or before the closing date.

The representation concerning the seller's power and authority is generally qualified by a reference to "corporate" power and authority. Use of the word "corporate" limits the representation to mean that the seller is authorized to conduct its business (as it is currently conducted) under applicable business corporation laws and its charter and by-laws -- that is, such action is not "ultra vires." If the word "corporate" is omitted, the term "power and authority" could be interpreted to mean "full power and authority" under all applicable laws and regulations; that the seller has such authority is a much broader representation.

The representation concerning qualification of the seller as a foreign corporation in other jurisdictions occasionally contains an exception for jurisdictions in which "the failure to be so qualified would not have a material adverse effect on the business or properties of Seller." Requiring a list of foreign jurisdictions does not limit or expand the breadth of the previous sentence but forces the seller to give proper attention to this matter.

The representation that the seller does not have a subsidiary is included to confirm that the business of the seller is conducted directly by it and not through subsidiaries. If the seller had conducted business through subsidiaries, the documentation for the transfer of the assets may need to be modified to transfer the stock or assets of the subsidiaries and, depending on the materiality of the subsidiaries, the buyer would want to include appropriate representations and covenants regarding the subsidiaries. See the *Model Stock Purchase Agreement with Commentary* for examples of representations that could be adapted and added to the Model Asset Purchase Agreement to deal with a sale of stock of a subsidiary.

To the extent that capital stock or other securities are included among the assets, the contemplated transactions would involve the sale of a security within the contemplation of the Securities Act and applicable state securities statutes. This would necessitate the parties structuring the transaction to comply with the applicable securities registration and other requirements or structure the contemplated transactions to be exempt from their registration requirements. See the Comments to Sections 3.2 and 3.33.

See Chapter 2, "Basic Corporate Documents", of the MANUAL ON ACQUISITION REVIEW.

3.2 ENFORCEABILITY; AUTHORITY; NO CONFLICT

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

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

(i) Breach (A) any provision of any of the Governing Documents of Seller, or (B) any resolution adopted by the board of directors or the shareholders of Seller;

(ii) Breach or give any Governmental Body or other Person the right to challenge any of the Contemplated Transactions or to exercise any remedy or obtain any relief under any Legal Requirement or any Order to which Seller or either Shareholder, or any of the Assets, may be subject;

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

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

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

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

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

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

COMMENT

The Seller may seek an exception to the representations in the first sentence of Section 3.2(a) to the extent that enforceability is limited by bankruptcy, insolvency or similar laws affecting creditors' rights and remedies or by equitable principles. Such an exception is almost universally found in legal opinions regarding enforceability, and some buyers may allow it in the representations. Other buyers will respond that the exception would be inappropriate because the risk of such limitations should fall on the seller and the shareholders.

In most states, shareholder approval of an asset sale has historically been required if the corporation is selling all or substantially all of its assets. The Delaware courts have used both "qualitative" and "quantitative" tests in interpreting the phrase "substantially all," as it is used in Section 271 of the Delaware General Corporation Law ("*DGCL*") which requires stockholder approval for a corporation to "sell, lease or exchange all or substantially all of its property and assets." *See Gimbel v. The Signal Companies, Inc.*, 316 A.2d 599 (Del. Ch. 1974) (assets representing 41% of net worth but only 15% of gross revenues held not to be "substantially all"); *Katz v. Bregman*, 431 A.2d 1274 (Del. Ch. 1981) (51% of total assets, generating approximately 45% of net sales, held to be "substantially all"); and *Thorpe v. CERBCO, Inc.*, 676 A.2d 436 (Del. 1996) (sale of subsidiary with 68% of assets, which was primary income generator, held to be "substantially all"; court noted that seller would be left with only one operating subsidiary, which was marginally profitable). *See Hollinger Inc. v. Hollinger International, Inc.*, 858 A.2d 342 (Del. Ch. 2004), *appeal refused*, 871 A.2d 1128 (Del. 2004), in which (A) the sale of assets by a subsidiary with approval of its parent corporation (its stockholder), but not the stockholders of the parent, was alleged by the largest stockholder of the parent to contravene DGCL § 271; (B) without reaching a conclusion, the Chancery Court commented in dicta that "[w]hen an asset sale by the wholly owned subsidiary is to be consummated by a contract in which the parent entirely guarantees the performance of the selling subsidiary that is disposing of all of its assets and in which the parent is liable for any breach of warranty by the subsidiary, the direct act of the parent's board can, without any appreciable stretch, be viewed as selling assets of the parent itself" (the Court recognized that the precise language of DGCL § 271 only requires a vote on covered sales by a corporation of "its" assets, but felt that analyzing dispositions by subsidiaries on the basis of whether there was fraud or a showing that the subsidiary was a mere alter ego of the parent as suggested in *Leslie v. Telephonics Office Technologies, Inc.*, 1993 WL 547188 (Del. Ch., Dec. 30, 1993) was too rigid); and (C) examining the consolidated economics of the subsidiary level sale, the Chancery Court held (1) that "substantially all" of the assets should be literally read, commenting that "[a] fair and succinct equivalent to the term 'substantially all' would be "essentially everything", notwithstanding past decisions that have looked at sales of assets around the 50% level, (2) that the principal inquiry was whether the assets sold were "quantitatively vital to the operations of" seller (the business sold represented 57.4% of parent's consolidated EBITDA, 49% of its revenues, 35.7% of the book value of its assets, and 57% of its asset values based on bids for the two principal units of the parent), (3) that the parent had a remaining substantial profitable business after the sale (the Chancery Court wrote: "if the portion of the business not sold constitutes a substantial, viable, ongoing component of the corporation, the sale is not subject to Section 271," quoting BALOTTI AND FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §10.2 at 10-7 (3rd ed. Supp. 2004), and (4) that the "qualitative" test of *Gimbel* focuses on "factors such as the cash-flow generating value of assets" rather than subjective factors such as whether ownership of the business would enable its managers to have dinner with the Queen. *See* Morton and Reilly, *Clarity or Confusion? The 2005 Amendment to Section 271 of the Delaware General Corporation Law*, X Deal Points – The Newsletter of the Committee on Negotiated Acquisitions 2 (Fall 2005); *see also* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 855-58 (2005); BALOTTI AND FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §10.2 (3rd ed. Supp. 2004).

To address the uncertainties raised by dicta in Vice Chancellor Strine's opinion in *Hollinger*, DGCL § 271 was amended effective August 1, 2005 to add a new subsection (c) which provides as follows:

> (c) For purposes of this section only, the property and assets of the corporation include the property and assets of any subsidiary of the corporation. As used in this subsection, "subsidiary" means any entity wholly-owned and controlled, directly or indirectly, by the corporation and includes, without limitation, corporations, partnerships, limited partnerships, limited liability partnerships, limited liability companies, and/or statutory trusts. Notwithstanding subsection (a) of this section, except to the extent the certificate of incorporation otherwise provides, no resolution by stockholders or members shall be required for a sale, lease or exchange of property and assets of the corporation to a subsidiary.

This amendment answered certain questions raised by *Hollinger*, but raised or left unanswered other questions (e.g., (i) whether subsection (c) applies in the case of a merger of a subsidiary with a third party even though literally read DGCL § 271 does not apply to mergers, (ii) what happens if the subsidiary is less than 100% owned, and (iii) what additional is meant by the requirement that the subsidiary be wholly "controlled" as well as "wholly owned"). *See* Morton and Reilly, *Clarity or Confusion? The 2005 Amendment to Section 271 of the Delaware General Corporation Law*, X Deal Points – The Newsletter of the Committee on Negotiated Acquisitions 2 (Fall 2005); *cf. Weinstein Enterprises, Inc. v. Orloff*, 870 A.2d 499 (Del. 2005) for a discussion of "control" in the context of a DGCL § 220 action seeking inspection of certain documents in the possession of a publicly held New York corporation of which the defendant Delaware corporation defendant was a 45.16% stockholder.

In *Story v. Kennecott Copper Corporation*, 394 N.Y.S. 2d 353 (N.Y. Sup. Ct. 1977), the court held that under New York law the sale by Kennecott of its subsidiary Peabody Coal Company, which accounted for approximately 55% of Kennecott's consolidated assets, was not a sale of "substantially all" of Kennecott's assets requiring shareholder approval even though Peabody was the only profitable operation of Kennecott for the past two years.

Difficulties in determining when a shareholder vote is required have led some states to adopt a bright line test. TEX. BUS. CORP. ACT ANN. arts. 5.09 and 5.10 provide, in essence, that shareholder approval is required under Texas law only if it is contemplated that the corporation will cease to conduct any business following the sale of assets. See Egan and Huff, *Choice of State of Incorporation --Texas versus Delaware: Is it Now Time to Rethink Traditional Notions?*", 54 SMU Law Review 249, 287-290 (Winter 2001). Under TBCA art. 5.10, a sale of all or substantially all of a corporation's property and assets must be approved by the shareholders (and shareholders who vote against the sale can perfect appraisal rights). TBCA art. 5.09(A) provides an exception to the shareholder approval requirement if the sale is "in the usual and regular course of the business of the corporation. . . .", and a 1987 amendment added section B to art. 5.09 providing that a sale is

> in the usual and regular course of business if, [after the sale,] the corporation shall, directly or indirectly, either continue to engage in one or more businesses or apply a portion of the consideration received in connection with the transaction to the conduct of a business in which it engages following the transaction.

In *Rudisill v. Arnold White & Durkee, P.C.*, 148 S.W.3d 556 (Tex. App. 2004), the 1987 amendment to art. 5.09 was applied literally. The *Rudisill* case arose out of the combination of Arnold White & Durke, P.C. ("*AWD*") with another law firm, Howrey & Simon ("*HS*"). The combination agreement provided that all of AWD's assets other than those specifically excluded (three vacation condominiums, two insurance policies and several auto leases) were to be transferred to HS in exchange for a partnership interest in HS, which subsequently changed its name to Howrey Simon Arnold & White, LLP ("*HSAW*"). In addition, AWD shareholders were eligible individually to become partners in HSAW by signing its partnership agreement, which most of them did.

For business reasons, the AWD/HS combination was submitted to a vote of AWD's shareholders. Three AWD shareholders submitted written objections to the combination, voted against it, declined to sign the HSAW partnership agreement, and then filed an action seeking a declaration of their entitlement to dissenters' rights or alternate relief. The court accepted AWD's position that these shareholders were not entitled to dissenters' rights because the sale was in the "usual and regular course of business" as AWD continued "to engage in one or more businesses" within the meaning of TBCA art. 5.09B, writing that "AWD remained in the legal services business, at least indirectly, in that (1) its shareholders and employees continued to practice law under the auspices of HSAW, and (2) it held an ownership interest in HSAW, which unquestionably continues directly in that business." The court further held that AWD's obtaining shareholder approval when it was not required by TBCA art. 5.09 did not create appraisal rights, pointing out that appraisal rights are available under the statute only "*if special authorization of the shareholders is **required***." *See* Subcommittee on Recent Judicial Developments, *ABA Negotiated Acquisitions Committee, Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 855-60 (2005).

A 1999 revision to the Model Business Corporation Act (**"MBCA"**) excludes from the requirement of a shareholder vote any disposition of assets that would not "leave the corporation without a significant continuing business activity." MBCA § 12.02(a). The revision includes a safe harbor definition of significant continuing business activity: at least 25 percent of the total assets and 25 percent of either income (before income taxes) or revenues from pre-transaction operations.

If shareholder approval is required, the buyer may want to require that it be obtained before or contemporaneously with execution of the asset purchase agreement. In *Optima International of Miami, Inc. v. WCI Steel, Inc.*, C.A. No. 3833-VCL (Del. Ch. June 27, 2008) (TRANSCRIPT), the Delaware Chancery Court, in the context of a merger agreement which required stockholder consent to the merger be delivered within 24 hours and which was adopted by the written consent of more than a majority of the stockholders promptly after its signing, wrote: "Nothing in the DGCL requires any particular period of time between a board's authorization of a merger agreement and the necessary stockholder vote [and] the board's agreement to proceed as it did [was not] a breach of duty." Although the buyer can include a no-shop provision (see Section 5.6 of the Model Agreement) in the acquisition agreement, the seller may want a fiduciary out to the no-shop provision, and with or without a fiduciary out provision, there is the possibility that the shareholder vote will not be obtained if a better offer comes along before the vote is held. Moreover, in some circumstances, a no-shop may be invalid. *See Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003) (Delaware Supreme Court directed Court of Chancery to preliminarily enjoin a merger, holding that the combination of deal protection measures (a provision in the merger agreement requiring a stockholder vote on the merger even if the board no longer recommended it, an agreement between the acquirer and the controlling stockholders that ensured a majority of the voting power would be voted in favor of the transaction, and the absence of any effective fiduciary termination right) were inequitably coercive and preclusive because they made it "mathematically impossible" for any alternative proposal to succeed); *Orman v. Cullman*, no. 18039, 2004 Del. Ch. LEXIS 150 (Del. Ch. Oct. 20, 2004) (Delaware Court of Chancery held that a fully informed "majority of the minority" stockholder vote operated to extinguish the plaintiff's breach of fiduciary duty claims even though the controlling stockholders had agreed to vote for the merger and against any alternative transaction for 18 months and not to sell their shares to another bidder during that period; the court distinguished *Omnicare* because (i) the target's public stockholders retained the power to reject the proposed transaction and (ii) the target's board had negotiated effective fiduciary outs that would enable it to entertain unsolicited proposals under certain circumstances and to withdraw its recommendation of the merger if the board concluded that its fiduciary duties so required); *Optima International of Miami, Inc. v. WCI Steel, Inc.*, C.A. No. 3833-VCL (Del. Ch. June 27, 2008) (TRANSCRIPT), ("Omnicare is of questionable continued vitality"); *Ace Limited v. Capital Re Corp.*, 747 A.2d 95 (Del. Ch. 1999); Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 853-55 (2005). While those cases typically involved publicly held companies, the courts have not generally made a distinction between publicly and closely held companies in discussing directors' fiduciary duties.

If the Seller insists on a fiduciary out to the no-shop provision and the transaction is one in which shareholder approval is required, the Buyer may request that the asset purchase agreement include a "force the vote" provision. A "force the vote" provision typically requires the Seller to convene a meeting by a date certain and to have the stockholder vote on the Buyer's proposal at that meeting even if the Seller has received another offer in the interim and employed the fiduciary out to engage in discussions with the new bidder. A "force the vote" provision is specifically authorized in Delaware by statute. See 8 Del. C. § 146.

In *Ryan v. Lyondell Chemical Company*, C.A. No. 3176-VCN (Del. Ch. July 29, 2008 and. August 20, 2008), the Delaware Chancery Court held that under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986), director fiduciary duties (i) require robust director involvement in sale of control transactions to confirm that the stockholders are getting the best price reasonably available and (ii) in the absence of adequate process do not permit the directors to approve typical deal protection provisions in the acquisition agreement. Directors fiduciary duties are applicable in the case of closely held corporations as well as corporations whose securities are publicly traded, although the conduct required to satisfy their fiduciary duties will be measured with reference to what is reasonable in the context. *See Optima International of Miami, Inc. v. WCI Steel, Inc.*, C.A. No. 3833-VCL (Del. Ch. June 27, 2008) (TRANSCRIPT), and *Julian v. Eastern States Construction Service, Inc.* (Del. Ch. No. 1892-VCP July 8, 2008).

The parties should consider the applicability of the Securities Act and state securities laws to the Contemplated Transactions notwithstanding receipt of the requisite shareholder vote. Ordinarily a sale of assets, even if it involves the sale of a business, to a sophisticated financial buyer who will use the assets as part of a business which it will manage and control does not implicate the registration provisions of the Securities Act. The inclusion of the Promissory Note as part of the Purchase Price (see Section 2.3) may, however, result in the Contemplated Transactions involving the sale of a security requiring structuring to comply with the Securities Act and applicable state securities laws. See Section 3.33 and the related Comment.

Section 3.2(b) contains the Seller's "no conflict" representation. The purpose of this representation is to assure the Buyer that, except as disclosed in the Disclosure Letter, the acquisition will not violate (or otherwise trigger adverse consequences under) any legal or contractual requirement applicable to the Seller or either Shareholder. In connection with clause (iv) of Section 3.2(b), the Seller's counsel should consider sales and transfer taxes. See the Comment to Section 10.2.

The purpose served by the no conflict representation differs from that served by the more general representations concerning Legal Requirements, Governmental Authorizations, Orders, and Contracts (see Sections 3.17, 3.18 and 3.20), which alert the Buyer to violations and other potential problems not connected with the acquisition. The no conflict representation focuses specifically on violations and other potential problems that would be triggered by the consummation of the acquisition and related transactions.

The term "Contemplated Transactions" is defined broadly in Article 1. The use of an expansive definition makes the scope of the no conflict representation very broad. A seller may argue for a narrower definition and may also seek to clarify that the no conflict representation does not extend to laws, contracts, or other requirements that are adopted or otherwise take effect after the closing date. In addition, the seller may seek to clarify that the no conflict representation applies only to violations arising from the seller's and the shareholders' performance of the acquisition and related transactions (and not to violations arising from actions taken by the buyer).

The no conflict representation relates both to requirements binding upon the Seller and to requirements binding upon the Shareholders. (Requirements binding upon the Buyer are separately covered by the Buyer's "no conflict" representation in Section 4.2 and the closing condition in Section 8.1.) The Shareholders may seek to eliminate the references to laws, regulations, orders, and contracts binding upon the Shareholders, arguing that violations of requirements applicable only to the Shareholders (and not also applicable to the Seller) should be of no concern to the Buyer because the Buyer is not making an investment in the Shareholders. The Buyer may respond to such an argument by pointing out that a violation of a law, regulation, order, or contract binding upon the Shareholders can be of substantial concern to the Buyer if such a violation would provide a governmental body or a third party with grounds to set aside or challenge the acquisition. The Buyer may also point out that, if the Shareholders were to incur a significant financial liability as a result of such a violation, the Shareholders' ability to satisfy their indemnification obligations and other post-closing obligations to the Buyer could be impaired.

The phrase "with or without notice or lapse of time," which appears in the introduction to the "no conflict" representation, requires the Seller to advise the Buyer of any "potential" or "unmatured" violations or defaults (circumstances that, while not technically constituting a violation or default, could become an actual violation or default if a specified grace period elapses or if a formal notice of violation or default is delivered) that may be caused by the acquisition or related transactions.

Clause (ii) of the "no conflict" representation focuses specifically on Legal Requirements and Orders that might be contravened by the acquisition or related transactions. The broad language of this provision requires disclosure not only of legal violations, but also of other types of adverse legal consequences that may be triggered by the Contemplated Transactions. For example, the "Exon-Florio" regulations, 31 C.F.R. § 800.101 *et seq.*, provide for the submission of notices to the Committee on Foreign Investment in the United States in connection with acquisitions of U.S. companies by "foreign persons." Because the filing of an "Exon-Florio" notice is voluntary, the failure to file such a notice is not a regulatory violation. However, the filing of such a notice shortens the time period within which the President can exercise divestment authority and certain other legal remedies with respect to the acquisition described in the notice. Thus, the failure to file such a notice can have an adverse effect on the Seller. Clause (ii) alerts the Buyer to the existence of regulatory provisions of this type.

The parties may face a troublesome dilemma if both the Buyer and the Seller are aware of a possible violation of law that might occur as a consequence of the acquisition or related transactions. If the possible violation is not disclosed by the Seller in the Disclosure Letter, as between the parties the Seller will bear the risks associated with any violation (see Section 11.2(a)). But if the Seller elects to disclose the possible violation in the Disclosure Letter, it may be providing a discoverable "road map for a lawsuit by the government or a third party." Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* § 11.04(7) (1992).

Although clause (iii) (which addresses the possible revocation of Governmental Authorizations) overlaps to some extent with clause (ii), clause (iii) is included because a Governmental Authorization may become subject to revocation without any statutory or regulatory "violation" actually having occurred.

Clause (iv) is important because the sale of the assets will trigger state and local tax concerns in most states. In many states, the sale of assets may routinely lead to a reassessment of real property and may increase taxes on personal property. For example, if rolling stock is to be transferred, the transfer will, in some cases, lead to increased local taxes. Seller's counsel should resist any representation to the effect that the sale of assets will not lead to a reassessment.

Clause (v) deals with contractual defaults and other contractual consequences that may be triggered by the acquisition or related transactions. Many contracts provide that the contracts may not be assigned without the consent of the other parties thereto. Hence, without such consents, the contracts would be breached upon the transfer at the closing. Clause (v) alerts the Buyer to the existence of any such contracts.

Clause (v) applies to "Seller Contracts," the definition of which extends both to contracts to which the Seller is a party and to contracts under which the Seller has any rights or by which the Seller may be bound. The inclusion of the latter type of contracts may be important to the Buyer. For example, the Buyer will want to know if the Seller's rights under a promissory note or a guaranty given by a third party and held by the Seller would be terminated or otherwise impaired as a result of the acquisition. Because such a promissory note or guaranty would presumably be signed only by the third party maker or guarantor (and would not be executed on behalf of the Seller in its capacity as payee or beneficiary), the Seller might not be considered a party to the note or guaranty.

Other examples of contracts that may be covered by the expansive definition of "Seller Contract" include the following:

1. contracts under which the Seller is a third party beneficiary;

2. contracts under which a party's rights or obligations have been assigned to or assumed by the Seller;

3. contracts containing obligations that have been guaranteed by the Seller;

4. recorded agreements or declarations that relate to real property owned by the Seller and that contain covenants or restrictions "running with the land"; and

5. contracts entered into by a partnership in which the Seller is a general partner.

The Seller is required to provide (in Part 3.2 of the Disclosure Letter) a list of governmental and third-party consents needed to consummate the acquisition. Some of these consents may be sufficiently important to justify giving the Buyer (and, in some cases, the Seller) a "walk right" if they are not ultimately obtained (see Sections 7.3 and 8.3 and the related Comments).

Clause (vii) deals with appraisal rights. MBCA § 13.02(a)(3) confers upon certain shareholders not consenting to the sale or other disposition the right to dissent from the transaction and to obtain appraisal and payment of the fair value of their shares. The right is generally limited to shareholders who are entitled to vote on the sale. Some states, such as Delaware, do not give appraisal rights in connection with sales of assets. The MBCA sets forth procedural requirements for the exercise of appraisal rights that must be strictly complied with. A brief summary follows:

1. If the sale or other disposition of the assets of a corporation is to be submitted to a meeting of the shareholders, the meeting notice must state that shareholders are or may be entitled to assert appraisal rights under the MBCA. The notice must include a copy of the section of the statute conferring those rights. MBCA § 13.20(a). A shareholder desiring to exercise those rights must deliver to the corporation before the vote is taken a notice of his or her intention to exercise dissenters' rights and must not vote in favor of the proposal. MBCA § 13.21(a).

2. Following the approval of the sale or other disposition, a specific notice must be sent by the corporation to the dissenting shareholders who have given the required notice, enclosing a form to be completed by those shareholders and specifying the date by which the form must be returned to the corporation and the date the shareholders' stock certificates must be returned for deposit with the corporation. The notice must also state the corporation's estimate of the fair value of the shares and the date by which any withdrawal must be received by the corporation. MBCA § 13.22.

3. Following the receipt by the corporation of the completed form from a dissenting shareholder and the return and deposit of his or her stock certificates, the corporation must pay to each shareholder who has complied with the appraisal requirements and who has not withdrawn his or her demand for payment, the amount of the corporation estimates to be the "fair value" of his or her shares, plus interest, and must accompany this payment with copies of certain financial information concerning the corporation. MBCA § 13.24. Some jurisdictions only require an offer of payment by the corporation, with final payment to await acceptance by the shareholder of the offer.

4. A dissenting shareholder who is not satisfied with the payment by the corporation must timely object to the determination of fair value and present his or her own valuation and demand payment. MBCA § 13.26.

5. If the dissenting shareholder's demand remains unresolved for sixty days after the payment demand is made, the corporation must either commence a judicial proceeding to determine the fair value of the shares or pay the amount demanded by the dissenting shareholder. The proceeding is held in a jurisdiction where the principal place of business of the corporation is located or at the location of its registered office. The court is required to determine the fair value of the shares plus interest. MBCA § 13.30. Under the prior MBCA, it was the shareholder's obligation to commence proceedings to value the shares. Currently forty-six jurisdictions require the corporation to initiate the litigation, while six put this burden on the dissenting shareholder.

Many jurisdictions follow the MBCA by providing that the statutory rights of dissenters represent an exclusive remedy and that shareholders may not otherwise challenge the validity or appropriateness of the sale of assets except for reasons of fraud or illegality. In other jurisdictions, challenges based on breach of fiduciary duty and other theories are still permitted.

While the material set forth above contains a general outline of the MBCA provisions as they relate to shareholders' rights to dissent from a sale of all or substantially all of a corporation's assets, counsel should consult the specific statute in the state of domicile of the seller to confirm the procedures that must be satisfied.

As to the impact of dissenters' rights on other provisions of the Model Agreement, counsel should bear in mind the potential for some disruption of the acquisition process as a result of the exercise of those rights, and might consider adding a closing condition to permit a quick exit by the Buyer from the transaction if it appears that dissenters' rights will be exercised.

See Chapter 3, "Contracts", of the MANUAL ON ACQUISITION REVIEW.

3.4 FINANCIAL STATEMENTS

Seller has delivered to Buyer: (a) an audited balance sheet of Seller as at ____________, 20__ (including the notes thereto, the **"Balance Sheet"**), and the related audited statements of income, changes in shareholders' equity and cash flows for the fiscal year then ended, including in each case the notes thereto, together with the report thereon of __________________, independent certified public accountants, (b) [audited] balance sheets of Seller as at _____________ in each of the years ___ through ___, and the related [audited] statements of income, changes in shareholders' equity, and cash flows for each of the fiscal years then ended, including in each case the notes thereto, [together with the report thereon of ___________, independent certified public accountants,] and (c) an unaudited balance sheet of Seller as at __________, 20__ (the **"Interim Balance Sheet"**) and the related unaudited statement[s] of income, [changes in shareholders' equity, and cash flows] for the ___ months then ended, including in each case the notes thereto certified by Seller's chief financial officer. Such financial statements (i) have been prepared in accordance with GAAP and (ii) fairly present (and the financial statements delivered pursuant to Section 5.8 will fairly present) the financial condition and the results of operations, changes in shareholders' equity, and cash flows of Seller as at the respective dates of and for the periods referred to in such financial statements. The financial statements referred to in this Section 3.4 and delivered pursuant to Section 5.8 reflect and will reflect the consistent application of such accounting principles throughout the periods involved, except as disclosed in the notes to such financial statements. The financial statements have been and will be prepared from and are in accordance with the accounting Records of Seller. Seller has also delivered to Buyer copies of all letters from Seller's auditors to Seller's board of directors or the audit committee thereof during the thirty-six months preceding the execution of this Agreement, together with copies of all responses thereto.

COMMENT

This representation, which requires the delivery of specified financial statements of the Seller and provides assurances regarding the quality of those financial statements, is almost universally present in an acquisition agreement. Financial statements are key items in the evaluation of nearly all potential business acquisitions. The Model Agreement representation requires financial statements to be delivered and provides a basis for contractual remedies if they prove to be inaccurate. Other provisions of the typical acquisition agreement also relate to the financial statements, including representations that deal with specific parts of the financial statements in greater detail and with concepts that go beyond GAAP (such as title to properties and accounts receivable), serve as the basis for assessing the quality of the financial statements (such as the representation concerning the accuracy of the Seller's books and records), or use the financial statements as a starting or reference point (such as the absence of certain changes since the date of the financial statements).

The Model Agreement representation requires the delivery of (1) audited annual financial statements as of the end of the most recent fiscal year, (2) annual financial statements for a period of years, which the Buyer will probably require be audited unless audited financial statements for those years do not exist and cannot be created, and (3) unaudited financial statements as of the end of an interim period subsequent to the most recent fiscal year. If the Seller had subsidiaries, the Agreement would refer to consolidated financial statements and could call for consolidating financial statements.

The determination of which financial statements should be required, and whether they should be audited, will depend upon factors such as availability, relevance to the buyer's commercial evaluation of the acquisition, and the burden and expense on the seller that the buyer is willing to impose and the seller is willing to bear. Especially if the acquired assets have been operated as part of a larger enterprise and the seller does not have a history of independent financing transactions with respect to such assets, separate financial statements (audited or otherwise) may not exist and, although the auditors that expressed an opinion concerning the entire enterprise's financial statements will of necessity have reviewed the financial statements relating to the acquired assets, that review may not have been sufficient for the expression of an opinion about the financial statements of the business represented by the acquired assets alone. This occurs most frequently when the acquired assets do not represent a major portion of the entire enterprise, so that the materiality judgments made in the examination of the enterprise's financial statements are not appropriate for an examination of the financial statements relating to the acquired assets. The representation concerning the accuracy of the seller's books and records (see Section 3.5) is critical because these books and records are the buyer's main tool for assessing the financial health of the business utilizing the acquired assets and guarding against fraud in the financial statements (under Section 5.1, the buyer has a right to inspect these books and records).

Many of the representations in the Model Agreement relate to the period since the date of the Balance Sheet because it is assumed that the Balance Sheet is audited and is therefore a more reliable benchmark than the Interim Balance Sheet, which is assumed to be unaudited.

The Model Agreement representation does not attempt to characterize the auditors' report. The buyer's counsel should determine at an early stage whether the report contains any qualifications regarding (1) conformity with GAAP, (2) the auditors' examination having been in accordance with the generally accepted auditing standards, (3) or fair presentation being subject to the outcome of contingencies. Any qualification in the auditors' report should be reviewed with the buyer's accountants.

In some jurisdictions, including California and New York, auditors cannot be held liable for inaccurate financial reports to persons not in privity with the auditors, with possible exceptions in very limited circumstances. *See Bily v. Arthur Young & Co.*, 11 Cal. Rptr. 2d 51 (1992); *Credit Alliance Corporation v. Arthur Andersen & Co.*, 65 N.Y.2d 536, 546, 547 (1985); *Ultramares Corp. v. Touche*, 255 N.Y. 170 (1931); *see also Security Pac. Bus. Credit, Inc. v. Peat Marwick Main & Co.*, 586 N.Y.S.2d 87, 90-91 (1992) (explaining the circumstances in which accountants may be held liable to third parties); *Greycas Inc. v. Proud*, 826 F.2d 1560, 1565 (7th Cir. 1987) (holding that, although privity of contract is not required in Illinois, the plaintiff must still demonstrate that a negligent misrepresentation induced detrimental reliance). If the audited financial statements were prepared in the ordinary course, the buyer probably will not satisfy the requirements for auditors' liability in those jurisdictions in the absence of a "reliance letter" from the auditors addressed to the buyer. Requests for reliance letters are relatively unusual in acquisitions, and accounting firms are increasingly unwilling to give them.

Issues frequently arise concerning the appropriate degree of assurance regarding the quality of the financial statements. The buyer's first draft of this representation often includes a statement that the financial statements are true, complete, and correct in an effort to eliminate the leeway for judgments about contingencies (such as to the appropriate size of reserves for subsequent events) and materiality inherent in the concept of fair presentation in accordance with GAAP. The seller may object that this statement is an unfair request for assurances that the financial statements meet a standard that is inconsistent with the procedures used by accountants to produce them. In addition, the seller may be reluctant to represent that interim financial statements (i) "have been prepared in accordance with GAAP" and (ii) "fairly present," either because of some question about the quality of the information contained (for example, there may be no physical inventory taken at the end of an interim period) or because of the level of disclosure included in the interim financial statements (such as the absence of a full set of notes to financial statements). A qualification that may be appropriate could be inserted at the end of the second sentence of Section 3.4 as follows: "subject, in the case of interim financial statements, to normal recurring year-end adjustments (the effect of which will not, individually or in the aggregate, be significant) and the absence of notes (that, if presented, would not differ materially from those included in the Balance Sheet)". It has been suggested that the representation concerning fair presentation should also be qualified with respect to audited financial statements. *See* Augenbraun & Eyck, *Financial Statement Representations in Business Transactions*, 47 Bus. Law. 157, 166 (1991). The buyer is unlikely to accept this view, especially in its first draft of the acquisition agreement.

The seller may be willing to represent only that the financial statements have been prepared from, and are consistent with, its books and records. The buyer should be aware that this representation provides far less comfort to the buyer than that provided by the Model Agreement representation. *See DCV Holdings, Inc. v. ConAgra, Inc.*, 2005 Del. Super. LEXIS 88 (March 24, 2005) (audited financial statements of joint venture company being sold in private equity financed management buyout accrued bogus rebate from affiliate in order to increase bonuses; no fraud found where seller disclosure schedule disclosed that accrual was not in accordance with GAAP and that rebate would not be collected; Court held no duty to disclose that rebate was "bogus" as Delaware duty of disclosure does not require "self-flagellation").

Many of the representations in Article 3 reflect the Buyer's attempt to obtain assurances about specific line items in the financial statements that go well beyond fair presentation in accordance with GAAP. Reliance on GAAP may be inadequate if the Seller is engaged in businesses (such as insurance) in which valuation or contingent liability reserves are especially significant. However, specific line item representations could lead a court to give less significance to the representation concerning overall compliance with GAAP in the case of line items not covered by a specific representation. *See, e.g., Delta Holdings, Inc. v. National Distillers & Chemical Corp.*, 945 F.2d 1226 (2d Cir. 1991), *cert. denied*, 503 U.S. 985 (1992). The specific content of these representations will vary greatly depending on the nature of the Seller's businesses and assets.

The Sarbanes-Oxley Act of 2002 (H.R. 3763), Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.) [hereinafter "*SOX*"], is generally applicable only to companies required to file reports with the Securities and Exchange Commission (the "*SEC*") under the Securities Exchange Act of 1934, as amended (the *"1934 Act"*) ("*reporting companies*"), or that have a registration statement on file with the SEC under the Securities Act of 1933, as amended (the "*1933 Act*"), in each case regardless of size (collectively, "*public companies*" or "*issuers*"). Private companies that contemplate going public, seeking financing from investors whose exit strategy is a public offering or being acquired by a public company may find it advantageous or necessary to conduct their affairs as if they were subject to SOX. *See* Byron F. Egan, *The Sarbanes-Oxley Act and Its Expanding Reach*, 40 Tex. J. of Bus. L. 305, 420 (Winter 2005), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=505. The provisions of SOX relating to financial statements are increasingly being addressed in the representations and warranties of agreements for the acquisition of closely held businesses.

Prior to SOX, the core of the financial statements representation was that the financial statements "fairly present the financial condition and results of operations of the target in accordance with GAAP." The certification required by SOX § 302 removes the GAAP qualification, so that the chief executive officer and chief financial officer of an issuer are required to certify that the issuer's financial statements fairly present the financial condition and results of operations of the issuer, without regard to GAAP. *See* Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, Release Nos. 33-8124, 34-46427 at 25 (August 28, 2002) (in which the SEC stated its belief that "Congress intended [the Section 302 certifications] to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and correctness that is broader than financial reporting requirements under generally accepted accounting principles"). Accordingly, Section 3.4 above requires the Seller and the Shareholders to represent that Seller's financial statements fairly present the financial condition and results of operations of the Company, while also requiring them to separately represent that its financial statements were prepared in accordance with GAAP. *See also*, *United States v. Simon*, 425 F.2d 796 (2d Cir. 1969) (in an appeal from a criminal conviction of three accountants with Lybrand, Ross Bros. & Montgomery for conspiring to knowingly draw up false and misleading financial statements that failed to adequately disclose looting by the corporate president and that receivables from an affiliate booked as assets were from an insolvent entity and secured by securities of the company (which itself was in a perilous predicament), the defendants called eight expert independent accountants (an impressive array of leaders of the profession) who testified generally that the financial statements were in no way inconsistent with generally accepted accounting principles or generally accepted auditing standards since the financial statements made all the informative disclosures reasonably necessary for fair presentation of the financial position of the company as of the close of the fiscal year in question, Judge Henry J. Friendly wrote:

> We do not think the jury was also required to accept the accountants' evaluation whether a given fact was material to overall fair presentation . . . it simply cannot be true that an accountant is under no duty to disclose what he knows when he has reason to believe that, to a material extent, a corporation is being operated not to carry out its business in the interest of all the stockholders but for the private benefit of its president. * * * The jury could reasonably have wondered how accountants who were really seeking to tell the truth could have constructed a footnote so well designed to conceal the shocking facts. . . . the claim that generally accepted

> accounting practices do not require accountants to investigate and report on developments since the date of the statements being certified has little relevance.).

If the buyer is a public company, its counsel should consider the requirements in SEC Regulation S X, 17 C.F.R. § 210 (2005), if any, that apply to post closing disclosure of audited financial statements for the assets being acquired. In general, these requirements depend on the relative size of the buyer and the assets being acquired.

In the case of a private company being acquired, the acquiring public company will have to certify under SOX §§ 302 and 906 in its SEC reports as to its consolidated financial statements in its first periodic report after the combination, which will put the CEO and CFO of the buyer in the position of having to certify as to the financial statements and internal controls of the consolidated entity, including the acquired company. *See* SEC Release No. 33-8238 (June 5, 2003), titled "Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports," which can be found at http://www.sec.gov/rules/final/33-8238.htm; Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, Exchange Act Release No. 34-55928 (June 20, 2007), available at http://www.sec.gov/rules/final.shtml; Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, Exchange Act Release No. 34-55929 (June 20, 2007), available at http://www.sec.gov/rules/interp.shtml; Public Company Accounting Oversight Board Auditing Standard No. 5 (May 24, 2007): An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements, available at http://www.pcaobus.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.5.aspx; Public Company Accounting Oversight Board: Order Approving Proposed Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements, a Related Independence Rule, and Conforming Amendments, Exchange Act Release No. 34-56152 (July 27, 2007), available at http://www.sec.gov/rules/pcaob.shtml. Those certifications in turn will require the buyer to be sure of the seller's SOX conformity before the transaction is completed so that there will not be a post closing financial reporting surprise.

Under these circumstances a Buyer may ask for a representation as to the internal controls of Seller such as the following:

> The Company has implemented and maintains a system of internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the 1934 Act) sufficient to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP, including, without limitation, that (i) transactions are executed in accordance with management's general or specific authorizations, (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP and to maintain asset accountability, (iii) access to assets is permitted only in accordance with management's general or specific authorization, and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The foregoing results in increased emphasis on due diligence. This emphasis manifests itself through expanded representations and warranties in acquisition agreements and financing agreements, as well as through hiring auditors to review the work papers of the seller's auditors.

3.6 SUFFICIENCY OF ASSETS

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

COMMENT

The purpose of the representation in subsection 3.6(a) is to confirm that the various assets to be purchased by the buyer constitute all those necessary for it to continue operating the business of seller in the same manner as it had been conducted by the seller. See the Comments to Sections 2.1 and 2.2. If any of the essential assets are owned by the principal shareholders or other third parties, the buyer may want assurances that it will have use of these assets on some reasonable basis before entering into the transaction with the seller. The representation in subsection 3.6(b) is to help confirm the availability of sales tax exemptions in certain states. See the Comment to Section 10.2.

3.13 NO UNDISCLOSED LIABILITIES

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

COMMENT

Transferee liability may be imposed on a buyer by the bulk sales statutes, the law of fraudulent conveyance and various doctrines in areas such as environmental law and products liability. Consequently, the buyer will have an interest not only in the liabilities being assumed under subsection 2.4(a), but also in the liabilities of the seller that are not being assumed. This representation assures the buyer that it has been informed of all Liabilities (which, as the term is defined in the Model Agreement, includes "contingent" liabilities) of the seller.

The seller may seek to narrow the scope of this representation by limiting the types of liabilities that must be disclosed. For example, the seller may request that the representation extend only to "liabilities of the type required to be reflected as liabilities on a balance sheet prepared in accordance with GAAP." The buyer will likely object to this request, arguing that the standards for disclosing liabilities on a balance sheet under GAAP are relatively restrictive and that the buyer needs to assess the potential impact of all types of liabilities on the seller, regardless of whether such liabilities are sufficiently definite to merit disclosure in the seller's financial statements.

If the seller is unsuccessful in limiting the scope of this representation to balance sheet type liabilities, additional language changes might be suggested. Many liabilities and obligations (*e.g.*, open purchase and sales orders, employment contracts) are not required to be reflected or reserved against in a balance sheet or even disclosed in the notes to the financial statements. For example, most of the disclosures made in the Disclosure Letter, particularly those with respect to leases and other contracts (see Section 3.20), involve liabilities or obligations of the seller. In addition, liabilities or obligations arise from other contracts not required to be included in the Disclosure Letter because they do not reach the dollar threshold requiring disclosure. This might be addressed by adding another exception to this representation for "Liabilities arising under the Seller Contracts disclosed in Part 3.20(a) or not required to be disclosed therein."

The seller may also seek to add a knowledge qualification to this representation, arguing that it cannot be expected to identify every conceivable contingent liability and obligation to which it may be subject. The buyer will typically resist the addition of such a qualification, pointing out that, even in an asset purchase, any exposure to unknown liabilities is more appropriately borne by the seller and the shareholders (who presumably have considerable familiarity with the past and current operations of the seller) than by the buyer.

Even if the buyer successfully resists the seller's attempts to narrow the scope of this representation, the buyer should not overestimate the protection that this representation provides. Although the representation extends to "contingent" liabilities (as well as to other types of liabilities that are not required to be shown as liabilities on a balance sheet under GAAP), it focuses exclusively on existing liabilities — it does not cover liabilities that may arise in the future from past events or existing circumstances. Indeed, a number of judicial decisions involving business acquisitions have recognized this critical distinction and have construed the term "liability" (or "contingent liability") narrowly. For example, in *Climatrol Indus. v. Fedders Corp.*, 501 N.E.2d 292 (Ill. App. Ct. 1986), the court concluded that a seller's defective product does not represent a "contingent liability" of the seller unless the defective product has actually injured someone. The court stated:

> As of [the date of the closing of the acquisition in question], there was no liability at all for the product liability suits at issue herein, because no injury had occurred. Therefore, these suits are not amongst the "liabilities . . . whether accrued, absolute, contingent or otherwise, which exist[ed] on the Closing Date," which defendant expressly assumed.

Id. at 294. Earlier in its opinion, the court noted:

> Other courts have sharply distinguished between "contingencies" and "contingent liabilities": A contingent liability is one thing, a contingency the happening of which may bring into existence a liability is another, and a very different thing. In the former case, there is a liability which will become absolute upon the happening of a certain event. In the latter there is none until the event happens. The difference is simply that which exists between a conditional debt or liability and none at all.

Id. (citations omitted); *see also Godchaux v. Conveying Techniques, Inc.*, 846 F.2d 306, 310 (5th Cir. 1988) (an employer's withdrawal liability under ERISA comes into existence not when the employer's pension plan first develops an unfunded vested liability, but rather when the employer actually withdraws from the pension plan; therefore, there was no breach of a warranty that the employer "did not have any liabilities of any nature, whether accrued, absolute, contingent, or otherwise"); *East Prairie R-Z School Dist. v. U.S. Gypsum Co.*, 813 F. Supp. 1396 (E.D. Mo. 1993) (cause of action for property damage based on asbestos contamination had not accrued at time of assumption of liabilities); *Grant-Howard Assocs. v. General Housewares Corp.*, 482 N.Y.S.2d 225, 227 (1984) (there is no contingent liability from a defective product until the injury occurs). *See DCV Holdings, Inc. v. ConAgra, Inc.*, 2005 Del. Super. LEXIS 88 (March 24, 2005), in which the issue was whether a no undisclosed liabilities representation that provided that none of the companies in division being sold "has any liabilities or obligations of any nature (whether absolute, accrued, contingent, unasserted, determined, determinable or otherwise)" included damages resulting from antitrust conspiracy; Court found the representation was inherently ambiguous because of uncertainty whether it embraced "future or potential liabilities"; extrinsic evidence showed that in negotiations buyer agreed to add knowledge qualifier to specific representations dealing with compliance with law and disclosure; Court concluded:

> [N]one of the testimony indicates that the parties agreed that [the no undisclosed liabilities representation] trumped all other representations. If the [buyer] pinned its hopes on a contract interpretation that was not conveyed to the sellers, such interpretation cannot stand. A contract will be construed against a party who maintains its own interpretation of an agreement and fails to inform the other party of that interpretation.

Even though the terms "liability" and "contingent liability" may be narrowly construed, other provisions in the Model Agreement protect the Buyer against various contingencies that may not actually constitute "contingent liabilities" as of the Closing Date. For example, the Model Agreement contains representations that no event has occurred that may result in a future material adverse change in the business of the Seller as carried on by the Buyer (see Section 3.15); that no undisclosed event has occurred that may result in a future violation of law by the Seller (see Section 3.17); that the Seller has no knowledge of any circumstances that may serve as a basis for the commencement of a future lawsuit against the Seller (see Section 3.18); that no undisclosed event has occurred that would constitute a future default under any of the Contracts of the Seller being assigned to or assumed by the Buyer (see Section 3.20); and that the Seller knows of no facts that materially threaten its business (see Section 3.33). In addition, the Model Agreement requires the Seller and the Shareholders to indemnify the Buyer against liabilities that may arise in the future from products manufactured by the Seller prior to the Closing Date (see Section 11.2).

If a buyer seeks even broader protection against undisclosed contingencies, it should consider expanding the scope of the seller's indemnity obligations under Section 11.2 so that the seller and the shareholders are obligated to indemnify the buyer not only against future product liabilities, but also against other categories of liabilities that may arise after the Closing Date from circumstances existing before the Closing Date.

3.14 TAXES

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

(b) Delivery of Tax Returns and Information Regarding Audits and Potential Audits. Seller has delivered or made available to Buyer copies of, and Part 3.14(b) contains a complete and accurate list of, all Tax Returns filed since _______, 20__. The federal and state income or franchise Tax Returns of Seller have been audited by the IRS or relevant state tax authorities or are closed by the applicable statute of limitations for all taxable years through ______, 20__. Part 3.14(b) contains a complete and accurate list of all Tax Returns that have been audited or are currently under audit and accurately describe any deficiencies or other amounts that were paid or are currently being contested. To the Knowledge of Seller, no undisclosed deficiencies are expected to be asserted with respect to any such audit. All deficiencies proposed as a result of such audits have been paid, reserved against, settled, or are being contested in good faith by appropriate proceedings as described in Part 3.14(b). Seller has delivered, or made available to Buyer, copies of any examination reports, statements or deficiencies, or similar items with respect to such audits. Except as provided in Part 3.14(b), Seller has no knowledge that any Governmental Body is likely to assess any additional taxes for any period for which Tax Returns have been filed. There is no dispute or claim concerning any Taxes of Seller either (i) claimed or raised by any Governmental Body in writing or (ii) as to which Seller has Knowledge. Part 3.14(b) contains a list of all Tax Returns for which the applicable statute of limitations has not run. Except as described in Part 3.14(b), Seller has not given or been requested to give waivers or extensions (or is or would be subject to a waiver or extension given by any other Person) of any statute of limitations relating to the payment of Taxes of Seller or for which Seller may be liable.

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

(d) Specific Potential Tax Liabilities and Tax Situations.

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

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

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

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

ALTERNATIVE No. 1:

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

ALTERNATIVE No. 2:

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

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

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

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

COMMENT

Section 3.14 seeks disclosure of tax matters that may be significant to a buyer. Although the buyer does not assume the seller's tax liabilities, the buyer would be interested in both ensuring that those liabilities are paid and understanding any possible tax issues that may arise in the buyer's post-acquisition operation of the business. By obtaining assurances that the seller has paid all of its taxes, the buyer reduces the likelihood of successor liability claims against it for the seller's unpaid taxes. Although such a claim is unlikely for the federal income tax liability of the seller, such a claim could be made for state or local taxes.

Some state laws specifically provide that a buyer in an asset acquisition may be liable for the selling corporation's state tax liability. For example, Section 212.10 of the Florida Statutes (1) requires a seller to pay any sales tax within 15 days of the closing; (2) requires a buyer to withhold a sufficient portion of the purchase price to cover the amount of such taxes; and (3) provides that if the buyer:

> shall fail to withhold a sufficient amount of the purchase money as above provided, he or she shall be personally liable for the payment of the taxes, interest, and penalties accruing and unpaid on account of the operation of the business by any former owner, owners or assigns.

In addition to statutory successor liability, a buyer could be subject to liability for a seller's taxes under a common law successor liability theory. *See e.g.*, Peter L. Faber, *State and Local Income and Franchise Tax Aspects of Corporate Acquisitions*, NEGOTIATING BUSINESS ACQUISITIONS, J-14 - J-15 (ABA-CLE, 1998).

If the buyer were acquiring subsidiaries of the seller, the buyer would want to be sure all taxes of the subsidiaries have been paid, because any acquired subsidiary remains responsible for any such liability after the acquisition. To avoid taking over all of a subsidiary's liabilities, the buyer could either (1) purchase the assets of the subsidiary, thereby making a multiple asset acquisition, or (2) have the seller liquidate the subsidiary, which can be accomplished tax-free under Code Section 332, and then acquire the assets of the former subsidiary directly from the seller.

Section 3.14(a) focuses on the tax returns and reports that are required to be filed by a seller, the accuracy thereof, and the payment of the taxes shown thereon. Thus, it is designed to ensure that the seller has complied with the basic tax requirements. This representation can stay the same even if the seller is an S corporation, because an S corporation may be subject to state, local and foreign taxes and may be subject to federal income tax with respect to built-in-gains under Code Section 1374 and to passive income under Code Section 1375. Even though an S corporation generally is not subject to federal income taxation, it still must file a return.

Section 3.14(b) deals with the background information relating to the seller's tax liability. Here the seller must turn over all tax returns and information relating to the audit of those returns. The seller may insist upon a carve-back on the returns and audit information it must provide, such as limiting the returns to the federal income tax returns and material state, local and foreign returns. This subsection also seeks information regarding tax issues that could be raised in the future with respect to returns that have not yet been audited or even filed. Thus, it might be seen as a provision designed to ferret out all issues with respect to the potential underpayment of taxes previously paid or currently due.

Section 3.14(c) is designed to ensure that any outstanding tax liabilities are properly reflected in the books of the seller.

Section 3.14(d) deals with specific potential tax liabilities or situations that may or may not be present depending upon the circumstances. Most of the items are addressed in a more general manner in preceding subsections, but it may be helpful in focusing the attention of the parties to address certain specific items in subsection (d). The first item, withholding obligations, is particularly important. Tax sharing agreements, covered in clause (ii), are common for consolidated groups where there is a minority interest. Clause (iii) is designed to ensure that there is no potential tax liability with respect to other consolidated groups of which the seller may have been a member.

Certain provisions of Section 3.14 are qualified by "Knowledge". The seller may argue that tax matters are the responsibility of a particular officer of the seller and only that officer's knowledge should be considered. The definition of "Knowledge", however, states that the seller will be deemed to have Knowledge of a fact or matter if any of its directors or officers has Knowledge of it. Therefore, the responsible officer's Knowledge is imputed to seller, and it is not necessary to change the language in Section 3.14 or to foreclose the possibility that another director or officer of seller may have Knowledge of relevant tax matters.

Section 3.14(d)(iv) addresses the basic situations that can arise with respect to S corporation status:

(1) The Seller is not an S corporation;

(2) The Seller is an S corporation and neither the built-in-gains tax nor the tax on passive income applies; or

(3) The Seller is an S corporation and the tax on passive income does not apply but the tax on built-in-gains does apply.

If the seller is an S corporation, the buyer will want to know the states and localities in which the seller is subject to tax as an entity, and that the seller has in fact discharged its obligations to those states. The last two sentences of clause (iv) address these issues.

The substantial understatement representation in clause (v) could help identify any aggressive practices in which the seller has engaged.

If the seller were publicly held, the buyer would want representations which address, respectively, excessive employee compensation under Code Section 162(m) and golden parachute payments under Code Section 280G. These representations could be worded as follows:

(v) Excessive Employee Remuneration. The disallowance of a deduction under Code Section 162(m) for employee remuneration will not apply to any amount paid or payable by Seller under any contractual arrangement currently in effect.

(vii) Golden Parachute Payments. Seller has not made any payments, is not obligated to make any payments, and is not a party to any agreement that under certain circumstances could obligate it to make any payments that will not be deductible under Code Section 280G.

Such representations should be included for publicly-held sellers only, because these Code sections specifically do not apply to certain defined closely-held corporations.

Finally, although the buyer in a taxable acquisition will not succeed to the seller's basis for its assets and other attributes, the buyer will in essence be taking over the basis and other tax attributes of any acquired subsidiaries. This information would permit the buyer to make the decision on whether or not to make a Section 338 election with respect to any acquired subsidiary for which a Section 338(h)(10) election is not filed. A representation soliciting this information would read as follows:

> (viii) <u>Basis and Other Information</u>. Part 3.14(d)(viii) sets forth the following information with respect to Seller and its subsidiaries (or in the case of clause (B) below, with respect to each of the subsidiaries) as of the most recent practicable date [(as well as on an estimated pro forma basis as of the Closing giving effect to the consummation of the transactions contemplated hereby)]: (A) the basis of Seller or subsidiary in its assets; (B) the basis of the shareholder(s) of each Subsidiary in such Subsidiary's stock (or the amount of any Excess Loss Account); (C) the amount of any net operating loss, net capital loss, unused investment or other credit, unused foreign tax, or excess charitable contribution allocable to Seller or any of its subsidiaries; and (D) the amount of any deferred gain or loss allocable to Seller or any of its subsidiaries arising out of any deferred intercompany transaction under the regulations under Code Section 1502.

The meaning of the term "Taxes" as used in an asset purchase agreement was determined in *Innophos, Inc. v. Rhodia, S.A.*, 10 N.Y.3d 25, 882 N.E.2d 389, 852 N.Y.S.2d 820 (N.Y. 2008), in connection with a claim for post-closing indemnification by the buyer. Two months after the closing, an agency of the Mexican government assessed the buyer (as successor in interest to a subsidiary acquired as part of the asset purchase) for over $130 million for water extraction fees. The buyer asserted an indemnification claim with respect to these fees, and litigation ensued when that claim was rejected. The asset purchase agreement provided: "The Sellers agree to indemnify and hold harmless the Purchaser against (i) Taxes of the Mexican Subsidiaries with respect to any taxable period (or portion thereof) that ends on or before the Closing Date . . ." The agreement's definition of "Taxes" provided: "'Tax' or 'Taxes' means all (i) United States federal, state or local or non-United States taxes, assessments, charges, duties, levies or other similar governmental charges of any nature, including all income, gross receipts, employment, franchise, profits, capital gains, capital stock, transfer, sales, use, occupation, property, excise, severance, windfall profits, stamp, stamp duty reserve, license, payroll, withholding, ad valorem, value added, alternative minimum, environmental, customs, social security (or similar), unemployment, sick pay, disability, registration and other taxes, assessments, charges, duties, fees, levies or other similar governmental charges of any kind whatsoever, whether disputed or not, together with all estimated taxes, deficiency assessments, additions to tax, penalties and interest; (ii) any liability for the payment of any amount of a type described in clause (i) arising as a result of being or having been a member of any consolidated, combined, unitary or other group or being or having been included or required to be included in any Tax Return related thereto; and (iii) any liability for the payment of any amount of a type described in clause (i) or clause (ii) as a result of any obligation to indemnify or otherwise assume or succeed to the liability of any other Person." The trial court found that the Mexican assessment was a "Tax" under this sweeping definition of Taxes. The Court of Appeals affirmed, finding persuasive buyer's argument that the fees were assessed by the Government of Mexico in its sovereign capacity, and, as such, they were similar to the examples of taxes contained in the definition, particularly with respect to severance taxes. The opinion pointed out that a severance tax is based on the volume of a natural resource exploited pursuant to a governmental concession. Both parties' experts agreed that Mexico's Constitution vests ownership over natural resources, including the water at issue, in the Mexican State. Thus in the Court's view the water was a state-owned natural resource regulated by the government in its capacity as a sovereign. See XIII Deal Points (The Newsletter of the ABA Bus. L. Sec. Committee on Negotiated Acquisitions) at 13-15 (Summer 2008).

3.15 NO MATERIAL ADVERSE CHANGE

Since the date of the Balance Sheet, there has not been any material adverse change in the business, operations, prospects, assets, results of operations or condition (financial or other) of Seller, and no event has occurred or circumstance exists that may result in such a material adverse change.

COMMENT

A seller may have several comments to this representation. First, the seller may resist the representation in its entirety on the basis that the buyer is buying assets, rather than stock. Second, if the seller is unsuccessful in eliminating the representation in its entirety, the seller might try to limit the representation by, for example, deleting certain portions of the representations, such as the reference to "prospects" on the basis that "prospects" is too vague. Third, the seller might try to specify a number of items that will not be deemed to constitute a material adverse change in the business, etc. of the seller even if they were to occur. In that regard, the seller might suggest the following "carve outs" be added to the end of Section 3.15:

> ; provided, however, that in no event shall any of the following constitute a material adverse change in the business, operations, prospects, assets, results of operations or condition of Seller: (i) any change resulting from conditions affecting the industry in which Seller operates or from changes in general business or economic conditions; (ii) any change resulting from the announcement or pendency of any of the transactions contemplated by this Agreement; and (iii) any change resulting from compliance by Seller with the terms of, or the taking of any action contemplated or permitted by, this Agreement.

The buyer, however, may resist the changes suggested by the seller on the basis that the buyer needs assurances that the business it is buying through its asset purchase has not suffered a material adverse change since the date of the most recent audited balance sheet of the seller. If the buyer agrees to one or more "carve outs" to the material adverse change provision, the buyer might want to specify a standard of proof with respect to the "carve outs" (*e.g.*, that (i) the only changes that will be excluded are those that are "proximately," "demonstrably" or "directly": caused by the particular circumstances described above, and (ii) with respect to any dispute regarding whether a change was proximately caused by one of the circumstances described above, the seller shall have the burden of proof by a preponderance of the evidence).

Whether or not the general material adverse change provision remains in the agreement, counsel to the buyer may wish to specifically identify those changes in the business or assets that the buyer would regard as important enough to warrant not going ahead with the transaction. *See Esplanade Oil & Gas, Inc. v. Templeton Energy Income Corporation*, 889 F.2d 621 (5th Cir. 1989) ("adverse material change to the Properties" held to refer to the seller's right, title and interest to oil properties and not to a decline in the value of those properties resulting from a precipitous drop in the price of oil). *See also John Borders v. KRLB, Inc.*, 727 S.W.2d 357 (Tex. Ct. App. 1987) (material adverse change in the target's "business, operations, properties and other assets which would impair the operation of the radio station" held not to include a significant decline in "Arbitron ratings" of the target radio station, indicating that the target had lost one-half of its listening audience, because (i) the material adverse change provision did not specifically refer to a ratings decline, and (ii) a ratings decline was not within the scope of the material adverse change provision at issue). *See also*, Greenberg and Haddad, *The Material Adverse Change Clause: Careful Drafting Key, But Certain Concerns May Need To Be Addressed Elsewhere*, New York Law Journal (April 23, 2001) at S5, S14-S15, for a discussion regarding the uncertainties in the judicial application of material adverse change provisions.

In *In re IBP, Inc. Shareholders Litigation*, 787 A.2d 14 (Del. Ch. 2001) ("*IBP v. Tyson*") (see Appendix C), the Delaware Chancery Court, applying New York law, granted IBP's request for specific performance of its merger agreement with Tyson and ordered Tyson to complete the merger. A central issue in the case involved application of the general no material adverse change provision included in the merger agreement. Section 5.10 of the merger agreement was a representation and warranty that IBP had not suffered a "Material Adverse Effect" since the "Balance Sheet Date" of December 25, 1999, except as set forth in the financial statements covered by the financial statement representation in the merger agreement or Schedule 5.10 of the merger agreement. Under the merger agreement, a "Material Adverse Effect" was defined as "any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect" … "on the condition (financial or otherwise), business, assets, liabilities or results of operations of [IBP] and [its] Subsidiaries taken as whole …" While the court's decision was based on a very fact specific analysis, the opinion focused on the information about IBP's difficulties that Tyson had gleaned through its negotiating and due diligence processes and Tyson's strategic objectives:

> These negotiating realities bear on the interpretation of § 5.10 and suggest that the contractual language must be read in the larger context in which the parties were transacting. To a short-term speculator, the failure of a company to meet analysts' projected earnings for a quarter could be highly material. Such a failure is less important to an acquiror who seeks to purchase the company as part of a long-term strategy. To such an acquiror, the important thing is whether the company has suffered a Material Adverse Effect in its business or results of operations that is consequential to the company's earnings power over a commercially reasonable period, which one would think would be measured in years rather than months. It is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause.
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> * * *
>
> Practical reasons lead me to conclude that a New York court would incline toward the view that a buyer ought to have to make a strong showing to invoke a Material Adverse Effect exception to its obligation to close. Merger contracts are heavily negotiated and cover a large number of specific risks explicitly. As a result, even where a Material Adverse Effect condition is as broadly written as the one in the Merger Agreement, that provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall

> earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror. In this regard, it is worth noting that IBP never provided Tyson with *quarterly* projections.
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> * * *
>
> Therefore, I conclude that Tyson has not demonstrated a breach of § 5.10. I admit to reaching this conclusion with less than the optimal amount of confidence. The record evidence is not of the type that permits certainty. *Id*. at 35-39.

IBP v. Tyson is affecting how attorneys and courts think about material adverse change provisions. In *Frontier Oil Corp. v. Holly Corp.*, CA No. 20502 2005, WL 1039027, (Del. Ch. Apr. 29, 2005) (see Appendix D), the Delaware Court of Chancery in reviewing Holly's claim that Frontier had breached its representation in Section 4.8 of the Merger Agreement that "there are no actions . . . threatened against Frontier . . . other than those which would not have or reasonably could be expected to have a Frontier Material Adverse Effect," the Court placed the burden of establishing a Material Adverse Effect with respect to Frontier on Holly. The Court noted that while the notion of a Material Adverse Effect "is imprecise and varies both with the context of the transaction and its parties and with the words chosen by the parties," the drafters of the Merger Agreement had the benefit of the analysis set forth in *IBP v. Tyson*, which discussed whether an acquiring party in a merger could invoke a Material Adverse Effect to escape from the transaction. With respect to the Merger Agreement's definition of Material Adverse Effect, the Court commented:

> It would be neither original nor perceptive to observe that defining a "Material Adverse Effect" as a "material adverse effect" is not especially helpful. Moreover, the definition chosen by the parties emphasizes the need for forward-looking analysis; that is especially true because the parties, through the drafting changes designed to assuage Holly's concerns about the threatened Beverly Hills Litigation added the "would not reasonably be expected to have" an MAE standard to the scope of inquiry regarding threatened litigation and the term "prospects" to the list of "the business, assets and liabilities . . . results of operations [and] condition" in the definition of an MAE.

The Court also commented in a footnote:

> The parties used "would," not "could" or "might." "Would" connotes a greater degree (although quantification is difficult) of likelihood than "could" or "might," which would have suggested a stronger element of speculation (or a lesser probability of adverse consequences).

The Court noted that the court in *IBP v. Tyson*, applying New York law, found that a buyer would be required to make a strong showing to invoke a Material Adverse Effect exception, namely, a showing that the complained of event would have a material effect on the long-term earnings potential of the target company. The Court wrote that in this context "it may be more useful to consider the standard drawn from *IBP* as one designed to protect a merger partner from the existence of unknown (or undisclosed) factors that would justify an exit from the transaction."

While noting that *IBP v. Tyson* applied New York law, the Court found no reason why Delaware law should prescribe a different approach. The Court found that since, under *IBP v. Tyson* a defendant seeking to avoid performance of a contract due to its counterparty's breach of warranty must assert that breach as an affirmative defense, it followed that the same defendant pursuing an affirmative counter-claim would be charged with the burden as well.

Whether the California litigation was, or was reasonably likely to have, a Material Adverse Effect was, in the Court's view, an issue with quantitative and qualitative aspects. Since Holly presented no evidence, scientific or otherwise, relating to the substance of the California plaintiffs' claims and how the California proceedings should play out, the Court found that Holly failed to meet its burden.

With respect to Holly's claims that the defense costs alone of the litigation constituted a Material Adverse Effect, Holly variously had estimated the defense costs of the litigation as ranging from $200,000 per month to $25 million to $40 million and then from $40 million to $50 million. Frontier produced separate estimates suggesting that the defense costs would be in the range of $11 million to $13 million. The Court found that a reasonable estimate of the costs would be in the range of $15 million to $20 million, and concluded that this range of costs alone did not constitute a Material Adverse Effect in a deal worth hundreds of millions.

Hexion Specialty Chemicals, Inc. v. Huntsman Corp., C.A. No. 3841-VCL (Del. Ch. Sept. 29, 2008), is the latest example of the reluctance of Delaware courts to find a Material Adverse Effect to have occurred in the context of a merger agreement. After a competitive auction, the buyer (Hexion) induced the target (Huntsman) to terminate target's merger agreement with another party and to enter into a merger agreement with it. While the parties were engaged in obtaining the necessary regulatory approvals, the target reported several disappointing quarterly results, missing the numbers it projected at the time the deal was signed. The buyer began exploring options for extricating the target from the transaction, first claiming that target had suffered a Material Adverse Effect and then obtaining an opinion that the combined entity would be insolvent, which caused buyer's lenders to try to get out of their commitment to fund the purchase price.

Because the buyer was eager to be the winning bidder in a competitive bidding situation, it agreed to pay a substantially higher price than the competition and to commit to stringent deal terms that were more than usually favorable to target. The merger agreement contained no financing contingency and required buyer to use its "reasonable best efforts" to consummate the financing. In addition, the agreement expressly provided for uncapped damages in the case of a "knowing and intentional breach of any covenant" by buyer and for liquidated damages of $325 million if buyer otherwise breached its terms. The merger provides that a non-breaching party may obtain specific performance of the other party's covenants, but that target "shall not be entitled to enforce specifically the obligations of [buyer] to consummate the merger."

The narrowly tailored Material Adverse Effect clause read as follows:

> any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of the Company and its Subsidiaries, taken as a whole; provided, however, that in no event shall any of the following constitute a Company Material Adverse Effect: (A) any occurrence, condition, change, event or effect resulting from or relating to changes in general economic or financial market conditions, except in the event, and only to the extent, that such occurrence, condition, change, event or effect has had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the chemical industry; (B) any occurrence, condition, change, event or effect that affects the chemical industry generally (including changes in commodity prices, general market prices and regulatory changes affecting the chemical industry generally) except in the event, and only to the extent, that such occurrence, condition, change, event or effect has had a disproportionate effect on the Company and its Subsidiaries, taken as a whole, as compared to other Persons engaged in the chemical industry . . . .

After six days of trial, Vice Chancellor Lamb found that the target had not suffered a Material Adverse Effect, as defined in the merger agreement, and that the buyer had knowingly and intentionally breached numerous of its covenants under that agreement. Recognizing that there remained substantial obstacles to closing the transaction, some resulting from the current unsettled credit environment and some resulting from the course of action the buyer pursued in place of the continued good faith performance of the buyer's contractual obligations, the Court ordered specific performance of all of buyer's covenants and obligations (other than the ultimate obligation to close).

The Court rejected the buyer's argument that it could be excused from performing its freely undertaken contractual obligations simply because its board of directors concluded that the performance of those contractual obligations risked insolvency. Instead, it was the duty of the buyer's board of directors to explore the many available options for mitigating the risk of insolvency while causing the buyer to perform its contractual obligations in good faith. If, at closing, and despite the buyer's best efforts, financing had not been available, the buyer could then have stood on its contract rights and faced no more than the contractually stipulated damages. The buyer and its parent, however, chose a different course.

In explaining its conclusion that target had not suffered a Material Adverse Effect, Vice Chancellor Lamb wrote:

> For the purpose of determining whether an MAE has occurred, changes in corporate fortune must be examined in the context in which the parties were transacting. In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. The important consideration therefore is whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months. A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close. Many commentators have noted that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement. This is not a coincidence. The ubiquitous material adverse effect clause should be seen

as providing a "backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather [an adverse change] should be material when viewed from the longer-term perspective of a reasonable acquirer." This, of course, is not to say that evidence of a significant decline in earnings by the target corporation during the period after signing but prior to the time appointed for closing is irrelevant. Rather, it means that for such a decline to constitute a material adverse effect, poor earnings results must be expected to persist significantly into the future.

* * *

[A]bsent clear language to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract.

* * *

The issue then becomes what benchmark to use in examining changes in the results of business operations post-signing of the merger agreement—EBITDA or earnings per share. In the context of a cash acquisition, the use of earnings per share is problematic. Earnings per share is very much a function of the capital structure of a company, reflecting the effects of leverage. * * * What matters is the results of operation of the business. Because EBITDA is independent of capital structure, it is a better measure of the operational results of the business. Changes in [target's] fortunes will thus be examined through the lens of changes in EBITDA. This is, in any event, the metric the parties relied on most heavily in negotiating and modeling the transaction.

* * *

There is no question that [target's] results from the time of signing in July 2007 until the end of the first half of 2008 have been disappointing. [Target's] first-half 2008 EBITDA was down 19.9% year-over-year from its first-half 2007 EBITDA. And its second-half 2007 EBITDA was 22% below the projections [target] presented to bidders in June 2007 for the rest of the year.

Realizing, however, that these results, while disappointing, were not compelling as a basis to claim an MAE, [buyer] focused its arguments on [target's] repeated misses from its forecasts. * * * As of August 1, 2008, [target] management projected EBITDA for 2008 was $879 million, a 32% decrease from the forecast the year before. [buyer] points to these shortfalls from the 2007 projections and claims that [target's] failure to live up to its projections are key to the MAE analysis.

But this cannot be so. Section 5.11(b) of the merger agreement explicitly disclaims any representation or warranty by [target] with respect to "any projections, forecasts or other estimates, plans or budgets of future

> revenues, expenses or expenditures, future results of operations . . ., future cash flows . . . or future financial condition . . . of [target] or any of its Subsidiaries . . . heretofore or hereafter delivered to or made available to [buyer or its affiliates] . . . ." The parties specifically allocated the risk to [buyer] that [target's] performance would not live up to management's expectations at the time. If [buyer] wanted the short-term forecasts of [target] warranted by [target], it could have negotiated for that. It could have tried to negotiate a lower base price and something akin to an earn-out, based not on [target's] post-closing performance but on its performance between signing and closing. Creative investment bankers and deal lawyers could have structured, at the agreement of the parties, any number of potential terms to shift to [target] some or all of the risk that [target] would fail to hit its forecast targets. But none of those things happened. Instead, [buyer] agreed that the contract contained no representation or warranty with respect to [target's] forecasts. To now allow the MAE analysis to hinge on [target's] failure to hit its forecast targets during the period leading up to closing would eviscerate, if not render altogether void, the meaning of section 5.11(b).

In *Genesco, Inc. vs. The Finish Line, Inc.*, No. 07-2137-II(III) (Tenn. Ch. Dec. 27, 2007), the buyer's allegations that a Material Adverse Effect had occurred were rejected and specific performance of the merger agreement was ordered. Within two months after the merger agreement was signed, it became apparent that Genesco's earnings would fall significantly short of projections. After Genesco's stockholders voted to approve the merger and Genesco demanded a closing, buyer refused to proceed. Genesco's lawsuit seeking specific performance followed. Finish Line asserted, *inter alia*, that the decline in Genesco's earnings constituted a "Material Adverse Effect, which was defined in the merger agreement as follows:

> "Company Material Adverse Effect" shall mean any event, circumstance, change or effect that, individually or in the aggregate, is materially adverse to the business, condition (financial or otherwise), assets, liabilities or results of operations of the Company and the Company Subsidiaries, taken as a whole; provided, however, that none of the following shall constitute, or shall be considered in determining whether there has occurred, and no event, circumstance, change or effect resulting from or arising out of any of the following shall constitute, a Company Material Adverse Effect: (A) the announcement of the execution of this Agreement or the pendency of consummation of the Merger (including the threatened or actual impact on relationships of the Company and the Company Subsidiaries with customers, vendors, suppliers, distributors, landlords or employees (including the threatened or actual termination, suspension, modification or reduction of such relationships)); (B) changes in the national or world economy or financial markets as a whole or changes in general economic conditions that affect the industries in which the Company and the Company Subsidiaries conduct their business, so long as such changes or conditions do not adversely affect the Company and the Company Subsidiaries, taken as a whole, in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate; (C) any change in applicable Law, rule or regulation or GAAP or interpretation thereof after the date hereof, so long as such

changes do not adversely affect the Company and the Company Subsidiaries, taken as a whole, in a materially disproportionate manner relative to other similarly situated participants in the industries or markets in which they operate; (D) the failure, in and of itself, of the Company to meet any published or internally prepared estimates of revenues, earnings or other financial projections, performance measures or operating statistics; provided, however, that the facts and circumstances underlying any such failure may, except as may be provided in subsection (A), (B), (C), (E), (F) and (G) of this definition, be considered in determining whether a Company Material Adverse Effect has occurred; (E) a decline in the price, or a change in the trading volume, of the Company Common Stock on the New York Stock Exchange ("NYSE") or the Chicago Stock Exchange ("CHX"); (F) compliance with the terms of, and taking any action required by, this Agreement, or taking or not taking any actions at the request of, or with the consent of, Parent; and (G) acts or omissions of Parent or Merger Sub after the date of this Agreement (other than actions or omissions specifically contemplated by this Agreement).

The Court held that a Material Adverse Effect had not occurred based on expert testimony that Genesco's performance decline was due to general economic conditions and, therefore, the exception set forth in subpart (B) above applied. *See* XIII Deal Points (The Newsletter of the ABA Bus. L. Sec. Committee on Negotiated Acquisitions) at 20-22 (Spring 2008).

For a discussion of the advisability of including a separate "no material adverse change" condition in the acquisition agreement, see the Comment to Section 7.1 under the caption "Desirability of Separate 'No Material Adverse Change' Condition." For a discussion of the implications of various methods of drafting a phrase such as "that may result in such a material adverse change" (which appears at the end of Section 3.15), see the introductory Comment to Section 3 under the caption "Considerations When Drafting 'Adverse Effect' Language in Representations."

The tragic events of September 11, 2001 have led to a focus on whether terrorism or war are among the class risks encompassed by a no material adverse change provision. In Warren S. de Weid, *The Impact of September 11 on M&A Transactions*, 5 The M&A Lawyer No. 5 (Oct. 2001), the author concluded that in the few deals surveyed the general practice was not to adopt specific language to deal with September 11 type risks, but discussed the issues and a few examples as follows:

> Unless the parties view terrorism or war as a class of risk that should be treated differently from other general risks, general effects of terrorism or war should be treated in the merger agreement in the same way as other general changes or events. It should be recognized that the exceptions for general events or changes relating to the financial markets, the economy, or parties' stock prices are not intended to protect a party from party-specific impacts of terrorism or other catastrophes, such as physical damage to its facilities, financial loss, or loss of key personnel, nor would one normally expect a party to be protected against such impacts. If, as was the case with the September 11 attacks, entire industries may be adversely affected by a general event, an exception for general industry changes may protect a party, depending upon the precise formulation of the

exception, and the factual context. But the scope of any of these exceptions is often ambiguous, leaving room for argument over whether a change is general or specific. Indeed, in order to avoid the problem that economic, financial or industry changes, while they may be general in nature, may have quite disparate impacts even on two similar companies in the same industry, it is not unusual to see language in the carve-out for general changes which provides that this carve-out does not apply to disproportionate impacts on the company that is the object of the clause.

In a few post-September 11 deals, the parties have addressed impacts of September 11, or of other acts of terrorism, war or armed conflict, in the MAC clause. A merger agreement between First Merchants Corporation and Lafayette Bancorporation dated October 14, 2001, expressly *excludes* from the definition of material adverse change "…events and conditions relating to the business and interest rate environment in general (*including consequences of the terrorist attack on the* United *States on September 11*…" (italics added). Since the italicized language is merely indicative of a type of event that may affect the business and interest rate environment in general, it was really not necessary to include such language in the agreement, although perhaps the parties took comfort from dealing explicitly with the events of September 11.

A merger agreement between Reliant Resources, Inc., Reliant Energy Power Generation Merger Sub, Inc. and Orion Power Holdings, Inc. dated as of September 26, 2001 expressly *includes* certain terrorism related events within the definition of a "Material Adverse Effect":

> "Material Adverse Effect" shall mean any change or event or effect that, individually or together with other changes, events and effects, is materially adverse to the business, assets or financial condition of the Company and its subsidiaries, taken as a whole, except for…(ii) changes or developments in national, regional, state or local electric transmission or distribution systems *except to the extent caused by a material worsening of current conditions caused by acts of terrorism or war (whether or not declared) occurring after the date of this Agreement which materially impair the Company's ability to conduct its operations except on a temporary basis*, (iii) changes or developments in financial or securities markets or the economy in *general except to the extent caused by a material worsening of current conditions caused by acts of terrorism or war (whether or not declared) occurring after the date of this Agreement*…" (italics added).

In this case, the italicized language creates two different types of exceptions to the provisions limiting the scope of the MAC clause. One exception (which is quite understandable) encompasses events that are materially adverse to the target and affect the target company specifically, e.g., by disrupting state or local transmission or distribution systems (although the clause also addresses changes that are much broader, and that affect national power systems, and presumably would affect the target company only as one of many other power companies). The other exception carves out the exclusions from the MAC clause changes in markets or the economy to the extent caused by terrorism or war, giving the buyer the right in certain circumstances not to close because of general changes due to terrorism or war. However the buyer must accept the risk of other general changes in the securities markets or the economy.

There are a number of interpretive and probative issues with the Reliant-type clause. If the buyer seeks to invoke the clause, the buyer must prove: (a) that *terrorism* or *war caused* a change; (b) the *extent* to which terrorism or war caused the change; and (c) specifically in the case of the particular language in Reliant, that there has been a *material worsening* of *current* conditions and, in the first of the two italicized clauses, that the change is not *temporary*. These issues create potentially significant obstacles to invoking the clause as a basis for termination.

As the Reliant transaction is an acquisition of Orion by Reliant and therefore the clause is not reciprocal, it is somewhat surprising that Reliant was able to negotiate "outs" for general changes caused by acts of terrorism or war, and it is to be expected that most sellers will vigorously resist such a provision. Granted, the effect of terrorism or war on the financial markets or business conditions could be unusually and unforeseeably severe, but sellers will likely object that the allocation to the seller of the risks of general changes caused by terrorism or war is arbitrary, particularly where, as in the Reliant transaction, other general changes in securities markets and the economy, regardless of their cause or severity, are for the account of the buyer. Moreover, by their very nature, acts of terrorism or war are unpredictable, and are as likely to occur the day after closing as the day before.

* * *

An alternative approach that would address a party's concern to preserve an escape clause in the face of major market disruption caused by terrorism would be to include a "Dow Jones" clause in the acquisition agreement. Common in the late 1980s after the steep market drop that occurred on October 19, 1987, such a clause permits a party to walk away from a transaction if the Dow Jones Industrial Average (or other specified market index) falls by more than a specified number of points or more than a specified percentage.

* * *

Another formulation for which there is a precedent post-September 11 is to provide a right to terminate based upon an extended market shutdown, banking moratorium or similar event. Under an agreement dated as of October 8, 2001, between Burlington Resources Inc. and Canadian Hunter Exploration Ltd., Burlington is entitled to terminate the agreement if at the time all other conditions are satisfied, there is a general suspension of trading or general limitation on prices on any United States or Canadian national securities exchange, a declaration of a banking moratorium or general suspension of payments by banks, a limitation on extension of credit by banks or financial institutions, or a material worsening of any of these conditions, which continues for not less than ten days.

How parties choose to allocate these risks in future deals will be influenced by transactions that were signed prior to September 11 that involve companies that have been, or are alleged to have been, affected by the events of that date or their consequences. One such deal was USA Networks, Inc.'s proposed acquisition of National Leisure Group, Inc., a seller and distributor of cruise and vacation packages and provider of travel support solutions. On October 3, 2001, USA notified NLG that it had terminated the merger agreement and simultaneously commenced an action in Delaware Chancery Court seeking declaratory and injunctive relief confirming that its actions in terminating the merger agreement with NLG were lawful. The grounds asserted by USA Networks were: (i) the termination of an allegedly material customer relationship and the receipt by NLG of various claims from that customer, and (ii) the alleged occurrence of a MAC, consisting of, inter alia, NLG's financial performance from signing to the date of termination, "as well as the effects and reasonably foreseeable future effects on NLG of the events of September 11 and their aftermath."

The MAC clause in the USA/NLG merger agreement did not contain any carve-outs for general economic, financial market or industry changes. Accordingly, the issue was relatively clear -- had changes occurred, either as a result of the events of September 11 or other facts alleged by USA, that were or would reasonably be expected to be materially adverse to the financial condition, results of operations, assets, properties or business of NLG? Given the substantial reduction in corporate and vacation travel since September 11, the business of NLG, a non-reporting company, could well have been materially impacted, and the absence of any carve-outs from the MAC clause eliminated a possible line of defense for NLG. In any event, NLG must have concluded that a settlement was preferable to litigating USA's termination of the agreement, as on October 29, the parties announced a settlement that involved USA taking an equity stake in NLG and entering into a commercial deal to market NLG travel packages on the USA Travel Channel. It is unlikely that NLG's position under the merger agreement would have been much stronger had there been a carve-out for general financial or market changes, as the changes alleged by USA were specific to the business of NLG.

The issues would have been more complicated, and the parties might have acted differently, had there been a carve-out for general industry changes. In that situation, even if the changes alleged as a result of the events of September 11 were material, there would still have been a question whether the changes were general industry changes. And if in fact there were widespread adverse effects on companies in the industry, but the impacts on the target company were much more pronounced, would the acquiror have been comfortable exercising a right to terminate? The presence of absence of language excluding disproportionate impacts of general changes would likely have significant impact on the acquiror's analysis.

In summary, the debate over the content of the material adverse change clause in merger and acquisition agreements will be more vigorous, stoked by the events of September 11, and cases like NLG and the earlier Tyson Foods case. The wording of the MAC clause may not look different in many post-September 11 deals than it did before, but the parties will be more conscious of the issues and the importance of the specific words used.

In addition to Section 3.15, which deals generally with material adverse changes affecting the Seller, Section 3.19 covers several specific matters that are considered significant (though not necessarily adverse) events for the Seller and may, individually or in the aggregate, constitute material adverse changes. Section 3.19 requires disclosure of such events that occurred after the date of the Balance Sheet but before the signing of the acquisition agreement, and Section 5.3 requires the Seller to prevent such events from occurring (to the extent it is within their power to do so) after the signing date but before the closing (for further discussion, see the Comment to Section 3.19). Together, Sections 3.15 and 3.19 require the Seller to disclose to the Buyer updated information concerning important developments in the business of the Seller after the date of the Balance Sheet.

3.18 LEGAL PROCEEDINGS; ORDERS

(a) Except as set forth in Part 3.18(a), there is no pending or, to Seller's Knowledge, threatened Proceeding:

(i) by or against Seller or that otherwise relates to or may affect the business of, or any of the assets owned or used by, Seller; or

(ii) that challenges, or that may have the effect of preventing, delaying, making illegal, or otherwise interfering with, any of the Contemplated Transactions.

To the Knowledge of Seller, no event has occurred or circumstance exists that is reasonably likely to give rise to or serve as a basis for the commencement of any such Proceeding. Seller has delivered to Buyer copies of all pleadings, correspondence, and other documents relating to each Proceeding listed in Part 3.18(a). There are no Proceedings listed or required to be listed in Part 3.18(a) that could have a material adverse effect on the business, operations, assets, condition, or prospects of Seller, or upon the Assets.

(b) Except as set forth in Part 3.18(b):

(i) there is no Order to which Seller, its business or any of the Assets is subject; and

(ii) to the Knowledge of Seller, no officer, director, agent, or employee of Seller is subject to any Order that prohibits such officer, director, agent, or employee from engaging in or continuing any conduct, activity, or practice relating to the business of Seller.

(c) Except as set forth in Part 3.18(c):

(i) Seller is, and at all times since __________, 20___ has been, in compliance with all of the terms and requirements of each Order to which it or any of the Assets is or has been subject;

(ii) no event has occurred or circumstance exists that is reasonably likely to constitute or result in (with or without notice or lapse of time) a violation of or failure to comply with any term or requirement of any Order to which Seller, or any of the Assets is subject; and

(iii) Seller has not received, at any time since __________, 20___, any notice or other communication (whether oral or written) from any Governmental Body or any other Person regarding any actual, alleged, possible, or potential violation of, or failure to comply with, any term or requirement of any Order to which Seller or any of the Assets is or has been subject.

COMMENT

The buyer would typically evaluate each disclosed proceeding to determine the probability of an adverse determination and the magnitude of the potential damages. The information provided in the disclosure letter and the seller's financial statements and accompanying notes, as well as attorneys' responses to auditors' requests for information, would typically be reviewed. However, if the buyer reviews privileged materials relating to legal proceedings in which the seller is involved, there may be a waiver of the attorney-client privilege (see Sections 5.1 and 12.6 and related Comments). For each proceeding, the buyer should determine whether the potential liability justifies a larger holdback of a portion of the purchase price or whether indemnification is sufficient. Finally, the buyer and the seller must agree on the manner in which all such proceedings will be conducted up to and after the closing (issues such as who will designate lead counsel and who is empowered to effect a settlement must be resolved).

The disclosures required by Section 3.18 will allow the buyer to determine whether the seller is subject to and in compliance with any judicial or other orders or is involved in any Proceedings that could affect the acquisition or the operation of the business. This representation does not address:

- violations of laws or other legal requirements of general application (see subsection 3.17(a));
- violations of the terms of governmental licenses or permits held by the seller (see Section 3.17(b));
- contractual compliance by the seller (see Section 3.20(d)); or
- violations of laws and other requirements that would be triggered by the acquisition (see Section 3.2(b)).

The representations in Section 3.18(c) focus on four overlapping categories of violations of judicial and other orders:

1. past violations (clause (i));

2. pending violations (clause (i));

3. potential or "unmatured" violations (clause (ii)); and

4. violations asserted by governmental authorities and other parties (clause (iii)).

A seller may object to the provision in clause (i) of subsection 3.18(c) that requires disclosure of past violations, arguing that the buyer should not be concerned about historical violations that have been cured and are no longer pending. The buyer may respond by pointing out that without this provision, the buyer may not be able to learn what type of litigation the seller's operations historically has attracted. The parties may compromise on this point by selecting a relatively recent date to mark the beginning of the period with respect to which disclosure of past violations is required.

In some acquisition agreements, the phrase "since ___________, 20__" (which appears in both clause (i) and clause (iii) of subsection 3.18(c)) is replaced with the phrase "during the _____-year period prior to the date of this Agreement" (or a similar phrase). For an explanation of why the use of this alternative language may be disadvantageous to the buyer, see the introductory Comment to Article 3 (under the caption "Considerations When Drafting Representations Incorporating Specific Time Periods").

For a discussion of the significance of the phrase "with or without notice or lapse of time" (which appears in clause (ii) of Section 3.18(c)), see the Comment to Section 3.2.

Although clause (iii) of Section 3.18(c) (which requires disclosure of notices received from governmental authorities and third parties concerning actual and potential violations) overlaps to some extent with clauses (i) and (ii), clause (iii) is not redundant. Clause (iii) requires disclosure of violations that have been asserted by other parties. The seller is required to disclose such asserted violations pursuant to clause (iii) even if there is some uncertainty or dispute over whether the asserted violations have actually been committed.

The parties should recognize that, if information regarding an actual or potential violation of a court order is included in the seller's disclosure letter, this information may be discoverable by adverse parties in the course of litigation involving the seller. Accordingly, it is important to use extreme care in preparing the descriptions included in part 3.18 of the disclosure letter (see the Comment to Section 3.2).

Certain of the provisions in Section 3.18 are sometimes the source of heated negotiation. For example, (a) the language in Section 3.18(a) with respect to knowledge of the basis for the commencement of any Proceeding is usually requested but often successfully resisted by the Seller; (b) Section 3.18(b)(i), a materiality carve-out for the effect on the operation of the Seller's business, is often negotiated; (c) clause (ii) of Section 3.18(b) is generally only requested by a buyer when the services of an individual are critical to the transaction; (d) the representation in clause (ii) of Section 3.18(c) with respect to the occurrence of events which might constitute violations is often successfully resisted by the seller; and (e) the representation in clause (iii) of Section 3.18(c) with respect to the absence of any oral notices from or communications with non-governmental persons is often successfully resisted by the seller.

A typical representation concerning litigation will require the seller to represent that "To the knowledge of Seller, no proceeding involving the Seller has been threatened." The word "threatened" connotes action that a prudent person would expect to be taken based either upon receipt of a written demand, letter threatening litigation, or notice of an impending investigation or audit or upon facts that a prudent person would believe indicate that action likely will be taken by another person (for example, a recent, well-publicized industrial accident likely to give rise to claims even though no claims have yet been filed). When the term "threatened" is used in conjunction with a knowledge qualification, the buyer will normally insist that the seller's knowledge be based upon some inquiry or process of investigation, while the seller may attempt to limit its knowledge of threatened action to the actual knowledge of the seller and perhaps the seller's senior management (or a limited number of designated officers) without any independent investigation. (See the definition of Knowledge in Section 1.1.)

By comparison, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975) (the "*Policy Statement*") also contains standards for determining when threatened litigation must be disclosed. The Policy Statement examines the appropriateness of responses by lawyers to auditors' requests for information concerning loss contingencies of their clients. The Policy Statement is the result of a carefully negotiated compromise between the ABA and the American Institute of Certified Public Accountants. The compromise involved the balancing of the public interest in protecting the confidentiality of lawyer-client communications, as well as the attorney-client privilege, with the need for public confidence in published financial statements. Under the terms of the Policy Statement, only "overtly threatened" litigation need be disclosed. *See* Byron F. Egan, James D. Goldsmith and Charles R. Lotter, "*How to Respond to Audit Letters*," TexasBar CLE: "How to Respond to Audit Letters" Telephone Seminar (July 29, 2005), which can be found at http://www.jw.com/site/jsp/publicationinfo.jsp?id=503. The customary threshold for disclosure in a business acquisition is lower, and the Policy Statement is not considered an appropriate benchmark for the allocation of risk between sellers and buyers in business acquisitions.

In addition to the representations concerning pending or threatened litigation, other provisions of the acquisition agreement may require disclosure of items that the seller is aware of and may affect the seller. For example, the expected effect of a possible catastrophe may be covered by representations concerning the financial statements (see Section 3.4) or the absence of certain changes and events (see Section 3.19) or provisions regarding disclosure (see Section 3.33). Even if such a matter does not warrant disclosure by means of a reserve, a provision, or a footnote in the seller's financial statements, and even if its significance cannot yet be fully assessed, the seller's failure to disclose it in the disclosure letter may give the buyer the right to elect not to close or, if the matter is discovered after the closing, to seek indemnification.

See the Comment to Section 3.15 and Appendix D for discussions of *Frontier Oil Corp. v. Holly Corp.*, CA No. 20502 2005, WL 1039027, (Del. Ch. Apr. 29, 2005), in which the no pending or threatened litigation representation provided that there were no pending or threatened proceedings "other than those that would not have or reasonably be expected to have, individually or in the aggregate, a Frontier Material Adverse Effect."

3.19 ABSENCE OF CERTAIN CHANGES AND EVENTS

Except as set forth in Part 3.19, since the date of the Balance Sheet, Seller has conducted its business only in the Ordinary Course of Business and there has not been any:

(a) change in Seller's authorized or issued capital stock, grant of any stock option or right to purchase shares of capital stock of Seller, or issuance of any security convertible into such capital stock;

(b) amendment to the Governing Documents of Seller;

(c) payment (except in the Ordinary Course of Business) or increase by Seller of any bonuses, salaries, or other compensation to any shareholder, director, officer, or employee or entry into any employment, severance, or similar Contract with any director, officer, or employee;

(d) adoption of, amendment to, or increase in the payments to or benefits under, any Employee Plan;

(e) damage to or destruction or loss of any Asset, whether or not covered by insurance;

(f) entry into, termination of, or receipt of notice of termination of (i) any license, distributorship, dealer, sales representative, joint venture, credit, or similar Contract to which Seller is a party, or (ii) any Contract or transaction involving a total remaining commitment by Seller of at least $___________;

(g) sale (other than sales of Inventories in the Ordinary Course of Business), lease, or other disposition of any Asset or property of Seller (including the Intellectual Property Assets) or the creation of any Encumbrance on any Asset;

(h) cancellation or waiver of any claims or rights with a value to Seller in excess of $_____________;

(i) indication by any customer or supplier of an intention to discontinue or change the terms of its relationship with Seller;

(j) material change in the accounting methods used by Seller; or

(k) Contract by Seller to do any of the foregoing.

COMMENT

This representation seeks information about actions taken by the Seller or other events affecting the Seller since the date of the Balance Sheet which may be relevant to the Buyer's plans and projections of income and expenses. In addition, this provision requires disclosure of actions taken by the Seller in anticipation of the acquisition.

Most of the subjects dealt with in this representation are also covered by other representations. For example, while Section 3.16 contains detailed representations concerning employee benefit plans, subsection 3.19(d) focuses on recent changes to such plans. For a discussion of the relationship between the representations in Sections 3.16 and 3.19, see the Comment to Section 3.16.

In addition to the disclosure function described above, this representation, along with Sections 5.2 and 5.3, serves another purpose. Section 5.3 provides that the Seller will not, without the prior consent of the Buyer, take any action of the nature described in Section 3.19 during the period between the date of signing the acquisition agreement and the closing. Section 5.2 is a general covenant by the Seller to operate its business between those dates only in the ordinary course; Section 5.3 specifically commits the Seller not to make changes as to the specific matters covered by Section 3.19.

Finally, there may be other specific matters that pose special risks to a buyer and should be included in this representation.

3.25 INTELLECTUAL PROPERTY ASSETS

(a) The term "**Intellectual Property Assets"** means all intellectual property owned or licensed (as licensor or licensee) by Seller, or in which Seller has a proprietary right or interest, including:

(i) Seller's name, all assumed fictional business names, trading names, registered and unregistered trademarks, service marks, and applications (collectively, "**Marks"**);

(ii) all patents, patent applications, and inventions and discoveries that may be patentable (collectively, "**Patents"**);

(iii) all registered and unregistered copyrights in both published works and unpublished works (collectively, "**Copyrights"**);

(iv) all rights in mask works (collectively, "**Rights in Mask Works"**);

(v) all know-how, trade secrets, confidential or proprietary information, customer lists, Software, technical information, data, process technology, plans, drawings, and blue prints (collectively, "**Trade Secrets"**); and

(vi) all rights in internet websites and internet domain names presently used by Seller (collectively "**Net Names"**).

(b) Part 3.25(b) contains a complete and accurate list and summary description, including any royalties paid or received by Seller, and Seller has delivered to Buyer accurate and complete copies, of all Seller Contracts relating to the Intellectual Property Assets, except for any license implied by the sale of a product and perpetual, paid-up licenses for commonly available Software programs with a value of less than $__________________ under which Seller is the licensee. There are no outstanding and, to Seller's Knowledge, no threatened disputes or disagreements with respect to any such Contract.

(c) (i) Except as set forth in Part 3.25(c), the Intellectual Property Assets are all those necessary for the operation of Seller's business as it is currently conducted.

Seller is the owner or licensee of all right, title, and interest in and to each of the Intellectual Property Assets, free and clear of all Encumbrances, and has the right to use without payment to a Third Party all of the Intellectual Property Assets, other than in respect of licenses listed in part 3.25(c).

(ii) Except as set forth in Part 3.25(c) , all former and current employees of Seller have executed written Contracts with Seller that assign to Seller all rights to any inventions, improvements, discoveries, or information relating to the business of Seller.

(d) (i) Part 3.25(d) contains a complete and accurate list and summary description of all Patents.

(ii) All of the issued Patents are currently in compliance with formal legal requirements (including payment of filing, examination, and maintenance fees and proofs of working or use), are valid and enforceable, and are not subject to any maintenance fees or taxes or actions falling due within ninety days after the Closing Date.

(iii) No Patent has been or is now involved in any interference, reissue, reexamination, or opposition Proceeding. To Seller's Knowledge, there is no potentially interfering patent or patent application of any Third Party.

(iv) Except as set forth in Part 3.25(d), (x) no Patent is infringed or, to Seller's Knowledge, has been challenged or threatened in any way and (y) none of the products manufactured or sold, nor any process or know-how used, by Seller infringes or is alleged to infringe any patent or other proprietary right of any other Person.

(v) All products made, used, or sold under the Patents have been marked with the proper patent notice.

(e) (i) Part 3.25(e) contains a complete and accurate list and summary description of all Marks.

(ii) All Marks that have been registered with the United States Patent and Trademark Office are currently in compliance with all formal legal requirements (including the timely post-registration filing of affidavits of use and incontestability and renewal applications), are valid and enforceable, and are not subject to any maintenance fees or taxes or actions falling due within ninety days after the Closing Date.

(iii) No Mark has been and is now involved in any opposition, invalidation, or cancellation Proceeding and, to Sellers' Knowledge, no such action is threatened with respect to any of the Marks.

(iv) To Seller's Knowledge, there is no potentially interfering trademark or trademark application of any other Person.

(v) No Mark is infringed or, to Seller's Knowledge, has been challenged or threatened in any way. None of the Marks used by Seller infringes or is alleged to infringe any trade name, trademark, or service mark of any other Person.

(vi) All products and materials containing a Mark bear the proper federal registration notice where permitted by law.

(f) (i) Part 3.25(f) contains a complete and accurate list and summary description of all Copyrights.

(ii) All of the registered Copyrights are currently in compliance with formal legal requirements, are valid and enforceable, and are not subject to any maintenance fees or taxes or actions falling due within ninety days after the date of Closing.

(iii) No Copyright is infringed or, to Seller's Knowledge, has been challenged or threatened in any way. None of the subject matter of any of the Copyrights infringes or is alleged to infringe any copyright of any Third Party or is a derivative work based on the work of any other Person.

(iv) All works encompassed by the Copyrights have been marked with the proper copyright notice.

(g) (i) With respect to each Trade Secret, the documentation relating to such Trade Secret is current, accurate, and sufficient in detail and content to identify and explain it and to allow its full and proper use without reliance on the knowledge or memory of any individual.

(ii) Seller has taken all reasonable precautions to protect the secrecy, confidentiality, and value of all Trade Secrets (including the enforcement by Seller of a policy requiring each employee or contractor to execute proprietary information and confidentiality agreements substantially in Seller's standard form and all current and former employees and contractors of Seller have executed such an agreement).

(iii) Seller has good title and an absolute right to use the Trade Secrets. The Trade Secrets are not part of the public knowledge or literature, and, to Seller's Knowledge, have not been used, divulged, or appropriated either for the benefit of any Person (other than Seller) or to the detriment of Seller. No Trade Secret is subject to any adverse claim or has been challenged or threatened in any way or infringes any intellectual property right of any other Person.

(h) (i) Part 3.25(h) contains a complete and accurate list and summary description of all Net Names.

(ii) All Net Names of Seller have been registered in the name of Seller and are in compliance with all formal legal requirements.

(iii) No Net Name of Seller has been or is now involved in any dispute, opposition, invalidation or cancellation Proceeding and, to Seller's Knowledge, no such action is threatened with respect to any Net Name of Seller.

(iv) To Seller's Knowledge there is no domain name application pending of any other person which would or would potentially interfere with or infringe any Net Name of Seller.

(v) No Net Name of Seller is infringed or, to Seller's Knowledge, has been challenged, interfered with or threatened in any way. No Net Name of Seller infringes, interferes with or is alleged to interfere with or infringe the trademark, copyright or domain name of any other Person.

COMMENT

The definition of "Intellectual Property Assets" encompasses all forms of intellectual property, including the forms expressly identified.

The representation in Section 3.25(b) requires the Seller to list license agreements and other agreements that relate to the Intellectual Property Assets, such as a covenant not to sue in connection with a patent, a noncompetition agreement, a confidentiality agreement, a maintenance and support agreement for any software the Seller is licensed to use, or an agreement to sell or license a particular asset. Disclosure of such agreements enables a buyer to identify which of the Intellectual Property Assets are subject to a license or other restriction and to determine whether the seller has the exclusive right to practice certain technology.

If there is a general representation that all of the seller's contracts are valid and binding and in full force and effect and that neither party is in default (see Section 3.20), a separate representation is not needed in this Section. If there is not a general representation on contracts, or if it is limited in some way, the buyer should consider including such a representation in this section, especially if the seller licenses intellectual property that is important to its business.

The seller may object to the representation called for in clause (i) of Section 3.25(c) as too subjective and try to force the buyer to draw its own conclusion as to whether the seller's Intellectual Property Assets are sufficient to operate its business.

Whether a buyer will want to include the representations in Section 3.25(d)-(g) depends upon the existence and importance of the various types of intellectual property assets in a particular transaction. For example, patents and trade secrets can be the key asset of a technology-driven manufacturing company, while trademarks and copyrights could be the principal asset of a service company. Below are descriptions of the main categories of intellectual property and how they are treated in the Model Agreement.

Patents. There are three types of United States patents. A "utility patent" may be granted under 35 U.S.C. § 101 for "any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof." Patents also may be granted under Chapter 15, 35 U.S.C. §§161-164 (a "plant patent") for new varieties of plants (other than tuber or plants found in an uncultivated state). Finally, a patent may be granted under Chapter 16, 35 U.S.C. §§ 171-173 (a "design patent") for a new, original, and ornamental design for an article of manufacture.

In the United States, the patenting process begins with the filing of a patent application in the Patent and Trademark Office ("PTO"). Except under certain limited conditions, the inventor (or the inventor's patent attorney) must file the application. A patent application or a patent may be assigned by the owner, whether the owner is the inventor or a subsequent assignee.

The term "patent" as used in the definition of Intellectual Property Assets includes utility, plant, and design patents, as well as pending patent applications and patents granted by the United States and foreign jurisdictions, and also includes inventions and discoveries that may be patentable.

Section 3.25(d) requires disclosure of information that will enable the buyer to determine whether the seller has patents for the technology used in its businesses and how long any such patents will remain in force; it will also enable the buyer to do its own validity and infringement searches, which the buyer should do if the seller's representations are subject to a knowledge qualification or if the patents are essential to the buyer.

The buyer should seek assurances that the seller's patents are valid. For a patent to be valid, the invention or discovery must be "useful" and "novel" and must not be "obvious." Very few inventions are not "useful"; well-known examples of inventions that are not "useful" are perpetual motion machines and illegal devices (such as drug paraphernalia). To qualify as "novel" the invention must be new; a patent cannot be granted for an invention already made by another person, even if the person seeking the patent made the invention independently. An invention is "obvious" if the differences between the invention sought to be patented and the prior art are such that the subject matter of the invention as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which the subject matter pertains.

To determine conclusively that an invention is not "obvious" requires knowledge of all prior art. It is difficult even to identify all prior art relevant to the invention, much less to make judgments about what would have been obvious to a person having reasonable skill in such art. Thus, although the seller may in good faith believe that its patents are valid, those patents are subject to challenge at any time. If someone can establish that the invention covered by a patent does not meet these three criteria, the patent will be invalid. Because of the difficulty in conclusively determining the validity of a patent, the seller will want to add a knowledge qualification to the representation concerning validity. Whether the buyer agrees to such a qualification is a question of risk allocation.

If the buyer agrees to a knowledge qualification, it may want to conduct a patent search in the PTO (and, if appropriate, the European Patent Office and other foreign patent offices) to identify all prior art and obtain a validity opinion. However, such searches and analysis of their results can be costly and take time.

The buyer should ensure that the terms of the seller's patents have not expired and that all necessary maintenance fees have been paid. In general, the term of a utility or plant patent is twenty years from the date of application. Special rules apply to patents in force on or applications filed before June 8, 1995. Patents that were in force on June 8, 1995 and patents issued on applications filed before that date have a term equal to the longer of seventeen years from the date of grant or twenty years from the date of application. The term of a design patent is fourteen years from the date of grant. Maintenance fees in design on utility patents must be paid during the six-month period beginning on the third, seventh and eleventh anniversary of the date of grant. Maintenance fees need not be paid on plant patents or design patents.

In many states, an invention made by an employee is not necessarily the property of the employer. The buyer should verify, therefore, that the seller has perfected title to all patents or patent applications for inventions made by its employees. In addition, the seller should have written agreements with its employees providing that all inventions, patent applications, and patents awarded to employees will be transferred to the seller to the full extent permissible under state law.

A United States patent has no extraterritorial effect--that is, a United States patent provides the patent owner the right to exclude others from making, using, or selling the invention in the United States only. Thus, the owner of a United States patent can prevent others from making the patented invention outside the United States and shipping it to a customer in the United States, and from making the invention in the United States and shipping it to a customer outside the United States. The patent owner cannot, however, prevent another from making the invention outside the United States and shipping it to a customer also outside the United Sates. If the seller has extensive foreign business, the buyer should seek assurances that important foreign markets are protected to the greatest extent possible under the intellectual property laws of the applicable foreign jurisdictions. Special rules apply in the case of foreign patents. If there are extensive foreign patents and patent application pending, the buyer's due diligence may become quite involved and time consuming. If foreign patents represent significant assets, reliance alone on the representations of the seller (in lieu of extensive buyer due diligence) may be seriously misplaced.

The buyer should seek assurances that the seller's patents are enforceable. Failure to disclose to the PTO relevant information material to the examination of a patent application can result in the patent being unenforceable. In addition, misuse of a patent (for example, use that results in an antitrust violation) can result in the patent being unenforceable. Finally, because patent rights vary in each jurisdiction, representations concerning enforceability require the seller to confirm the enforceability of foreign patents separately in each jurisdiction.

The grant of a patent does not provide any assurance that using the invention will not infringe another person's patent. A patent could be granted, for example, for an improvement to a previously patented device, but the practice of the improvement might infringe the claims of the earlier patent on the device. A patent confers no rights of any kind to make, use, or sell the invention; it grants the inventor only the right to exclude others. Therefore, the buyer should seek assurances that it can use the inventions covered by the seller's patents. The buyer may conduct a patent search in the PTO and obtain an infringement opinion as a step in the process of determining whether certain technology owned (or licensed) by the seller infringes any United States patents. In addition, the buyer may conduct a "right to practice examination" for expired patents covering inventions that have passed into the public domain.

The seller may want to add a knowledge qualification to the representation in clause (iv) of Section 3.25(d) because it cannot verify that no one else in the world is practicing the technology covered by the seller's patent. Whether the buyer accepts such a qualification is a question of risk allocation.

Without proper marking of the patented product or the product made using a patented process, damages cannot be collected for infringement of the patent.

Trademarks. A trademark is a word, name, symbol, or slogan used in association with the sale of goods or the provision of services. Generally, all trademarks are created under the common law through use of the mark in offering and selling goods or services. Although both state and federal trademark registration systems exist, trademarks need not be registered at either level. A trademark that is not registered is commonly referred to as an "unregistered mark" or a "common law mark." The term "trademark" as used in the definition of Intellectual Property Assets includes both registered and unregistered marks. If the seller has many unregistered trademarks, it may want to limit the definition to registered trademarks. The buyer should insist that the definition include any unregistered trademarks that the buyer identifies as important and that all goodwill associated with these trademarks is transferred to the buyer.

The owner of a trademark can prevent others from using infringing marks and, in some instances, can recover damages for such infringement.

Although trademark registration systems are maintained at both the state and federal levels, trademarks need not be registered at either level. State registrations are of little value to businesses that operate in more than one state or whose market is defined by customers from more than one state.

Two of the major benefits of registration at the federal level are "constructive use" and "constructive notice." The owner of a federal registration is deemed to have used the mark in connection with the goods or services recited in the registration on a nationwide basis as of the filing date of the application. Therefore, any other person who first began using the mark after the trademark owner filed the application is an infringer, regardless of the geographic areas in which the trademark owner and the infringer use their marks. Federal registration also provides constructive notice to the public of the registration of the mark as of the date of issuance of the registration. Because of the importance of federal registration, the representations in Section 3.25(e)(ii) require the Seller to ensure that it has obtained federal registration of its trademarks.

An application for federal registration of a trademark is filed in the PTO. The PTO maintains two trademark registers: the Principal Register and the Supplemental Register. The Supplemental Register is generally for marks that cannot be registered on the Principal Register. The Supplemental Register does not provide the trademark owner the same rights as those provided by the Principal Register, and it provides no rights in addition to those provided by the Principal Register. The buyer should determine whether the seller's trademarks are on the Principal Register or the Supplemental Register. If the buyer learns that an important mark is on the Supplemental Register, the buyer should find out why it was not registered on the Principal Register. If the mark cannot be registered on the Principal Register, the buyer should consult trademark counsel to determine the scope of protection for the mark.

After a trademark has been registered with the PTO, the owner should file two affidavits to protect its rights. An affidavit of "incontestability" may be filed within the sixth year of registration of a mark to strengthen the registration by marking it "incontestable." An affidavit of "continuing use" must be filed with the PTO during the sixth year of registration; otherwise, the PTO will automatically cancel the registration at the end of the sixth year. Cancellation of a registration (or abandonment of an application) does not necessarily mean that the trademark owner has abandoned the mark and no longer has rights in the mark; proving abandonment of a mark requires more than merely showing that an application has been abandoned or that a registration has been canceled. Nevertheless, because of the benefits of federal registration, the representations in Section 3.25(e)(ii) require the seller to have timely filed continuing use affidavits (as well as incontestability affidavits, which are often combined with continuing use affidavits) for all of the seller's trademarks.

The buyer should verify that the terms of the seller's federal registrations have not expired. Federal registrations issued on or after November 16, 1989 have a term of ten years; registrations issued prior to that date have a term of twenty years. All federal registrations may be renewed if the mark is still in use when the renewal application is filed. Registrations expiring on or after November 16, 1989 may be renewed for a term of ten years. A registration that was renewed before November 16, 1989 has a renewal term of twenty years. Registrations may be renewed repeatedly. An application for renewal must be filed within the six-month period immediately preceding the expiration of the current term (whether an original or renewal term).

A trademark that is not registered is commonly referred to as an "unregistered mark" or a "common law mark." Generally, the owner of a common law mark can prevent others from using a confusingly similar mark only in the trademark owner's "trading area." Thus, the owner of a common law mark may find, upon expanding use of the mark outside that area, that another has established superior rights there and can stop the trademark owner's expansion. If the buyer plans to expand the seller's business into new geographic markets, it should verify that all of the seller's important trademarks have been registered at the federal level.

Rights in a trademark can be lost through non-use or through non-authorized use by others. In an extreme example of the latter, long use of a mark by the public to refer to the type of goods marketed by the trademark owner and its competitors can inject the trademark into the public domain. Therefore, the buyer should determine whether the seller is using the marks that are of primary interest to the buyer, and whether any others using those marks for similar goods or services are doing so under a formal license agreement.

The trademark owner must ensure a certain level of quality of the goods or services sold with the mark. A license agreement thus must provide the licensor with the right to "police" the quality of the goods or services sold with the mark, and the licensor must actually exercise this right-failure to do so works an abandonment of the mark by the licensor. Similarly, an assignment of a mark without an assignment of the assignor's "goodwill" associated with the mark constitutes an abandonment of the mark.

Because the representation in Section 3.25 (e)(iv) is qualified by the seller's knowledge, the buyer may want to conduct a trademark search to ensure that there are no potentially interfering trademarks or trademark applications. Several search firms can do a trademark search; limited searching can also be done through databases. A trademark search and analysis of the results should be much less costly than a patent search and analysis.

A mark need not be identical to another mark or be used with the same goods or services of the other mark to constitute an infringement. Rather, a mark infringes another mark if it is confusingly similar to it. Several factors are examined to determine whether two marks are confusingly similar, including the visual and phonetic similarities between the marks, the similarities between the goods or services with which the marks are used, the nature of the markets for the goods or services, the trade channels through which the goods or services flow to reach the markets, and the media in which the goods or services are advertised. As with patents, the seller may want to add a knowledge qualification to the representations in clause 3.25(e)(v) because of the difficulty in conclusively determining that no other person is infringing the seller's trademarks and that the seller's marks do not infringe other trademarks.

Copyrights: 17 U.S.C. §102(a) provides that "[C]opyright protection subsists . . . in original works of authorship fixed in any tangible medium of expression . . . from which they can be perceived, reproduced, or otherwise communicated." Works of authorship that can be protected by copyright include literary works, musical works, dramatic works, pantomimes and choreographic works, pictorial, graphic, and sculptural works, motion pictures and other audiovisual works, architectural works, and sound recordings. See 17 U.S.C. § 102(a)(1)-(8). Computer software is considered a "literary work" and can be protected by copyright. Ideas, procedures, processes, systems, methods of operation, concepts, principles, and discoveries cannot be copyrighted. See 17 U.S.C. §102(b). The copyright in a work subsists at the moment of creation by the author--registration of the copyright with the U.S. Copyright Office is not necessary. The term "copyright" as used in the definition of Intellectual Property Assets includes all copyrights, whether or not registered.

Section 3.25(c) provides assurances to the the Buyer that the Seller actually has title to the copyrights for works used in the Seller's business. Such assurances are important because the copyright in a work vests originally in the "author," who is the person who created the work unless the work is a "work made for hire." See 17 U.S.C. § 201(a)-(b). A work can be a "work made for hire" in two circumstances: (i) when it is created by an employee in the course of employment, or (ii) when it is created pursuant to a written agreement that states that the work will be a work made for hire, and the work is of a type listed in 17 U.S.C. § 101 under the definition of "work made for hire. "

Although rights in a copyright may be assigned or licensed in writing, the transfer of copyrights in a work (other than a "work made for hire") may be terminated under the conditions described in 17 U.S.C. § 203. If a seller owns copyrights by assignment or license, the buyer should ensure that the copyrights cannot be terminated, or at least that such termination would not be damaging to the buyer.

The buyer should verify that the terms of the seller's copyrights have not expired. The term of a copyright is as follows:

1. For works created on or after January 1, 1978, the life of the author plus seventy years after the author's death.

2. For joint works created by two or more authors "who did not work for hire," the life of the last surviving author plus seventy years after the death of the last surviving author.

3. For anonymous works, pseudonymous works, and works made for hire, ninety-five years from the date of first publication or 120 years from the year of creation of the work, whichever expires first.

Although it is not necessary to register a copyright with the U.S. Copyright Office for the copyright to be valid, benefits (such as the right to obtain statutory damages, attorneys' fees, and costs) may be obtained in a successful copyright infringement action if the copyright in the work has been registered and a notice of copyright has been placed on the work. Indeed, registration is a prerequisite to bringing an infringement suit with respect to U.S. works and foreign works not covered by the Berne Convention.

Due to the broad range of items that could be subject to copyrights, depending upon the nature of the seller's business, it may be appropriate to limit the representations in Section 3.25(f) to copyrighted works that are "material" to the seller's business.

As with patents and trademarks, the seller may want to add a knowledge qualification to the representations in Section 3.25(f)(iii) because of the difficulty in conclusively determining that no other person is infringing the sellers' copyrights and that the seller does not infringe other copyrights (such determinations would require, among other things, judgments regarding whether another person and the seller or its employees independently created the same work and whether the allegedly infringing party is making "fair use" of the copyrighted material). Again, whether the buyer accepts such a qualification is a question of risk allocation.

<u>Trade Secrets</u>. Trade secret protection traditionally arose under common law, which remains an important source of that protection. Now, however, a majority of the states have adopted some version of the Uniform Trade Secrets Act which defines and protects trade secrets. Moreover, the misappropriation of trademarks is punishable as a federal crime under the Economic Espionage Act of 1996, PUB. L. 104-294, Oct. 11, 1996, 110 Stat. 3488 (18 U.S.C. §§ 1831-39). Trade secrets need not be technical information--they can include customer lists, recipes, or anything of value to a company, provided that it is secret, substantial, and valuable. One common type of trade secret is "know-how": a body of information that is valuable to a business and is not generally known outside the business. The term "trade secret" as used in the definition of Intellectual Property Assets includes both common law and statutory trade secrets of all types, including "know-how".

As part of the disclosure required by Section 3.25(g)(i), the buyer may want a list of all of the seller's trade secrets and the location of each document that contains a description of the trade secret. Although a trade secret inventory would assist the parties in identifying the trade secrets that are part of the acquisition, it may be difficult or impossible to create a trade secret inventory, especially if the seller is retaining certain parts of its business. The buyer could ask the seller to identify key trade secrets, which would enable the buyer to determine whether information regarded by the buyer as important is treated by the seller as proprietary. However, the seller may be reluctant to disclose trade secrets to the buyer prior to either the closing or a firm commitment by the buyer to proceed with the acquisition. Moreover, the buyer's receipt of this information can place the buyer in a difficult position if the acquisition fails to close and the buyer subsequently wants to enter the same field or develop a similar product or process. In these circumstances, the buyer risks suit by the seller for theft of trade secrets, and the buyer may have the burden of proving that it developed the product or process independently of the information it received from the seller, which may be very difficult.

Because the validity of trade secrets depends in part on the efforts made to keep them secret, the representation in Section 3.25(g)(ii) provides assurances to the buyer that the seller treated its trade secrets as confidential. Important methods of maintaining the confidentiality of trade secrets include limiting access to them, marking them as confidential, and requiring everyone to whom they are disclosed to agree in writing to keep them confidential. In particular, the buyer should verify that the seller has treated valuable "know-how" in a manner that gives rise to trade secret protection, such as through the use of confidentiality agreements. In the case of software, the buyer should determine whether the software is licensed to customers under a license agreement that defines the manner in which the customer may use the software, or whether the software is sold on an unrestricted basis. The buyer should also investigate any other procedures used by the seller to maintain the secrecy of its trade secrets, and the buyer should determine whether agreements exist that govern the disclosure and use of trade secrets by employees and consultants of the seller and others who need to learn of them. The seller may seek a knowledge qualification to the last sentence of clause (iii) of Section 3.25(g) because of the difficulty in determining that trade secrets do not infringe any third party's intellectual property. As previously stated, whether the buyer accepts this is a matter of risk allocation.

Mask Works. Mask works are related to semiconductor products and are protected under 17 U.S.C. § 901 et seq. Because this technology is unique to a particular industry (the microchip industry), the Model Agreement does not contain a representation concerning mask works.

Domain Names. Internet domain names may be obtained through a registration process. Internet domain name registration is a process which is separate and independent of trademark registration, but registering another's trademark as a domain name for the purpose of selling it to the trademark owner ("cybersquatting") or diverting its customers ("cyberpiracy") may be actionable as unfair competition, trademark infringement or dilution or under Section 43(d) of the Lanham Act (the "Anticybersquatting Consumer Protection Act"). Domain name disputes may also be resolved under the ICANN Rules for Uniform Domain Name Dispute Resolution.

3.32 SOLVENCY

(a) Seller is not now insolvent, and will not be rendered insolvent by any of the Contemplated Transactions. As used in this Section, **"insolvent"** means that the sum Seller's debts and other probable Liabilities exceeds the present fair saleable value of Seller's assets.

(b) Immediately after giving effect to the consummation of the Contemplated Transactions, (i) Seller will be able to pay its Liabilities as they become due in the usual course of its business, (ii) Seller will not have unreasonably small capital with which to conduct its present or proposed business, (iii) Seller will have assets (calculated at fair market value) that exceed its Liabilities and (iv) taking into account all pending and threatened litigation, final judgments against Seller in actions for money damages are not reasonably anticipated to be rendered at a time when, or in amounts such that, Seller will be unable to satisfy any such judgments promptly in accordance with their terms (taking into account the maximum probable amount of such judgments in any such actions and the earliest reasonable time at which such judgments might be rendered) as well as all other obligations of Seller. The cash available to Seller, after taking into account all other anticipated uses of the cash, will be sufficient to pay all such debts and judgments promptly in accordance with their terms.

COMMENT

Most jurisdictions have statutory provisions relating to fraudulent conveyances or transfers. The Uniform Fraudulent Transfer Act (**"UFTA"**) and Section 548 of the United States Bankruptcy Code (the **"Bankruptcy Code"**) generally provide that a "transfer" is voidable by a creditor if the transfer is made (i) with actual intent to hinder, delay or defraud a creditor or (ii) if the transfer leaves the debtor insolvent, undercapitalized or unable to pay its debts as they mature, and is not made in exchange for reasonably equivalent value. If a transfer is found to be fraudulent, courts have wide discretion in fashioning an appropriate remedy, and could enter judgment against the transferee for the value of the property, require the transferee to return the property to the transferor or a creditor of the transferor, or exercise any other equitable relief as the circumstances may require. If a good faith transferee gave some value to the transferor in exchange for the property, the transferee may be entitled to a corresponding reduction of the judgment on the fraudulent transfer, or a lien on the property if the court requires its return to the transferor. If the transferor liquidates or distributes assets to its shareholders after the transaction, a court could collapse the transaction and hold that the transferor did not receive any consideration for the assets and that the transferor did not receive reasonably equivalent value for the transfer. *See Wieboldt Stores, Inc. v. Schotlenstein*, 94 B.R. 488 (N.D. Ill. 1988). The statute of limitations on a fraudulent transfer action can be as long as six years under some states' versions of the UFTA.

This solvency representation is included to address the risk of acquiring assets of the seller in a transaction which could be characterized as a fraudulent transfer or conveyance by the seller and may be required by the lender financing the acquisition. It is intended to provide evidence of the seller's sound financial condition and the buyer's good faith, which may affect the defenses available to the buyer in a fraudulent transfer action. Conclusionary statements in an asset purchase agreement would be of limited value if not supported by the facts. Since financial statements referenced in Section 3.4 as delivered by the seller are based on GAAP rather than the fair valuation principles applicable under fraudulent transfer laws, a buyer may seek further assurance as to fraudulent transfer risks in the form of (i) a solvency opinion to the effect that the seller is solvent under a fair valuation although it may not be solvent under GAAP (which focuses on cost) and has sufficient assets for the conduct of its business and will be able to pay its debts as they become due, or (ii) a third party appraisal of the assets to be transferred which confirms that reasonably equivalent value was to be given for the assets transferred. *Cf. Brown v. Third National Bank (In re Sherman)*, 67 F.3d 1348 (8th Cir. 1995). The need for this representation will depend, in part, upon a number of factors, including the financial condition of the seller and the representations which the buyer must make to its lenders.

Statutory Scheme. UFTA is structured to provide remedies for creditors in specified situations when a debtor "transfers" assets in violation of UFTA. A "creditor" entitled to bring a fraudulent transfer action is broadly defined as a person who has "a right to payment or property, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." Persons which could be included as creditors under the statute include: noteholders, lessees on capital leases or operating leases, litigants with claims against the seller that have not proceeded to judgment, employees with underfunded pension plans and persons holding claims which have not yet been asserted. There is a presumption of insolvency when the debtor is generally not paying its debts as they become due.

A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation. A significant body of law under the Bankruptcy Code interprets the phrase "at a fair valuation" to mean the amount that could be obtained for the property within a reasonable time by a capable and diligent business person from an interested buyer who is willing to purchase the assets under ordinary selling conditions. A "fair valuation" is not the amount that would be realized by the debtor if it was instantly forced to dispose of the assets or the amount that could be realized from a protracted search for a buyer under special circumstances or having a particular ability to use the assets. For a business which is a going concern, it is proper to make a valuation of the assets as a going concern, and not on an item-by-item basis.

The UFTA avoidance provisions are divided between those avoidable to creditors holding claims at the time of the transfer in issue, and those whose claims arose after the transfer. The statute is less protective of a creditor who began doing business with a debtor after the debtor made the transfer rendering it insolvent. Most fraudulent transfer actions, however, are brought by a bankruptcy trustee, who under Section 544(b) of the Bankruptcy Code, 11 U.S.C. § 544(b) (1994), can use the avoiding powers of any actual creditor holding an unsecured claim who could avoid the transfer under applicable non-bankruptcy law.

<u>Intent to Hinder, Delay, or Defraud Creditors</u>. An asset transfer would be in violation of UFTA § 4(a)(1), and would be fraudulent if the transfer was made "with actual intent to hinder, delay, or defraud any creditor of the debtor." If "actual intent" is found, it does not matter if value was given in exchange for the assets, or if the seller was solvent. A number of factors (commonly referred to as "badges of fraud") which are to be considered in determining actual intent under UFTA § 4(a)(1) are set out in UFTA § 4(b), and include whether:

(1) the transfer or obligation was to an insider;

(2) the debtor retained possession or control of the property transferred after the transfer;

(3) the transfer or obligation was disclosed or concealed;

(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;

(5) the transfer was of substantially all the debtor's assets; . . . [and]

(10) the transfer occurred shortly before or shortly after a substantial debt was incurred.

Although the existence of one or more "badges of fraud" may not be sufficient to establish actual fraudulent intent, "the confluence of several can constitute conclusive evidence of an actual intent to defraud, absent 'significantly clear' evidence of a legitimate, supervening purpose." *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248, 1254-55 (1st Cir. 1991).

Fraudulent Transfer Without Intent to Defraud. An asset purchase may be found to be fraudulent if it was effected by the seller "without receiving a reasonably equivalent value in exchange for the transfer or obligation," and:

(A) the seller's remaining assets, after the transaction, were unreasonably small in relation to the business or transaction that the seller was engaged in or was about to engage in, or

(B) the seller intended to incur, or believed (or should have believed) that it would incur, debts beyond its ability to pay as they became due.

The "unreasonably small assets" test is a distinct concept from insolvency and is not specifically defined by statute. In applying the unreasonably small assets test, a court may inquire whether the seller "has the ability to generate sufficient cash flow on the date of transfer to sustain its operations." *See In re WCC Holding Corp.*, 171 B.R. 972, 986 (Bankr. N.D. Tex. 1994). In pursuing such an inquiry, a court will not ask whether the transferor's cash flow projections later proved to be correct, but whether they were reasonable and prudent at the time they were made.

Remedies for Fraudulent Transfers. The remedies available to a creditor in a fraudulent transfer action include entry of judgment against the transferee for the value of the property at the time it was transferred, entry of an order requiring return of the property to the transferor for satisfaction of creditors' claims, or any other relief the circumstances may require. UFTA §§ 7(a), 8(b). Courts have wide discretion in fashioning appropriate remedies.

Transferee Defenses and Protections. Even if a transfer is voidable under the UFTA, a good faith transferee is entitled under UFTA § 8, *to the extent of the value given to the transferor*, to (a) a lien on or right to retain an interest in the asset transferred; (b) enforcement of the note or other obligation incurred; or (c) reduction in the amount of the liability on the judgment against the transferee in favor of the creditor. UFTA § 8(d)(1)-(3) If the value paid by the transferee was not received by the transferor, the good faith transferee would not be entitled to the rights specified in the preceding sentence. If the transferor distributed the proceeds of sale, in liquidation or otherwise to its equity holders, a court could collapse the transaction and find that the proceeds were not received by the transferor, thereby depriving the good faith transferee of the rights to offset the value it paid against a fraudulent transfer recovery. With this in mind, a buyer may seek to require that the seller pay all of its retained liabilities prior to making any distribution, in liquidation or otherwise, to its equity holders. See Sections 10.3 and 10.4.

3.33 DISCLOSURE

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

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

COMMENT

The representation in subsection (a) assures the Buyer that the specific disclosures made in the Seller's representations and in the Disclosure Letter do not, and neither any supplement to the Disclosure Letter (see Section 5.5) nor the specified certificates will, contain any misstatements or omissions. By including in subsection (a) the clause "otherwise in connection with the Contemplated Transactions," every statement (whether written or oral) made by the Seller or the Shareholders in the course of the transaction may be transformed into a representation. This might even apply to seemingly extraneous materials furnished to a buyer, such as product and promotional brochures. Thus, a seller may ask that this language be deleted from subsection (a).

There is no materiality qualification (except for omissions) in subsection (a) because the representations elsewhere in Article 3 contain any applicable materiality standard — to include an additional materiality standard here would be redundant. For example, Section 3.1 represents that the Seller is qualified to do business in all jurisdictions in which the failure to be so qualified would have a material adverse effect; if subsection (a) provided that there is no untrue statement of a "material" fact, one would have to determine first whether the consequences of a failure to qualify were "material" under Section 3.1, and then whether the untrue statement itself was "material" under subsection (a). Subsection (a) contains no requirement of knowledge or scienter by the Seller (any such requirements would be in the representations elsewhere in Article 3) and no requirement of reliance by the Buyer. As a result, subsection (a) imposes a higher standard of accuracy on the Seller than the applicable securities laws.

Subsection (a) contains a materiality standard with respect to information omitted from the representations and from the Disclosure Letter because the representations concerning omitted information are independent from the representations elsewhere in Article 3. Although the omissions language is derived from Section 12(2) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, the representations are contractual in nature, do not require any proof of reliance on the part of the Buyer, and do not require any proof of negligence or knowledge on the part of the Seller or Shareholder. Thus, the Model Agreement imposes a contractual standard of strict liability, in contrast with (a) Rule 10b-5, which predicates liability for misrepresentation or nondisclosure on reliance by the buyer and conduct involving some form of scienter, (b) Section 12(2) of the Securities Act, which provides a defense if one "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission," and (c) common law fraud, which is usually predicated upon actual intent to mislead. *See B. S. Int'l Ltd. v. Licht*, 696 F. Supp. 813, 827 (D.R.I. 1988); BROMBERG & LOWENFELS, 4 SECURITIES FRAUD & COMMODITIES FRAUD § 8.4 (1988).

The buyer should ensure that it receives the disclosure letter (subject to necessary modifications) before signing the acquisition agreement. If the seller insists on signing the acquisition agreement before delivering the disclosure letter, the buyer should demand that the acquisition agreement require delivery of the disclosure letter by a specific date far enough before the closing to permit a thorough review of the disclosure letter and an analysis of the consequences of disclosed items, and that the buyer has the right to terminate the agreement if there are any disclosures it finds objectionable in its sole discretion. *See* Freund, *Anatomy of a Merger* 171-72 (1975).

Subsection (b) is a representation that there is no material information regarding the Seller that has not been disclosed to the Buyer. This representation is common in a buyer's first draft of an acquisition agreement. A seller may argue that the representation expands, in ways that cannot be foreseen, the detailed representations and warranties in the acquisition agreement and is neither necessary nor appropriate. The buyer can respond that the seller and its shareholders are in a better position to evaluate the significance of all facts relating to the seller.

In contrast to subsection (a), subsection (b) imposes a knowledge standard on the Seller. A buyer could attempt to apply a strict liability standard here as well, as in the following example:

> There does not now exist any event, condition, or other matter, or any series of events, conditions, or other matters, individually or in the aggregate, adversely affecting Seller's assets, business, prospects, financial condition, or results of its operations, that has not been specifically disclosed to Buyer in writing by Seller on or prior to the date of this Agreement.

A seller may respond that such a standard places on it an unfair burden.

A seller, particularly in the case of an auction for the business or where it perceives that there is competition for the transaction, may seek to eliminate Section 3.33 and replace it with a converse provision such as the following:

> Except for the representations and warranties contained in Article 3, none of Seller or any Shareholder has made any representation or warranty, expressed or implied, as to Seller or as to the accuracy or completeness of any information regarding Seller furnished or made available to Buyer and its representatives, and none of Seller or any Shareholder shall have or be subject to any liability to Buyer or any other Person resulting from the furnishing to Buyer, or Buyer's use of or reliance on, any such information or any information, documents or material made available to Buyer in any form in expectation of, or in connection with, the transactions contemplated by this Agreement.

For a discussion regarding the legal effect of such a provision, see the Comment to Section 13.7 and the discussion of *ABRY Partners V, L.P. v. F&W Acquisition LLC* in Appendix E.

In *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 500 F.3d 188 (2nd Cir. 2007), an asset purchase agreement contained a representation to the effect that "[t]he information provided by [sellers] to [purchasers], in the aggregate, includes all information known to [sellers] which, in their reasonable judgment exercised in good faith, is appropriate for [purchasers] to evaluate the trading positions and trading operations of the Business", which was an energy-commodities trading business. After closing the purchasers alleged that the sellers failed to disclose sham trades with Enron, which inflated the profitability of the business and violated applicable laws. The Second Circuit held that these warranties "imposed a duty on [Merrill Lynch] to provide accurate and adequate facts and entitled

[Allegheny] to rely on them without further investigation or sleuthing" (although, upon the retrial, Allegheny would be required to offer proof "that its reliance on the alleged misrepresentations was not so utterly unreasonable, foolish or knowingly blind as to compel the conclusion that whatever injury it suffered was its own responsibility") and cited "the general rule" "that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue", although if "the seller has disclosed at the outset facts that would constitute a breach of warranty" and "the buyer closes with full knowledge and acceptance of those inaccuracies", the buyer could not prevail on the breach of warranty claim. For a further discussion of the *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.* case, see the Comment to Section 13.7 *infra*.

5. COVENANTS OF SELLER PRIOR TO CLOSING

COMMENT

Articles 3 and 4 contain the parties' representations to each other. Although some acquisition agreements intermingle covenants and conditions with representations, the Model Agreement segregates the representations in Articles 3 and 4 from the covenants to be performed prior to the closing in Articles 5 and 6 and from the conditions to the parties' obligations to complete the acquisition in Articles 7 and 8. Article 10 contains certain additional covenants that do not relate solely to the period between signing and closing.

A breach of a covenant in Article 5, just like the breach of any other covenant, under normal contract principles, will result in liability by the breaching party (the Seller) to the non-breaching party (the Buyer) if the transaction does not close. Article 11 provides that the Seller and the Shareholders are obligated to indemnify the Buyer after the closing for breaches of the covenants in Article 5. Additionally, the Seller and the Shareholders could be obligated to indemnify the Buyer for such breaches if the Agreement is terminated pursuant to Article 9.

5.1 ACCESS AND INVESTIGATION

Between the date of this Agreement and the Closing Date, and upon reasonable advance notice received from Buyer, Seller shall (and Shareholders shall cause Seller to) (a) afford Buyer and its Representatives and prospective lenders and their Representatives (collectively, **"Buyer Group"**) full and free access, during regular business hours, to Seller's personnel, properties (including subsurface testing), Contracts, Governmental Authorizations, books and Records, and other documents and data, such rights of access to be exercised in a manner that does not unreasonably interfere with the operations of Seller, (b) furnish Buyer Group with copies of all such Contracts, Governmental Authorizations, books and Records, and other existing documents and data as Buyer may reasonably request, (c) furnish Buyer Group with such additional financial, operating, and other relevant data and information as Buyer may reasonably request, and (d) otherwise cooperate and assist, to the extent reasonably requested by Buyer, with Buyer's investigation of the properties, assets and financial condition related to Seller. In addition, Buyer shall have the right to have the Real Property and Tangible Personal Property inspected by Buyer Group, at Buyer's sole cost and expense, for purposes of determining the physical condition and legal characteristics of the Real Property and Tangible Personal Property. In the event subsurface or other destructive testing is recommended by any of Buyer Group, Buyer shall be permitted to have the same performed.

COMMENT

Section 5.1 provides the Buyer Group with access to the Seller's personnel, properties, and records so that the Buyer can continue its investigation of the Seller, confirm the accuracy of the Seller's representations and also verify satisfaction of the various conditions to its obligation to complete the acquisition; such as, for example, the absence of a material adverse change in the financial condition, results of operations, business or prospects of the Seller.

Note that the access right provided for in Section 5.1 extends to the Buyer Group, which includes prospective lenders and their Representatives. A prospective lender to a buyer may want to engage environmental consultants, asset appraisers and other consultants to present their findings before making a definitive lending commitment.

The access right in Section 5.1(a) is accompanied by the rights in subsection (b) to obtain copies of existing documents which may include licenses, certificates of occupancy and other permits issued in connection with the ownership, development or operation of the Real Property and in subsection (c) to obtain data not yet reduced to writing or data storage.

In many acquisitions, the buyer's investigation occurs both before and after the signing of the acquisition agreement. While the Model Agreement provides for comprehensive representations from the Seller, the importance of these representations increases if the Buyer is unable to complete its investigation prior to execution of the acquisition agreement. In those circumstances, the representations can be used to elicit information that the Buyer will be unable to ferret out on its own prior to execution (see the introductory comment to Article 3 under the caption "Purposes of the Seller's Representations"). If a buyer later discovers, during its post-signing investigation, a material inaccuracy in the seller's representations, the buyer can terminate or consummate the acquisition, as discussed below. Conversely, if the buyer has been able to conduct a significant portion of its investigation prior to execution and is comfortable with the results of that investigation, the buyer may have greater latitude in responding to the seller's requests to pare down the seller's representations.

The seller may want to negotiate certain limitations on the scope of the buyer's investigation. For example, the seller may have disclosed that it is involved in a dispute with a competitor or is the subject of a governmental investigation. While the buyer clearly has a legitimate interest in ascertaining as much as it can about the dispute or investigation, both the seller and the buyer should exercise caution in granting access to certain information for fear that such access would deprive the seller of its attorney-client privilege. *See generally* Hundley, *White Knights, Pre-Nuptial Confidences and the Morning After: The Effect of Transaction-Related Disclosures on the Attorney-Client and Related Privileges*, 5 DEPAUL BUS. L.J. 59 (1993). Section 12.6 provides that the parties do not intend any waiver of the attorney-client privilege.

The seller is likely to resist subsurface testing by the buyer. Test borings could disclose the existence of one or more adverse environmental situations, which the seller or the buyer or its tester may be obligated to report to a governmental agency without certainty that the closing will ever occur. A test boring could exacerbate or create an adverse environmental situation by carrying an existing subsurface hazardous substance into an uncontaminated subsurface area or water source. The seller would ordinarily not be in privity of contract with the buyer's testing organization nor would communications and information received from the testing organization ordinarily be protected by an attorney-client privilege available to the seller. Assuming testing is to be permitted, the seller would also be concerned that the buyer undertake to fully indemnify, defend and hold the seller harmless from any physical damage and liens claimed or asserted to have been caused or arisen as a result of the testing by or on behalf of the buyer.

Special considerations obtain when the seller and the buyer are competitors. In that situation, the seller may be reluctant to share sensitive information with its competitor until it is certain that the transaction will close. Moreover, both parties will want to consider the extent to which the sharing of information prior to closing may raise antitrust concerns. See generally Steptoe, *Premerger Coordination/Information Exchange*, Remarks before the American Bar Association Section of Antitrust Law Spring Meeting, April 7, 1994, 7 TRADE REG. REP. (CCH) ¶ 50,134.

The buyer's right of access is not limited to testing the seller's representations and confirming the satisfaction of conditions to closing. The buyer may want to learn more about the operations of the seller in order to make appropriate plans for operating the business after the closing. In particular, the buyer may want to have some of its personnel investigate the seller to prepare for the integration of the buyer's and the seller's product lines, marketing strategies, and administrative functions.

During the investigation, the buyer has access to a great deal of information concerning the seller. If the information reveals a material inaccuracy in the seller's representations as of the date of the acquisition agreement, the buyer has several options. If the inaccuracy results in the Seller not being able to satisfy the applicable closing condition in Section 7.1, the Buyer can terminate the acquisition and pursue its remedies under Section 9.2. The Buyer may, however, want to complete the acquisition despite the inaccuracy if it can obtain, for example, an adjustment in the Purchase Price. If the Seller refuses to reduce the Purchase Price, the Buyer must either terminate the acquisition and pursue its remedies for breach under Section 9.2 or close and pursue its indemnification rights (and any available claim for damages) based on the inaccuracy of the Seller's representation (see the Comment to Section 7.1).

If the buyer's investigation does not reveal an inaccuracy that actually exists, because the inaccuracy is subtle or because the buyer's personnel did not read all the relevant information or realize the full import of apparently inconsequential matters, the buyer may not be able to exercise its right to terminate the acquisition prior to closing, but upon discovery of such an inaccuracy following closing, the buyer should be entitled to pursue its indemnification rights. Section 11.1 attempts to preserve the Buyer's remedies for breach of the Seller's representations regardless of any knowledge acquired by the Buyer before the signing of the acquisition agreement or between the signing of the acquisition agreement and the closing. This approach reflects the view that the risks of the acquisition were allocated by the representations when the acquisition agreement was signed. The Model Agreement thus attempts to give the buyer the benefit of its bargain regardless of the results of its investigation and regardless of any information furnished to the buyer by the seller or its shareholders. There is case law, however, indicating that this may not be possible in some jurisdictions. See the Comment to Section 11.1.

The seller may want the contract to include pre-closing indemnification from the buyer, in the event the closing does not occur, with respect to any claim, damage or expense arising out of inspections and related testing conducted on behalf of the buyer, including the cost of restoring the property to its original condition, the removal of any liens against the real property and improvements and compensation for impairment to the seller's use and enjoyment of the same. If the contract is terminated, the seller does not want to be left without recourse against the buyer with respect to these matters. Any such indemnification should survive the termination of the agreement. In addition, upon termination, the seller may wish to have the buyer prove payment for all work performed and deliver to the seller copies of all surveys, tests, reports and other materials produced for the buyer to compensate the seller for the inconvenience of enduring the inspection only to have the contract terminated. Having the benefit of use of the reports will save the seller time in coming to terms with the next prospective buyer.

5.2 OPERATION OF THE BUSINESS OF SELLER

Between the date of this Agreement and the Closing, Seller shall (and Shareholders shall cause Seller to):

(a) conduct its business only in the Ordinary Course of Business;

(b) except as otherwise directed by Buyer in writing, and without making any commitment on Buyer's behalf, use its Best Efforts to preserve intact its current business organization, keep available the services of its officers, employees, and agents, and maintain its relations and good will with suppliers, customers, landlords, creditors, employees, agents, and others having business relationships with it;

(c) confer with Buyer prior to implementing operational decisions of a material nature;

(d) otherwise report periodically to Buyer concerning the status of its business, operations and finances;

(e) make no material changes in management personnel without prior consultation with Buyer;

(f) maintain the Assets in a state of repair and condition which complies with Legal Requirements and is consistent with the requirements and normal conduct of Seller's business;

(g) keep in full force and effect, without amendment, all material rights relating to Seller's business;

(h) comply with all Legal Requirements and contractual obligations applicable to the operations of Seller's business;

(i) continue in full force and effect the insurance coverage under the policies set forth in Part 3.21 or substantially equivalent policies;

(j) except as required to comply with ERISA or to maintain qualification under Section 401(a) of the Code, not amend, modify or terminate any Employee Plan without the express written consent of Buyer, and except as required under the provisions of any Employee Plan, not make any contributions to or with respect to any Employee Plan without the express written consent of Buyer, provided that Seller shall contribute that amount of cash to each Employee Plan necessary to fully fund all of the benefit liabilities of such Employee Plan on a plan termination basis as of the Closing Date;

(k) cooperate with Buyer and assist Buyer in identifying the Governmental Authorizations required by Buyer to operate the business from and after the Closing Date and either transferring existing Governmental Authorizations of Seller to Buyer, where permissible, or obtaining new Governmental Authorizations for Buyer;

(l) upon request from time to time, execute and deliver all documents, make all truthful oaths, testify in any Proceedings and do all other acts that may be reasonably necessary or desirable, in the opinion of Buyer, to consummate the Contemplated Transactions, all without further consideration; and

(m) maintain all books and Records of Seller relating to Seller's business in the Ordinary Course of Business.

COMMENT

Section 5.2(a) requires the Seller to operate its business only in the "Ordinary Course of Business" (as defined in Section 1.1). This provision prohibits the Seller from taking certain actions that could adversely affect the value of the Assets to the Buyer or interfere with the Buyer's plans for the business.

If a buyer is uncomfortable with the leeway that the Ordinary Course of Business restriction provides to the seller, the buyer may want to provide a list of activities it considers to be outside of the ordinary course of business and perhaps also set dollar limits on the seller's right to take certain types of action without the buyer's prior approval. Note, however, that Section 5.3 incorporates a number of specific prohibitions by reference to Section 3.19.

Because many companies are not accustomed to operating under such restrictions, the seller may have to implement new procedures to ensure that the restrictions will be honored. Depending on the nature of the restricted activity, the seller should ensure that the appropriate persons (such as directors, officers, and employees) are aware of the obligations imposed on the seller, and that procedures are implemented and monitored at the appropriate levels.

When the acquisition agreement is signed, the buyer typically expects to become informed about and involved to some extent in material decisions concerning the seller. Thus, Section 5.2(c) and (d) require the Seller to confer with the Buyer on operational matters of a material nature and to cause the Seller to report periodically to the Buyer on the status of its business, operations and finances. The reach of subsection (c) is broader than that of subsection (a) because it provides that the Seller must confer with the Buyer on operational matters of a material nature even if such matters do not involve action outside the Ordinary Course of Business. On matters falling into this category, however, the Buyer has only a right to be conferred with, and the Seller retains the freedom to make the decisions. The Seller has the obligation to take the initiative in conferring with the Buyer under subsection (c) and in reporting to the Buyer under subsection (d). For example, if a seller were a retail company, subsection (c) would require the seller to confer with the buyer about large purchases of seasonal inventory within the ordinary course of business. However, the decision whether to purchase such inventory would remain with the seller.

Because the transaction involves the transfer of assets, it is likely that the environmental permits and other governmental authorizations possessed by the seller will need to be transferred or obtained by the buyer. Some permits, for example RCRA Part B Permits for the storage, treatment or disposal of hazardous waste and many National Pollution Discharge Elimination Systems ("NPDES"), require pre-closing notification and approval. Other permits may be transferred post-closing. As the actual requirements vary by jurisdiction, it is important that these issues are addressed initially in the due diligence stage and more definitively in the time between signing and closing.

In negotiating the covenants in Sections 5.2 and 5.3, a buyer should consider whether the exercise of the power granted to the buyer through expansive covenants might result in the buyer incurring potential liability under statutory or common law. For example, because of the broad reach of many environmental statutes (see Section 3.22 and "Environmental Law" (as defined in Section 1.1)) and expanding common law tort theories, the buyer should be cautious in exercising its powers granted by expansive covenants to become directly involved in making business decisions. Similarly, if the seller is financially troubled, the buyer may want to be circumspect in the degree of control it exercises over the seller lest the acquisition fail to close and claims akin to "lender liability" be asserted against the buyer. If the seller and the buyer are competitors, they will want to consider the extent to which control by the buyer over the seller's conduct of its business may raise antitrust concerns. *See* Steptoe, *Premerger Coordination/Information Exchange*, Remarks before the American Bar Association Section of Antitrust Law Spring Meeting, April 7, 1994, 7 TRADE REG. REP. (CCH) ¶ 50,134. If the seller is publicly held, the buyer should consider the impact of any exercise of rights with respect to the seller's public disclosure on control person liability under Section 20(a) of the Exchange Act and Section 15(a) of the Securities Act. *See* Radol v. Thomas, 556 F. Supp. 586, 592 (S.D. Ohio 1983), *aff'd*, 772 F.2d 244 (6th Cir. 1985), *cert. denied*, 477 U.S. 903 (1986). *See generally* BLUMBERG & STRASSER, THE LAW OF CORPORATE GROUPS: STATUTORY LAW, SPECIFIC chs. 2-7 (1992 & Supp. 1993); BLUMBERG & STRASSER, THE LAW OF CORPORATE GROUPS: STATUTORY LAW, GENERAL chs. 19-28 (1989 & Supp. 1993).

5.3 NEGATIVE COVENANT

Except as otherwise expressly permitted herein, between the date of this Agreement and the Closing Date, Seller shall not, and Shareholders shall not permit Seller to, without the prior written Consent of Buyer, (a) take any affirmative action, or fail to take any reasonable action within its control, as a result of which any of the changes or events listed in Section 3.15 or 3.19 would be likely to occur; (b) make any modification to any material Contract or Governmental Authorization; (c) allow the levels of raw materials, supplies or other materials included in the Inventories to vary materially from the levels customarily maintained; or (d) enter into any compromise or settlement of any litigation, proceeding or governmental investigation relating to the Assets, the business of Seller or the Assumed Liabilities.

COMMENT

Section 5.2 requires the Seller to conduct its business between the signing of the acquisition agreement and the Closing only in the Ordinary Course of Business. Section 5.3

eliminates any risk to the Buyer that the items specified in Section 3.19 could be deemed to be within the Ordinary Course of Business by expressly prohibiting the Seller from taking such actions without the Buyer's prior consent.

The Buyer should understand, however, that Section 5.3 applies only to matters within the control of the Seller. Some of the changes and events described in Section 3.19 (such as the suffering of damage or loss of property as a result of an earthquake) are not within the control of the Seller. Section 5.3 does not require the Seller to not suffer damage from events described in Section 3.19 that are beyond its control -- such a covenant is impossible to perform. Accordingly, if the Seller suffers damage or loss of property between the signing of the acquisition agreement and the Closing, and that damage or loss was not the result of the Seller's failure to take steps within its control to prevent the damage or loss, the Buyer would have the right to terminate the acquisition, but the Buyer would not have the right to obtain damages from the Seller or the Shareholders unless the Buyer had obtained a warranty that the representations in Article 3 would be accurate as of the Closing Date (see the Comment to Section 7.1 under the caption "Supplemental 'Bring Down' Representation"). If, however, the seller could have prevented the damage or loss (because, for example, the loss resulted from a fire that was caused by the seller's negligent storage of hazardous substances), the buyer not only would have the right to terminate the acquisition but also would have the right to pursue damages from the seller and its shareholders (regardless of whether the buyer elects to proceed with the acquisition).

In addition to the items listed in Section 3.19, there may be other items of concern to the buyer between the signing of the acquisition agreement and the Closing. Such items could be added to either Section 5.2 or Section 5.3.

Note that Section 5.7, operating in conjunction with Section 7.1, requires the Seller to use its Best Efforts to ensure that the representations in Section 3.19 are accurate as of the Closing Date. Thus, Sections 5.3 and 5.7 overlap to some degree.

5.4 REQUIRED APPROVALS

As promptly as practicable after the date of this Agreement, Seller shall make all filings required by Legal Requirements to be made by it in order to consummate the Contemplated Transactions (including all filings under the HSR Act). Seller and Shareholders also shall cooperate with Buyer and its Representatives with respect to all filings that Buyer elects to make, or pursuant to Legal Requirements shall be required to make, in connection with the Contemplated Transactions. Seller and Shareholders also shall cooperate with Buyer and its Representatives in obtaining all Material Consents (including taking all actions requested by Buyer to cause early termination of any applicable waiting period under the HSR Act).

COMMENT

Section 5.4 works in conjunction with Section 6.1. Section 5.4 requires the Seller to make all necessary filings as promptly as practicable and to cooperate with the Buyer in obtaining all approvals the Buyer must obtain from Governmental Bodies and private parties (including, for example, lenders) to complete the acquisition. Section 5.4 does not contain a proviso similar to that in Section 6.1 limiting the Seller's obligations because normally the potential incremental burdens on the Seller are not as great as those that could be imposed on the Buyer.

The need for governmental approvals invariably arises in acquisitions of assets which include such items as permits and licenses. Even in stock acquisitions, however, governmental notifications or approvals may be necessary if a company being acquired conducts business in a regulated industry (see the Comment to Section 3.2). *See generally* BLUMBERG & STRASSER, THE LAW OF CORPORATE GROUPS: STATUTORY LAW, SPECIFIC chs. 2-7 (1992 & Supp. 1993); BLUMBERG & STRASSER, THE LAW OF CORPORATE GROUPS: STATUTORY LAW, GENERAL chs. 19-28 (1989 & Supp. 1993).

The HSR Act requires both the seller and the buyer (or their ultimate parent entities, which would include a shareholder who owns fifty per cent or more of the stock) to make separate filings. Accordingly, Sections 5.4 and 6.1 impose mutual filing obligations on the Seller and the Buyer and provide that each party will cooperate with the other party in connection with these filings. There may be circumstances, however, in which it is appropriate to give one party control over certain aspects of the approval process. For example, under the HSR Act, the acquisition cannot be consummated until the applicable waiting period expires. Although the parties have the ability to request early termination of the waiting period, Section 5.4 gives the Buyer control over the decision to request early termination.

The obligation to pay the HSR Act filing fee is generally the obligation of the buyer, but the Model Agreement allocates responsibility for the HSR Act filing fee equally in Section 13.1.

5.5 NOTIFICATION

Between the date of this Agreement and the Closing, Seller and Shareholders shall promptly notify Buyer in writing if any of them becomes aware of (i) any fact or condition that causes or constitutes a Breach of any of Seller's representations and warranties made as of the date of this Agreement, or (ii) the occurrence after the date of this Agreement of any fact or condition that would or be reasonably likely to (except as expressly contemplated by this Agreement) cause or constitute a Breach of any such representation or warranty had that representation or warranty been made as of the time of the occurrence of, or Seller's or either Shareholders' discovery of, such fact or condition. Should any such fact or condition require any change to the Disclosure Letter, Seller shall promptly deliver to Buyer a supplement to the Disclosure Letter specifying such change. Such delivery shall not affect any rights of Buyer under Section 9.2 and Article 11. During the same period, Seller and Shareholders also shall promptly notify Buyer of the occurrence of any Breach of any covenant of Seller or Shareholders in this Article 5 or of the occurrence of any event that may make the satisfaction of the conditions in Article 7 impossible or unlikely.

COMMENT

Section 5.5 requires that the Seller and the Shareholders notify the Buyer if they discover that a representation made when they signed the acquisition agreement was inaccurate or that a representation will be inaccurate if made as of the Closing Date because of occurrences after the acquisition agreement was signed. This notification is not simply for the Buyer's information. Section 7.1 makes it a condition to the Buyer's obligation to complete the acquisition that the Seller's representations were materially correct when the acquisition agreement was signed and that they are still correct as of the Closing Date. Section 5.5 also requires the Seller to provide a supplement to the Disclosure Letter that clarifies which representations or conditions are affected by the newly discovered facts or conditions.

A seller's disclosure of an inaccurate representation does not cure the resulting breach of that representation. Depending upon the seriousness of the matter disclosed by the seller, the buyer may decide to terminate the acquisition or at least to cease incurring expenses until the buyer concludes, on the basis of further evaluation and perhaps price concessions from the seller, to proceed with the acquisition. Section 5.5 notwithstanding, if the buyer proceeds with the acquisition without an amendment to the acquisition agreement after the seller has disclosed a real or anticipated breach, the buyer's remedies for this breach could be affected (see the Comment to Section 11.1). A seller may object to a provision that permits the buyer to close and seek indemnification for a breach of a representation that has been disclosed prior to closing.

The provision in Section 5.5 requiring notice of events that render unlikely the satisfaction of closing conditions also gives the Buyer an opportunity to limit its ongoing expenses and decide whether to abandon the acquisition.

5.6 NO NEGOTIATION

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

COMMENT

Section 5.6 is commonly called a "no shop" provision. This provision was originally developed for acquisitions of public companies to prevent another buyer from interfering with the acquisition during the period between signing and closing. A "no shop" provision may be unnecessary if the acquisition agreement is a legally binding undertaking of the seller and its shareholders to consummate the acquisition, subject only to the satisfaction of the various closing conditions (not including shareholder approval), for the seller and the shareholders who signed the acquisition agreement would be liable for damages if they breach the acquisition agreement by pursuing a transaction with another buyer, and the other buyer may be liable for tortious interference with the signed acquisition agreement. Nonetheless, a buyer has a legitimate interest in preventing the seller from seeking to obtain a better offer and in learning of any third party inquiries or proposals, and the "no shop" provision may provide a basis for the buyer to obtain injunctive relief if appropriate.

Section 5.6 is not qualified by a "fiduciary out" exception. A "fiduciary out" exception typically is not appropriate in a merger, a share exchange, or a sale of substantially all of the assets of a company where the directors and the shareholders of that company are the same or the number of shareholders is small enough to obtain shareholder approval prior to the signing of the acquisition agreement or, as is the case in the Model Agreement, all of the principal shareholders sign the acquisition agreement. *See* Comment to Section 3.2. As a practical matter, once the shareholders have approved the agreement (either by consent or at a meeting), the contract is complete and the seller's board of directors no longer has a fiduciary responsibility to consider later arriving bidders. For that reason, it is increasingly common in the private company setting for a buyer to request that the seller's shareholders consent to the proposed transaction at the time the acquisition agreement is signed.

5.7 BEST EFFORTS

Seller and Shareholders shall use their Best Efforts to cause the conditions in Article 7 and Section 8.3 to be satisfied.

COMMENT

Section 5.7 establishes a contractual obligation of the Seller and the Shareholders to use their Best Efforts (as defined in Section 1.1) to cause the Article 7 conditions to the Buyer's obligation to complete the acquisition to be satisfied. The condition in Section 8.3 (a condition to the Seller's obligation) as well as those in Article 7 are included in this provision because obtaining the Consents specified as a condition to the Seller's obligation to close may be partly within the control of the Seller and the Shareholders and the Buyer will want assurance that they have exercised their Best Efforts to cause that condition to be satisfied.

The definition of Best Efforts in Article 1 makes it clear that the Seller and the Shareholders are obligated to do more than merely act in good faith — they must exert the efforts that a prudent person who desires to complete the acquisition would use in similar circumstances to ensure that the Closing occurs as expeditiously as possible.

Thus, for example, Section 5.7 requires that the Seller and the Shareholders use their Best Efforts to ensure that their representations are accurate in all material respects as of the Closing Date, as if made on that date, because Section 7.1(a) makes such accuracy a condition to the Buyer's obligation to complete the acquisition. Section 5.7 also requires the Seller and the Shareholders to use their Best Efforts to obtain all of the Material Consents necessary for the Seller and the Buyer to complete the acquisition (those listed on Schedules 7.3 and 8.3) because Sections 7.3 and 8.3 make the obtaining of such Consents conditions to the parties' obligations to consummate the acquisition.

If the Closing does not occur because one of the conditions in Article 7 or Section 8.3 is not satisfied, the Seller and the Shareholders may have some liability to the Buyer for breach of their Best Efforts covenant if they in fact have not used their Best Efforts to cause the condition to be satisfied (see also the introductory Comment to Article 7).

5.8 INTERIM FINANCIAL STATEMENTS

Until the Closing Date, Seller shall deliver to Buyer within ____ days after the end of each month a copy of the [describe financial statements] for such month prepared in a manner and containing information consistent with Seller's current practices and certified by Seller's chief financial officer as to compliance with Section 3.4.

COMMENT

Section 5.8 requires the Seller to deliver interim, monthly financial statements to the Buyer to enable the Buyer to monitor the performance of the Seller during the period prior to the Closing. This provision also supplements the notification provisions of Section 5.5.

5.9 CHANGE OF NAME

On or before the Closing Date, Seller shall (a) amend its Governing Documents and take all other actions necessary to change its name to one sufficiently dissimilar to Seller's present name, in Buyer's judgment, to avoid confusion; and (b) take all actions requested by Buyer to enable Buyer to change its name to the Seller's present name.

COMMENT

This provision should be included in the acquisition agreement if the buyer (or the division or subsidiary which will conduct the purchased business) wants to continue business under the seller's name. Although the use of this name by the buyer could cause some confusion, particularly with respect to liabilities that are not assumed, this risk is acceptable if the name of the seller and the goodwill associated with it are important to the continued conduct of the business. A change in the seller's name prior to the Closing may not be practicable, in which case Section 5.9 should be reworded and moved to Article 10.

5.10 PAYMENT OF LIABILITIES

Seller shall pay or otherwise satisfy in the Ordinary Course of Business all of its liabilities and obligations. Buyer and Seller hereby waive compliance with the bulk transfer provisions of the Uniform Commercial Code (or any similar law) (***"Bulk Sales Laws"***) in connection with the Contemplated Transactions.

COMMENT

A buyer wants assurance that the seller will pay its liabilities in the ordinary course of business, and before there is any default, in order that the seller's creditors will not seek to collect them from buyer under some successor liability theory. See Sections 3.32, 10.3 and 10.4. This is particularly the case where the buyer does not require the seller to comply with the Bulk Sales Laws described below.

Statutory provisions governing bulk transfers (Article 6 of the Uniform Commercial Code ("*UCC*"), various versions of which are in effect in certain states) (the "*Bulk Sales Laws*") require the purchaser of a major part of the materials, supplies or other inventory of an enterprise whose principal business is the sale of merchandise from stock (including those who manufacture what they sell) to give advance notice of the sale to each creditor of the transferor. To properly analyze the issue, the parties must review the Bulk Sales Laws in effect for the state(s) containing the transferor's principal place of business, its executive offices, and the assets to be transferred. Often the purchaser and the transferor waive the requirement of notices under Bulk Sales Laws, despite the serious consequences of noncompliance, and include an indemnity by the transferor against claims arising as a result of the failure to comply.

Noncompliance with the Bulk Sales Laws may give a creditor of the transferor a claim against the transferred assets or a claim for damages against the transferee, even against a transferee for full value without notice of any wrongdoing on the part of the transferor. This claim may be superior to any acquisition-lender's security interest; for this reason, a lender may not allow waiver of compliance with Bulk Sales Laws without a very strong indemnity from the transferor. In addition, some states have imposed upon the purchaser the duty to insure that the transferor applies the consideration received to its existing debts; this may include an obligation to hold in escrow amounts sufficient to pay any disputed debts. In Section 5.10, compliance with the Bulk Sales Laws is waived and the contractual indemnities in Section 11.2(g) cover the risk of noncompliance.

Bulk Sales Laws provide a specific kind of protection for creditors of businesses that sell merchandise from stock. Creditors of these businesses are vulnerable to a "bulk sale," in which the business sells all or a large part of inventory to a single buyer outside the ordinary course of business, following which the proprietor absconds with the proceeds. The original Article 6 of the UCC ("*Original UCC 6"*) requires "bulk sale" buyers to provide notice of the transaction to the transferor's creditors and to maintain a list of the transferor's creditors and a schedule of property obtained in a "bulk sale" for six months after the "bulk sale" takes place. In those jurisdictions that have adopted optional Section 6-106, there is also a duty to assure that the new consideration for the transfer is applied to pay debts of the transferor. Unless these procedures are followed, creditors may void the sale.

Compliance with the notice provisions of Original UCC 6 can be extremely burdensome, particularly when the transferor has a large number of creditors, and can adversely affect relations with suppliers and other creditors. When the goods that are the subject of the transfer are located in several jurisdictions, the transferor may be obligated to comply with Article 6 as enacted in each jurisdiction.

Failure to comply with the provisions of Original UCC 6 renders the transfer entirely ineffective, even when the transferor has attempted compliance in good faith, and even when no creditor has been injured by the noncompliance. A creditor, or a bankruptcy trustee, of the transferor may be able to set aside the entire transaction and recover from the noncomplying transferee all the goods transferred or their value. In contrast to the fraudulent transfer laws discussed in the Comment to Section 3.32, a violation of Original UCC 6 renders the entire transfer ineffective without awarding the transferee any corresponding lien on the goods for value given in exchange for the transfer. Thus, the transferee could pay fair value for the goods, yet lose the goods entirely if the transfer is found to have violated Original UCC 6.

Because (i) business creditors can evaluate credit-worthiness far better than was the case when Original UCC 6 was first promulgated, (ii) modern fraudulent transfer actions under the Uniform Fraudulent Transfer Act overlap the Bulk Sales law in a significant way, and (iii) a Bulk Sales Law impedes normal business transactions, the National Conference of Commissioners on Uniform State Laws and the American Law Institute have recommended the repeal of UCC Article 6. The Commissioners have proposed an alternative Article 6 ("*Revised UCC 6"*) which addresses many of the concerns with the Original UCC 6. As a result, as of February 1, 1999, the breakdown of states with the Original UCC 6, the Revised UCC 6 and no Bulk Sales Law, was as follows:

Original UCC 6:

Georgia	New York	South Carolina
Maryland	North Carolina	Wisconsin
Missouri	Rhode Island	

Adoption of Revised UCC 6:	Arizona California	District of Columbia Indiana	 Virginia
Repeal of UCC 6:	Alabama Alaska Arkansas Colorado Connecticut Delaware Florida Hawaii Idaho Illinois Iowa Kansas Kentucky	Louisiana Maine Massachusetts Michigan Minnesota Mississippi Montana Nebraska Nevada New Hampshire New Jersey New Mexico North Dakota	Ohio Oklahoma Oregon Pennsylvania Puerto Rico South Dakota Tennessee Texas Utah Vermont Washington West Virginia Wyoming

A "bulk transfer" under Original UCC 6 took place with the transfer "of a major part of the materials, supplies, merchandise or other inventory" outside the ordinary course of business. Under Revised UCC 6 a "bulk sale" takes place if there is a sale of "more than half the seller's inventory" outside the ordinary course of business and under conditions in which the "buyer has notice . . . that the seller will not continue to operate the same or a similar kind of business after the sale." Since the risk to creditors arises from the sale in which the seller goes out of business, Revised UCC 6 applies only to those situations. Revised UCC 6, also, excepts for the first time any asset sales that fall below a net value of $10,000 or that exceed a value of $25,000,000.

The duties of the transferee under Revised UCC 6 are primarily the same as those under Original UCC 6. The transferee must obtain a list of creditors ("claimants" under Revised UCC 6) and provide them with notice of the "bulk sale." Revised UCC 6, however, provides that, if the transferor submits a list of 200 or more claimants, or provides a verified statement that there are more than 200, the transferee may simply file a written notice of the "bulk sale" with the office of the Secretary of State (or other applicable official, as a statute provides) rather than send written notice to all claimants.

Under Original UCC 6, the transferee was required to keep a schedule of property and a list of claimants for a six month period following the sale. Under Revised UCC 6, the transferor and transferee instead must agree on "a written schedule of distribution" of the net contract proceeds, which schedule must be included in the notice to claimants. The "schedule of distribution" may provide for any distribution that the transferor and transferee agree to, including distribution of the entire net contract price to the seller, but claimants will have received advance notice of the intended distribution, giving them the opportunity to file an action for appropriate relief.

The last significant change in Revised UCC 6 is the basic remedy available to creditors. In Original UCC 6, a bulk sale in violation of the statute was entirely void. Revised UCC 6 provides for money damages rather than for voiding the sale. The creditor must prove its losses resulting from noncompliance with the statute. There are cumulative limits on the damages that may be assessed, and buyers are given a "good faith" defense in complying with Revised UCC 6.

Finally, Revised UCC 6 extends the statute of limitations on creditor's actions from six months under Original UCC 6 to one year. The period runs from the date of the sale. Concealed sales toll the statute of limitations in Revised UCC 6, as they do under Original UCC 6.

7. CONDITIONS PRECEDENT TO BUYER'S OBLIGATION TO CLOSE

Buyer's obligation to purchase the Assets and to take the other actions required to be taken by Buyer at the Closing is subject to the satisfaction, at or prior to the Closing, of each of the following conditions (any of which may be waived by Buyer, in whole or in part):

COMMENT

Article 7 sets forth the conditions precedent to the Buyer's obligation to consummate the acquisition of the Assets. If any one of the conditions in Article 7 is not satisfied as of the Closing, the Buyer may decline to proceed with the acquisition (without incurring liability to the Seller or the Shareholders) and may terminate the acquisition agreement in accordance with Article 9. A party's right to refuse to consummate the acquisition when a closing condition remains unsatisfied is often referred to as a "walk right" or an "out."

Conditions to closing can be interpreted and enforced literally. In *Annecca v. Lexent*, 307 F.Supp.2d 999 (N.D. Ill. 2004), the buyer terminated a stock purchase agreement alleging that the following conditions precedent to the closing had not been satisfied: (a) the target's failure to meet a specified minimum net worth requirement at the closing, and (b) that the representations and warranties as to the target would be true, complete and correct as of the closing date—specifically, that (i) the target's financial statements would be prepared in accordance with generally accepted accounting principles, and (ii) the target's books, records and accounts accurately reflected its transactions, assets and liabilities in accordance with generally accepted accounting principles. The target and its shareholders sued the buyer for breach of the stock purchase agreement, and the buyer ultimately moved for summary judgment that it was not obligated to close, which the court granted. Although the target admitted that its net worth was below the required minimum, it argued that the buyer could not terminate the stock purchase agreement because of the target's failure to meet the minimum net worth requirement since the deficiency could be cured by stockholder capital contributions. The court, applying, New York law, disagreed, holding that "[e]xpress conditions precedent must be literally performed—substantial compliance is not enough to compel the other party's performance..." The target also admitted that its financial statements were not prepared in accordance with generally accepted accounting principles but urged, as a defense, that the buyer was aware of such non-compliance at the time the stock purchase agreement was signed. Nevertheless, the court stated that the representation and warranty regarding the financial statements was unambiguous and, furthermore, that the integration clause in the stock purchase agreement precluded any defense based upon prior oral understandings. The court also found that the target's books and records did not accurately reflect its transactions, assets and liabilities in accordance with generally accepted accounting principles. The court determined that the failures of the conditions precedent were not curable because (a) a capital infusion by the shareholders would not place the target company in the same position as the target would have been in had it achieved the minimum net worth requirements through its own operations and (b) the court was not convinced that the target could cure the representations as to the financial statements and books and records.

It is critical for the parties and their attorneys to appreciate the fundamental differences between closing conditions, on the one hand, and representations and covenants, on the other. While every representation and covenant of the Seller also operates as a closing condition (subject in most cases to a materiality qualification) through Sections 7.1 and 7.2, some of the closing conditions in Article 7 do not constitute representations or covenants of the Seller and the Shareholders. If the Seller fails to satisfy any of these closing conditions, the Buyer will have the right to terminate the acquisition, but unless there has also been a separate breach by the Seller and the Shareholders of a representation or covenant, the Seller and the Shareholders will not be liable to the Buyer for their failure to satisfy the condition. However, because of the Seller's and the Shareholders' obligation (in Section 5.7) to use their Best Efforts to satisfy all of the conditions in Article 7 and Section 8.3 and their undertaking in clause (v) of Section 2.7(a) and Section 10.11 to provide at Closing such instruments and take such actions as the Buyer shall reasonably request, even if a particular closing condition does not constitute a representation or covenant of the Seller and the Shareholders, they will be liable if they fail to use their Best Efforts to satisfy those conditions or fail to satisfy the requirements of Sections 2.7(a)(v) and 10.11.

The importance of the distinction between conditions and covenants can be illustrated by examining the remedies that may be exercised by the Buyer if the Seller and the Shareholders fail to obtain the releases referred to in Section 7.4(e). Because the delivery of the releases is a condition to the Buyer's obligation to consummate the acquisition, the Buyer may elect to terminate the acquisition as a result of the failure to procure the releases. However, the delivery of the releases is not an absolute covenant of the Seller. Accordingly, the Seller's failure to obtain the releases will not, in and of itself, render the Seller and the Shareholders liable to the Buyer. If the Seller and the Shareholders made no attempt to obtain the releases, however, they could be liable to the Buyer under Section 5.7 for failing to use their Best Efforts to satisfy the applicable closing condition even though they lack the power to obtain the releases without the cooperation of a third party. For discussions of the relationships and interplay between the representations, pre-closing covenants, closing conditions, termination provisions, and indemnification provisions in an acquisition agreement, see Freund, *Anatomy of a Merger* 153-68 (1975), and *Business Acquisitions* ch. 31, at 1256 (Herz & Baller eds., 2d ed. 1981).

Although Section 7 includes many of the closing conditions commonly found in acquisition agreements, it does not provide an exhaustive list of all possible closing conditions. A buyer may want to add to Section 7 a "due diligence out" (making the buyer's obligation to purchase the assets subject to the buyer's satisfactory completion of a "due diligence" investigation relating to the business of the seller).

The buyer may find it difficult to persuade the seller to include such an additional condition because it would give the buyer very broad "walk rights" and place the buyer in a position similar to that of the holder of an option to purchase the assets. For a discussion of "due diligence outs" and "financing outs" such as that in Section 7.14, see Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* §§ 14.10, 14.11[4] (1992). A number of other closing conditions that the buyer may seek to include in Section 7 are discussed in the Comments to Sections 7.1 and 7.4

The buyer may waive any of the conditions to its obligation to close the acquisition. However, the buyer will not be deemed to have waived any of these conditions unless the waiver is in writing (see Section 13.6). This requirement avoids disputes about whether a particular condition has actually been waived.

7.1 ACCURACY OF REPRESENTATIONS

(a) All of Seller's and Shareholders' representations and warranties in this Agreement (considered collectively), and each of these representations and warranties (considered individually), shall have been accurate in all material respects as of the date of this Agreement, and shall be accurate in all material respects as of the time of the Closing as if then made, without giving effect to any supplement to the Disclosure Letter.

(b) Each of the representations and warranties in Sections 3.2(a) and 3.4, and each of the representations and warranties in this Agreement that contains an express materiality qualification, shall have been accurate in all respects as of the date of this Agreement, and shall be accurate in all respects as of the time of the Closing as if then made, without giving effect to any supplement to the Disclosure Letter.

COMMENT

Pursuant to this Section, all of the Seller's representations function as closing conditions. Thus, the Seller's representations serve a dual purpose — they provide the Buyer with a possible basis not only for recovering damages against the Seller and the Shareholders (see Section 11.2(a)), but also for exercising "walk rights."

Materiality Qualification in Section 7.1(a). Section 7.1(a) allows the Buyer to refuse to complete the acquisition only if there are material inaccuracies in the Seller's representations. A materiality qualification is needed in Section 7.1 because most of the Seller's representations do not contain any such qualification. The materiality qualification in Section 7.1(a) prevents the Buyer from using a trivial breach of the Seller's representations as an excuse for terminating the acquisition.

Subsection 7.1(a) provides that the materiality of any inaccuracies in the Seller's representations is to be measured both by considering each of the representations on an individual basis and by considering all of the representations on a collective basis. Accordingly, even though there may be no individual representation that is materially inaccurate when considered alone, the Buyer will be able to terminate the acquisition if several different representations contain immaterial inaccuracies that, considered together, reach the overall materiality threshold.

The materiality qualification in Section 7.1 can be expressed in different ways. In some acquisition agreements, the materiality qualification is expressed as a specific dollar amount, which operates as a cumulative "basket" akin to the indemnification "basket" in Section 11.5.

Absence of Materiality Qualification in Section 7.1(b). A few of the Seller's representations (such as the "no material adverse change" representation in Section 3.15 and the "disclosure" representation in Section 3.33) already contain express materiality qualifications. It is appropriate to require that these representations be accurate "in all respects" (rather than merely "in all material respects") in order to avoid "double materiality" problems. Section 7.1(b), which does not contain a materiality qualification, accomplishes this result. Section 3.4 is included because GAAP contains its own materiality standards. For a further discussion of "double materiality" issues, see Freund, *Anatomy of a Merger*

35-36, 245-46 (1975), and Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* § 14.02[3] (1999).

In addition, some of the Seller's representations that do not contain express materiality qualifications may be so fundamental that the Buyer will want to retain the ability to terminate the acquisition if they are inaccurate in <u>any</u> respect. Consider, for example, the Seller's representations in Section 3.2(a), which state that the acquisition agreement constitutes the legal, valid and binding obligation of Seller and the Shareholders, enforceable against them, that the Seller has the absolute and unrestricted right, power, authority and capacity to execute and deliver the acquisition agreement, and that the Shareholders have all requisite legal capacity to enter into the agreement and to perform their respective obligations thereunder. To avoid a dispute about the meaning of the term "material" in such a situation, the Buyer may seek to include the representations in Section 3.2(a) (and other fundamental representations made by the Seller) among the representations that must be accurate in <u>all</u> respects pursuant to Section 7.1(b).

To the extent that there is no materiality qualification in the representations identified in Section 7.1(b), a court might establish its own materiality standard to prevent a buyer from terminating the acquisition because of a trivial inaccuracy in one of those representations. *See Business Acquisitions* ch. 31, n.24 (Herz & Baller eds., 2d ed. 1981).

<u>Time as of Which Accuracy of Representations Is Determined</u>. The first clause in Section 7.1(a) focuses on the accuracy of the Seller's representations on the date of the acquisition agreement, while the second clause refers specifically to the time of closing. Pursuant to this second clause -- referred to as the "bring down" clause -- the Seller's representations are "brought down" to the time of closing to determine whether they would be accurate if then made.

Although it is unlikely that a seller would object to the inclusion of a standard "bring down" clause, they may object to the first clause in Section 7.1, which requires the Seller's representations to have been accurate on the original signing date. This clause permits the Buyer to terminate the acquisition because of a representation that was materially inaccurate when made, even if the inaccuracy has been fully cured by the closing. If a seller objects to this clause, the buyer may point out that the elimination of this clause would permit the seller to sign the acquisition agreement knowing that their representations are inaccurate at that time (on the expectation that they will be able to cure the inaccuracies before the closing). This possibility could seriously undermine the disclosure function of the seller's representations (see the introductory Comment to Article 3 under the caption "Purposes of the Seller's Representations"). *See generally* Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* § 14.02[1] (1999).

<u>Effect of Disclosure Letter Supplements</u>. Section 7.1 specifies that supplements to the Disclosure Letter have no effect for purposes of determining the accuracy of the Seller's representations. This ensures the Buyer that its "walk rights" will be preserved notwithstanding any disclosures made by the Seller after the signing of the acquisition agreement.

The importance of the qualification negating the effect of supplements to the Disclosure Letter can be illustrated by a simple example. Assume that a material lawsuit is brought against the Seller after the signing date and that the Seller promptly discloses the lawsuit to the Buyer in a Disclosure Letter supplement as required by Section 5.5. Assume further that the lawsuit remains pending on the scheduled closing date. In these circumstances, the representation in Section 3.18(a) (which states that, except as disclosed in the Disclosure Letter, there are no legal Proceedings pending against the Seller) will be deemed accurate as of the Closing Date if the Disclosure Letter supplement is taken into account, but will be deemed materially inaccurate if the supplement is not taken into account. Because Section 7.1 provides specifically that supplements to the Disclosure Letter are not to be given effect, the Buyer will be able to terminate the acquisition in this situation. Although supplements to the Disclosure Letter are not given effect for purposes of determining whether the Buyer has a "walk right" under Section 7.1, such supplements are given limited effect (in one circumstance) for purposes of determining whether the Buyer has a right to indemnification after the Closing (see Section 11.2(a)).

Operation of the "Bring Down" Clause. It is important that the parties and their counsel understand how the "bring down" clause in Section 7.1 operates. Consider, for example, the application of this clause to the representation in Section 3.4 concerning the Seller's financial statements. This representation states that the financial statements "fairly present the financial condition . . . of the Seller as at the respective dates thereof." Does the "bring down" clause in Section 7.1 require, as a condition to the Buyer's obligation to close, that these historical financial statements also fairly reflect the Seller's financial condition as of the Closing Date?

The answer to this question is "no." The inclusion of the phrase "as at the respective dates thereof" in the Section 3.4 representation precludes the representation from being "brought down" to the Closing Date pursuant to Section 7.1. Nevertheless, to eliminate any possible uncertainty about the proper interpretation of the "bring down" clause, a seller may insist that the language of this clause be modified to include a specific exception for representations "expressly made as of a particular date."

A seller may also seek to clarify that certain representations speak specifically as of the signing date and are not to be "brought down" to the Closing Date. For example, the Seller may be concerned that the representation in Section 3.20(a)(i) (which states that the Disclosure Letter accurately lists all of the Seller's contracts involving the performance of services or the delivery of goods or materials worth more than a specified dollar amount) would be rendered inaccurate as of the closing date if the seller were to enter into a significant number of such contracts as part of its routine business operations between the signing date and the closing date. (Note that, because Section 7.1 does not give effect to supplements to the Disclosure Letter, the Seller would not be able to eliminate the Buyer's "walk right" in this situation simply by listing the new contracts in a Disclosure Letter supplement.) Because it would be unfair to give a buyer a "walk right" tied to routine actions taken in the normal course of the seller's business operations, the seller may request that the representation in Section 3.20(a)(i) be introduced by the phrase "as of the date of this Agreement" so that it will not be "brought down" to the Closing Date. *See* Freund, *Anatomy of a Merger* 154 (1975). The buyer may respond that, if the new contracts do not have a material adverse effect on the seller's business, the representation in Section 3.20(a)(i) would remain accurate in all material respects and the buyer therefore could not use the technical inaccuracy resulting from the "bring down" of this representation as an excuse to terminate the acquisition.

A seller may also request that the "bring down" clause be modified to clarify that the buyer will not have a "walk right" if any of the seller's representations is rendered inaccurate as a result of an occurrence specifically contemplated by the acquisition agreement. The requested modification entails inserting the words "except as contemplated or permitted by this Agreement" (or some similar qualification) in Section 7.1.

The buyer may object to the qualification requested by the seller because of the difficulty inherent in ascertaining whether a particular inaccuracy arose as a result of something "contemplated" or "permitted" by the acquisition agreement. *See* Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* § 14.02[4] (1992). The buyer may argue that, if the seller is truly concerned about technical inaccuracies in its representations, it should bear the burden of specifically disclosing these inaccuracies in its disclosure letter, rather than relying on a potentially overbroad qualification in the "bring down" clause.

"Bring Down" of Representations That Include "Adverse Effect" Language. See the introductory Comment to Article 3.

"Bring Down" of Representations Incorporating Specific Time Periods. See the introductory Comment to Article 3.

Desirability of Separate "No Material Adverse Change" Condition. Some acquisition agreements contain a separate closing condition giving the buyer a "walk right" if there has been a "material adverse change" in the seller's business since the date of the agreement. The Model Agreement does not include a separate condition of this type because the Buyer receives comparable protection by virtue of the Seller's "no material adverse change" representation in Section 3.15 (which operates as a closing condition pursuant to Section 7.1).

There is, however, a potentially significant difference between the representation in Section 3.15 and a typical "no material adverse change" condition. While the representation in Section 3.15 focuses on the time period beginning on the date of the most recent audited Balance Sheet of the Seller (see Section 3.4), a "no material adverse change" condition normally focuses on the period beginning on the date on which the acquisition agreement is signed (which may be months after the Balance Sheet date). Because of this difference, the Buyer can obtain broader protection in some circumstances by adding a separate "no material adverse change" condition to Article 7.

The following example describes circumstances in which a buyer can obtain extra protection by including a separate "no material adverse change" condition. Assume that the seller's business has improved between the balance sheet date and the signing date, but has deteriorated significantly between the signing date and the closing date. Assume further that the net cumulative change in the seller's business between the balance sheet date and the closing date is not materially adverse (because the magnitude of the improvement between the balance sheet date and the signing date exceeds the magnitude of the deterioration between the signing date and the closing date). In this situation, the buyer would have a "walk right" if a separate "no material adverse change" condition (focusing on the time period from the signing date through the scheduled closing date) were included in the acquisition agreement, but would not have a "walk right" if left to rely exclusively on the "bring down" of the representation in Section 3.15.

Supplemental "Bring Down" Representation. A buyer may seek to supplement the "bring down" clause in Section 7.1 by having the seller make a separate "bring down" representation in Article 3. By making such a representation, the seller would be providing the Buyer with binding assurances that the representations in the acquisition agreement will be accurate as of the closing date as if made on that date.

The seller will likely resist the buyer's attempt to include a "bring down" representation because such a representation could subject the seller and its shareholders to liability for events beyond their control. For example, assume that there is a major hurricane a short time after the signing date, and that the hurricane materially and adversely affects the seller's properties within the meaning of Section 3.19(e). If there were a "bring down" representation in Article 3 (in addition to the "bring down" clause in Section 7.1), the buyer not only would be permitted to terminate the acquisition because of the destruction caused by the hurricane, but also would be entitled to sue and recover damages from the seller and its shareholders for their breach of the "bring down" representation. Although the seller would presumably consider this an inappropriate result, the buyer may defend its request for a "bring down" representation by arguing that the buyer is entitled to the benefit of its original bargain - the bargain that it struck when it signed the acquisition agreement - notwithstanding the subsequent occurrence of events beyond the seller's control. Thus, the buyer would argue, the seller and the shareholders should be prepared to guarantee, by means of a "bring down" representation, that the state of affairs existing on the signing date will remain in existence on the closing date.

If the buyer succeeds in its attempt to include a "bring down" representation in the acquisition agreement, the Seller may be left in a vulnerable position. Even when the seller notifies the buyer before the closing that one of the seller's representations has been rendered materially inaccurate as of the closing date because of a post-signing event beyond the seller's control, the buyer would retain the right to "close and sue" - the right to consummate the purchase of the assets and immediately bring a lawsuit demanding that the seller and its shareholders indemnify the buyer against any losses resulting from the breach of the "bring down" representation. The buyer should be aware, however, that courts may not necessarily enforce the buyer's right to "close and sue" in this situation (see the cases cited in the Comment to Section 11.1).

Effect of "Knowledge" Qualifications in Representations. See the introductory Comment to Article 3.

7.2 SELLER'S PERFORMANCE.

All of the covenants and obligations that Seller and Shareholders are required to perform or to comply with pursuant to this Agreement at or prior to the Closing (considered collectively), and each of these covenants and obligations (considered individually), shall have been duly performed and complied with in all material respects.

COMMENT

Pursuant to Section 7.2, all of the Seller's pre-closing covenants function as closing conditions. Thus, if the Seller materially breaches any of its pre-closing covenants, the Buyer will have a "walk right" (in addition to its right to sue and recover damages because of the breach).

Among the provisions encompassed by Section 7.2 is the covenant of Seller and the Shareholders to use their Best Efforts to cause the conditions to closing to be satisfied. See Section 5.7.

7.3 CONSENTS

Each of the Consents identified in Exhibit 7.3 (the **"Material Consents"**) shall have been obtained and shall be in full force and effect.

COMMENT

Under Section 7.3, the Buyer's obligation to purchase the Assets is conditioned upon the delivery of certain specified Material Consents (see the Comment to Section 2.10) (which may include both governmental approvals and contractual consents). For a discussion of the types of consents that might be needed for the sale of all or substantially all of a seller's assets, see the Comments to Sections 2.10, 3.2(b) and 5.4. The condition in Section 7.3 does not overlap with the "bring down" of the Seller's representation in Section 3.2, because subsection 3.2(b) contains an express carve-out for consents identified in the Disclosure Letter.

Part 3.2 of the Disclosure Letter will pick up all material and non-material consents, without differentiating between the two types (a different approach might also be taken), because it is essential to disclose all consents that must be obtained from any person in connection with the execution and delivery of the agreement and the consummation and performance of the transactions contemplated by the agreement. The parties are obligated to use their Best Efforts to obtain all Consents listed on Exhibits 7.3 and 8.3 prior to the Closing. (See Section 5.7 and the related Comment.) The failure to obtain such a scheduled Consent will relieve the appropriate party of the obligation to close (see the Comment to Section 2.10). Thus, before the acquisition agreement is signed, the parties must determine which of the various consents identified in Part 3.2 of the Disclosure Letter are significant enough to be a Material Consent, and in turn which of these is important enough to justify allowing the Buyer to terminate the acquisition if the consent cannot be obtained.

Exhibit 7.3 will specifically identify the Material Consents that are needed to satisfy this condition on the Buyer's obligation to close. Exhibit 8.3 will identify those required to satisfy the condition imposed by Section 8.3 on the Seller's obligation to close. Some of those consents may be listed on both Exhibits 7.3 and 8.3 because of their importance to both the Buyer and the Seller.

Part 3.2 of the Disclosure Letter might include as Material Consents, for example, a consent required to be obtained by a seller from a third-party landlord under a lease containing a "non-assignability" provision or a consent required from a lender with respect to an indebtedness of the seller which the buyer wishes to assume (because of favorable terms) or which the buyer may be required to assume as a part of the arrangement between the buyer and the seller. These consents would be needed because of contractual requirements applicable to the seller. There may be other consents that need to be identified in Exhibit 7.3 because of legal requirements applicable to the seller. These might include certain governmental approvals, consents, or other authorizations. Some of these consents might show up on Exhibit 8.3 as well because of their importance to the seller.

There is no need to refer to the HSR Act in Section 7.3 because Section 2.6 already specifies that the Closing cannot take place until the waiting period prescribed by that Act has been terminated.

7.4 ADDITIONAL DOCUMENTS

Seller and Shareholders shall have caused the documents and instruments required by Section 2.7(a) and the following documents to be delivered (or tendered subject only to Closing) to Buyer:

(a) an opinion of ______________, dated the Closing Date, in the form of Exhibit 7.4(a);

(b) The [certificate] [articles] of incorporation and all amendments thereto of Seller, duly certified as of a recent date by the Secretary of State of the jurisdiction of Seller's incorporation;

(c) If requested by Buyer, any Consents or other instruments that may be required to permit Buyer's qualification in each jurisdiction in which Seller is licensed or qualified to do business as a foreign corporation under the name, "__________________," or, "________________________," or any derivative thereof;

(d) A statement from the holder of each note and mortgage listed on Exhibit 2.4(a)(vii), if any, dated the Closing Date, setting forth the principal amount then outstanding on the indebtedness represented by such note or secured by such mortgage, the interest rate thereon, and a statement to the effect that Seller, as obligor under such note or mortgage, is not in default under any of the provisions thereof;

(e) Releases of all Encumbrances on the Assets, other than Permitted Encumbrances, including releases of each mortgage of record and reconveyances of each deed of trust with respect to each parcel of real property included in the Assets;

(f) Certificates dated as of a date not earlier than the [third] business day prior to the Closing as to the good standing of Seller and payment of all applicable state Taxes by Seller, executed by the appropriate officials of the State of _________ and each jurisdiction in which Seller is licensed or qualified to do business as a foreign corporation as specified in Part 3.1(a) ; and

(g) Such other documents as Buyer may reasonably request for the purpose of:

(i) evidencing the accuracy of any of Seller's representations and warranties,

(ii) evidencing the performance by Seller or either Shareholder of, or the compliance by Seller or either Shareholder with, any covenant or obligation required to be performed or complied with by Seller or such Shareholder,

(iii) evidencing the satisfaction of any condition referred to in this Article 7, or

(iv) otherwise facilitating the consummation or performance of any of the Contemplated Transactions.

COMMENT

Pursuant to Section 7.4, the Buyer's obligation to purchase the Assets is conditioned upon the Seller's delivery to the Buyer of certain specified documents, including a legal opinion of the Seller's counsel and releases of Encumbrances upon the Assets and various other certificates and documents.

Section 7.4 works in conjunction with Section 2.7. Section 2.7 identifies various documents that the Seller and the Shareholders have covenanted to deliver at the Closing. These documents include various instruments signed by the Seller and the Shareholders (such as the Escrow Agreement, the Employment Agreements, and the Noncompetition Agreements). The delivery of these documents is separately made a condition to the Buyer's closing obligation in Section 7.2(b).

In contrast, the documents identified in Section 7.4 are executed by parties other than the Seller and the Shareholders. Because the Seller cannot guarantee that these other parties will deliver the specified documents at the Closing, the delivery of these documents is not made an absolute covenant, but rather is merely a closing condition. (For a discussion of the differences between covenants and conditions, see the introductory Comment to Article 7.) Pursuant to Section 5.7, however, the Seller and the Shareholders are obligated to use their Best Efforts to obtain all of the documents identified in Section 7.4.

A buyer may deem it appropriate to request the delivery of certain additional documents as a condition to its obligation to consummate the acquisition. These additional documents may include, for example, an employment agreement signed by a key employee of the seller (who is not a shareholder), resignations of officers and directors of any subsidiary the stock of which is among the assets to be acquired, and a "comfort letter" from the seller's independent auditors. For a discussion of the use of "comfort letters" in acquisitions, see Freund, *Anatomy of a Merger* 301-04 (1975); Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* § 14.06[2] (1992); and Statement on Auditing Standards No. 72 ("Letters for Underwriters and Certain Other Requesting Parties"). Although the buyer might be able to demand various additional documents after the signing of the acquisition agreement under the "catch-all" language of Section 7.4(g), it is better to identify specifically all important closing documents in the acquisition agreement.

Section 7.4(f) calls for a certificate as to the Seller's good standing and payment of taxes from the appropriate officials of its domicile and any state in which it is licensed or qualified to do business as a foreign corporation. The availability of a certificate, waiver or similar document, or the practicality of receiving it on a timely basis, will vary from state to state. For example, provision is made in California for the issuance of certificates by (i) the Board of Equalization stating that no sales or use taxes are due (Cal. Rev. & Tax. Code § 6811), (ii) the Employment Development Department stating that no amounts are due to cover contributions, interest or penalties to various unemployment funds (Cal. Un. Ins. Code §§ 1731-32), and (iii) the Franchise Tax Board stating that no withholding taxes, interest or penalties are due (Cal. Rev. & Tax. Code § 18669). In the absence of such a certificate, a buyer may have liability for the seller's failure to pay or withhold the sums required. These agencies must issue a certificate within a specified number of days (varying from 30 to 60 days) after request is made or, in one case, after the sale. Because it usually is not practical to wait, or it may not be desirable to cause the agency to conduct an audit or other examination in order for such a certificate to issue, most buyers assume the risk and rely on indemnification, escrows or other protective devices to recover any state or local taxes that are found to be due and unpaid.

There may be other certificates or documents that a buyer may require as a condition to closing, depending upon the circumstances. For example, it may require an affidavit under the Foreign Investment in Real Property Tax Act of 1980 to avoid the obligation to withhold a portion of the purchase price under Section 1445 of the Code.

7.5 NO PROCEEDINGS

Since the date of this Agreement, there shall not have been commenced or threatened against Buyer, or against any Related Person of Buyer, any Proceeding (a) involving any challenge to, or seeking Damages or other relief in connection with, any of the Contemplated Transactions, or (b) that may have the effect of preventing, delaying, making illegal, imposing limitations or conditions on, or otherwise interfering with any of the Contemplated Transactions.

COMMENT

Section 7.5 contains the Buyer's "litigation out." This provision gives the Buyer a "walk right" if any litigation relating to the acquisition is commenced or threatened against the Buyer or a Related Person.

Section 7.5 relates only to litigation against the Buyer and its Related Persons. Litigation against the Seller is separately covered by the "bring down" of the Seller's litigation representation in Section 3.18(a) pursuant to Section 7.1(a). The Seller's litigation representation in Section 3.18(a) is drafted very broadly so that it extends not only to litigation involving the Seller, but also to litigation brought or threatened against other parties (including the Buyer) in connection with the acquisition. Thus, the "bring down" of Section 3.18(a) overlaps with the Buyer's "litigation out" in Section 7.5. However, a seller may object to the broad scope of the representation in Section 3.18(a) and may attempt to modify this representation so that it covers only litigation against the seller (and not litigation against other parties). If the seller succeeds in so narrowing the scope of Section 3.18(a), the buyer will not be able to rely on the "bring down" of the seller's litigation representation to provide the Buyer with a "walk right" if a lawsuit relating to the acquisition is brought against the buyer. In this situation, a separate "litigation out" (such as the one in Section 7.5) covering legal proceedings against the buyer and its related persons will be especially important to the buyer.

The scope of the buyer's "litigation out" is often the subject of considerable negotiation between the parties. The seller may seek to narrow this condition by arguing that threatened (and even pending) lawsuits are sometimes meritless, and perhaps also by suggesting the possibility that the buyer might be tempted to encourage a third party to threaten a lawsuit against the buyer as a way of ensuring that the buyer will have a "walk right." Indeed, the seller may take the extreme position that the buyer should be required to purchase the assets even if there is a significant pending lawsuit challenging the buyer's acquisition of the assets — in other words, the seller may seek to ensure that the buyer will not have a "walk right" unless a court issues an injunction prohibiting the buyer from purchasing the assets. If the buyer accepts the seller's position, Section 7.5 will have to be reworded to parallel the less expansive language of Section 8.5.

There are many possible compromises that the parties may reach in negotiating the scope of the buyer's "litigation out." For example, the parties may agree to permit the buyer to terminate the acquisition if there is acquisition-related litigation pending against the buyer, but not if such litigation has merely been threatened. Alternatively, the parties may decide to give the buyer a right to terminate the acquisition if a governmental body has brought or threatened to bring a lawsuit against the buyer in connection with the acquisition, but not if a private party has brought or threatened to bring such a lawsuit.

For the Buyer to terminate the acquisition under Section 7.5, a legal proceeding must have been commenced or threatened "since the date of this Agreement." The quoted phrase is included in Section 7.5 because it is normally considered inappropriate to permit a buyer to terminate the acquisition as a result of a lawsuit that was originally brought before the buyer signed the acquisition agreement. Indeed, the Buyer represents to the Seller in the Model Agreement that no such lawsuit relating to the acquisition was brought against the Buyer before the signing date (see Section 4.3).

A buyer may, however, want to delete the quoted phrase so that it can terminate the acquisition if, after the signing date, there is a significant adverse development in a lawsuit previously brought against the buyer in connection with the acquisition. Similarly, the buyer may want to add a separate closing condition giving the buyer a "walk right" if there is a significant adverse development after the signing date in any legal proceeding that the seller originally identified in its Disclosure Letter as pending against the seller or either shareholder as of the signing date.

7.6 NO CONFLICT

Neither the consummation nor the performance of any of the Contemplated Transactions will, directly or indirectly (with or without notice or lapse of time), contravene, or conflict with, or result in a violation of, or cause Buyer or any Related Person of Buyer to suffer any adverse consequence under, (a) any applicable Legal Requirement or Order, or (b) any Legal Requirement or Order that has been published, introduced, or otherwise proposed by or before any Governmental Body, excluding Bulk Sales Laws.

COMMENT

Section 7.6 allows the Buyer to terminate the acquisition if the Buyer or any related person would violate any law, regulation, or other legal requirement as a result of the acquisition. This Section supplements the Seller's "no conflict" representation in Section 3.2(b)(ii) and the Seller's "compliance with legal requirements" representation in Section 3.18(a), both of which operate as closing conditions pursuant to Section 7.1(a). However, unlike the representations in Sections 3.2(b)(ii) and 3.18(a) (which focus exclusively on legal requirements applicable to the Seller), Section 7.6 focuses on legal requirements applicable to the Buyer and its Related Persons. For example, environmental agencies in some states, *e.g.*, New Jersey, have the ability to void a sale if no clean-up plan or "negative declaration" has been filed, and because there are significant fines for failure to comply with these regulations, a buyer should identify such regulations, or if any are applicable in the state in which the agreement is to be performed, require that their compliance (including the Seller's cooperation with such compliance) be a condition to the Closing, and the requirement for the Seller's cooperation should be inserted as a covenant (Article 5) or a representation and warranty of the Seller (Article 3).

Section 7.6 refers to proposed legal requirements as well as to those already in effect. Thus, if legislation is proposed that would prohibit or impose material restrictions on the Buyer's control or ownership of the Assets, the Buyer will be able to terminate the acquisition, even though the proposed legislation might never become law. A seller may seek to limit the scope of Section 7.6 to legal requirements that are in effect on the scheduled closing date, and to material violations and material adverse consequences.

The Buyer may exercise its "walk right" under Section 7.6 if the acquisition would cause it to "suffer any adverse consequence" under any applicable law, even though there might be no actual "violation" of the law in question. Thus, for example, the Buyer would be permitted to terminate the acquisition under Section 7.6 because of the enactment of a statute prohibiting the Buyer from using or operating the Assets in substantially the same manner as they had been used and operated prior to the closing by the Seller, even though the statute in question might not actually impose an outright prohibition on using or operating the Assets or any of them.

Section 7.6 does not allow the Buyer to terminate the acquisition merely because of an adverse change in the general regulatory climate in which the Seller operates. The Buyer cannot terminate the acquisition under Section 7.6 unless the acquisition itself (or one of the other Contemplated Transactions) would trigger a violation or an adverse consequence under an applicable or proposed legal requirement.

A seller may take the position that Section 7.6 should extend only to legal requirements that have been adopted or proposed since the date of the acquisition agreement, arguing that the buyer should not be entitled to terminate the acquisition as a result of an anticipated violation of a statute that was already in place (and that the buyer presumably knew to be in place) when the buyer signed the agreement. The buyer may respond that, even if a particular statute is already in effect as of the signing date, there may subsequently be significant changes in the statute or in the regulations under the statute, and that such changes should be sufficient to justify the buyer's refusal to complete the acquisition. Indeed, the buyer may seek to expand the scope of Section 7.6 to ensure that the buyer will have a "walk right" if any change in the interpretation or enforcement of a legal requirement creates a mere risk that such a violation might occur or be asserted, even though there may be some uncertainty about the correct interpretation of the legal requirement in question.

7.9 GOVERNMENTAL AUTHORIZATIONS

Buyer shall have received such Governmental Authorizations as are necessary or desirable to allow Buyer to operate the Assets from and after the Closing.

COMMENT

In some circumstances, the Seller will want to limit this condition to material Governmental Authorizations or require that those Governmental Authorizations intended to be closing conditions be listed.

7.10 ENVIRONMENTAL REPORT

Buyer shall have received an environmental site assessment report with respect to Seller's Facilities, which report shall be acceptable in form and substance to Buyer in its sole discretion.

COMMENT

A buyer may decide to require, as a condition to closing, receipt of a satisfactory environmental evaluation of the seller's real property, or at least its principal properties, by a qualified consultant. These evaluations generally are categorized as either Phase I or Phase II environmental reviews. A Phase I review is an assessment of potential environmental contamination in the property resulting from past or present land use. The assessment usually is based on site inspections and interviews, adjacent land use surveys, regulatory program reviews, aerial photograph evaluations and other background research. The scope usually is limited to an analysis of existing data, excluding core samples or physical testing. A Phase II review is a subsurface investigation of the property through selected soil samples, laboratory analysis and testing. These reviews are then reduced to writing in a detailed report containing the consultant's conclusions and recommendations. Subsurface testing may be resisted by the seller. See the Comment to Section 5.1.

Assuming that the buyer knows little about the seller's real property at the time of drafting the acquisition agreement, a Phase I report would be appropriate requirement. Once the work is completed and the Phase I report issued, the buyer could then delete the condition or require a Phase II report, depending on the conclusions and recommendations of the consultant.

7.11 WARN ACT NOTICE PERIODS AND EMPLOYEES

(a) All requisite notice periods under the Warn Act shall have expired.

(b) Buyer shall have entered into employment agreements with those employees of Seller identified in Exhibit 7.11.

(c) Those key employees of Seller identified on Exhibit 7.11, or substitutes therefor who shall be acceptable to Buyer, in its sole discretion, shall have accepted employment with Buyer with such employment to commence on and as of the Closing Date.

(d) Substantially all other employees of Seller shall be available for hiring by Buyer, in its sole discretion, on and as of the Closing Date.

COMMENT

As indicated in the Comment to Section 3.23, the WARN Act contains an ambiguous provision that deals with the sale of a business. This provision has two basic components: (1) it assigns the responsibility, respectively, to the seller for giving WARN Act notices for plant closings or mass layoffs that occur "up to and including the effective date of the sale" and to the buyer for giving WARN Act notices for plant closings or mass layoffs that occur thereafter; (2) it deems, for WARN Act purposes, any non-part-time employee of the seller to be "an employee of the purchaser immediately after the effective date of the sale." 29 U.S.C. § 2101(b)(1).

A buyer seeking to avoid WARN Act liability may require that the seller permanently lay off its employees on or before the effective date of the sale so that the WARN Act notice obligations are the seller's. Of course, a seller seeking to avoid these notice obligations (or any WARN Act liability) may seek a representation from the buyer that it will employ a sufficient number of seller's employees so that the WARN Act is not triggered. Alternatively, the seller may seek to postpone the closing date so as to allow sufficient time to provide any requisite WARN notice to its employees. In those circumstances, the seller would ordinarily insist that a binding acquisition agreement be executed (with a deferred closing date) before it gives the WARN notice. Further, the buyer may agree to employ a number of the seller's employees on substantially similar terms and conditions of employment such that an insufficient number of the seller's employees will experience an "employment loss," thereby relieving the seller of WARN notice obligations or any other WARN liability. The buyer may consider this option if it desires to close the transaction promptly without the delay, business disruption and adverse effect on employee morale that may occur if the seller provides the WARN notice. This approach is often utilized if there is a concurrent signing and closing of the acquisition agreement. Once the buyer employs the seller's employees, it is then the buyer's responsibility to comply with WARN in the event that it implements any layoffs after the closing date.

It is not uncommon in acquisition transactions for the seller and buyer to "design around" the statutory provisions so that the WARN notice is not legally required. However, it is important to note that if the buyer represents that it will hire most of the seller's employees, it may become a "successor employer" under the National Labor Relations Act if the seller's employees are covered by a collective bargaining agreement. See the Comment to Section 3.24.

7.13 FINANCING

Buyer shall have obtained on terms and conditions satisfactory to it all of the financing it needs in order to consummate the Contemplated Transactions and to fund the working capital requirements of the Buyer after the closing.

COMMENT

This Section permits broad discretion to the Buyer in determining the manner and nature of its financing. The section is sufficiently broad as to permit a seller to argue that the condition turns the agreement into a mere option to purchase. This argument is even more compelling where a general due diligence condition to closing is inserted. See the introductory Comment to Article 7. Where the buyer does not in fact have the necessary financing in place, either the agreement should not be executed or some condition of this sort should be inserted. An alternative that might be satisfactory to both parties is the forfeiture of a substantial earnest money deposit should the transaction fail because of the absence of financing.

A number of options are available to the seller who objects to such a broad condition. The buyer might be given a relatively short period, such as thirty or sixty days, in which the condition must either be satisfied or waived. Time periods for the Buyer to reach various stages, such as a term sheet and a definitive credit agreement, might be specified. The terms of the financing might be narrowly defined so as to permit the buyer little leeway in using this condition to avoid the closing of the transaction or the seller might require presentation by the buyer of any existing term sheet or proposal letter.

A more extreme position on the part of the seller would be to require a representation by the buyer to the effect that financing is in place or that it has sufficient resources to fund the acquisition.

9. TERMINATION

9.1 TERMINATION EVENTS

By notice given prior to or at the Closing, subject to Section 9.2, this Agreement may be terminated as follows:

(a) by Buyer if a material Breach of any provision of this Agreement has been committed by Seller or Shareholders and such Breach has not been waived by Buyer;

(b) by Seller if a material Breach of any provision of this Agreement has been committed by Buyer and such Breach has not been waived by Seller;

(c) by Buyer if any condition in Article 7 has not been satisfied as of the date specified for Closing in the first sentence of Section 2.6 or if satisfaction of such a condition by such date is or becomes impossible (other than through the failure of Buyer to comply with its obligations under this Agreement) and Buyer has not waived such condition on or before such date; or

(d) by Seller, if any condition in Article 8 has not been satisfied as of the date specified for Closing in the first sentence of Section 2.6 or if satisfaction of such a condition by such date is or becomes impossible (other than through the failure of Seller or the Shareholders to comply with their obligations under this Agreement) and Seller has not waived such condition on or before such date;

(e) by mutual consent of Buyer and Seller;

(f) by Buyer if the Closing has not occurred on or before _______________, or such later date as the parties may agree upon, unless the Buyer is in material Breach of this Agreement; or

(g) by Seller if the Closing has not occurred on or before _________________, or such later date as the parties may agree upon, unless the Seller or Shareholders are in material Breach of this Agreement.

COMMENT

Under basic principles of contract law, one party has the right to terminate its obligations under an agreement in the event of a material breach by the other party or the nonfulfillment of a condition precedent to the terminating party's obligation to perform. An acquisition agreement does not require a special provision simply to confirm this principle. However, Section 9 serves two additional purposes: first, it makes it clear that a non-defaulting party may terminate its further obligations under the Model Agreement before the Closing if it is clear that a condition to that party's obligations cannot be fulfilled by the calendar date set for the Closing; second, it confirms that the right of a party to terminate the acquisition agreement does not necessarily mean that the parties do not have continuing liabilities and obligations to each other, especially if one party has breached the agreement.

The first basis for termination is straightforward — one party may terminate its obligations under the acquisition agreement if the other party has committed a material default or breach. While there may be a dispute between the parties that results in litigation, this provision makes it clear that a non-defaulting party can walk away from the acquisition if the other party has committed a material breach. To the extent that there is any ambiguity in the law of contracts that might require that the parties consummate the acquisition and litigate over damages later, this provision in combination with Section 9.2 should eliminate that ambiguity.

Under subsections (c) and (d), each party has the right to terminate if conditions to the terminating party's obligation to close are not fulfilled, unless such nonfulfillment has been caused by the terminating party. Unlike subsections (a) and (b), these provisions enable a party to terminate the agreement without regard to whether the other party is at fault, if one or more of the conditions to Closing in Articles 7 and 8 are not fulfilled. For example, it is a condition to each party's obligation to close that the representations and warranties of the other party be correct at the Closing (see Sections 7.1 and 8.1). This condition might fail due to outside forces over which neither party has control, such as a significant new lawsuit. The party for whose benefit such a condition was provided should have the right to terminate its obligations under the agreement, and subsections (b) and (d) provide this right. If the condition cannot be fulfilled in the future, that party need not wait until the scheduled closing date to exercise its right to terminate. Also, unlike subsections (a) and (b), subsections (c) and (d) have no materiality test. The materiality and reasonableness qualifications, where appropriate, are incorporated into the closing conditions of Articles 7 and 8.

Subsections (a), (b), (c) and (d) may overlap to some extent in that the breach of a representation will often also result in the failure to satisfy a condition and neither provision contains a right by the breaching party to cure the breach. However, either party (more likely the Seller) may suggest that a non-breaching party should not be able to terminate the agreement if the breaching party cures all breaches before the scheduled closing date. This may be reasonable in some circumstances, but both parties (especially the buyer) should carefully consider the ramifications of giving the other party a blanket right to cure any breaches regardless of their nature.

The third basis for termination, the mutual consent of the parties, makes it clear that the parties do not the need the consent of the shareholders or any third-party beneficiaries (despite the disclaimer of any third-party beneficiaries in Section 13.9) to terminate the acquisition agreement.

The final basis for termination is the "drop dead" date provision. Section 2.6 provides that the closing will take place on the later of a specified date or the expiration of the HSR waiting period. Section 2.6 states that failure to close on the designated closing date does not, by itself, constitute a termination of the obligations under the acquisition agreement. Subsections (f) and (g) of Section 9.1 complement Section 2.6 by enabling the parties to choose a date beyond which either party may call off the deal simply because it has taken too long to get it done. Again, like subsections (c) and (d), this right of termination does not depend upon one party being at fault. Of course, if there is fault, Section 9.2 preserves the rights of the party not at fault. However, even if no one is at fault, a non-breaching party should be entitled to call a halt to the acquisition at some outside date. Sometimes the "drop dead" date will be obvious from the circumstances of the acquisition. In other cases it may be quite arbitrary. In any event, it is a good idea for the parties to resolve the issue when the acquisition agreement is signed.

The parties may negotiate and agree that other events will permit one or both of them to terminate the acquisition agreement. If so, it will be preferable to add these events or situations to the list of "termination events" to avoid any concern about whether Article 9 is exclusive as to the right to terminate and, therefore, overrides any other provision of the acquisition agreement regarding termination.

Such events or situations are similar to the types of matters that are customarily set as conditions to the closing, but are of sufficient importance to one party or the other that a party does not want to wait until the closing date to determine whether the condition has occurred thus avoiding continuing expense and effort in the transaction. The kinds of events and situations a buyer might seek as giving it a right to terminate earlier than the closing date include the buyer's inability to conclude an employment arrangement with one or more key persons on the seller's staff, the buyer's dissatisfaction with something turned up in its due diligence investigation, or material damage to or destruction of a significant asset or portion of the assets. The seller might seek the right to terminate earlier than the closing date due to the buyer's inability to arrange its acquisition financing.

In *Henkel Corporation v. Innovative Brands Holdings, LLC* (Del. Ch. No. 3663-VCN August 6, 2008), an asset purchase agreement did not specify an outside date by which the transaction must close and provided only that the closing would occur within five business days after all closing conditions were satisfied. Buyer declined to close because it claimed the absence of Material Adverse Effect condition had not been satisfied, but declined to either waive the condition or terminate the agreement. Contending that the no-shop clause in the asset purchase agreement effectively precluded it from seeking other purchasers, seller sued buyer to compel it to close. Buyer counterclaimed for a declaratory judgment that it was not obligated to close until all conditions were satisfied. In denying seller's motion to dismiss the counterclaim, the Court found that the question was when, if ever, the buyer must make a decision whether to claim or waive the alleged Material Adverse Effect, and explained:

> In short, the Agreement does not set any time by which [buyer] must decide whether to claim that an MAE has occurred or to waive any such claim. It is, however, unreasonable, to believe that sophisticated parties would have agreed upon an open-ended, unlimited period for making such a decision. Accordingly, as with contracts lacking a time for performance generally, the Court will be required to determine a "reasonable" period for performance.
>
> With that conclusion, it remains an open question as to whether [buyer]'s time for making such a decision has come and gone or when it may be in the future. The Court cannot conclude, as a matter of law from reading the Agreement, that [buyer] is not entitled to make its decision in the future. The reasonableness of a time period with which an act must occur is necessarily dependent upon the factual context and cannot be set with this case in its current procedural posture.

9.2 EFFECT OF TERMINATION

Each party's right of termination under Section 9.1 is in addition to any other rights it may have under this Agreement or otherwise, and the exercise of such right of termination will not be an election of remedies. If this Agreement is terminated pursuant to Section 9.1, all obligations of the parties under this Agreement will terminate, except that the obligations of the parties in this Section 9.2 and Articles 12 and 13 (except for those in Section 13.5) will survive; provided, however, that if this Agreement is terminated because of a Breach of this Agreement by the non-terminating party or because one or more of the conditions to the terminating party's obligations under this Agreement is not satisfied as a result of the party's failure to comply with its obligations under this Agreement, the terminating party's right to pursue all legal remedies will survive such termination unimpaired.

COMMENT

Section 9.2 provides that if the acquisition agreement is terminated through no fault of the non-terminating party, neither party has any further obligations under the acquisition agreement. The exceptions acknowledge that the parties will have continuing obligations to pay their own expenses (see Section 13.1) and to preserve the confidentiality of the other party's information (see Article 12).

The parties should consider the possibility of preserving the continued viability of other provisions in the acquisition agreement. For example, Sections 3.30 and 4.4 are reciprocal representations by the parties that there are no broker's fees. While any broker's fee most likely would be due only upon the successful closing of the acquisition, it is possible that a broker will demand payment of a fee after termination, in which case the parties may want this representation to continue in full force and effect. Another example is Section 13.4, which provides for the jurisdiction and venue of any action arising out of the acquisition agreement. While this provision would probably remain in effect regardless of the exceptions in Section 9.2, it is possible that the obligations of the parties in Section 13.4 would terminate along with the acquisition agreement.

If the terminating party asserts that the acquisition agreement has been terminated due to a breach by the other party, the terminating party's rights are preserved under Section 9.2. This provision deals only with the effect of termination by a party under the terms of this Section and does not define the rights and liabilities of the parties under the acquisition agreement except in the context of a termination provided for in Section 9.1.

Many times the parties will negotiate specific consequences or remedies that will flow from and be available to a party in the event of a termination of the acquisition agreement rather than rely on the preservation of their general legal and equitable rights and remedies. Such remedies will typically differentiate between a termination that is based on the fault or breach of a party and a termination that is not. In some transactions, the parties may agree to relieve each other of consequential or punitive damages.

In the former category, the parties may negotiate a liquidated damages remedy or may agree in lieu of damages and an election to terminate, that the non-breaching party (or party without fault) may pursue specific performance of the acquisition agreement. Such remedies must be carefully drafted and comply with any applicable state statutory and case law governing such remedies.

In the latter category, the parties may provide for a deposit by the buyer to be paid to the seller if there is a termination of the acquisition agreement by the buyer without fault on the part of the seller. In lieu of a forfeitable deposit, the parties may agree that in the event of a termination of the acquisition agreement pursuant to the right of a party (often the buyer), the terminating party will reimburse the other party (often the seller) if not in default for some or all of the expenses it has incurred in the transaction, such as a costs for environmental studies, the HSR filing fee and/or fees of special consultants and counsel.

10. ADDITIONAL COVENANTS

10.1 EMPLOYEES AND EMPLOYEE BENEFITS

(a) **Information on Active Employees**. For the purpose of this Agreement, the term "**Active Employees**" shall mean all employees employed on the Closing Date by Seller for its business who are: (i) bargaining unit employees currently covered by a collective bargaining agreement or (ii) employed exclusively in Seller's business as currently conducted, including employees on temporary leave of absence, including family medical leave, military leave, temporary disability or sick leave, but excluding employees on long term disability leave.

(b) **Employment of Active Employees by Buyer.**

(i) Buyer is not obligated to hire any Active Employee, but may interview all Active Employees. Buyer will promptly provide Seller a list of Active Employees to whom Buyer has made an offer of employment that has been accepted to be effective on the Closing Date (the "**Hired Active Employees**"). Subject to Legal Requirements, Buyer will have reasonable access to the facilities and personnel Records (including performance appraisals, disciplinary actions, grievances, and medical Records) of Seller for the purpose of preparing for and conducting employment interviews with all Active Employees and will conduct the interviews as expeditiously as possible prior to the Closing Date. Access will be provided by Seller upon reasonable prior notice during normal business hours. Effective immediately before the Closing, Seller will terminate the employment of all of its Hired Active Employees.

(ii) Neither Seller nor either Shareholder nor their Related Persons shall solicit the continued employment of any Active Employee (unless and until Buyer has informed Seller in writing that the particular Active Employee will not receive any employment offer from Buyer) or the employment of any Hired Active Employee after the Closing. Buyer shall inform Seller promptly of the identities of those Active Employees to whom it will not make employment offers, and Seller shall assist Buyer in complying with the WARN Act as to those Active Employees.

(iii) It is understood and agreed that (A) Buyer's expressed intention to extend offers of employment as set forth in this Section shall not constitute any commitment, Contract or understanding (expressed or implied) of any obligation on the part of Buyer to a post-Closing employment relationship of any fixed term or duration or upon any terms or conditions other than those that Buyer may establish pursuant to individual offers of employment, and (B) employment offered by Buyer is "at will" and may be terminated by Buyer or by an employee at any time for any reason (subject to any written commitments to the contrary made by Buyer or an employee and Legal Requirements). Nothing in this Agreement shall be deemed to prevent or restrict in any way the right of Buyer to terminate, reassign, promote or demote any of the Hired Active Employees after the Closing, or to change adversely or favorably the title, powers, duties, responsibilities, functions, locations, salaries, other compensation or terms or conditions of employment of such employees.

(c) **Salaries and Benefits.**

(i) Seller shall be responsible for (A) the payment of all wages and other remuneration due to Active Employees with respect to their services as employees of Seller through the close of business on the Closing Date, including pro rata bonus payments and all vacation pay earned prior to the Closing Date, (B) the payment of any termination or severance payments and the provision of health plan continuation coverage in accordance with the requirements of COBRA and Section 601 through 608 of ERISA, and (C) any and all payments to employees required under the WARN Act.

(ii) Seller shall be liable for any claims made or incurred by Active Employees and their beneficiaries through the Closing Date under the Employee Plans. For purposes of the immediately preceding sentence, a charge will be deemed incurred, in the case of hospital, medical or dental benefits, when the services that are the subject of the charge are performed and, in the case of other benefits (such as disability or life insurance), when an event has occurred or when a condition has been diagnosed which entitles the employee to the benefit.

(d) **Seller's Retirement and Savings Plans.**

(i) All Hired Active Employees who are participants in Seller’s retirement plans shall retain their accrued benefits under Seller’s retirement plans as of the Closing Date, and Seller (or Seller’s retirement plan) shall retain sole liability for the payment of such benefits as and when such Hired Active Employees become eligible therefor under such plans. All Hired Active Employees shall become fully vested in their accrued benefits under Seller’s retirement plans as of the Closing Date, and Seller will so amend such plans if necessary to achieve this result. Seller shall cause the assets of each Employee Plan to equal or exceed the benefit liabilities of such Employee Plan on a plan termination basis as of the Effective Time.

(ii) Seller will cause its savings plan to be amended in order to provide that the Hired Active Employees shall be fully vested in their accounts under such plan as of the Closing Date and all payments thereafter shall be made from such plan as provided in the plan.

(e) **No Transfer of Assets.** Neither Seller nor Shareholders nor their respective Related Persons will make any transfer of pension or other employee benefit plan assets to the Buyer.

(f) **Collective Bargaining Matters.** Buyer will set its own initial terms and conditions of employment for the Hired Active Employees and others it may hire, including work rules, benefits and salary and wage structure, all as permitted by law. Buyer is not obligated to assume any collective bargaining agreements under this Agreement. Seller shall be solely liable for any severance payment required to be made to its employees due to the Contemplated Transactions. Any bargaining obligations of Buyer with any union with respect to bargaining unit employees subsequent to the Closing, whether such obligations arise before or after the Closing, shall be the sole responsibility of Buyer.

(g) **General Employee Provisions.**

(i) Seller and Buyer shall give any notices required by law and take whatever other actions with respect to the plans, programs and policies described in this Section 10.1 as may be necessary to carry out the arrangements described in this Section 10.1.

(ii) Seller and Buyer shall provide each other with such plan documents and summary plan descriptions, employee data or other information as may be reasonably required to carry out the arrangements described in this Section 10.1.

(iii) If any of the arrangements described in this Section 10.1 are determined by the IRS or other Governmental Body to be prohibited by law, Seller and Buyer shall modify such arrangements to as closely as possible reflect their expressed intent and retain the allocation of economic benefits and burdens to the parties contemplated herein in a manner which is not prohibited by law.

(iv) Seller shall provide Buyer with completed I-9 forms and attachments with respect to all Hired Active Employees, except for such employees as Seller shall certify in writing to Buyer are exempt from such requirement.

(v) Buyer shall not have any responsibility, liability or obligation, whether to Active Employees, former employees, their beneficiaries or to any other Person, with respect to any employee benefit plans, practices, programs or arrangements (including the establishment, operation or termination thereof and the notification and provision of COBRA coverage extension) maintained by Seller.

COMMENT

A sale of assets presents some unique problems and opportunities in dealing with employees and employee benefits. In a sale of assets, unlike a stock purchase or statutory combination, the buyer can be selective in determining who to employ and has more flexibility in establishing the terms of employment. The action taken by the buyer, however, will have an impact on its obligations with respect to any collective bargaining agreements (see the Comment to Section 3.24) and the application of the WARN Act (see the Comment to Section 3.23).

Although many of the obligations of a seller and buyer will flow from the structure of the acquisition or legal requirements, it is customary to set out their respective obligations with respect to employees and employee benefits in the acquisition agreement. Section 10.1 has been drafted to deal with these issues from a buyer's perspective. Subsection (b) provides that the Buyer may interview and extend offers of employment to employees, all of whom will be terminated by the Seller immediately before the closing. The Buyer is not committed to extend offers and is not restricted with respect to termination, reassignment, promotion or demotion, or changes in responsibilities or compensation, after the closing. In subsection (c), the Seller's obligations for payment of wages, bonuses, severance and other items are set forth.

In most cases, the seller and buyer share a desire to make the transition as easy as possible so as not to adversely affect the morale of the workforce. For this reason, the seller may prevail on the buyer to agree to employ all the employees after the closing. The seller may also want to provide for a special severance arrangement applicable to long-time employees who may be terminated by the buyer within a certain period of time after the acquisition. Section 10.1 should be modified accordingly.

Subsections (d) and (e) deal with certain employee benefit plans. The employees hired by the Buyer are to retain their accrued benefits and become fully vested under the retirement and savings plans, which will be maintained by the Seller. However, the Seller may want to provide that certain benefits be made available to its employees under the Buyer's plans, particularly if its management will continue to have a role in managing the ongoing business for the buyer. It is not uncommon for a seller to require that its employees be given prior service credit for purposes of vesting or eligibility under a buyer's benefit plans. A review and comparison of the terms and scope of the Seller's and Buyer's plans will suggest provisions to add to this portion of the Model Agreement.

If special provisions benefiting the employees of a seller are included in the acquisition agreement, the seller may ask that these employees be made third-party beneficiaries with respect to these provisions. See the Comment to Section 13.9.

10.2 PAYMENT OF ALL TAXES RESULTING FROM SALE OF ASSETS BY SELLER

Seller shall pay in a timely manner all Taxes resulting from or payable in connection with the sale of the Assets pursuant to this Agreement, regardless of the Person on whom such Taxes are imposed by Legal Requirements.

COMMENT

Federal. See Section III.E in the introductory text for a discussion of federal income taxes that would be payable if the seller were a C corporation. If the seller is an S corporation, it will not owe federal income taxes on the sale unless it is subject to the built-in-gains tax under Code Section 1374.

State. States commonly impose an obligation on the buyer to pay sales tax on sales of assets and impose on the seller an obligation to collect the tax due. "Sale" is normally defined to include every transfer of title or possession except to the extent that specific exceptions are prescribed by the legislature. In many (but not all) states, however, there are exemptions for isolated sales of assets outside of the ordinary course of business, although the exemptions tend to be somewhat imprecisely drafted and narrow in scope. For example, (1) California exempts the sale of the assets of a business activity only when the product of the business would not be subject to sales tax if sold in the ordinary course of business (*Cal. Rev. and Tax. Code § 6006.5(a)*); and (2) Texas exempts a sale of the "entire operating assets" of a "business or of a separate division, branch or identifiable segment of a business" (*Tex. Tax Code § 151.304(b)(2)*). In contrast, Illinois has a sweeping exemption that applies to the sale of any property to the extent the seller is not engaged in the business of selling that property (*Ill. Retailers Occ. Tax § 1; Regs. § 130.110(a)*). This will often exempt all of the seller's assets except inventory, which will be exempted because the buyer will hold it for resale (*Illinois Department of Revenue Private Letter Ruling No. 91-0251 [March 27, 1991]*). In states that impose separate tax regimes on motor vehicles, an exemption for these assets must be found under the applicable motor vehicle tax statute. See, *e.g.*, *Tex. Tax Code § 152.021* (no exemption for assets and tax is paid on registration of transfer of title). Accordingly, the availability and scope of applicable state sales and use tax exemptions should be carefully considered.

10.3 PAYMENT OF OTHER RETAINED LIABILITIES

In addition to payment of Taxes pursuant to Section 10.2, Seller shall pay, or make adequate provision for the payment, in full of all of the Retained Liabilities and other Liabilities of Seller under this Agreement. If any such Liabilities are not so paid or provided for, or if Buyer reasonably determines that failure to make any payments will impair Buyer's use or enjoyment of the Assets or conduct of the business previously conducted by Seller with the Assets, Buyer may at any time after the Closing Date elect to make all such payments directly (but shall have no obligation to do so) and set off and deduct the full amount of all such payments from the first maturing installments of the unpaid principal balance of the Purchase Price pursuant to Section 11.8. Buyer shall receive full credit under the Promissory Note and this Agreement for all payments so made.

COMMENT

The buyer wants assurances that the ascertainable retained liabilities, including tax liabilities, will be paid from the proceeds of the sale so that these liabilities will not blossom into lawsuits in which the creditor names buyer as a defendant and seeks to "follow the assets".

The seller will likely resist being required to determine and pay amounts which may be unknown at the time of the closing or which may otherwise go unclaimed by the creditor in question. Moreover, the seller will argue that this Section deprives it not only of its right to contest or compromise liability for these retained liabilities but also of its right of defense provided under Section 11.9 relating to indemnification. The seller would likely request that this Section be stricken or, at a minimum, that it be limited to specifically identified retained liabilities, with the seller preserving the right to contest, compromise and defend.

10.4 RESTRICTIONS ON SELLER DISSOLUTION AND DISTRIBUTIONS.

Seller shall not dissolve, or make any distribution of the proceeds received pursuant to this Agreement, until the later of (a) 30 days after the completion of all adjustment procedures contemplated by Section 2.9, (b) Seller's payment, or adequate provision for the payment, of all of its obligations pursuant to Sections 10.2 and 10.3 or (c) the elapse of more than one year after the Closing Date.

COMMENT

Section 10.4 of the Model Agreement imposes restrictions on the Seller's ability to dissolve or distribute the proceeds of the asset sale to its shareholders. The limitation is not lifted until the parties complete any Purchase Price adjustment required under Section 2.8 and the Seller has either paid, or made provision for the payment of, its obligations pursuant to Sections 10.2 and 10.3.

Section 10.4(a), restricting the Seller's dissolution or its distribution of the sales proceeds until completion of all price adjustment procedures under Section 2.9, is intended to assure the Buyer that the Seller will continue to work until those post-closing procedures are concluded and will have the assets necessary to satisfy any obligations to Buyer under the Model Agreement. Without such a restriction, the Buyer might have to address the settlement of any disputes arising from those procedures or the payment of any adjustment owed (particularly if owed to the Buyer) with all of the Seller's shareholders, some of whom are not parties to the Model Agreement. Depending on tax and other considerations, however, a seller may want to dissolve or distribute more quickly. The parties may then negotiate a means by which the buyer can resolve any post-closing procedures without dealing with all of the seller's shareholders (for example, a liquidating trust) and the determination and, if needed, inclusion in the escrow of an estimated amount to provide a sufficient source for any post-closing adjustment which may be payable to the buyer.

The Section 10.4(b) limitation upon dissolution and distribution until payment, or provision for payment, of the Seller's obligations reflects the Buyer's concern about its exposure to the risks that fraudulent conveyance or bulk sales statutes may adversely affect the Buyer's ownership or enjoyment of the purchased assets after the Closing. See the Comments to Sections 3.32 and 5.10. By requiring payment, or provision for payment, the Model Agreement sets a standard which reflects what many business corporation statutes require before permitting a corporation to dissolve. *See*, *e.g.*, Tex. Bus. Corp. Act arts. 2.38 (a corporation may not make any distribution to its shareholders if afterward it would not have surplus or be able to pay its debts as they come due in the usual course of its business) and 6.04 (before dissolution a corporation must discharge, or make adequate provision for the discharge, of all of its liabilities or apply all of its assets so far as they will go to the discharge of its liabilities). Depending on the length of the applicable statute of limitations for actions against a dissolved corporation's shareholders compared to the period of limitations for contractual obligations, the incorporation of this standard in the agreement between the parties may also extend the time during which a buyer could bring an action, particularly in the case where one or more principal shareholders are parties to the agreement (as is the case under the Model Agreement). See Section 11.7 regarding contractual time limits for claims for indemnification.

A buyer may desire to restrict distribution of the Promissory Note to the seller's shareholders, particularly if some of the shareholders are not "accredited investors" (as defined in SEC Regulation D), in order to facilitate compliance with applicable securities laws. See Section 3.31 and the related Comment.

The seller may resist the requirement for payment, or provision for payment, of its obligations because it interferes with its ability to control its own affairs and to wind them up promptly after the completion of the sale of its assets. There may also be matters in dispute which may practically eliminate the seller's ability to make distributions because the difficulty of determining what provision should be made. The seller may also point to the escrow, if substantial, as providing adequate protection for the buyer.

On the other hand, if the buyer has reason to be concerned about the financial ability or resolve of the seller to pay its creditors, the buyer may want to insist on a provision more stringent than that contained in the Model Agreement. As an example, Section 10.4(c) prohibits the Buyer from making any distributions for a period of time, perhaps, as a minimum, the period in which creditors can bring actions under an applicable bulk sales statute. In the extreme case, the buyer may want to insist that the seller's obligations be paid as a part of the closing.

10.8 NONCOMPETITION, NONSOLICITATION AND NONDISPARAGEMENT

(a) **Noncompetition.** For a period of _____ years after the Closing Date, Seller shall not, anywhere in ________, directly or indirectly invest in, own, manage, operate, finance, control, advise, render services to, or guarantee the obligations of, any Person engaged in or planning to become engaged in the ____________ business (**"Competing Business"**); provided, however, that Seller may purchase or otherwise acquire up to (but not more than) ____ percent of any class of the securities of any Person (but may not otherwise participate in the activities of such Person) if such securities are listed on any national or regional securities exchange or have been registered under Section 12(g) of the Exchange Act.

(b) **Nonsolicitation.** For a period of_____ years after the Closing Date, Seller shall not, directly or indirectly:

(i) solicit the business of any Person who is a customer of Buyer;

(ii) cause, induce or attempt to cause or induce any customer, supplier, licensee, licensor, franchisee, employee, consultant or other business relation of Buyer to cease doing business with Buyer, to deal with any competitor of Buyer, or in any way interfere with its relationship with Buyer;

(iii) cause, induce or attempt to cause or induce any customer, supplier, licensee, licensor, franchisee, employee, consultant or other business relation of Seller on the Closing Date or within the year preceding the Closing Date to cease doing business with Buyer, to deal with any competitor of Buyer, or in any way interfere with its relationship with Buyer; or

(iv) hire, retain, or attempt to hire or retain any employee or independent contractor of Buyer, or in any way interfere with the relationship between any Buyer and any of its employees or independent contractors.

(c) **Nondisparagement.** After the Closing Date, Seller will not disparage Buyer or any of Buyer's shareholders, directors, officers, employees or agents.

(d) **Modification of Covenant.** If a final judgment of a court or tribunal of competent jurisdiction determines that any term or provision contained in Section 10.8(a) through (c) is invalid or unenforceable, then the parties agree that the court or tribunal will have the power to reduce the scope, duration, or geographic area of the term or provision, to delete specific words or phrases, or to replace any invalid or unenforceable term or provision with a term or provision that is valid and enforceable and that comes closest to expressing the intention of the invalid or unenforceable term or provision. This Section 10.8 will be enforceable as so modified after the expiration of the time within which the judgment may be appealed. This Section 10.8 is reasonable and necessary to protect and preserve Buyer's legitimate business interests and the value of the Assets and to prevent any unfair advantage being conferred on Seller.

COMMENT

Certain information must be provided to complete Section 10.8, including (1) the duration of the restrictive covenants, (2) the geographic scope of the noncompetition provisions, (3) a description of the Competing Business, and (4) the percentage of securities that the sellers may own of a publicly-traded company that is engaged in a Competing Business. Before designating the temporal and geographic scope of the restrictive covenants, counsel should review applicable state law to determine if there is a statute which dictates or affects the scope of noncompetition provisions in the sale of a business context, and, if not, examine state case law to determine the scope of restrictive covenants that state courts are likely to uphold as reasonable.

Care must be taken in drafting language which relates to the scope of noncompetition provisions. If the duration of the noncompetition covenant is excessive, the geographic scope is greater than the scope of the seller's market, or the definition of "Competing Business" is broader than the Company's product markets, product lines and technology, then the covenant is more likely to be stricken by a court as an unreasonable restraint on competition. Buyer's counsel should be alert to the fact that, in some jurisdictions, courts will not revise overreaching restrictive covenants, but will strike them completely. From the buyer's perspective, the objective is to draft a provision which fully protects the goodwill the buyer is purchasing, but which also has a high likelihood of being enforced. Sometimes this means abandoning a geographic restriction and replacing it with a prohibition on soliciting the Company's customers or suppliers.

The activities which constitute a "Competing Business" are usually crafted to prohibit the sellers from competing in each of the Company's existing lines of business, and in areas of business into which, as of the date of the agreement, the Company has plans to expand. Drafting this language often requires a thorough understanding of the seller's business, including, in some cases, an in-depth understanding of the parties' product lines, markets, technology, and business plans. As a result, drafting this language is frequently a collaborative effort between buyer and its counsel. In some cases, a buyer also will want the sellers to covenant that they will not compete with certain of the buyer's business lines, regardless of whether, on or before the Closing Date, the Company conducted or planned to conduct business in those areas. This construction is likely to be strongly resisted by sellers, who will argue that they are selling goodwill associated only with the Company's business, not other lines of business, and that such a provision would unreasonably prohibit them from earning a living.

Noncompetition provisions should not be intended to prohibit sellers from non-material, passive ownership in an entity which competes with the buyer. As a result, most restrictive covenants provide an exception which permits the sellers to own up to a certain percentage of a publicly-traded company. Often, a buyer's first draft will permit the sellers to own up to 1% of a public company. In any case, a buyer should resist the sellers' attempts to increase the percentage over 5%, the threshold at which beneficial owners of public company stock must file a Schedule 13D or 13G with the SEC. Ownership of more than 5% of a public company's stock increases the likelihood that a party may control the company or be able to change or influence its management, a situation anathema to the intention of the noncompetition covenant. The exception to the noncompetition provision for stock ownership in a public company usually does not include ownership of stock in private, closely-held entities because, since such entities are not SEC reporting entities, it is too difficult to determine whether an investor in such an entity is controlling or influencing the management of such entities.

For a detailed discussion of substantive legal issues involving noncompetition, nonsolicitation and nondisparagement provisions, see the commentary to Section 4 of the Noncompetition, Nondisclosure and Nonsolicitation Agreement.

10.11 FURTHER ASSURANCES

Subject to the proviso in Section 6.1, the parties shall cooperate reasonably with each other and with their respective Representatives in connection with any steps required to be taken as part of their respective obligations under this Agreement, and the parties agree (a) to furnish upon request to each other such further information, (b) to execute and deliver to each other such other documents, and (c) to do such other acts and things, all as the other party may reasonably request for the purpose of carrying out the intent of this Agreement and the Contemplated Transactions.

COMMENT

This Section reflects the obligation, implicit in other areas of the Model Agreement, for the parties to cooperate to fulfill their respective obligations under the agreement and to satisfy the conditions precedent to their respective obligations. The Section would be invoked if one party were, for example, to intentionally fail to undertake actions necessary to fulfill its own conditions to closing and use the failure of those conditions as a pretext for refusing to close.

A further assurances provision is common in acquisition agreements. Often there are permits, licenses, and consents that can be obtained as a routine matter after the execution of the acquisition agreement or after the closing. The further assurances provision assures each party that routine matters will be accomplished and that the other party will not withhold signatures required for transferring assets or consenting to transfers of business licenses in an attempt to extract additional consideration.

In addition to the covenants in Section 10.11, the acquisition agreement may contain covenants that involve matters that cannot be conditions precedent to the closing because of time or other considerations, but that the buyer views as an important part of the acquisition. These additional covenants may arise out of exceptions to the seller's representations noted in the disclosure letter. For example, the seller may covenant to remove a title encumbrance, finalize a legal proceeding, or resolve an environmental problem. Ordinarily there is a value placed upon each post-closing covenant so that if the seller does not perform, the buyer is compensated by an escrow or hold-back arrangement. Post-closing covenants may also include a covenant by the seller to pay certain debts and obligations of the seller to third parties not assumed by the buyer, or deliver promptly to the buyer any cash or other property that the seller may receive after the closing that the acquisition agreement requires them to transfer to the buyer.

Finally, the buyer may want either to include provisions in the acquisition agreement or to enter into a separate agreement with the seller requiring the seller to perform certain services during the transition of ownership of the assets. Such provisions (or such an agreement) typically describe the nature of the seller's services, the amount of time (in hours per week and number of days or weeks) the seller must devote to such services, and the compensation, if any, they will receive for performing such services. Because such arrangements are highly dependent on the circumstances of each acquisition, these provisions are not included in the Model Agreement.

11. INDEMNIFICATION; REMEDIES

COMMENT

Article 11 of the Model Agreement provides for indemnification and other remedies. Generally, the buyer of a privately-held company seeks to impose not only on the seller, but also on its shareholders, financial responsibility for breaches of representations and covenants in the acquisition agreement and for other specified matters that may not be the subject of representations. The conflict between the buyer's desire for that protection and the shareholders' desire not to have continuing responsibility for a business that they no longer own often results in intense negotiations. Thus, there is no such thing as a set of "standard" indemnification provisions. There is, however, a standard set of issues to be dealt with in the indemnification provisions of an acquisition agreement. Article 11 of the Model Agreement addresses these issues in a way that favors the Buyer. The Comments identify areas in which the Seller may propose a different resolution.

The organization of Article 11 of the Model Agreement is as follows. Section 11.1 provides that the parties' representations survive the closing and are thus available as the basis for post-closing monetary remedies. It also attempts to negate defenses based on knowledge and implied waiver. Section 11.2 defines the matters for which the Seller and the Shareholders will have post-closing monetary liability. It is not limited to matters arising from inaccuracies in the Seller's representations. Section 11.3 provides a specific monetary remedy for environmental matters. It is included as an example of a provision that deals specifically with contingencies that may not be adequately covered by the more general indemnification provisions. The types of contingencies that may be covered in this manner vary from transaction to transaction. Section 11.4 defines the matters for which the Buyer will have post-closing monetary liability. In a cash acquisition, the scope of this provision is very limited; indeed, it is often omitted entirely. Sections 11.5 and 11.6 set forth levels of damage for which post-closing monetary remedies are not available. Section 11.7 specifies the time periods during which post-closing monetary remedies may be sought. Section 11.8 provides setoff rights against the promissory note delivered as part of the purchase price as an alternative to claims under the escrow. Section 11.9 provides procedures to be followed for, and in the defense of, third party claims. Section 11.10 provides the procedure for matters not involving third party claims. Section 11.11 provides that the indemnification provided for in Article 11 is applicable notwithstanding the negligence of the indemnitee or the strict liability imposed on the indemnitee.

11.1 SURVIVAL

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

COMMENT

The representations and warranties made by the seller and its shareholders in acquisitions of assets of private companies are typically, although not universally, intended to provide a basis for post-closing liability if they prove to be inaccurate. In acquisitions of assets of public companies without controlling shareholders, the seller's representations typically terminate at the closing and thus serve principally as information gathering mechanisms, closing conditions, and a basis for liability if the closing does not occur (see the introductory Comment to Article 3 under the caption "Purposes of the Seller's Representations"). If the shareholders of a private company selling its assets are numerous and include investors who have not actively participated in the business (such as venture capital investors in a development stage company), they may analogize their situation to that of the shareholders of a public company and argue that their representations should not survive the closing. However, it would be unusual for the shareholders' representations to terminate at the closing in a private sale. If the shareholders are numerous, they can sign a joinder agreement, which avoids having each of them sign the acquisition agreement.

If the seller's representations are intended to provide a basis for post-closing liability, it is common for the acquisition agreement to include an express survival clause (as set forth above) to avoid the possibility that a court might import the real property law principle that obligations merge in the delivery of a deed and hold that the representations merge with the sale of the assets and thus cannot form the basis of a remedy after the closing. *Cf. Business Acquisitions* ch. 31, at 1279-80 (Herz & Baller eds., 2d ed. 1981). A survival clause was construed in *Herring v. Teradyne, Inc*., 242 F. App'x 469, 2007 WL 2034502 (9th Cir. 2007), which stated that its "disposition is not suitable for publication and is not precedent" and reversed *Herring v. Teradyne, Inc.*, 256 F. Supp.2d 1118 (S.D. Cal. 2002). *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 63 Bus. Law. 531, 551-552 (2008). The *Herring* case arose out of a stock-for-stock merger in which Teradyne, a publicly held company, purchased two closely held companies from plaintiffs after an auction. After the merger closed on August 15, 2000, plaintiffs discovered that Teradyne's true performance had been spiraling downward, allegedly contrary to representations in the merger agreement and unknown to plaintiffs. On September 5, 2001, more than a year after closing, plaintiffs filed suit alleging fraud and breach of contract. The breach of contract claims were based primarily on the "no material adverse change" and "no failure to disclose" representations of Teradyne contained in the merger agreement.

Unlike Section 11.1 above from the Model Agreement, which simply provides that "[a]ll representations, warranties, covenants…shall survive the Closing…subject to Section 11.7 [which essentially provides that notice of claims (but not lawsuits thereon) must be given to the other party within the time periods provided therein]," the survival clause in the *Herring* merger agreement read as follows:

> ***11.01 Survival.*** The covenants, agreements, representations and warranties of the parties hereto contained in this Agreement or in any certificate or other writing delivered pursuant hereto or in connection herewith shall survive the Closing until the first anniversary of the Closing Date [except for certain enumerated sections which were to survive either indefinitely, or until the expiration of the applicable statutory period of limitations, or for other periods specified elsewhere in the agreement]. No claim for indemnity under this Agreement with respect to any breach of any representations, warranties and/or covenants of Company and/or Seller shall be made after the applicable period specified in the preceding sentence and all such claims shall be made in accordance with the applicable provisions of the Escrow Agreement. [Emphasis added].

In *Herring*, the defendant buyer contended that the first sentence of the language quoted above created a one-year statute of limitations applicable to contract claims based on the merger agreement and, since plaintiffs did not sue within one year after closing, plaintiffs' claims were barred by the contractual one year limitations period instead of California's four year statute of limitations for contract claims. The plaintiffs argued, in effect, that such a result would require something more explicit, similar to the second sentence, but specifically requiring that indemnification lawsuits must be brought within the survival period set forth in the first sentence. The second sentence limited the period for notifying the other party of a claim, not the period within which a lawsuit would be required to be filed.

In its opinion, after a review of numerous cases and treatises, including Samuel C. Thompson, *Business Planning for Mergers and Acquisitions* 779-80 (2nd ed. 2001), the District Court stated that neither it nor the parties had found binding precedent, but that:

> [T]he treatises presented to the Court indicate that where an agreement does not provide that representations and warranties survive the closing, they extinguish on the closing date.... It follows then that where an agreement provides that representations and warranties "survive", a party can sue for breaches of the representations and warranties, but only during the time period the contract states those representations and warranties survive. Therefore, if they survive indefinitely, then the state's four-year statute of limitations would apply from the date of the breach. But if [they] survive for a fixed period of time, it follows that once that time period has elapsed, a party cannot sue for breach of the representations and warranties, absent circumstances surrounding the negotiations that would counsel against such an interpretation....

The Ninth Circuit's July l3, 2007 opinion, in reversing the District Court and in effect holding that California's four year statute of limitations for contract claims controlled, explained:

> Parties may contractually reduce the statute of limitations, but any reduction is construed with strictness against the party seeking to enforce it. Here, we find no clear and unequivocal language in the survival clauses that permits the conclusion that the parties have unambiguously expressed a desire to reduce the statute of limitations.

The *Herring* saga was replicated in *Western Filter Corporation v. Argan, Inc.*, 2008 U.S. App. LEXIS 18147 (9th Cir. August 25, 2008), in which the Ninth Circuit had to decide whether a provision within a stock purchase agreement providing that the representations and warranties of the parties survive closing for one year also served as a contractual statute of limitation that reduced a longer period otherwise provided by California law. The Court held that the stock purchase agreement's one-year survival period served only to specify when a breach of the representations and warranties could occur, but not when an action had to be filed.

The portion of the stock purchase agreement at issue (the "*Survival Clause*") provided that "[t]he representations and warranties of [buyer] and [seller] in this Agreement shall survive the Closing for a period of one year, except the representations and warranties contained in Section 3.1(a), (b), (c), and (f) and 3.2(a) and (b) shall survive indefinitely."

After closing, the buyer found that the target's inventory was worth significantly less than what seller represented. Less than one year after closing, buyer sent written notice to seller, claiming that "the management of [seller and the target] grossly misrepresented the financial condition of [the target]." About 1½ years after the closing, the buyer filed suit against seller and its officers for breach of contract, intentional misrepresentation, concealment and nondisclosure, negligent misrepresentation, false promise, negligence, and declaratory relief.

The trial court granted seller's motion for summary judgment, concluding that buyer's claims were barred by the one-year limitation set forth in the Survival Clause, accepting and adopting the trial court's decision in *Herring*.

On appeal buyer argued that the Survival Clause's one-year limitation serves only to set forth the time period for which a breach may occur or be discovered, whereas seller maintained that the Survival Clause serves as a contractual limitation on the applicable statute of limitation. In accepting buyer's position and reversing the trial court, the Ninth Circuit wrote:

> Both parties agree that without the Survival Clause the representations and warranties would have terminated at the time of closing. "[R]epresentations and warranties are statements of fact as of the date of the execution of the acquisition agreement, and the truthfulness of the representations and warranties as of both the date of execution and, when appropriate, the date of the closing is generally a condition to the closing." Samuel C. Thompson, Jr., *Business Planning for Mergers and Acquisitions* 780 (Carolina Academic Press 2001) (1997). In other words, the representations and warranties serve as a safety net for the seller and buyer. If, prior to closing, either the seller or buyer discovers that a representation or warranty made by the other party is not true, they have grounds for backing out of the deal. *See id.* ("If prior to closing a party discovers that a representation or warranty is materially inaccurate, the party can refuse to close and possibly sue for damages.").
>
> The closing date itself triggers the contractual limitation on liability. Unless the parties agree to a survival clause--extending the representations and warranties past the closing date--the breaching party cannot be sued for damages post-closing for their later discovered breach. With that premise in

> mind, [seller] reasonably argues that the one-year limitation in the Survival Clause was intended to serve as a contractual time limit on any action brought based on a breach of the contract's representations and warranties. Under [seller's] theory, [buyer] could not bring a claim without the Survival Clause, and, even with the Survival Clause, [buyer] only had one year after closing to bring such a claim.
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> * * *
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> Although [seller's] interpretation is reasonable--and ultimately may be more practical--the Survival Clause can also be reasonably read as [buyer] suggests: that the one-year limitation serves only to specify when a breach of the representations and warranties may occur, but not when an action must be filed. [Buyer's] interpretation becomes even more reasonable in light of California's policy of strictly construing any contractual limitation against the party seeking to invoke the time limitation. * * * Because the language of the Survival Clause is ambiguous, the district court erred in holding that the clause created a limitation period. Accordingly, we reverse the summary judgment entered by the district court.

Some state statutes limit the ability of parties by contract to limit the applicable statutory statute of limitations. *See, e.g., Tex. Civ. Practices & Remedies Code* § 16.070 (2008) ("[A] person may not enter into a stipulation…or agreement that purports to limit the time in which to bring suit [thereon] to a period shorter than two years [and one that does] is void in this state"; provided that the foregoing "does not apply to a stipulation…or agreement relating to the sale or purchase of a business entity if a party [thereto] pays or receives or is obligated to pay or entitled to receive consideration [thereunder] having an aggregate value of not less than $500,000.")

Even in the relatively rare cases in which the shareholders of a private company selling its assets are able to negotiate the absence of contractual post-closing remedies based on their representations, they may still be subject to post-closing liability based on those representations under principles of common law fraud.

Section 11.1 provides that knowledge of an inaccuracy by the indemnified party is not a defense to the claim for indemnity, which permits the buyer to assert an indemnification claim not only for inaccuracies first discovered after the closing, but also for inaccuracies disclosed or discovered before the closing. This approach is often the subject of considerable debate. A seller may argue that the buyer should be required to disclose a known breach of the seller's representations before the closing, and waive it, renegotiate the purchase price or refuse to close. The buyer may respond that it is entitled to rely on the representations made when the acquisition agreement was signed — which presumably entered into the buyer's determination of the price that it is willing to pay — and that the seller should not be able to limit the buyer's options to waiving the breach or terminating the acquisition. The buyer can argue that it has purchased the representations and the related right to indemnification and is entitled to a purchase price adjustment for an inaccuracy in those representations, regardless of the buyer's knowledge. In addition, the buyer can argue that any recognition of a defense based on the buyer's knowledge could convert each claim for indemnification into an extensive discovery inquiry into the state of the buyer's knowledge. *See generally* Committee on Negotiated Acquisitions, *Purchasing the Stock of a*

Privately Held Company: The Legal Effect of an Acquisition Review, 51 Bus. Law. 479 (1996).

If the buyer is willing to accept some limitation on its entitlement to indemnification based on its knowledge, it should carefully define the circumstances in which knowledge is to have this effect. For example, the acquisition agreement could distinguish between knowledge that the buyer had before signing the acquisition agreement, knowledge acquired through the buyer's pre-closing investigation, and knowledge resulting from the seller's pre-closing disclosures, and could limit the class of persons within the buyer's organization whose knowledge is relevant (for example, the actual personal knowledge of named officers). An aggressive seller may request a contractual provision requiring that the buyer disclose its discovery of an inaccuracy immediately and elect at that time to waive the inaccuracy or terminate the acquisition agreement, or an "anti-sandbagging" provision precluding an indemnity claim for breaches known to the buyer before closing. An example of such a provision follows:

> [Except as set forth in a Certificate to be delivered by Buyer at the Closing,] to the Knowledge of Buyer, Buyer is not aware of any facts or circumstances that would serve as the basis for a claim by Buyer against Seller or any Shareholder based upon a breach of any of the representations and warranties of Seller and Shareholders contained in this Agreement [or breach of any of Seller's or any Shareholders' covenants or agreements to be performed by any of them at or prior to Closing]. Buyer shall be deemed to have waived in full any breach of any of Seller's and Shareholders' representations and warranties [and any such covenants and agreements] of which Buyer has such awareness [to its Knowledge] at the Closing.

A buyer should be wary of such a provision, which may prevent it from making its decision on the basis of the cumulative effect of all inaccuracies discovered before the closing. The buyer should also recognize the problems an "anti-sandbagging" provision presents with respect to the definition of "Knowledge". See the Comment to that definition in Section 1.1.

The buyer's ability to assert a fraud claim after the closing may be adversely affected if the buyer discovers an inaccuracy before the closing but fails to disclose the inaccuracy to the seller until after the closing. In such a case, the seller may assert that the buyer did not rely on the representation, or that its claim is barred by waiver or estoppel.

The doctrine of substituted performance can come into play when both parties recognize before the closing that the seller and the shareholders cannot fully perform their obligations. If the seller and the shareholders offer to perform, albeit imperfectly, can the buyer accept without waiving its right to sue on the breach? The common law has long been that if a breaching party expressly conditions its substitute performance on such a waiver, the non-breaching party may not accept the substitute performance, even with an express reservation of rights, and also retain its right to sue under the original contract. *See United States v. Lamont*, 155 U.S. 303, 309-10 (1894); *Restatement, (Second) of Contracts* §278, comment a. Thus, if the seller offers to close on the condition that the buyer waive its right to sue on the breach, under the common law the buyer must choose whether to close or to sue, but cannot close and sue. Although the acquisition agreement may contain an express reservation of the buyer's right to close and sue, it is unclear whether courts will respect such a provision and allow the buyer to close and sue for indemnification.

The survival of an indemnification claim after the buyer's discovery during pre-closing investigations of a possible inaccuracy in the seller's representations was the issue in *CBS, Inc. v. Ziff-Davis Publishing Co.*, 553 N.E.2d 997 (N.Y. 1990). The buyer of a business advised the seller before the closing of facts that had come to the buyer's attention and, in the buyer's judgment, constituted a breach of a warranty. The seller denied the existence of a breach and insisted on closing. The buyer asserted that closing on its part with this knowledge would not constitute a waiver of its rights. After the closing, the buyer sued the seller on the alleged breach of warranty. The New York Court of Appeals held that, in contrast to a tort action based on fraud or misrepresentation, which requires the plaintiff's belief in the truth of the information warranted, the critical question in a contractual claim based on an express warranty is "whether [the buyer] believed [it] was purchasing the [seller's] promise as to its truth." The Court stated:

> The express warranty is as much a part of the contract as any other term. Once the express warranty is shown to have been relied on as part of the contract, the right to be indemnified in damages for its breach does not depend on proof that the buyer thereafter believed that the assurances of fact made in the warranty would be fulfilled. The right to indemnification depends only on establishing that the warranty was breached.

Id. at 1001 (citations omitted).

Although the *Ziff-Davis* opinion was unequivocal, the unusual facts of this case (a pre-closing assertion of a breach of warranty by the buyer and the seller's threat to litigate if the buyer refused to close), the contrary views of the lower courts, and a vigorous dissent in the Court of Appeals all suggest that the issue should not be regarded as completely settled. A decision of the U.S. Court of Appeals for the Second Circuit (applying New York law) increased the uncertainty by construing *Ziff-Davis* as limited to cases in which the seller does not acknowledge any breach at the closing and, thus, as inapplicable to situations in which the sellers disclose an inaccuracy in a representation before the closing. *See Galli v. Metz*, 973 F.2d 145, 150-51 (2d Cir. 1992). The *Galli* court explained:

> In *Ziff-Davis*, there was a dispute at the time of closing as to the accuracy of particular warranties. *Ziff-Davis* has far less force where the parties agree at closing that certain warranties are not accurate. Where a buyer closes on a contract in the full knowledge and acceptance of facts disclosed by the seller which would constitute a breach of warranty under the terms of the contract, the buyer should be foreclosed from later asserting the breach. In that situation, unless the buyer expressly preserves his rights (as CBS did in *Ziff-Davis*), we think the buyer has waived the breach.

Id.

It is not apparent from the *Galli* opinion whether the agreement in question contained a provision similar to Section 11.1 purporting to avoid such a waiver; under an agreement containing such a provision, the buyer could attempt to distinguish *Galli* on that basis. It is also unclear whether *Galli* would apply to a situation in which the disclosed inaccuracy was not (or was not agreed to be) sufficiently material to excuse the buyer from completing the acquisition (see Section 7.1 and the related Comment).

The Eighth Circuit seems to agree with the dissent in *Ziff-Davis* and holds, in essence, that if the buyer acquires knowledge of a breach from any source (not just the seller's acknowledgment of the breach) before the closing, the buyer waives its right to sue. *See Hendricks v. Callahan*, 972 F.2d 190, 195-96 (8th Cir. 1992) (applying Minnesota law and holding that a buyer's personal knowledge of an outstanding lien defeats a claim under either a property title warranty or a financial statement warranty even though the lien was not specifically disclosed or otherwise exempted).

The conflict between the *Ziff-Davis* approach and the *Hendricks* approach has been resolved in subsequent decisions under Connecticut, Delaware, Missouri, New York and Pennsylvania law in favor of the concept that an express warranty in an acquisition agreement is now grounded in contract, rather than in tort, and that the parties should be entitled to the benefit of their bargain expressed in the purchase agreement. In *Pegasus Management Co., Inc. v. Lyssa, Inc.*, 995 F. Supp. 43 (D. Mass. 1998), the court followed *Ziff-Davis* and held that Connecticut law does not require a claimant to demonstrate reliance on express warranties in a purchase agreement in order to recover on its warranty indemnity claims, commenting that under Connecticut law indemnity clauses are given their plain meaning, even if the meaning is very broad. The court further held that the claimant did not waive its rights to the benefits of the express warranties where the purchase agreement provided that "[e]very . . . warranty . . . set forth in this Agreement and . . . the rights and remedies . . . for any one or more breaches of this Agreement by the Sellers shall . . . not be deemed waived by the Closing and shall be effective regardless of . . . any prior knowledge by or on the part of the Purchaser." Similarly in *American Family Brands, Inc. v. Giuffrida Enterprises, Inc.*, 1998 1998 WL 196402 (E.D. Pa. Apr. 23, 1998), the court, following Pennsylvania law and asset purchase agreement sections providing that "[a]ll of the representations . . . shall survive the execution and delivery of this Agreement and the consummation of the transactions contemplated hereunder" and "no waiver of the provisions hereof shall be effective unless in writing and signed by the party to be charged with such waiver," sustained a claim for breach of a seller's representation that there had been no material adverse change in seller's earnings, etc. even though the seller had delivered to the buyer interim financial statements showing a significant drop in earnings. *Id.* at *6. Further, in *Schwan-Stabilo Cosmetics GmbH & Co. v. PacificLink International Corporation*, 401 F.3d 28 (2d Cir. 2005), the Second Circuit upheld a lower court determination that the acquirer was entitled to indemnification under a stock-purchase agreement, despite the acquiror's pre-closing knowledge of the liabilities for which indemnification was sought and cited *Ziff-Davis* favorably; and again in *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 500 F.3d 188 (2d Cir. 2007) the Second Circuit cited *Ziff-Davis* in holding:

> Under New York law, an express warranty is part and parcel of the contract containing it and an action for its breach is grounded in contract. *See CBS, Inc. v. Ziff-Davis Publ'g Co.*, 75 NY2d 496, 503 (1990). A party injured by breach of contract is entitled to be placed in the position it would have occupied had the contract been fulfilled according to its terms.
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> In contrast to the reliance required to make out a claim for fraud, the general rule is that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue. [Citations omitted] This rule is subject to an important condition. The plaintiff must show that it believed that it was purchasing seller's promise regarding the

> truth of the warranted facts. [Citation omitted] We have held that where the seller has disclosed at the outset facts that would constitute a breach of warranty, that is to say, the inaccuracy of certain warranties, and the buyer closes with full knowledge and acceptance of those inaccuracies, the buyer cannot later be said to believe he was purchasing the seller's promise respecting the truth of the warranties. [Citations omitted]

See Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 61 Bus. Law. 987, 1002 (2006). In 2007 there were two additional cases following the *Ziff-Davis* approach: (i) *Power Soak Systems, Inc. v. Emco Holdings, Inc.*, 482 F. Supp 2d 1125 (W.D. Mo. March 20, 2007) ("The key question is not 'whether the buyer believed in the truth of the warranted information … but whether it believed it was purchasing the promise as to its truth'"); (ii) *Cobalt Operating, LLC v. James Crystal Enterprises LLC* (Del. Ch. No. 714 VCS July 20, 2007) (the Cobalt decision involved indemnification claims based on breaches of representations in an asset purchase agreement as to financial statements, conduct of business and no untrue material information provided; in holding for the plaintiff buyer as to the claims for indemnification under the purchase agreement, Delaware Vice Chancellor Leo Strine rejected defendant's "sandbagging" contention that buyer's preclosing due diligence had surfaced the facts that buyer initially discounted as immaterial discrepancies and later made a central part of its lawsuit evidence, which plaintiff contended thereby precluded plaintiff from suing on those facts and held that a breach of a contractual representation claim is not dependant on a showing of justifiable reliance, noting that the purchase agreement expressly provided that no inspection, etc. shall affect seller's representations: "[h]aving contractually promised [buyer] that it could rely on certain representations, [seller] is in no position to contend that [buyer] was unreasonable in relying on [seller's] own binding words"). *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 63 Bus. Law. 531, 546-547 (2008).

Given the holdings of *Galli* and *Hendricks* and notwithstanding the trend of more recent cases to follow the *Ziff-Davis* approach, uncertainties remain as to the effect of the survival and non-waiver language in Section 11.1. Section 11.1 protects the Buyer if, in the face of a known dispute, the Seller and the Shareholders close believing or asserting that they are offering full performance under the acquisition agreement when, as adjudged later, they have not. However, reliance on Section 11.1 may be risky in cases in which there is no dispute over the inaccuracy of a representation. A Buyer that proceeds with the closing and later sues for indemnification can expect to be met with a defense based upon waiver and nonreliance with an uncertain outcome.

There does not appear to be any legitimate policy served by refusing to give effect to an acquisition agreement provision that the buyer is entitled to rely on its right to indemnification and reimbursement based on the seller's representations even if the buyer learns that they are inaccurate before the closing. Representations are often viewed by the parties as a risk allocation and price adjustment mechanism, not necessarily as assurances regarding the accuracy of the facts that they state, and should be given effect as such. *Galli* should be limited to situations in which the agreement is ambiguous with respect to the effect of the buyer's knowledge.

11.2 INDEMNIFICATION AND REIMBURSEMENT BY SELLER AND SHAREHOLDERS

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

(a) any Breach of any representation or warranty made by Seller or either Shareholder in (i) this Agreement (without giving effect to any supplement to the Disclosure Letter), (ii) the Disclosure Letter, (iii) the supplements to the Disclosure Letter, (iv) the certificates delivered pursuant to Section 2.7 (for this purpose, each such certificate will be deemed to have stated that Seller's and Shareholders' representations and warranties in this Agreement fulfill the requirements of Section 7.1 as of the Closing Date as if made on the Closing Date without giving effect to any supplement to the Disclosure Letter, unless the certificate expressly states that the matters disclosed in a supplement have caused a condition specified in Section 7.1 not to be satisfied), (v) any transfer instrument or (vi) any other certificate, document, writing or instrument delivered by Seller or either Shareholder pursuant to this Agreement;

(b) any Breach of any covenant or obligation of Seller or either Shareholder in this Agreement or in any other certificate, document, writing or instrument delivered by Seller or either Shareholder pursuant to this Agreement;

(c) any Liability arising out of the ownership or operation of the Assets prior to the Effective Time other than the Assumed Liabilities;

(d) any brokerage or finder's fees or commissions or similar payments based upon any agreement or understanding made, or alleged to have been made, by any Person with Seller or either Shareholder (or any Person acting on their behalf) in connection with any of the Contemplated Transactions;

(e) any product or component thereof manufactured by or shipped, or any services provided by, Seller, in whole or in part, prior to the Closing Date;

(f) any matter disclosed in Parts _____ of the Disclosure Letter;

(g) any noncompliance with any Bulk Sales Laws or fraudulent transfer law in respect of the Contemplated Transactions;

(h) any liability under the WARN Act or any similar state or local Legal Requirement that may result from an "**Employment Loss"**, as defined by 29 U.S.C. § 2101(a)(6), caused by any action of Seller prior to the Closing or by Buyer's decision not to hire previous employees of Seller;

(i) any Employee Plan established or maintained by Seller; or

(j) any Retained Liabilities.

COMMENT

Although the inaccuracy of a representation that survives the closing may give rise to a claim for damages for breach of the acquisition agreement without any express indemnification provision, it is customary in the acquisition of assets of a privately held company for the buyer to be given a clearly specified right of indemnification for breaches of representations, warranties, covenants, and obligations and for certain other liabilities. Although customary in concept, the scope and details of the indemnification provisions are often the subject of intense negotiation.

Indemnification provisions should be carefully tailored to the type and structure of the acquisition, the identity of the parties, and the specific business risks associated with the seller. The Model Agreement indemnification provisions may require significant adjustment before being applied to a merger or stock purchase, because the transfer of liabilities by operation of law in each case is different. Other adjustments may be required for a purchase from a consolidated group of companies, a foreign corporation, or a joint venture, because in each case there may be different risks and difficulties in obtaining indemnification. Still other adjustments will be required to address risks associated with the nature of the seller's business and its past manner of operation.

Certain business risks and liabilities are not covered by traditional representations and may be covered by specific indemnification provisions (see, for example, subsections (c) through (i)). Similar provision may also be made for liability resulting from a pending and disclosed lawsuit against the Seller which is not an assumed liability. See also the discussion concerning WARN Act liabilities in the Comment to Section 10.1.

In the absence of explicit provision to the contrary, the buyer's remedies for inaccuracies in the seller's and the shareholders' representations may not be limited to those provided by the indemnification provisions. The buyer may also have causes of action based on breach of contract, fraud and misrepresentation, and other federal and state statutory claims, until the expiration of the applicable statute of limitations. The seller, therefore, may want to add a clause providing that the indemnification provisions are the sole remedy for any claims relating to the sale of the assets. This clause could also limit the parties' rights to monetary damages only, at least after the closing. (See Section 13.5 with respect to equitable remedies for enforcement of the Model Agreement and the first sentence of Section 13.6 relating to cumulative remedies.) In some cases, the seller may prefer not to raise the issue and instead to rely on the limitations on when claims may be asserted (Section 11.7) and the deductible or "basket" provisions (Sections 11.5 and 11.6) as evidence of an intention to make the indemnification provisions the parties' exclusive remedy. The Model Agreement does not state that indemnification is the exclusive remedy, and these limitations expressly apply to liability "for indemnification or otherwise", indicating a contrary intention of the parties.

The scope of the indemnification provisions is important. A buyer generally will want the indemnification provisions to cover breaches of representations in the disclosure letter, any supplements to the disclosure letter, and any other certificates delivered pursuant to the acquisition agreement, but may not want the indemnification provisions to cover breaches of noncompetition agreements, ancillary service agreements, and similar agreements related to the acquisition, for which there would normally be separate breach of contract remedies, separate limitations (if any) regarding timing and amounts of any claims for damages, and perhaps equitable remedies.

The Model Agreement provides for indemnification for any inaccuracy in the documents delivered pursuant to the acquisition agreement. Broadly interpreted, this could apply to any documents reviewed by the buyer during its due diligence investigation. The buyer may believe that it is entitled to this degree of protection, but the seller can argue that (a) if the buyer wants to be assured of a given fact, that fact should be included in the representations in the acquisition agreement, and (b) to demand that all documents provided by the seller be factually accurate, or to require the seller to correct inaccuracies in them, places unrealistic demands on the seller and would needlessly hamper the due diligence process. As an alternative, the seller and its shareholders may represent that they are not aware of any material inaccuracies or omissions in certain specified documents reviewed by the buyer during the due diligence process.

Section 11.2(a)(i) provides for indemnification for any breach of the Seller's and the Shareholders' representations in the acquisition agreement and the Disclosure Letter as of the date of signing. A seller may seek to exclude from the indemnity a breach of the representations in the original acquisition agreement if the breach is disclosed by amendments to the disclosure letter before the closing. This provides an incentive for the seller to update the disclosure letter carefully, although it also limits the buyer's remedy to refusing to complete the acquisition if a material breach of the original representations is discovered and disclosed by the Seller. For a discussion of related issues, see the Comment to Section 11.1.

Section 11.2(a)(iv) also provides for indemnification for an undisclosed breach of the Seller's representations as of the closing date through the reference in subsection (a) to the closing certificate required by Section 2.7. This represents customary practice. However, the Model Agreement departs from customary practice by providing that, if a certificate delivered at Closing by the Seller or a Shareholder discloses inaccuracies in the Seller's representations as of the closing date, this disclosure will be disregarded for purposes of an indemnification claim under Section 11.2(a)(iv) (that is, the Seller and the Shareholders will still be subject to indemnification liability for such inaccuracies) unless the Seller states in the certificates delivered pursuant to Section 2.7 that these inaccuracies resulted in failure of the condition set forth in Section 7.1, thus permitting the Buyer to elect not to close. Although unusual, this structure is designed to protect the Buyer from changes that occur after the execution of the acquisition agreement and before the closing that are disclosed before the closing. The provision places an additional burden upon the Seller to expressly state in writing that due to inaccuracies in its representations and warranties as of the closing date, Buyer has no obligation to close the transaction. Only if the Buyer elects to close after such statement is made in the certificate, will the Buyer lose its right to indemnification for damages resulting from such inaccuracies. Such disclosure, however, would not affect the Buyer's indemnification rights to the extent that the representations and warranties were also breached as of the signing date.

Sections 11.2(c) – (j) are intended to be standalone provisions that allocate the specified risks independently of any allocation in the representations and warranties or in the covenants stated elsewhere in the Model Agreement. Thus, Seller could be obligated to indemnify Buyer under Section 11.2(c) – (j) irrespective of whether the claim could be based a breach of a representation or warranty in Article III or any of Seller's promises elsewhere in the agreement. This is significant because the limitation on Seller's indemnification obligations in Section 11.5 references only Section 11.2(a) and thus is only applicable to breeches of representations. This significance is increased by *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.3d 1032 (Del. Ch. 2006), which held that a seller cannot limit its liability for knowing breaches of its representations and warranties in a stock purchase agreement. In *ABRY*, the Court held that a seller cannot protect itself from the possibility that the sale could be rescinded if the buyer can show that either (1) the seller knew the contractual representations and warranties were false, or (2) the seller lied to the buyer about a contractual representation or warranty; but, conversely, the seller will be protected – and the buyer will not be permitted to seek rescission- if the buyer's claim is premised on intentional misrepresentation by the seller as to matters that the buyer expressly agreed to leave outside of the scope of the representations and warranties written into the agreement. See Comments to Sections 11.5 and 11.7 *infra* and the discussion of *ABRY Partners V, L.P. v. F&W Acquisition LLC* in Appendix E.

The suggestion in *The Hartz Consumer Group v. JWC Hartz Holdings, Inc.*, New York Law Journal Vol. 234 (New York County Supreme Court, November 18, 2005) (appeal pending), that a provision in the Model Stock Purchase Agreement comparable Section 11.2(e) is not a standalone provision that allocates the specified risks independently of any breech of the representations and warranties is incorrect, represents a misreading of the ABA Model Stock Purchase Agreement, and should not be authoritative in respect of Section 11.2 of the Model Agreement or otherwise.

Section 11.2(c) provides that Buyer will be indemnified for "any Liability arising out of the ownership or operation of the [purchased] Assets prior to the Effective Time other than Assumed Liabilities." In *Honeywell International, Inc. v. Phillips Petroleum Co.*, 415 F.3d 429 (5th Cir. 2005), the Fifth Circuit held that such a provision did not obligate buyer to indemnify seller for liabilities related to assets of the sold business that had been previously sold to a third party as the liabilities did not relate to assets transferred in the transaction to which the indemnification related.

Section 11.2 provides for joint and several liability, which the buyer will typically request and the seller, seeking to limit the exposure of its shareholders to several liability (usually in proportion to each shareholder's percentage ownership), may oppose. Occasionally, different liability will be imposed on different shareholders, depending on the representations at issue, and the seller itself will almost always be jointly and severally liable to the buyer without any such limitation. The shareholders may separately agree to allocate responsibility among themselves in a manner different from that provided in the acquisition agreement (for example, a shareholder who has been active in the business may be willing to accept a greater share of the liability than one who has not).

Factors of creditworthiness may influence the buyer in selecting the persons from whom to seek indemnity. For example, a seller would not be creditworthy after the closing if it were likely to distribute its net assets to its shareholders as soon as practicable thereafter. If the seller is part of a consolidated group of companies, it may request that the indemnity be limited to, and the buyer may be satisfied with an indemnity from, a single member of the seller's consolidated group (often the ultimate parent), as long as the buyer is reasonably comfortable with the credit of the indemnitor. In other circumstances, the buyer may seek an indemnity (or guaranty of an indemnity) from an affiliate (for example, an individual who is the sole shareholder of a thinly capitalized holding company). For other ways of dealing with an indemnitor whose credit is questionable, see the Comment to Section 11.8.

The persons indemnified may include virtually everyone on the buyer's side of the acquisition, including directors, officers, and shareholders who may become defendants in litigation involving the acquired business or the assets or who may suffer a loss resulting from their association with problems at the acquired business. It may be appropriate to include fiduciaries of the buyer's employee benefit plans if such plans have played a role in the acquisition, such as when an employee stock ownership plan participates in a leveraged buyout. These persons are not, however, expressly made third-party beneficiaries of the indemnification provisions, which may therefore be read as giving the buyer a contractual right to cause the seller to indemnify such persons, and Section 13.9 provides that no third-party rights are created by the acquisition agreement. Creation of third-party beneficiary status may prevent the buyer from amending the indemnification provisions or compromising claims for indemnification without obtaining the consent of the third-party beneficiaries.

The scope of damage awards is a matter of state law. The definition of "Damages" in the Model Agreement is very broad and includes, among other things, "diminution of value" and other losses unrelated to third-party claims. Moreover, the definition of "Damages" does not exclude incidental, consequential or punitive damages, thereby reserving to the buyer a claim for these damages in an indemnification dispute. A seller may seek to narrow the definition. *See* Glenn D. West and Sara G. Duran, *Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements*, 63 Bus. Law. 777 (May 2008).

The common law definition of the term "indemnification" describes a restitutionary cause of action in which a plaintiff sues a defendant for reimbursement of payments made by the plaintiff to a third party. A court may hold, therefore, that a drafter's unadorned use of the term "indemnification" (usually coupled with "and hold harmless") refers only to compensation for losses due to third-party claims. *See Pacific Gas & Electric Co. v. G. W. Thomas Drayage & Rigging Co.*, 442 P.2d 641, 646 n.9 (Cal. 1968) (indemnity clause in a contract ambiguous on the issue; failure to admit extrinsic evidence on the point was error); *see also Mesa Sand & Gravel Co. v. Landfill, Inc.*, 759 P.2d 757, 760 (Colo. Ct. App. 1988), *rev'd in part on other grounds*, 776 P.2d 362 (Colo. 1989) (indemnification clause covers only payments made to third parties). *But see Atari Corp. v. Ernst & Whinney*, 981 F.2d 1025, 1031 (9th Cir. 1992) (limiting *Pacific Gas & Electric* and relying on Black's Law Dictionary; the term "indemnification" is not limited to repayment of amounts expended on third party claims); *Edward E. Gillen Co. v. United States*, 825 F.2d 1155, 1157 (7th Cir. 1987) (same). Modern usage and practice have redefined the term "indemnification" in the acquisition context to refer to compensation for all losses and expenses, from any source, caused by a breach of the acquisition agreement (or other specified events). The courts presumably will respect express contract language that incorporates the broader meaning. In Section 11.2 of the Model Agreement, the express language that a third-party claim is not required makes the parties' intent unequivocally clear that compensable damages may exist absent a third-party claim and if no payment has been made by the Buyer to any person.

The amount to be indemnified is generally the dollar value of the out-of-pocket payment or loss. That amount may not fully compensate the buyer, however, if the loss relates to an item that was the basis of a pricing multiple. For example, if the buyer agreed to pay $10,000,000, which represented five times earnings, but it was discovered after the closing that annual earnings were overstated by $200,000 because inventories were overstated by that amount, indemnification of $200,000 for the inventory shortage would not reimburse the buyer fully for its $1,000,000 overpayment. The acquisition agreement could specify the basis for the calculation of the purchase price (which may be hotly contested by the seller) and provide specifically for indemnification for overpayments based on that pricing methodology. The buyer should proceed cautiously in this area, since the corollary to the argument that it is entitled to indemnification based on a multiple of earnings is that any matter that affects the balance sheet but not the earnings statement (for example, fixed asset valuation) should not be indemnified at all. Furthermore, raising the subject in negotiations may lead to an express provision excluding the possibility of determining damages on this basis. The inclusion of diminution of value as an element of damages gives the buyer flexibility to seek recovery on this basis without an express statement of its pricing methodology.

The seller often argues that the appropriate measure of damages is the amount of the buyer's out-of-pocket payment, less any tax benefit that the buyer receives as a result of the loss, liability, or expense. If this approach is accepted, the logical extension is to include in the measure of damages the tax cost to the buyer of receiving the indemnification payment (including tax costs resulting from a reduction in basis, and the resulting reduction in depreciation and amortization or increase in gain recognized on a sale, if the indemnification payment is treated as an adjustment of purchase price). The resulting provisions, and the impact on the buyer's administration of its tax affairs, are highly complex and the entire issue of adjustment for tax benefits and costs is often omitted to avoid this complexity. The seller may also insist that the acquisition agreement explicitly state that damages will be net of any insurance proceeds or payments from any other responsible parties. If the buyer is willing to accept such a limitation, it should be careful to ensure that it is compensated for any cost it incurs due to insurance or other third-party recoveries, including those that may result from retrospective premium adjustments, experience-based premium adjustments, and indemnification obligations.

An aggressive seller may also seek to reduce the damages to which the buyer is entitled by any so-called "found assets" (assets of the seller not reflected on its financial statements). The problems inherent in valuing such assets and in determining whether they add to the value to the seller in a way not already taken into account in the purchase price lead most buyers to reject any such proposal.

Occasionally, a buyer insists that damages include interest from the date the buyer first is required to pay any expense through the date the indemnification payment is received. Such a provision may be appropriate if the buyer expects to incur substantial expenses before the buyer's right to indemnification has been established, and also lessens the seller's incentive to dispute the claim for purposes of delay.

If the acquisition agreement contains post-closing adjustment mechanisms, the seller should ensure that the indemnification provisions do not require the seller and the shareholders to compensate the buyer for matters already rectified in the post-closing adjustment process. This can be done by providing that the damages subject to indemnification shall be reduced by the amount of any corresponding post-closing purchase price reduction.

Generally, indemnification is not available for claims made that later prove to be groundless. Thus, the buyer could incur substantial expenses in investigating and litigating a claim without being able to obtain indemnification. In this respect, the indemnification provisions of the Model Agreement, and most acquisition agreements, provide less protection than indemnities given in other situations such as securities underwriting agreements.

One method of providing additional, if desired, protection for the buyer would be to insert "defend," immediately before "indemnify" in the first line of Section 11.2. Some attorneys would also include any allegation, for example, of a breach of a representation as a basis for invoking the seller's indemnification obligations. Note the use of "alleged" in Section 11.2(d). "Defend" has not been included in the first line of Section 11.2 for several reasons: (i) Sections 11.2, 11.3 and 11.4 address the monetary allocation of risk; (ii) Section 11.9 deals specifically with the procedures for handling the defense of Third Party Claims; and (iii) perhaps most importantly, the buyer does not always want the seller to be responsible for the actual defense of a third party claim, as distinguished from the issue of who bears the cost of defense. Note that Section 11.10 provides that a claim for indemnification not involving a third party claim must be paid promptly by the party from whom indemnification is sought.

11.3 INDEMNIFICATION AND REIMBURSEMENT BY SELLER — ENVIRONMENTAL MATTERS

In addition to the other indemnification provisions in this Article 11, Seller and each Shareholder, jointly and severally, will indemnify and hold harmless Buyer and the other Buyer Indemnified Persons, and will reimburse Buyer and the other Buyer Indemnified Persons, for any Damages (including costs of cleanup, containment, or other remediation) arising from or in connection with:

(a) any Environmental, Health and Safety Liabilities arising out of or relating to: (i) the ownership or operation by any Person at any time on or prior to the Closing Date of any of the Facilities, Assets, or the business of Seller, or (ii) any Hazardous Materials or other contaminants that were present on the Facilities or Assets at any time on or prior to the Closing Date; or

(b) any bodily injury (including illness, disability and death, and regardless of when any such bodily injury occurred, was incurred, or manifested itself), personal injury, property damage (including trespass, nuisance, wrongful eviction, and deprivation of the use of real property), or other damage of or to any Person or any Assets in any way arising from or allegedly arising from any Hazardous Activity conducted by any Person with respect to the business of Seller or the Assets prior to the Closing Date, or from any Hazardous Material that was (i) present or suspected to be present on or before the Closing Date on or at the Facilities (or present or suspected to be present on any other property, if such Hazardous Material emanated or allegedly emanated from any Facility and was present or suspected to be present on any Facility on or prior to the Closing Date) or Released or allegedly Released by any Person on or at any Facilities or Assets at any time on or prior to the Closing Date.

Buyer will be entitled to control any Remedial Action, any Proceeding relating to an Environmental Claim, and, except as provided in the following sentence, any other Proceeding with respect to which indemnity may be sought under this Section 11.3. The procedure described in Section 11.9 will apply to any claim solely for monetary damages relating to a matter covered by this Section 11.3.

COMMENT

It is not unusual for an asset purchase agreement to contain indemnities for specific matters that are disclosed by the seller and, therefore, would not be covered by an indemnification limited to breaches of representations (such as a disclosed pending litigation) or that represent an allocation of risks for matters not known to either party. The Section 11.3 provision for indemnification for environmental matters is an example of this type of indemnity, and supplements and overlaps the indemnification provided in Section 11.2(a), which addresses inaccuracies in or inconsistencies with the Seller's representations (including those pertaining to the environment in Section 3.22).

There are several reasons why a buyer may seek to include separate indemnification for environmental matters instead of relying on the general indemnification based on the seller's representations. Environmental matters are often the subject of a risk allocation agreement with respect to unknown and unknowable liabilities, and sellers who are willing to assume those risks may nevertheless be reluctant to make representations concerning factual matters of which they can not possibly have knowledge. An indemnification obligation that goes beyond the scope of the representation implements such an agreement. In addition, the nature of, and the potential for disruption arising from, environmental clean up activities often leads the buyer to seek different procedures for handling claims with respect to environmental matters. A buyer will often feel a greater need to control the clean up and related proceedings than it will to control other types of litigation. Finally, whereas indemnification with respect to representations regarding compliance with laws typically relates to laws in effect as of the closing, environmental indemnification provisions such as that in Section 11.3 impose an indemnification obligation with respect to Environmental, Health and Safety Liabilities, the definition of which in Section 1.1 is broad enough to cover liabilities under not only existing, but future, Environmental Laws.

The seller may object to indemnification obligations regarding future environmental laws and concomitant liabilities arising from common law decisions interpreting such laws. From the buyer's perspective, however, such indemnification is needed to account for strict liability statutes such as CERCLA that impose liability retroactively. The seller may insist that the indemnification clearly be limited to existing or prior laws.

The effectiveness of contractual provisions such as indemnification in protecting the buyer against environmental liabilities is difficult to evaluate. Such liabilities may be discovered at any time in the future and are not cut off by any statute of limitations that refers to the date of release of hazardous materials. In contrast, a contractual provision may have an express temporal limitation, and in any event should be expected to decrease in usefulness over time as parties go out of existence or become difficult to locate (especially when the shareholders are individuals). The buyer may be reluctant to assume that the shareholders will be available and have adequate resources to meet an obligation that matures several years after the acquisition. In addition, environmental liabilities may be asserted by governmental agencies and third parties, which are not bound by the acquisition agreement and are not bound to pursue only the indemnitor.

It is often difficult to assess the economic adequacy of an environmental indemnity. Even with an environmental audit, estimates of the cost of remediation or compliance may prove to be considerably understated years later when the process is completed, and the shareholders' financial ability to meet that obligation at that time cannot be assured. These limitations on the usefulness of indemnification provisions may lead, as a practical matter, to the negotiation of a price reduction, environmental insurance or an increased escrow of funds or letter of credit to meet indemnification obligations, in conjunction with some limitation on the breadth of the provisions themselves. Often, the amount of monies saved by the buyer at the time of the closing will be far more certain than the amount it may receive years later under an indemnification provision.

Despite some authority to the effect that indemnity agreements between potentially responsible parties under CERCLA are unenforceable (*see CPC Int'l, Inc. v. Aerojet-General Corp.*, 759 F. Supp. 1269 (W.D. Mich. 1991); *AM Int'l Inc. v. International Forging Equip.*, 743 F. Supp. 525 (N.D. Ohio 1990)), it seems settled that Section 107(e)(1) of CERCLA (42 U.S.C. Section 9607(e)(1)) expressly allows the contractual allocation of environmental liabilities between potentially responsible parties, and such an indemnification provision would thus be enforceable between the buyer and the seller. *See*, *e.g.*, *Smith Land & Improvement Corp. v. Celotex Corp.*, 851 F.2d 86 (3rd Cir.1988), cert. denied, 488 U.S. 1029 (1989); *Mardan Corp. v. CGC Music, Ltd.*, 804 F.2d 1454 (9th Cir. 1986); Parker and Savich, *Contractual Efforts to Allocate the Risk of Environmental Liability: Is There a Way to Make Indemnities Worth More Than the Paper They Are Written On?*, 44 Sw. L.J. 1349 (1991). Section 107(e)(1) of CERCLA, however, bars such a contractual allocation between parties from limiting the rights of the government or any third parties to seek redress from either of the contracting parties.

One consequence of treating an unknown risk through an indemnity instead of a representation is that the buyer may be required to proceed with the acquisition even if a basis for the liability in question is discovered prior to the closing, because the existence of a liability subject to indemnification will not by itself cause a failure of the condition specified in Section 7.1. The representations in Section 3.22 substantially overlap this indemnity in order to avoid that consequence.

The issue of control of cleanup and other environmental matters is often controversial. The buyer may argue for control based upon the unusually great potential that these matters have for interference with business operations. The seller may argue for control based upon its financial responsibility under the indemnification provision.

If the seller and the shareholders are unwilling to commit to such broad indemnification provisions, or if the buyer is not satisfied with such provisions because of specific environmental risks that are disclosed or become known through the due diligence process or are to be anticipated from the nature of the seller's business, several alternatives exist for resolving the risk allocation problems that may arise. For example, the seller may ultimately agree to a reduction in the purchase price in return for deletion or limitation of its indemnification obligations.

The seller and the shareholders are likely to have several concerns with the indemnification provisions in Section 11.3. Many of these concerns are discussed in the comments to Section 3.22, such as the indemnification for third-party actions and with respect to substances that may be considered hazardous in the future or with respect to future environmental laws. The seller and the shareholders may also be interested in having the buyer indemnify them for liabilities arising from the operation of the seller's business after the closing, although they may find it difficult to articulate the basis on which they may have liability for these matters.

Although representations and indemnification provisions address many environmental issues, it is typical for the buyer to undertake an environmental due diligence process prior to acquiring any interest from the seller. See the Comment to Section 7.10.

11.4 INDEMNIFICATION AND REIMBURSEMENT BY BUYER

Buyer will indemnify and hold harmless Seller, and will reimburse Seller, for any Damages arising from or in connection with:

(a) any Breach of any representation or warranty made by Buyer in this Agreement or in any certificate, document, writing or instrument delivered by Buyer pursuant to this Agreement;

(b) any Breach of any covenant or obligation of Buyer in this Agreement or in any other certificate, document, writing or instrument delivered by Buyer pursuant to this Agreement;

(c) any claim by any Person for brokerage or finder's fees or commissions or similar payments based upon any agreement or understanding alleged to have been made by such Person with Buyer (or any Person acting on Buyer's behalf) in connection with any of the Contemplated Transactions;

(d) any obligations of Buyer with respect to bargaining with the collective bargaining representatives of Active Hired Employees subsequent to the Closing; or

(e) any Assumed Liabilities.

COMMENT

In general, the indemnification by the buyer is similar to that by the seller. The significance of the buyer's indemnity will depend to a large extent on the type of consideration being paid and, as a result, on the breadth of the buyer's representations. If the consideration paid to a seller is equity securities of the buyer, the seller may seek broad representations and indemnification comparable to that given by the seller, including indemnification that covers specific known problems. In all cash transactions, however, the buyer's representations are usually minimal and the buyer generally runs little risk of liability for post-closing indemnification. It is not unusual for the buyer's first draft to omit this provision entirely.

A seller might request that the acquisition agreement contain an analogue to Section 11.2(c) to allocate the risk of post-closing operations more clearly to the buyer. Such a provision could read as follows:

> "(c) Any Liability arising out of the ownership or operation of the Assets after the Closing Date other than the Retained Liabilities."

In the event that a buyer wrongfully terminates the purchase agreement or refuses to close, the buyer could be liable under Section 11.4 of the Model Agreement and under common law for breach of contract. *Rus, Inc. v. Bay Industries, Inc. and SAC, Inc.*, 2004 WL 1240578 (S.D.N.Y. May 25, 2004), was a breach of contract action arising out of the proposed sale by Rus. Inc. ("*Seller*") of a wholly owned subsidiary to Bay Industries, Inc. ("*Buyer*") and SAC, Inc. (Buyer's newco acquisition subsidiary) pursuant to a stock purchase agreement they entered into on January 29, 2001. Buyer refused to close the sale on the grounds that certain conditions to closing enumerated in the purchase agreement had not been satisfied by the Seller. Seller brought a breach of contract action, asserting that in fact all purchase agreement conditions to the closing had been fulfilled and seeking money damages from the Buyer for its failure to close pursuant to the purchase agreement. In a lengthy and detailed factual analysis in which the Court weighed the testimony of expert and party witnesses, the Court concluded that these closing conditions had been satisfied and that the real reason for the Buyer's decision to walk was Buyer's remorse – concern on the Buyer's part that it had over-extended itself financially and that it had made a bad deal. The Court found that the Buyer had breached the contract and awarded substantial damages to the Seller. The *Rus* case is interesting both for (i) its focus on the contemporaneous actions of the parties in weighing the materiality of the developments and the reasonableness of the actions in response and (ii) its analysis in calculating the damages awarded to Seller to compensate it for Buyer's breach of contract.

In *Russ* the two purchase agreement conditions to closing that were relied upon by Buyer in aborting the transaction were receipt of (1) a satisfactory Phase I environmental report and (2) two landlord consents. As to the Phase I environmental report, the purchase agreement only required that the report be delivered, which happened, and that "Buyer shall be *reasonably satisfied* therewith," which was the issue. The Court held that "*reasonably satisfied*" required that Buyer act in "good faith" in evaluating the issues raised by the report. After weighing testimony and noting that that (i) Seller had agreed to pay the cost of remediation, which was nominal in view of the size of the transaction and could have been completed prior to closing if Buyer had not agreed to postpone the work until after closing, (ii) there was no evidence of any material environmental liabilities or any governmental enforcement action, and (iii) the parties, their consultants and counsel did not act as if the environmental issues identified in the report were serious until Buyer decided to abort the deal, the Court found that the environmental issues were trivial and that Buyer was not acting in good faith and reasonably in refusing to close on the basis thereof.

As to the landlord consents, the Court found that (a) the landlords had initially declined to consent because Buyer's credit was not as good as Seller's, (b) after Seller had agreed to guarantee Buyer's leasehold obligations, the landlords agreed to consent, and (c) Buyer knew the written consents would be forthcoming when it declined to close. Thus, the Court found the landlord consents were no justification for Buyer not closing.

Finally, Buyer argued that the target's financial condition was deteriorating such that there had been a "material adverse change" that would entitle Buyer to abort the deal in accordance with the purchase agreement. The Court, noting that the Buyer was a strategic buyer whose owner testified that "short-term swings in profits" were not particularly significant as Buyer was focused on "long-term synergies" and that the material adverse change ground appeared to be an afterthought defense, found that the financial change concerns were little more than "buyer's remorse" and that Buyer's "belated effort…to renegotiate the purchase price further bolsters this conclusion, indicating [Buyer's] belief that it had agreed to too high a price."

On the issue of damages, the Court held that "[u]nder New York law, the measure of damages for the breach of a contract of sale is the difference between the contract price and the fair market value of the item or property being sold at the time of the breach…Fair market value means the price that a willing buyer would pay a willing seller in a fair transaction." The Court found that business had been seriously damaged as a result of its aborted sale, noting testimony to the effect that "sales suffered because employees were 'demotivated' and distracted by the uncertainty surrounding the pending transition in ownership….[the business] lost key personnel…and [c]ompetitors took advantage to make inroads into [its] customer base." At the time of trial Seller had been unable to find another purchaser for the business, and argued that the damages should be equal to the difference between the purchase price and the liquidation value of the assets of the business. The Court found that Seller's inability to find a purchaser by the time of trial did not mean that the business had no going concern value. The Court ultimately found that the value of the business was 50% above its liquidation value, and awarded damages equal to the difference between that value and what Seller would have received if Buyer had performed under the purchase agreement.

11.5 LIMITATIONS ON AMOUNT — SELLER AND SHAREHOLDERS

Seller and Shareholders shall have no liability (for indemnification or otherwise) with respect to claims under Section 11.2(a) until the total of all Damages with respect to such matters exceeds $_______________, and then only for the amount by which such Damages exceed $_______________. However, this Section 11.5 will not apply to claims under Section 11.2(b) through (i) or to matters arising in respect of Sections 3.9, 3.11, 3.14, 3.22, 3.29, 3.30, 3.31 or 3.32 or to any Breach of any of Seller's and Shareholders' representations and warranties of which the Seller had Knowledge at any time prior to the date on which such representation and warranty is made or any intentional Breach by Seller or either Shareholder of any covenant or obligation, and Seller and the Shareholders will be jointly and severally liable for all Damages with respect to such Breaches.

COMMENT

Section 11.5 provides the Seller and the Shareholders with a safety net, or "basket," with respect to specified categories of indemnification but does not establish a ceiling, or "cap." The basket is a minimum amount that must be exceeded before any indemnification is owed — in effect, it is a deductible. A more aggressive buyer may wish to provide for a "threshold" deductible that, once crossed, entitles the indemnified party to recover all damages, rather than merely the excess over the basket. The purpose of the basket or deductible is to recognize that representations concerning an ongoing business are unlikely to be perfectly accurate and to avoid disputes over insignificant amounts. In addition, the buyer can point to the basket as a reason why specific representations do not need materiality qualifications.

In the Model Agreement, the Seller's and Shareholders' representations are generally not subject to materiality qualifications, and the full dollar amount of damages caused by a breach must be indemnified, subject to the effect of the basket established by this Section. This framework avoids "double-dipping" — that is, the situation in which a seller contends that the breach exists only to the extent that it is material, and then the material breach is subjected to the deduction of the basket. If the acquisition agreement contains materiality qualifications to the seller's representations, the buyer should consider a provision to the effect that such a materiality qualification will not be taken into account in determining the magnitude of the damages occasioned by the breach for purposes of calculating whether they are applied to the basket; otherwise, the immaterial items may be material in the aggregate, but not applied to the basket. Another approach would involve the use of a provision such as the following:

> If Buyer would have a claim for indemnification under Sections 11.2(a) [and others] if the representation and warranty [and others] to which the

> claim relates did not include a materiality qualification and the aggregate amount of all such claims exceeds $__X__, then the Buyer shall be entitled to indemnification for the amount of such claims in excess of $__X__ in the aggregate (subject to the limitations on amount in Section 11.5) notwithstanding the inclusion of a materiality qualification in the relevant provisions of this Agreement.

A buyer will usually want the seller's and the shareholders' indemnity obligation for certain matters, such as the retained liabilities, to be absolute or "first dollar" and not subject to the basket. For example, the buyer may insist that the seller pay all tax liabilities from a pre-closing period or the damages resulting from a disclosed lawsuit without regard to the basket. Section 11.5 lists a number of Sections to which the basket would not apply, including title, labor and environmental matters. The parties also may negotiate different baskets for different types of liabilities; the buyer should consider the aggregate effect of those baskets.

The shareholders may also seek to provide for a maximum indemnifiable amount. The shareholders' argument for such a provision is that they had limited liability as shareholders and should be in no worse position with the seller having sold the assets than they were in before the seller sold the assets; this argument may not be persuasive to a buyer that views the assets as a component of its overall business strategy or intends to invest additional capital. If a maximum amount is established, it usually does not apply to liabilities for taxes, environmental matters, or ERISA matters — for which the buyer may have liability under applicable law — or defects in the ownership of the Assets. The parties may also negotiate separate limits for different kinds of liabilities.

Often, baskets and thresholds do not apply to breaches of representations of which the seller had knowledge or a willful failure by the seller to comply with a covenant or obligation — the rationale is that the seller should not be allowed to reduce the purchase price or the amount of the basket or threshold by behavior that is less than forthright. Similarly, the buyer will argue that any limitation as to the maximum amount should not apply to a seller that engages in intentional wrongdoing.

The basket in Section 11.5 only applies to claims under Section 11.2(a), which provides for indemnification for breaches of representations and warranties. The basket does not apply to any other indemnification provided in Section 11.2 (*e.g.*, breaches of obligations to deliver all of the Assets as promised or from Seller's failure to satisfy retained liabilities) or 11.3 (environmental matters). This distinction is necessary to protect the buyer from net asset shortfalls that would otherwise preclude the buyer from receiving the net assets for which it bargained.

In *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.3d 1032 (Del. Ch. 2006), which is discussed further in the Comment to Section 13.7 and in Appendix E, the Delaware Chancery Court held that a contractual damage cap would not be enforced to limit a rescission claim where the buyer could prove intentional false statements in representations set forth in the purchase agreement.

11.6 LIMITATIONS ON AMOUNT – BUYER

Buyer will have no liability (for indemnification or otherwise) with respect to claims under Section 11.4(a) until the total of all Damages with respect to such matters exceeds $__________, and then only for the amount by which such Damages exceed $_______________. However, this Section 11.6 will not apply to claims under Section 11.4(b) through (e) or matters arising in respect of Section 4.4 or to any Breach of any of Buyer's representations and warranties of which Buyer had Knowledge at any time prior to the date on which such representation and warranty is made or any intentional Breach by Buyer of any covenant or obligation, and Buyer will be liable for all Damages with respect to such Breaches.

COMMENT

In its first draft, the buyer will usually suggest a basket below which it is not required to respond in damages for breaches of its representations, typically the same dollar amount as that used for the seller's basket.

11.7 TIME LIMITATIONS

(a) If the Closing occurs, Seller and Shareholders will have liability (for indemnification or otherwise) with respect to any Breach of (i) a covenant or obligation to be performed or complied with prior to the Closing Date (other than those in Sections 2.1 and 2.4(b) and Articles 10 and 12, as to which a claim may be made at any time) or (ii) a representation or warranty (other than those in Sections 3.9, 3.14, 3.16, 3.22, 3.29, 3.30, 3.31 and 3.32 as to which a claim may be made at any time), but only if on or before _______________, 20__ Buyer notifies Seller or Shareholders of a claim specifying the factual basis of the claim in reasonable detail to the extent then known by Buyer.

(b) If the Closing occurs, Buyer will have liability (for indemnification or otherwise) with respect to any Breach of (i) a covenant or obligation to be performed or complied with prior to the Closing Date (other than those in Article 12, as to which a claim may be made at any time) or (ii) a representation or warranty (other than that set forth in Section 4.4, as to which a claim may be made at any time), but only if on or before _______________, 20__ Seller or Shareholders notify Buyer of a claim specifying the factual basis of the claim in reasonable detail to the extent then known by Seller or Shareholders.

COMMENT

It is common for an acquisition agreement to specify the time period within which a claim for indemnification must be made. The seller and its shareholders want to have uncertainty eliminated after a period of time, and the buyer wants to have a reasonable opportunity to discover any basis for indemnification. The time period will vary depending on factors such as the type of business, the adequacy of financial statements, the buyer's plans for retaining existing management, the buyer's ability to perform a thorough investigation prior to the acquisition, the method of determination of the purchase price, and the relative bargaining strength of the parties. A two-year period may be sufficient for most liabilities because it will permit at least one post-closing annual audit and because, as a practical matter, many hidden liabilities will be uncovered within two years. However, an extended or unlimited time period for title to assets, products liability, taxes, employment issues, and environmental issues is not unusual.

Section 11.7 provides that claims generally with respect to representations or covenants must be asserted by the buyer giving notice to seller and the shareholders (as contrasted with filing a lawsuit) within a specified time period known as a "survival" period, except with respect to identified representations or covenants as to which a claim may be made at any time. *See* Comment to Section 11.1 for a discussion of the *Herring v. Teradyne, Inc.* and *Western Filter Corporation v. Argan, Inc.* cases in which it was argued that acquisition agreement wording that covenants, representations and warranties shall survive the Closing until the first anniversary of the Closing Date created a one year contractual statute of limitations requiring a claimant to file a lawsuit (not merely give notice asserting a claim) within the contractual limitation period. Unlike the Model Agreement, some purchase agreements provide that the failure to give timely notice of a claim will not bar the claim if the recipient is not prejudiced thereby. *See Schrader-Bridgeport International, Inc. v Arvinmeritor, Inc.*, 2008 WL 977604 (W.D.N.C. 2008) ("While . . . the Stock Purchase Agreement requires the [buyer] to give the [seller] 'prompt written notice' of an indemnity claim, it also provides that the [buyer's] failure to give such notice 'within the time frame specified shall not release the [seller], in whole or in part, from its obligations hereunder except to the extent that the [seller's] ability to defend such claim is prejudiced thereby.'"; Court found that buyer had "alleged sufficient facts, which if taken as true, support its contention that the [seller] was not prejudiced by the [buyer's] untimely notice of its indemnity claims").

It is also possible to provide that a different (than the general) survival period will apply to other identified representations or covenants. Some attorneys request that representations which are fraudulently made survive indefinitely. It is also important to differentiate between covenants to be performed or complied with before and after closing.

The appropriate standard for some types of liabilities may be the period of time during which a private or governmental plaintiff could bring a claim for actions taken or circumstances existing prior to the closing. For example, indemnification for tax liabilities often extends for as long as the relevant statute of limitations for collection of the tax. If this approach is taken, the limitation should be drafted to include extensions of the statute of limitations (which are frequently granted in tax audits), situations in which there is no statute of limitations (such as those referred to in Section 6501(c) of the Code), and a brief period after expiration of the statute of limitations to permit a claim for indemnification to be made if the tax authorities act on the last possible day.

The seller's obligations with respect to retained liabilities should not be affected by any limitations on the time or amount of general indemnification payments.

The buyer should consider the relationship between the time periods within which a claim for indemnification may be made and the time periods for other post-closing transactions. For example, if there is an escrow, the buyer will want to have the escrow last until any significant claims for indemnification have been paid or finally adjudicated. Similarly, if part of the purchase price is to be paid by promissory note, or if there is to be an "earn-out" pursuant to which part of the consideration for the assets is based on future performance, the buyer will want to be able to offset claims for indemnification against any payments that it owes on the promissory note or earn-out (see Section 11.8).

In drafting time limitations, the buyer's counsel should consider whether they should apply only to claims for indemnification (see the Comment to Section 11.2).

11.8 RIGHT OF SET-OFF; ESCROW

Upon notice to Seller specifying in reasonable detail the basis therefor, Buyer may setoff any amount to which it may be entitled under this Article 11 against amounts otherwise payable under the Promissory Note or may give notice of a claim in such amount under the Escrow Agreement. The exercise of such right of setoff by Buyer in good faith, whether or not ultimately determined to be justified, will not constitute an event of default under the Promissory Note or any instrument securing the Promissory Note. Neither the exercise of nor the failure to exercise such right of setoff or to give a notice of a claim under the Escrow Agreement will constitute an election of remedies or limit Buyer in any manner in the enforcement of any other remedies that may be available to it.

COMMENT

Regardless of the clarity of the acquisition agreement on the allocation of risk and the buyer's right of indemnification, the buyer may have difficulty enforcing the indemnity — especially against shareholders who are individuals — unless it places a portion of the purchase price in escrow, holds back a portion of the purchase price (often in the form of a promissory note, an earn-out, or payments under consulting or non-competition agreements) with a right of setoff, or obtains other security (such as a letter of credit) to secure performance of the seller's and the shareholders' indemnification obligations. These techniques shift bargaining power in post-closing disputes from the seller and the shareholders to the buyer and usually will be resisted by the seller.

An escrow provision may give the buyer the desired security, especially when there are several shareholders and the buyer will have difficulty in obtaining jurisdiction over the shareholders or in collecting on the indemnity without an escrow. Shareholders who are jointly and severally liable may also favor an escrow in order to ensure that other shareholders share in any indemnity payment. The amount and duration of the escrow will be determined by negotiation, based on the parties' analyses of the magnitude and probability of potential claims and the period of time during which they may be brought. The shareholders may insist that the size of the required escrow diminish in stages over time. The buyer should be careful that there is no implication that the escrow is the exclusive remedy for breaches and nonperformance, although a request for an escrow is often met with a suggestion by the shareholders that claims against the escrow be the buyer's exclusive remedy.

The buyer may also seek an express right of setoff against sums otherwise payable to the seller or the shareholders. The buyer obtains more protection from an express right of setoff against deferred purchase price payments due under a promissory note than from a deposit of the same amounts in an escrow because the former leaves the buyer in control of the funds, thus giving the buyer more leverage in resolving disputes with the seller. The buyer may also want to apply the setoff against payments under employment, consulting, or non-competition agreements (although state law may prohibit setoffs against payments due under employment agreements). The comfort received by the buyer from an express right of setoff depends on the schedule of the payments against which it can withhold. Even if the seller agrees to express setoff rights, the seller may attempt to prohibit setoffs prior to definitive resolution of a dispute and to preserve customary provisions that call for acceleration of any payments due by the buyer if the buyer wrongfully attempts setoff. Also, the seller may seek to require that the buyer exercise its setoff rights on a pro rata basis in proportion to the amounts due to each shareholder. If the promissory note is to be pledged to a bank, the bank as pledgee will likely resist setoff rights (especially because the inclusion of express setoff rights will make the promissory note non-negotiable). As in the case of an escrow, the suggestion of an express right of setoff often leads to discussions of exclusive remedies.

The buyer may wish to expressly provide that the setoff applies to the amounts (principal and interest) first coming due under the promissory note. This is obviously more advantageous to the buyer from a cash flow standpoint. The seller will prefer that the setoff apply to the principal of the promissory note in the inverse order of maturity. This also raises the question of whether the seller is entitled to interest on the amount setoff or, in the case of an escrow, the disputed amount. The buyer's position will be that this constitutes a reduction in the purchase price and therefore the seller should not be entitled to interest on the amount of the reduction. The seller may argue that it should be entitled to interest, at least up to the time the buyer is required to make payment to a third party of the amount claimed. It may be difficult, however, for the seller to justify receiving interest when the setoff relates to a diminution in value of the assets acquired.

Rather than inviting counterproposals from the seller by including an express right of setoff in the acquisition agreement, the buyer's counsel may decide to omit such a provision and instead rely on the buyer's common law right of counter-claim and setoff. Even without an express right of setoff in the acquisition agreement or related documents such as a promissory note or an employment, consulting, or non-competition agreement, the buyer can, as a practical matter, withhold amounts from payments due to the seller and the shareholders under the acquisition agreement or the related documents on the ground that the buyer is entitled to indemnification for these amounts under the acquisition agreement. The question then is whether, if the seller and the shareholders sue the buyer for its failure to make full payment, the buyer will be able to counterclaim that it is entitled to setoff the amounts for which it believes it is entitled to indemnification.

The common law of counterclaim and setoff varies from state to state, and when deciding whether to include or forgo an express right of setoff in the acquisition agreement, the buyer's counsel should examine the law governing the acquisition agreement. The buyer's counsel should determine whether the applicable law contains requirements such as a common transaction, mutuality of parties, and a liquidated amount and, if so, whether those requirements would be met in the context of a dispute under the acquisition agreement and related documents. Generally, counterclaim is mandatory when both the payment due to the plaintiff and the amount set off by the defendant relate to the same transaction, *see United States v. Southern California Edison Co.*, 229 F. Supp. 268, 270 (S.D. Cal. 1964); when different transactions are involved, the court may, in its discretion, permit a counterclaim, *see Rochester Genesee Regional Transp. Dist., Inc. v. Trans World Airlines, Inc.*, 383 N.Y.S.2d 856, 857 (1976), but is not obligated to do so, *see Columbia Gas Transmission v. Larry H. Wright, Inc.*, 443 F. Supp. 14 (S.D. Ohio 1977); *Townsend v. Bentley*, 292 S.E.2d 19 (N.C. Ct. App. 1982). Although a promissory note representing deferred purchase price payments would almost certainly be considered part of the same transaction as the acquisition, it is less certain that the execution of an employment, consulting, or non-competition agreement, even if a condition to the closing of the acquisition, and its subsequent performance would be deemed part of the same transaction as the acquisition. In addition, a counterclaim might not be possible if the parties obligated to make and entitled to receive the various payments are different (that is, if there is not "mutuality of parties").

Under the *D'Oench, Duhme* doctrine, which arose from a 1942 Supreme Court decision and has since been expanded by various statutes and judicial decisions, defenses such as setoff rights under an acquisition agreement generally are not effective against the

Federal Deposit Insurance Corporation (FDIC), the Resolution Trust Corporation (RTC), and subsequent assignees or holders in due course of a note that once was in the possession of the FDIC or the RTC. *See D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447 (1942); *see also* 12 U.S.C. § 1823(e); *Porras v Petroplex Sav. Ass'n*, 903 F.2d 379 (5th. Cir. 1990); *Bell & Murphy Assoc., Inc. v. InterFirst Bank Gateway, N.A.*, 894 F.2d 750 (5th. Cir. 1990), *cert. denied*, 498 U.S. 895 (1990); *FSLIC v. Murray*, 853 F.2d 1251 (5th. Cir. 1988). An exception to the *D'Oench, Duhme* doctrine exists when the asserted defense arises from an agreement reflected in the failed bank's records. *See FDIC v. Plato*, 981 F.2d 852 (5th. Cir. 1993); *Resolution Trust Ccorp. v. Oaks Apartments Joint Venture*, 966 F.2d 995 (5th. Cir. 1992). Therefore, if a buyer gives a seller a negotiable promissory note and that note ever comes into the possession of a bank that later fails, the buyer could lose its setoff rights under the acquisition agreement unless the failed bank had reflected in its records the acquisition agreement and the buyer's setoff rights. As an alternative to nonnegotiable notes, a buyer could issue notes that can be transferred only to persons who agree in writing to recognize in their official records both the acquisition and the buyer's setoff rights.

Section 11.8 addresses the possible consequences of an unjustified setoff. It allows the Buyer to set off amounts for which the Buyer in good faith believes that it is entitled to indemnification from the Seller and the Shareholders against payments due to them under the promissory note without bearing the risk that, if the Seller and the Shareholders ultimately prevail on the indemnification claim, they will be able to accelerate the promissory note or obtain damages or injunctive relief. Such a provision gives the Buyer considerable leverage and will be resisted by the Seller. To lessen the leverage that the Buyer has from simply withholding payment, the Seller might require that an amount equal to the setoff be paid by the Buyer into an escrow with payment of fees and costs going to the prevailing party.

11.9 THIRD PARTY CLAIMS

(a) Promptly after receipt by a Person entitled to indemnity under Section 11.2, 11.3 (to the extent provided in the last sentence of Section 11.3) or 11.4 (an **"Indemnified Person"**) of notice of the assertion of a Third-Party Claim against it, such Indemnified Person shall give notice to the Person obligated to indemnify under such Section (an **"Indemnifying Person"**) of the assertion of such Third-Party Claim; provided that the failure to notify the Indemnifying Person will not relieve the Indemnifying Person of any liability that it may have to any Indemnified Person, except to the extent that the Indemnifying Person demonstrates that the defense of such Third-Party Claim is prejudiced by the Indemnified Person's failure to give such notice.

(b) If an Indemnified Person gives notice to the Indemnifying Person pursuant to Section 11.9(a) of the assertion of such Third-Party Claim, the Indemnifying Person shall be entitled to participate in the defense of such Third-Party Claim and, to the extent that it wishes (unless (i) the Indemnifying Person is also a Person against whom the Third-Party Claim is made and the Indemnified Person determines in good faith that joint representation would be inappropriate, or (ii) the Indemnifying Person fails to provide reasonable assurance to the Indemnified Person of its financial capacity to defend such Third-Party Claim and provide indemnification with respect to such Third-Party Claim), to assume the defense of such Third-Party Claim with counsel satisfactory to the Indemnified Person. After notice from the Indemnifying Person to the Indemnified Person of its election to assume the defense of such Third-Party Claim, the Indemnifying Person shall not, as long as it diligently conducts such defense, be liable to the Indemnified Person under this Article 11 for any fees of other counsel or any other expenses with respect to the defense of such Third-Party Claim, in each case subsequently incurred by the Indemnified Person in connection with the defense of such Third-Party Claim, other than reasonable costs of investigation. If the Indemnifying Person assumes the defense of a Third-Party Claim, (i) such assumption will conclusively establish for purposes of this Agreement that the claims made in that Third-Party Claim are within the scope of and subject to indemnification; and (ii) no compromise or settlement of such Third-Party Claims may be effected by the Indemnifying Person without the Indemnified Person's Consent unless (A) there is no finding or admission of any violation of Legal Requirement or any violation of the rights of any Person, (B) the sole relief provided is monetary damages that are paid in full by the Indemnifying Person, and (C) the Indemnified Person shall have no liability with respect to any compromise or settlement of such Third-Party Claims effected without its Consent. If notice is given to an Indemnifying Person of the assertion of any Third-Party Claim and the Indemnifying Person does not, within ten days after the Indemnified Person's notice is given, give notice to the Indemnified Person of its election to assume the defense of such Third-Party Claim, the Indemnifying Person will be bound by any determination made in such Third-Party Claim or any compromise or settlement effected by the Indemnified Person.

(c) Notwithstanding the foregoing, if an Indemnified Person determines in good faith that there is a reasonable probability that a Third-Party Claim may adversely affect it or its Related Persons other than as a result of monetary damages for which it would be entitled to indemnification under this Agreement, the Indemnified Person may, by notice to the Indemnifying Person, assume the exclusive right to defend, compromise, or settle such Third-Party Claim, but the Indemnifying Person will not be bound by any determination of any Third-Party Claim so defended for the purposes of this Agreement or any compromise or settlement effected without its Consent (which may not be unreasonably withheld).

(d) Notwithstanding the provisions of Section 13.4, Seller and each Shareholder hereby consent to the non-exclusive jurisdiction of any court in which a Proceeding in respect of a Third-Party Claim is brought against any Buyer Indemnified Person for purposes of any claim that a Buyer Indemnified Person may have under this Agreement with respect to such Proceeding or the matters alleged therein, and agree that process may be served on Seller and Shareholders with respect to such a claim anywhere in the world.

(e) With respect to any Third-Party Claim subject to indemnification under this Article 11: (i) both the Indemnified Person and the Indemnifying Person, as the case may be, shall keep the other Person fully informed of the status of such Third-Party Claims and any related Proceedings at all stages thereof where such Person is not represented by its own counsel, and (ii) the parties agree (each at its own expense) to render to each other such assistance as they may reasonably require of each other and to cooperate in good faith with each other in order to ensure the proper and adequate defense of any Third-Party Claim.

(f) With respect to any Third-Party Claim subject to indemnification under this Article 11, the parties agree to cooperate in such a manner as to preserve in full (to the extent possible) the confidentiality of all Confidential Information and the attorney-client and work-product privileges. In connection therewith, each party agrees that: (i) it will use its

Best Efforts, in respect of any Third-Party Claim in which it has assumed or participated in the defense, to avoid production of Confidential Information (consistent with applicable law and rules of procedure), and (ii) all communications between any party hereto and counsel responsible for or participating in the defense of any Third-Party Claim shall, to the extent possible, be made so as to preserve any applicable attorney-client or work-product privilege.

COMMENT

It is common to permit an indemnifying party to have some role in the defense of the claim. There is considerable room for negotiation of the manner in which that role is implemented. Because the buyer is more likely to be an indemnified party than an indemnifying party, the Model Agreement provides procedures that are favorable to the indemnified party.

The indemnified party normally will be required to give the indemnifying party notice of third-party claims for which indemnity is sought. The Model Agreement requires such notice only after a proceeding is commenced, and provides that the indemnified party's failure to give notice does not affect the indemnifying party's obligations unless the failure to give notice results in prejudice to the defense of the proceeding. A seller may want to require notice of threatened proceedings and of claims that do not yet involve proceedings and to provide that prompt notice is a condition to indemnification; the buyer likely will be very reluctant to introduce the risk and uncertainty inherent in a notice requirement based on any event other than the initiation of formal proceedings.

The Model Agreement permits the indemnifying party to participate in and assume the defense of proceedings for which indemnification is sought, but imposes significant limitations on its right to do so. The indemnifying party's right to assume the defense of other proceedings is subject to (a) a conflict of interest test if the claim is also made against the indemnifying party, (b) a requirement that the indemnifying party demonstrate its financial capacity to conduct the defense and provide indemnification if it is unsuccessful, and (c) a requirement that the defense be conducted with counsel satisfactory to the indemnified party. The seller will often resist the financial capacity requirement and seek either to modify the requirement that counsel be satisfactory with a reasonableness qualification or to identify satisfactory counsel in the acquisition agreement (the seller's counsel should carefully consider in whose interest they are acting if they specify themselves). The seller may also seek to require that, in cases in which it does not assume the defense, all indemnified parties be represented by the same counsel (subject to conflict of interest concerns).

The seller may seek to modify the provision that the indemnifying party is bound by the indemnified party's defense or settlement of a proceeding if the indemnifying party does not assume the defense of that proceeding within ten days after notice of the proceeding. The seller may request a right to assume the defense of the proceeding at a later date and a requirement for advance notice of a proposed settlement.

An indemnified party usually will be reluctant to permit an indemnifying party to assume the defense of a proceeding while reserving the right to argue that the claims made in that proceeding are not subject to indemnification. Accordingly, the Model Agreement excludes that possibility. However, the seller may object that the nature of the claims could be unclear at the start of a proceeding and may seek the right to reserve its rights in a manner similar to that often permitted to liability insurers.

An indemnifying party that has assumed the defense of a proceeding will seek the broadest possible right to settle the matter. The Model Agreement imposes strict limits on that right; the conditions relating to the effect on other claims and the admission of violations of legal requirements are often the subject of negotiation.

Section 11.9(c) permits the indemnified party to retain control of a proceeding that presents a significant risk of injury beyond monetary damages that would be borne by the indemnifying party, but the price of that retained control is that the indemnifying party will not be bound by determinations made in that proceeding. The buyer may want to maintain control of a proceeding seeking equitable relief that could have an impact on its business that would be difficult to measure as a monetary loss, or a proceeding involving product liability claims that extend beyond the seller's businesses (a tobacco company that acquires another tobacco company, for example, is unlikely to be willing to surrender control of any of its products liability cases).

Section 11.9(d) permits the Buyer to minimize the risk of inconsistent determinations by asserting its claim for indemnification in the same proceeding as the claims against the Buyer.

Environmental indemnification often presents special procedural issues because of the wide range of remediation techniques that may be available and the potential for disruption of the seller's businesses. These matters are often dealt with in separate provisions (see Section 11.3).

11.10 Procedure for Indemnification — Other Claims

A claim for indemnification for any matter not involving a Third-Party Claim may be asserted by notice to the party from whom indemnification is sought and shall be paid promptly after such notice.

COMMENT

This Section emphasizes the parties' intention that indemnification remedies provided in the acquisition agreement are not limited to third-party claims. Some courts have implied such a limitation in the absence of clear contractual language to the contrary. See the Comment to Section 11.2.

11.11 Indemnification In Case Of Strict Liability or Indemnitee Negligence

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

COMMENT

Purpose of Section. The need for this section is illustrated by *Fina, Inc. v. ARCO*, 200 F.3rd 266 (5th Cir. 2000) in which the U.S. Court of Appeals for the Fifth Circuit invalidated an asset purchase agreement indemnification provision in the context of environmental liabilities. In the *Fina* case, the liabilities arose from actions of three different owners over a thirty-year period during which both seller and buyer owned and operated the business and contributed to the environmental condition. The asset purchase agreement indemnification provision provided that the indemnitor "shall indemnify, defend and hold harmless [the indemnitee] . . . against all claims, actions, demands, losses or liabilities arising from the use or operation of the Assets . . . and accruing from and after closing." The Fifth Circuit, applying Delaware law pursuant to the agreement's choice of law provision, held that the indemnification provision did not satisfy the Delaware requirement that indemnification provisions that require payment for liabilities imposed on the indemnitee for the indemnitee's own negligence or pursuant to strict liability statutes such as CERCLA must be clear and unequivocal. The court explained that the risk shifting in such a situation is so extraordinary that to be enforceable the provision must state with specificity the types of risks that the agreement is transferring to the indemnitor.

There are other situations where the acquisition agreement may allocate the liability to the seller while the buyer's action or failure to act (perhaps negligently) may contribute to the loss. For example, a defective product may be shipped prior to closing but the buyer may fail to effect a timely recall which could have prevented the liability, or an account receivable may prove uncollectible because of the buyer's failure to diligently pursue its collection or otherwise satisfy the customer's requirements.

This section is intended to prevent the allocation of risks elsewhere in Article 11 from being frustrated by court holdings, such as the *Fina* case, that indemnification provisions are ambiguous and unenforceable because they do not contain specific words that certain kinds of risks are intended to be shifted by the Agreement. As discussed below, the majority rule appears to be that agreements that have the effect of shifting liability for a person's own negligence, or for strict liability imposed upon the person, must at a minimum be clear and unequivocal, and in some jurisdictions must be expressly stated in so many words. The section is in bold faced type because a minority of jurisdictions require that the risk shifting provision be conspicuously presented.

Indemnification for Indemnitee's Own Negligence. Indemnities, releases and other exculpatory provisions are generally enforceable as between the parties absent statutory exceptions for certain kinds of liabilities (*e.g.*, Section 14 of the Securities Act and Section 29 of the Exchange Act) and judicially created exceptions (e.g. some courts as a matter of public policy will not allow a party to shift responsibility for its own gross negligence or intentional misconduct). *See* RESTATEMENT (SECOND) OF CONTRACTS §195 cmt.b (1981) ("Language inserted by a party in an agreement for the purpose of exempting [it] from liability for negligent conduct is scrutinized with particular care and a court may require specific and conspicuous reference to negligence . . . . Furthermore, a party's attempt to exempt [itself] from liability for negligent conduct may fail as unconscionable.") As a result of these public policy concerns or seller's negotiations, some counsel add an exception for liabilities arising from an indemnitee's gross negligence or willful misconduct.

Assuming none of these exceptions is applicable, the judicial focus turns to whether the words of the contract are sufficient to shift responsibility for the particular liability. A minority of courts have adopted the "literal enforcement approach" under which a broadly worded indemnity for any and all claims is held to encompass claims from unforseen events including the indemnitee's own negligence. The majority of courts closely scrutinize, and are reluctant to enforce, indemnification or other exculpatory arrangements that shift liability away from the culpable party and require that provisions having such an effect be "clear and unequivocal" in stating the risks that are being transferred to the indemnitor. *See* Conwell, *Recent Decisions: The Maryland Court of Appeals*, 57 MD. L. REV. 706 (1998). If an indemnity provision is not sufficiently specific, a court may refuse to enforce the purported imposition on the indemnitor of liability for the indemnitee's own negligence or strict liability. *Fina, Inc. v. ARCO*, 200 F.3d 266 (5th Cir. 2000).

The actual application of the "clear and unequivocal" standard varies from state to state and from situation to situation. Jurisdictions such as Florida, New Hampshire, Wyoming and Illinois do not mandate that any specific wording or magic language be used in order for an indemnity to be enforceable to transfer responsibility for the indemnitee's negligence. *See Hardage Enterprises v. Fidesys Corp.*, 570 So.2d 436, 437 (Fla. App. 1990); *Audley v. Melton*, 640 A. 2d 777 (N.H. 1994); *Boehm v. Cody Country Chamber of Commerce*, 748 P.2d 704 (Wyo.1987); *Neumann v. Gloria Marshall Figure Salon*, 500 N.E. 2d 1011, 1014 (Ill. 1986). Jurisdictions such as New York, Minnesota, Missouri, Maine, North Dakota, and Delaware require that reference to the negligence or fault of the indemnitee be set forth within the contract. *See Gross v. Sweet*, 458 N.Y.S.2d 162 (1983)(holding that the language of the indemnity must plainly and precisely indicate that the limitation of liability extends to negligence or fault of the indemnitee); *Schlobohn v. Spa Petite, Inc.*, 326 N.W.2d 920, 923 (Minn. 1982)(holding that indemnity is enforceable where "negligence" is expressly stated); *Alack v. Vic Tanny Intern*, 923 S.W.2d 330 (Mo. 1996)(holding that a bright-line test is established requiring that the words "negligence" or "fault" be used conspicuously); *Doyle v. Bowdoin College*, 403 A.2d 1206, 1208 (Me. 1979); (holding that there must be an express reference to liability for negligence); *Blum v. Kauffman*, 297 A.2d 48,49 (Del. 1972)(holding that a release did not "clearly and unequivocally" express the intent of the parties without the word "negligence"); *Fina v. Arco*, 200 F.3d 266, 270 (5th Cir. 2000)(applying Delaware law and explaining that no Delaware case has allowed indemnification of a party for its own negligence without making specific reference to the negligence of the indemnified party and requiring at a minimum that indemnity provisions demonstrate that "the subject of negligence of the indemnitee was expressly considered by the parties drafting the agreement"). Under the "express negligence" doctrine followed by Texas courts, an indemnification agreement is not enforceable to indemnify a party from the consequences of its own negligence unless such intent is specifically stated within the four corners of the agreement. *See Ethyl Corporation v. Daniel Construction Company*, 725 S.W.2d 705, 708 (Tex. 1987); *Atlantic Richfield Co. v. Petroleum Personnel, Inc.*, 768 S.W.2d 724 (Tex. 1989).

<u>Indemnification for Strict Liability</u>. Concluding that the transfer of a liability based on strict liability involves an extraordinary shifting of risk analogous to the shifting of responsibility for an indemnitee's own negligence, some courts have held that the clear and unequivocal rule is equally applicable to indemnification for strict liability claims. *See, e.g., Fina, Inc. v. ARCO*, 200 F.2d 300 (5th Cir. 2000); *Purolator Products v. Allied Signal, Inc.*, 772 F. Supp. 124, 131 n.3 (W.D.N.Y. 1991; and *Houston Lighting & Power Co. v. Atchison, Topeka & Santa Fe Ry.*, 890 S.W.2d 455, 458 (Tex. 1994); *see also* Parker and Savich, *Contractual Efforts to Allocate the Risk of Environmental Liability: Is There a Way to Make Indemnities Worth More Than the Paper They Are Written On?*, 44 Sw. L.J. 1349 (1991). The court concluded that this broad clause in the *Fina* asset purchase agreement did not

satisfy the clear and unequivocal test in respect of strict liability claims since there was no specific reference to claims based on strict liability.

In view of the judicial hostility to the contractual shifting of liability for strict liability risks, counsel may wish to include in the asset purchase agreement references to additional kinds of strict liability claims for which indemnification is intended.

Conspicuousness. In addition to requiring that the exculpatory provision be explicit, some courts require that its presentation be conspicuous. *See Dresser Industries v. Page Petroleum, Inc.*, 853 S.W.2d 505 (Tex. 1993) ("Because indemnification of a party for its own negligence is an extraordinary shifting of risk, this Court has developed fair notice requirements which . . . include the express negligence doctrine and the conspicuousness requirements. The express negligence doctrine states that a party seeking indemnity from the consequences of that party's own negligence must express that intent in specific terms within the four corners of the contract. The conspicuous requirement mandates that something must appear on the face of the [contract] to attract the attention of a reasonable person when he looks at it."); *Alack v. Vic Tanny Intern. of Missouri, Inc.*, 923 S.W.2d 330, 337 (Mo. banc 1996). Although most courts appear not to have imposed a comparable "conspicuousness" requirement to date, some lawyers feel it prudent to put their express negligence and strict liability words in bold face or other conspicuous type, even in jurisdictions which to date have not imposed a conspicuousness requirement.

12. CONFIDENTIALITY

COMMENT

Article 12 of the Model Agreement provides more in-depth treatment of confidentiality issues than many asset acquisition agreements. Often this greater detail will be appropriate.

Most of the time, a confidentiality agreement will have been signed by the time a buyer and seller are negotiating the terms of an asset acquisition agreement. Most definitive asset acquisition agreements therefore give only passing treatment to confidentiality issues, typically by addressing the existing confidentiality agreement in the integration clause to provide either that the confidentiality agreement survives or does not survive execution of the agreement or closing of the transaction.

For several reasons, this approach may not be satisfactory to the buyer. First, typically a confidentiality agreement is a unilateral document drafted by the seller to protect the confidentiality of its information. In the course of negotiating the asset purchase agreement and closing the transaction, confidential information of the buyer may be disclosed to the seller. This is likely when part of the consideration for the purchase is stock or other securities of the buyer. The buyer wants the confidentiality of this information protected. This issue may sometimes be addressed during the course of due diligence by agreeing to make the provisions of the confidentiality agreement reciprocal and bilateral or entering into a mirror agreement protecting the buyer's confidential information that is disclosed to the seller. Neither of these steps, however, fully addresses the confidentiality issues that arise at the definitive agreement stage.

Second, the treatment of confidential information of the seller under a typical confidentiality agreement may not be appropriate following the closing of the transaction.

There are four categories for consideration: (1) seller treatment of information relating to assets and liabilities retained by the seller, (2) seller treatment of information relating to assets and liabilities transferred to the buyer, (3) buyer treatment of information relating to assets and liabilities retained by the seller, and (4) buyer treatment of information relating to assets and liabilities transferred to the buyer. Typically, after the closing the buyer should maintain the confidentiality of category (3) information and be able to utilize category (4) information however it wants as the buyer now owns those assets and liabilities. Providing for the survival of the confidentiality agreement would prohibit the buyer from using category (4) information, and providing for the termination of the confidentiality agreement would release the buyer from its obligation relating to the category (3) information. Neither option addresses category (2) information, which a typical buyer will want the seller to refrain from using and keep confidential. Article 12 is intended to address these issues.

The Model Agreement follows typical practice and assumes that a confidentiality agreement has already been signed. Article 12 supersedes that agreement, which under Section 13.7 does not survive the signing of the Model Agreement. The provisions in Article 12 would also be applicable, however, where a confidentiality agreement had not been signed.

Because Article 12 assumes that a confidentiality agreement has already been signed, Article 12 is balanced, and not as favorable to the Buyer as it could be. Drafting a section heavily favoring the Buyer would have required substantial deviation from the terms of the typical confidentiality agreement and resulted in inconsistent treatment of information as confidential or not. A drafter may want to consider this coverage issue when preparing an agreement for a specific transaction.

12.1 DEFINITION OF CONFIDENTIAL INFORMATION

(a) As used in this Article 12, the term **"Confidential Information"** includes any and all of the following information of Seller, Buyer or Shareholders that has been or may hereafter be disclosed in any form, whether in writing, orally, electronically, or otherwise, or otherwise made available by observation, inspection or otherwise by either party (Buyer on the one hand or Seller and Shareholders collectively on the other hand) or its Representatives (collectively, a **"Disclosing Party"**) to the other party or its Representatives (collectively, a **"Receiving Party"**):

(i) all information that is a trade secret under applicable trade secret or other law;

(ii) all information concerning product specifications, data, know-how, formulae, compositions, processes, designs, sketches, photographs, graphs, drawings, samples, inventions and ideas, past, current, and planned research and development, current and planned manufacturing or distribution methods and processes, customer lists, current and anticipated customer requirements, price lists, market studies, business plans, computer hardware, Software, and computer Software and database technologies, systems, structures and architectures;

(iii) all information concerning the business and affairs of the Disclosing Party (which includes historical and current financial statements, financial projections and budgets, tax returns and accountants' materials, historical, current and projected sales, capital spending budgets and plans, business plans, strategic plans, marketing and advertising plans, publications, client and customer lists and files, contracts, the names and backgrounds of key personnel, and personnel training techniques and materials, however documented), and all information obtained from review of the Disclosing Party's documents or property or discussions with the Disclosing Party regardless of the form of the communication; and

(iv) all notes, analyses, compilations, studies, summaries, and other material prepared by the Receiving Party to the extent containing or based, in whole or in part, on any information included in the foregoing.

(b) Any trade secrets of a Disclosing Party shall also be entitled to all of the protections and benefits under applicable trade secret law and any other applicable law. If any information that a Disclosing Party deems to be a trade secret is found by a court of competent jurisdiction not to be a trade secret for purposes of this Article 12, such information shall still be considered Confidential Information of that Disclosing Party for purposes of this Article 12 to the extent included within the definition. In the case of trade secrets, each of Buyer, Seller and Shareholders hereby waives any requirement that the other party submit proof of the economic value of any trade secret or post a bond or other security.

COMMENT

Section 12.1 follows the same general approach as Section 2 of the Model Confidentiality Agreement in describing the confidential information. The major difference is that Section 12.1 describes confidential information of both Buyer and Seller while the Model Confidentiality Agreement only describes confidential information of Seller.

Given that a buyer typically will be receiving information, a buyer may want to limit the scope of material within the "Confidential Information" definition. For example, a buyer may not want to include oral disclosures or material made available for review within the definition and may also want to require confidential information to be specifically marked as confidential.

12.2 RESTRICTED USE OF CONFIDENTIAL INFORMATION

(a) Each Receiving Party acknowledges the confidential and proprietary nature of the Confidential Information of the Disclosing Party and agrees that such Confidential Information (i) shall be kept confidential by the Receiving Party, (ii) shall not be used for any reason or purpose other than to evaluate and consummate the Contemplated Transactions, and (iii) without limiting the foregoing, shall not be disclosed by the Receiving Party to any Person, except in each case as otherwise expressly permitted by the terms of this Agreement or with the prior written consent of an authorized representative of Seller with respect to Confidential Information of Seller or Shareholders (each, a **"Seller Contact"**) or an authorized representative of Buyer with respect to Confidential Information of Buyer (each, a **"Buyer Contact"**). Each of Buyer and Seller and Shareholders shall disclose the Confidential Information of the other party only to its Representatives who require such material for the purpose of evaluating the Contemplated Transactions and are informed by Buyer, Seller, or Shareholders as the case may be, of the obligations of this Article 12 with respect to such information. Each of Buyer, Seller and Shareholders shall (x) enforce the terms of this Article 12 as to its respective Representatives, (y) take such action to the extent necessary to cause its Representatives to comply with the terms and conditions of this Article 12, and (z) be responsible and liable for any breach of the provisions of this Article 12 by it or its Representatives.

(b) Unless and until this Agreement is terminated, Seller and each Shareholder shall maintain as confidential any Confidential Information (including for this purpose any information of Seller or Shareholders of the type referred to in Sections 12.1(a)(i), (ii) and (iii), whether or not disclosed to Buyer) of the Seller or Shareholders relating to any of the Assets or the Assumed Liabilities. Notwithstanding the preceding sentence, Seller may use any Confidential Information of Seller before the Closing in the Ordinary Course of Business in connection with the transactions permitted by Section 5.2.

(c) From and after the Closing, the provisions of Section 12.2(a) above shall not apply to or restrict in any manner Buyer's use of any Confidential Information of the Seller or Shareholders relating to any of the Assets or the Assumed Liabilities.

COMMENT

Section 12.2(a) follows the same general approach as Section 3 of the Model Confidentiality Agreement in describing the restrictions placed on confidential information. This Section permits the confidential information to be used in connection with any of the Contemplated Transactions. This may not be expansive enough for the buyer's needs. For example, the buyer may need to obtain financing and to disclose some confidential information in connection with that process. In that situation, a buyer would want to make sure that obtaining financing was part of the Contemplated Transactions or to specifically permit disclosures of seller confidential information during that process.

Section 12.2(b) requires the Seller to keep confidential all information relating to the assets and liabilities to be transferred to the Buyer beginning when the agreement is signed. However, because the Seller needs to continue to operate its business until closing, the Seller is permitted to use this information in connection with pre-closing activities permitted by the Model Agreement.

Section 12.2(c) relieves the Buyer from the obligation to keep confidential information about the assets and liabilities to be acquired by it. Note that this provision becomes operative only upon the closing. Thus, the Buyer's confidentiality obligation continues until it actually acquires the assets and assumes the liabilities.

12.3 EXCEPTIONS

Sections 12.2(a) and (b) do not apply to that part of the Confidential Information of a Disclosing Party that a Receiving Party demonstrates (a) was, is or becomes generally available to the public other than as a result of a breach of this Article 12 or the Confidentiality Agreement by the Receiving Party or its Representatives, (b) was or is developed by the Receiving Party independently of and without reference to any Confidential Information of the Disclosing Party, or (c) was, is or becomes available to the Receiving Party on a non-confidential basis from a Third Party not bound by a confidentiality agreement or any legal, fiduciary or other obligation restricting disclosure. Neither Seller nor either Shareholder shall disclose any Confidential Information of Seller or

Shareholders relating to any of the Assets or the Assumed Liabilities in reliance on the exceptions in clauses (b) or (c) above.

COMMENT

Section 12.3 follows the same general approach as Section 6 of the Model Confidentiality Agreement in describing the exceptions from the restrictions placed on confidential information. Unlike that Section 6, Section 12.3 does include an exception for independently developed information. This may be included in a buyer's draft as the buyer typically will be the recipient of confidential information. For that same reason, the criteria to qualify for an exemption are easier to satisfy than in the Model Confidentiality Agreement.

Finally, the last sentence of Section 12.3 prevents the Seller from using certain exemptions to disclose information about the assets and liabilities to be transferred to the Buyer. The use of these exemptions would be inappropriate given that these items are the Seller's property until closing.

Regulations relating to the disclosure to the IRS of certain reportable transactions, the registration of certain tax shelters and tax shelter list maintenance requirements were issued by the IRS on February 28, 2003 (T.D. 9046, 2003-12 I.R.B. 614 (February 28, 2003); Treas. Reg. §1.6011-4 [the "**February 2003 Regulations**"]). While the purpose of the February 2003 Regulations was to require taxpayers to report tax shelter transactions to the IRS, the February 2003 Regulations were drafted so broadly that they could apply to certain commercial transactions that do not involve a tax shelter. One of the provisions of the February 2003 Regulations required reporting to the IRS on Form 8886 of transactions subject to conditions of confidentiality with respect to the "tax treatment" (defined in the February 2003 Regulations as "the purported or claimed Federal income tax treatment of the transaction") or "tax structure" (defined in the February 2003 Regulations as "any fact that may be relevant to understanding the purported or claimed Federal income tax treatment of the transaction") of the transaction. The broad ambit of the February 2003 Regulations reached acquisition agreements, settlement agreements, employment agreements and private placement memoranda. There were two limited exceptions to reportability in the February 2003 Regulations: (x) the securities law exception and (y) the mergers and acquisitions ("**M&A**") exception. The securities law exception permitted restrictions on disclosure of tax treatment or tax structure to the extent reasonably necessary to comply with applicable securities laws if disclosure was not otherwise limited. The M&A exception was only for a taxable or tax free acquisition of (x) historic assets of a corporation that constituted an active trade or business that the acquiror intended to continue or (y) more than 50% of the stock of a corporation that owned historic assets used in an active trade or business that acquiror intends to continue. In either case, the M&A exception was only for a limited period and the parties had to be permitted to disclose the tax treatment and tax structure of the acquisition transaction no later than the earlier of: (A) the date of the public announcement of discussions relating to the transaction, (B) the date of the public announcement of the transaction, or (C) the date of the execution of an agreement (with or without conditions) to enter into the transaction. The M&A exception was not available where the taxpayer's ability to consult any tax advisor was limited in any way. The February 2003 Regulations, however, granted a presumption of nonconfidentiality if there was a written disclosure authorization in the form provided by the February 2003 Regulations that excluded from confidentiality matters relating to the tax treatment or tax structure of the transaction. See *Overview of Reportable Transaction Regulations* by William H. Hornberger (July 24, 2003), which can be found at http://www.jw.com/site/jsp/featureinfo.jsp?id=10. The M&A exception afforded by the February 2003 Regulations was not applicable to the Model Agreement because it purports to be a definitive agreement, and, as a result and in order to comply with the February 2003 Regulations, Section 12.3 would have needed a provision such as the following:

> "Notwithstanding anything herein to the contrary and except as reasonably necessary to comply with applicable securities laws, any of Buyer, Seller or any Shareholder (and each employee, representative or agent of any of Buyer, Seller or any Shareholder) may disclose to any and all Persons, without limitation of any kind, the U.S. federal income tax treatment (as defined in Treas. Reg. § 1.6011-4) and U.S. federal income tax structure (as defined in Treas. Reg. § 1.6011-4) of the transactions contemplated by this Agreement and all materials of any kind (including opinions or other tax analyses) that are or have been provided to any of Buyer, Seller or any Shareholder relating to such tax treatment or tax structure."

If confidentiality provisions were included in a separate confidentiality agreement entered into early in the negotiations, and the M&A exception in the February 2003 Regulations were being relied upon, the analogue to the foregoing could have read as follows:

> Notwithstanding anything set forth herein to the contrary and except as reasonably necessary to comply with applicable securities laws, the parties hereto (and any employee, representative or other agent of any of the parties) are hereby expressly authorized to disclose the U.S. federal income tax treatment (as defined in Treas. Reg. § 1.6011-4) and U.S. federal income tax structure (as defined in Treas. Reg. § 1.6011-4) of the transactions contemplated by this Agreement and all materials of any kind (including opinions or other tax analyses) that are provided to the parties relating to such tax treatment or tax structure; provided, however, that such disclosure shall not be made (except to a Representative, including any tax advisor of a party) until the earlier of (i) the date of the public announcement of discussions relating to the transactions, (ii) the date of the public announcement of the transactions, or (iii) the date of the execution of an agreement to enter into the transactions.

Recognizing the overkill of the February 2003 Regulations, the IRS concluded that its definition of reportable confidential transactions (i) should be limited to situations where the tax advisor is paid a large fee and imposes a limitation on disclosure that protects the confidentiality of the advisor's strategies and (ii) should not apply to transactions in which the confidentiality is imposed by a party to a transaction acting in such capacity. TD 9108 (December 18, 2003). As a result, a "transaction is considered to be offered to a taxpayer under confidentiality if the advisor who is paid the minimum fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that tax advisor's strategies." *Id*. For this purpose, the "minimum fee" is $250,000 for a transaction involving a corporation or a tax pass through partnership or trust whose beneficiaries are all corporations, and $50,000 for all other transactions. *Id*. As a result of TD 9108 and after its December 29, 2003 effective date, confidentiality restrictions imposed by parties to a transaction to protect their own interests do not need the exceptions that were crafted to comply with the February 2003 Regulations.

12.4 LEGAL PROCEEDINGS

If a Receiving Party becomes compelled in any Proceeding or is requested by a Governmental Body having regulatory jurisdiction over the Contemplated Transactions to make any disclosure that is prohibited or otherwise constrained by this Article 12, that Receiving Party shall provide the Disclosing Party with prompt notice of such compulsion or request so that it may seek an appropriate protective order or other appropriate remedy or waive compliance with the provisions of this Article 12. In the absence of a protective order or other remedy, the Receiving Party may disclose that portion (and only that portion) of the Confidential Information of the Disclosing Party that, based on advice of the Receiving Party's counsel, the Receiving Party is legally compelled to disclose or that has been requested by such Governmental Body; provided, however, that the Receiving Party shall use reasonable efforts to obtain reliable assurance that confidential treatment will be accorded by any Person to whom any Confidential Information is so disclosed. The provisions of this Section 12.4 do not apply to any Proceedings between the parties to this Agreement.

COMMENT

Section 12.4 follows the same general approach as Section 7 of the Model Confidentiality Agreement in describing when a Receiving Party may disclose Confidential Information due to legal compulsion. However, given that the buyer typically will be the recipient of confidential information, the criteria to permit disclosure are easier to satisfy. Also, the last sentence of Section 12.4 clarifies that the parties are not restricted by this Section in connection with any proceedings between them.

12.5 RETURN OR DESTRUCTION OF CONFIDENTIAL INFORMATION

If this Agreement is terminated, each Receiving Party shall (a) destroy all Confidential Information of the Disclosing Party prepared or generated by the Receiving Party without retaining a copy of any such material, (b) promptly deliver to the Disclosing Party all other Confidential Information of the Disclosing Party, together with all copies thereof, in the possession, custody or control of the Receiving Party or, alternatively, with the written consent of a Seller Contact or a Buyer Contact (whichever represents the Disclosing Party) destroy all such Confidential Information, and (c) certify all such destruction in writing to the Disclosing Party; provided, however, that the Receiving Party may retain a list that contains general descriptions of the information it has returned or destroyed to facilitate the resolution of any controversies after the Disclosing Party's Confidential Information is returned.

COMMENT

Section 12.5 follows the same general approach as Section 9 of the Model Confidentiality Agreement in describing the procedure for return or destruction of confidential information if the Model Agreement is terminated. The last clause authorizes a Receiving Party to retain a list of returned or destroyed information. This list may be helpful in resolving issues relating to the confidential information. For example, this list may support a Receiving Party's contention that it independently developed information because it never received confidential information from the other party on that topic.

12.6 ATTORNEY-CLIENT PRIVILEGE

The Disclosing Party is not waiving, and will not be deemed to have waived or diminished, any of its attorney work product protections, attorney-client privileges, or similar protections and privileges as a result of disclosing its Confidential Information (including Confidential Information related to pending or threatened litigation) to the Receiving Party, regardless of whether the Disclosing Party has asserted, or is or may be entitled to assert, such privileges and protections. The parties (a) share a common legal and commercial interest in all of the Disclosing Party's Confidential Information that is subject to such privileges and protections, (b) are or may become joint defendants in Proceedings to which the Disclosing Party's Confidential Information covered by such protections and privileges relates, (c) intend that such privileges and protections remain intact should either party become subject to any actual or threatened Proceeding to which the Disclosing Party's Confidential Information covered by such protections and privileges relates, and (d) intend that after the Closing the Receiving Party shall have the right to assert such protections and privileges. No Receiving Party shall admit, claim or contend, in Proceedings involving either party or otherwise, that any Disclosing Party waived any of its attorney work product protections, attorney-client privileges, or similar protections and privileges with respect to any information, documents or other material not disclosed to a Receiving Party due to the Disclosing Party disclosing its Confidential Information (including Confidential Information related to pending or threatened litigation) to the Receiving Party.

COMMENT

Purpose of Section 12.6. One of the more troublesome problems related to the disclosure of Confidential Information during the due diligence process is how to disclose certain information to the Recipient to facilitate a meaningful evaluation of litigation-related Confidential Information without waiving any work-product protections, attorney-client privileges, and similar protections and privileges. The language of Section 12.6 constitutes an attempt to allow the seller to furnish to the buyer Confidential Information without waiving the seller's work product, attorney-client privilege and similar protections by demonstrating that the buyer and seller have or should be presumed to have common legal and commercial interests, or are or may become joint defendants in litigation. The language of Section 12.6 is not yet reflected in statutory or case law, may be disregarded by a court, and may even "flag" the issue of privilege waiver for adverse parties which obtain the Agreement. As a result, Section 12.6 should not be viewed as an alternative to managing issues of privilege in a cautious manner.

There may be instances when the Receiving Party is an actual or potentially adverse party in litigation with the Disclosing Party (*e.g.*, when litigation is the driving force behind an acquisition). In those cases, the language of Section 12.6 is intended to bolster a claim by the Disclosing Party that the Recipient is later precluded from using disclosure as a basis for asserting that the privilege was waived.

Whether work product protections and attorney-client privileges will be deemed to be waived as a result of disclosures in connection with a consummated or unconsummated asset purchase depends on the law applied by the forum jurisdiction and the forum jurisdiction's approach to the joint defendant and common interest doctrines (these doctrines are discussed below). In most jurisdictions, work product protection will be waived only if the party discloses the protected documents in a manner which substantially increases the opportunities for its potential adversaries to obtain the information. By contrast, the attorney-client privilege will be waived as a result of voluntary disclosure to any third party, unless the forum jurisdiction applies a form of the joint defense or common interest doctrines.

Work Product Doctrine. The work product doctrine protects documents prepared by an attorney in anticipation of litigation or for trial. *See Hickman v. Taylor*, 329 U.S. 495, 511 (1947). The work product doctrine focuses on the adversary system and attorney's freedom in preparing for trial. *See Union Carbide Corp. v. Dow Chem*., 619 F.Supp. 1036, 1050 (D.C.Del. 1985). The threshold determination in a work product case is whether the material sought to be protected was prepared in anticipation of litigation or for trial. *Binks Mfg. Co. v. National Presto Indus., Inc.*, 709 F.2d 1109, 1118 (7th Cir. 1983). Work product protection, codified by FED. R. CIV. P. 26(b)(3), allows protected material to be obtained by the opposing party only upon a showing of substantial need and undue hardship. FED. R. CIV. P. 26(b)(3). This form of protection relates strictly to documents prepared in anticipation of litigation or for trial. *See Hickman v. Taylor*, 329 U.S. at 512. Therefore, in absence of any anticipated or pending litigation, documents prepared for the purposes of a specific business transaction are not protected by the work product doctrine.

In most jurisdictions, a waiver of the work-product protection can occur where the protected communications are disclosed in a manner which "substantially increases the opportunity for potential adversaries to obtain the information." *See Behnia v. Shapiro*, 176 F.R.D. 277, 279 (N.D.Ill. 1997); see also 8 WRIGHT, MILLER & MARCUS, FEDERAL PRACTICE AND PROCEDURE: CIVIL, § 2024, at 369 (1994). Waiver of work product protection by sharing the work product with one adversary can result in waiver as to other unrelated adversaries. *See In re Stone Energy Corporation*, Fed. Sec. L. Rep. (CCH) ¶94,809 (W.D.La. August 14, 2008) (Plaintiff in securities fraud class action entitled to review attorney internal investigation report prepared for audit committee in anticipation of litigation because defendant company provided it to SEC which was held to be adversary even though no action was pending). The question is whether the particular disclosure was of such a nature as to enable an adversary to gain access to the information. *See Behnia*, 176 F.R.D. at 279-80; *U.S. v. Amer. Tel. & Tel.*, 642 F.2d 1285, 1299 (D.C.Cir. 1980). Disclosure under a confidentiality agreement militates against a finding of waiver, for it is evidence the party took steps to insure that its work product did not land in the hands of its adversaries. *Blanchard v. EdgeMark Financial Corp.*, 192 F.R.D., 233, 237 (N.D.Ill. 2000). In a minority of jurisdictions, the waiver of work product protection depends on whether the parties share a common legal interest. In such jurisdictions, the courts will apply the same analysis as for the waiver of attorney-client privilege. *See In re Grand Jury Subpoenas* 89-3 v. U.S., 902 F.2d 244, 248 (4th Cir. 1990).

Attorney-Client Privilege. The attorney-client privilege protects communications of legal advice between attorneys and clients, including communications between corporate employees and a corporation's attorneys to promote the flow of information between clients and their attorneys. *See Upjohn Co. v. U.S.*, 449 U.S. 383, 389 (1981). An oft-quoted definition of the attorney-client privilege is found in *United States v. United Shoe Mach. Corp.*, 89 F. Supp. 357, 358-59 (D. Mass. 1950):

> "The privilege applies only if (1) the asserted holder of the privilege is or sought to become a client; (2) the person to whom the communication was made (a) is a member of the bar of a court, or his subordinate and (b) in connection with this communication is acting as a lawyer; (3) the

> communication relates to a fact of which the attorney was informed (a) by his client (b) without the presence of strangers (c) for the purpose of securing primarily either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding, and not (d) for the purpose of committing a crime or tort; and (4) the privilege has been (a) claimed and (b) not waived by the client."

Although the attorney-client privilege does not require ongoing or threatened litigation, it is more narrow that the work product doctrine because it covers only "communications" between the lawyer and his client for the purposes of legal aid. *See Upjohn*, 449 U.S. at 389.

The core requirement of the attorney-client privilege is that the confidentiality of the privileged information be maintained. Therefore, the privilege is typically waived when the privilege holder discloses the protected information to a third party. A waiver of attorney-client privilege destroys the attorney-client privilege with respect to all future opposing parties and for the entire subject matter of the item disclosed. *See In re Grand Jury Proceedings*, 78 F.3d 251, 255 (6th Cir. 1996).

The courts have developed two doctrines of exceptions to the waiver of the privilege through voluntary disclosure. The joint defendant rule, embodied in UNIF. R. EVID. 502(b)(5), protects communications relevant to a matter of common interest between two or more clients of the same lawyer from disclosure. UNIF. R. EVID. 502 (d)(5). This widely accepted doctrine applies strictly to clients of the same lawyer who are joint defendants in litigation. Several courts have expanded the joint defense doctrine in order to create another exception to the waiver of attorney-client privilege: the doctrine of common-interest. Under the common interest doctrine, privileged information can be disclosed to a separate entity that has a common legal interest with the privilege holder, whether or not the third party is a co-defendant.

Federal circuit courts and state courts diverge in their interpretation and application of the common interest and joint defendant doctrine. *U.S. v. Weissman*, 1996 WL 737042 *7 (S.D.N.Y. 1996). In the most expansive application of the common interest doctrine, courts exclude a waiver of the attorney-client privilege when there is a common interest between the disclosing party and the receiving party, and parties have a reasonable expectation of litigation concerning their common interest. *See Hewlett-Packard Co. v. Bausch & Lomb*, 115 F.R.D. 308, 309 (N.D.Cal. 1987). More restrictive courts require that the parties share an identical legal, as opposed to purely commercial, interest. *See Duplan Corp. v. Deering Milliken*, 397 F. Supp. 1146, 1172 (D.S.C. 1974). Finally, some courts persist in rejecting the common interest theory absent actual or pending litigation in which both parties are or will be joint defendants. *See Int'l Ins. v. Newmont Mining Corp.*, 800 F.Supp. 1195, 1196 (S.D.N.Y. 1992).

Although there is no uniform test for application of the common interest doctrine, courts have consistently examined three elements when applying the doctrine: (1) whether the confidentiality of the privileged information is preserved despite disclosure; (2) whether, at the time that the disclosures were made, the parties were joint defendants in litigation or reasonably anticipated litigation; and (3) whether the legal interests of the parties are identical or at least closely aligned at the time of disclosure. *See, e.g. U.S. v. Gulf Oil Corp.*, 760 F.2d 292, 296 (Temp. Emer. Ct. App. 1985).

Waiver in M&A Transactions. The core requirement of the common interest doctrine is the existence of a shared legal interest. Courts will have less difficulty in finding an exception to a waiver when the parties to the purchase agreement actively pursue common legal goals. *See U.S. v. Schwimmer*, 892 F.2d 237, 244 (2nd Cir. 1989). An agreement in which the buyer does not assume the litigation liability of the seller does not demonstrate an alignment of the parties' interests. A common business enterprise, such as the sale of assets, or a potential merger, will not suffice unless the parties' legal interests are at least parallel and non-adverse. *Jedwab v. MGM Grand Hotels*, 1986 WL 3426 * 2 (Del. Ch. 1986). Disclosures by a corporation and its counsel to the corporation's investment banking firm during merger discussions have resulted in a waiver of the attorney-client privilege because the common interest rule did not apply. *See Blanchard v. EdgeMark Financial Corp.*, 192 F.R.D. 233 (N.D. Ill. 2000). The court said the common-interest rule protects from disclosure those communications between one party and an attorney for another party "where a joint defense effort or strategy has been decided upon and undertaken by the parties and their respective counsel," noting that the common interest must be a legal one, not commercial or financial. *Id* at 236. The court concluded, however, that the common interest rule did not apply because the defendants did not demonstrate that the investment banking firm's legal interest in the threatened litigation was anything more than peripheral. *Id* at 237.

Although the consummation of a transaction is not determinative of the existence of a waiver, the interests of the parties may become closely aligned as a result of the closing. As a result, there is a higher probability that information will remain protected in a transaction that closes and in which the buyer assumes liability for the seller's litigation, than in a transaction that does not close and in which the buyer does not assume liability for the seller's litigation. *See* Hundley, "*White Knights, Pre-Nuptial Confidences, and the Morning After: The Effect of Transaction-Related Disclosures on the Attorney-Client and Related Privileges*," 5 DEPAUL BUS. L.J. 59 (Fall/Winter, 1992/1993); *cf. Cheeves v. Southern Clays, Inc.*, 128 F.R.D. 128, 130 (M.D. Ga. 1989) ("Courts have found a community of interest where one party owes a duty to defend another, or where both consult the same attorney".). Generally, (i) in a statutory merger the surviving corporation can assert the attorney-client privilege, (ii) in a stock-for-stock deal the privilege goes with the corporation, although in some cases the buyer and seller may share the privilege, and (iii) in the case of an asset sale some cases hold no privilege passes because the corporate holder of the privilege has not been sold while others hold that a transfer of all of sellers right, title and interest in the assets of a business effectively transfers the right to assert or waive the privilege. *Id.*; *Louisiana Municipal Police Employees' Retirement System v. Sealed Air Corp.*, Fed. Sec. L. Rep. (CCH) ¶94,807 (D.N.J. August 11, 2008) (In rejecting plaintiff's assertion of both attorney work product and attorney-client privilege waivers because buyer and seller were on opposite sides of a negotiated transaction, the Court wrote, "The weight of case law suggests that, as a general matter, privileged information exchanged during a merger between two unaffiliated business would fall within the common-interest doctrine," quoting from *Cavallaro v. United States*, 153 F. Supp. 2d 52, 61 (D. Mass. 2001), *aff'd on other grounds* 284 F.3d 236 (1st Cir. 2002), and citing *Rayman v. Am. Charter Fed. Sav. & Loan Ass'n*, 148 F.R.D. 647, 655 (D. Neb. 1993)); *Coffin v. Bowater Incorporated*, Civ. No. 03-227-P-C, 2005 U.S. Dist. LEXIS 9395 (D. Maine May 13, 2005); *Soverain Software LLC v. Gap, Inc.*, 340 F. Supp. 2d 760 (E.D. Tex. 2004); *Cheeves v. Southern Clays*, 128 F.R.D. 128, 130 (M.D. Ga. 1989); *In re Cap Rock Elec. Coop., Inc.*, 35 S.W.3d 222 (Tex. App.—Texarkana 2000, no pet.); *see* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 61 Bus. Law. 1007-1009 (2006).

In *Tekni-Plex, Inc. v. Meyner and Landis*, 89 N.Y.2d 123, 674 N.E. 2d 663 (1996), the New York Court of Appeals held that in a triangular merger the purchaser could not preclude long-time counsel for the seller and its sole shareholder from representing the shareholder in an indemnification claim arising out of the merger, and that the purchaser controlled the attorney-client privilege as to pre-merger communications with the seller, other than those relating to the merger negotiations. Responding to an argument that the transaction was really an asset acquisition, the Court said in dictum: "When ownership of a corporation changes hands, whether the attorney-client relationship transfers . . . to the new owners turns on the practical consequences rather than the formalities of the particular transaction." 89 N.Y.2d at 133.

Postorivo v. AG Paintball Holdings, Inc., 2008 WL 343856 (Del. Ch. 2008), arose in the context of a contract indemnity action brought by the buyer under an asset purchase agreement against the seller over seller's representations, warranties and covenants. The Delaware Chancery Court (applying New York law and relying on *Tekni-Plex, Inc. v. Meyner & Landis*, *supra*) held that, under the asset purchase agreement, the seller retained the attorney-client privilege with respect to communications regarding the excluded assets and liabilities. The Court confirmed the agreement of the parties that buyer holds the attorney-client privilege with respect to communications regarding the operation of the business before and after the asset purchase agreement, and seller holds the privilege as to communications regarding the negotiation of the asset purchase agreement. In so holding, the Court cited with approval the *Tekni-Plex* approach that practical consequences trump the form of the transaction, and rejected buyer's argument that the attorney-client privilege is "an incident of control and cannot be split among several different entities, even if a written contract among the parties provides to the contrary").

Contractual Provisions to Reduce Waiver Risk. The Hundley article suggests that in an asset sale, including a sale of a division, the parties could provide contractually for the buyer to have the benefit of the privilege, as Section 12.6 does, and, by analogy to joint defense and common interest cases, the privilege agreement should be upheld. *Id.*; *see* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 861-63 (2005) (discussing *Venture Law Group v. Superior Court*, 12 Cal. Rptr. 3d 656 (Cal. Ct. App. 2004) which held that the surviving corporation in a merger is the holder of the attorney-client privileges of both constituent corporations post merger and an attorney for the non-surviving corporation has a duty to exercise the privilege unless instructed not to do so by the surviving corporation). Further, by analogy to those cases and the principle that the privilege attaches to communications between an attorney and prospective client prior to engagement, parties should be able to provide that due diligence information provided is protected by the attorney-client privilege. *Cap Rock*, 35 S.W.3d at 222; *cf. Cheeves v. Southern Clays*, 128 F.R.D. 128, 130 (M.D. Ga. 1989) ("Courts have found a community of interest where one party owes a duty to defend another, or where both consult the same attorney".)

Courts may also maintain the attorney-client privilege when the interests of both parties are aligned through specific contractual relationships. *See In Re Regents of Univ. of Cal.*, 101 F.3d 1386, 1390 (Fed. Cir. 1996) (holding that parties to an exclusive license agreement have a substantially identical legal interest). Therefore, the parties may find some comfort in provisions that align their legal interests and burdens, such as provisions pursuant to which buyer assumes the litigation liability of seller, indemnification provisions or assistance provisions which may facilitate a court's application of the common interest doctrine. If appropriate, the parties also should consider signing a “common interest agreement” or a “joint defense plan” that evidences their common legal interests and stipulates a common plan for litigation.

13. GENERAL PROVISIONS

13.4 JURISDICTION; SERVICE OF PROCESS

Any Proceeding arising out of or relating to this Agreement or any Contemplated Transaction may be brought in the courts of the State of ____________, County of _____________, or, if it has or can acquire jurisdiction, in the United States District Court for the _____________ District of _____________, and each of the parties irrevocably submits to the exclusive jurisdiction of each such court in any such Proceeding, waives any objection it may now or hereafter have to venue or to convenience of forum, agrees that all claims in respect of the Proceeding shall be heard and determined only in any such court, and agrees not to bring any Proceeding arising out of or relating to this Agreement or any Contemplated Transaction in any other court. The parties agree that either or both of them may file a copy of this paragraph with any court as written evidence of the knowing, voluntary and bargained agreement between the parties irrevocably to waive any objections to venue or to convenience of forum. Process in any Proceeding referred to in the first sentence of this Section may be served on any party anywhere in the world.

COMMENT

The forum in which controversies relating to an acquisition are litigated can have a significant impact on the dynamics of the dispute resolution and can also affect the outcome. In this Section the parties select an exclusive forum for actions arising out of or relating to the Model Agreement and submit to jurisdiction in that forum. The forum selected by the buyer usually will be its principal place of business, which may not be acceptable to the seller. Often the seller will attempt to change the designation to a more convenient forum or simply to confer jurisdiction in the forum selected by the buyer without making it the exclusive forum. For an analysis of whether a forum selection clause is permissive or exclusive, *see Action Corp. v. Toshiba America Consumer Prods., Inc.*, 975 F. Supp. 170 (D.P.R. 1997).

Clauses by which the parties consent to jurisdiction are usually given effect so long as they have been freely negotiated among sophisticated parties. Exclusive forum selection clauses are generally upheld by the courts if they have been freely bargained for, are not contrary to an important public policy of the forum and are generally reasonable. *See generally* CASAD, JURISDICTION AND FORUM SELECTION § 4.17 (1988 & Supp. 1998); *cf. Bremen v. Zapata Offshore-Shore Co.*, 407 U.S. 1, 10 (1972) (forum selection clauses are prima facie valid and enforceable under unless they are unreasonable under the circumstances; a forum selection clause may be unreasonable if (1) the enforcement would be so gravely difficult and inconvenient that for all practical purposes the party resisting enforcement would be deprived of his day in court; (2) the clause is invalid for such reasons as fraud or overreacting; or (3) enforcement would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or judicial decision; the party claiming unfairness has a heavy burden of proof); *Holeman v. National Business Institute*, 94 S.W. 3rd 91, 97 (Tex. App.—Houston 2002, no writ) (“In Texas, forum selection clauses are valid and enforceable if (1) the parties have contractually consented to submit to the exclusive jurisdiction of another state and (2) the other state recognizes the validity of such provisions [unless] the interests of witnesses and the public strongly favor jurisdiction in a forum other than the one to which the parties agreed in the contract"); *Prosperous Maritime Corp. v. Farwah*, 189 SW 3rd 389 (Tex. App.—January 26, 2006) ("While a Texas court may enforce a valid forum-selection clause and thereby require the parties to litigate their dispute in the jurisdiction agreed to by the parties, the existence of a forum-selection clause does not generally deprive the forum of jurisdiction over parties. 'Generally, a forum-selection clause operates as consent to jurisdiction in one forum, not proof that the Constitution would allow no other.' *Michiana Easy Livin' Country, Inc. v. Holten*, 168 S.W. 3d 777, 792 (Tex. 2005). As a result, courts do not require that a party file a special appearance to perfect its right to enforce a forum-selection clause. *In re AIU Ins. Co.*, 148 S.W. 3d 109, 121 (Tex. 2004)."). Accordingly, a court in a forum other than the one selected may, in certain circumstances, elect to assert jurisdiction, notwithstanding the parties' designation of another forum. In these situations, the courts will determine whether the provision in the agreement violates public policy of that state and therefore enforcement of the forum selection clause would be unreasonable.

A forum selection clause in an ancillary document can affect the forum in which disputes regarding the principal acquisition agreement are to be resolved. In a choice of forum skirmish regarding the *IBP v. Tyson Foods* case discussed in the Comment to Section 3.15 and in Appendix C, the Delaware Chancery Court concluded: (1) Tyson's Arkansas claims and IBP's Delaware clause claims were contemporaneously filed, even though Tyson had won the race to the courthouse by five business hours, and (2) most of Tyson's Arkansas claims fell within the scope of the contractual choice of forum clause in a confidentiality agreement requiring litigation in the courts of Delaware. The Chancery Court then concluded that because of the forum selection clause, only a Delaware court could handle all of the claims by Tyson, including the disclosure and material adverse change disputes. *IBP, Inc. v. Tyson Foods, Inc. and Lasso Acquisition Corporation*, No. 18373, 2001 Del. Ch. LEXIS 81 (Del. Ch. April 18, 2001). The confidentiality agreement provision explicitly limited Tyson's ability to base litigable claims on assertions that the evaluation materials it received were false, misleading or incomplete as follows:

> "We understand and agree that none of the Company [i.e., IBP], its advisors or any of their affiliates, agents, advisors or representatives (i) have made or make any representation or warranty, expressed or implied, as to the accuracy or completeness of the Evaluation Material or (ii) shall have any liability whatsoever to us or our Representatives relating to or resulting to or resulting from the use of the Evaluation Materials or any errors therein or omissions therefrom, except in the case of (i) and (ii), to the extent provided in any definitive agreement relating to a Transaction."

The confidentiality agreement also limited Tyson's ability to sue over evaluation materials in a forum of its own choice:

> "We hereby irrevocably and unconditionally submit to the exclusive jurisdiction of any State or Federal court sitting in Delaware over any suit, action or proceeding arising out of or relating to this Agreement. We hereby agree that service of any process, summons, notice or document by U.S. registered mail addressed to us shall be effective service of process for any action, suit or proceeding brought against us in any such court. You hereby irrevocably and unconditionally waive any objection to the laying of venue of any such suit, action or proceeding brought in any such court and

> any claim that any such court and any claim that any such suit, action or proceeding brought in any such court has been brought in an inconvenient form. We agree that a final judgment in any such suit, action or proceeding brought in any such court shall be conclusive and binding upon us and may be enforced in any other courts to whose jurisdiction we are or may be subject, by suit upon such judgment. . . .
>
> "This agreement shall be governed by, and construed and enforced in accordance with, the laws of the State of Delaware."

Noting that Tyson had not argued that the forum selection clause had been procured by fraud, the Chancery Court commented that forum selection clauses are *prima facie* valid and enforceable in Delaware, and in footnote 21 wrote as follows:

> "*Chaplake Holdings, Ltd. v. Chrysler Corp.*, Del. Super., 1995 Del. Super. LEXIS 463, at *17- *18, Babiarz, J. (Aug. 11, 1995) ("forum selection clauses are 'prima facie valid' and should be 'specifically' enforced unless the resisting party 'could clearly show that enforcement would be unreasonable and unjust, or that the clause is invalid for reasons such as fraud or overreaching'" (*quoting M/S Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972)).
>
> "Delaware courts have not hesitated to enforce forum selection clauses that operate to divest the courts of this State of the power they would otherwise have to hear a dispute. See, e.g., *Elf Atochem North Am., Inc. v. Jaffari*, Del. Supr., 727 A.2d 286, 292-96 (1999) (affirming dismissal of an action on grounds that a Delaware Limited Liability Company had, by the LLC agreement, bound its members to resolve all their disputes in arbitration proceedings in California); *Simon v. Navellier*, Series Fund, Del. Ch., 2000 Del. Ch. LEXIS 150, Strine, V.C. (Oct. 19, 2000) (dismissing an indemnification claim because a contract required the claim to be brought in the courts of Reno, Nevada). The courts of Arkansas are similarly respectful of forum selection clauses:
>
>> "We cannot refuse to enforce such a clause, which we have concluded is fair and reasonable and which we believe meets the due process test for the exercise of judicial juridiction. To do otherwise would constitute a mere pretext founded solely on the forum state's preference for its own judicial system and its own substantive law.
>>
>> "Accordingly, we conclude that the express agreement and intent of the parties in a choice of forum clause should be sustained even when the judicial jurisdiction over the agreements is conferred upon a foreign state's forum.
>>
>> "*Nelms v. Morgan Portable Bldg. Corp.*, 808 S.W. 2d 3 14, 3 18 (Ark. 1991)."

Thus, the inclusion of a forum selection clause in the IBP/Tyson confidentiality agreement ended up dictating where the litigation over major disclosure and material adverse change issues and provisions would be litigated.

Some state statutes attempt to validate the parties' selection of a forum. For example, a California statute provides that actions against foreign corporations and nonresident persons can be maintained in California where the action or proceeding arises out of or relates to an agreement for which a choice of California law has been made by the parties, and the contract relates to a transaction involving not less than $1 million and contains a provision whereby the corporation or nonresident agrees to submit to the jurisdiction of the California courts. CAL. CIV. PROC. CODE § 410.40. *See also* DEL. CODE tit. 6, § 2708; N.Y. GEN. OBLIG. LAW § 5-1402.

The parties may also want to consider the inclusion of a jury trial waiver clause such as the following:

> THE PARTIES HEREBY WAIVE ANY RIGHT TO TRIAL BY JURY IN ANY PROCEEDING ARISING OUT OF OR RELATING TO THIS AGREEMENT OR ANY OF THE CONTEMPLATED TRANSACTIONS, WHETHER NOW OR EXISTING OR HEREAFTER ARISING, AND WHETHER SOUNDING IN CONTRACT, TORT OR OTHERWISE. THE PARTIES AGREE THAT ANY OF THEM MAY FILE A COPY OF THIS PARAGRAPH WITH ANY COURT AS WRITTEN EVIDENCE OF THE KNOWING, VOLUNTARY AND BARGAINED FOR AGREEMENT AMONG THE PARTIES IRREVOCABLY TO WAIVE TRIAL BY JURY, AND THAT ANY PROCEEDING WHATSOEVER BETWEEN THEM RELATING TO THIS AGREEMENT OR ANY OF THE CONTEMPLATED TRANSACTIONS SHALL INSTEAD BE TRIED IN A COURT OF COMPETENT JURISDICTION BY A JUDGE SITTING WITHOUT A JURY.

The jury trial waiver may be used in conjunction with, or in substitution for, the arbitration clause discussed below in jurisdictions where the enforceability of such clauses is in question.

The Seventh Amendment to the U.S. Constitution guarantees the fundamental right to a jury trial in "suits at common law, where the value in controversy shall exceed twenty dollars," and there is therefore a strong presumption against the waiver of the right to a jury trial. *Aetna Ins. Co. v. Kennedy*, 301 U.S. 389, 393 (1937) ("courts indulge every reasonable presumption against waiver"). As a result, courts have held that jury waiver clauses are to be narrowly construed and that any ambiguity is to be decided against the waiver. *National Equipment Rental, Ltd. v. Hendrix*, 565 F.2d 255 (2nd Cir. 1977); *Phoenix Leasing, Inc. v. Sure Broadcasting, Inc.*, 843 F. Supp. 1379, 1388 (D.Nev. 1994), *aff'd without opinion*, 89 F.3rd 846 (9th Cir. 1996). *See also Truck World, Inc. v. Fifth Third Bank*, No. C-940029, 1995 WL 577521, at *3 (Ohio App. Ct. Sept. 29, 1995) ("jury waiver clause should be strictly construed and should not be extended beyond its plain meaning"). The constitutional right to a jury trial is a question to be determined as a matter of federal law, while the substantive aspects of the claim are determined under state law. *Simler v. Conner*, 372 U.S. 221 (1963) (citing *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938) and other cases); *In Re DaimlerChrysler AG Sec. Litig. Tracinda Corp. v. DaimlerChrysler AG*, C.A. No. 00-993-JJF, 2003 WL 22769051, at *2 (D. Del. Nov. 19, 2003) (hereinafter "DaimlerChrysler").

Simler v. Conner, 372 U.S. 221 (1963) (citing *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938) and other cases). The Delaware Constitution preserves the right to trial by jury, as it existed at common law. *Graham v. State Farm Mutual Automobile Ins. Co.*, 565 A.2d 908, 912 (Del. 1989). "The right [to a jury trial] existed at common law for actions arising from breach of contract." *Seaford Assoc. v. Hess Apparel, Inc.*, C.A. No. 92C-10-11, 1993 WL 258723, at *1 (Del. Super. June 22, 1993).

While "nearly every state court that has considered the issue has held that parties may agree to waive their right to trial by jury in certain future disputes . . . ." (*In re Prudential Ins. of America*, 148 S.W.3d 124, 132-133 (Tex. 2004)), either expressly (*United States v. Moore*, 340 U.S. 616 (1951)), or by implication (*Commodity Futures Trading Com'n. v. Schor*, 478 U.S. 833 (1986)), courts have also held that jury waiver clauses must be knowingly and voluntarily entered into to be enforceable. *Morgan Guar. Trust Co. v. Crane*, 36 F. Supp.2d 602 (S.D.N.Y. 1999); *but see Grafton Partners L.P. v. The Superior Court of Alameda County (PriceWaterHouseCoopers L.L.P., Real Party in Interest)*, 116 P.3rd 479 (Calif. 2005) (California Supreme Court holding that a pre-dispute agreement waiving the right to a jury trial in the event of a dispute between the parties to the contract is unenforceable under the California Constitution which accords the right to trial by jury to parties who elect a judicial forum to resolve their disputes with a few inapplicable exceptions). In deciding whether a jury waiver clause was knowingly and voluntarily entered into, the court will generally consider four factors: (1) the extent of the parties' negotiations, if any, regarding the waiver provision; (2) the conspicuousness of the provision; (3) the relative bargaining power of the parties; and (4) whether the waiving party's counsel had an opportunity to review the agreement. *Whirlpool Financial Corp. v. Sevaux*, 866 F. Supp. 1102, 1105 (N.D. Ill. 1994), *aff'd*, 96 F.3d 216 (7th Cir. 1996). Other courts have formulated the fourth factor of this test as "the business acumen of the party opposing the waiver." *Morgan Guaranty*, 36 F. Supp.2d at 604.

While there are no special requirements for highlighting a jury waiver clause in a contract to meet the second prong of this test, there are ways to craft a sufficiently conspicuous jury waiver clause to support the argument that the waiver was knowingly entered into, including having the clause typed in all bold face capital letters and placing it at the end of the document directly above the signature lines. Although adherence to these techniques will not guarantee enforceability of the jury waiver clause (*Whirlpool Financial*, 866 F. Supp. at 1106, holding that there was no waiver despite the fact that the clause was printed in capital letters), courts have found these to be important factors in deciding the validity of jury waiver clauses. *See, e.g., Morgan Guaranty*, 36 F. Supp.2d at 604, where the court held that the defendant had knowingly waived the right because the clause immediately preceded the signature line on the same page. In *In re General Electric Capital Corp.*, 203 S.W. 3d 314 (Tex. 2006), the Texas Supreme Court in rejecting the argument that evidence was not presented showing that the required jury waiver was entered into knowingly and voluntarily, wrote:

> The waiver provision, however, was written in capital letters and bold print, providing that:
>
> > THE MAKER HEREBY UNCONDITIONALLY WAIVES ITS RIGHTS TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION BASED UPON OR ARISING OUT OF, DIRECTLY OR INDIRECTLY, THIS NOTE, ... IN THE EVENT OF LITIGATION,

5295380v.1

THIS NOTE MAY BE FILED AS A WRITTEN CONSENT TO A TRIAL BY THE COURT.

Such a conspicuous provision is prima facie evidence of a knowing and voluntary waiver and shifts the burden to the opposing party to rebut it.

In deciding whether a jury waiver clause was voluntarily entered into, courts generally will consider (1) the disparity of the parties' bargaining power positions, (2) the parties' opportunity to negotiate, and (3) the parties' experience or business acumen. *See, e.g., Morgan Guaranty*, 36 F. Supp.2d at 604, where the court enforced a jury waiver when it found that certain terms of the note at issue had been negotiated, and *Sullivan v. Ajax Navigation Corp.*, 881 F. Supp. 906, 910 (S.D.N.Y. 1995), where the court refused to enforce a jury waiver contained in a pre-printed cruise ship ticket.

Even where the terms of the acquisition agreement are heavily negotiated, the drafter may want to anticipate a challenge to the jury waiver clause, particularly if the seller is financially distressed or not particularly sophisticated. *See, e.g., Phoenix Leasing*, 843 F. Supp. at 1385, where the court held that the waiver was voluntary because some of the agreement's terms were negotiated, evidencing bargaining power, and finding that knowledge by the other party that funds were "badly needed" did not indicate gross disparity of bargaining power. The Phoenix Leasing court also enforced the waiver because it found that the defendant was "experienced, professional and sophisticated in business dealings" and "all parties were represented by counsel." Similarly, in *Bonfield v. Aamco Transmissions, Inc.*, 717 F. Supp. 589, 595-6 (N.D.Ill. 1989), the court found the waiver voluntary (1) because the party challenging the waiver was an experienced businessman who chose not to have counsel review the agreement, and (2) the defendant had explained the purpose of the jury waiver to the party challenging the waiver in terms of "the large verdicts juries tend to award" to which the court noted, "[i]f that did not grab [the] attention [of the party objecting to the waiver], nothing would." In *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 2003 U.S. Dist. Lexis 21122 (S.D.N.Y. 2003), a jury waiver in an asset purchase agreement was enforced and held to apply to a claim for fraudulent inducement where the agreement was the product of negotiations among sophisticated parties and there was no allegation that the waiver provision itself was procured by fraud. *But see Whirlpool Financial*, 866 F. Supp. at 1106, where the court held that the waiver was not voluntary in the light of evidence showing that the party challenging the jury waiver clause was desperate for cash and had no ability to change the inconspicuous terms of a standardized contract.

It is worth noting that the courts are split on the question of which party carries the burden of proving that a jury waiver was knowing and voluntary. Some have held that the burden is placed on the party attempting to enforce the waiver, *Sullivan*, 881 F. Supp. 906, while some have held that the party opposing the waiver bears the burden of proving that the waiver was *not* knowing and voluntary, *K.M.C. Co., Inc. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985), while still other courts have expressly avoided the issue altogether, Connecticut Nat'l. Bank v. Smith, 826 F. Supp. 57 (D.RI. 1993); *Whirlpool Financial*, 866 F. Supp. at 1102; *Bonfield*, 717 F. Supp. at 589. In Bonfield, the court also noted that there do not appear to be any reported decisions regarding the required standard of proof in these cases.

The last sentence of Section 13.4 provides that service of process may be obtained on any party anywhere in the world and is intended to waive the requirement of acquiring in personam jurisdiction.

The Model Agreement does not contain an alternate dispute resolution ("*ADR*") provision (other than that related to the purchase price adjustment procedure in Section 2.9) and contemplates litigation as the principal means of dispute resolution. Because of the growing use of ADR in acquisition documentation, the practitioner might wish to consider the advisability of various ADR clauses in the initial draft. ADR comes in many forms and variants, the most common of which is mandatory arbitration. Other forms of ADR are discussed later in this Comment.

For many years there was considerable debate in the various jurisdictions as to the enforceability of mandatory arbitration clauses. Those discussions have been resolved by a number of recent U.S. Supreme Court decisions that leave little doubt as to the enforceability of arbitration clauses in commercial documents. In *Southland Corp. v. Keating*, 465 U.S. 1 (1984), the Supreme Court held that Section 2 of the Federal Arbitration Act preempted a provision of the California Franchise Investment Law which California courts had interpreted as necessitating judicial consideration rather than arbitration. In *Allied-Bruce Terminix Companies, Inc. v. Dobson*, 513 U.S. 265 (1995), the Supreme Court held that the Federal Arbitration Act applies to the full extent of the Commerce Clause of the U. S. Constitution, and supersedes efforts by some state courts to limit the effect of arbitration clauses within their jurisdictions. In *Allied-Bruce*, the Court held that arbitration may include all forms of damages, including punitive damages claims. *See also Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52 (1995). *In First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938 (1995), the U.S. Supreme Court addressed the issue of who decides whether a dispute is arbitrable, the arbitrator or the court, and held that where the clause itself confers this power on the arbitrator the clause should be respected and the courts should give the arbitrator great flexibility in making such determinations.

Notwithstanding the evolution of the law to enforce such clauses, there is much debate among practitioners as to the advisability of including mandatory binding arbitration clauses in acquisition documents. Factors which support exclusion of a mandatory binding arbitration clause include the following: (i) litigation is the appropriate dispute resolution mechanism because the buyer is more likely than the seller to assert claims under the acquisition agreement; (ii) the prospect of litigation may give the buyer greater leverage with respect to resolving such claims than would the prospect of mandatory arbitration; (iii) arbitration may promote an unfavorable settlement; (iv) arbitration brings an increased risk of compromised compensatory damage awards; (v) arbitration lowers the likelihood of receiving high punitive damages; (vi) certain provisional remedies (such as injunctive relief) may not be available in arbitration; (vii) the arbitration decision may not be subject to meaningful judicial review; (viii) rules of discovery and evidence (unavailable in some arbitration proceedings) may favor the buyer's position; (ix) the ease with which claims may be asserted in arbitration increases the likelihood that claims will be asserted; and (x) because many of the facts necessary for favorable resolution of the buyer's claims may be in the seller's possession (especially if a dispute centers on representations and warranties containing knowledge qualifications), these facts may not be available to the buyer without full discovery. Factors which would encourage inclusion of a mandatory binding arbitration clause in a buyer's initial draft include the following: (i) arbitration may promote a reasonable settlement; (ii) arbitration may reduce costs; (iii) arbitration creates the possibility of keeping the dispute confidential; (iv) arbitrators may be more sophisticated in business affairs than judges or juries and reach a more appropriate result; (v) arbitration may be speedier than litigation; (vi) arbitration eliminates any "home court" advantage to a seller litigating in its own jurisdiction; (vii) arbitration is a less confrontational environment and may better maintain the business relations of the buyer and the seller; (viii) arbitration furnishes an opportunity to have special experts selected by the parties rule on technical issues; and (ix) arbitration decreases the risk of punitive damages.

Any analysis of this issue must begin with a determination of whether the buyer is more likely to sue or be sued, with the second step of the process being a selection of the environment which would most favor the buyer under those circumstances. The practice remains for a buyer's first draft to exclude any mandatory arbitration clause, but a number of factors, particularly concern over appearing before a judge and jury in a seller's jurisdiction, are resulting in increasing use of these clauses.

The American Arbitration Association issues general rules for commercial arbitration and specific rules for other types of arbitration including construction, patent, real estate valuation, securities, employment, title insurance, and franchises. The New York Stock Exchange and the National Association of Security Dealers also have specific rules of arbitration. Often the use of such arbitration procedures is part of the ordinary course of business, especially in the securities industry.

A complete ADR provision for mandatory binding arbitration generally addresses the following topics: consent by the parties to arbitration, the disputes which will be covered (generally all matters arising out of the transaction), the rules under which the arbitration will be governed, the substantive law to be applied, the location of the arbitration, the mechanism for selecting arbitrators (including their number and qualification), the person (arbitrator or court) who is to determine whether a dispute is subject to arbitration, any agreed limitation upon damages that can be awarded (although limitations on the remedies to be awarded have been looked upon with disfavor by the courts), and any requirements that the arbitrator recognize rules of evidence or other procedural rules or issue a written opinion. Some ADR provisions leave the qualifications and the number of the arbitrators to be determined once the need for arbitration is evident; others specify as much as possible in advance. Some ADR provisions also specify discovery procedures and procedures concerning exchange of information by the parties. The discovery provisions may require that discovery proceed in accordance with the Federal Rules of Civil Procedure. A comprehensive provision generally includes enforceability language and procedures for appeal of the award, although provisions for appeal may undercut the entire rationale for ADR. *See generally* American Arbitration Association, DRAFTING DISPUTE RESOLUTION CLAUSES: A PRACTICAL GUIDE (1993).

Drafters of ADR provisions should check for case law and statutes governing arbitration in the jurisdiction selected as the site of the arbitration to avoid unintended outcomes. For example, in California, an agreement to arbitrate claims relating to a contract creates authority to arbitrate "tort claims," and an agreement to arbitrate "any controversy" creates authority to award punitive damages. *See Tate v. Saratoga Savings & Loan Ass'n*, 216 Cal. App. 3d 843 (1989).

An example of a mandatory binding arbitration clause that might be appropriate for a buyer's first draft follows:

> Any controversy or claim arising out of or relating to this Agreement or any related agreement shall be settled by arbitration in accordance with the following provisions:
>
> A. Disputes Covered. The agreement of the parties to arbitrate covers all disputes of every kind relating to or arising out of this Agreement,

any related agreement or any of the Contemplated Transactions. Disputes include actions for breach of contract with respect to this Agreement or the related agreement, as well as any claim based on tort or any other causes of action relating to the Contemplated Transactions such as claims based on an allegation of fraud or misrepresentation and claims based on a federal or state statute. In addition, the arbitrators selected according to procedures set forth below shall determine the arbitrability of any matter brought to them, and their decision shall be final and binding on the parties.

B. Forum. The forum for the arbitration shall be ________________, _______________.

C. Law. The governing law for the arbitration shall be the law of the State of ____________, without reference to its conflicts of laws provisions.

D. Selection. There shall be three arbitrators, unless the parties are able to agree on a single arbitrator. In the absence of such agreement within ten days after the initiation of an arbitration proceeding, Seller shall select one arbitrator and Buyer shall select one arbitrator, and those two arbitrators shall then select, within ten days, a third arbitrator. If those two arbitrators are unable to select a third arbitrator within such ten day period, a third arbitrator shall be appointed by the commercial panel of the American Arbitration Association. The decision in writing of at least two of the three arbitrators shall be final and binding upon the parties.

E. Administration. The arbitration shall be administered by the American Arbitration Association.

F. Rules. The rules of arbitration shall be the Commercial Arbitration Rules of the American Arbitration Association, as modified by any other instructions that the parties may agree upon at the time, except that each party shall have the right to conduct discovery in any manner and to the extent authorized by the Federal Rules of Civil Procedure as interpreted by the federal courts. If there is any conflict between those Rules and the provisions of this Section, the provisions of this Section shall prevail.

G. Substantive Law. The arbitrators shall be bound by and shall strictly enforce the terms of this Agreement and may not limit, expand or otherwise modify its terms. The arbitrators shall make a good faith effort to apply substantive applicable law, but an arbitration decision shall not be subject to review because of errors of law. The arbitrators shall be bound to honor claims of privilege or work product doctrine recognized at law, but the arbitrators shall have the discretion to determine whether any such claim of privilege or work product doctrine applies.

H. Decision. The arbitrators' decision shall provide a reasoned basis for the resolution of each dispute and for any award. The arbitrators shall not have power to award damages in connection with any dispute in excess of actual compensatory damages and shall not multiply actual damages or award consequential or punitive damages or award any other damages that are excluded under the provisions of Article 11 of this Agreement.

I. Expenses. Each party shall bear its own fees and expenses with respect to the arbitration and any proceeding related thereto and the parties shall share equally the fees and expenses of the American Arbitration Association and the arbitrators.

J. Remedies; Award. The arbitrators shall have power and authority to award any remedy or judgment that could be awarded by a court of law in [designate jurisdiction]. The award rendered by arbitration shall be final and binding upon the parties, and judgment upon the award may be entered in any court of competent jurisdiction in the United States.

If each party selects one arbitrator, it might be appropriate to make clear in the arbitration clause whether those party-appointed arbitrators are to be neutral or are, in effect, advocate-arbitrators. Some arbitration clauses require the selection of three neutral arbitrators, all of whom are appointed in accordance with the rules of the arbitration authority.

An alternative to mandatory binding arbitration is mediation. A mediation clause may simply require negotiation (with or without a good faith standard) prior to litigation. Mediation is often an optional pre-arbitration procedure offered by the arbitration authority to the parties involved in an arbitration. The following is an example of a mediation provision:

Any controversy or claim arising out of or relating to this Agreement or any related agreement or any of the Contemplated Transactions will be settled in the following manner: (a) senior executives representing each of Seller and Buyer will meet to discuss and attempt to resolve the controversy or claim; (b) if the controversy or claim is not resolved as contemplated by clause (a), Seller and Buyer will, by mutual consent, select an independent third party to mediate such controversy or claim, provided that such mediation will not be binding upon any of the parties; and (c) if such controversy or claim is not resolved as contemplated by clauses (a) or (b), the parties will have such rights and remedies as are available under this Agreement or, if and to the extent not provided for in this Agreement, are otherwise available.

Among other alternative dispute resolution mechanisms is the private judge. The use of a private judge represents a combination of litigation and arbitration techniques and addresses the need for expedited trials between private parties. California statutes and other state laws specifically sanction this procedure, whereby the parties agree to appoint a "referee" to decide the dispute. Once appointed, the referee assumes all the power of a trial judge except contempt power. For example, testimony is made under oath but is often neither recorded nor reported. If the parties so desire, rules of evidence, procedures, or pleading may be modified. The referee provides the supervising court with a written report. This report stands as an appealable judgment.

In international transactions, mandatory binding arbitration often is preferred. Many attorneys and clients believe that the presence of an arbitration provision in an international contract gives some assurance that the contract will be performed in accordance with its terms because parties may be more reluctant to arbitrate than to litigate in a foreign national forum where one party would have a local advantage. In deciding to arbitrate a controversy in a country outside the United States, drafters of ADR provisions should verify that the arbitration result will not be disregarded by the courts of the country in which a decision may be enforced. Drafters of ADR provisions in the international context should be aware that resolutions of controversies by institutional arbitration (such as the International Chamber of Commerce or the London Court of Arbitration) are somewhat more readily honored by national courts outside the United States for enforcement purposes than are decisions of private party arbitrators operating outside the formal institutions. The Federal Arbitration Act recognizes the enforceability of international arbitration.

A commonly used international arbitration institution is the International Chamber of Commerce (the "*ICC*"), headquartered in Paris. The ICC provides for a review of all arbitration awards issued under its authority through its Court of Arbitration, a built-in review procedure. Drafters of ADR provisions who want to use the ICC Rules of Arbitration may want to first review the most recent version of the Rules. In general, the ICC Rules of Arbitration provide broad latitude to the arbitrators to determine whether to allow expert testimony and the amount of fact-finding to be conducted. Generally, an arbitration award under the ICC is rendered within six months after the close of hearings. A standard short form ICC arbitration clause is as follows:

> All disputes arising in connection with this Agreement or any of the Contemplated Transactions will be finally settled under the rules of conciliation and arbitration of the International Chamber of Commerce by one or more arbitrators appointed in accordance with these rules.

The rules often used within institutional arbitration are the rules of the United Nations Commission on International Trade Law ("*UNCITRAL*"). Among others, the American Arbitration Association and the ICC also provide for the use of UNCITRAL rules. Although the UNCITRAL rules reflect an effort to develop a standard international practice for arbitration, such rules may depart from United States practice in important respects. For example, all costs of arbitration under the UNCITRAL rules are paid by the unsuccessful party unless the arbitrators specifically determine that apportionment is necessary.

As with all ADR provisions, the substantive and governing procedural law (including application of conflicts of law) must be considered. The ADR provision may indicate whether custom or usage or subjective standards of what is just and equitable are to be considered by the arbitration panel in interpreting a contract. A key variable in choosing the forum for arbitration will be the location of the person against whom an award may be enforced and the enforceability of an arbitration award made in a local jurisdiction as opposed to a foreign jurisdiction. The currency for the award in an international dispute could be specified in the ADR provisions.

For a detailed discussion of international arbitration, see LETTERMAN, LETTERMAN'S, LAW OF PRIVATE INTERNATIONAL BUSINESS § 11.11 (1990 & Supp. 1991). For additional guidance on alternative dispute resolution, see the CORPORATE COUNSELLORS' DESK BOOK (Block & Epstein eds., 4th ed. 1992, Supp. 1998). For a general discussion of the types of ADR and the issues involved, see A DRAFTER'S GUIDE TO ALTERNATIVE DISPUTE RESOLUTION (Cooper & Meyerson eds., 1991).

13.5 ENFORCEMENT OF AGREEMENT

Seller and Shareholders acknowledge and agree that Buyer would be irreparably damaged if any of the provisions of this Agreement are not performed in accordance with their specific terms and that any Breach of this Agreement by Seller or Shareholders could not be adequately compensated in all cases by monetary damages alone. Accordingly, in addition to any other right or remedy to which Buyer may be entitled, at law or in equity, it shall be entitled to enforce any provision of this Agreement by a decree of specific performance and to temporary, preliminary and permanent injunctive relief to prevent Breaches or threatened Breaches of any of the provisions of this Agreement, without posting any bond or other undertaking.

COMMENT

This Section provides that the buyer is entitled to certain equitable remedies in those situations where monetary damages may be inadequate. For example, the buyer after the closing may seek to compel performance of the further assurances provision (Section 10.11), the confidentiality provision (Article 12) or, if included in the acquisition agreement, an arbitration provision.

The buyer may also seek specific performance of the acquisition agreement if the seller fails to perform its obligations to close the transaction. THE RESTATEMENT, (SECOND) OF CONTRACTS § 357(1) provides that, with certain exceptions, "specific performance of a contract duty will be granted in the discretion of the court against a party who has committed or is threatening to commit a breach of the duty." One of the exceptions is "if damages would be adequate to protect the expectation interest of the injured party." *Id.* § 359(1). Courts in exercising their discretion generally will specifically enforce contracts for the sale of real estate, subject to satisfaction of the usual equitable doctrines, but not contracts for the sale of personal property or the sale of stock, at least where there is a ready market or control does not shift. For specific performance to be granted, the Buyer will have to convince a court that the business being acquired is unique and damages would not be adequate to protect its interest. *See Allegheny Energy, Inc. v. DQE, Inc.*, 171 F.3d 153 (3d Cir. 1999). The seller may request a similar provision for its benefit, but its ability to obtain specific performance may be limited, particularly where the consideration is quantifiable in monetary terms.

In *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810 (Del. Ch. 2007), the dispute centered on whether the merger agreement limited seller's remedy to the reverse breakup fee or whether seller could seek specific performance. The Court determined that the merger agreement was ambiguous as to whether the parties had agreed that specific performance was intended to be an available remedy. As a result, the Court reviewed the extrinsic evidence, including the drafting and negotiating history of the merger agreement and related documents, and determined that the extrinsic evidence was not clear enough to conclude that there was a single, shared understanding with respect to the availability of specific performance under the merger agreement. Further, the Court determined that the evidence concerning the negotiations demonstrated that under the "**forthright negotiator**" principle of contract interpretation (i) the buyer did not know or have a reason to know that seller believed specific performance was an available remedy under the merger agreement,

(ii) seller knew or should have known that buyer believed that specific performance was not to be available, and (iii) in the face of the foregoing, seller failed to clarify its position affirmatively. Accordingly, the Court concluded that seller had failed to meet its burden of demonstrating that the common understanding of the parties permitted specific performance and denied specific performance. *See* XIII Deal Points (The Newsletter of the ABA Bus. L. Sec. Committee on Negotiated Acquisitions) at 19-20 (Spring 2008); *see DCV Holdings, Inc. v. ConAgra, Inc.*, 2005 Del. Super. LEXIS 88 (March 24, 2005) (In the course of reading a knowledge qualifier into a stock purchase agreement no undisclosed liabilities representation that was found to be ambiguous, a Delaware Superior Court wrote: "A contract will be construed against a party who maintains its own interpretation of an agreement and fails to inform the other party of that interpretation"); *cf. Julian v. Eastern States Construction Service, Inc.* (Del. Ch. No. 1892-VCP July 8, 2008) ("**forthright negotiator**" principle applied in construction of buyout rights in stockholder agreement for family owned business).

The buyer may seek to enjoin a breach by the seller or the shareholders of their covenants in the acquisition agreement, such as the covenant not to compete. In the case of a covenant not to compete, an injunction may be the only way for a buyer to prevent irreparable injury to the goodwill purchased by the buyer. As in the case of specific performance, an injunction against a breach of contract duty can be granted in the discretion of the court. RESTATEMENT, (SECOND) OF CONTRACTS § 357(2).

Providing for equitable remedies will not insure that the buyer will be successful in obtaining the requested relief, but the acknowledgment of the buyer's right to equitable relief may be persuasive to a court that is considering the matter. Similarly, on granting an injunction, a court may have little or no discretion in requiring a bond or undertaking, but expressly negating this in the acquisition agreement may be helpful in causing a court to minimize the impact on the buyer.

13.6 WAIVER; REMEDIES CUMULATIVE

The rights and remedies of the parties to this Agreement are cumulative and not alternative. Neither any failure nor any delay by any party in exercising any right, power, or privilege under this Agreement or any of the documents referred to in this Agreement will operate as a waiver of such right, power, or privilege, and no single or partial exercise of any such right, power, or privilege will preclude any other or further exercise of such right, power, or privilege or the exercise of any other right, power, or privilege. To the maximum extent permitted by applicable law, (a) no claim or right arising out of this Agreement or any of the documents referred to in this Agreement can be discharged by one party, in whole or in part, by a waiver or renunciation of the claim or right unless in writing signed by the other party; (b) no waiver that may be given by a party will be applicable except in the specific instance for which it is given; and (c) no notice to or demand on one party will be deemed to be a waiver of any obligation of that party or of the right of the party giving such notice or demand to take further action without notice or demand as provided in this Agreement or the documents referred to in this Agreement.

COMMENT

A waiver provision is common in acquisition agreements. A waiver provision specifies that the rights of the parties are cumulative in order to avoid construction that one remedy is sufficient. For example, if a party first requests an injunction and later requests money damages, the waiver provision is intended to eliminate any chance that the party will be deemed to have waived its right to money damages when it requested an injunction.

The waiver provision also is intended to defeat arguments that the course of performance or course of dealing with respect to the acquisition agreement dictates the outcome of disputes between the parties and that an immaterial delay prejudices the rights of the delaying party. Counsel might want to consider the relationship between the second sentence of Section 13.6 and the "time is of the essence" provision in Section 13.12.

A seller may seek to exclude Article 11 from the provision in Section 13.6 that the rights of a party in respect of the Model Agreement are cumulative. The effect of Section 13.6 in relation to Article 11 is that a party may elect whether to seek indemnification under Article 11 or pursue its remedies under common law, by statute or otherwise for breach of contract or other damages or relief. A seller may seek to provide that the indemnification provided by Article 11 is the buyer's exclusive remedy for breach of the Model Agreement, arguing that any limitations on damages and the time for asserting claims the seller has succeeded in negotiating would be frustrated if Article 11 were not the buyer's exclusive remedy.

13.7 ENTIRE AGREEMENT AND MODIFICATION

This Agreement supersedes all prior agreements, whether written or oral, between the parties with respect to its subject matter (including any letter of intent and any confidentiality agreement between Buyer and Seller) and constitutes (along with the Disclosure Letter, Exhibits and other documents delivered pursuant to this Agreement) a complete and exclusive statement of the terms of the agreement between the parties with respect to its subject matter. This Agreement may not be amended, supplemented or otherwise modified except by a written agreement executed by the party to be charged with the amendment.

COMMENT

This Section provides that the Model Agreement (along with the documents referred to in the acquisition agreement) contains the entire understanding of the Buyer and the Seller regarding the acquisition so that, unless otherwise specified, all prior agreements (whether written or oral) between the parties relating to the acquisition are superseded by (and not incorporated into) the terms of the acquisition agreement and any conflicts between previous agreements and the acquisition agreement are eliminated. *Dujardin v. Liberty Media Corporation*, 2005 WL 612835 (S.D.N.Y. March 16, 2005) ("It is generally understood that the purpose of an integration clause 'is to require full application of the parol evidence rule in order to bar the introduction of extrinsic evidence to vary or contradict the terms of the writing'"). Accordingly, if the parties were to agree that any pre-existing agreements between the parties regarding the acquisition (such as the confidentiality agreement or certain provisions in the letter of intent) should remain in effect, this Section would have to be revised accordingly. The Model Agreement addresses confidentiality (see Article 12) and "no-shop" (see Section 5.6) obligations; thus, there is no need for the letter of intent or any confidentiality agreement to remain in effect. For an example of the codification of non-integration clauses, see CAL. CIV. PROC. CODE § 1856.

As discussed in the Comment to Section 3.33 above, a seller may seek to contractually negate that seller has made any representations beyond those expressly set forth in Article 3 by inserting either in Article 3 or in Section 13.7 a statement such as the following:

> Except for the representations and warranties contained in Article 3, none of Seller or any Shareholder has made any representation or warranty, expressed or implied, as to Seller or as to the accuracy or completeness of any information regarding Seller furnished or made available to Buyer and its representatives, and none of Seller or any Shareholder shall have or be subject to any liability to Buyer or any other Person resulting from the furnishing to Buyer, or Buyer's use of or reliance on, any such information or any information, documents or material made available to Buyer in any form in expectation of, or in connection with, the transactions contemplated by this Agreement.

Such a statement would be intended both to emphasize that the Agreement is not intended to include any representations not expressly set forth therein, and also to negate common law claims such as fraud or negligent misrepresentation that occurred in the negotiations or due diligence that preceded the execution of the Agreement. A common law fraud claim generally requires the plaintiff to prove: (1) the speaker knowingly or recklessly made a misrepresentation of, or failed to disclose, a material fact known to the speaker; (2) the speaker knew that the other party did not know the fact and did not have an equal opportunity to discover it; (3) the speaker intended thereby to induce the other party to act on the misrepresentation or omission; and (4) the other party relied on the misrepresentation or omission and suffered injury as a result. *See*, *e.g.*, *Daldav Assocs., L.P. v. Lebor*, 391 F. Supp. 2d 472 (N.D. Tex. 2005); *Cronus Offshore, Inc. v. Kerr McGee Oil & Gas Corp.*, 369 F. Supp. 2d 848 (E.D. Tex. 2004), *affirmed* 133 Fed. App'x 944 (5th Cir. 2005); *Stephenson v. Capano Dev., Inc.*, 462 A.2d 1069, 1074 (Del. Super. 1983) (under Delaware law the elements of fraud are: "(1) a false or misleading representation, or deliberate concealment of a material fact, by the defendant; (2) the defendant's knowledge or belief that the representation was false, or was made with reckless indifference to the truth; (3) an intent to induce the plaintiff to act or refrain from acting; (4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of such reliance"; "one is equally culpable of fraud who by omission fails to reveal that which it is his duty to disclose in order to prevent statements actually made from being misleading").

A negligent misrepresentation claim is similar to a common law fraud claim, but does not require proof of a knowing or reckless misrepresentation. *See*, *e.g.*, *In re Med. Wind Down Holdings III, Inc.*, 332 B.R. 98, 102 (Bankr. D. Del. 2005); *BCY Water Supply Corp. v. Residential Inv., Inc.*, 170 S.W.3d 596, 602 (Tex. App.—Tyler 2005, pet. denied).

The element of reliance that a plaintiff must prove in a fraud or negligent misrepresentation case may be negated as to extra-contractual statements or omissions by a non-reliance provision such as the one quoted above. *See*, *e.g.*, *H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129, 142 n.18 (Del. Ch. 2003) ("sophisticated parties to negotiated commercial contracts may not reasonably rely on information that they contractually agreed did not form a part of the basis for their decision to contract"); *Prudential Ins. Co. of Am. v. Jefferson Assocs., Ltd.*, 896 S.W.2d 156 (Tex. 1995); *Schlumberger Tech. Corp. v. Swanson*, 959 S.W.2d 171 (Tex. 1997); *see also* Glenn D. West and Adam Nelson, *Corporations*, 57 SMU L. Rev. 799, 814-17 (2004); *but see Kronenberg v. Katz*, 872 A.2d 568, 591 (Del. Ch. 2004) (a general integration clause is insufficient to bar claims of fraud: "for a contract to bar a fraud in the inducement claim, the contract must contain language that, when read together, can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract. The presence of a standard integration clause alone, which does not contain explicit anti-reliance representations and which is not accompanied by other contractual provisions demonstrating with clarity that the plaintiff had agreed that it was not relying on facts outside the contract, will not suffice to bar fraud claims").

In *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.3d 1032 (Del. Ch. 2006), which is discussed further in Appendix E, a stock purchase agreement included a merger clause or a "buyer's promise" that it was not relying upon any representations and warranties not stated in the contract, and the Delaware Chancery Court wrote that such provisions are generally enforceable:

> When addressing contracts that were the product of give-and-take between commercial parties who had the ability to walk away freely, this court's jurisprudence has . . . honored clauses in which contracted parties have disclaimed reliance on extra-contractual representations, which prohibits the promising party from reneging on its promise by premising a fraudulent inducement claim on statements of fact it had previously said were neither made to it nor had an effect on it.
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> * * *
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> The teaching of this court . . . is that a party cannot promise, in a clear integration clause of a negotiated agreement, that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a "but we did rely on those other representations" fraudulent inducement claim. The policy basis for this line of cases is, in my view, quite strong. If there is a public policy interest in truthfulness, then that interest applies with more force, not less, to contractual representations of fact. Contractually binding, written representations of fact ought to be the most reliable of representations, and a law intolerant of fraud should abhor parties that make such representations knowing they are false.
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> * * *
>
> Nonetheless, . . . we have not given effect to so-called merger or integration clauses that do not clearly state that the parties disclaim reliance upon extra-contractual statements. Instead, we have held . . . that murky integration clauses, or standard integration clauses without explicit anti-reliance representations, will not relieve a party of its oral and extra-contractual fraudulent representations. The integration clause must contain "language that . . . can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract." This approach achieves a sensible balance between fairness and equity — parties can protect themselves against unfounded fraud claims through explicit anti-reliance language. If parties fail to include unambiguous anti-reliance language, they will not be able to escape responsibility for their own fraudulent representations made outside of the agreement's four corners.

In *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 2003 U.S. Dist. Lexis 21122 (S.D.N.Y. 2003), an asset purchase agreement contained a "merger clause" equivalent to Section 13.7. After closing, the purchasers alleged that the sellers failed to disclose sham trades with Enron, which inflated the profitability of the business and violated applicable laws. Sellers argued that the analogue to Section 13.7 and a provision in the confidentiality agreement (which survived the making of the asset purchase agreement, unlike this Agreement in which the confidentiality agreement does not survive) precluded purchasers from making fraud in the inducement claims since they were not based on specific representations in the agreement. In ruling that purchasers' allegations were sufficient to survive a motion to dismiss, the Court wrote:

> In its counterclaim, Allegheny [purchaser] alleges that Merrill Lynch [seller] misrepresented GEM's [acquired business] internal controls, its infrastructure, its historical revenues, its trading volume, its growth rate, and the qualifications of Gordon. Merrill Lynch contends that Allegheny's counterclaims for fraudulent inducement should be dismissed because the alleged misrepresentations are not in Article III of the Purchase Agreement and the Purchase Agreement provided that only those representations and warranties in Article III had any legal effect [the Purchase Agreement provided: "Except for the representations and warranties contained in this Article III, neither the Sellers nor any other Person make any express or implied representation or warranty on behalf of or with respect to the Sellers, the Business or the Purchased Assets, and the Sellers hereby disclaim any representation or warranty not contained in this Article III."] Also, the Purchase Agreement contains a standard merger clause [like Section 13.7, the Purchase Agreement provided that the Purchase Agreement shall "constitute the entire agreement of the parties hereto with respect to the subject matter hereof . . . and supercede all prior agreements and undertakings, both written and oral, between the Purchasers and the Sellers . . . other than the Confidentiality Agreement," which does not survive in this Agreement]. In addition, the Confidentiality Agreement provided that "neither party makes any representation or warranty as to the accuracy or completeness of the Evaluation Material and that only those representations and warranties made in a definitive agreement, if any, shall have any legal effect." Merrill Lynch contends that given the disclaimer and the merger clause in the Purchase Agreement and the disclaimer in the Confidentiality Agreement, both of which documents were negotiated between sophisticated parties represented by counsel, Allegheny relied at its peril on any representations not included in the Purchase Agreement and that this lack of reasonable reliance is fatal to a claim for fraudulent inducement, whether the remedy is rescission or money, and negligent misrepresentation. Allegheny advances two theories to get their claim for fraudulent inducement around the provisions in the Purchase Agreement and the Confidentiality Agreement: First, they contend a general, non-specific disclaimer does not bar a fraudulent-inducement claim, and second, the matters misrepresented were peculiarly within Merrill Lynch's knowledge.
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> As the Second Circuit noted, "Where sophisticated businessmen engaged in major transactions enjoy access to critical information but fail to take advantage of that access, New York courts are particularly disinclined

to entertain claims of justifiable reliance." *Grumman Allied Industries, Inc. v. Rohr Industries, Inc.,* 748 F.2d 729, 737 (2d Cir. 1984). "In assessing the reasonableness of a plaintiff's alleged reliance, we consider the entire context of the transaction, including factors such as its complexity and magnitude, the sophistication of the parties, and the content of any agreements between them." *Emergent Capital Inv. Mgmt., LLC v. Stonepath Group, Inc.,* 343 F.3d 189, 195 (2d Cir. 2003). It is settled in New York that "Where a party specifically disclaims reliance upon a representation in a contract, that party cannot, in a subsequent action for fraud, assert it was fraudulently induced to enter into the contract by the very representation it has disclaimed." *Banque Arabe Et Internationale D'Investissement v. Maryland Nat'l Bank*, 57 F.3d 146, 155 (2d Cir. 1995) (quoting *Grumman Allied Indus. Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 734-35 (2d Cir. 1984)). However, a "disclaimer is generally enforceable only if it 'tracks the substance of the alleged misrepresentation . . . .'" *Caio/a v. Citibank, NA.,* 295 F.3d 312, 330 (2d Cir. 2002) (quoting *Grumman Allied,* 748 F.2d at 735). As Merrill Lynch concedes, the disclaimer at issue here is general and does not track the substance of the alleged misrepresentations — *i.e.*, it does not state that Merrill Lynch disclaims any prior representations about the Enron transactions or Gordon's qualifications. Nevertheless, there is considerable authority for Merrill Lynch's position that this general disclaimer, which was between sophisticated entities negotiated at arms' length, should nevertheless be given effect and deprive Allegheny of a claim for reasonable reliance on any other representation — especially where the agreement enumerates representations in detail and contains a merger clause. *See, e.g., Harsco Corp. v. Segui*, 91 F.3d 337, 345-46 (2d Cir, 1996); *Consolidated Edison, Inc. v. Northeast Utilities*, 249 F. Supp. 2d 387, 401 (S.D.N.Y. 2003) ("In this case, the specific disclaimer in the Confidentiality Agreement combined with the merger clause in the Merger Agreement defeat any claim of reasonable reliance on the alleged oral statements in the course of due diligence and the written August Policies."). In *Harsco*, the Court explained:

> [R]elying on the sophisticated context of this transaction, we hold that Harsco must be held to its agreement. . . . We think Harsco should be treated as if it meant what it said when it agreed in Section 2.05 that there were no representations other than those contained in Sections 2.01 through 2.04 that were part of the transaction. [T]he exhaustive nature of the Section 2.04 representations adds to the specificity of Section 2.05's disclaimer of other representations. We can see no reason not to hold Harsco to the deal it negotiated.

Harsco, 91 F.3d at 346; *see also id.* ("Under the circumstances of this case, 'no other representations' means no other representations.").

Despite the general hostility of courts to claims by sophisticated business entities for fraudulent inducement, under the standards applicable at this stage of the litigation, I am unwilling to conclude as a matter of law

> that Allegheny's reliance on these alleged misrepresentations was unreasonable. Most significantly, the agreements in the cases that Merrill Lynch relies on placed the burden on the buyer to perform its due diligence and to ensure that the representations in the final agreement covered known or readily knowable risks. Here, the Purchase Agreement places at least some of that burden on Merrill Lynch, *e.g.*, "all information known to Sellers which, in their reasonable judgment exercised in good faith, is appropriate for Purchasers to evaluate the trading positions and trading operations of the Business." Also significant is the fiduciary relationship, which, though terminated when the alleged misrepresentations and/or omissions were made, had existed until shortly before the representations. Finally, Allegheny Energy has alleged that the information was peculiarly within Merrill Lynch's knowledge. *See Banque Arabe*, 57 F.3d at 155 ("[E]ven such an express waiver or disclaimer 'will not be given effect where the facts are peculiarly within the knowledge of the party invoking it.'" (quoting *Stambovsky v. Ackley*, 572 N.Y.S.2d 672, 677 (App. Div. 1st Dep't 1991)). In *Banque Arabe*, the court determined that the party could not reasonably rely on the other party to disclose the allegedly fraudulently concealed information because the information generally was readily accessible to anyone who inquired and the risk associated with this information was known and disclosed. *BanqueArabe*, 57 F.3d at 156-57. Here, in contrast, Allegheny has alleged that the information at issue was not generally known nor readily accessible because it pertained to potentially illegal activity that Merrill Lynch would not want to disclose.

After a bench trial on the merits, the Court commented that the case is a "saga of missteps taken by two of America's largest and most respected entities and which it is sad to say can only be characterized as having happened through a combination of fraud and greed." *Merrill Lynch & Co., Inc. v. Allegheny Energy, Inc.*, 2005 WL 1663265 (S.D.N.Y. 2005). The Court found that Merrill Lynch had unknowingly provided false and misleading information during the course of a four-month $6 million due diligence process conducted for Allegheny by a team of "revered" accounting, legal and investment banking firms, but that Allegheny was never in the dark about "the incredible difficulty in nailing down any sort of concrete value" for a key asset and had received corrected financial data as the asset purchase agreement was being finally negotiated and before it was signed. The Court concluded that there was no proof the Merrill Lynch provided "financial material was not prepared in good faith or that it is not basically accurate." In holding against Allegheny on its breach of warranty and fraudulent inducement claims, the Court wrote:

> It is not enough that Allegheny show that warranties in the Purchase Agreement were breached. In order to prevail in its breach of contract claims, Allegheny must show that the misrepresentations or omissions were the proximate cause of reasonably certain damages.
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> * * *
>
> Allegheny conflates proximate cause and calculation of damages through its assertion that it is entitled to the difference between the price it paid and the hypothetical "true value" of the GEM at the time of purchase. Allegheny claims that it was deceived into paying a premium for GEM by Merrill Lynch's misrepresentations about GEM's earnings and the quality

and integrity of its personnel and this translates directly into money damages. But Allegheny has not been able to overcome the hurdle of proving that the damages, if any, were proximately caused by any of Merrill Lynch's misdeeds, so any discussion of damages, which in this Court's view are too speculative anyway, is misplaced.

* * *

Moreover, Allegheny's claim for benefit-of-the-bargain damages must be based on the "bargain that was actually struck, not on a bargain whose terms must be supplied by hypothesis about what the parties would have done if the circumstances surrounding their transaction had been different." * * *

To prevail on its claim of fraudulent inducement, Allegheny must prove (1) that Merrill Lynch made a material misrepresentation of fact or omission of fact; (2) Merrill Lynch acted knowingly or with reckless disregard of the truth; (3) Merrill Lynch intended to induce Allegheny's reliance; (4) Allegheny justifiably relied on ML's misrepresentation or omission; and (5) Allegheny suffered injury as a result. [citation omitted]

Allegheny argues there was a conspiracy afoot at Merrill Lynch to gain a fraudulent purchase price for its energy trading desk, the GEM. While it is certain that through its agent, Dan Gordon [a confessed embezzler who admitted he altered certain data to make GEM look more profitable], and perhaps others, Merrill Lynch made material misrepresentations of fact with regard to the financial documents provided to Allegheny, and these documents made the GEM look more attractive for purchase than it really was. The critical problem for Allegheny is with regard to its justifiable reliance on any of the representations or omissions made by Merrill Lynch. * * * "Where sophisticated businessmen engaged in major transactions enjoy access to critical information but fail to take advantage of that access, New York courts are particularly disinclined to entertain claims of justifiable reliance." [citation omitted] Allegheny is undoubtedly a sophisticated party that was represented at every step by competent, experienced, and expensive advisors. Without exploring the parameters of their legal obligations, suffice it to say that by reputation at least they are the best in the business. Further, the evidence shows that Merrill Lynch opened its books and records and accorded Allegheny four months of due diligence. Allegheny cannot now claim to have reasonably relied on non-disclosures as to information that was available had it pursued its due diligence with a little more pizzazz.

* * *

The misrepresentations of which Allegheny now complains could have been discovered without great difficulty. It would not have taken much effort to discover the $43 million fraudulent insurance contract sold to the GEM by Dan Gordon, and pocketed by him, considering that the entire existence of the insurance company was a sham.

> Moreover, Allegheny's fraud claim suffers from the same deficiency as its breach of contract claims in that it has failed to prove that its injury was the result of Merrill Lynch's misrepresentations or omissions. In actions for fraud too, proximate cause (or loss causation) requires a plaintiff to show a direct link between the wrongdoings complained of and the damages alleged.

* * *

The District Court's dismissal, following a bench trial, of Allegheny's fraudulent inducement and breach of warranty claims was reversed by the Second Circuit in *Merrill Lynch & Co. v. Allegheny Energy, Inc.*, 500 F.3d 188 (2d Cir. 2007). *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 63 Bus. Law. 531, 543-546 (2008). As to liability, the Second Circuit focused on Merrill Lynch's warranties relating to the material accuracy of the financial records of the acquired business ("*GEM*"), as well as a broad warranty that the material Merrill Lynch had provided to Allegheny "in the aggregate, includes all information known to the Sellers which, in their reasonable judgment exercised in good faith, is appropriate for [Allegheny] to evaluate [GEM's] trading positions and trading operations".

On the fraudulent inducement claim, the Second Circuit held that the warranties "imposed a duty on [Merrill Lynch] to provide accurate and adequate facts and entitled [Allegheny] to rely on them without further investigation or sleuthing" (although, upon the retrial, Allegheny would be required to offer proof "that its reliance on the alleged misrepresentations was not so utterly unreasonable, foolish or knowingly blind as to compel the conclusion that whatever injury it suffered was its own responsibility"). For purposes of the breach of warranty claim, the Second Circuit cited "the general rule" "that a buyer may enforce an express warranty even if it had reason to know that the warranted facts were untrue", although if "the seller has disclosed at the outset facts that would constitute a breach of warranty" and "the buyer closes with full knowledge and acceptance of those inaccuracies", the buyer could not prevail on the breach of warranty claim.

As to claims for causation and damages for fraudulent inducement, the Second Circuit ruled that if the seller of the business fraudulently misrepresented the qualities of the business (including its key personnel and financial performance), the buyer would be entitled to an award of damages measured by the extent to which the purchase price overstated the value of the business on the date of sale as a result of the sellers' misrepresentations and omissions. On the breach of warranty contract claim, the buyer would be "entitled to the benefit of its bargain", measured as the difference between the value of the business as warranted by the seller and its true value "as delivered" at the time of the transaction. This "value as delivered", in the court's view, "should reflect any deductions from [the] purchase price necessary to reflect the broken warranties".

In the event that the transaction in the *Merrill Lynch* case had involved a "security" within the meaning of the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (the "*1934 Act*"), and the purchasers were asserting claims under Rule 10b-5 under the 1934 Act, the sellers could have argued that the combination of the merger clause and the provision that no representations were made beyond those expressly set forth in Article 3 negated the "reliance" necessary to state a claim for fraud under Rule 10b-5. Purchasers would have countered that such a provision constitutes an "anticipatory waiver" which is void under Section 29(a) of the 1934 Act, which provides: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of any rule or regulation thereunder…shall be void." The result is a matter of federal law, and may vary depending upon the circuit in which the matter is litigated. *Compare AES Corp. v. Dow Chemical Co.*, 325 F.3d 174 (3d Cir. 2003) and *Rogen v. Illikon*, 361 F.2d 260 (1st Cir. 1966) holding that such a non-reliance provision is not enforceable as a matter of law, although it may support a finding of fact that purchasers' alleged reliance was not reasonable under the circumstances, *with Harsco Corp. v. Sequi*, 91 F.3d 337 (2nd Cir. 1966) holding that such a provision does not constitute a forbidden waiver where it is developed via negotiations among sophisticated business entities and their advisors.

This Section also states that the acquisition agreement may be amended only by a written agreement signed by the party to be charged with the amendment. This Section reflects the principle that a contract required by the Statute of Frauds to be in writing may not be orally modified, and follows Section 2-209(2) of the Uniform Commercial Code, which provides that "[a] signed agreement which excludes modification or recision except by a signed writing cannot be otherwise modified or rescinded. . . ." *Cf.* CAL. CIV. CODE § 1698; *Deering Ice Cream Corp. v. Columbo, Inc.*, 598 A.2d 454, 456 (Me. 1991) ("The parties never memorialized any meeting of the minds on modifying their contract in the form required by the contract documents.") However, the rule prohibiting oral modification of contracts within the Statute of Frauds has not been applied in cases in which there has been partial performance of an oral agreement to modify the written contract, especially if one party's conduct induces another to rely on the modification agreement. *See, e.g.*, *Rose v. Spa Realty Assoc.*, 42 N.Y.2d 338, 340-41 (1977); *Ridley Park Shopping Ctr., Inc. v. Sun Ray Drug Co.*, 180 A.2d 1 (Pa. 1962); *Paul v. Bellavia*, 536 N.Y.S.2d 472, 474 (App. Div. 1988); *cf.* Jolls, *Contracts as Bilateral Commitments: A New Perspective on Contract Modification*, 26 J. LEGAL STUD. 203 (1997).

13.8 DISCLOSURE LETTER

(a) The information in the Disclosure Letter constitutes (i) exceptions to particular representations, warranties, covenants and obligations of Seller and Shareholders as set forth in this Agreement or (ii) descriptions or lists of assets and liabilities and other items referred to in this Agreement. If there is any inconsistency between the statements in this Agreement and those in the Disclosure Letter (other than an exception expressly set forth as such in the Disclosure Letter with respect to a specifically identified representation or warranty), the statements in this Agreement will control.

(b) The statements in the Disclosure Letter, and those in any supplement thereto, relate only to the provisions in the Section of this Agreement to which they expressly relate and not to any other provision in this Agreement.

COMMENT

Section 13.8 represents the buyer's opening position in a debate that occurs frequently in the negotiation of acquisition agreements: what effect does a disclosure made with respect to one representation have on other representations? The buyer typically seeks to limit the effect of such a disclosure to the specific representation to which the disclosure refers, arguing that the impact of the matter disclosed cannot be evaluated in the absence of the context given by the particular representation. For example, the buyer may view differently a contract disclosed in response to a representation that calls for a list of material contracts than one disclosed in response to a representation concerning transactions with related parties -- the latter situation increases the likelihood that the economic terms of the contract are not at arm's length. The seller and the shareholders will frequently argue that it is unfair for them to be penalized for a failure to identify each of the many representations in a long-form acquisition agreement -- which often overlap -- to which a disclosed state of facts relate. Indeed, the seller often prefers not to characterize the disclosures made in the Disclosure Letter by reference to any representations and attempts to qualify all representations by the Disclosure Letter (for example, Article 3 would begin "Seller and each Shareholder represent and warrant, jointly and severally, to Buyer as follows, except as otherwise set forth in the Disclosure Letter"). A frequent compromise is to modify Section 13.8(a) by adding at the end "except to the extent that the relevance to such other representation and warranty is manifest on the face of the Disclosure Letter."

Some sellers might prefer to insert a provision such as the following in lieu of Section 13.8:

> (a) Any disclosure under one Part of the Disclosure Letter shall be deemed disclosure under all Parts of the Disclosure Letter and this Agreement. Disclosure of any matter in the Disclosure Letter shall not constitute an expression of a view that such matter is material or is required to be disclosed pursuant to this Agreement.
>
> (b) To the extent that any representation or warranty set forth in this Agreement is qualified by the materiality of the matter(s) to which the representation or warranty relates, the inclusion of any matter in the Disclosure Letter does not constitute a determination by Seller and Shareholders that any such matter is material. The disclosure of any [information concerning a] matter in the Disclosure Letter does not imply that any other, undisclosed matter which has a greater significance [or value] is material.

13.9 ASSIGNMENTS, SUCCESSORS AND NO THIRD-PARTY RIGHTS

(a) No party may assign any of its rights or delegate any of its obligations under this Agreement without the prior written consent of the other parties, except that Buyer may assign any of its rights and delegate any of its obligations under this Agreement to any Subsidiary of Buyer and may collaterally assign its rights hereunder to any financial institution providing financing in connection with the Contemplated Transactions. Subject to the preceding sentence, this Agreement will apply to, be binding in all respects upon and inure to the benefit of the successors and permitted assigns of the parties.

(b) Nothing expressed or referred to in this Agreement will be construed to give any Person other than the parties to this Agreement any legal or equitable right, remedy or claim under or with respect to this Agreement or any provision of this Agreement, except such rights as shall inure to a successor or permitted assignee pursuant to this Section 13.9. No party shall have the right or power to make any assignment of rights or delegation of obligations not permitted by this Section 13.9, and any assignment of rights or delegation of obligations in violation of this Section 13.9 shall be void.

COMMENT

No Assignments. This Section requires the other party's consent before a party may assign its rights under the acquisition agreement (except that the buyer may assign its rights to a subsidiary or collaterally assign its rights to a lender without consent). This provision is necessary because the modern rule is that, absent an express provision to the contrary, contract rights are freely assignable. *See, e.g., Scott v. Fox Bros. Enter., Inc.*, 667 P.2d 773 (Colo. Ct. App. 1983); MURRAY, MURRAY ON CONTRACTS § 138 (3d ed. 1990). Although the terms of the acquisition agreement will be binding upon, and will inure to the benefit of, the successors and assigns of the parties, the assignment will not release the assignor from its duties and obligations unless the obligee consents to the assignment. *See, e.g.*, CAL. CIV. CODE § 1457; MURRAY ON CONTRACTS § 140. The seller may nonetheless want to specify that no assignment relieves the buyer from its obligations, and could do so by adding the following proviso at the end of the first sentence of Section 13.9: "; provided that no such assignment or delegation shall relieve Buyer from any of its obligations hereunder." The seller also needs to consider whether it wishes, for tax or other reasons, to have the express right to assign its rights to its shareholders or to a liquidating trust for the benefit of its shareholders. For example, a shareholder of an S corporation, who received shares of stock of that corporation as compensation, may have a tax basis in those shares that will not be recovered until the corporation has been liquidated. The shareholder may wish to have such basis offset the shareholder's gain from the sale of the corporation's assets rather than realizing a capital loss with respect to such stock basis when the corporation is liquidated in a later year with no capital gains against which to offset the capital loss. An earlier liquidation of the corporation could be desirable in these circumstances. See also Section 453(h) of the Internal Revenue Code with respect to the distribution of installment obligations within 12 months after adopting a plan of liquidation.

Liquidating trusts are often used in sales of assets when it is desirable to liquidate or dissolve the seller before all its liabilities have been paid or provided for or all its assets have been sold. For example, it may be impractical to distribute real estate or notes receivable in liquidation when there are a large number of shareholders or some of the shareholders cannot be located. The liquidating trust can settle liabilities and dispose of the remaining assets in an orderly manner and then distribute the remaining funds to the shareholders. In providing for a liquidating trust, the assignment provision in Section 13.9 should be reconciled with Section 10.4, which restricts the Seller's ability to dissolve or make distributions.

For business, financial, strategic, or even emotional reasons, the Seller may try to limit the Buyer's right of assignment by requiring the Seller's prior consent even for assignments to the Buyer's subsidiaries.

Some courts have distinguished between the assignor's "right" and "power" to assign. These courts hold that a contractual provision limiting or prohibiting assignments operates only to limit the parties' right to assign the contract (for which the remedy would be damages for breach of a covenant not to assign) but not their power to do so (which would invalidate the assignment), unless the contract explicitly states that a nonconforming assignment shall be "void" or "invalid," or that the assignee shall acquire no rights, or the non-assigning party shall not recognize the assignment. *See, e.g., Bel-Ray Co. v. Chemrite (Pty.) Ltd.*, 181 F.3d 435, 442 (3d Cir. 1999) and *Rumbin v. Utica Mutual Insurance Company*, 254 Conn. 259, 757 A.2d 526 (2000).

Third Party Beneficiaries. In order to establish third party beneficiary status, courts generally require that the following two elements be present: (a) the contracting parties must intend to confer a benefit on the third party, and (b) the benefit conferred on the third party either must satisfy a pre-existing obligation owed by a party to the contract to the third party (a "creditor third party"), or must be intended as a gift to the third party (a "donee third party"). Delaware courts have also required a third element to establish third party beneficiary status, namely that "the intent to benefit the third party must be a material part of the parties purpose in entering into the contract." *Comrie v. Enterasys Networks, Inc.*, 2004 WL 293337 at *3 (Del. Ch.), quoting *Madison Realty Partners 7, LLC v. AG ISA, LLC*, 2001 WL 406268 at *5. Third parties who benefit from performance of a contract, but with respect to whom these requirements are not met, are referred to as "incidental beneficiaries" and have no right to enforce an agreement as third party beneficiaries.

The intent of the contracting parties to confer a benefit on a third party is the main focus of the inquiry. *See* RESTATEMENT (SECOND) OF CONTRACTS §302 (2004); CORBIN, CORBIN ON CONTRACTS § 776 (Supp. 1999); *see also Norton v. First Fed. Sav.*, 624 P.2d 854, 856 (Ariz. 1981); *Sheetz, Aiken & Aiken, Inc. v. Spann, Hall, Ritchie, Inc.*, 512 So.2d 99, 101-02 (Ala. 1987); *Strutz v. State Farm Mut. Ins. Co.*, 609 A.2d 569, 570 (Pa. Super. 1992). Moreover, states may have specific statutes requiring that "[i]n order for a contract to be enforceable by a third party, the contract must be made expressly for the benefit of the third person." *Eastern Aviation Group, Inc. v. Airborne Express, Inc.*, 6 Cal. App. 4th 1448, 1452 (1992) (interpreting CAL. CIV. CODE § 1559). Section 13.9 expressly states that the parties do not intend to benefit, or create any rights, remedies, or claims in, any third parties. *See* Goodchild and Berard, *Shareholder Lawsuits Arising From Busted Deals*, 6 The M&A Lawyer No. 1 (May 2002) and Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 847-51 (2005), for cases that have and have not respected provisions like Section 13.9.

In some cases, however, the seller may want certain provisions of the agreement to benefit third parties. Generally, the groups whose members may become third party beneficiaries in an M&A transaction are (i) shareholders (e.g., merger agreement provisions to the effect that the shareholders of the target will receive the merger consideration in exchange for their target shares upon consummation of the merger), (ii) employees, officers and directors (e.g., provisions describing how the acquiror will treat target company employees at or after the closing and indemnification provisions requiring a party to indemnify the officers, directors, employees and shareholders of the other party), and (iii) creditors of the target company (e.g., asset purchase agreement provisions specifying which of the target's liabilities to creditors the acquiror will assume and which will be retained by the target).

If the buyer agrees to hire the employees of the seller or to provide certain compensation and benefits to such employees, the seller may want such promises to be enforceable by the employees. The buyer is likely to resist making the employees third-party beneficiaries so as not to subject itself to potential claims by numerous employees. *See Comrie v. Enterasys Networks, Inc.*, 2004 WL 293337 (Del. Ch. February 17, 2004) (acquiror promised in a stock purchase agreement to issue to the employees of the target options to buy stock in the acquiror, and further promised that, if the acquiror did not proceed with an anticipated public offering, it would issue replacement options or a cash substitute to the employees to adjust for the loss of expected value attributable to the failure to proceed with the IPO; the court held that some of the employees, as donee third party beneficiaries, had standing to bring an action based on a violation of the agreement (but that other employees were barred from bringing suit because of releases that they had signed as part of a severance package); the stock purchase agreement at issue in *Comrie* did not contain a provision designed to negate third party beneficiary claims) and *Halliburton Company Benefits Committee v. Graves*, 2006 WL 2499142 (5th Cir. 2006) (where the merger agreement provided that the acquiror would maintain the target's retiree benefit program except to the extent that acquiror made comparable changes in the benefit plans for its active employees, the no-third-party-beneficiary clause in the merger agreement was held not to bar the retirees from enforcing the terms of the merger agreement because the merger agreement was deemed to have amended the benefit plans to include the benefit maintenance provisions and the no-third-party-beneficiary clause cannot trump rights prescribed by ERISA. *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 60 Bus. Law. 843, 847-49 (2005), and Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 61 Bus. Law. 987, 988-89 (2006). If an acquisition agreement provides for the continued employment or compensation of employees but also contains a no third party beneficiaries clause, the court may ignore the no third party beneficiaries clause. *See Prouty v. Gores Technology Group*, 18 Cal. Rptr. 3d 178 (Cal. App. 2004) (California appellate court granted employees of the target company the right to enforce against the acquiror provisions of an acquisition agreement to the effect that they would not be terminated for a specified period post-closing (when in fact the acquirer promptly terminated them after closing), despite the fact that they were not parties to the agreement, and despite the presence of a no-third party beneficiaries provision in the agreement).

Where third party beneficiaries are recognized, the parties should consider limiting the rights of those third parties to enforcement of the agreement after the closing, so as to preserve in the target company all rights in the event of a pre-closing breach by the acquiror. *See In re Enron Corp.*, 292 B.R. 507; Bankr. L. Rep. (CCH) ¶78,738; 2002 U.S. Dist LEXIS 19987; 2002 WL 31374717 (S.D.N.Y. October 22, 2002), which addresses issues arising from making target stockholders third party beneficiaries of a merger agreement after closing. In the Enron-Dynegy merger agreement, Dynegy agreed in the "assignment/benefit" provisions that shareholders of Enron were third-party beneficiaries of the sections of the merger agreement dealing with the conversion of the Enron stock, surrender of certificates, etc. at and after the effective time of the merger. When Dynegy terminated the merger agreement under the MAC-out provisions, both Enron and Enron's shareholders commenced litigation, with Enron's shareholders claiming that they were intended third party beneficiaries under the merger agreement with a cause of action for wrongful termination of the merger agreement separate from Enron's and unaffected by Enron's bankruptcy or settlement with Dynegy. The court, applying Texas law regarding the derivative rights of shareholders because the merger agreement provided that it was governed by Texas law and even though neither Enron nor Dynegy was incorporated in Texas, held that the shareholders' derivative rights were separate and independent from Enron's rights. Consequently neither the bankruptcy stay nor Enron's corporate settlement with Dynegy barred the shareholders' derivative action. The court rejected the argument that the merger agreement granted the Enron shareholders rights to enforce their rights to receive the merger consideration only after the effective time, finding that Dynegy's repudiation of the merger agreement denied them the opportunity to receive the merger consideration.

In *Consolidated Edison, Inc. v. Northeast Utilities*, 426 F.3d 524 (2d Cir. 2005), the Second Circuit held that the target company could not recover the lost merger premium as an element of damages for the acquiror's breach of a merger agreement because (i) the shareholders of the target company were not third-party beneficiaries of the merger agreement prior to closing and (ii) the agreement did not specify target shareholder damages as an element of damages recoverable by the target company following a breach by the acquiror. *See* Subcommittee on Recent Judicial Developments, ABA Negotiated Acquisitions Committee, *Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions*, 61 Bus. Law. 987, 989-992 (2006).

Under Sections 9.1 and 9.2, the parties do not need the consent of any third-party beneficiary to terminate the acquisition agreement. For a discussion of the indemnification procedure relating to third-party claims, see the Comment to Section 11.9.

Banks and other funding sources typically are willing to finance a transaction only after conducting some due diligence on the seller. To reduce the risks associated with a leveraged transaction, a lender may desire the right to proceed directly against a seller for breaches of the seller's representations, warranties, covenants and obligations in its purchase agreement with the buyer. Therefore, the buyer, having been pressured by the lender, may attempt to include a provision, similar to the provision contained in Section 13.9, pursuant to which the buyer may assign its rights under a purchase agreement to the financing source.

Such assignment provisions are frequently not found in a buyer's first draft, and a seller is likely to object to any such provision. First, a seller may argue that its relationship with the buyer pertains only to the sale of the Company's assets, and not to the buyer's financing, that it has no relationship with the buyer's lender, and that what the buyer must do to secure financing for the transaction is no concern of the seller. Second, the seller may object on the ground that the lender does not have the same incentives and motivations to resolve disputes that the buyer has. For example, the buyer may have a continuing relationship with the seller (through employment agreements, consulting agreements, earnout agreements and other contractual relationships) which may make the buyer more likely to take a softer approach with the seller than would a lender. Further, in cases where a seller has indemnification claims against a buyer, the buyer may be more willing to compromise on its own indemnification claims against the seller, whereas a lender may have no such motivation. The seller may argue, in short, that lenders have different motives than buyers and such motives work to a seller's disadvantage.

13.13 GOVERNING LAW

This Agreement will be governed by and construed under the laws of the State of __________ without regard to conflicts of laws principles that would require the application of any other law.

COMMENT

The parties' choice of law can affect the outcome of litigation over a merger agreement. In a case granting specific performance to a target, *IBP, Inc. v. Tyson Foods, Inc. and Lasso Acquisition Corporation*, 789 A.2d 14 (Del. Ch. 2001), the Delaware Court of Chancery suggested that its decision might have been different if it had applied Delaware rather than New York law (the law chosen by the parties to govern the merger agreement) as governing the burden of proof to justify that remedy. The standard under New York law is a "preponderance of the evidence," whereas Delaware law would have required a showing by "clear and convincing" evidence. Of course it may be impractical to fully evaluate at the drafting stage the potential effect of choosing the law of one state over another because of the many ways in which disputes can arise over the interpretation and enforcement of a merger agreement.

This Section allows the parties to select the law that will govern the contractual rights and obligations of the Buyer, the Seller and the Shareholders. (The parties may want to specify a different choice of law with regard to non-competition provisions.) Without a choice of law provision, the court must assess the underlying interest of each jurisdiction to determine which jurisdiction has the greatest interest in the outcome of the matter. The part of Section 13.13 following the designation of a state seeks to have applied only those conflicts of laws principles of the state designated that validate the parties' choice of law. As for which laws the parties may select, the *Restatement, (Second) of Conflict of Laws* § 187 provides:

> § 187. Law of the State Chosen by the Parties
>
> (1) The law of the state chosen by the parties to govern their contractual rights and duties will be applied if the particular issue is one which the parties could have resolved by an explicit provision in their agreement directed to that issue.
>
> (2) The law of the state chosen by the parties to govern their contractual rights and duties will be applied, even if the particular issue is one which the parties could not have resolved by an explicit provision in their agreement directed to that issue, unless either
>
> > (a) the chosen state has no substantial relationship to the parties or the transaction and there is no other reasonable basis for the parties' choice, or
> >
> > (b) application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of § 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.
>
> (3) In the absence of a contrary indication of intention, the reference is to the local law of the state of the chosen law.

In *Nedlloyd Lines B.V. v. Superior Court of San Mateo County (Seawinds Ltd.)*, 3 Cal. 4th 459 (1992), the Supreme Court of California applied these principles to uphold a choice of law provision requiring a contract between commercial entities to finance and operate an international shipping business to be governed by the laws of Hong Kong, a jurisdiction having a substantial connection with the parties:

> Briefly restated, the proper approach under Restatement section 187, subdivision (2) is for the court first to determine either: (1) whether the chosen state has a substantial relationship to the parties or their transaction,

> or (2) whether there is any other reasonable basis for the parties' choice of law. If neither of these tests is met, that is the end of the inquiry, and the court need not enforce the parties' choice of law . . . . If, however, either test is met, the court must next determine whether the chosen state's law is contrary to a *fundamental* policy of California. . . . If there is no such conflict, the court shall enforce the parties' choice of law. If, however, there is a fundamental conflict with California law, the court must then determine whether California has a "materially greater interest than the chosen state in the determination of the particular issue."... If California has a materially greater interest than the chosen state, the choice of law shall not be enforced, for the obvious reason that in such circumstance we will decline to enforce a law contrary to this state's fundamental policy.

Id. at 466 (footnotes omitted); *see also Kronovet v. Lipchin*, 415 A.2d 1096, 1104 n.16 (Md. Ct. App. 1980) (noting that "courts and commentators now generally recognize the ability of parties to stipulate in the contract that the law of a particular state or states will govern construction, enforcement and the essential validity of their contract" but recognizing that "the parties' ability to choose governing law on issues of contract validity is not unlimited and will not be given effect unless there is a 'substantial' or 'vital' relationship between the chosen sites and issues to be decided.").

However, choice of law provisions have not been uniformly upheld by the courts. *See, e.g., Rosenmiller v. Bordes*, 607 A.2d 465, 469 (Del. Ch. 1991) (holding that, notwithstanding an express choice of New Jersey law in the agreement, Delaware had a greater interest than New Jersey in regulating stockholder voting rights in Delaware corporations, and therefore the parties' express choice of New Jersey law could not apply to this issue); *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670, 677-78 (Tex. 1990) (Supreme Court of Texas adopted the choice of law rule set forth in § 187 of the *Restatement, (Second) of Conflict of Laws*, and held that a choice of law provision (such as Section 13.13) will be given effect if the contract bears a reasonable relation to the state whose law is chosen and no public policy of the forum state requires otherwise; at issue in that case was a covenant not to compete in an employment context and the court held that its holdings on the nonenforceability of covenants not to compete were a matter of fundamental public policy which overrode the parties' choice of law agreement. *DeSantis* was in turn overridden by the subsequent enactment of Section 35.51 of the Texas Business and Commerce Code which generally validates the contractual choice of governing law for transactions involving at least $1,000,000).

Historically, courts had applied rigid tests for determining what substantive law was to govern the parties' relationship. In a contractual setting, the applicable test, *lex contractus*, stated that the substantive law of the place of contract formation governed that contract. As interstate and international commerce grew, several problems with this test became evident. First, at all times it was difficult to determine which jurisdiction constituted the place of contract formation. Second, this rule frustrated the ability of sophisticated parties to agree on the law that would govern their relationship.

A modern approach, exemplified in the *Restatement, (Second) of Conflict of Laws* (particularly Sections 6, 187 and 188), focuses on the jurisdiction with the "most significant relationship" to the transaction and the parties where the parties did not choose a governing law. Where the parties did choose a governing law, that choice was to be respected if there was a reasonable basis for the choice and the choice did not offend a fundamental public policy of the jurisdiction with the "most significant relationship."

Several states have now gone a step further by enacting statutes enabling parties to a written contract to specify that the law of that state would govern the parties' relationship, notwithstanding the lack of any other connection to that state. *See e.g.*, Del. Code tit. 6, § 2708; Fla. Stat. § 685.101; 735 Ill. Comp. Stat. 105/5-5; N.Y. Gen. Oblig. Law § 5-1401; and Ohio Rev. Code § 2307.39. These statutes recognize that sophisticated parties may have valid reasons to choose the law of a given jurisdiction to govern their relationship, even if the chosen jurisdiction is not otherwise involved in the transaction.

These statutes contain several criteria intended to ensure that they are used by sophisticated parties who understand the ramifications of their choice. The primary requirement is that the transaction involve a substantial amount. Certain of these statutes do not apply to transactions for personal, family or household purposes or for labor or personal services. Further, these statutes do not apply to transactions where Section 1-105(2) of the Uniform Commercial Code provides another governing law. One of these statutes requires the parties to be subject to the jurisdiction of the courts of that jurisdiction and subject to service of process. That statute also specifically authorizes courts of that jurisdiction to hear disputes arising out of that contract. Del. Code tit. 6. § 2708. *See also* Ohio Rev. Code § 2307.39 (authorizing commencement of a civil proceeding in Ohio courts if the parties choose Ohio governing law and consent to jurisdiction of its courts and further providing that Ohio law would be applied). See the Comment to Section 13.4.

Practitioners may wish to consider the use of one of these statutes in appropriate circumstances, perhaps to choose a neutral jurisdiction if the choice of law negotiation has become heated. However, these statutes are a relatively new development and, as such, are not free from uncertainty. Perhaps the most significant uncertainty is whether the choice of law based on such a statute would be respected by a court of a different jurisdiction. While valid reasons (such as protecting the parties' expectations) suggest their choice is likely to be respected, the outcome is not yet clear.

While a choice of law clause should be enforceable as between the parties where the appropriate relationship exists, the parties' choice of law has limited effect with respect to third party claims (*e.g.*, claims under Bulk Sales Laws, Fraudulent Transfer Laws or various common law successor liability theories). *But c.f. Oppenheimer v. Prudential Securities, Inc.*, 94 F.3d 189 (5th Cir. 1996) (choice of New York law in asset purchase agreement applied in successor liability case without dispute by any of parties). Further, an asset transaction involving the transfer of assets in various jurisdictions may be governed as to title transfer matters by the law of each jurisdiction in which the transferred assets are located. *Restatement, (Second) of Conflict of Laws* §§ 189, 191, 222 and 223. In particular, the transfer of title to real estate is ordinarily governed by the laws of the state where the real estate is located. *Restatement, (Second) of Conflict of Laws* § 223.

13.14 EXECUTION OF AGREEMENT; COUNTERPARTS; ELECTRONIC SIGNATURES

(a) This Agreement may be executed in several counterparts, each of which shall be deemed an original and all of which shall constitute one and the same instrument, and shall become effective when counterparts have been signed by each of the parties and delivered to the other parties; it being understood that all parties need not sign the same counterpart.

(b) The exchange of copies of this Agreement or of any other document contemplated by this Agreement (including any amendment or any other change thereto) and of signature pages thereof by facsimile transmission (whether directly from one facsimile device to another by means of a dial-up connection or whether otherwise transmitted via electronic transmission), by electronic mail in "portable document format" (".pdf") form, or by any other electronic means intended to preserve the original graphic and pictorial appearance of a document, or by a combination of such means, shall constitute effective execution and delivery of this Agreement as to the parties and may be used in lieu of an original Agreement or other document for all purposes. Signatures of the parties transmitted by facsimile, by electronic mail in .pdf form or by any other electronic means referenced in the preceding sentence, or by any combination thereof, shall be deemed to be original signatures for all purposes.

(c) Notwithstanding the Electronic Signatures in Global and National Commerce Act (15 U.S.C. Sec. 7001 *et seq.*), the Uniform Electronic Transactions Act (6 Del. C. §§ 12A – 101 et. seq.), or any other Legal Requirement relating to or enabling the creation, execution, delivery, or recordation of any contract or signature by electronic means, and notwithstanding any course of conduct engaged in by the parties, no party shall be deemed to have executed this Agreement or any other document contemplated by this Agreement (including any amendment or other change thereto) unless and until such party shall have executed this Agreement or such document on paper by a handwritten original signature or any other symbol executed or adopted by a party with current intention to authenticate this Agreement or such other document contemplated and an original of such signature has been exchanged by the parties hereto either by physical delivery or in the manner set forth in Section 8.5(b). "Originally signed" or "original signature" means or refers to a signature that has not been mechanically or electronically reproduced.

COMMENT

This section, which permits execution in counterparts, is common in acquisition agreements. It is inserted for the convenience of the parties and facilitates execution of the agreement when the signatories are not available at the same time or place. This section does not alter the effective date specified on the initial page of the acquisition agreement. The certificate of incorporation, the bylaws and the resolutions of the board of directors authorizing execution of the acquisition agreement will determine which persons have the authority to execute the agreement on behalf of corporations that are parties to the transaction.

The language with respect to exchange of copies and signature pages by facsimile or other electronic transmission recognizes the increasing trend to rely on facsimile and electronic transmissions of signature pages for execution and delivery of acquisition agreements. In most cases, arrangements are made to exchange the original signed copies, but there is always the concern that this might, for some reason, not take place. The question then becomes whether one can rely on a signature that is only digitally recreated by facsimile transmission or whether electronic signatures can be denied enforceability or validity solely because they are in electronic form.

Although Section 103 of the Delaware Electronic Transactions Act ("*UETA*"), 6 Del. C. §§ 12A – 101 et. seq. expressly provides that such Act does not apply to transactions under the DGCL, DGCL § 103(h) permits any signature on any instrument authorized to be filed with the Secretary of State under the DGCL, which includes a merger agreement, to be a facsimile, a conformed signature or an electronically transmitted signature. Once executed, under UETA § 12A-107, a record or signature may not be denied legal effect or enforceability solely because it is in electronic form. Delaware law does require that there be an original executed acquisition agreement. This requirement can be met by having the counterpart signature pages attached to the acquisition agreement. Under UETA § 12A-115, unless otherwise agreed, an electronic record or signature is sent when it: (i) is properly addressed to the information system designated or used by the addressee; (ii) in a form capable of being processed by that system; and from which the addressee is able to retrieve; and (iii) enters the system outside the control of the sender. It should be noted, under UETA § 12A-115(e), an e-mail containing an electronic record or signature is deemed received when the addressee's computer system actually receives the mail, regardless of when the recipient actually opens and reads the e-mail. Any form of electronic signature can be sufficient to execute agreement. "Electronic signature" is defined as "an electronic sound, symbol, or process, attached to or logically associated with a contract or other record and executed or adopted by a person with the intent to sign the record." (UETA § 12A-102(8)). This includes the technology of a digital signature, with its use of public-key encryption and third-party certifying authorities, e-mail text or digitized images, smart cards, passwords, personal identification numbers, or biometrics, such as thumbprints, voiceprints, or retinal scans. The critical element that makes any of these technologies a signature is the intent of the person to sign the record, and the logical association of the signature with the record. The language we have included contemplates that only the transmission of a signature that was not mechanically or electronically created or reproduced will constitute an effective signature. UETA § 12A-113 of specifically notes that evidence of a record or signature may not be excluded by a court solely because it is in electronic form. If the parties do not desire to permit to conduct the transaction by electronic means they should restrict the ability to do so in the contract (UETA § 12A-105(b)). Further, a party that agrees to conduct one transaction by electronic means may refuse to permit amendments electronically (UETA § 12A-105(c)). If you desire to broaden the nature of electronic signatures that would be accepted you could consider inclusion of language such as the following:

> The words “execution,” “signed,” “signature,” and words of like import shall be deemed to include electronic signatures or the keeping of records in electronic form, each of which shall be of the same legal effect, validity or enforceability as a manually executed signature or the use of a paper-based recordkeeping system, as the case may be, to the extent and as provided for in any Applicable Law, including the Federal Electronic Signatures in Global and National Commerce Act, the Delaware Electronic Transactions Act, or any other similar state laws based on the Uniform Electronic Transactions Act..

The essential elements to the formation of a contract are an offer, acceptance and manifestation of assent or meeting of the minds. When an offer upon specified terms is accepted without conditions and acceptance is communicated to the other party without unreasonable delay, a contract arises. The offeror can prescribe conditions on the method of acceptance. Restatement, (Second) of Contracts § 30. If a condition calling for a signature is not met, the contract does not come into being. *See Kroeze v. Chloride Group Ltd.*, 572 F.2d 1099 (5th Cir. 1978). Like earlier cases dealing with telegrams and telexes, there is authority to the effect that the exchange of writings and acceptance by facsimile creates a binding contract. *See Holbrook v. A C and S, Inc.*, No. Civ. A. 92-1906 1997 WL 52060, at *1 (E.D.

Pa. Feb. 3, 1997); *Coin Automatic Laundry Equip. Co. v. Pheasant Hollow Assocs.*, No. Civ. A. 92-7041 1993 WL 267446 (E.D. Pa. June 30, 1993). In addition, a facsimile signature can satisfy the statute of frauds. *See*, *e.g.*, N.Y. Gen. Oblig. Law § 5-701 (written text produced by telefacsimile constitutes a writing and any symbol executed or adopted by a party with the present intention to authenticate a writing constitutes a signing); *see also* Restatement, (Second) of Contracts § 134 cmt. b; *Birenbaum v. Option Care, Inc.*, 971 S.W.2d 497, 502 (Tex. Ct. App. 1997) (statute of frauds not satisfied because acquiror signed a post-it cover memo rather than letter of intent that was sent by facsimile).

Although language in the agreement validating signature by facsimile or other electronic transmission may not be essential, it might be helpful to have authorized the practice of exchanging signature pages by facsimile or other electronic transmission if a dispute should arise over the agreement.

Appendix A

SUCCESSOR LIABILITY

I. Introduction

In a stock purchase or merger, the entity that the buyer is acquiring will retain all of its liabilities as a matter of law, and the buyer will have the risk of the assertion of such liabilities against the entity post-closing. In an asset deal, however, the purchase agreement will delve in great detail into what liabilities of the seller will remain with the seller post-closing, and what liabilities of the seller will be assumed by the buyer. In this context, it would not be unusual for representatives of the buyer to assume that the contract governed how the seller's liabilities would be divided between the seller and the buyer, and that, where the contract specifies that a liability is to be retained by the seller and not assumed by the buyer, the buyer need not worry about the matter. While such an assumption might have been reasonable at one time, it no longer is. Buyer and its counsel need to consider from the beginning of a transaction that, as a matter of law, and notwithstanding any allocation of a seller's liabilities contained in an asset purchase agreement, the buyer may, under certain circumstances, find itself responsible for liabilities of the seller — even though these liabilities were explicitly retained by the seller in the agreement. The purpose of this discussion is to advise the reader as to the different legal theories by which a purchaser of assets may find itself liable for the liabilities of a seller, as well as to provide practical advice as to what, in certain circumstances, might be done to lessen the risk.

II. Background: The General Rule of Successor Liability

Until about 25 years ago, the general (and well-settled) rule of successor liability was that "where one company sells or transfers all of its assets to another, the second entity does not become liable for the debts and liabilities" of the transferor.[1] This rule was derived in the corporate world of contracts between commercial equals, where both parties were knowledgeable and had access to sophisticated advice. Two justifications historically have been given for the rule. First, it "accords with the fundamental principle of justice and fairness, under which the law imposes responsibility for one's own acts and not for the totally independent acts of others."[2] The second justification is based on the bona fide purchaser doctrine, which holds that a purchaser who gives adequate consideration and who has no knowledge of claims against the item purchased, buys the item free of those claims.[3]

More recently, however, the theory of successor liability has evolved and expanded as the result of a series of clashes between conflicting policies. This is a recurring theme throughout the successor liability cases, as the benefits attendant to a corporation's being able to sell its assets in an unrestricted manner are balanced against other policies, such as the availability of other remedies to

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1 Polius v. Clark Equipment Co., 802 F.2d 75, 77 (3d Cir. 1986) (citing 15 Fletcher, Cyclopedia of the Law of Private Corporations, §7122 (Perm. Ed. 1983); Chicago Truck Drivers, Helpers and Warehouse Workers Union Pension Fund v. Tasemkin, Inc., 59 F.3d 48 (7th Cir. 1995).

2 Leannais v. Cincinnati, Inc., 565 F.2d 437, 439 (7th Cir. 1977).

3 Note, "Products Liability and Successor Corporations", 13 U.C. Davis L. Rev. 1000, 1005-06 (1980).

the injured party, and who can best bear the cost of protecting persons in the same situation as the plaintiff.

III. The Different Theories of Successor Liability

There are nine different theories under which one or more types of a predecessor's liabilities could be imposed upon a successor. These are:

1. express or implied agreement to assume;
2. de facto merger (a/k/a consolidation);
3. mere continuation;
4. fraud;
5. continuity of enterprise (a/k/a substantial continuation);
6. product line;
7. duty to warn;
8. inadequate consideration for the transfer, coupled with the failure to make provision for the transferor's creditors; and
9. liability imposed by statute.

The first four exceptions are often referred to as the "traditional" exceptions, because they were developed first, whereas the fifth and sixth exceptions, which have developed more recently, are sometimes called the "modern exceptions". The last three exceptions are somewhat more narrow and fact-specific, and are therefore less prevalent in the literature than the others.

1. Express or Implied Assumption

The determination as to whether the purchaser expressly assumed the seller's obligations usually involves a fact-specific inquiry, which focuses on the provisions of the purchase agreement (especially the included and excluded asset descriptions, the definition (if any) of the term "assumed liabilities" and the indemnity clause) and the parties' intent.

Similarly, a buyer's implied assumption of a seller's obligations often is determined by the buyer's conduct or representations indicating an intention by the buyer to assume the seller's debts, coupled with reliance by the party asserting liability on that conduct or on those representations.[4]

The other issue which arises regarding the assumption of liabilities relates to whether an unforeseen liability was implicitly assumed. For example, in Mobay Corp. v. Allied-Signal, Inc.,[5] the court ruled that the purchaser had not assumed environmental claims brought under the Comprehensive Environmental Response Compensation and Liability Act of 1980, as amended ("CERCLA" or "Superfund")[6] merely by agreeing to indemnify the seller from all obligations and

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4 15 Fletcher, Cyclopedia of the Law of Private Corporations, §7124 (1989 Rev. Vol.).

5 761 F. Supp. 345 (D.N.J. 1991).

6 42 U.S.C. §9601 et seq. See, for example, Smith Land & Improvement Corp. v. Celotex Corp., 851 F.2d 86 (3d Cir. 1988,); Louisiana-Pacific Corp. v. Asarco, Inc., 909 F.2d 1260 (9th Cir. 1990); U.S. v. Carolina Transformer Co., 978 F.2d 832 (4th Cir. 1992); and U.S. v. Mexico Feed & Seed Co., Inc., 980 F.2d 478 (3d Cir. 1992).

liabilities arising out of post-closing claims or lawsuits for personal injury or property damage. Contrast that with Kessinger v. Grefco, Inc.,[7] in which the court held that an asset purchase agreement (in which the buyer assumed and agreed "to pay, perform and discharge all debts, obligations, contracts and liabilities") amounted to the assumption, by the buyer, of the seller's unforseen product liability claims.

2. De Facto Merger

The de facto merger exception was first developed in cases relating to corporate taxation or as a way of providing dissenters' rights for shareholders disgruntled by corporate transactions which were structured to avoid statutory dissenters' rights. In most of these cases,[8] the pattern was similar — an otherwise solvent corporation (or if technically insolvent, one which has significant assets with which to pay its creditors) transfers its assets to another entity in which the seller's shareholders end up with an unencumbered ownership interest. The transaction is structured so that either the seller is paid with shares of the buyer's stock (which it promptly distributes to its shareholders), or the buyer directly gives its stock to the seller's shareholders. In either case, the seller's owners avoid paying their creditors without losing control of the business.[9]

The four elements required for finding that a de facto merger has occurred are:

1. a continuation of the seller's enterprise, evidenced by a continuation of management, personnel, physical location, assets and operations;

2. a continuity of shareholders between the seller and the purchaser;

3. the seller's ceasing its business operations, liquidating, and dissolving as soon as legally and practically possible; and

4. the buyer's assuming those liabilities and obligations of the seller which would be necessary for the uninterrupted continuation of normal business operations.[10]

Most courts consider the "transfer of stock to be a key element for finding a de facto merger because it represents a continuity of shareholder ownership and interest."[11] Without the "continuity of shareholders" element, the purchaser and seller "are strangers, both before and after the sale."[12]

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7 875 F.2d 153 (7th Cir. 1989).

8 See, for example, U.S. Fidelity & Guaranty Co. v. Citizen's Nat'l. Bank, 13 F.2d 213 (D.N.M. 1924); Drug, Inc. v. Hunt, 35 Del. 339, 168 A. 87 (Del. 1933); and Ruedy v. Toledo Factories Co., 61 Ohio App. 21, 22 N.E. 2d 293 (Ohio App. 1939).

9 Nat'l. Gypsum Co. v. Continental Brands Corp., 895 F. Supp. 328, 337 (D. Mass. 1995). The Court also noted, in footnote 11 therein, that these cases could also have been characterized as fraudulent conveyances.

10 Shannon v. Samuel Langston Co., 379 F. Supp. 797, 801 (W.D. Mich. 1974), quoting from Mckee v. Harris-Seybold Co., 264 A.2d 98, 103 (N.J. 1970)

Over time, some courts have used less than all of the elements to support a finding of de facto merger,[13] finding that these factors merely indicate the existence of a de facto merger.[14] The courts in Knapp v. North American Rockwell[15] and Shannon v. Samuel Langston Co.[16] held the successor liable even where the seller continued in existence for a period of time after the sale, during which time the seller could have paid off adverse judgments. Both courts found the seller's continued existence to be a mere formality, insufficient to prevent the transfer from being considered a sale, based on the brevity of the seller's continued life after the transfer, the requirement in the purchase agreement that the seller be dissolved as soon as possible, the prohibition in the same document against the seller conducting normal business operations, and the limited nature and quantity of assets retained by the seller after the transaction.[17]

As significant as Knapp and Shannon were, both of those cases involved transactions where assets were exchanged for shares of the buyer's stock, thus maintaining the element of continuity of ownership. In Diaz v. South Bend Lathe, Inc.,[18] the court concluded that plaintiff's failure to establish continuity of ownership was not fatal to its claim of de facto merger because "the consuming public should not be frustrated merely because the stock ownership of a corporation has not changed while all else - employees, products, supervision, and plants are transferred...."[19]

Another issue which has been raised has been the extent of the ownership in the buyer that seller's shareholders must own after the transaction to support a finding of de facto merger. In Lumbard v. Maglia,[20] a case involving a transfer of assets, contracts and employees to a new company nominally owned by the seller's brother, the court held that continuity, not uniformity, of ownership is the key factor.[21]

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11 Savini v. Kent Mach. Works, Inc., 525 F. Supp. 711,717 (E.D. Pa. 1981), citing Leannais v. Cincinnati, Inc., supra, note 2, at 440.

12 Travis v. Harris Corp., 565 F.2d 443, 447 (7th Cir. 1977). See also Cargo Partner AG v. Albatrans Inc., 2d Cir, No. 02-9322 (12/9/03), in which the U.S. Court of Appeals for the Second Circuit ruled that, without determining whether all factors need to be present for there to be a de facto merger, a corporation that purchases assets will not be liable for a seller's contract debts under New York law absent continuity of ownership which "is the essence of a merger" (citing Fitzgerald v. Fahnestock & Co., 730 N.Y.S.2d 70 (2001), in which the court had stated that not all of the elements are necessary to find a de facto merger).

13 See, for example, Suarez v. Sherman Gin Co., 697 S.W. 2d 17 (Tex. App. 1985); and Lumbard v. Maglia, 621 F.Supp. 1529 (S.D.N.Y. 1985).

14 Lumbard, id., at 1535 (citing Menacho v. Adamson United Co., 420 F. Supp. 128, 133 (D.N.J. 1976)).

15 506 F.2d 361 (3d Cir. 1974), cert. denied 421 U.S. 963 (1975).

16 Supra, note 10.

17 Knapp, supra, note 15, at 367. In addition to moving the rule away from its traditional components, Knapp is important as well for its use of products liability policies as a basis for its analysis and conclusion. See Section III.1, supra; Shannon, supra, note 10, at 800.

18 707 F.Supp. 97 (E.D.N.Y. 1989).

19 Id., at 101.

20 621 F. Supp. 1529 (S.D.N.Y. 1985).

21 Id., at 1535.

3. Mere Continuation

The mere continuation doctrine differs from the de facto merger exception more in form than in substance, and the factors considered by the courts are very similar. "The primary elements of [mere] continuation include the common identity of officers, directors or stockholders between the seller and buyer, and the existence of only one corporation at the completion of the transfer."[22] The exception is very limited and relies on the continuity of the corporate identity, and not on the continuation of the business or its operations.[23]

4. Fraud

The fraud exception arises from the judicial doctrine that transactions entered into to escape liability should not be permitted. This exception covers the "easy" cases, such as where the consideration for the assets was fictitious or inadequate, or where there is demonstrable intent to defraud creditors; but it has also been applied in the more difficult situations where the transfer of assets, while perfectly legitimate, is done (at least in part) to avoid liability. In some cases, there was a question of whether disclosure to the plaintiff overcame the seller's objective of avoiding liability,[24] while another early case held that nothing short of actual fraud will vitiate a sale of corporate assets.[25]

In addition to the case law, this area is governed by the Uniform Fraudulent Transfer Act ("UFTA"), which has been enacted in most jurisdictions. The purpose of UFTA is to limit a debtor's ability to transfer assets if doing so puts them out of reach of its creditors at a time when the debtor's financial condition is, or would be, precarious. The UFTA provides that a "transfer" is voidable by a creditor if (i) the transfer is made with actual intent to hinder, delay or defraud a creditor[26] or (ii) the transfer leaves the debtor insolvent or undercapitalized, and it is not made in exchange for reasonably equivalent value.[27] If a transaction is determined by a court to constitute a fraudulent transfer under UFTA, the court can order any appropriate equitable relief, such as voiding or enjoining the transfer in whole or to the extent necessary to satisfy creditors' claims, attaching the transferred assets or appointing a receiver to take control of the transferred assets.

5. Continuity of Enterprise (a/k/a Substantial Continuation

The continuity of enterprise exception (which is also known as the "substantial continuation" doctrine) was established by the Michigan Supreme Court in 1976 in Turner v. Bituminous Casualty Co.[28] This exception is essentially an expansion of the mere continuation doctrine, except that the

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22 Jacobs v. Lakewood Aircraft Service, Inc., 512 F.Supp 176, 181 (E.D.Pa. 1981) (citations omitted).

23 Savini, supra, note 11, citing Travis, supra, note 12.

24 Raytech Corp. v. White, 54 F.3d 187 (3d Cir. 1995).

25 Davis v. Hemming, 101 Conn. 713, 127 A. 514 (1918).

26 Since intent to hinder, delay or defraud is usually inferred, a set of factors has been developed to assist in making the determination. Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248, 1254 (1st Cir. 1991).

27 In re WCC Holding Corp., 171 B.R. 972, 986 (Bankr.N.D. Tex 1994).

28 244 N.W.2d 873 (Mich. 1976).

focus of the inquiry is the continuity of the business operations, and not the corporate structure. The exception consists of an eight-part standard:

1. retention of the same employees;
2. retention of the same supervisory personnel;
3. retention of the same product facilities in the same locations;
4. production of the same product;
5. retention of the same name;
6. continuity of assets;
7. continuity of general business operations; and
8. representation by the successor as the continuation of the previous enterprise.[29]

The continuity of enterprise exception has been rejected in some products liability cases because it ignores basic concepts of causation that underlie all tort liability,[30] and it has been narrowed in some environmental cases which hold that the purchaser must have knowledge of the contamination to be liable.[31] Besides Michigan, the exception has been adopted in Alabama,[32] but it has been rejected in at least nine states.[33]

6. Product Line

One year after the Turner decision in Michigan, the California Supreme Court created the product line exception. In Ray v. Alad Corp.,[34] the defendant successor acquired the assets of a company that manufactured ladders, after which it continued to manufacture the same products, under the same brand name, without indicating that there had been a change in ownership. The plaintiff was injured in a fall off a defective ladder, and finding that the predecessor had dissolved, sued the successor. The Court presented a three-part justification for imposition of liability on the successor:

1. the virtual destruction of the plaintiff's remedies against the original manufacturer caused by the successor's acquisition of the business;

2. the successor's ability to assume the original manufacturer's risk-spreading role; and

3. the fairness of requiring the successor to assume the burden of being responsible for defective products that attached to the original

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29 Carolina Transformer, supra, note 6, at 838.

30 Atlantic Richfield Co. v. Blosenski, 847 F. Supp. 1261, 1285 (E.D.Pa. 1994) (citing Polius, supra note 1, at 75).

31 See Section III.2, supra.

32 Andrews v. John E. Smith's Sons Co., 269 So.2d 781 (Ala. 1979).

33 Colorado, Maryland, Minnesota, Nebraska, New York, North Dakota, South Dakota, Vermont and Wisconsin.

34 19 Cal.3d 22, 560 P.2d 3 (1977).

> manufacturer's goodwill (which in turn is being enjoyed by the purchaser in the continued operation of the business).[35]

Courts applying the product line exception have reasoned that because a corporation that acquires the benefits of the predecessor's goodwill also acquires the built-in resources to meet its various responsibilities, it should assume the concomitant responsibility of redressing any harm caused by a product it continues to manufacture.[36]

In 1979, two years after Ray, in Rawlings v. D. M. Oliver, Inc.,[37] the defendant successor corporation purchased the seller's assets and continued its general business, but it ceased the manufacture of the specialized product that caused the plaintiff's injury. The Court found the failure to manufacture the identical product did not remove the case from the Ray product line exception, and it imposed liability on the successor. Support for the ruling came from the successor's purchase of an ongoing business which it continued at the same location under the same fictitious name, as well as a broad reading of California's policy in strict liability cases to assign responsibility to the enterprise that received the benefit and is in the best position to spread the cost of the injury among members of society.[38] Other cases decided since Ray have noted that the application of the product line exception requires a balancing of the risks shifting principle against the fault principle which underlies all tort law.[39]

One of the factors articulated in Ray which has received significant review in subsequent cases is the requirement that the plaintiff's remedies were destroyed by the purchaser's acquisition.[40] In Kline v. Johns Manville,[41] the court held that a successor would not be liable when it purchased a product line from a predecessor which continued in business until its bankruptcy years later. Similarly, in Chaknova v. Wilber-Ellis Co.,[42] the court held that a successor was not liable under the product line exception where, among other things, the predecessor continued to exist for 15 months after the acquisition and the successor had no part in the predecessor's eventual dissolution. In both of these cases, the essential element of causation was missing, since the successor's purchase did not cause either the predecessor's dissolution or the destruction of the plaintiff's remedy. Not all jurisdictions agree, however.[43]

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35 Id., at 560 P.2d 9.

36 Nieves v. Bruno Sherman, 86 N.J. 361, 431 A.2d 826 (1981).

37 97 Cal.App.3d 890, 159 Cal.Rptr. 119.

38 Id., at Cal.App.3d 901, and at Cal.Rptr. 124; see generally Greenman v. Yuba Power Products, Inc., 59 Cal.2d 57, 377 P.2d 897 (1963).

39 Hall v. Armstrong, 103 Wash.2d 258, 692 P.2d 787, 791 (1984).

40 See, for example, Kline v. Johns-Manville, 745 F.2d 1217, 1220 (9th Cir. 1984); Nelson v. Tiffany Industries, Inc.,778 F.2d 533, 538 (9th Cir. 1985); and Santa Maria v. Owens-Illinois, Inc., 808 F.2d 848, 859 (1st Cir. 1986).

41 Supra, note 40, at 1220.

42 69 Cal. App. 4th 962, 81 Cal. Rptr. 871 (1999).

43 See, for example, Pacius v. Thermtroll Corp., 611 A.2d 153 (N.J.Super.Ct. 1992), which focused more on the fact of the predecessor's nonviability and on the plaintiff's need to have a remedy than on the reason for the predecessor's cessation of operations.

The product line exception is not without its critics.[44] Corporate defense counsel also will be reassured that the product line exception has several limitations. First, it is available only in cases where strict tort liability for defective products is an available theory of recovery.[45] Second, the State of Washington, which is one of the few states to adopt explicitly the product line exception, has stated just as clearly that the exception does not apply where there is a sale of less than all of the predecessor's assets, because the purchaser cannot be deemed to have caused the destruction of plaintiff's remedy.[46] Finally, the product line exception is clearly a minority rule, having been adopted only in four states and rejected in over 20 states.[47]

7. Duty to Warn

The duty to warn exception is an anomaly among the successor liability exceptions, in that it is an independent duty of the successor, and it is derived from the successor's own actions or omissions — namely, the failure to warn customers about defects in the predecessor's products. There are two elements to this exception: first, the successor must know about the defects in the predecessor's products, either before or after the transaction is completed; second, there must be some continuing relationship between the successor and the predecessor's customers, such as (but not limited to) the obligation to service machinery manufactured by the predecessor.[48]

8. Inadequate Consideration/Creditors Not Provided For

Although the concept of inadequate consideration usually arises as an element of one or more of the other exceptions (typically fraud or de facto merger), occasionally it is cited as a separate exception where the purchaser has not paid adequate consideration, and the seller would be rendered insolvent and unable to pay its debts.[49] Since the asset sale is the cause of the seller's problems, many courts will try to find a way to rule in favor of an innocent third person who otherwise may be without a remedy. The various rationales used often sound like the analyses used in some de facto merger cases, or those found in the product line exception cases.

Quite often, the inquiry in inadequate consideration cases focuses on the fact that consideration is paid directly to the seller's shareholders rather than to the seller. If the consideration takes the form of the purchaser's stock, one again finds oneself in the de facto merger or mere continuation cases.

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44 See, for example, Mullen v. Alarmguard of Delmarva, Inc., 1993 Del. Super. LEXIS 213 (1993); Leannais, supra, note 2, at 439; and Woody v. Combustion Engineering, Inc., 463 F.Supp 817 (E.D.Tenn. 1978).

45 Ray, supra, note 34, at 19 Cal.3d 34. See, also, Florom v. Elliott Mfg., 867 F.2d 570, 578 (10th Cir. 1989); and Welco Indus., Inc. v. Applied Companies, 617 N.E.2d 1129, 1133 (Ohio 1993).

46 Hall, supra, note 39, at 787.

47 Adopted in California, New Jersey, Pennsylvania and Washington. Rejected in Arizona, Colorado, Florida, Georgia, Iowa, Kansas, Massachusetts, Minnesota, Missouri, Nebraska, New Hampshire, North Dakota, Ohio, Oklahoma, Texas, Vermont, Virginia and Wisconsin.

48 For cases discussing the "duty to warn" exception, see, for example, Chadwick v. Air Reduction Co., 239 F. Supp 247 (E.D. Ohio 1965); Shane v. Hobam, Inc., 332 F. Supp. 526 (E.D. Pa. 1971; Gee v. Tenneco, Inc., 615 F.2d 857 (9th Cir. 1980); and Travis v. Harris Corp., 565 F.2d 443, 449 (7th Cir. 1977).

49 West Texas R&D Co. v. Comm'r. of Internal Revenue, 68 F.2d 77 (10th Cir. 1933).

9. Liability Imposed by Statute

Some courts have found support for successor liability in the broad purpose language of various statutes, such as CERCLA, the Federal Insecticide, Fungicide & Rodenticide Act,[50] the Employee Retirement Income Security Act of 1974 ("ERISA")[51] and Title VII of the Civil Rights Act of 1964 ("Title VII").[52] The two-part analysis often used by the courts in the Superfund cases requires the court to first find that a successor could be liable under the provisions of the statute, and then to apply one or more of the exceptions described above to determine whether the corporation in question is, in fact, a successor upon which liability could be imposed.

Besides federal statutes, state laws may also be used to impose liability on a successor. Many states have enacted statutes which largely parallel federal counterparts, especially with respect to environmental obligations. In addition, state tax statutes often impose liability on a successor for certain types of unpaid taxes of the seller, although the types of asset sales which are covered, the types of taxes and the notice and clearance procedures that allow the buyer to eliminate its potential liability differ from state to state. The buyer must determine which states' laws apply, keeping in mind that more than one state's laws may be applicable. State laws often apply to assets located in that state, regardless of the jurisdiction selected by the parties in their choice of law provision. The validity of such statutes generally has been upheld against attacks on a variety of grounds, including allegations that the statutes violated the due process or equal protection clauses of the Constitution, or unconstitutionally impaired the asset purchase agreement.[53]

IV. Public Policy Considerations — Does It Matter What Kind Of Case It Is?

1. Product Liability Cases

As products liability law has evolved since the early 1960s, the courts increasingly have determined that injured consumers who otherwise lack a remedy should be able to recover against successors. More than one court found itself swayed by the plaintiff's inability to bring suit against either a dissolved corporation or its scattered former shareholders.[54]

In Knapp,[55] in addition to the de facto merger exception, the court referenced policies underlying the need for the law of products liability. In Turner,[56] in which the Michigan Supreme

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50 7 U.S.C. §136 et seq. See, for example, Oner II v. EPA, 597 F.2d 184 (9th Cir. 1974), the first reported environmental case to impose successor liability.

51 29 U.S.C. §1001 et seq. See, for example, Upholsterers' Int'l. Union Pension Fund v. Artistic Furniture, 920 F.2d 1323 (7th Cir. 1990).

52 42 U.S.C. §2000e et seq. See, for example, E.E.O.C. v. MacMillan Bloedel Containers, Inc., 503 F.2d 1086 (6th Cir. 1974).

53 People et rel. Salisbury Axle Co. v. Lynch, 259 N.Y. 228, 181 N.E. 460 (1932); Knudsen Dairy Products Co. v. State Board of Equalization, 12 Cal.App. 3d 47, 90 Cal.Rptr. 533 (1970); Pierce-Arrow Motor Corp. v. Mealey, 59 N.Y.S.2d 568 (1946); and Tri-Financial Corp. v. Dept. of Revenue, 6 Wash.App. 637, 495 P.2d 690 (Wash.App. 1972).

54 Schulman, Commentary: Successor Corporation Liability and the Inadequacy of the Product Line Continuity Approach, 1986-1987 Corp. Prac. Commentator 588, 5990.

55 Supra, note 15, at 361.

Court created the continuity of enterprise exception, the court noted that the plaintiff's injury and loss would be identical regardless of whether the sale of assets was for cash or stock, and therefore disregarded the issue entirely as being irrelevant to the analysis. Noting that "this is a products liability case first and foremost,"[57] the court determined that justice would not be promoted if a successor was liable in a merger or a de facto merger, but not in a sale of assets for cash, when the needs and objectives of the parties are the same in all three instances.[58]

The use of public policy to find a remedy for a products liability plaintiff where none traditionally existed reached its height in Ray and its product line exception progeny.[59] After determining that the four traditional exceptions did not provide grounds for the plaintiff to recover, the court decided that a "special departure from [the general rule governing succession to liabilities]" was called for by the policies underlying strict tort liability for defective products.[60]

Finally, as a harbinger of things yet to come, in Maloney v. American Pharmaceutical Co.,[61] the plaintiffs contended that the Ray court did not intend that the product line exception should apply only to strict liability, but rather to all forms of tort liability involving negligence, on the basis of the policy considerations discussed therein. The court declined to do so for procedural reasons, but indicated that plaintiffs' policy arguments might be sound.[62]

2. Environmental Cases

A similar pattern can be discerned in the environmental cases. Where the early cases found little or no liability on the successor, unless the underlying facts were particularly egregious, the later cases broadened the successor's exposure by eliminating some of the requirements needed to hold an asset purchaser liable.

While observing that the provisions of CERCLA do not explicitly require that the successor be liable, the court in Smith Land & Improvement Corp. v. Celotex Corp.[63] compared the benefits derived by the predecessor and successor corporations from having used a pollutant and from failing to use non-hazardous disposal methods with the indirect benefits which accrued to the general public, and concluded that having the successor bear the costs of remediation was consistent with both Congressional intent and the purpose of the statute.[64] Since the Smith Land decision in 1988, a

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56 Supra, note 28, at 873.

57 Id., 397 Mich. at 416, 244 N.W.2d at 877.

58 Id., at 429-30, and at 883.

59 See notes 34-47 and accompanying text.

60 Ray, supra, note 34, 560 P.2d at 8-9.

61 207 Cal.App.3d 282, 255 Cal.Rptr. 1 (1988).

62 Id., 207 Cal.App.3d at 289, 255 Cal.Rptr. at 4.

63 851 F.2d 86 (3d Cir. 1988).

64 Id., at 91-92.

number of other courts, as well as the Environmental Protection Agency and the Department of Justice, have adopted its policy rationale.[65]

Courts also have held that, at least with respect to environmental liabilities, a successor corporation must have substantial ties to the seller for CERCLA liability to attach, unless the purchaser had knowledge of the contamination, or if there was willful blindness or collusion on the part of the purchaser.[66] Other leading circuit court environmental cases, U.S. v. Mexico Feed and Seed Co.[67] and Carolina Transformer,[68] concur that knowledge on the part of the purchaser of the seller's offending conduct is an important element for environmental liability, although at least one recent case holds otherwise.[69]

This analysis has continued to be expanded, culminating in two rather extreme decisions. In Kleen Laundry & Dry Cleaning Services, Inc. v. Total Waste Management, Inc.,[70] the asset purchaser was held liable, under the continuity of enterprise exception, for leaks in underground storage tanks which had been leased by the seller for six weeks some four years before the transaction. The ruling was influenced by the purchaser's intention to buy the seller's business, as well as by purchaser's continued servicing of the seller's customers after the sale. In U.S. v. Keystone Sanitation Co., Inc.,[71] the successor was held liable for a landfill site which had been specifically excluded from the assets conveyed because the purchaser used its shares as consideration (thus making the case look more like a de facto merger or mere continuation case), the agreement stated that the "business" was being bought, the purchaser assumed the seller's service obligation to its customers, the purchaser agreed to help with the collection of the pre-closing receivables, and the seller and its shareholders agreed to enter into noncompetition and consulting agreements with the purchaser.

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65 See, for example, United States v. Crown Roll Leaf, Inc., 29 ERC 2018, 19 ELR 20262, 1988 U.S. Dist. LEXIS 15785, (D.N.J. 1988); United States v. Bliss, 20 ELR 20879, 1988 U.S. Dist. LEXIS 10683 (E.D. Mo. 1988); and In re Acushnet River & New Bedford Harbor, 712 F. Supp. 1010 (D. Mass. 1989). As to EPA, see EPA Memorandum, "Liability of Corporate Shareholders and Successor Corporations for Abandoned Sites Under the Comprehensive Environmental Response Compensation and Liability Act:, June 13, 1984; as to DOJ, see Joint Motion of Plaintiffs for Summary Judgment on Fraudulent Conveyance and Successor Corporation Claims, in Kelly v. Thomas Solvent Co., 725 F.Supp. 1446 (W. D. Mich. 1988); and Memorandum of Points and Authorities of the United States in Operation to Motion of Chemical & Pigment Company for Partial Summary Judgment and in Support of Cross-Motion of United States for Partial Summary Judgment, in United States v. Allied Chem. Corp., 1990 U.S. Dist. LEXIS 11695 (N.D. Cal. 1990).

66 U.S. v. Atlas Minerals & Chemicals, Inc., 824 F. Supp. 46 (E.D. Pa. 1993), with findings of fact and conclusions of law issued at 41 E.R.C. 1417 (E.D. Pa. 1995).

67 Supra, note 6.

68 Supra, note 6.

69 Gould, Inc. v. A&M Battery and Tire Service, 1997 WL 16507 (M.D.Pa. 1997).

70 867 F.Supp. 1136 (D.N.H. 1994).

71 1996 U.S. Dist. LEXIS 13651 (M.D.Pa. 1996).

3. Labor, Employment and Benefits Cases

In the labor and employment context, the issue of successor liability has arisen in numerous cases, both in federal courts (up to and including the Supreme Court[72]) and in administrative proceedings held before the National Labor Relations Board ("NLRB")[73] under various provisions of the National Labor Relations Act (the "Act").[74] The labor and employment cases tend to utilize the continuity of enterprise analysis almost exclusively, focusing on the nature of the business operations both before and after the asset acquisition, including how many of the seller's employees were retained by the purchaser, and what percentage those employees constitute of the purchaser's total workforce at the work site after the transaction is completed.[75]

Two other common themes in the labor and employment arena are whether the successor had knowledge of the predecessor's unfair labor practices,[76] and the nature of the remedy sought by the plaintiff.[77] With respect to the issue of remedy, courts have generally, but not universally, determined that a successor will be liable if reinstatement is sought, since only the successor can accomplish this, whereas if monetary damages are sought, the predecessor (if still viable) can satisfy the remedy, thus reducing the need to find the successor liable.[78]

The other trend in this area is the number and diversity of statutes under which cases are being brought. Besides the National Labor Relations Act and the Labor Management Relations Act, cases alleging successor liability for labor, discrimination and benefits issues have been brought

72 See, for example, John Wiley & Sons, Inc. v. Livingston, 376 U.S. 543 (1964); NLRB v. Burns Int'l Security Services, Inc., 406 U.S. 272 (1972); Golden States Bottling Co., Inc. v. NLRB, 414 U.S. 168 (1973); Howard Johnson Co., Inc. v. Detroit Local Joint Executive Bd., 417 U.S. 249 (1974); and Fall River Dyeing & Finishing Corp. v. NLRB, 482 U.S. 27 (1987).

73 See, for example, South Carolina Granite Co., 58 NLRB 1448, enforced sub nom. NLRB v. Blair Quarries, Inc., 152 F.2d 25 (4th Cir. 1945); Alexander Milburn Co., 78 NLRB 747 (1947); and Perma Vinyl Corp., 164 N.L.R.B 968 (1967), enforced sub nom. United States Pipe & Foundry Co. v. NLRB, 398 F. 2d 544 (Fifth Cir. 1968).

74 29 U.S.C. §§151 et seq.

75 But, as to this issue, there has been conflicting guidance from the courts. Compare the holding of Saks & Co. v. NLRB, 634 F.2d 681, 685 (2d Cir. 1980) ("the appropriate test of continuity is whether a majority of the successor's bargaining unit is composed of the predecessor's employees.") with NLRB v. Bausch & Lomb, Inc., 526 F.2d 817, 824 (2d Cir. 1975), which held that a finding of successorship "requires retention of at least a majority of the predecessor's workforce."

76 See, for example, Alexander Milburn, supra, note 73, and Perma Vinyl, supra, note 73.

77 See, for example, Perma Vinyl, supra, note 73, at 968-9.

78 See, for example, EEOC v. MacMillan Bloedel Containers, Inc., 503 F.2d 1086 (6th Cir. 1974); Trujillo v. Longhorn Mfg. Co., Inc., 694 F.2d 221 (10th Cir. 1982); Bates v. Pacific Maritime Assn., 744 F.2d 705 (9th Cir. 1984); and Rojas v. TK Communications, Inc., 87 F.3d 745 (5th Cir. 1996).

under Title VII,[79] the Age Discrimination in Employment Act (the "ADEA"),[80] ERISA,[81] and the Multiemployer Pension Plan Amendments Act of 1980 (the "MPPAA").[82]

4. Personal Injury and Tort Cases

The analysis used to determine whether a successor is liable for the tortious acts of its predecessor, and the policies underlying such determinations, are similar to those used in the product liability/strict liability cases. The courts attempt to balance the injured person's need to recover damages against the successor's need to accurately determine the nature, scope and costs of risks it assumes. It is not surprising that in the last two or three decades, which saw an increase in strict liability, the injured party makes for a more sympathetic and victorious party. The cases of Cyr v. Offen & Co., Inc.,[83] and McKee v. Harris-Seybold Company[84] are instructive. In both cases, each of which predated the creation of the substantial continuity and product line exceptions, the court disposed of the traditional exceptions in short order, finding that they had no applicability to the facts presented.[85] And yet, the New Jersey Superior Court found in favor of the corporate successor in McKee, while the U.S. Court of Appeals for the First Circuit found for the injured plaintiff in Cyr. The primary difference in the two cases is that the predecessor and successor in McKee were two unrelated corporate entities which engaged in an arms length sale of assets with sufficient consideration, and no continuity of shareholders and little if any continuity of management.

In Cyr, however, a sole proprietorship was sold after the proprietor's death to a newly-formed corporation formed by the proprietorship's key employees and owned seventy percent by them and thirty percent by an outside financier. The same products were produced at the same plant with the same supervision, and, in compliance with the asset sale contract, the business continued to be run under the same principles as it had been as a proprietorship. The purchase of goodwill was central to the agreement, as the new company continued to service and renovate old equipment sold by its predecessor. No notice was given to the customers of the business, and the new company even advertised itself as a forty-year-old, ongoing businesses enterprise. The court determined that the public policies underlying tort liability mandated finding that the mere continuation exception would apply even where there was no continuity of ownership, and concluded that, with so much continuity in the business, identity of ownership could not be the sole determinant. Moreover, the Court supported and applied the policy justification used as the bases for the theory of product liability — namely, that the successor who carries on the manufacturing of a predecessor's product can best bear the cost of insuring against liability, and that the successor is the only entity interested in improving the product's quality in order to maintain and exploit the product's goodwill and reputation.[86]

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79 42 U.S.C. §2000e et seq.

80 29 U.S.C. §§621-634.

81 Employee Retirement Income Security Act of 1974, 29 U.S.C. §1001 et seq.

82 29 U.S.C. §1381 et seq.

83 501 F.2d 1145 (1st Cir. 1974).

84 109 N.J. Super. 555, 264 A.2d 98 (Super. Ct. N.J. 1970).

85 Cyr, supra, note 83, at 1152; McKee, id., at 103, 105-07.

86 Id., at 1152-54.

5. Contract Cases

In certain instances, a party seeks to enforce an existing contract against the successor of its counterparty. These cases often arise in the context of bankruptcies or secured party asset sales made under UCC Section 9-504, and to the extent that there is a relationship between the alleged predecessor and its alleged successor prior to the bankruptcy filing or the forced asset sale, the courts are more likely to find the successor liable.[87]

The two leading cases where courts have imposed successor liability without requiring continuity of corporate ownership are Glynwed, Inc. v. Plastimatic, Inc.[88] and Fiber-Lite Corp. v. Molded Acoustical Prod. of Easton, Inc.,[89] although these decisions had been criticized for unjustifiably relaxing the traditional test of successor liability, and for importing the "continuity of enterprise" doctrine from the product liability context into commercial law, when, by doing so, no public policy would be served, and there would be the risk of having a chilling affect on potential purchasers who would have to be concerned that, by acquiring a foreclosed business, they would also acquire liabilities they never intended to assume.[90]

V. Practical Considerations: Reducing the Chances Successor Liability Will Be Imposed

As the prior discussion has demonstrated, a purchaser of corporate assets will not be able to fully assure itself that it is safe from the obligations of the seller. While there may be certain actions which the purchaser (or its attorney) can take to reduce the likelihood that a court will impose the predecessor's liability on the purchaser, it is probably just as important that the buyer's counsel make sure that its client accepts this reality even before the buyer starts negotiating the terms of the transaction. By doing this, the buyer will have the opportunity to consider whether it needs to adjust the purchase price it is willing to pay to reflect this risk, or whether it wants to assume certain liabilities in the contract that it may have imposed upon it anyway as a matter of law (again, presumably making the deal more attractive to the seller and thus justifying a reduced purchase price).

Having said that, and depending on the particular circumstances, any of the following suggestions may be appropriate for counsel to discuss with representatives of the buyer. It should not be assumed, however, from the inclusion of any of the suggestions set forth below that any such suggestion will be practicable in every (or even most) situations.

1. Thorough Due Diligence

Even though the purchaser may take the position that it is not assuming any of the seller's liabilities, as the prior cases have indicated, the purchaser frequently gets an unwelcome surprise

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87 See, for example, Gallenberg Equipment, Inc. v. Agromac International, Inc., 10 F.Supp. 1050 (E.D. Wisc. 1998).

88 869 F.Supp 265 (D.N.J. 1997).

89 186 B.R. 603 (E.D. Pa. 1994).

90 Gallenberg, supra note 87, at 1055-56; citing G. P. Publication, Inc. v. Quebecor Printing - St. Paul, Inc., 125 N. C. App. 424, 481 S.E. 2d 674, 680-82 (N.C. Ct. App. 1997).

when a court issues its decision. Accordingly, the purchaser (other than for all the other business considerations) must do a thorough job of reviewing the seller's files and business records. Due diligence does not, however, stop there.

A prospective purchaser must also be proactive. Within the confines of confidentiality, the purchaser should also talk to the seller's lower level staff and line employees, suppliers and customers, in order to determine whether or not any liabilities exists and, if so, the nature, scope, extent and potential exposure related to such liabilities. Visit the local and regional offices of federal and state governmental agencies, review public files, and talk to compliance and enforcement personnel. Review the seller's internal compliance programs. Check out insurance policies (more on this below).

2. Indemnities, Purchase Price Adjustments, or Other Retention Mechanisms

In those instances where the purchaser knows that the seller is either going to dissolve or that the seller will distribute the sale proceeds to its shareholders, the purchaser must take extra care. An escrow arrangement, holding back a portion of the purchase price, or some other retention mechanism where a portion of the purchase price can be segregated and used if unforeseen liabilities arise within a specified period of time are effective means of making sure that the plaintiffs in a successor liability case have an adequate remedy against the predecessor, thus obviating the need for seeking recovery from the successor. Purchase price adjustments may also be appropriate; however, the trade-off of using a purchase price reduction is that the purchaser gets to keep the amount of reduction in its treasury, but it leaves the purchaser, as the seller's successor, vulnerable to paying out that money (and perhaps even greater amounts) in the event that the number of plaintiffs claiming successor liability is greater than anticipated. Conversely, if the seller is not intending to dissolve, or if it is a stable entity, an appropriately worded indemnity given by the seller to the purchaser may be sufficient.

3. Careful Drafting of the Purchase and Sale Agreement

In addition to thorough and clearly written indemnities, there are several other clauses in the purchase and sale agreement which, if properly drafted, can help protect the purchaser against unwanted successor liability. First, the assets and liabilities being included and those which are excluded from the transaction should be listed with as much specificity as possible. Second, the purchaser should ask for a representation that there are no undisclosed liabilities. It may be useful to include as part of this representation a statement that the relevant line and staff employees who work with the assets on a daily basis were consulted as to this statement. Third, the purchaser could propose a post-closing covenant from the seller that the seller will not dissolve or merge out of existence within a specified period of time after closing. Fourth, avoid any references in the agreement to the fact that the purchaser is buying the "business" of the seller. This last clause may be somewhat problematical, since many drafters and/or business people often wish to include a statement that the purchaser is buying the particular business of the seller, both because the buyer's representatives view the transaction as an acquisition of a business and because such language could arguably pick up related assets which are overlooked or inadvertently left out of the appropriate schedules or exhibits.

4. Choice of Law

In transactions where the assets or divisions being purchased are in more than one location or jurisdiction, or where the seller and buyer are based in different states, the selection of choice of law, which governs interpretation and construction of the agreement, and the venue for bringing disputes, can be critical. As was discussed above, certain states (notably Pennsylvania, New Jersey, Michigan and California) are often in the vanguard of expanding the scope of existing exceptions to the general rule of successor liability, and of developing new theories. Although frequently overlooked in most agreements, these clauses can be critical to avoiding successor liability. Thus, the buyer's position could be improved if the transaction or one or more of the parties can be found to have an appropriate nexus to a jurisdiction which reflects the traditional rule or has eliminated one or more exceptions by statute — e.g., Texas has eliminated the de facto merger doctrine by statute.

5. Retention of Management and Employees

As more fully described in the discussion of the elements of the "mere continuation" and "substantial continuity" doctrines, and in the discussion of the policies underlying the labor and employment cases above, the higher the number of officers, management, supervisors and employees retained by the purchaser, the closer the purchaser gets to finding that it is the seller's successor. There is a natural tension, however, between the avoidance of liability and the client's need to retain persons who are familiar with the assets and operations being purchased, including institutional history. Recognizing that retention of none of the seller's supervisors and employees is impractical, your best advice might be to identify for the buyer the risk associated with retaining a large number of employees, while counseling that only the barest minimum number of employees needed for smooth transaction be retained.

6. Operational Changes

Even though the purchaser may be loathe to change the operations of a successful business, consider that the more the new business looks like the old business, the greater the risk that a "substantial continuity" claim can be sustained.

7. Insurance

Depending upon the nature risks assumed and the nature of the business and assets being acquired, the purchaser may have two options when it comes to insurance. First, the purchaser may be able to obtain insurance, based on the results of its due diligence and the other clauses in the purchase and sale agreement, from its own insurers insuring against unknown and contingent liabilities which may have been inadvertently assumed. Second, if found to be the seller's successor, the purchaser may be able to salvage a reasonable resolution from an adverse result by arguing that it should be able to obtain the benefits of the seller's insurance.[91] This would especially be true if the

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[91] But see, for example, Henkel Corp. v. Hartford Accident & Indem. Co., 29 Cal. 4th 934 (2003), in which the California Supreme Court held that, where a successor's liability for injuries arose by contract rather than by operation of law, the successor was not entitled to coverage under a predecessor's insurance policies because the insurance company had not consented to the assignment of the policies. For an analysis of the Henkel decision and a discussion of decisions in other jurisdictions, see Lesser, Tracy &

seller's insurance policies were "occurrence" policies, which cover all claims attributable to the period the policy was in effect, rather than "claims made" policies which merely cover those claims actually made during the pendency of the policy.

8. Transactional Publicity and Announcements

Again recognizing the inevitable tension between your clients' business objectives and your role in helping avoid unnecessary liability, your will want the client to announce that it has bought certain specified assets of the seller, or to announce that the "business" is under new management. In many of the cases discussed, the purchaser announced that, despite the sale, the business was in the same location, providing the same quality sales and service, and that the sale would not change any of its operations. Those kinds of announcements, while perhaps being good for business and goodwill, are likely to invite parties to whom the predecessor owed obligations to initiate successor liability litigation against your client.

9. Post-Closing Business Operations

To the extent that minimizing the risk of successor liability is a more important objective than maintaining the seller's day-to-day operations, consideration should be given to the following precautions: (i) not all the employees and managers be retained, (ii) the physical location of the manufacturing facility be relocated, (iii) all communications with existing customers indicate that the plant is under new ownership or management, and (iv) the seller be prohibited contractually from dissolving or distributing the sale proceeds to its shareholders.

McKitterick, M&A Acquirors Beware: When You Succeed to the Liabilities of a Transferor, Don't Assume (At Least, in California) That the Existing Insurance Transfers Too, VIII Deal Points 2 (The Newsletter of the ABA Bus. L. Sec. Committee on Negotiated Acquisitions, No. 3, Fall 2003).

Appendix B

ACQUISITION OF A DIVISION OR LINE OF BUSINESS

The Model Asset Purchase Agreement contemplates the acquisition of all of the operating assets of a corporation, comprising its entire business and goodwill and excluding only organizational material and memorabilia in order to allow undistracted focus on the documentation of the full mechanics of an asset purchase, including extensive warranties and purchase price calculations and adjustments. A transaction in which the buyer will acquire less than all of the operating assets of the selling corporation, particularly a transaction in which the assets represent an unincorporated division or product line of a seller which will remain in business and which may continue product lines which have affinities to the transferred "Business", presents a number of additional issues which are implicated in the drafting of the agreement and in the mechanics of consummating a transaction in which the buyer and the seller may find themselves having various continuing relationships. The following sections discuss the most significant of these issues. Because of the infinite variety of circumstances of a divisional acquisition, however, it generally is not productive to propose exact language for inclusion in an agreement.

I. IDENTIFICATION OF THE ASSETS TO BE ACQUIRED

The most important task of the buyer's counsel in a divisional acquisition is to design a contractual description of the assets to be acquired by reference to a defined "Business". That description is critical not only to the goal of assuring that the buyer obtains what it intends to acquire, but also provides a reference for the buyer to avoid errors in the assumption of liabilities, to identify the mechanics of taking hold of the acquired assets and the need for post-closing cooperative activities between buyer and seller, and to design appropriate warranties and purchase price adjustments. The lawyer's success in this effort depends greatly upon the buyer's willingness to devote all the attention that may be required to understanding how the seller has organized and operated the business to be acquired.

The "devil" in this exercise is not in the details of specifically identifiable assets but in the generalities of the activities in which the assets are used. In some instances the assets to be acquired consist of production assets which are located in a single facility and comprehend that entire facility. In those cases, the buyer's concerns may be satisfied by a definition of the acquired Business which refers to the activities of that location. In other cases, the assets may not be so neatly packaged, but the Business can be described as relating to the manufacture of a certain product which is distinguishable from other products which the seller intends to continue. At the other end of the spectrum, there are situations in which the seller wishes to dispose of a variety of related activities, conducted in several countries, which the seller has operated as a loosely-structured division. In such instances, counsel may find that it will require a long, fully negotiated paragraph to capsulize those activities as a "business".

1. In regard to the contractual identification of the assets to be acquired, the definition of the "Business" serves as a gather-all clause, and it is appropriate for the buyer's counsel to seek initially to define that Business comprehensively. An example of such a definition is found in the first paragraph of Example 1 of this Appendix. The objective of the definition illustrated in Example 1 (if appropriate in the particular transaction) is to obtain for the buyer every asset of the seller

(except cash) used to operate the described activity: put another way, the objective is to equip the buyer to carry on the activity on the day after closing with the same resources as the seller had on the day before closing.

The seller will wish to limit the conveyance to assets "used exclusively in the Business" and to narrow the description of "Business". The thrust of the negotiations is fundamentally one of allocation of the risk of misidentification, and, at least as to a buyer's first draft, the burden should be shifted to the seller to identify excluded assets. In the course of those negotiations, the seller's counsel will of necessity be required to educate the buyer's counsel on the structure and operations of the activity which the buyer wishes to acquire. The end result should be an accurate frame of reference and an allocation of the risk of ambiguity which reflects the bargaining power of the parties.

2. To the maximum possible extent, buyer's counsel should include in the description of the assets being acquired a reference to categories of assets and provide for schedules which contemplate the identification of specific assets. Such provisions as are illustrated in Example 1 (and in the Model Agreement) are particularly important in divisional acquisitions. The completion of detailed schedules may be time-consuming but it is a very important exercise.

3. Buyer's counsel should require copies of the seller's internal accounts as to the assets employed in the division offered for sale (and the kinds of service charges imposed by the seller for services by non-division personnel). Although the seller's internal recordkeeping may not be exactly congruent with the way the division's activities actually are conducted, such information can be useful to buyer and its counsel in completing the schedules discussed in the preceding paragraph.

II. ASSUMPTION OF LIABILITIES RELATING TO THE ACQUIRED DIVISION

Because the divisional acquisition is a form of asset acquisition, absent the express agreement of the parties, no liabilities of the seller will be transferred to the buyer. To the extent that the buyer will assume liabilities which are described by category rather than identified specifically by schedule, there will be a reversal of the respective roles of buyer and seller in regard to the definition of the "Business". The seller's interests will be better served by a very broad definition of "Business". Another difference from the asset-description exercise is that while some assets are intangible, all liabilities have that characteristic, and do not have a physical home from which they can be distinguished from other liabilities of the seller.

Contemporary information technology makes it possible to reduce or eliminate many uncertainties as to the identification of liabilities to be assumed by the buyer. If the seller maintains information systems which are congruent with the Business which is offered for sale, it generally will be possible to obtain a current payables schedule which can be used as an exhibit to the Agreement. The buyer can review that schedule to determine whether it appears reasonable in the light of the description of the acquired business, and the buyer may require the seller to warrant that such liabilities have arisen only in the ordinary course of the business. The schedule of payables at the date of the Agreement provides a baseline against which seller's claims regarding payables arising in the interval between signing and closing can be evaluated.

As a general rule, buyer will require a specific identification of the contracts to be assumed by the buyer (subject to a materiality qualification), while the seller will propose to include every contract of every description relating to the Business which is being sold. In most transactions, the seller will want the buyer to assume unfilled customer orders, because the seller will be parting with the assets to complete those orders, and the buyer will want to assume the orders (subject to inquiry as to potentially unprofitable orders) so that the cash flow of the business will not be interrupted.

III. ADJUSTMENTS TO THE PURCHASE PRICE IN DIVISIONAL ACQUISITIONS

The Model Agreement provides for a form of post-closing purchase price adjustment based upon movements in the seller's working capital between the date of the Agreement and the closing date. An adjustment of that sort is appropriate in an asset acquisition — in which the buyer typically does not acquire cash — to assure that the buyer obtains the benefit of the working capital contemplated by the Model Agreement. That principle is applicable, of course, in the context of a divisional acquisition, but the design of the adjustment formula often is made difficult by the lack of adequate financial statements for the acquired Business. There is no simple solution to that difficulty. The importance of a post-closing purchase-price adjustment will vary with the particular facts of the transaction, and it is expected that the buyer will rely upon its financial and accounting advisors to develop a workable formula to protect the buyer's interests. Where inventory is a significant measure of the value of the acquired Business, a post-closing audit of the acquired inventory may be used in place of a financial-statement formula. Similarly, the effect of changes in receivables (if receivables are to be acquired, rather than taken on an agency basis) and in assumed liabilities may be taken into account through a post-closing audit without regard to seller's financial statements. In other situations, the buyer's accountants may conclude that they can adjust for the internal accounting practices of the seller so that the seller's statements, with review, can be used.

IV. SELLER'S REPRESENTATIONS AND WARRANTIES IN A DIVISIONAL ACQUISITION

The fact that a division, rather than the entire activities of the seller, is offered for sale will affect the significance and formulation of the seller's representations and warranties. It is likely that the seller will contend that several of the standard warranties are unnecessary and most other standard warranties are overbroad unless they are limited by phrases like "in the conduct of business". Although the persuasiveness of seller's position will vary in relation to the significance of the division to the seller's entire activities and in relation to the specific representation being negotiated, the seller's counsel often is correct in arguing that the seller should not be required to give assurances (or even provide information) as to matters which have no effect on the value of the acquired Business. The status of the seller's insurance coverage or of its reportable benefit plans, for example, may be of diminished relevance to the buyer in the context of an acquisition of all of the assets, as opposed to all of the stock, of a target corporation, and those items may be of no relevance in the context of the acquisition of a division which constitutes only a small portion of the seller's activities.

The negotiation as to whether a particular seller's representation or warranty should be limited by a phrase such as "in the conduct of the business" presents another illustration of the significance to the buyer of the contractual definition of the "Business". For example, the warranty contained in Section 3.6 of the Model Agreement that the transferred assets constitute all of the assets "required to operate the seller's business" often is of relatively little significance in a transaction in which all of the assets of the seller are being acquired, but is of fundamental concern to the buyer in a divisional acquisition. The effectiveness of that warranty depends entirely on whether the contractual definition of the "Business" is sufficient to comprehend all of the activities which the buyer seeks to acquire. Similarly, where the division buyer concedes that the typical seller representations relating to contracts and commitments, adverse changes, or litigation, for example, need not apply to the seller's entire activities, the limitation of such provisions to the "Business" places a further burden on that definition to protect the buyer from risk of loss. It is not possible to illustrate the negotiating positions between buyer and seller as to all representations and warranties, but the following issues deserve particular attention:

<u>Financial Statements</u>. There will be a broad range of reliability of divisional financial statements. Buyer's counsel will wish to include specific warranties as to the nature of the representation being made by such statements, particularly as to related party transactions (and as to whether all related party services are billed to the division). Divisional financial statements as used for the seller's internal purposes often lack notes, and unless notes are added for purposes of the transaction documents, counsel for the buyer must be sure that the buyer's assumption as to the accounting principles and method of preparation of internal divisional statements are backed by a representation of the seller.

<u>Intellectual Property</u>. In those situations where the division being sold employs some of the same technology as the activities which will be retained by the seller, the buyer will be concerned that the agreement identify and contain appropriate warranties as to all such property. The buyer may seek specific assurance that it is acquiring ownership or use of all of the technology required to conduct the Business. Where research and development activities of the seller are conducted on a centralized basis, the buyer requires assurance that it will receive all relevant information (subject, most likely, to non-compete and confidentiality agreements) (see Section VI, below).

V. SELLER'S PRE-CLOSING COVENANTS IN A DIVISIONAL ACQUISITION

In a typical acquisition agreement the buyer will require the seller to take, or refrain from taking, certain actions between the date of the agreement and the closing date in order to preserve for the buyer the condition and value of the business which is being acquired. The kinds of covenants illustrated in the Model Agreement generally are suitable to divisional acquisitions, but the following points should be considered.

1. Seller's counsel is likely to take the position that covenants relating to the seller's pre-closing activities should be limited only to the "Business" which is being acquired. As to many of the standard covenants, seller's counsel is correct, and the covenant can be confined to the Business and the assets which comprise the Business. Buyer's counsel, financial staff and advisors must understand the implications of each covenant on a case-by-case basis.

2. Even if buyer's counsel is comfortable in limiting most covenants to the seller's operation of the Business, buyer's counsel should consider whether there are specific covenants which appropriately may be required of the seller in light of the particular facts of the transaction. Many of such pre-closing covenants arise by implication from any anticipated post-closing relationships between buyer and seller. If the transaction contemplated, for example, that the seller

would continue to manufacture and sell a certain grade of alloy to the buyer after the sale of the Business, it would be appropriate to require the seller pre-closing (and post-closing) to maintain its capacity to produce that product. Similarly, a seller may be required to agree not to sell prior to closing a certain other line of its business which, after closing, would be bound by the seller's non-competition agreement in favor of the buyer.

3. Except in those rare situations where the acquired Business is located in facilities separate from the seller's other activities and is highly self-contained, the uncoupling of the acquired assets from the seller's retained assets generally requires substantial cooperation from the seller. In many instances that uncoupling must be carried out over a period of time and requires specific agreements as to services and access to facilities which are discussed in the following section. Even in those cases where it is expected that the buyer can take hold of the Business in a single delivery, counsel for the buyer, in consultation with the buyer's staff, must plan the procedures for transferring the tangible assets and should insert in the agreement covenants to accomplish the plan. Such covenants can be as simple as requiring the seller to assemble items on a loading dock. Other agreements may require the seller to pack and ship items or to leave premises in a specified condition. The transfer of unwritten intellectual property may present a significant concern. The buyer often will require that proprietary techniques and research in process be reduced to writing and delivered to the buyer at closing. It falls upon buyer's counsel in each case to anticipate the specific requirements of transfer and to incorporate them into the seller's obligations.

VI. POST-CLOSING COVENANTS AND POST-CLOSING BUSINESS RELATIONSHIPS BETWEEN BUYER AND SELLER

One of the most critical elements of lawyering for the buyer's counsel in the divisional acquisition is to identify the shared relationships which are, or post-closing will be, critical to the success of the acquired Business. It is not possible to illustrate all of the relationships as to which the acquired Business may depend upon the seller (and in some cases vice-versa), nor is it possible to illustrate all of the different contractual responses which counsel may devise to protect the interests of his or her client. In some instances, the matters described in this section can be dealt with as covenants recited in the acquisition agreement. In other instances, the required agreements will be sufficiently detailed to justify a separate agreement to be executed by the parties at closing.

Covenants against competition. The covenant of the seller to refrain from competition with the transferred business in the context of a sale of substantially all of the assets of the seller is routine and often of little consequence to either the buyer or to a seller which probably will liquidate and cease its operations entirely; obtaining such a covenant from the seller's principals may in such context be of more significance to the buyer. In a divisional acquisition, on the other hand, the non-competition covenants generally will be vital to both buyer and seller and will be one of the principal business points of the transaction. Where there are affinities in products or technology between the transferred Business and the continuing activities of the seller, counsel for both buyer and seller should be alert to the possibility that either may wish to dispose of the competitive or potentially competitive product lines during the continuation of the covenant, and that situation should be addressed in negotiations.

Facilities and Services. There are an infinite variety of arrangements which may be required to assure the proper transfer of the business to the buyer, particularly in cases where the acquired

Business will for a period of time occupy its historic space in facilities in which the seller also will continue to operate. The buyer's business officers must in the first instance develop a business plan for the transition. An experienced attorney can assist in that regard, but cannot substitute for the expertise of the buyer. In most instances it will be desirable to have a written agreement between the seller and buyer to take effect at closing with regard to the continuation of services and use of facilities. A complicating factor for the buyer's counsel in this context is that, although it is desirable to have such an agreement as an exhibit to the Purchase Agreement, it often is difficult to direct the client's attention to post-closing procedures at the same time that the Purchase Agreement is being drafted and due diligence is underway. The best that buyer's counsel often can do is to negotiate a post-closing agreement in very general terms.

Example 2 of this Appendix is a form of a Transitional Services Agreement which illustrates the types of issues, and their resolution, which may be presented where the buyer requires continuing support from the seller for the period immediately following the closing.

In those instances where the buyer intends to maintain the acquired Business proximately to facilities of the seller for an extended period of time, it is essential that the parties address and agree upon, as part of the basic deal, any necessary cooperation. If the buyer, for example, intends to lease a building in the seller's campus to operate the acquired Business, the buyer may require various easements, use of storage yards, access to transportation facilities (rail platforms), shipping and receiving and materials handling services and possibly other "utilities" which the seller has developed.

Seller as Supplier. It is common to find that a division, particularly of a highly-integrated corporation, will obtain raw materials and partially-finished goods from other units of the corporation. The buyer must determine as part of the negotiation of the acquisition whether it requires continuation of that source of supply in order to preserve the performance of the acquired Business. If such supply is required, the terms of the supply contract should be negotiated, and the buyer's obligation to close may be conditioned upon the execution of the supply contract. In some instances, the buyer may attempt to obtain exclusive rights to the materials supplied by the seller, particularly where the quality of those materials is believed to have contributed significantly to the success of the division. Occasionally the momentum to have a supply contract as part of the transaction may come from the seller; this situation occurs, for example, where the supplied material is a by-product of the seller's retained manufacturing process, and the external market for that product is very small.

Intellectual Property. The transfer of trade-marks and service-marks applicable to the products or services of the acquired Business ordinarily will be an essential business issue for the buyer. If the seller is not prepared, because of the needs of its retained activities, to part with a name which is material to the value of the Business which is put up for sale, that position ordinarily will be known at the outset of negotiations and will have a significant effect on the purchase price. If the buyer and the seller can agree to share the trade names, the transaction will require carefully-drawn license arrangements. The more frequent sharing of intellectual property arises in the context of patented and unpatented inventions and processes. In this context the negotiations involve whether the technology will be sold to the buyer, with a license back to the seller, or retained by the seller, with a license to the buyer. In some instances, buyer and seller may agree to share research and development activities for a period of time, along the lines of a joint venture. All such arrangements will require carefully drawn confidentiality and field-of-use or non-competition provisions. The latter may be particularly complex if the technology has a potential use that is broader than the current activities of the seller or the acquired Business; in those instances it will be necessary to agree upon who has the right to use or license the technology for those other purposes. In drafting all shared-technology agreements, counsel for both parties must be sensitive to the difficulties which might arise in the event that one of the parties becomes bankrupt or comes under the control of a competitor of the other party.

Information Systems; Software. The computer systems of the acquired Business probably will be linked with all operations of the seller, and the critical question is the extent to which the information systems of the division can function on their own if they are uncoupled from the rest of the seller's enterprise. The same issue is presented by telephone systems, customer communication systems, vendor purchasing links, satellite communications, and other information processing systems. These needs can be resolved either by the buyer supplying or contracting for such services from other suppliers or by continuing support agreements between the seller and the buyer for continuation of the seller's services after closing, generally only for an interim period. Special care should be given to the need to obtain computer source codes from the seller, and on difficulties in converting important data bases of the seller for the use by buyer. Proprietary software of the seller which is critical to the activities of the acquired Business may be purchased outright and included in the assets conveyed or may be subjected to a perpetual license from seller to buyer.

Records. It is likely that there will be records of past activities of the division which will be retained in some central location by seller and which will not be transferred to the buyer. The buyer should impose strict confidentiality on any seller-retained records which contain business or trade secrets and should provide for continuing access of the buyer to those records in the future.

Seller's Contracts with Third Parties. Most asset acquisitions involve the assignment of contracts from the seller to the buyer. The buyer generally protects its business expectations by requiring that the seller warrant that the assignment does not require consent of the other contracting party or by requiring that the seller deliver consents prior to closing. As to those contracts which relate only to the activities of the acquired Business, the divisional acquisition proceeds identically to the acquisition of all of the assets of a corporation. In some instances, however, the seller may have purchase contracts for materials with a single provider which are applicable to various or all of the seller's operations, including the division which is offered for sale. Such contracts will not be assigned to the buyer, and it is incumbent upon the buyer to determine, early in the negotiations, whether any such contracts are so favorable that their loss would materially adversely affect the acquired Business. If there are such contracts, and assuming that it is unlikely that the supplier would extend similarly favorable terms to a separated division of the seller, the buyer should negotiate for a resale of the material by the seller to the buyer. Although that two-step process may be the best that the buyer can do in that situation, it should be noted that such an arrangement may be thwarted by prohibitions against resale in the contract between the supplier and the seller, or it may come undone as a result of disagreements between the seller and the supplier after the closing.

Post-Closing Covenants Relating to Seller's Employees. Most of the issues relating to employment of seller's employees after closing in respect to a divisional acquisition are identical to those arising in respect of the sale of seller's entire operations by way of an asset sale. The buyer is concerned with retaining key employees of the acquired business and with a variety of issues relating to the renegotiation of labor contracts and the assumption of benefit plans and translation of benefits. The seller is concerned, among other things, with avoidance of severance costs, the application of business-closing statutes and possibly multiemployer pension plan withdrawal liability. The negotiated resolution of those issues is generally reflected in the statement of conditions of closing as well as in post-closing covenants.

Additional employee issues are presented in the divisional acquisition context, particularly where the seller will continue one or more lines of business which have affinities with the division that is being sold. The seller often will require that the buyer agree not to recruit or hire any of the seller's employees for a stated period of time, and the buyer would expect similar protection. Post-closing covenants also may be used to define the terms under which seller and buyer may share the services of employees for a period of time, although collateral agreements are often drafted to cover such arrangements.

EXAMPLE 1

SAMPLE DESCRIPTION OF ASSETS

Buyer hereby agrees to purchase from Seller, and Seller hereby agrees to sell to Buyer, all the assets, tangible and intangible, of Seller, wherever located, used by the Seller or usable by the Seller in its business of designing, manufacturing, and selling Alpha widgets or otherwise related to the design, manufacture and sale of Alpha widgets, and all business and activities of Seller carried out under the name "Alpha Division" (all of the foregoing being herein referred to as the **"Business"**), all of said assets being herein referred to as the **"Assets"**. Without limiting the generality of the foregoing, the Assets shall include the following:

1. good and marketable title in fee simple to full, undivided ownership in all real property used in the Business, including, without limitation, the real property more particularly described in Schedule 1 attached hereto (collectively, the **"Real Estate"**), and all buildings, improvements, other constructions, construction-in-progress and fixtures (collectively, the **"Improvements"**) now or hereafter located on the Real Estate, together with, as they relate to the Real Estate, all right, title and interest of Seller or the Seller affiliates in all options, easements, servitudes, rights-of-way and other rights associated therewith;

2. all tangible personal property (collectively, the **"Personal Property"**) of every kind and nature used in the Business other than (i) items of tangible personal property that are consumed, disposed of or held for sale or are inventoried in the ordinary course of business and (ii) fixed assets transferred in compliance with [the bring-down provisions of this Agreement], including without limitation, all furniture, fixtures, machinery, vehicles, owned or licensed computer systems, and equipment, including, without limitation, the Personal Property listed in Schedule 2 hereto;

3. all those inventories of supplies, office supplies, maintenance and shop supplies, and other disposables, which are used in connection with the operation of the Business and which are existing as of the closing date, the current categories and amounts of which are set forth on Schedule 3 (the **"Inventory"**);

4. all accounts, notes, receivables and other rights to receive money, arising out of or relating to the operations of the Business, including, without limitation, all those categories and classes of accounts receivable listed on Schedule 4 (the **"Receivables"**);

5. all intangible property (collectively, the **"Intangible Property"**) of every kind and nature which exists as of the closing date and is related to the Business, including, without limitation, the following:

(a) all patents, trademarks, trade names, service marks, logos, trade secrets, copyrights, and all applications and registrations therefor that are used in the Business, and licenses thereof pursuant to which seller has any right to the use or benefit of, or other rights with respect to, any of the foregoing (the **"Intellectual Property"**), including, without limitation, the terms identified in Schedule 5 attached hereto;

(b) all telephone numbers;

(c) all licenses, permits, certificates, franchises, registrations, authorizations, filings, consents, accreditations, approvals and other indicia of authority relating to the operation of the Business as presently conducted by Seller (collectively, the **"Licenses and Permits"**), which Licenses and Permits are listed in Schedule 5 attached hereto;

(d) all benefits, proceeds or any other amounts payable under any policy of insurance maintained by Seller with respect to destruction of, damage to or loss of use of any of the Assets, but excluding all benefits, proceeds or any other amounts payable under any policy of insurance maintained by Seller with respect to the Business;

(e) all deposits held by Seller in connection with future services to be rendered by Seller in connection with the Business; and

(f) all warranties, guarantees, and covenants not to compete with respect to the Business.

6. all the books, records, forms and files relating to the operations of the Business or reflecting the operations thereof, but excluding therefrom records reflecting the operations of the Seller as a whole or records to which Seller and Buyer shall have joint access thereto pursuant to other provisions of this Agreement.

Without limiting the generality of the foregoing, the Assets shall include all such assets as are included on the balance sheet of the Alpha Division of Seller bearing even date herewith as amended to reflect the condition of the Alpha Division as of the closing date.

INTRODUCTION TO TRANSITIONAL SERVICES AGREEMENT

In a divisional purchase, the purchaser often does not acquire an entire free-standing business because some of the services which were being provided to the divisional business were being provided by other departments of the seller or its affiliates or pursuant to third party contracts and, in all such cases, those service providers continue to provide their services to the non-purchased businesses and are not part of the acquisition. Depending upon its resources, this may lead the purchaser to request a transitional services agreement from the seller. The seller may view such an agreement as an accommodation on its part because it had hoped to be completely free of the divisional business on closing. For these reasons and because purchasers, when preparing their initial purchase documentation, may not appreciate the complexities of the transition or the timing constraints which may arise, many transitional services agreements are initially prepared by the seller's counsel and many (including the one following) are somewhat pro-seller. In the transitional services agreement which follows, the general thrust is to allow the seller to continue its past internal practices and internal pricing allocations and it puts minimal representation and warranty-type responsibility on the seller.

The following transitional services agreement deals with certain common types of transitional services: HR services, MIS services and sales support services. However, it is intended to be a framework agreement into which any relevant transitional services could be placed with minimal additional changes to the form of the agreement. For example, the agreement could deal with insurance management and risk management, advertising and marketing services, and legal services. The first two of these examples might be useful to a purchaser not only for reasons of timing but also because the seller may have favorable contracts on which the purchaser could effectively piggy-back for some interim period. By way of example, the following transitional services agreement includes both fixed price services and services priced on a fully allocated cost methodology.

This transitional services agreement is designed for the types of services outlined above. In purchases and sales of divisions which are goods producing businesses, it may be necessary to prepare a separate interim supply or contract manufacturing agreement. In some divisional purchase contexts, there may be a need for interim patent, technology or trade mark licenses from the seller to the purchaser. The following transitional services agreement is not intended to include such agreements or licenses.

The Model Asset Purchase Agreement was prepared on the basis of a purchase of substantially all of the assets of the seller and there was no need for a transitional services agreement. The following transitional services agreement was prepared as an independent form of agreement. Ordinarily, its provisions would dovetail into and be consistent with those of the purchase agreement to which it related. For example, if the Model Asset Purchase Agreement had been a divisional purchase, the provisions regarding confidentiality in Section 6.1 of this transitional services agreement would have been revised to conform to those of Article 12 of the Model Agreement.

With minor modifications, this transitional services agreement could be used in the context of a divisional asset purchase, the purchase of stock of a subsidiary which uses services of affiliates within its group and the purchase of one division of a multi-national business where the divisional business is operated as a subsidiary in some countries and a division in other countries.

TRANSITIONAL SERVICES AGREEMENT

THIS AGREEMENT made as of the _____ day of __________, 20___.

B E T W E E N:

■

(hereinafter called **“Seller”**)

- and -

■

(hereinafter called **“Buyer”**)

WHEREAS Seller and Buyer have entered into an asset purchase agreement dated ___________ (the **“Purchase Agreement”**) for the sale of the _________________ business conducted by Seller (the **“Business”**);

AND WHEREAS the Business uses certain services provided by Seller or by third parties under contract to Seller;

AND WHEREAS Section ____ of the Purchase Agreement provides that on the Closing Date, Seller and Buyer shall execute and deliver a transitional services agreement, pursuant to which, for a period of one year after the Closing Date, Seller shall make available to Buyer certain transitional services being provided as of the signing date of the Purchase Agreement, on a basis substantially consistent with Seller s recent historical practice and for a price equal to Seller s fully allocated cost of the service (which shall be substantially similar to that reflected with respect to such services in the financial statements specified in Section ______ of the Purchase Agreement);

AND WHEREAS Buyer desires to obtain the use of certain services for the purpose of enabling Buyer to manage an orderly transition in its operation of the Business;

NOW THEREFORE, in consideration of the mutual covenants and agreements contained herein and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereto agree as follows:

1. Definitions

1.1 **“Business”** shall have the meaning set forth in the first recital of this Agreement.

1.2 **“Fixed Price Services”** shall include HR Services, MIS Services and other services as set forth in Schedule 1.2.

1.3 **"Fully Allocated Cost"** shall have the meaning set forth in Schedule 1.3.

1.4 **"HR Services"** shall mean the services of Seller's internal human resources staff as provided to the Business in accordance with recent historical practice, as further specified in Schedule 1.4.

1.5 **"MIS Services"** shall mean all computer and data processing services and support provided to the Business in accordance with recent historical practice, as further specified in Schedule 1.5.

1.6 **"Sales Support Services"** shall mean, with respect to the sale of products of the Business, financial and accounting support, record keeping, customer billing and collections, order processing, and preparing and reporting of monthly estimates and results.

1.7 **"Transitional Services"** shall mean the aggregate of all HR Services, MIS Services and Sales Support Services, the use of office space and other services, including those set forth in Schedule 1.2.

1.8 Capitalized terms not expressly defined in this Agreement shall have the meanings ascribed to them in the Purchase Agreement.

2. Provision of Services

2.1 Subject to Article 7 hereof, Seller shall provide to Buyer such Transitional Services for a period of up to ___ months after the Closing Date as are requested by Buyer by written notice to Seller on or before ____________________. It is understood by the parties that the quantity of services to be provided under this Section 2.1 shall be substantially consistent with recent historical practice. Where the quantity of services to be provided to Buyer is greater than an amount which is substantially consistent with recent historical practice, Seller reserves the right (after so advising Buyer) to utilize third-party providers to provide the services to Buyer, in which event Seller may charge Buyer for any additional costs associated with such greater quantity of services calculated on the basis of Fully Allocated Cost; except that no such additional charges shall be applicable to the services described in Paragraph 2 of Schedule 1.5.

2.2 Seller s obligation to deliver any service described in this Agreement is conditional upon Seller obtaining the consent, where necessary, of any relevant third party provider; provided, however, that if such consent cannot be obtained, the parties shall use their respective reasonable efforts to arrange for alternative methods of delivering such service.

2.3 With respect to Sales Support Services, (i) pricing for products of the Business shall be at the prices specified by Buyer, and (ii) monthly financial reports shall be provided to Buyer, on a time schedule consistent with recent historical practice. Such financial reports shall be in substantially the form currently provided by Seller with respect to sales of the products of the Business.

2.4 During the period of this Agreement, Buyer agrees to provide to Seller a total of __________ employees of Buyer, ____________ HR and __________ MIS, exclusively to provide HR Services and MIS Services, respectively, to the Business, in consideration for which Buyer shall be entitled to a credit against the charges for such services, as provided in paragraph 2 of Schedule 1.2 In the event that any of such employees shall cease to be employees of Buyer for any reason during the period in which Transitional Services in such employee s field of responsibility are provided, Buyer shall, after consultation with Seller, provide to Seller services of appropriate substitute personnel (who may be employees or independent contractors) on a one-for-one basis at no cost to Seller.

3. Pricing, Billing and Payment

3.1 All Transitional Services other than Fixed Price Services shall be charged to and payable by Buyer at the Fully Allocated Cost of such service. All Fixed Price Services shall be charged to and payable by Buyer at the prices set forth in Schedule 1.2.

3.2 Charges for Transitional Services shall be billed monthly by Seller, and shall be payable on the fifteenth day of the month following the month in which such services are rendered.

3.3 Seller shall remit the proceeds of invoices collected on behalf of Buyer, net of charges for Transitional Services. Such remittance shall be submitted concurrently with the reports specified in Section 2.3 above.

4. Warranty, Liability and Indemnity

4.1 Seller shall provide Transitional Services to Buyer in a manner consistent with the manner they have heretofore been provided to the Business while it was operated by Seller. Seller makes no other warranties, express or implied, with respect to the services to be provided to Buyer hereunder.

4.2 Seller’s maximum liability to, and the sole remedy of, Buyer for breach of this Agreement or otherwise with respect to Transitional Services is a refund of the price paid for the particular service or, at the option of Buyer, a redelivery (or delivery) of the service, unless the breach arises out of the gross negligence or willful failure of performance of Seller.

4.3 In no event shall Seller be liable to Buyer for any consequential, incidental or special damages suffered by Buyer arising out of this Agreement, whether resulting from negligence of Seller or otherwise.

4.4 Buyer agrees to indemnify and hold Seller harmless from any damages, loss, cost or liability (including legal fees and expenses and the cost of enforcing this indemnity) arising out of or resulting from a third party claim regarding Seller’s performance, purported performance or non-performance of this Agreement.

5. Force Majeure

5.1 Seller shall not be responsible for failure or delay in delivery of any Transitional Service, nor shall Buyer be responsible for failure or delay in receiving such service, if caused by an act of God or public enemy, war, government acts, regulations or orders , fire, flood, embargo, quarantine, epidemic, labor stoppages or other disruptions, accident, unusually severe weather or other cause similar or dissimilar, beyond the control of the defaulting party.

6. Proprietary Information and Rights

6.1 Each party acknowledges that the other possesses, and will continue to possess, information that has been created, discovered or developed by them and/or in which property rights have been assigned or otherwise conveyed to them, which information has commercial value and is not in the public domain. The proprietary information of each party will be and remain the sole property of such party and its assigns. Each party shall use the same degree of care which it normally uses to protect its own proprietary information to prevent the disclosure to third parties of information that has been identified as proprietary by written notice to such party from the other party. Neither party shall make any use of the information of the other which has been identified as proprietary except as contemplated or required by the terms of this Agreement. Notwithstanding the foregoing, this Article shall not apply to any information which a party can demonstrate (i) was, at the time of disclosure to it, in the public domain through no fault of such party; (ii) was received after disclosure to it from a third party who had a lawful right to disclose such information to it; or (iii) was independently developed by the receiving party.

7. Termination

7.1 This is a master agreement and shall be construed as a separate and independent agreement for each and every service provided under this Agreement. Any termination of this Agreement with respect to any service shall not terminate this Agreement with respect to any other service then being provided pursuant to this Agreement.

7.2 Upon 10 days' written notice, Seller may terminate this Agreement with respect to any Transitional Service, or at its option suspend performance of its obligations with respect thereto, in either case in the event of the failure of Buyer to pay any invoice within 30 days of the receipt of such invoice or upon any other material breach by Buyer of this Agreement with respect to such service, unless Buyer is disputing the invoice in good faith or Buyer shall have paid the invoice or cured such breach within the 10-day notice period.

7.3 Any one or more of the Transitional Services may be terminated (i) upon mutual agreement of Buyer and Seller or (ii) at Buyer s option upon 60 days advance notice to Seller. All accrued and unpaid charges for Transitional Services shall be due and payable upon termination of this Agreement with respect to such services.

7.4 Following any termination of this Agreement, each party shall cooperate in good faith with the other to transfer and/or retain all records, prepare and file tax returns and take all other actions necessary to provide Seller and Buyer and their respective successors and assigns with sufficient information in the form requested by Seller or Buyer, or their respective successors and assigns, as the case may be, to make alternative service arrangements substantially consistent with those contemplated by this Agreement.

8. <u>No Implied Assignments or Licenses</u>

8.1 Nothing in this Agreement is to be construed as an assignment or grant of any right, title or interest in any trademark, copyright, design or trade dress, patent right or other intellectual or industrial property right.

9. <u>Relationship of Parties</u>

9.1 The parties are independent contractors under this Agreement. Except as expressly set forth herein, neither party has the authority to, and each party agrees that it shall not, directly or indirectly contract any obligations of any kind in the name of or chargeable against the other party without such party's prior written consent.

10. <u>Assignment and Delegation</u>

10.1 Neither party to this Agreement may assign any of its rights or obligations under this Agreement without the prior written consent of the other party hereto.

11. <u>Notices</u>

11.1 All notices or other communications hereunder shall be deemed to have been duly given and made if in writing and (i) if served by personal delivery upon the party for whom it is intended, on the day so delivered, (ii) if mailed by registered or certified mail, return receipt requested, on the third business day following such mailing, (iii) if deposited for delivery by a reputable courier service, on the business day following deposit with such courier, or (iv) if sent by electronic facsimile transmission, on the day the facsimile is transmitted electronically, or if not a business day, the next succeeding business day; to the person at the address set forth below, or such other address as may be designated in writing hereafter, in the same manner, by such person:

To Seller:

■

To Buyer:

■

12. Entire Agreement

12.1 This Agreement, including the Schedules, together with the Purchase Agreement, contains the entire agreement between the parties with respect to the subject matter hereof and supersedes all prior agreements and understandings, oral or written, with respect to such matters.

13. Parties in Interest

13.1 This Agreement shall inure to the benefit of and be binding upon the parties and their respective successors and permitted assigns. Nothing in this Agreement, express or implied, is intended to confer upon any Person other than Seller or Buyer, or their respective successors or permitted assigns, any rights or remedies under or by reason of this Agreement.

14. Governing Law; Submission to Jurisdiction

14.1 This Agreement shall be governed by, and construed in accordance with, the laws of the State of ________________ without regard to conflicts of laws principles. Each party hereto agrees that it shall bring any action or proceeding in respect of any claim arising out of or related to this Agreement or the transactions contained in or contemplated by this Agreement, whether in tort or contract or at law or in equity, exclusively in ______________ (the **"Chosen Courts"**) and (i) irrevocably submits to the exclusive jurisdiction of the Chosen Courts, (ii) waives any objection to laying venue in any such action or proceeding in the Chosen Courts, (iii) waives any objection that the Chosen Courts are an inconvenient forum or do not have jurisdiction over any party hereto and (iv) agrees that service of process upon such party in any such action or proceeding shall be effective if notice is given in accordance with section 11.1 of this Agreement.

15. Amendment; Waiver

15.1 Any provision of this Agreement may be amended or waived if, and only if, such amendment or waiver is in writing and signed, in the case of an amendment, by Seller and Buyer, or in the case of a waiver, by the party against whom the waiver is to be effective. No failure or delay by any party in exercising any right, power or privilege hereunder shall operate as a waiver thereof nor shall any single or partial exercise thereof preclude any other or further exercise thereof or the exercise of any other right, power or privilege.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed and delivered by their duly authorized officers as of the date first above written.

SELLER

By:______________________________
Name:
Title

BUYER

By:______________________________
Name:
Title:

SCHEDULE 1.2

FIXED PRICE SERVICES PROVIDED BY SELLER TO BUYER

(1) HR Services, as described in Schedule 1.4.

(2) MIS Services, as described in Schedule 1.5.

The Fixed Price Services set forth in 1 and 2 above are to be provided at the monthly rates specified in the table below subject to adjustment as provided in the following sentence:

HR Services	$______
MIS Services	$______

In the case of HR Services and MIS Services, the rates in the table above shall be reduced by an amount equal to the aggregate monthly salary and benefit expense attributable to the __________ HR employees and __________ MIS employees whose identity has been previously agreed between the parties, but only to the extent that such employees, or substitutes therefor, are provided to Seller in accordance with section 2.4 of the Agreement.

(3) Use of furnished space in _______________ office building for a period of up to __________ months from the Closing Date. The annual charge for this Fixed Price Service will be _______________ per useable square foot, and this charge shall be billed weekly.

SCHEDULE 1.3

FULLY ALLOCATED COST

The term "fully allocated cost" is used by Seller to represent the methodology whereby unit manufacturing, internally sourced products and services and supply billing or charge rates are calculated for both actual and forecast purposes.

The "fully allocated cost" of a product or service is intended to reflect all labor, overhead and materials expenditures allocated to such product or service which is "sold" to an external or internal (i.e., another business unit of Seller) customer, on a basis substantially consistent with Seller's recent historical practice and for a price substantially equal to that reflected with respect to such products or services in the financial statements specified in Section _____ of the Purchase Agreement.

The method of determining Fully Allocated Cost for products and services will be as follows:

- The unit providing the product or performing the service is defined.
- All the expenditures incurred by the unit directly are accumulated, i.e., supervision, labor, services, supplies, etc.
- Any allocations of divisional or management overhead to the unit are determined and treated as unit overhead.
- Charges for services rendered by third parties (e.g., long distance telephone charges) are passed through to the user directly without markup.

SCHEDULE 1.4

HR SERVICES

HR Services shall include the HR services provided by the Seller's HR Department and staff substantially consistent with recent historical practice.

[Provide some elaboration of the HR Services]
[Address whether certain outside HR Services will or will not continue to be provided]

SCHEDULE 1.5

MIS SERVICES

(a) **MIS Services.** The MIS Services shall include all computer and data processing services and support as provided to the Business in accordance with recent historical practice, as well as the expiration/termination assistance described in paragraph 2 below.

(b) **Expiration/Termination Assistance.** Seller will, upon 60 days' notice, provide all reasonable expiration/termination assistance requested by Buyer, including, without limitation, the following:

- cooperating with Buyer in effecting the orderly transfers of the MIS Services to a third party provider or in connection with the resumption of the services by Buyer, including during a period of parallel operations between the MIS Services provided hereunder and any replacement system being developed and tested by Buyer;

- using such services as may be requested by Buyer in connection with the transfer of the services to a third party or the resumption of the services by Buyer;

- notifying all vendors and third-party outsourcers of procedures to be followed during the termination assistance period;

- generating and delivering to Buyer a tape and computer listing of the source code and copies of technical documentation for the software applications covered under the Software License Agreement, dated as of _______________, between Seller and Buyer;

- unloading the production and test data bases;

- delivering tapes or other media requested by Buyer of production data bases to the new operations staff.

In re IBP, Inc. Shareholders Litigation

--

IBP, Inc., Defendant and Cross-Claim Plaintiff, and Counterclaim Defendant

v.

Tyson Foods, Inc. and Lasso Acquisition Corporation, Defendants, Cross-Claim Defendants and Counterclaim Plaintiffs

Civil Action No. 18373
In the Court of Chancery of the State of Delaware
(Decided June 15, 2001 and Corrected June 18, 2001)
787 A.2d 14 (Del. Ch. 2001)

IBP, Inc. ("*IBP*"), the nation's number one beef and number two pork distributor, sued for specific performance seeking to compel Tyson Foods, Inc. ("*Tyson*"), the nation's number one chicken distributor, to consummate an Agreement and Plan of Merger (the "*Merger Agreement*") between IPB and Tyson pursuant to which IBP stockholders would receive their choice of $30 a share in cash or Tyson stock, or a combination of the two.

Background

In December 2000, Tyson won an auction against Smithfield Foods to acquire IBP, which was already the subject of a definitive agreement with a leveraged buyout group. As a result of its acquisition of IBP, Tyson would be the number one distributor of chicken, beef and pork in the United States and operate a diverse food processing business. The Merger Agreement was signed on January 1, 2001.

During the auction process, Tyson was provided information that suggested that (i) IBP was heading into a trough in the beef business, (ii) an IBP subsidiary, DFG, had been victimized by accounting fraud of over $30 million in charges to earnings and was the active subject of an assessment impairment study and (iii) IBP was projected to fall seriously short of the fiscal year 2000 earnings predicted in projections prepared in August 2000 in connection with the leveraged buyout proposal.

By the end of the auction process, Tyson had come to have great doubts about IBP's ability to project its future earnings, the credibility of IBP's management, and thought that the important business unit in which DFG was located – Foodbrands – was in trouble.

Nevertheless, Tyson raised its bid by a total of $4.00 a share after learning of these problems and signed the Merger Agreement, which permitted IBP to recognize unlimited additional liabilities on account of the accounting improprieties at DFG.

After the Merger Agreement was signed, Tyson trumpeted the value of the merger to its stockholders and the financial community, and indicated that it was fully aware of the risks that attended the cyclical nature of IBP's business. In early January, Tyson's stockholders ratified the merger agreement and authorized its management to take whatever action was needed to close the transaction.

During the spring of 2001, Tyson began to suffer buyer's remorse because of dismal business performance by both Tyson and IBP due in large part to a severe winter, which adversely affected livestock supplies.

At the same time, IBP was struggling to resolve issues that had been raised about it financial statements by the SEC in connection with proxy materials previously filed for the leveraged buyout, including how to report the problems at DFG. The SEC first raised these issues in a faxed letter on December 29, 2000 to IBP's outside counsel. Neither IBP management nor Tyson learned of the SEC's letter until the second week of January 2001. Even after learning of the letter, Tyson management had put the Merger Agreement to a successful board and stockholder vote.

On March 29, 2001, Tyson gave notice that it was terminating the Merger Agreement and suing in Arkansas for damages for breach of contract. IBP's stated reasons for terminating the Merger Agreement were that it was induced to enter into the Merger Agreement based on misleading information in IBP's financial statements that were restated after the Merger Agreement was signed and that IPB failed to provide Tyson with an SEC comment letter issued by the SEC on December 29, 2000 that raised important issues about IBP's financial statements. Tyson's notice of termination did not allege any material adverse change in IBP's business and stated.

> Tyson Foods ... will issue a press release today announcing discontinuation of the transactions contemplated by the Agreement and Plan of Merger dated as of January 1, 2001 among IBP, inc. ("IBP") and Tyson (the "Merger Agreement"). We intend to include this letter with our press release.
>
> On December 29, 2000, the Friday before final competitive negotiations resulting in the Merger Agreement, your counsel received comments from the Securities and Exchange Commission ("SEC") raising important issues concerning IBP's financial statements and reports filed with the SEC. As you know, we learned of the undisclosed SEC comments on January 10, 2001. Ultimately, IBP restated its financials and filings to address the SEC's issues and correct earlier misstatements. Unfortunately, we relied on that misleading information in determining to enter into the Merger Agreement. In addition, the delays and restatements resulting from these matters have created numerous breaches by IBP of representations, warranties, covenants and agreements contained in the Merger Agreement which cannot be cured.
>
> Consequently, whether intended or not, we believe Tyson Foods, Inc. was inappropriately induced to enter into the Merger Agreement. Further, we believe IBP cannot perform under the Merger Agreement. Under these facts, Tyson has a right to rescind or terminate the Merger Agreement and to receive compensation from IBP. We have commenced legal action in Arkansas seeking such relief. We hope to resolve these matters outside litigation in an expeditious and business-like manner. However, our duties dictate that we preserve Tyson's rights and protect the interests of our shareholders.

> If our belief is proven wrong and the Merger Agreement is not rescinded, this letter will serve as Tyson's notice, pursuant to sections 11.01(f) and 12.01 of the Merger Agreement, of termination.

The day after Tyson filed suit in Arkansas, IBP filed its specific performance lawsuit in Delaware. The Delaware Court ruled that because the confidentiality agreement between the parties contained a provision designating Delaware as the exclusive jurisdiction for disputes under that agreement, complete justice could not be achieved unless the entire matter was decided by the Delaware Court. See Comment to Section 13.4 of the Model Agreement elsewhere herein.

In the Delaware case, Tyson claimed that it had justification to terminate the Merger Agreement because: (a) an impairment charge that IBP took with respect to its food processing division and IBP's last quarter 2000 and first quarter 2001 performance was evidence of a Material Adverse Effect with respect to IBP's business; and (b) IBP breached the financial statement representation in the Merger Agreement as evidenced by its later restatement of its financial statements. Tyson also claimed that it was fraudulently induced to enter into the Merger Agreement because IBP failed to provide Tyson with the SEC comment letter and other information about the food processing division.

Confidentiality Agreement

In order to do due diligence review in connection with the negotiation of the definitive Merger Agreement, Tyson and IBP executed a "Confidentiality Agreement" which would permit Tyson to have access to non-public, due diligence information about IBP. That Confidentiality Agreement contained a broad definition of "Evaluation Material" that stated (emphasis added):

> For purposes of this Agreement, Evaluation Material shall mean *all* information, data, reports, analyses, compilations, studies, interpretations, projections, forecasts, records, and other **materials (whether prepared by the Company, its agent or advisors or otherwise), regardless of the form of communication, that contain or otherwise reflect information concerning the Company** that we or our Representatives may be provided by or on behalf of the Company or its agents or advisors in the course of our evaluation of a possible Transaction.

The Confidentiality Agreement carved out from the definition the following:

> This Agreement shall be inoperative as to those particular portions of the Evaluation Material that (i) become available to the public other than as a result of a disclosure by us or any of our Representatives, (ii) were available to us on a non-confidential basis prior to the disclosure of such Evaluation Material to us pursuant to this Agreement, or (iii) becomes available to us or our Representatives on a non-confidential basis from a source other than the Company or its agents or advisors provided that the source of such information was not know by us to be contractually prohibited from making such disclosure to us or such Representative.

The Confidentiality Agreement thus defines Evaluation Material to include essentially all non-public information in IBP's possession, regardless of whether the IBP employees or agents prepared it. The Confidentiality Agreement also provided:

> We understand and agree that none of the Company, its advisors or any of their affiliates, agents, advisors or representatives (i) have made or make any representation or warranty, expressed or implied, as to the accuracy or completeness of the Evaluation Material or (ii) shall have any liability whatsoever to us or our Representatives relating to or resulting from the use of the Evaluation Material or any errors therein or omissions therefrom, except in the case of (i) and (ii), to the extent provided in any definitive agreement relating to a Transaction."

Thus, the Confidentiality Agreement in essence provided that Tyson could not rely on information obtained in its due diligence unless covered by an express representation or warranty in the Merger Agreement.

<u>The Merger Agreement's Basic Terms and Structure</u>

The Merger Agreement contemplated that:

- Tyson would make a cash tender offer (the "*Cash Offer*") for $30 per IBP share for 50.1% of the outstanding IBP shares.

- Tyson would couple the cash tender offer with an "*Exchange Offer*" in which it would offer $30 of Tyson stock (subject to a collar) for each share of IBP stock. This would permit IBP stockholders who wished to participate in the potential benefits of the Tyson/IBP combination to do so.

- The Cash Offer would close no later than February 28, 2001, unless the closing condition set forth in Annex I of the Merger Agreement were not satisfied, and be followed by a merger in which IBP stockholders would receive $30 in Tyson stock (subject to a collar).

- If the conditions to the Cash Offer were not met by February 28, 2001, Tyson would proceed with a "*Cash Election Merger*" to close on or before May 15, 2001 unless the closing conditions set forth in Annex III of the Merger Agreement were not satisfied. In the Cash Election Merger, IBP stockholders would be able to receive $30 in cash, $30 in Tyson stock (subject to a collar), or a combination of the two.

Primarily implicated in the litigation were the following representations and warranties in the Merger Agreement (emphasis added):

> ARTICLE 5
> REPRESENTATIONS AND WARRANTIES OF THE COMPANY
>
> The Company represents and warrants to Parent as of the date hereof and as of the Effective Time that:

Section 5.01. Corporate Existence and Power. The Company is a corporation duly incorporated, validly existing and in good standing under the laws of the State of Delaware, and has all corporate powers and all material governmental licenses, authorizations, consents and approvals required to carry on its business as now conducted. The Company is duly qualified to do business as a foreign corporation and is in good standing in each jurisdiction where the character of the property owned or leased by it or the nature of its activities makes such qualification necessary, except for those jurisdictions where the failure to be so qualified would not, individually or in the aggregate, reasonably be expected to have a **material adverse effect on the condition (financial or otherwise), business, assets, liabilities or results of operations of the Company and the Subsidiaries taken as a whole ("Material Adverse Effect")**. The Company has heretofore delivered or made available to Parent true and complete copies of the Company's certificate of incorporation and bylaws as currently in effect.

* * *

Section 5.07. SEC Filings. (a) The Company has delivered or made available to Parent (i) the Company's annual report on Form 10-K for the year ended December 25, 1999 (the "Company 10-K"), (ii) its quarterly report on Form 10-Q for its fiscal quarter ended September 23, 2000, its quarterly report on Form 10-Q for its fiscal quarter ended June 24, 2000 (as amended) and its quarterly report on Form 10-Q for its fiscal quarter ended March 25, 2000 (together, the "Company 10-Qs"), (iii) its proxy or information statements relating to meetings of, or actions taken without a meeting by, the stockholders of the Company held since January 1, 1998, and (iv) all of its other reports, statements, schedules and registration statements filed with the SEC since January 1, 1998.

(b) As of its filing date, each such report or statement filed pursuant to the Exchange Act did not contain any untrue statement of a material fact of omit to state any material fact necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading.

(c) Each such registration statement, as amended or supplemented, if applicable, filed pursuant to the Securities Act of 1933, as amended (the "Securities Act"), as of the date such statement or amendment became effective did not contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary to make the statements therein not misleading.

Section 5.08. Financial Statements. The audited consolidated financial statements of the Company included in the Company 10-K and unaudited consolidated financial statements of the Company included in the Company 10-Qs each fairly present, in all material respects, in conformity with generally accepted accounting principles applied on a consistent basis (except as may be indicated in the notes thereto), the consolidated financial position of the Company and its consolidated subsidiaries as of the dates thereof and their consolidated results of operations and changes in financial position for the periods the ended (subject to normal year-end adjustments in the case of any unaudited interim financial statements). For purposes of this Agreement, "Balance Sheet" means the consolidated balance sheet of the Company as of December 25, 1999 set forth in the Company 10-K and "Balance Sheet Date" means December 25, 1999.

Section 5.09. Disclosure Documents. (a) Each document required to be filed by the Company with the SEC in connection with the transactions contemplated by this Agreement (the "Company Disclosure Documents"), including, without limitation, (i) the Exchange Schedule 14D-9 (including information required by Rule 14f-1 under the Exchange Act), the Schedule 14D-9A (including information required by Rule 14f-1 under the Exchange Act) and (iii) the proxy or information statement of the Company containing information required by Regulation 14A under the Exchange Act (the "Company Proxy Statement"), if any, to be filed with the SEC in connection with the Offer or the Merger and any amendments or supplements thereto will, when filed, comply as to form in all material respects with the applicable requirements of the Exchange Act except that no representation or warranty is made hereby with respect to any information furnished to the Company by Parent in writing specifically for inclusion in the Company Disclosure Documents.

(b) At the time the Schedule 14D-9/A, the Exchange Schedule 14D-9 and the Company Proxy Statement or any amendment or supplement thereto is first mailed to stockholders of the Company, and, with respect to the Company Proxy Statement only, at the time such stockholders vote on adoption of this Agreement and at the Effective Time, the Schedule 14D-9/A, the Exchange Schedule 14D-9 and the Company Proxy Statement, as supplemented or amended, if applicable, will not contain any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading. At the time of the filing of any Company Disclosure Document other than the Company Proxy Statement and at the time of any distribution thereof, such Company Disclosure Document will not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading. The representations and warranties contained in this Section 5.09(b) will not apply to statements or omissions included in the Company Disclosure Documents based upon information furnished to the Company in writing by Parent specifically for use therein.

(c) Neither the information with respect to the Company or any Subsidiary that the Company furnishes in writing to Parent specifically for use in the Parent Disclosure Documents (as defined in Section 6.09(a)) nor the information incrporated (sic) by reference from documents filed by the Company with the SEC will, at the time of the provision thereof to Parent or at the time of the filing thereof by the Company with the SEC, as the case may be, at the time of the meeting of the Company's stockholders, if any, contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary in order to make the statements made therein, in the light of the circumstances under which they were made, not misleading.

Section 5.10. Absence of Certain Changes. Except as set forth in Schedule 5.10 hereto, the Company 10-K or the Company 10-Qs, since the Balance Sheet Date, the Company and the Subsidiaries have conducted their business in the ordinary course consistent with past practice and there has not been:

(a) any event, occurrence or development of a state of circumstances or facts which has had or reasonably could be expected to have a Material Adverse Effect;

(b) other than regular quarterly dividends in an amount not in excess of $.025 per share per quarter, any declaration, setting aside or payment of any dividend or other distribution with respect to any shares of capital stock of the Company, or any repurchase, redemption or other acquisition by the Company or any Subsidiary of any outstanding shares of capital stock or other securities of, or other ownership interests in, the Company or any Subsidiary;

(c) any amendment of any material term of any outstanding security of the Company or any Subsidiary that could reasonably be expected to be materially adverse to the Company;

(d) any incurrence, assumption or guarantee by the Company or any Subsidiary of any indebtedness for borrowed money other than in the ordinary course of business and in amounts and on terms consistent with past practices;

(e) any creation or assumption by the Company or any Subsidiary of any material Lien on any material asset other than in the ordinary course of business consistent with past practices;

(f) any making of any material loan, advance or capital contributions to or investment in any Person other than loans, advances or capital contributions to or investments in wholly-owned Subsidiaries made in the ordinary course of business consistent with past practices;

(g) any damage, destruction or other casualty loss (whether or not covered by insurance) affecting the business or assets of the Company or any Subsidiary which, individually or in the aggregate, has had or would reasonably be expected to have a Material Adverse Effect;

(h) any transaction or commitment made, or any contract or agreement entered into, by the Company or any Subsidiary relating to its assets or business (including the acquisition or disposition of any assets) or any relinquishment by the Company or any Subsidiary of any contract or other right, in either case, that has had or would reasonably be expected to have a Material Adverse Affect, other than transactions and commitments in the ordinary course of business consistent with past practice and those contemplated by this Agreement;

(i) any change in any method of accounting or accounting practice by the Company or any Subsidiary, except for any such change required by reason of a concurrent change in generally accepted accounting principles;

(j) any (i) grant of any severance or termination pay to any director or executive officer of the Company or any Subsidiary, (ii) entering into of any employment, deferred compensation or other similar agreement (or any amendment to any such existing agreement) with any director or executive officer of the Company or any Subsidiary, (iii) material increase in benefits payable under any existing severance or termination pay policies or employment agreements or (iv) increase in compensation, bonus or other benefits payable to directors, officers or employees of the Company or any Subsidiary, other than in each case in the ordinary course of business consistent with past practice;

(k) any labor dispute, other than routine individual grievances, or any activity or proceeding by a labor union or representative thereof to organize any employees of the Company or any Subsidiary, which employees were not subject to a collective bargaining agreement at the Balance Sheet Date, or any lockouts, strikes, slowdowns, work stoppages or threats thereof by or with respect to such employees which have had or could reasonably be expected to have a Material Adverse Effect; or

(l) any cancellation of any licenses, sublicenses, franchises, permits or agreements to which the Company or any Subsidiary is a party, or any notification to the Company or any Subsidiary that any party to any such arrangements intends to cancel or not renew such arrangements beyond its expiration date as in effect on the date hereof, which cancellation or notification, individually or in the aggregate, has had or reasonably could be expected to have a Material Adverse Effect.

Section 5.11. <u>No Undisclosed Material Liabilities</u>. Except as set forth in Schedule 5.11, the Company 10-K or the Company 10-Qs, there are no liabilities of the Company or any Subsidiary of any kind whatsoever, whether accrued, contingent, absolute, determined, determinable or otherwise, and there is no existing condition, situation or set of circumstances which could reasonably be expected to result in such a liability, other than:

(a) liabilities disclosed or provided for in the Balance Sheet;

(b) liabilities incurred in the ordinary course of business consistent with past practice since the Balance Sheet Date or as otherwise specifically contemplated by this Agreement;

(c) liabilities under this Agreement; and

(d) other liabilities which individually or in the aggregate do not and could not reasonably be expected to have a Material Adverse Effect.

Section 5.12. Litigation. Except as set forth in Schedule 5.12, the Company 10-K or the Company 10-Qs, there is no action, suit, investigation or proceeding (or any basis therefor) pending against, or to the knowledge of the Company threatened against or affecting, the Company or any Subsidiary or any of their respective properties before any court or arbitrator or any governmental body, agency or official which could reasonably be expected to have a Material Adverse Effect, or which as of the date hereof in any manner challenges or seeks to prevent enjoin, alter or materially delay the Merger or any of the other transactions contemplated hereby.

Merger Agreement Disclosure Schedules

Late on December 30, 2000 and prior to execution of the Merger Agreement on January 1, 2001, IBP sent to Tyson's negotiators the Disclosure Schedule to the Merger Agreement, which had been drafted by IBP's General Counsel and which included a Schedule 5.11 that expressly qualified Section 5.11 of the Merger Agreement as follows (emphasis added):

No Undisclosed Material Liabilities

Except as to those potential liabilities disclosed in Schedule 5.12, 5.13, 5.16 and 5.19, the Injunction against IBP in the Department of Labor Wage and Hour litigation (requiring compliance with the Wage and Hour laws), and **any further liabilities (in addition to IBP's restatement of earnings in its 3rd Quarter 2000) associated with certain improper accounting practices at DFG Foods, a subsidiary of IBP, there are none**. [Emphasis added]

The Disclosure Schedule further stated:

"Items disclosed for any one section of this Disclosure Schedule are deemed to be disclosed for all other sections of this Disclosure Schedule to the extent that it is reasonably apparent that such disclosure is applicable to other such section(s)."

Tyson contended that the foregoing Disclosure Schedule wording was insufficient to make Schedule 5.11 applicable to representations that the Merger Agreement did not expressly qualify thereby. The Court found that the Merger Agreement was ambiguous on this point, which made the consideration of parole evidence appropriate, and suggested that the "sort of hair splitting [advocated by Tyson] has no rational commercial purpose" and would be "unreal to men of business and practical affairs." The Court wrote that "New York law disfavors a reading of a contract that produces capricious and absurd results, in favor of a reading that is reasonable in the commercial context in which the parties were contracting." The Court referenced a Comment to Section 7.1 of the ABA Model Stock Purchase Agreement (1995), from which Section 7.1 of the Model Asset Purchase Agreement was derived, as follows:

> According to IBP, Schedule 5.11 specifically permits IBP to recognize further liabilities on account of the accounting improprieties at DFG. Thus, according to IBP, the Annexes protect IBP by ensuring that its specific contractual right to do so does not result in a technical breach of a more general representation and warranty that permits Tyson to walk. IBP supports this contention by pointing to the Model Stock Purchase Agreement produced by the American Bar Association's Committee on Negotiated Acquisitions. The Committee Commentary states:
>
> > The Sellers may also request that the 'bring down' clause [i.e., the Annexes] be modified to clarify that the Buyer will not have a 'walk right' if any of the Sellers' representations is rendered inaccurate as a result of an occurrence specifically contemplated by the acquisition agreement. The requested modification entails inserting the words 'except as contemplated or permitted by this Agreement' (or some similar qualification).

The Court concluded that IBP's position was the more commercially reasonable one, that Tyson's negotiators knew that IBP believed Schedule 5.11 covered the DFG liabilities and a resulting restatement of IBP's financial statements and that, if Tyson's negotiators disagreed, they should have spoken up. The Court was influenced by the fact that Schedule 5.11 was not brought to the attention of the Chairman or the President of Tyson until the litigation commenced, nor disclosed in the proxy materials in connection with Tyson's shareholder approval of the deal, and drew therefrom the inference that the DFG situation did not influence Tyson's decision to terminate the Merger Agreement.

Material Adverse Effect

Under the Merger Agreement, IBP represented that since December 25, 1999, there had been no "…event, occurrence or development of a state of circumstances which has had or reasonably could be expected to have a Material Adverse Effect [a material adverse effect "…on the condition (financial or otherwise), business, assets, liabilities or results of operation…" of IBP and its subsidiaries taken as a whole.]

The Court, in holding that no Material Adverse Effect had occurred stated:

> To a short-term speculator, the failure of a company to meet analysts' projections for a quarter could be highly material. Such failure is less important to an acquiror who seeks to purchase the company as part of a long-term strategy. To such an acquiror, the important thing is whether the company has suffered a Material Adverse Effect in its business or results of

> operations that is consequential to the company's earning power over a commercially reasonable period , which one would think would be measured in years rather than months. It is odd to think that a strategic buyer would view a short-term blip in earnings as material, so long as the target's earnings-generated potential is not materially affected by that blip or the blip's cause.

The Court stated that even a broadly written Material Adverse Effect provision, such as the one in the Merger Agreement:

> "…is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror. In this regard, it is worth noting that IBP never provided Tyson with quarterly projections."

The Court found that IPB was consistently profitable despite strong historical swings in EBIT, including as a result of the severe winter of 2000-2001, which adversely affected Tyson's and IBP's businesses. The Court also pointed to analysts' projections for the next two years and that Tyson's investment banker had issued a fairness opinion, even after receiving the information which Tyson was claiming entitled Tyson to terminate the Merger Agreement, that the deal was fairly priced, made strategic sense and offered long-term value to Tyson.

<u>Breach of Representation</u>

The Court held that IBP did not breach its financial statement representation when it restated its financial statements to take a charge against earnings with respect to a very troubled food processing company, DFG, that IBP had acquired. The Court found that Tyson was well aware, prior to executing the Merger Agreement, of accounting issues with respect to DFG, that the schedule to the no undisclosed liabilities representation had disclosed such problems, and that the financial statement representation had to be construed in light of such disclosure. The Court also found that Tyson re-affirmed the transaction even after learning that the financial statements would be restated and that such re-affirmation by Tyson was inconsistent with its with its later disavowal of the transaction.

<u>Fraudulent Inducement</u>

The Court held that IBP did not fraudulently induce Tyson to enter into the Confidentiality Agreement or Merger Agreement. The Court found that IBP never intended to mislead Tyson. The Court also held that IBP was not liable for negligent or innocent misrepresentations. The court found that Tyson did not reasonably rely to its detriment on IBP's projections as to IBP's business even though IBP's management had expressed confidence in the projections. Tyson had performed its own due diligence as to the projections, and no representation or warranty in the Merger Agreement covered the projections. Tyson's own Cash Offer documents filed with the SEC noted a lack of reliance on the projections. Furthermore, the Confidentiality Agreement contained a provision that no written or oral information furnished to Tyson could be relied upon except to the extent contained in a subsequent written contract.

The Court also found that IBP had not denied Tyson access to information during the due diligence process, and that the failure to provide Tyson with a copy of the SEC comment letter to IBP was not actionable because the comment letter contained no information as to which Tyson was not already aware.

Conclusion

The Court ruled that "specific performance is the decisively preferable remedy for Tyson's breach, as it is the only method by which to adequately redress the harm threatened to IBP and its stockholders." Twelve days later, on June 27, 2001, the parties announced that the Delaware Chancery Court had approved their revised Merger Agreement. As in the original Merger Agreement, Tyson agreed to pay $30.00 in cash for 50.1% of IBP's common shares and the remaining IBP shares were to be converted into Tyson Class A common stock. On September 28, 2001, the transaction was consummated.

Frontier Oil Corp. v. Holly

Frontier Oil Corporation, Plaintiff and Counterclaim Defendant

v.

Holly Corporation, Defendant and Counterclaim Plaintiff

Civil Action No. 20502
In the Court of Chancery of the State of Delaware
(Decided April 29, 2005)
2005 WL 1039027

In *Frontier Oil Corp. v. Holly Corp.*, CA No. 20502 2005, WL 1039027, (Del. Ch. Apr. 29, 2005), the Delaware Court of Chancery addressed claims of repudiation and breach of the covenant of good faith and fair dealing in the context of a merger agreement containing representations as to the absence of material pending or threatened litigation that could have a "Material Adverse Effect," a "fiduciary out" clause and other customary termination provisions. The claims and counter-claims at issue arose in connection with the proposed $450 million merger of two mid-sized, Texas-based independent petroleum refiners, Frontier Oil Corporation, a Wyoming corporation ("*Frontier*"), and Holly Corporation, a Delaware corporation ("*Holly*").

Pre-Merger Agreement Litigation Threat and Negotiations

Prior to the execution of a merger agreement on March 30, 2003 (the "*Merger Agreement*"), Holly's merger counsel, in the course of due diligence, uncovered a news article describing plans by activist Erin Brockovich and related plaintiffs' law firms (known to be highly-organized and well funded) to bring a mass tort claim alleging that students attending Beverly Hills High School in California suffered from a disproportionate incidence of cancer attributable to the release of toxic chemicals from oil drilling and production activities, which had continued for decades on the campus of Beverly Hills High School. The crude oil production activities were carried out, at that time, by a company which had acquired its interest in the Beverly Hills site from a subsidiary of Frontier in 1995, which in turn had obtained its interest in 1985 from another oil company.

Recognizing its potential seriousness, Holly retained special California counsel to provide advice and guidance as to this threatened California claim. After further investigation, the Holly board was advised by its counsel that (i) Frontier had not publicly disclosed the potential claim in its SEC filings, (ii) Frontier had a strong indemnity right against the current operator, which may not have had the financial ability to satisfy all of its indemnification obligations, (iii) Frontier probably did not have insurance coverage that would cover such potential claim, (iv) potential legal defenses might be available to Frontier, including expiration of the applicable statute of limitations period, whether any potential liability could be limited to Frontier's subsidiary, whether California has damage caps, and burden of proof issues were being looked at, (v) Holly was assessing whether the potential claim was a substantial practical risk, but (vi) there was no assurance as to whether a more meaningful assessment could be made in any particular time frame. Holly's desire to take the time necessary to acquire the additional information about the California claim was tempered by concern that the plans for the merger might be leaked to the public or that stock might be traded based on nonpublic information regarding the transaction.

Confronted with this information, the Holly board deferred approving a merger agreement and directed management to pursue various options, including making changes to the draft merger agreement that would afford Holly the opportunity to exit the transaction in the event that further information regarding the potential claim made it inadvisable to proceed. As a result, several changes to the agreement were made. For example, the definition of "Material Adverse Effect" was modified to include "results of operations" and "prospects." Likewise, Frontier's Disclosure Letter to be delivered at signing of the Merger Agreement was modified to provide that the disclosure of the "threatened" litigation did not operate to remove the prospective California litigation from Frontier's representation that there were no pending or threatened suits that could reasonably be expected to have a Material Adverse Effect.

Merger Agreement dated March 30, 2003

The Merger Agreement, as executed on March 30, 2003, provided that the chief executive officer ("*CEO*") of Holly would be the chairman of the board of Frontier as the surviving corporation in the merger, the CEO of Frontier would become the president and CEO and the directors of both constituent corporations would become directors of the surviving corporation. In the merger, the Holly stockholders would receive approximately 63% of the common stock of the surviving corporation, $172.5 million in cash and a right to receive additional cash in the event Holly were successful in a specified litigation claim.

The Merger Agreement, as executed, contained several customary termination provisions, including, *inter alia*, the right of each party to terminate the agreement if the other party's representations or warranties were or became inaccurate or if threatened litigation would be expected to have a Material Adverse Effect. The Merger Agreement also provided termination rights upon the exercise of a "fiduciary out" by the board of Holly or Frontier. Exercise of the "fiduciary out" required payment of a break-up fee of $15 million (plus reimbursement of expenses up to $1 million). The Merger Agreement provided that it was governed by Delaware law.

Frontier's representations and warranties were set forth in Article IV of the Merger Agreement, which provided in relevant part:

> Except as set forth in the disclosure letter delivered to Holly concurrently with the execution hereof (the "Frontier Disclosure Letter"), . . . Frontier represents and warrants to Holly that:
>
> * * *
>
> **Section 4.8 LITIGATION AND LIABILITIES**. Except as set forth on Schedule 4.8 of the Frontier Disclosure Letter, there are no actions, suits or proceedings pending against Frontier or any of its Subsidiaries or, to Frontier's knowledge, threatened against Frontier or any of its Subsidiaries, at law or in equity, or before or by any federal, state or foreign commission, court, board,

bureau, agency or instrumentality, other than those that would not have or reasonably be expected to have, individually or in the aggregate, a Frontier Material Adverse Effect. There are no outstanding judgments, decrees, injunctions, awards or orders against Frontier or any of its Subsidiaries, other than those that would not have, individually or in the aggregate, a Frontier Material Adverse Effect. There are no obligations or liabilities of any nature, whether accrued, absolute, contingent or otherwise, of Frontier or any of its Subsidiaries, other than those liabilities and obligations (a) that are disclosed in the Frontier Reports, (b) that have been incurred in the ordinary course of business since December 31, 2002, (c) related to expenses associated with the transactions contemplated by this Agreement or (d) that would not have or reasonably be expected to have, individually or in the aggregate, a Frontier Material Adverse Effect.

Section 4.9 ABSENCE OF CERTAIN CHANGES. Since December 31, 2002, Frontier has conducted its business only in the ordinary and usual course of business and during such period there has not been any (i) event, condition, action or occurrence that has had or would reasonably be expected to have, individually or in the aggregate, a Frontier Material Adverse Effect; . . .

Schedule 4.8 (referenced in Section 4.8 of the Merger Agreement) to the Frontier Disclosure Letter disclosed the threatened California claim as follows:

Wainoco Oil & Gas Company ("Wainoco") owned an interest in an oil field from 1985 until early 1995 in the area where the Beverly Hills High School is located. News articles in February 2003 indicated that the Brockovich and Masry law firm were preparing a lawsuit involving that site. Wainoco sold its interest to Venoco, Inc. by a Purchase and Sale Agreement dated February 9, 1995. Frontier has not been contacted by anyone concerning a possible lawsuit, and does not have any knowledge of any litigation being filed.

For avoidance of doubt and only for the limited purpose of the Agreement, Frontier agrees with, and for the sole benefit of, Holly that this potential litigation will be considered as "threatened" (as such term is used in Section 4.8 of the Agreement) and that the disclosure of the existence of this "threatened" litigation herein is not an exception to Section 4.8, 4.9 or 4.13 of the Agreement and despite being known by Holly, will have no effect with respect to, or have any limitation on, any rights of Holly pursuant to the Agreement.

The definition of Material Adverse Effect, as used in Sections 4.8 and 4.9 of the Merger Agreement, is contained in Section 8.9(d) which provides in its entirety:

(d) "Material Adverse Effect" with respect to Holly or Frontier shall mean a material adverse effect with respect to (A) the business, assets and liabilities (taken together), results of operations, condition (financial or otherwise) or prospects of a party and its Subsidiaries on a consolidated basis or (B) the ability of the party to consummate the transactions contemplated by this

> Agreement or fulfill the conditions to closing set forth in Article 6, except to the extent (in the case of either clause (A) or clause (B) above) that such adverse effect results from (i) general economic, regulatory or political conditions or changes therein in the United States or the other countries in which such party operates; (ii) financial or securities market fluctuations or conditions; (iii) changes in, or events or conditions affecting, the petroleum refining industry generally; (iv) the announcement or pendency of the Mergers or compliance with the terms and conditions of Section 5.1 hereof; or (v) stockholder class action or other litigation arising from allegations of a breach of fiduciary duty relating to this Agreement. "Holly Material Adverse Effect" and "Frontier Material Adverse Effect" mean a Material Adverse Effect with respect to Holly and Frontier, respectively.

The obligation of Holly to complete the Merger was conditioned by Section 6.2(a) which provides in relevant part:

> Frontier shall have performed in all material respects its covenants and agreements contained in this Agreement required to be performed on or prior to the Closing Date and the representations and warranties of Frontier contained in this Agreement and in any document delivered in connection herewith (i) to the extent qualified by Frontier Material Adverse Effect or any other materiality qualification shall be true and correct and (ii) to the extent not qualified by Frontier Material Adverse Effect or any other materiality qualification shall be true and correct in all material respects, in each case as of the date of this Agreement and as of the Closing Date (except for representations and warranties made as of a specified date, which need be true and correct only as of the specified date), and Holly shall have received a certificate of Frontier, executed on its behalf by its Chairman of the Board, President and Chief Executive Officer, dated the Closing Date, certifying to such effect.

Frontier's obligation to proceed with the Merger was similarly conditioned by Section 6.3.

The termination provisions were as follows:

> **Section 7.1 TERMINATION BY MUTUAL CONSENT**. This Agreement may be terminated at any time prior to the Effective Time by the mutual written agreement of Holly and Frontier approved by action of their respective Board of Directors in their respective discretion for any reason, including due to the number of Holly Dissenting Shares exceeding 5% of the Total Holly Common Stock Number or the number of Frontier Dissenting Shares exceeding 5% of the total number of shares of Frontier Common Stock outstanding immediately prior to the Effective Time.
>
> **Section 7.2 TERMINATION BY FRONTIER OR HOLLY**. At any time prior to the Effective Time, this Agreement may be terminated by Holly or Frontier, in either case by action of its Board of Directors, if:

(a) the Mergers shall not have been consummated by October 31, 2003; provided, however, that the right to terminate this Agreement pursuant to this clause (a) shall not be available to any party whose failure or whose affiliates' failure to perform or observe in any material respect any of its obligations under this Agreement in any manner shall have been the principal cause or, or resulted in, the failure of the Mergers to occur on or before such date; or

(b) the Holly Requisite Vote shall not have been obtained at a meeting (including adjournments and postponements) of Holly's stockholders that shall have been duly convened for the purpose of obtaining the Holly Requisite Vote; or

(c) the Frontier Requisite Vote shall not have been obtained at a meeting (including adjournments and postponements) of Frontier's stockholders that shall have been duly convened for the purpose of obtaining the Frontier Requisite Vote. . . .

Section 7.3 TERMINATION BY HOLLY. At any time prior to the Effective Time, this Agreement may be terminated by Holly, by action of its Board of Directors, if:

(a) (i) there has been a breach by Frontier of any representation, warranty, covenant or agreement set forth in this Agreement or if any representation or warranty of Frontier shall have become untrue, in either case such that the conditions set forth in Section 6.2(a) would not be satisfied and (ii) such breach is not curable, or, if curable, is not cured within 30 days after written notice of such breach is given to Frontier by Holly; provided, however, that the right to terminate this Agreement pursuant to this Section 7.3(a) shall not be available to Holly if it, at such time, is in material breach of any representation, warranty, covenant or agreement set forth in the Agreement such that the conditions set forth in Section 6.3(a) shall not be satisfied;

(b) prior to obtaining the Frontier Requisite Vote, the Board of Directors of Frontier shall have withdrawn, modified, withheld or changed, in a manner adverse to Holly, such Board's approval or recommendation of the Agreement or the transactions contemplated hereby, or recommended a Frontier Superior Proposal, or resolved to do any of the foregoing; or

(c) prior to obtaining the Holly Requisite Vote, Holly is the Withdrawing Party pursuant Section 5.4(b) (it being understood that Holly shall not have the right to terminate this Agreement pursuant to this Section 7.3(c) unless and until Holly shall have paid Frontier all amounts due under Section 7.5(a)).

Section 7.4 TERMINATION BY FRONTIER. At any time prior to the Effective Time, this Agreement may be terminated by Frontier, by action of its Board of Directors, if:

(a) (i) there has been a breach by Holly of any representation, warranty[,] covenant or agreement set forth in this Agreement or if any representation or warranty of Holly shall have become untrue, in either case such that the conditions set forth in Section 6.3(a) would not be satisfied and (ii) such breach is not curable, or, if curable, is not cured within 30 days after written notice of such breach is given by Frontier to Holly; provided, however, that the right to terminate this Agreement pursuant to Section 7.4(a) shall not be available to Frontier if it, at such time, is in material breach of any representation, warranty, covenant or agreement set forth in this Agreement such that the conditions set forth in Section 6.2(a) shall not be satisfied;

(b) prior to obtaining the Holly Requisite Vote, the Board of Directors of Holly shall have withdrawn, modified, withheld or changed, in a manner adverse to Frontier, such Board's approval or recommendation of this Agreement or the transactions contemplated hereby, or recommend a Holly Superior Proposal, or resolved to do any of the foregoing; or

(c) prior to obtaining the Frontier Requisite Vote, Frontier is the Withdrawing Party pursuant to Section 5.4(b) (it being understood that Frontier shall not have the right to terminate this Agreement pursuant to this Section 7.4(c) unless and until Frontier shall have paid Holly all amounts due under Section 7.5(b)).

The term "Withdrawing Party," employed in both Section 7.3 and Section 7.4, is defined in Section 5.4(b) which obligated Holly (and Frontier), through its Board of Directors, to recommend the Merger Agreement to the shareholders and provides in relevant part:

> The Board of Directors of Holly or Frontier, as applicable (the "Withdrawing Party," the other party being the "Non-Withdrawing Party"), may at any time prior to obtaining the Holly Requisite Vote or Frontier Requisite Vote, as applicable, (A) withdraw, withhold, modify, or change, in a manner adverse to the Non-Withdrawing Party, any approval or recommendation regarding this Agreement or the transactions contemplated hereby or (B) approve and be prepared to enter into or recommend and declare advisable any Holly Superior Proposal or Frontier Superior Proposal, as the case may be, if its Board of Directors determines in good faith after consultation with its outside legal counsel that the failure to take the action in question would be inconsistent with the fiduciary obligations of such Board of Directors under applicable law.

If either party used the fiduciary duty termination provisions to avoid the Merger, Section 7.5 provides that the terminating party would pay the other party $15 million as a break-up fee in addition to reimbursing the other party up to $1 million in expenses incurred in connection with the Merger Agreement. Section 7.5 provides in relevant part:

Section 7.5 EFFECT OF TERMINATION

(a) If this Agreement is terminated

(i) by Holly or Frontier, after the public announcement (made prior to the closing of the polls for the vote of Holly stockholders for the purpose of obtaining the Holly Requisite Vote) of a Holly Acquisition Proposal, pursuant to Section 7.2(b);

(ii) by Frontier pursuant to Section 7.4(b);

(iii) by Holly pursuant Section 7.3(c);

then Holly shall pay Frontier the Holly Termination Amount (as defined below) and, in addition, reimburse Frontier for all expenses incurred by Frontier in connection with this Agreement up to the Reimbursement Maximum Amount (as defined below) prior to or upon termination of this Agreement. All payments under this Section 7.5(a) shall be made in cash by wire transfer to an account designated by Frontier at the time of such termination or, in the case of a termination pursuant to Section 7.3(c), prior to such termination). The term "Holly Termination Amount" shall mean $15,000,000. The term "Reimbursement Maximum Amount" shall mean $1,000,000. In addition, Holly shall reimburse Frontier for all expenses incurred by Frontier in connection with this Agreement up to the Reimbursement Maximum Amount if this Agreement has been terminated pursuant to Section 7.2(b) even if Frontier is not entitled to any Holly Termination Amount under this Section 7.5(a). Holly acknowledges that the agreements contained in this Section 7.5(a) are an integral part of the transactions contemplated by this Agreement, and that, without these agreements, Frontier would not enter into this Agreement; accordingly, if Holly fails promptly to pay any amount due pursuant to this Section 7.5(a), and, in order to obtain such payment, Frontier commences a suit which results in a judgment against Holly for the payment set forth in this Section 7.5(a), Holly shall pay Frontier its costs and expenses (including attorneys' fees) in connection with such suit, together with interest on the Holly Termination Amount and other amounts to be reimbursed to Frontier under this Section 7.5(a) from the date payment was required to be made until the date of such payment at the prime rate of Union Bank of California, N.A. in effect on the date such payment was required to made plus one percent (1%). If this Agreement is terminated pursuant to a provision that calls for a payment to be made under this Section 7.5(a), it shall not be a defense to Holly's obligation to pay hereunder that this Agreement could have been terminated at an earlier or later time.

California Litigation Commences

Following the execution of the Merger Agreement, the threatened California lawsuit was actually filed on April 28, 2003, and the parties learned from the pleadings that Frontier had, through leases and related agreements, guaranteed its subsidiary's obligations under the lease of the Beverly Hills oil wells and was itself named as a defendant as well as its subsidiary and parties that it was obligated to indemnify. Both Frontier and Holly were surprised by the guarantee, although it had been in a box of documents available for review by an associate of Holly's merger counsel.

Holly was advised by its California counsel that defense costs could range from $25 to $50 million, while Frontier's expert suggested that the case could be defended for $11 million to $13 million.

Master Limited Partnership

During the same period, Lehman Brothers made a presentation to Holly suggesting that Holly's pipeline assets were so undervalued that Frontier could potentially recoup more than 100% of the merger consideration by contributing its pipeline assets to a "master limited partnership" ("*MLP*") and selling a portion thereof in a public offering. The Lehman Brothers value of Holly's pipeline assets was more than double what Holly thought their value to be prior to the Merger Agreement.

Further Negotiations

Holly's board became concerned about the prolonged and potentially devastating effect of the litigation on the stock of the surviving corporation. During the course of a meeting on June 9, 2003, Holly's board considered issuing a notice that the California litigation constituted a Material Adverse Effect as a result of which Frontier had breached its representations in Sections 4.8 and 4.9 of the Merger Agreement, but instead directed management to express its concerns to Frontier.

After Holly's board expressed concern about proceeding with the merger, the parties engaged in almost a month of further negotiations. Thereafter, the parties reached agreement on a restructured deal which provided that the Holly stockholders could choose between a transaction with a nominally higher value or one with nominally lower value but a greater cash component. Following conclusion of negotiations, Holly's CEO, who had agreed to recommend the reformulated deal to his board, determined *not* to recommend the revised transaction to his board, in part due to a concern that he and his associates would be in breach of their fiduciary duties if they took the high cash option without disclosing their plans, which would expose them to lawsuits if the Frontier stock issued in the transaction performed poorly, and that there would not be enough cash to satisfy the cash elections if they disclosed their plan. Predictably, the Holly board rejected the transaction.

Thereafter, on August 19, 2003, the CEOs of the two companies spoke by telephone. Frontier's CEO presented a series of questions scripted by his counsel to Holly's CEO, including whether Holly was still prepared to recommend the Merger Agreement to its stockholders. Holly's CEO replied that Holly was not prepared to recommend the transaction and that Holly's board was no longer willing to support the Merger Agreement on its existing terms. There was some dispute as to what was actually said, with Holly's CEO denying that he said anything to suggest Holly would do anything not authorized by the Merger Agreement.

Holly sought to avoid the risk of the California litigation on the value of the Frontier stock by making the deal an all cash merger. Frontier rejected an all cash deal because it thought the surviving corporation would be over-leveraged as a result.

Frontier Commences Litigation

The following day, August 20, 2003, Frontier filed an action in the Delaware Court of Chancery alleging that Holly had repudiated the Merger Agreement. Frontier asserted that the statements of Holly's CEO repudiated the Merger Agreement, which allowed Frontier to declare a breach of the Merger Agreement and to sue for damages. Frontier also asserted a claim for breach of the covenant of good faith and fair dealing implied in every Delaware contract with respect to Holly's conduct, and sought damages totaling $160 million.

In response to Frontier's repudiation lawsuit, Holly issued a notice claiming that the California litigation constituted a Material Adverse Effect. In addition, Holly argued that the CEOs' phone call could not form the basis of a repudiation claim because there was no clear expression of a refusal to comply with the terms of the Merger Agreement, given that Holly still had avenues of exit under the Merger Agreement. Holly also argued that Frontier breached its representations and warranties in the Merger Agreement with respect to the tort litigation. Finally, Holly claimed that Frontier's repudiation constituted a breach of contract, which entitled Holly to recover damages.

Vice Chancellor Noble Opinion

<u>Repudiation Claim</u>. In weighing Frontier's repudiation claim, the Court applied basic principles of contract interpretation and stated that repudiation involves an unequivocal statement by a promisor that he will not perform his promise. The Court noted, however, that the Merger Agreement was not an ordinary contract and that Holly's directors were under continuing fiduciary duties to Holly's stockholders:

> The Merger Agreement, of course, was not an ordinary contract. Before the Merger could occur, the shareholders of Holly had to approve it. The directors of Holly were under continuing fiduciary duties to the shareholders to evaluate the proposed transaction. The Merger Agreement accommodated those duties by allowing, under certain circumstances, the board of directors to withdraw or change its recommendation to the shareholders that they vote for the Merger. The presence of a "fiduciary out" does not preclude a finding of repudiation. It does, however, establish a specific context in which the conduct of the players must be assessed.

The Court found that Holly had not repudiated the Merger Agreement, because it had not made an unequivocal statement that it would not perform its promise. The Court noted that Holly's CEO had not stated that Holly intended to ignore the terms of the Merger Agreement and that his statement confirming that the Holly board would not recommend the Merger Agreement was contractually permitted. The Court also found that by declaring a repudiation following the call, Frontier deprived Holly of its right to exercise its fiduciary out or otherwise terminate the Merger Agreement in accordance with its terms. The Court commented that the telephone call appeared orchestrated by Frontier's counsel to set up the repudiation lawsuit and that a "phone call is a somewhat strange (perhaps calculated) way to close off a contract involving hundreds of millions of dollars and which had been negotiated and monitored by a number of talented and informed lawyers," suggesting that "a written demand is 'preferable,' especially for a transaction of the complexity and sophistication of the one anticipated by the Merger Agreement."

<u>Covenant of Good Faith and Fair Dealing</u>. The Court also found that Holly did not breach the covenant of good faith and fair dealing. Frontier argued that Holly's conduct stemmed in large part from its discovery that Holly had substantially undervalued its MLP assets in negotiating the merger terms, and that it sought to avoid paying the break-up fee by dragging the negotiations on past the "drop dead" date in the Merger Agreement. The Court found, however, that Holly did not mislead Frontier. While Holly's board had not formally opted to terminate the agreement and pay Frontier its break-up fee, the Court suggested that Frontier's suing for repudiation effectively cut off that opportunity. The Court commented:

> The covenant of good faith and fair dealing is, by its very nature, context-specific. The directors of publicly traded companies pursuing a merger are frequently buffeted by conflicting forces. The Holly-Frontier Merger presented unusually difficult problems, especially for the Holly directors. They, of course, were required, as a matter of fiduciary duty, to continue their assessment of whether to recommend the Merger to Holly's shareholders. The directors had learned of Frontier's potential liability in the Beverly Hills Litigation and had seen the scope of that litigation increase significantly. Also, they had come to realize that they had approved a transaction which had not maximized value for the shareholders.
>
> * * *
>
> [A compromise] solution collapsed, not because of value, but because [Holly CEO] Norsworthy came to realize that he could not pawn off the Frontier stock on Holly shareholders without either disclosing his true aspiration (cash, not Frontier stock) or violating his fiduciary duties. Finally, Holly proposed an all-cash transaction of $28 for each Holly share, only a slight increase in the effective merger consideration and without any upside for Holly shareholders under either an MLP or the aviation fuel claim that was the basis for the CVR [contingent lawsuit right]. Again, there is no suggestion that Holly was seeking to increase consideration materially; Holly even offered to help finance the additional cash requirements for an all-cash transaction.
>
> The Court, thus, concludes that Holly pursued the post-July 9 negotiations in a good faith effort to find a way to meet the concerns that it had identified. Holly had shared the Lehman Brothers MLP Presentation with Frontier. As soon as the Holly Board met after having been informed of Frontier's indemnities at Beverly Hills, it advised Frontier of its concerns. All subsequent negotiations focused on finding a way around Beverly Hills issues.

<u>Break-up Fee</u>. The Court also denied Frontier's claim for the break-up fee under the agreement. The Court held that Holly's board never formally withdrew or modified its recommendation, even though the directors had clearly determined individually not to proceed under the merger terms originally negotiated. In addition, the Court found that Frontier's right to

seek the break-up fee was conditioned upon its termination of the Merger Agreement, and rejected the argument that Frontier's institution of its litigation constituted termination. Finally, the Court held that a consequence of Frontier's decision to sue for repudiation was that it could not maintain a claim for relief under the contract.

Holly Damages. In a counterclaim, Holly sought damages from Frontier as a result of Frontier's alleged repudiation and breach of representations and warranties in the Merger Agreement. The Court found that Frontier's decision to file the anticipatory repudiation litigation and to abandon the Merger Agreement constituted a breach of the Merger Agreement.

In assessing Holly's claim for damages as a result of Frontier's breach, the Court's decision not to grant Holly damages was based in part on the finding that Holly, prior to Frontier's repudiation, had determined that the Merger Agreement would not proceed on its terms and that, as a consequence, the harm about which Holly complained was not caused by Frontier's breach. The Court awarded Holly nominal damages of $1.00.

Breaches of Frontier Representations. In reviewing Holly's claim that Frontier had breached its representation in Section 4.8 of the Merger Agreement that "there are no actions . . . threatened against Frontier . . . other than those which would not have or reasonable could be expected to have a Frontier Material Adverse Effect," the Court found that the burden of establishing a Material Adverse Effect with respect to Frontier fell on Holly. The Court noted that while the notion of a Material Adverse Effect "is imprecise and varies both with the context of the transaction and its parties and with the words chosen by the parties," the drafters of the Merger Agreement had the benefit of the analysis set forth in *In re IBP, Inc. Shareholders Litigation*, 787 A.2d 14 (Del. Ch. 2001) ("*IBP v. Tyson*"), which discussed whether an acquiring party in a merger could invoke a Material Adverse Effect to escape from the transaction. With respect to the Merger Agreement's definition of Material Adverse Effect, the Court commented:

> It would be neither original nor perceptive to observe that defining a "Material Adverse Effect" as a "material adverse effect" is not especially helpful. Moreover, the definition chosen by the parties emphasizes the need for forward-looking analysis; that is especially true because the parties, through the drafting changes designed to assuage Holly's concerns about the threatened Beverly Hills Litigation added the "would not reasonably be expected to have" an MAE standard to the scope of inquiry regarding threatened litigation and the term "prospects" to the list of "the business, assets and liabilities . . . results of operations [and] condition" in the definition of an MAE.

The Court also commented in footnote 209:

> The parties used "would," not "could" or "might." "Would" connotes a greater degree (although quantification is difficult) of likelihood than "could" or "might," which would have suggested a stronger element of speculation (or a lesser probability of adverse consequences).

The Court noted that the court in *IBP v. Tyson*, applying New York law, found that a buyer would be required to make a strong showing to invoke a Material Adverse Effect exception, namely, a showing that the complained of event would have a material effect on the long-term earnings potential of the target company. The Court wrote that in this context "it may be more useful to consider the standard drawn from *IBP* as one designed to protect a merger partner from the existence of unknown (or undisclosed) factors that would justify an exit from the transaction."

While noting that *IBP v. Tyson* applied New York law, the Court found no reason why Delaware law should prescribe a different approach. The Court found that since, under *IBP v. Tyson* a defendant seeking to avoid performance of a contract due to its counterparty's breach of warranty must assert that breach as an affirmative defense, it followed that the same defendant pursuing an affirmative counter-claim would be charged with the burden as well.

Whether the California litigation was, or was reasonably likely to have, a Material Adverse Effect was, in the Court's view, an issue with quantitative and qualitative aspects, which it analyzed as follows:

> Frontier argues that threatened litigation can never constitute an MAE because litigation results are inherently speculative. This argument ignores that threatened litigation can be so certain, the outcome so predictable, and the likely consequences (*i.e.*, "prospects") so negative, that an observer could readily conclude that the impact that one would reasonably expect to result from the litigation would be material and adverse. Predicting the outcome of unfiled (or even filed) litigation may be difficult and conclusions must be drawn with care; those considerations, however, neither require nor prudently allow for the absolute rule espoused by Frontier, particularly in light of the parties' drafting efforts to accommodate the then-threatened Beverly Hills Litigation.
>
> The Beverly Hills Litigation poses serious risks for Frontier. Defense costs will be substantial; the risk of adverse results exists; and it is likely that, given the nature of the alleged health effects, if plaintiffs prevail on the merits of their claims, damage awards will be large. Whether this all reaches "Material Adverse Effect" under the terms of the Merger Agreement, however, mandates a more thorough review of the details.
>
> Holly focuses on the nature of the Beverly Hills forum and not on the merits of the actions there. Much of its argument is premised on its impressions of California law and procedure as plaintiff-friendly for mass toxic tort claims. This ranges from reporting that plaintiffs' lawyers affectionately refer to the venue as "the Bank" to noting that California has not adopted the *Daubert* standard which authorizes an expanded role for the trial judge as a gatekeeper with respect to so-called "junk science" expert testimony. Holly also foresees an antibusiness jury pool that would be sympathetic to the plaintiffs. The choice of a forum, of course, may be a factor in assessing the probable outcome of any litigation. Yet, Holly has not demonstrated, and I would suspect that is because it cannot, that Frontier would not receive a fair trial in California.

> Significantly, Holly devotes little effort to developing the merits of the plaintiffs' case against Frontier. It produced no data or studies suggesting that individuals with long-term exposure to petroleum suffer a higher incidence of the cancers suffered by the plaintiffs in the Beverly Hills Litigation. It offered no expert testimony as to how current scientific and medical knowledge supports its position. It did perform a "back of the envelope" calculation to the effect that the cancer rate among the Beverly Hills High School community was higher than that of the general populace, but the process had no validation and no rigorous review.
>
> Holly is correct that the Beverly Hills litigation could be catastrophic for Frontier. It is not possible to rule out judgments running into the hundreds of millions of dollars. Holly has not, however, demonstrated (or even seriously tried to demonstrate) the likelihood of the event. It suggests that any jury trial carries a ten percent chance of losing. That contention is little more than an acknowledgement that the system is not perfect. More importantly, it is more in the nature of random speculation. It is possible, in the right case, for a party in a position comparable to Holly's, to come forward with factual and opinion testimony that would provide a court with the basis to make a reasonable and an informed judgment of the probability of an outcome on the merits. Holly simply has not provided that foundation.

While holding that Holly had not proved that the litigation would have a Material Adverse Effect, the court recognized that Holly would be reluctant to prove plaintiffs' case because Frontier was a potential merger partner and because such could be adverse to Holly itself, writing in footnote 221 as follows:

> Perhaps Holly was reluctant to advance a scientific, including epidemiological, basis (assuming that one exists) to support, on the substantive merits of the dispute, its view that the litigation poses great risk to Frontier. It might not be in Holly's self-interest, as a participant in the petroleum industry, to champion the cause of linking exposure to petroleum (or petroleum products) to cancer.

Since Holly presented no evidence, scientific or otherwise, relating to the substance of the California plaintiffs' claims and how the California proceedings should play out, the Court found that Holly failed to meet its burden.

With respect to Holly's claims that the defense costs alone of the litigation constituted a Material Adverse Effect, Holly variously had estimated the defense costs of the litigation as ranging from $200,000 per month to $25 million to $40 million and then from $40 million to $50 million. Frontier produced separate estimates suggesting that the defense costs would be in the range of $11 million to $13 million. The Court found that a reasonable estimate of the costs would be in the range of $15 million to $20 million, and concluded that this range of costs alone did not constitute a Material Adverse Effect in a deal worth $450 million.

In addition, the Court found that Frontier did not breach its warranty as to the absence of material contracts (*i.e.*, its guarantees). The Court found that the documents relating to the guarantee would be material at the time of the Merger Agreement if the litigation risks related thereto were sufficiently foreseeable and large. In light of the Court's holding relating to the litigation, the Court found no breach of warranty.

ABRY Partners V, L.P., et al., Plaintiffs
v.
F&W Acquisition LLC, et al., Defendants

Civil Action No. 1756-N
In the Court of Chancery of the State of Delaware
(Decided February 14, 2006)

891 A.3d 1032

Whether contractual limitations on liability are enforceable for breaches of seller representations in an agreement for the purchase of the stock or assets of a private company often arises during the negotiation of an acquisition agreement. In *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.3d 1032 (Del. Ch. 2006), a "sophisticated private equity firm" purchased for $500 million the stock of a portfolio company from another sophisticated private equity firm and then sued in Delaware Chancery Court to rescind the stock purchase agreement on the basis that factual representations therein turned out not to be true. In filing suit, the purchaser ignored and repudiated the arbitration, exculpation and liability cap provisions in the purchase agreement. In an opinion that denied the selling firm's motion to dismiss, Vice Chancellor Leo Strine wrote: "Delaware law permits sophisticated commercial parties to craft contracts that insulate a seller from a rescission claim for a contractual false statement of fact that was not intentionally made . . . parties may allocate the risk of factual error freely as to any error where the speaking party did not consciously convey an untruth." However, "the contractual freedom to immunize a seller from liability for a false contractual statement of fact ends there . . . when a seller intentionally misrepresents a fact embodied in a contract – that is, when a seller lies – public policy will not permit a contractual provision to limit the remedy of the buyer to a capped damage claim [and] the buyer is free to press a claim for rescission or for full compensatory damages." The purchaser was permitted to proceed to trial on its rescission claims to the extent that they allege that selling firm actually "lied" and knew its representations in contract were false.

Background

In 2005, ABRY Partners V, L.P., a sophisticated media-focused private equity firm, and a group of affiliated entities (collectively "*Buyer*") bought F&W Publications Inc. (the "*Company*") from Providence Equity Partners Inc., another sophisticated private equity firm ("*Seller*"), for $500 million pursuant to a Stock Purchase Agreement. The Company, incorporated in Delaware and based in Ohio, is a publisher of special interest books and magazines, including Popular Woodworking, Scuba Diving, Family Tree Magazine, and Writer's Digest. Seller had owned the Company since 2002.

However once it took over, Buyer uncovered a host of allegedly serious financial and operational problems, and concluded that it had been defrauded. The Company allegedly had manipulated its earnings and falsely stated that its new book-ordering system was fully functional when in fact it was not working properly such that distributors had refused to do business with the Company.

Buyer asked Seller to rescind the deal, claiming that it would never have bought the Company if it had known about its fraudulent accounting and unethical business practices, that the true value of the Company was more like $400 million than the $500 million purchase price paid, and that the failure of the new book-ordering system was a material adverse event under the Stock Purchase Agreement. When Seller refused, Buyer sued Seller for rescission of the contract. Buyer included claims of fraudulent inducement and negligent misrepresentation, both based on nondisclosure of the financial manipulation.

<u>Stock Purchase Agreement Provisions</u>

The Stock Purchase Agreement recognized a distinction between Seller and the Company and gave this distinction importance in addressing questions relating to liability. The Stock Purchase Agreement did not make Seller responsible for everything the Company and the Company's management did or said. Rather, Seller only accepted responsibility for the Company's actions and words to the extent set forth in the Stock Purchase Agreement and the required Officer's Certificate of its representative which was a closing condition under the Stock Purchase Agreement.

The Stock Purchase Agreement provided in § 7.8 that neither the Company nor Seller had made any representation or warranty as to the accuracy of any information about the Company except as set forth in the Agreement itself and that neither Seller nor the Company would have any liability to Buyer or any other person for any extra-contractual information made available to Buyer in connection with the contemplated sale of the Company, as follows:

> Acquiror acknowledges and agrees that neither the Company nor the Selling Stockholder has made any representation or warranty, expressed or implied, as to the Company or any Company Subsidiary or as to the accuracy or completeness of any information regarding the Company or any Company Subsidiary furnished or made available to Acquiror and its representatives, except as expressly set forth in this Agreement . . . and neither the Company nor the Selling Stockholder shall have or be subject to any liability to Acquiror or any other Person resulting from the distribution to Acquiror, or Acquiror's use of or reliance on, any such information or any information, documents or material made available to Acquiror in any "data rooms," "virtual data rooms," management presentations or in any other form in expectation of, or in connection with, the transactions contemplated hereby.

The Court found the foregoing § 7.8 to be a critical provision that operated to define what information Buyer relied upon in deciding to execute the Stock Purchase Agreement. In the Stock Purchase Agreement carefully delineated that the Company was making the exhaustive representations and warranties regarding the Company's business and condition. With respect to the Company's financial statements, the Company (not Seller) in Stock Purchase Agreement § 3.6 represented as follows:

> The Company Financial Statements: (i) are derived from and reflect, in all material respects, the books and records of the Company and the Company Subsidiaries; (ii) fairly present in all material respects the financial condition of the Company and the Company Subsidiaries at the dates therein indicated and the results of operations for the periods therein specified; and (iii) have been prepared in accordance with GAAP applied on a basis consistent with prior periods except, with respect to the unaudited Company Financial Statements, for any absence of required footnotes and subject to the Company's customary year-end adjustments.

Seller's representations and warranties in the Stock Purchase Agreement were limited to matters such as its existence and authority to act and that it owned the shares of the Company that were to be transferred to Buyer in the sale.

The Company's representations and warranties were Article III, which contained twenty-two general representations and warranties and included in § 3.23, the following promise of Buyer that it was not relying on extra-contractual representations:

> EXCEPT AS EXPRESSLY SET FORTH IN THIS ARTICLE III, THE COMPANY MAKES NO REPRESENTATION OR WARRANTY, EXPRESSED OR IMPLIED, AT LAW OR IN EQUITY IN RESPECT OF THE COMPANY OR THE COMPANY SUBSIDIARIES, OR ANY OF THEIR RESPECTIVE ASSETS, LIABILITIES OR OPERATIONS, INCLUDING WITH RESPECT TO MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE, AND ANY SUCH OTHER REPRESENTATIONS OR WARRANTIES ARE HEREBY EXPRESSLY DISCLAIMED. ACQUIROR HEREBY ACKNOWLEDGES AND AGREES THAT, EXCEPT TO THE EXTENT SPECIFICALLY SET FORTH IN THIS ARTICLE III, THE ACQUIROR IS ACQUIRING THE COMPANY ON AN "AS IS, WHERE IS" BASIS. THE DISCLOSURE OF ANY MATTER OR ITEM IN ANY SCHEDULE HERETO SHALL NOT BE DEEMED TO CONSTITUTE AN ACKNOWLEDGEMENT THAT ANY SUCH MATTER IS REQUIRED TO BE DISCLOSED.

Buyer got Seller to back up the Company's representations and warranties by (i) a closing condition in § 8.2(h)(i) of the Stock Purchase Agreement that required Seller to provide an Officer's Certificate stating that the closing conditions relating to the accuracy of not only Seller's, but also the Company's, representations and warranties, were satisfied, that the Company and Seller had complied with the covenants applicable to them, and also that the Company had not suffered events that had had or would reasonably be expected to constitute a material adverse effect ("*MAE*"). In compliance with that requirement, Seller provided the Officer's Certificate which stated:

> Pursuant to Section 8.2(h)(i) of the Agreement, the undersigned duly elected and authorized officer of the Selling Stockholder, hereby certifies that . . . (1) Each representation and warranty of the Company set forth in Article III and the Selling Stockholder set forth in Article IV of the Agreement or in each case deemed made pursuant to Section 7.10(a) is true and correct as of the Closing Date . . . (2) Each

> of the Selling Stockholder and the Company have performed and complied in all material respects with the agreements and covenants required to be performed or complied with by it on or prior to the Closing Date . . . (3) Since the date of the Agreement, there has been no change, event or condition of any character (whether or not covered by insurance) which, in the aggregate, has had or would reasonably be expected to have a Company Material Adverse Effect.

Seller agreed in Stock Purchase Agreement § 9.1 to indemnify Buyer in respect of its and the Company's representations and warranties as follows:

> [T]he Selling Stockholder agrees that, after the Closing Date, the Acquiror and the Company and . . . each controlling shareholder of the Acquiror or the Company . . . shall be indemnified and held harmless by the Selling Stockholder from and against, any and all claims, demands, suits, actions, causes of actions, losses, costs, damages, liabilities and out-of-pocket expenses incurred or paid, including reasonable attorneys' fees, costs of investigation or settlement, other professionals' and experts' fees, and court or arbitration costs but specifically excluding consequential damages, lost profits, indirect damages, punitive damages and exemplary damages . . . to the extent such Damages . . . have arisen out of or . . . have resulted from, in connection with, or by virtue of the facts or circumstances (i) which constitute an *inaccuracy*, *misrepresentation*, *breach of*, default in, or failure to perform any of the *representations, warranties or covenants* given or made by the *Company* or the *Selling Stockholder* in this Agreement . . .

Section 9.1(c) of the Stock Purchase Agreement, however, limited the aggregate liability of Seller for conduct covered by § 9.1(a) to the amount of a $20 million escrowed Indemnity Fund.

The Stock Purchase Agreement in § 9.9(a) contained the following "*Exclusive Remedy Provision*:"

> Except as may be required to enforce post-closing covenants hereunder . . . after the Closing Date the indemnification rights in this <u>Article IX</u> are and shall be the sole and exclusive remedies of the Acquiror, the Acquiror Indemnified Persons, the Selling Stockholder, and the Company with respect to this Agreement and the Sale contemplated hereby; <u>provided</u> that this sentence shall not be deemed a waiver by any party of its right to seek specific performance or injunctive relief in the case of another party's failure to comply with the covenants made by such other party.

In addition, Stock Purchase Agreement § 9.9(b) provided that "[t]he provisions of <u>Article IX</u> were specifically bargained for and reflected in the amounts payable to the Selling Stockholder in connection with the Sale pursuant to <u>Article II</u>." The provisions of Article IX included the Exclusive Remedy Provision, the Indemnity Claim provision, and the Indemnity Fund provision.

Further, the Stock Purchase Agreement required that Indemnity Claims be arbitrated in Massachusetts if they could not be resolved consensually. Despite the selection of Massachusetts as an arbitration forum, the Stock Purchase Agreement, in § 9.5 and § 11.9, chooses Delaware law to govern any claim submitted to arbitration.

Buyer ignored the arbitration provisions in the Stock Purchase Agreement and sued for the equitable remedy of rescission in the Delaware Court of Chancery.

This case was decided in the context of a Court of Chancery Rule 12(b)(6) motion to dismiss. As a result, the Court assumed that all well pled facts were true although Buyer would have to, and might not be able to, prove them at trial.

Legal Analysis

A. Choice Of Law.

Buyer claimed that Massachusetts law governed its claims because its operations were located in Massachusetts. The Court, however, noted that (1) Buyer, Seller and the Company were all Delaware corporations; (2) the Stock Purchase Agreement, even though it required arbitration of an Indemnity Claim to occur in Massachusetts, provided Delaware law was to govern the burden of proof in such proceedings and Delaware courts are to review the arbitrators' rulings and (3) § 11.9(a) of the Stock Purchase Agreement provides: "This Agreement shall be governed by, and construed in accordance with, the Laws of the State of Delaware, regardless of the Laws that might otherwise govern under applicable principles of conflicts of law."

Finding that Delaware law clearly had a material relationship to the transaction among Buyer, Seller, and the Company and that Delaware courts are bound to respect the chosen law of contracting parties, so long as that law has a material relationship to the transaction, the Court focused on Delaware's public policy expressed 6 *Del. C.* § 2708, which provides:

> (a) The parties to any contract, agreement or other undertaking, contingent or otherwise, may agree in writing that the contract, agreement or other undertaking shall be governed by or construed under the laws of this State, without regard to principles of conflicts of laws, or that the laws of this State shall govern, in whole or in part, any or all of their rights, remedies, liabilities, powers and duties if the parties, either as provided by law or in the manner specified in such writing are, (i) subject to the jurisdiction of the courts of, or arbitration in, Delaware and, (ii) may be served with legal process. *The foregoing shall conclusively be presumed to be a significant, material and reasonable relationship with this State and shall be enforced whether or not there are other relationships with this State* . . . (b) Any person may maintain an action in a court of competent jurisdiction in this State where the action or proceeding arises out of or relates to any contract, agreement or other undertaking for which a choice of Delaware law has been made in whole or in part and which contains the provision permitted by subsection (a) of this section . . . (c) This section shall not apply to any contract, agreement or other undertaking . . . (ii) involving less than $100,000.

The Court rejected as "not sensible" the Buyer argument that the choice of law provision in the Stock Purchase Agreement only meant for Delaware law to govern contract claims that might arise among the parties, but not claims in tort seeking rescission of the Stock Purchase Agreement on grounds that false contractual representations were made.

B. Entire Agreement/Merger/Non-Reliance Clauses.

In finding that the non-reliance provision in § 7.8 of the Stock Purchase Agreement was enforceable and barred Buyer from making any claim in respect of any information or representation not set forth in the four corners of the Stock Purchase Agreement, the Court wrote:

> When addressing contracts that were the product of give-and-take between commercial parties who had the ability to walk away freely, this court's jurisprudence has . . . honored clauses in which contracted parties have disclaimed reliance on extra-contractual representations, which prohibits the promising party from reneging on its promise by premising a fraudulent inducement claim on statements of fact it had previously said were neither made to it nor had an effect on it.
>
> * * *
>
> The teaching of this court . . . is that a party cannot promise, in a clear integration clause of a negotiated agreement, that it will not rely on promises and representations outside of the agreement and then shirk its own bargain in favor of a "but we did rely on those other representations" fraudulent inducement claim. The policy basis for this line of cases is, in my view, quite strong. If there is a public policy interest in truthfulness, then that interest applies with more force, not less, to contractual representations of fact. Contractually binding, written representations of fact ought to be the most reliable of representations, and a law intolerant of fraud should abhor parties that make such representations knowing they are false.
>
> * * *
>
> Nonetheless, . . . we have not given effect to so-called merger or integration clauses that do not clearly state that the parties disclaim reliance upon extra-contractual statements. Instead, we have held . . . that murky integration clauses, or standard integration clauses without explicit anti-reliance representations, will not relieve a party of its oral and extra-contractual fraudulent representations. The integration clause must contain "language that . . . can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract." This approach achieves a sensible balance between fairness and equity — parties can protect themselves against unfounded fraud claims through explicit anti-reliance language. If parties fail to include unambiguous anti-reliance language, they will not be able to escape

responsibility for their own fraudulent representations made outside of the agreement's four corners.

C. Exculpation for Lies in Purchase Agreement Unenforceable—Public Policy.

In holding that the Exclusive Remedy Provision in § 9.9 of the Stock Purchase Agreement was unenforceable as a matter of public policy, Vice Chancellor Strine wrote:

> This case, however, raises a related, but more difficult, question: to what extent may a contract exculpate a contracting party from a rescission or damages claim based on a false representation of fact made within the contract itself? May parties premise a contract on defined representations but promise in advance to accept a less-than-adequate remedy if one of them has been induced by lies about one of those material facts?
>
> * * *
>
> There are various reconciliations of this clash of interests. At one extreme, some courts are extremely grudging about enforcing contractual limitations on a buyer's right to sue for rescission or damages for an innocent misrepresentation. This reluctance has generally manifested itself in refusals to preclude negligent misrepresentation claims based on general merger clauses and in requiring very specific waivers of negligence-based claims. The balancing possibilities extend from there, with some courts willing to tolerate waivers of the right to sue for negligent or even grossly negligent misrepresentations. As § 195 of the Restatement [(Second) of Contracts] reflects, however, courts have generally refused to go further and allow a contractual waiver of the buyer's right to sue on the basis that a contractually-represented fact was false as a result of the seller's reckless or intentional conduct. Abundant case law to this effect exists.
>
> Delaware courts have shared this distaste for immunizing fraud. As the Buyer notes, prior Delaware decisions have used language that is generally condemnatory of contractual limitations on a party's exposure to a fraud claim for making a false statement. To wit, our courts have said that "[a] perpetrator of fraud cannot close the lips of his innocent victim by getting him blindly to agree in advance not to complain against it" and "fraud vitiates every contract, and no man may invoke the law to enforce his fraudulent acts." Those decisions primarily involve the protection of a relatively unsophisticated party or a party lacking bargaining clout who signs a contract with a boilerplate merger clause.
>
> * * *
>
> When fashioning common law limits on contractual freedom, we must be mindful of these factors and other commercial realities, lest we inhibit economic activity that might be valuable to the parties and society more generally. In that respect, the common law ought to be especially chary about relieving sophisticated business entities of the burden of freely negotiated contracts. There remains much harshness in the world, and such entities are unlikely candidates to

place at the head of the line for judicial protection, especially when the legislature is free to consider providing such relief. . . .

At the same time, a concern for commercial efficiency does not lead ineluctably to the conclusion that there ought to be no public policy limitations on the contractual exculpation of misrepresented facts. Even commentators who recognize that there are aspects of bargaining in which it is often expected that parties will lie — such as when agents refuse to disclose or misrepresent their principals' reservation price — there is little support for the notion that it is efficient to exculpate parties when they lie about the material facts on which a contract is premised.

I use the plain word "lie" intentionally because there is a moral difference between a lie and an unintentional misrepresentation of fact. This moral difference also explains many of the cases in the *fraus omnia corrumpit* strain, which arose when the concept of fraud was more typically construed as involving lying, and thus it is understandable that courts would find it distasteful to enforce contracts excusing liars for responsibility for the harm their lies caused.

There is also a practical difference between lies and unintentional misrepresentations. A seller can make a misrepresentation of fact because it was misinformed by someone else, was negligent, or even was reckless. All of those possibilities can be enhanced if the seller does little to investigate its own representations and compounded if the buyer does little independent due diligence of its own. The level of self-investigation expected from a seller, to me, seems to be a more legitimate subject for bargaining than whether the seller can insulate itself from liability for lies.

This case involves a good example of this aspect of the problem. The Seller did not manage the Company being sold directly. Most of the key representations of fact were made by the Company to the Buyer in the first instance, primarily through managers working directly for the Company who were not otherwise affiliated with the Seller. The Seller did not necessarily possess the same information as the managers of the Company.

In this circumstance, it seems legitimate for the Seller to create exculpatory distance between itself and the Company. That is, I find it difficult to fathom how it would be immoral for the Seller and Buyer to allocate the risk of intentional lies by the Company's managers to the Buyer, and certainly that is so as to reckless, grossly negligent, negligent, or innocent misrepresentations of fact by the Company. Such an allocation of risk does not permit the Seller to engage in consciously improper conduct itself, it simply requires the Buyer to hold the Company and its speaking managers exclusively responsible for their own misstatements of fact.

In considering how to allocate the risk of misrepresentations consistent with public policy, I also consider our General Assembly's approach to exculpation in the case of business entities. In the corporate context, the General Assembly has permitted corporate charters to exculpate directors for liability for gross negligence. In the alternative entity context, where it is more likely that sophisticated parties have carefully negotiated the governing agreement, the General Assembly has authorized even broader exculpation, to the extent of eliminating fiduciary duties altogether.

* * *

With that in mind, I resolve this case in the following manner. To the extent that the Stock Purchase Agreement purports to limit the Seller's exposure for its own conscious participation in the communication of lies to the Buyer, it is invalid under the public policy of this State. That is, I find that the public policy of this State will not permit the Seller to insulate itself from the possibility that the sale would be rescinded if the Buyer can show either: 1) that the Seller knew that the Company's contractual representations and warranties were false; or 2) that the Seller itself lied to the Buyer about a contractual representation and warranty. This will require the Buyer to prove that the Seller acted with an illicit state of mind, in the sense that the Seller knew that the representation was false and either communicated it to the Buyer directly itself or knew that the Company had. In this case, that distinction is largely of little importance because of the Officer's Certificate provided by the Seller. In that certificate, the Seller certified that (1) each representation and warranty of the Company and Seller was true and correct as of the closing date; (2) the Seller and Company performed and complied in all material respects with the agreements and covenants required to be performed or complied with; and (3) between the date of signing the Stock Purchase Agreement and closing, there had been no change, event or condition of any character which had or would reasonably be expected to constitute a material adverse effect for the Company.

By contrast, the Buyer may not obtain rescission or greater monetary damages upon any lesser showing. If the Company's managers intentionally misrepresented facts to the Buyer without knowledge of falsity by the Seller, then the Buyer cannot obtain rescission or damages, but must proceed with an Indemnity Claim subject to the Indemnity Fund's liability cap. Likewise, the Buyer may not escape the contractual limitations on liability by attempting to show that the Seller acted in a reckless, grossly negligent, or negligent manner. The Buyer knowingly accepted the risk that the Seller would act with inadequate deliberation. It is an experienced private equity firm that could have walked away without buying. It has no moral justification for escaping its own voluntarily-accepted limits on its remedies against the Seller absent proof that the Seller itself acted in a consciously improper manner.[1]

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[1] As a matter of logical consistency and intellectual candor, it is important to recognize that the line I draw still leaves a residual double liar problem. That is, if the Buyer in fact promised not to sue for rescission even if the Seller lied to it about the accuracy of a contractual representation, its decision to later renege on that promise suggests that it was untruthful in making the promise in the first instance. This concern is far less compelling than

In sum, I conclude that the Seller's motion to dismiss the complaint in its entirety must be denied. But the Buyer may only obtain its desired relief — rescission or in the alternative, full compensatory damages — if it meets the burden of proof described.[2]

The Court thus granted Seller's motion to dismiss the claim for rescission and claims based on negligent misrepresentation. It allowed to go forward only the claims that Seller intentionally misrepresented a fact within the Stock Purchase Agreement or knew that the Company had misrepresented such a fact.

D. Negotiating/Drafting Considerations.

Citing the *ABRY* decision that public policy will preclude a party from contractually limiting its liability for its own fraud, a buyer may seek a statement in the acquisition agreement to the effect that the contractual limitations on indemnification such as Section 11.5 are not

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in a situation when a buyer that has expressly disclaimed reliance upon, or the existence of, extra-contractual statements of fact claims that it relied upon such statements in determining to sign or close a contract. For one thing, the promise is far more explicit than the usual remedial limitations buyers accept, as this case illustrates. Although I agree with the Seller's reading of the Agreement, the Agreement does not explicitly state that the Buyer was waiving the right to rescind even if the Seller and Company lied about contractual representations. Furthermore, in this context, it is also not unrealistic to assume that the contracting parties knew that there were public policy limitations that would come into play, to the extent that the contract attempted to exculpate the Seller for lies about contractual representations, and that the Buyer was not necessarily lying when it promised to limit its remedial options. *See* **ABA Comm. on Negotiated Acquisitions, Model Stock Purchase Agreement 143** ("In the absence of a specific provision to the contrary, the Buyer's remedies for inaccuracies in the Sellers' representations may not be limited to those provided by the indemnification provisions; the Buyer may also have causes of action based on breach of contract, fraud and misrepresentation . . . The Sellers therefore may want to add a clause providing that the indemnification provisions are the sole remedy for any claims relating to the sale of the shares . . . Other claims, including those based on common law fraud, may also survive an exclusivity clause under applicable state law."); *cf*. **ABA Comm. on Negotiated Acquisitions, Model Agreement and Plan of Merger and Reorganization 207** (noting that, even in the context of a public company merger, irrespective of a contractual provision stating that representations and warranties do not survive the closing, such a provision would not normally preclude post-closing fraud claims by one party against former officers and directors of the other party). Finally, sellers do not face as much evidentiary uncertainty as a result of this balance as they do from a refusal to enforce a non-reliance provision. By refusing to enforce a non-reliance provision, a court subjects a seller to the risk that the court will erroneously conclude that the seller even made an extra-contractual representation of fact. By contrast, by refusing to allow a contract to exculpate a seller for lies about contractual representations of fact, there is no evidentiary uncertainty over whether the allegedly false representations were made, only over whether they were materially false and whether the seller knew them to be false.

[2] Of course, it will be incumbent upon the Buyer to prove reasonable reliance, an element that is required by common law fraud and that also has relevance in contract law in this context. *See Browne v. Robb*, 583 A.2d 949, 955 (Del. 1990) ("The general elements of common law fraud [include] . . . action or inaction [resulting] from a reasonable reliance on the representation."); *H-M Wexford*, 832 A.2d at 142-43 ("Justifiable reliance is an element of common law fraud, equitable fraud, and negligent misrepresentation under Delaware law. Because Wexford cannot claim that it justifiably relied on the information in the PPM, these claims must fail as a matter of law."). In that respect, nothing in this opinion suggests that a buyer can escape an exclusive remedy provision when it was aware of the falsity of a contractual representation of fact before the closing and nonetheless elected to close on the contract, despite having a contractual right to terminate. *See* **ABA Comm. on Negotiated Acquisitions, Model Stock Purchase Agreement 139** ("The Buyer's ability to assert a fraud claim based on . . . the common law after the closing may be adversely affected if the Buyer discovers an inaccuracy before the closing but fails to disclose the inaccuracy to the Sellers until after the closing."). In that scenario, there is no public policy interest in permitting the buyer to escape a remedial limitation when they could have avoided the contract simply by refraining from closing.

intended to affect the common law liability of a seller for that seller's own fraud and may seek to craft an exception that goes beyond *ABRY*:

> The buyer's counsel might, for example, attempt to expand the exception clause so that it refers to something beyond fraud – to "fraud *or willful misconduct*," for example. This type of expanded language may be controversial because the additional words may not have as well established a meaning as "fraud" (which we know must be pleaded with particularity and which typically requires proof of a number of distinct elements, such as scienter and reliance).
>
> The buyer's counsel may also seek to expand the scope of the fraud exception in other ways. For example, the buyer may attempt to word the exception to say generally that the limitations on indemnification won't apply "in the event of fraud." Now this particular formulation does not really make it clear whose fraud will make the indemnification limitations inapplicable, leaving open the possibility that a completely innocent seller which did not itself commit fraud may be obligated to indemnify the buyer without limitation, beyond the negotiated dollar cap and after the expiration of the negotiated survival period, for the consequences of a fraud committed *by someone else* – by another, unrelated seller, for example. This is a result that is not necessarily compelled by law, and needless to say, a result that many sellers and their counsel might find objectionable.[3]

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[3] Wilson Chu, Rick Climan and Joel Greenberg, "*M&A 'Nuggett' – The 'Fraud Exception' to Limitations on Indemnification*," Deal Points, Volume XI, Issue 2 (Summer 2006) at Page 17.

Confidentiality Agreement

PRELIMINARY NOTE

Although the Asset Purchase Agreement provisions included herein are intended to represent an aggressive Buyer's first draft, confidentiality agreements are primarily a concern for the seller who is disclosing essential and very confidential information regarding its assets and business to prospective Buyer who is currently, or if the transaction is not consummated may later become a competitor of the Seller or the ultimate purchaser of its business. Consequently, this Confidentiality Agreement has been prepared as a Seller's (**"Discloser"**) first draft and includes provisions favorable to the Seller. The prospective Buyer (**"Recipient"**) may want to modify many of its provisions to be more in the Recipient's favor.

The Confidentiality Agreement is usually the first document in the acquisition process, and is signed by the Recipient before Discloser provides any confidential information. If the parties agree to proceed with the transaction, Article 12 of the Asset Purchase Agreement has its own provisions on obligations of confidentiality which would supersede the Confidentiality Agreement. See Comment to Article 12 of the Model Asset Purchase Agreement, *supra*.

This Confidentiality Agreement has no "sunset" provision and is silent on the topics of the duration of obligations of confidentiality and to what extent the obligations continue if the acquisition closes or does not close. Absent such a provision, the Discloser may take the position that they continue forever. The Recipient, on the other hand, may think that even the Discloser's proprietary know-how will become obsolete and assert that all obligations of confidentiality should come to an end at some early point. The parties may consider whether their interests would be served by "sunsetting" the Confidentiality Agreement as a whole or by providing different survival provisions for different categories of information or different obligations of confidentiality.

If an Asset Purchase Agreement is entered into, it will have to deal with the extent to which the Confidentiality Agreement (or portions of it) will be modified or superseded by that agreement, particularly in terms of the typical "integration" provision. Article 12 of the Model Asset Purchase Agreement contemplates a regimen of confidentiality that will restate and supersede Recipient's and Discloser's obligations under the Confidentiality Agreement. Certain other provisions of the Confidentiality Agreement do not appear in Article 12 of the Model Asset Purchase Agreement because their subject matter is covered by other provisions of the Model Asset Purchase Agreement.

The Confidentiality Agreement takes the form of a "unilateral agreement" that protects Discloser's confidential information in the hands of Recipient. Discloser may want details about Recipient's capacity to finance the transaction, other transactions Recipient has done, the identity of Recipient's lenders and other confidential information. Moreover, where the consideration includes securities of Buyer, the Discloser may require confidential information about the Recipient at a very early stage. Accordingly, the Recipient and the Discloser may find it appropriate to make obligations under the Confidentiality Agreement reciprocal and bilateral.

An alternative, when the parties have initially signed a unilateral Confidentiality Agreement presented by the Discloser (the seller) to the Recipient (the buyer), is for the parties to enter into a mirror agreement to protect the Recipient's information in the hands of the Discloser (of course, in that case, the prospective buyer will be the **"Discloser,"** and the prospective seller will be the **"Recipient"**).

FORM OF CONFIDENTIALITY AGREEMENT

[Date]

[Name]
[Discloser]
[Address]

PRIVATE AND CONFIDENTIAL

Dear __________:

In connection with the consideration by __________ (**"Recipient"**) of a possible transaction (the **"Transaction"**) with __________ (**"Discloser"**), Recipient has requested access to certain information, properties and personnel of Discloser.

COMMENT

In its first sentence, this Confidentiality Agreement defines that Recipient's use of Confidential Information is limited to Recipient's consideration of the proposed transaction. The Confidentiality Agreement does not characterize the transaction, does not identify the parties as "Buyer" and "Seller," and describes the transaction only as "possible" to avoid implication that any agreement about the transaction has been made between the parties or will be created by the Confidentiality Agreement.

In consideration for and as a condition to Discloser's furnishing access to such information, properties and personnel of Discloser as Discloser, in its sole discretion, agrees to deliver or otherwise make available (**"disclose"**) to Recipient, Recipient agrees to the terms and conditions set forth in this agreement:

COMMENT

Although the Confidentiality Agreement does not expressly provide that Discloser must disclose all information requested by Recipient, consideration is often given to the inclusion here of the following language: "Discloser may, in its sole discretion, withhold information where it concludes that the disclosure of such information would violate applicable law, breach a duty, subject Discloser to risk of a material penalty, or be detrimental to its interests, in which case it shall advise Recipient as to the general nature or category of information withheld." In some circumstances, the Discloser may be prohibited from disclosing certain information by restrictions under its existing contractual relationships.

1. CONFIDENTIAL AND PROPRIETARY NATURE OF THE INFORMATION

Recipient acknowledges the confidential and proprietary nature of the Confidential Information (as defined below), agrees to hold and keep the Confidential Information as provided in this agreement and otherwise agrees to each and every restriction and obligation in this agreement.

2. CONFIDENTIAL INFORMATION

As used in this agreement, the term **"Confidential Information"** means and includes any and all of the items described in paragraphs (a) and (b) below that has been or may hereafter be disclosed to Recipient by Discloser or by the directors, officers, employees, agents, consultants, advisors or other representatives, including legal counsel, accountants and financial advisors (**"Representatives"**) of Discloser:

(a) trade secrets concerning the business and affairs of Discloser (which includes the materials dated ________ ____, 20___, and disclosed to Recipient by __________), product specifications, data, know-how, formulae, compositions, processes, designs, sketches, photographs, graphs, drawings, samples, inventions and ideas, past, current, and planned research and development, current and planned manufacturing or distribution methods and processes, customer lists, current and anticipated customer requirements, price lists, supplier lists, market studies, business plans, computer software and programs (including object code and source code), computer software and database technologies, systems, structures and architectures (and related processes, formulae, composition, improvements, devices, know-how, inventions, discoveries, concepts, ideas, designs, methods and information), __________ and any other information, however documented, that is a trade secret within the meaning of __________ § ____-____-____ [applicable state trade secret law]); and

(b) information concerning the business and affairs of Discloser (which includes historical financial statements, financial projections and budgets, historical and projected sales, capital spending budgets and plans, the names and backgrounds of key personnel, personnel training techniques and materials and _____), however documented, or is otherwise obtained from review of Discloser's documents or property or discussions with Discloser's Representatives or by Recipient's Representatives (including current or prospective financing sources) or Representatives of Recipient's Representatives irrespective of the form of the communication, and also includes all notes, analyses, compilations, studies, summaries and other material prepared by Recipient or Recipient's Representatives containing or based, in whole or in part, upon any information included in the foregoing.

Any trade secrets of Discloser will also be entitled to all of the protections and benefits under _____ Section _____ [applicable state trade secret law] and any other applicable law. If any information that Discloser deems to be a trade secret is found by a court of competent jurisdiction not to be a trade secret for purposes of this agreement, such information will in any event still be considered Confidential Information for purposes of this agreement. In the case of trade secrets, Recipient hereby waives any requirement that Discloser submit proof of the economic value of any trade secret or post a bond or other security.

To the extent that any Confidential Information may include materials subject to the attorney-client privilege, the Discloser is not waiving and will not be deemed to have waived or diminished its attorney work-product protections, attorney-client privileges or similar protections and privileges as a result of disclosing any Confidential Information (including Confidential Information related to pending or threatened litigation) to Recipient, regardless of whether Discloser has asserted or is or may be entitled to assert such privileges and protections. The parties (a) share a common legal and commercial interest in all such Confidential Information that is subject to such privileges and protections; (b) are or may become joint defendants in proceedings to which such Confidential Information covered by such protections and privileges relates; and (c) intend that such privileges and protections remain intact should either party become subject to any actual or threatened proceeding to which such Confidential Information covered by such protections and privileges relates. In furtherance of the foregoing, Recipient shall not claim or contend, in proceedings involving either party, that Discloser waived its attorney work-product protections, attorney-client privileges or similar protections and privileges with respect to any information, documents or other material not disclosed to Recipient due to Discloser disclosing Confidential Information (including Confidential Information related to pending or threatened litigation) to Recipient.

COMMENT

The term **"Confidential Information"** is defined broadly to include all information concerning the business and affairs of Discloser that will be disclosed to Recipient. Exceptions are carved out—not from the definition but rather as exceptions to the obligation of nonuse and nondisclosure in Sections 6 and 7 below—in order to provide for circumstances in which the information is no longer required to be treated as Confidential Information. Such circumstances include information that becomes generally available to the public (other than by a result of unauthorized disclosure) or information that is otherwise made available to Recipient without a wrongful act on the part of the party providing the information.

In the absence of a confidentiality agreement and subject to applicable state law, trade secrets, but not confidential information, can be protected from disclosure. *See* RESTATEMENT OF THE LAW OF UNFAIR COMPETITION § 41, cmt. d (1995). Many states have adopted a version of the Uniform Trade Secrets Act that defines information as a "trade secret" if it (a) derives economic value from being generally unknown to other persons who can obtain economic value from its disclosure or use and (b) is subject to efforts that are reasonable under the circumstances to maintain its secrecy or confidentiality. *See* UNIF. TRADE SECRETS ACT § 1(4), 14 U.L.A. 438 (1990) and 152 (1998 supp.). The Restatement of the Law of Unfair Competition Section 39 defines trade secrets slightly differently, but comment b to that section states that the definition is intended to be consistent with the definition in the Uniform Trade Secrets Act. The Uniform Trade Secrets Act and the Confidentiality Agreement complement one another because protection of information under such trade secret law provides Discloser with another enforceable way to prevent misappropriation of information. Many states have also adopted criminal statutes specifically addressed to the misappropriation of trade secrets. In other states, more general criminal statutes have been interpreted to reach such misappropriations. In some circumstances, a misappropriation of trade secrets may also violate federal wire and mail fraud statutes (18 U.S.C. §§ 1341, 1343), the National Stolen Property Act (18 U.S.C. § 2314) and the Economic Espionage Act of 1996 (18 U.S.C. §§ 1831 et seq.).

The Confidentiality Agreement serves three primary purposes: (a) it expands the state law protection of trade secrets to confidential information, (b) it clarifies and delineates the obligations of Recipient, particularly with respect to its Representatives, and (c) it helps Discloser demonstrate that it used appropriate efforts to protect the information.

The Uniform Trade Secrets Act Section 1(4) requires reasonable efforts "under the circumstances" to maintain the secrecy of information constituting trade secrets, and such efforts are at least advisable for confidential information. While executing the Confidentiality Agreement demonstrates such efforts, stamping materials to be protected "CONFIDENTIAL" further demonstrates such efforts. If the parties decide to require that all documents containing confidential information be stamped, the Discloser should include a provision that its inadvertent failure to stamp a document is not a waiver of its confidentiality. The Discloser should, at a minimum, keep a list or copies of all documents disclosed to the Recipient and all persons with whom the Recipient spoke.

Both the Discloser and the Recipient may find it advantageous to have significant oral information promptly confirmed by the Discloser in writing as being confidential and acknowledged by the Recipient. In the event of a dispute over the disclosure, the evidentiary problems of proof are lessened when oral communications are reduced to writing. Because of the difficulty in consistently adhering to such requirement, the Confidentiality Agreement excludes such a requirement. Additionally, there may be oral disclosures sufficiently sensitive that neither party wants them reduced to writing.

Special issues may arise when the Recipient is a competitor or potential competitor of the Discloser. In such cases, the Recipient may not wish to review (and the Discloser may not wish the Recipient to review) certain technical information in order to preclude any future claims of misuse of proprietary information. It may prove advantageous to list or otherwise describe all such excluded materials in, or on a schedule or supplement to, the Confidentiality Agreement.

Further, when the acquisition involves a competitor, special steps need to be taken in connection with the disclosure of pricing or other competitively sensitive information. The Recipient's possession of such information could be damaging evidence if the acquisition is not completed and an antitrust claim is subsequently asserted. Alternatives to not disclosing such information are to (a) limit disclosure to the Recipient's personnel who are not in a position to use the information in a manner that would violate the antitrust laws or (b) defer disclosure until as late as possible in the process.

The risks that preacquisition disclosure of sensitive information will violate antitrust laws can be considerable. In the settlement of a divestiture case in which it found unlawful preacquisition transfers of competitively sensitive information, the Federal Trade Commission imposed lengthy bans upon the divesting company's obtaining or providing such information in any future acquisition of a competitor's stock or assets without specific safeguards. *In re* Insilco Corp., FTC File No. 961-0106, 5 Fed. Trade Reg. Rptr. (CCH) ¶ 24,319 (Aug. 27, 1997); *see* Blumenthal, *The Scope of Permissible Coordination between Merging Entities prior to Consummation*, 63 ANTITRUST L.J. 1 (1994).

The final paragraph of Section 2 addresses how to disclose sufficient information to the Recipient to facilitate a meaningful evaluation of litigation-related confidential information without waiving the attorney-client and other privileges that protect the information. See the Comment to Section 12.6 of the Model Asset Purchase Agreement and the authorities discussed therein.

Furthermore, if the acquisition is not consummated, the Recipient should be required to return the competitively sensitive information (together with copies and derivative materials) or to certify to the Discloser that all copies of such information have been destroyed. Section 9 of the Confidentiality Agreement imposes such a requirement.

3. RESTRICTED USE OF CONFIDENTIAL INFORMATION

Recipient agrees that the Confidential Information (a) will be kept confidential by Recipient and Recipient's Representatives and (b) without limiting the foregoing, will not be disclosed by Recipient or Recipient's Representatives to any person (including current or prospective financing sources) except with the specific prior written consent of _____ (the **"Discloser Contact"**) [a designated individual or a designated position, such as chief financial officer] or except as expressly otherwise permitted by this agreement. It is understood that Recipient may disclose Confidential Information to only those of Recipient's Representatives who (a) require such material for the purpose of evaluating the Transaction and (b) are informed by Recipient of the confidential nature of the Confidential Material and the obligations of this agreement. Recipient further agrees that Recipient and Recipient's Representatives will not use any of the Confidential Information either for any reason or purpose other than to evaluate and to negotiate the Transaction. Recipient also agrees to be responsible for enforcing this agreement as to Recipient's Representatives and to take such action, legal or otherwise, to the extent necessary to cause them to comply with this agreement and thereby prevent any disclosure of the Confidential Information by any of Recipient's Representatives (including all actions that Recipient would take to protect its own trade secrets and confidential information) except as permitted by this agreement.

COMMENT

The Confidentiality Agreement defines who will be allowed to use the Confidential Information and the scope and extent of such use.

The foregoing provisions require only that Recipient inform the persons to whom the Confidential Information is disclosed of the confidential nature and the obligations under this Agreement. A Discloser may want to add clauses providing that the Confidential Information may not be disclosed except to persons approved in writing by the Discloser contact prior to any disclosure and requiring such persons to acknowledge, in writing, the obligations of the Confidentiality Agreement. Such written acknowledgment could be accomplished by having a one-sentence cover letter signed by each Representative ("I hereby agree to be bound by the attached agreement from X to Y dated Z") or (as a less burdensome alternative) by having the Recipient's Representatives sign a statement acknowledging that they are familiar with the confidentiality obligations in the Confidentiality Agreement and agree to be bound by its provisions. Another alternative is to merely provide in the Confidentiality Agreement that the Recipient retains responsibility for any unauthorized disclosures or use of the confidential information and for ensuring compliance with the Confidentiality Agreement. This approach may be more acceptable to the Discloser if the Recipient's employees have signed secrecy agreements as a condition of employment with the Recipient.

4. NONDISCLOSURE OF TRANSACTION

Except as expressly permitted by Section 3 and except as expressly permitted by a definitive agreement with respect to the Transaction, if any, entered into between the parties, neither Recipient, Discloser nor their Representatives will disclose to any person the fact that the Confidential Information has been disclosed to Recipient or Recipient's Representatives or that Recipient or Recipient's Representatives have inspected any portion of the Confidential Information or that any discussions or negotiations are taking place concerning the Transaction, provided, however, Recipient and its Representatives may make such a disclosure if, and solely to the extent that, Discloser has already done so or Recipient has received the written opinion of its outside counsel that such a disclosure must be made by Recipient in order that it not commit a violation of law, and further provided, Recipient and its Representatives shall consult with Discloser, to the extent reasonably practicable, before making any such disclosure, and any such permitted disclosure shall not affect or impair Recipient's obligations of confidentiality with respect to the Confidential Information. Without limiting the generality of the foregoing, Recipient further agrees that, without the prior written consent of Discloser, Recipient will not, directly or indirectly, enter into any agreement, arrangement or understanding, or any discussions that might lead to such an agreement, arrangement or understanding, with any person regarding a possible transaction involving Discloser[, provided, however, nothing contained herein shall be deemed to inhibit, impair or restrict the ability of Recipient or its Representatives to have discussions or negotiations with other persons relating to potential financing and/or partnering in connection with and/or investment in the Transaction so long as each of such persons agrees in writing to be bound by the terms of this agreement].

COMMENT

As the parties often want to keep secret the very fact of any negotiation discussions, the Confidentiality Agreement prevents the disclosure of such information or the fact that negotiations are taking place.

Because Recipient may need to disclose the pendency of the discussions under certain circumstances (e.g., under federal securities laws), Recipient is permitted to disclose information without violating Section 4 based upon the written opinion of its counsel that the disclosure is required by applicable law. Recipient is obligated to consult with Discloser, to the extent reasonably practicable, before making any such disclosure.

5. DISCLOSER CONTACT

All requests by Recipient or Recipient's Representatives for Confidential Information, meetings with Discloser's personnel or Representatives or inspection of Discloser's properties must be made to the Discloser Contact.

COMMENT

The Confidentiality Agreement imposes a procedural "bottleneck" whereby all communications with employees of Discloser must be approved by a designated Representative of Discloser—the Discloser Contact—in advance. This procedure provides an opportunity for any employees to be interviewed to be briefed beforehand by Discloser and its counsel so that no unauthorized disclosures of information will be made.

The Discloser and the Recipient may want to implement mechanisms to catalog, control and monitor the delivery of, and access to, Confidential Information and also to coordinate their efforts to some degree.

6. EXCEPTIONS

All of the foregoing obligations and restrictions do not apply to that part of the Confidential Information that Recipient demonstrates (a) was or becomes generally available to the public prior to, and other than as a result of, a disclosure by Recipient or Recipient's Representatives or (b) was available, or becomes available, to Recipient on a nonconfidential basis prior to its disclosure to Recipient by Discloser or a Discloser's Representative, but only if (i) the source of such information is not bound by a confidentiality agreement with Discloser or is not otherwise prohibited from transmitting the information to Recipient or Recipient's Representatives by a contractual, legal, fiduciary or other obligation and (ii) Recipient provides Discloser with written notice of such prior possession either (A) prior to the execution and delivery of this agreement or (B) if Recipient later becomes aware of (through disclosure to Recipient or otherwise through Recipient's work on the Transaction) any aspect of the Confidential Information of which Recipient had prior possession, promptly upon Recipient becoming aware of such aspect.

COMMENT

There is often an exception for materials independently developed by a Recipient, but it is not included in this Confidentiality Agreement because of the potential for disputes over what was "independently developed."

The requirement that the Recipient demonstrate prior possession shifts the burden of proof to the person claiming to be exempt from the obligations of confidentiality.

In certain instances, the Discloser will include a provision prohibiting the Recipient from competing with the Discloser for a specified period of time because of the difficulty the Discloser might otherwise have in proving that the Recipient did, in fact, use the confidential information in its business. Such a noncompetition provision is generally strongly resisted by prospective buyers who are engaged, or have an interest in engaging, in the same business as the Discloser. Moreover, there may be antitrust risks in such a restriction on competition.

7. LEGAL PROCEEDINGS

If Recipient or any of Recipient's Representatives becomes legally compelled (by oral questions, interrogatories, requests for information or documents, subpoena, civil or criminal investigative demand or similar process) to make any disclosure that is prohibited or otherwise constrained by this agreement, Recipient or such Representative, as the case may be, will provide Discloser with prompt notice of such legal proceedings so that it may seek an appropriate protective order or other appropriate relief or waive compliance with the provisions of this agreement. In the absence of a protective order or Recipient's receiving such a waiver from Discloser, Recipient or its Representative is permitted (with Discloser's cooperation but at Recipient's expense) to disclose that portion (and only that portion) of the Confidential Information that Recipient or the Representative is legally compelled to disclose; provided, however, that Recipient and Recipient's Representatives must use reasonable efforts to obtain reliable assurance that confidential treatment will be accorded by any person to whom any Confidential Information is so disclosed.

COMMENT

A Confidentiality Agreement will not protect Discloser against disclosures of information required by legal proceedings. The Discloser, however, wants to be in a position to object to the disclosure of any information or, at a minimum, that it is able to limit or control the scope of any court-ordered disclosure. The Confidentiality Agreement addresses this concern by requiring Recipient and its Representatives to notify Discloser upon their receipt of any such request for information, which enables Discloser to seek a protective order or other relief.

8. CONTACT WITH EMPLOYEES

Without the prior written consent of the Discloser Contact, neither Recipient nor any of Recipient's Representatives will (a) initiate or cause to be initiated (other than through the Discloser Contact) any communication with any employee of Discloser concerning the Confidential Information or the Transaction or (b) for a period of two years after the date of this agreement, solicit or cause to be solicited the employment of any person who is now employed by Discloser.

COMMENT

The Recipient typically wants to interview employees of the Discloser while in the process of evaluating the acquisition. The Discloser, however, may object because (1) it may prematurely communicate to the Discloser's employees the possibility of a sale of the business and (2) it raises the concern that the Recipient may solicit these employees for employment if the acquisition is not consummated.

Thus, the Confidentiality Agreement requires that Recipient not to solicit any employees of Discloser for a period after the date of the Confidentiality Agreement. The Recipient may argue that this provision should be limited to "key" employees, excluding those not encountered in connection with (or more broadly, not involved with) the proposed acquisition. The Recipient may also insist on being permitted to continue ordinary-course-of-business hiring practices, e.g., help-wanted ads in newspapers and trade publications. A possible solution is to list the "protected" employees or define them to include those persons involved in negotiating the acquisition.

9. RETURN OR DESTRUCTION OF CONFIDENTIAL INFORMATION

If Recipient determines that it does not wish to proceed with the Transaction or if Discloser notifies Recipient that it does not wish Recipient to consider the Transaction any further, then (a) Recipient (i) shall promptly deliver to Discloser Contact all documents or other materials disclosed by Discloser or any Discloser's Representative to Recipient or Recipient's Representatives constituting Confidential Information, together with all copies and summaries thereof in the possession or under the control of Recipient or Recipient's Representatives, and (ii) shall destroy materials generated by Recipient or Recipient's Representatives that include or refer to any part of the Confidential Information, without retaining a copy of any such material or (b) alternatively, if the Discloser Contact requests or gives his prior written consent to Recipient's request, Recipient will destroy all documents or other matters constituting Confidential Information in the possession or under the control of Recipient or Recipient's Representatives. Any such destruction pursuant to the foregoing must be certified by an authorized officer of Recipient in writing to Discloser (and such certification shall include a list of the destroyed materials).

COMMENT

The Recipient will often prefer to destroy materials rather than return them. This is particularly the case because the distinction between Confidential Information disclosed by Discloser and Confidential Information generated by Recipient is often hard to apply in practice. The Recipient's Representatives may well have made notes on the documents they received from the Discloser or incorporated the content of those documents into memoranda and analyses, which are not readily redactable. Accordingly, the Recipient may be unwilling to accept a provision that permits the Discloser to withhold consent to the Recipient's blanket destruction as an alternative to return. The Discloser may be willing to permit blanket destruction but only when the documents disclosed by it that are to be destroyed, rather than returned, are listed. The Recipient may find this unduly burdensome. In addition, the Recipient may want to couple the destruction alternative with a right to retain an archival set of all confidential information with its in-house or outside lawyers.

10. NO OBLIGATION TO NEGOTIATE OR ENTER A TRANSACTION

Discloser reserves the right, in its sole discretion, to reject any and all proposals made by Recipient or Recipient's Representatives with regard to a Transaction and to terminate discussions and negotiations with Recipient and Recipient's Representatives at any time. Neither Recipient nor Discloser shall have rights or obligations of any kind whatsoever with respect to the Transaction by virtue of this agreement other than for the matters specifically agreed to herein. Without limiting the preceding sentences, nothing in this agreement requires either Recipient or Discloser to enter into a Transaction or to negotiate such transaction for any specified period of time.

COMMENT

See *Crane Co. v. Coltec Industries, Inc.*, 171 F.3d 733 (2d Cir. 1999), in which two public companies entered into a confidentiality agreement that contained a provision similar to the second sentence of Section 10 above which was applied as part of the justification for holding that the plaintiff had no contractual right that was violated when the other party entered into a merger agreement with another suitor.

The parties may want to consider provisions that the confidentiality obligations terminate upon the completion of the acquisition and add a separate section to the Confidentiality Agreement stating the survival period of the confidentiality obligations if the acquisition closes or fails to close.

11. NO REPRESENTATIONS OR WARRANTIES

Discloser retains the right to determine, in its sole discretion, what information, properties and personnel it wishes to make available to Recipient, and neither Discloser nor its Representatives make any representation or warranty (express or implied) concerning the completeness or accuracy of the Confidential Information, except pursuant to representations and warranties that may be made in a definitive agreement for the Transaction, if any, between the parties.

COMMENT

Because at the time the parties enter into the Confidentiality Agreement neither the Discloser nor the Recipient knows what information might be of particular interest to the Recipient or whether the discussions will lead to a definitive agreement, the Discloser may seek a disclaimer of any representations or warranties concerning the accuracy or completeness of the Confidential Information. This provision is common.

12. REMEDIES

Recipient agrees to indemnify and hold Discloser and its Shareholders[, and Discloser's Representatives,] harmless from any damages, loss, cost or liability (including legal fees and the cost of enforcing this indemnity) arising out of or resulting from any disclosure by Recipient or Recipient's Representatives of the Confidential Information other than as expressly permitted by this agreement. In addition, because an award of money damages (whether pursuant to the foregoing sentence or otherwise) would be inadequate for any breach of this agreement by Recipient or Recipient's Representatives, and any such breach would cause Discloser irreparable harm, Recipient also agrees that, in the event of any breach or threatened breach of this agreement, Discloser will also be entitled, without the requirement of posting a bond or other security, to equitable relief, including injunctive relief and specific performance. Such remedies will not be the exclusive remedies for any breach of this agreement but will be in addition to all other remedies available at law or equity to Discloser.

COMMENT

The Discloser wants the Recipient to acknowledge its right to injunctive relief in order to facilitate the Discloser's obtaining an injunction if it is the Discloser's best remedy. The Recipient may object to the legal fees provision, and perhaps an intermediate position is to provide that the prevailing party receives its legal fees reimbursed. The Discloser may also want to add the bracketed phrase to include its Representatives among the indemnitees if they are at risk for any of the kinds of matters covered by this section.

13. MISCELLANEOUS

COMMENT

The following miscellaneous provisions are similar to those under Article 13 of the Model Asset Purchase Agreement and are subject to the comments under that Article for discussion of issues and considerations in using these provisions.

(a) *Modification*. This agreement and the agreements set forth in this agreement may be modified or waived only by a separate writing signed by Discloser and Recipient expressly modifying or waiving this agreement orsuch agreements.

(b) *Waiver*. Neither the failure nor any delay by any party in exercising any right, power or privilege under this agreement will operate as a waiver of such right, power or privilege, and no single or partial exercise of any such right, power or privilege will preclude any other or further exercise of such right, power or privilege or the exercise of any other right, power or privilege.

(c) *Person*. The term **"person"** means any individual, corporation (including any nonprofit corporation), general or limited partnership, limited liability company, joint venture, estate, trust, association, organization, labor union or other entity or governmental body.

(d) *Severability*. The invalidity or unenforceability of any provision of this agreement shall not affect the validity or enforceability of any other provisions of this agreement, which shall remain in full force and effect. If any of the covenants or provisions of this agreement are determined to be unenforceable by reason of its extent, duration, scope or otherwise, then the parties contemplate that the court making such determination shall reduce such extent, duration, scope or other provision and enforce them in their reduced form for all purposes contemplated by this agreement.

(e) *Costs*. Recipient agrees that if it is held by any court of competent jurisdiction to be in violation, breach or nonperformance of any of the terms of this agreement, then it will promptly pay to Discloser all costs of such action or suit, including reasonable attorneys' fees.

(f) *Section Headings, Construction*. The headings of Sections in this agreement are provided for convenience only and will not affect its construction or interpretation. All references to **"Section"** or **"Sections"** refer to the corresponding Section or Sections of this agreement unless otherwise specified. All words used in this agreement will be construed to be of such gender or number as the circumstances require. Unless otherwise expressly provided, the word **"including"** does not limit the preceding words or terms.

(g) *Jurisdiction; Service of Process*. Any action or proceeding seeking to enforce any provision of, or based upon any right arising out of, this agreement may be brought against either of the parties in the courts of the State of ______ County of ______, or, if it has or can acquire jurisdiction, in the United States District Court for the ______, District of ______, and each of the parties consents to the jurisdiction of such courts (and of the appropriate appellate courts) in any such action or proceeding and waives any objection to venue laid therein. Process in any action or proceeding referred to in the preceding sentence may be served on any party anywhere in the world.

(h) *Governing Law*. This agreement will be governed by the laws of the State of ______ without regard to conflicts-of-laws principles.

(i) *Execution of Agreement*. This agreement may be executed in one or more counterparts, each of which will be deemed to be an original copy of this agreement, and all of which, when taken together, shall be deemed to constitute one and the same agreement. The exchange of copies of this agreement and of signature pages by facsimile transmission shall constitute effective execution and delivery of this agreement as to the parties and may be used in lieu of the original agreement for all purposes. Signatures of the parties transmitted by facsimile shall be deemed to be their original signatures for any purpose whatsoever.

[consider adding the following, if appropriate]

(j) *Construction*. The parties have participated jointly in the negotiation and drafting of this agreement. If an ambiguity or question of intent or interpretation arises, this agreement shall be construed as if drafted jointly by the parties and no presumption or burden of proof shall arise favoring or disfavoring any party by virtue of the authorship of any of the provisions of this agreement.

If you are in agreement with the foregoing, please sign and return one copy of this agreement, which thereupon will constitute our agreement with respect to its subject matter.

Very truly yours,

[Discloser's Name]

By:_______________
Name:
Its:

DULY EXECUTED and agreed to on _____ _____, 20_____.

[Recipient's Name]

By:_______________
Name:
Its: