# PARTNERSHIP BUSINESS COMBINATIONS: SUCCESSOR LIABILITY AND OTHER ISSUES

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## CURRENT ISSUES AFFECTING Partnerships, Limited Partnerships, and Limited Liability Companies

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Appendix A - Selected Partnership Merger Provisions

Appendix B - Selected Partnership Interest Purchase Agreement

Appendix C - Selected Asset Purchase Agreement Provisions

# PARTNERSHIP BUSINESS COMBINATIONS: SUCCESSOR LIABILITY AND OTHER ISSUES

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Today partnerships, like corporations, can combine with partnerships and other entities by merger, acquisition of partnership interests or asset purchase. Determining which form of transaction is appropriate in a particular situation requires consideration of partnership agreements, state entity statutes, partner fiduciary duties and tax laws. Whether or to what extent the acquiring entity will be responsible for the obligations of its predecessor is a fundamental issue.

There are three basic forms of business combinations available for partnerships:

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

(ii) Partnership interest purchases; and

(iii) Asset purchases.

These forms of business combination and related issues will be analyzed principally (1) as to general partnerships under the Texas Revised Partnership Act (***"TRPA"***)[1] and the Delaware

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[1] Tex. Rev. Civ. Stat. Ann. art. 6132b-1.01 et seq (Vernon Supp. 2002).

Uniform Partnership Act (***"DUPA"***),[2] and (2) as to limited partnerships under the Texas Revised Limited Partnership Act (***"TRLPA"***)[3] and the Delaware Revised Uniform Limited Partnership Act (***"DRULPA"***).[4]

## I. TYPICAL ISSUES IN BUSINESS COMBINATIONS

### A. Elements Common To All Acquisition Agreements

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 partners; 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 partnership 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.

### B. 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

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[2] 6 Del. Code Ann. tit. 6 §§ 1501 et seq. (2002).

[3] Tex. Rev. Civ. Stat. Ann. art. 6132a-1 (Vernon Supp. 2002).

[4] Del. Code Ann. tit. 6 §§ 17-101 et seq. (2002).

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.

C. 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.

D. Fiduciary Duties

1. Basics

Partners in general partnerships and general partners of limited partnerships owe the partnerships and other partner duties which are fiduciary in nature. These duties, which are generally described below, are particularly applicable in the context of partnership business combinations.

2. Fiduciary Duties in General Partnerships

Under TRPA § 4.04, a partner in a general partnership owes the partnership and the other partners duties of loyalty and care, which are fiduciary in nature although not so labeled by TRPA.

The duty of loyalty requires a general partner to place the interests of the partnership at the forefront.[5] It requires a partner to account to the partnership for any partnership asset

[5] *Meinhard v. Salmon*, 249 NY 458, 164 N.E. 545 (1928), Justice Cardozo wrote:

> Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. * * * Only thus has the level of conduct for fiduciaries been kept at a level higher than

received or used by the partner and prohibits a partner from competing with the partnership or dealing with the partnership in an adverse manner. The following fact patterns may evidence a breach of the fiduciary duty of loyalty in the general partnership context on the part of general partners, creating liability to the partnership or the other partners:

- Self-dealing or profiting from dealing with the partnership in ways not contemplated by the partnership agreement;
- Appropriation of partnership opportunities;
- A refusal to distribute profits to other members of the partnership;
- Diversion of an asset of the partnership for a non-intended use; and
- Failure to disclose plans and conflicts to partners, and a general lack of candor with partners.[6]

The degree of care required is to act as an ordinarily prudent person would act under similar circumstances.[7] A partner is presumed to satisfy the duty of care if the partner acts on an informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.[8]

In addition to the duties of loyalty and care, a partner owes his copartners a fiduciary duty of candor, sometimes referred to as a duty of disclosure.[9]

A partner is liable to the partnership and the other partners for violation of a TRPA duty that results in harm to the partnership or the other partners and for a breach of the partnership agreement.[10] TRPA provides that a partner, in that capacity, is not a trustee and is not held to the same standards as a trustee,[11] which represents a change from cases under TUPA.[12] A managing partner stands in a higher fiduciary relationship to other partners than partners usually occupy.[13]

Under TRPA § 1.03 a partnership agreement for a general partnership governs the relations of the partners, but may not (i) unreasonably restrict a partner's statutory rights of

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> that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

6 *See* TRPA § 4.04(b); *Bromberg & Ribstein on Partnership* § 6.07 (1997).

7 TRPA § 4.04(c).

8 TRPA §§ 4.04(c) and (d).

9 *Bromberg & Ribstein on Partnership* §§ 6.05(c) and 6.06 (1997).

10 TRPA § 4.05.

11 TRPA § 4.04(f).

12 *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex.Civ.App.--Austin 1980).

13 *See e.g., Hughes v. St. David's Support Corp.,* 944 S.W.2d 423 (Tex. Civ. App.--Austin 1997); *Conrad v. Judson*, 465 S.W.2d 819, 828 (Tex. Civ. App.--Dallas 1971, writ ref'd n.r.e.); *Huffington v. Upchurch*, 532 S.W.2d 576, 579 (Tex. 1976); *see* also, *Brazosport Bank of Texas v. Oak Park Townhouses*, 837 S.W.2d 652, 659 (Tex.App.--Houston 1992); *Crenshaw v. Swenson*, 611 S.W.2d 886, 890 (Tex.Civ.App.--Austin 1980).

access to books and records, (ii) eliminate the duty of loyalty, although the agreement may within reason identify specific types or categories of activities that do not violate the duty of loyalty, (iii) eliminate the duty of care, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured, (iv) eliminate the obligation of good faith, although the agreement may within reason determine the standards by which the performance of the obligation is to be measured, (v) vary the power to withdraw as a partner, except to require the notice be in writing, or (vi) vary certain other requirements.[14]

3. Fiduciary Duties in Limited Partnerships

Case law has adopted for general partners of limited partnerships[15] the unbending fiduciary standards espoused in general partnership cases.[16] Because of their control over partnership affairs, general partners may be subjected to an even higher fiduciary standard with respect to limited partners.[17] Those in control of the general partner have been held to the same high standards.[18]

Since a general partner in a limited partnership has the powers, duties and liabilities of a partner in a general partnership unless TRLPA or the partnership agreement provides otherwise,[19] a general partner in a limited partnership has the duties of care and loyalty set forth in TRPA § 4.04, which basically codifies those duties without giving them the "fiduciary" appellation. As TRPA provides that a general partner's conduct is not to be measured by trustee standards,[20] it may no longer be appropriate to measure general partner conduct in terms of trustee fiduciary standards. Courts, however, continue to refer to the trustee standard.[21]

TRPA § 4.04(a) states that a partner has the duties of care and loyalty to the partnership and the other partners. TRPA § 4.04(c) defines the duty as requiring a partner to act in the conduct and winding up of the partnership business with the care of an ordinarily prudent person under similar circumstances. An error in judgment does not by itself constitute a breach of the duty of care. Further, a partner is presumed to satisfy the duty of care if the partner acts on an

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14 TRPA § 1.03(b).

15 *See Hughes v. St. David's Support Corp.*, 944 S.W.2d 423 (Tex.App.-Austin 1997, writ denied) ("[I]n a limited partnership, the general partner stands in the same fiduciary capacity to the limited partners as a trustee stands to a trust."); *McLendon v. McLendon*, 862 S.W.2d 662 (Tex.App.-Dallas 1993, writ denied) ("In a limited partnership, the general partner acting in complete control stands in the fiduciary capacity to the limited partners as a trustee stands to the beneficiaries of a trust."); *Crenshaw v. Swenson*, 611 S.W.2d 886 (Tex.Civ.App.-Austin 1980, writ ref'd n.r.e.) (same); *Watson v. Limited Partners of WCKT*, 570 S.W.2d 179 (Tex.Civ.App.-Austin 1978, writ ref'd n.r.e.(same); Hamilton, *Corporate General Partners of Limited Partnerships*, 1 J. of Small and Emerging Bus. L. 73 (Spring 1997).

16 *See Huffington v. Upchurch*, 532 S.W.2d 576 (Tex. 1976; *Johnson v. Peckham*, 132 Tex. 148, 120 S.W.2d 786 (1938); *Kunz v. Huddleston*, 546 S.W.2d 685 (Tex.App.-El Paso 1977, writ ref'd n.r.e.).

17 In *Palmer v. Fuqua*, 641 F.2d 1146, 1155 (5th Cir. 1981), the Fifth Circuit noted that under Texas law a general partner having exclusive power and authority to control and manage the limited partnership "owe[s] the limited partners an even greater duty than is normally imposed [upon general partners]."

18 *See In re Bennett*, 989 F.2d 779 (5th Cir. 1993).

19 TRLPA §§ 4.03(b), 13.03.

20 TRPA § 4.04(f).

21 *See Hughes v. St. David's Support Corp., supra.*

informed basis, in good faith and in a manner the partner reasonably believes to be in the best interest of the partnership.[22] These provisions draw on the corporate business judgment rule in articulating the duty of care. Nevertheless, TRPA does not specify whether the standard of care is one of simple or gross negligence. The sparse case law in this area (pre-dating TRPA) indicates that a partner will not be held liable for mere negligent mismanagement.[23]

In TRPA § 4.04(b), the duty of loyalty is defined as including:

1. accounting to the partnership and holding for it any property, profit, or benefit derived by the partner in the conduct and winding up of the partnership business or from use of partnership property;

2. refraining from dealing with the partnership on behalf of a party having an interest adverse to the partnership; and

3. refraining from competing with the partnership or dealing with the partnership in a manner adverse to the partnership.

These provisions mirror the common areas traditionally encompassed by the duty of loyalty (e.g., self-dealing, conflicts of interest and usurpation of partnership opportunity). To temper some of the broader expressions of partner duties in the pre-TRPA case law and permit a balancing analysis as in the corporate cases, TRPA specifically states that a partner does not breach a duty merely because his conduct furthers his own interest and that the trustee standard should not be used to test general partner conduct.[24] TRPA does, however, impose on a general partner in a limited partnership the obligation to discharge any duty, and exercise any rights or powers, in conducting or winding up partnership business in good faith and in a manner that the partner reasonably believes to be in the best interest of the partnership.[25]

Whether or to what extent <u>limited</u> partners owe fiduciary duties to the partnership or other partners is not settled. A literal reading of TRPA and TRLPA suggests that limited partners have the duties enumerated in TRPA § 4.04 (by virtue of the linkage of TRPA to TRLPA under TRLPA § 13.03). That literal interpretation of the statutes, however, is contrary to the general concept that limited partners are merely passive investors and should not be subjected to liability for their actions as limited partners. There is some case law to the effect that limited partners do not have fiduciary duties.[26] In the case where a limited partner actually has or exercises control in management matters (e.g., because of control of the general partner or contractual veto powers over partnership actions), the limited partner's conduct may be judged by fiduciary principles.[27]

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[22] TRPA § 4.04(c), (d).

[23] *See Ferguson v. Williams*, 670 S.W.2d 327 (Tex.App.-Austin 1984, writ ref'd n.r.e.).

[24] TRPA § 4.04(e), (f).

[25] TRPA § 4.04(d).

[26] *See Villa West Associates v. Kay*, 146 F.3d 798 (10th Cir. 1998); *In re Kids Creek Partners*, 212 B.R. 898 (N.D. Ill. 1997, no pet.).

[27] *See RJ Associates, Inc. v. Health Payors' Organization Ltd. Partnership*, 1999 WL 550350 (Del. Ch. 1999)(certain dicta in this case suggests that, unless a partnership agreement provides to the contrary, any

The duties of a general partner in a limited partnership may be limited by the partnership agreement. TRLPA § 4.03(b) provides:

> . . .Except as provided by this Act *or in the partnership agreement*, a general partner of a limited partnership has the liabilities of a partner in a partnership without limited partners to the partnership and the other partners. [emphasis added]

This language indicates that the partnership agreement may modify the liabilities of a general partner, but it is not clear whether it is an authorization without express limits or would link to the provisions in TRPA § 1.03(b) of TRPA that prohibit elimination of duties and set a "manifestly unreasonable" floor for contractual variation.[28] Delaware also allows the limitation of partner fiduciary duties in the partnership agreement.[29] Although limitations on fiduciary duty in a partnership agreement may be respected by courts when they are expressly set forth in the four corners of the partnership agreement, "a topic as important as this should not be addressed coyly".[30]

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limited partner owes fiduciary duties to the partnership); *KE Property Management v. 275 Madison Management*, 1993 WL 285900 (Dell.Ch.1993).

28 When originally drafted, it was the intent of the Partnership Law Committee of the Business Law Section of the State Bar of Texas that the TRLPA be subject to variation by agreement *only* if expressly permitted by the TRLPA; otherwise, the parties were *not* free to agree to provisions in the partnership agreement that differ from those contained in the TRLPA. Given the subsequent adoption of the TRPA, with its more flexible approach to contractual modifications of the statutory provisions, and the linkage provision contained in Section 13.03 of the TRLPA, there is some question as to whether the more restrictive approach of the TRLPA to contractual modifications continues to have any application. A prudent course would be to draft the partnership agreement as if the flexibility afforded by the TRPA applies, but to be aware that any provisions of the partnership agreement that vary the requirements of the TRLPA without express statutory authority are subject to challenge.

"Partnership agreement" is defined to be either a written *or oral* agreement of the partners concerning the affairs of the partnership and the conduct of its business. *See* TRLPA § 1.02(11).

Some provisions of the TRLPA permit modification by either a written or oral partnership agreement, while others require the modification to be included in a written partnership agreement. *Compare* TRLPA § 4.03(a) concerning restrictions on a general partner *with* § 11.02 concerning indemnification of a general partner.

29 Section 17-1101(d) of DRULPA provides as follows:

> (d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) and liabilities relating thereto to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, (1) any such partner or other person acting under the partnership agreement shall not be liable to the limited partnership or to any such other partner or to any such other person for the partner's or other person's good faith reliance on the provisions of the partnership agreement, and (2) the partner's or other person's duties and liabilities may be expanded or restricted by provisions in the partnership agreement.

30 *Miller v. American Real Estate Partners, L.P.* 2001 WL 1045643 (Del. Ch. September 6, 2001). In *Miller* the general partner contended that the partnership agreement eliminated any default fiduciary duty of loyalty owed by the general partner to the limited partners in § 6.13(d) of the partnership agreement, which reads as follows:

> Whenever in this Agreement the General Partner is permitted or required to make a decision (i) in its "sole discretion" or "discretion", with "absolute discretion" or under a

> grant of similar authority or latitude, the General Partner shall be entitled to consider only such interests and factors as it desires and shall have no duty or obligation to give any consideration to any interest of or factors affecting the Partnership, the Operating Partnership or the Record Holders, or (ii) in its "good faith" or under another express standard, the General Partner shall act under such express standard and shall not be subject to any other or different standards imposed by this Agreement or any other agreement contemplated herein.

In finding that the foregoing provision was not adequate to eliminate the general partner's fiduciary duty of loyalty, Vice Chancellor Strine wrote:

> This is yet another case in which a general partner of a limited partnership contends that the partnership agreement eliminates the applicability of default principles of fiduciary duty, and in which this court finds that the drafters of the agreement did not make their intent to eliminate such duties sufficiently clear to bar a fiduciary duty claim. Here, the drafters of the American Real Estate Partners, L.P. partnership agreement did not clearly restrict the fiduciary duties owed to the partnership by its general partner, a defendant entity wholly owned by defendant Carl Icahn. Indeed, the agreement seems to contemplate that the general partner and its directors could be liable for breach of fiduciary duty to the partnership if they acted in bad faith to advantage themselves at the expense of the partnership.
>
> * * *
>
> Once again, therefore, this court faces a situation where an agreement which does not expressly preclude the application of default principles of fiduciary is argued to do so by implication. Indeed, this case presents the court with an opportunity to address a contractual provision similar to the one it interpreted on two occasions in *Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, and contemporaneously with this case in *Gelfman v. Weeden Investors, L.P.* In each of those cases, this court held that the traditional fiduciary entire fairness standard could not be applied because it was inconsistent with a contractual provision providing a general partner with sole and complete discretion to effect certain actions subject solely to a contract-specific liability standard. The court's decision was based on two factors. First, the court noted the difference between the sole and complete discretion standard articulated in the agreements, which explicitly stated that the general partner had no duty to consider the interests of the partnership or the limited partner in making its decisions, and the traditional notion that a fiduciary acting in a conflict situation has a duty to prove that it acted in a procedurally and substantively fair manner. Second, and even more critically, however, each of the agreements indicated that when the sole and complete discretion standard applied, any other conflicting standards in the agreements, other contracts, or under law (including the DRULPA) were to give way if it would interfere with the general partners' freedom of action under the sole and complete discretion standard. That is, in each case, the agreement expressly stated that default principles of fiduciary duty would be supplanted if they conflicted with the operation of the sole and complete discretion standard.
>
> This case presents a twist on *Gotham Partners* and *Gelfman*. Like the provisions in *Gotham Partners* and *Gelfman*, § 6.13(d) sets forth a sole discretion standard that appears to be quite different from the duty of a fiduciary to act with procedural and substantive fairness in a conflict situation. What is different about § 6.13(d), however, is that it does not expressly state that default provisions of law must give way if they hinder the General Partner's ability to act under the sole discretion standard. Rather, § 6.13(d) merely states that other standards in the Agreement or agreements contemplated by the agreement give way to the sole discretion standard. By its own terms, § 6.13(d) says nothing about default principles of law being subordinated when the sole discretion standard applies.

Under TRPA § 1.03(b), the duties of care and loyalty and the obligation of good faith may not be eliminated by the partnership agreement, but the statute leaves room for some modification by contract. With respect to a partner's duty of care, TRPA provides that the partnership agreement may not eliminate the duty of care but may determine the standards by which the performance of the obligation is to be measure, if the standards are not "manifestly unreasonable."[31] In one case decided prior to the passage of TRPA, the court stated that, when the parties bargain on equal terms, a fiduciary may contract for the limitation of liability, though public policy would preclude limitation of liability for self-dealing, bad faith, intentional adverse acts, and reckless indifference with respect to the interest of the beneficiary.[32]

With respect to a partner's duty of loyalty, TRPA provides that the partnership agreement may not eliminate the duty of loyalty, but may identify specific types or categories of activities that do not violate the duty of loyalty, again if not "manifestly unreasonable."[33] The level of specificity required of provisions in the partnership agreement limiting duties pursuant to TRPA is unknown. In fact, it may depend upon the circumstances, such as the sophistication and relative bargaining power of the parties, the scope of the activities of the partnership, etc.

TRPA provides that the obligation of good faith may not be eliminated by the partnership agreement, but the agreement may determine the standards by which the performance is to be measured if not "manifestly unreasonable."[34] Again the parameters of this provision are not readily apparent and probably will depend, at least in part, on the circumstances of any particular case. TRLPA § 1.07 provides that a limited partnership shall keep in its registered office, and make available to the partners for copying and inspection, certain minimum books and records of the partnership. This provision provides a statutory mechanism by which a partner may obtain the documents specified therein, but should not be viewed as in any way limiting a general

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* * *

> This court has made clear that it will not be tempted by the piteous pleas of limited partners who are seeking to escape the consequences of their own decisions to become investors in a partnership whose general partner has clearly exempted itself from traditional fiduciary duties. The DRULPA puts investors on notice that fiduciary duties may be altered by partnership agreements, and therefore that investors should be careful to read partnership agreements before buying units. In large measure, the DRULPA reflects the doctrine of *caveat emptor*, as is fitting given that investors in limited partnerships have countless other investment opportunities available to them that involve less risk and/or more legal protection. For example, any investor who wishes to retain the protection of traditional fiduciary duties can always invest in corporate stock.
>
> But just as investors must use due care, so must the drafter of a partnership agreement who wishes to supplant the operation of traditional fiduciary duties. In view of the great freedom afforded to such drafters and the reality that most publicly traded limited partnerships are governed by agreements drafted exclusively by the original general partner, it is fair to expect that restrictions on fiduciary duties be set forth clearly and unambiguously. A topic as important as this should not be addressed coyly.

[31] TRPA § 1.03(a)(3).

[32] *Grider v. Boston Co., Inc.*, 773 S.W.2d 338, 343 (Tex.App.-Dallas 1989, writ denied).

[33] TRPA § 1.03(a)(2).

[34] TRPA § 1.03(a)(4).

partner's broader fiduciary duty of candor regarding partnership affairs as developed in case law and as provided in TRPA § 4.03, which should apply to limited partnerships.

## II. PARTNERSHIP MERGERS

### A. Introduction

Partnership mergers involve a vote of partners, resulting in the merging or disappearance of one partnership entity into or with another entity.

When starting to work on a partnership merger a number of questions over and above the normal merger questions should be asked.

> First, how is the liability of the ongoing partners and limited partners (if any) for the debts and obligations of the disappearing partnership going to fall out?
>
> Second, how will the incoming partners to the surviving partnership be treated as far as the creditors of the surviving partnership are concerned?
>
> Third, if the disappearing entity is a limited liability company (***"LLC"***) or corporation and the surviving entity is a partnership, how will the incoming partners be treated in so far as the creditors of the corporation are concerned and in so far as the creditors of the surviving partnership are concerned?
>
> Fourth, if the disappearing entity is a partnership and the surviving entity is an LLC or corporation, how will the incoming shareholders be treated in so far as the creditors of the disappearing partnership are concerned?
>
> Fifth, if the disappearing entity is a registered limited liability partnership (***"LLP"***)[35] and the surviving entity is an LLC or corporation, how will the incoming shareholders be treated in so far as the creditors of the disappearing LLP are concerned?
>
> Sixth, if the merging entities are both LLPs, is the treatment any different for the partners of the disappearing LLP than in a regular partnership and is the treatment any different for the incoming partners in the surviving LLP? Are there any special considerations that need to be examined when merging LLPs?
>
> Seventh, if the merger is being used to divide the partnership or partnerships into a number of new partnerships and other entities, the question of how are the liabilities going to be divided and how are the assets going to be

[35] An LLP is a species of general partnership in which the liability of partners for both contract and tort liabilities can be substantially limited if the statutory requirements as to name, insurance and statutory filings are satisfied. See TRPA § 3.08 and DUPA § 1515. A "LLLP" is a limited partnership which has made the statutory election to become an LLP. See TRPA § 3.08(e) and TRLPA § 2.14.

divided is important. Watch out for the language of the statute with respect to "adequate provision."

**Appendix A** sets forth certain operative provisions from a limited partnership agreement and plan of merger.

B. Limited Partnerships

1. Basics

(1) TRLPA § 2.11 provides the basic structure for the merger of a limited partnership with any other type of entity.[36]

(2) Note the special requirement that the partnership agreement of each domestic limited partnership must contain a provision permitting the merger – the statutory language – "the partnership agreement of each domestic *** partnership contains provisions that authorize the merger provided for in the plan *** adopted by the *** partnership." We interpret this to be a must provision that does not have a waiver provided for.

(3) Each domestic partnership must approve as provided for in the partnership agreement. Again the statute does not provide a default provision that will save the day if not provided for in the partnership agreement.

(4) The merger with a foreign limited partnership must be permitted either by the laws under which such foreign limited partnership is formed or organized or by the partnership agreement or other constituent documents of the foreign limited partnership that are not inconsistent with such laws. This provisions is straight forward enough if the laws of the other jurisdiction provide for a merger. However, note that the Texas statute contains a provision which will permit a merger with a foreign limited partnership if it is provided for in the foreign limited partnership agreement and is "not inconsistent with such laws" [meaning the laws of the other jurisdiction]. Extraterritorial effect may be given to our laws. So far as can be

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[36] "(a) A domestic limited partnership may adopt a plan of merger and one or more domestic limited partnerships may merge with one or more domestic or foreign limited partnerships or other entities if:

(1) the partnership agreement of each domestic limited partnership that is a party to the plan of merger contains provisions that authorize the merger provided for in the plan of merger adopted by the limited partnership;

(2) each domestic limited partnership that is a party to the plan of merger approves the plan of merger in the manner prescribed in the its partnership agreement;

(3) if one or more foreign limited partner or other entities is a party to the merger or is to be created by the terms of the plan of merger, (i) the merger is permitted either by the laws under which each foreign limited partnership and each other entity that is a party to the merger is formed or organized or by the partnership agreement or other constituent documents of the foreign limited partnership or other entity that are not inconsistent with such laws, and (ii) each foreign limited partnership or other entity that is a party to the merger complies with such laws or documents in effecting the merger;

(4) no limited partner of a domestic limited partnership that is a party to the merger will, as a result of such merger, become personally liable for the liabilities or obligations of any other person or entity unless such limited partner consents to becoming personally liable by action taken in connection with the specific plan of merger approved by such domestic limited partnership.

found, this has never been tried but should work on a theoretical basis. The problem will be that the Secretary of State of the foreign jurisdiction may not be willing to file the articles of merger because there is no specific authority to do so. The question then becomes whether there can be an effective merger with a one-sided filing.

(5) TRLPA § 2.11(g)(9) very clearly deals with the liability of the limited partners by providing that no limited partner of a domestic limited partnership will as a result of the merger become personally liable for the obligations of any other person or entity unless consented to. This provision has not been tested, but it should hold up because it follows public policy. However, if a limited partnership is merging into a general partnership, what happens if nothing is said in the merger documents about becoming personally liable for the obligations of the ongoing entity: do the limited partners who become general partners thereupon become liable for the ongoing obligations of the surviving entity. The closest analogy is partner who is admitted to a general partnership at a date after its formation and is personally liable only to the extent of the partnership assets for past partnership obligations.[37] As to new obligations of the general partnership, the newly admitted partner will have joint and several liability for all new obligations.[38] This puts TRLPA § 2.11(g)(9) in direct conflict with TRPA §§ 3.04 and 3.07. It would appear that, as a practical matter, the new general partner will not have personal liability for existing liabilities, but whether the new general partner will have a right of indemnification for the value of partnership assets lost to satisfy past partnership obligations is not clear.

(6) Note that a new entity or new entities may be created by the merger. TRPA is not clear that the creation of a new entity must be permitted by the laws permitting the mergers of the constituent entities or is it enough if such laws permit the mergers and then the partnership agreements permit the creation of the new entity. This creation of a new entity appears to permit a divisive merger.

2. The Plan of Merger[39]

(1) TRLPA § 2.11(b) provides the essentials that the plan of merger must set forth:

(a) The name and domicile of each of the entities to the merger and the name of the party or parties that are to survive the merger. In addition, if a new entity or entities are to be created by the merger, then the name and state of domicile of the new entity. [40]

(b) The manner and basis of allocating and vesting the real estate and other property of the partnerships or other entities and the manner and basis of allocating all liabilities and obligations of the parties to the merger. It should be noted that the statute provides that were there is more than one surviving entity then with respect to the allocation of liabilities and obligations the parties must

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37 TRPA §§ 3.07, 9.01(b) and (c).

38 TRPA §§ 3.04 and 3.07.

39 TRLPA § 2.11 (b).

40 TRLPA § 2.11 (b)(1).

also set forth those provisions for "making adequate provision for the payment and discharge thereof."[41]

(c) The manner and basis of converting any of the ownership interests of a each party to the merger into partnership interests, shares, obligations, evidences of ownership, rights to purchase securities or other securities or one or more of the surviving or new partnerships or other entities, into cash or other property including shares, obligations, evidences of ownership, rights to purchase securities or other securities of any other person or entity or into any combination of the forgoing. The flexibility is unlimited as to the type of consideration and the structure of the consideration. [42]

Can you provide for the same type of interests to receive different type of consideration? How does fairness play in the equation. TRPA is not clear that all parties having the same interest have to be treated the same. Assuming the accuracy of that statement, then does the question become one of breach of duty.

(d) The formation documents for the new entity to be formed as a result of the merger. [43]

(e) The plan may set forth any of the following:[44]

1. amendments to existing organizational documents

2. any other provisions relating to the merger.

3. The Certificate of Merger[45]

(1) After approval of the plan, a certificate of merger is to be executed by at least one general partner for each domestic limited partnership and by the agent, officer or general partner for each other person to the plan.

(2) The Certificate of Merger is to contain the plan of merger or a statement certifying the following 7 items:[46]

(a) the name and state of formation of each party to the merger and the organizational form of each new or surviving entity;

(b) that a plan has been approved;

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[41] TRLPA § 2.11 (b)(2).

[42] TRLPA § 2.11 (b)(3).

[43] TRLPA § 2.11 (b)(4).

[44] TRLPA § 2.11 (c).

[45] TRLPA § 2.11 (d).

[46] TRLPA § 2.11 (d)(1).

(c) any amendments or changes to the organizational documents or a statement that no amendments were affected by the merger;

(d) the certificate of formation for each domestic limited partnership formed by the merger;

(e) a statement to the effect that an executed plan of merger is on file at the principal place of business of each surviving or new domestic or foreign limited partnership or other entity, stating the address;

(f) a statement that a copy or summary of the plan of merger has been or is being furnished to each partner in each domestic limited partnership that is a party to the merger at least 20 days before the merger is effective unless waived by the partner, or a statement that the domestic partnership has complied with the provisions of its partnership agreement regarding furnishing partners copies or summaries of the plan of merger or notices regarding the merger;

(g) if there are multiple surviving domestic or foreign partnerships or the entities, a statement that a copy of the plan of merger will be furnished by each new or surviving entity, on written request and without cost, to any creditor or obligee of the parties to the merger at the time of the merger if the obligation is then outstanding;

(3) As to each party, a statement that the plan of merger was duly authorized by all action required by the laws under which it was formed or organized and by its constituent documents.[47]

4. Filing[48]

(1) The original of the certificate of merger shall be delivered to the Secretary of State. An additional copy of the certificate of merger for each surviving or new entity shall also be delivered to the Secretary of State. [49]

(2) Rather than pay franchise taxes and fees, one of the new or surviving entities may represent that it will be responsible for the payment of the franchise taxes and fees.[50]

(3) If the Secretary of State finds that the certificate conforms to law and on receipt of all applicable filing fees and franchise taxes, it will endorse on the original Certificate of Merger filed and the date of filing. Upon receipt of the filed Certificate of Merger it will file and index the endorsed certificate and return the copy to each surviving or new domestic or foreign entity.[51]

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[47] TRLPA § 2.11 (d)(2).

[48] TRLPA § 2.11 (e).

[49] TRLPA § 2.11 (e).

[50] TRLPA § 2.11 (e).

[51] TRLPA § 2.11 (e).

(4) The merger is effective upon the issuance of the certificate of merger.[52]

5. Effect of Merger[53]

(1) When the merger takes effect nine events automatically take place, as follows.

(a) the separate existence of each merging entity ceases except for new entities and surviving entities;[54]

(b) all rights, title and interests in all real estate and other property shall be allocated to and vested in one or more of the surviving or resulting entities as provided in the plan without reversion or impairment, without further act or deed and without any transfer or assignment having occurred but subject to existing liens;[55]

(c) all liabilities and obligations shall be allocated to one or more of the surviving or new entities in the manner set forth in the plan, and each entity to which a liability has been allocated pursuant to the plan shall be the primary obligor and except as set forth in the plan or as otherwise provided by law or contract, no other party to the merger, other then the surviving or other entity liable thereon at the time of the merger and no other new entity created thereby shall be liable therefore;[56]

(d) any litigation may proceed against the original entity as if the merger did not occur or against the surviving or new entity to which the liability, obligation, asset or right associated with such proceeding is allocated to and vested in pursuant to the plan of merger may be substituted in the proceeding;[57]

(e) certificate of limited partnership of each surviving domestic limited partnership shall be amended to the extent provided in the plan;[58]

(f) each new entity shall be formed upon the filing;[59]

(g) the interests of each domestic or foreign entity that are to be converted or exchanged into such rights, interests, obligations, cash etc. shall be

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52 TRLPA § 2.11 (f).

53 TRLPA § 2.11 (g).

54 TRLPA § 2.11 (g)(1).

55 TRLPA § 2.11 (g)(2).

56 TRLPA § 2.11 (g)(3).

57 TRLPA § 2.11 (g)(4).

58 TRLPA § 2.11 (g)(5).

59 TRLPA § 2.11 (g)(6).

converted as provided in the plan of merger and the participants shall only be entitled to those items provided in the plan;[60]

(h) if the plan does not provided for the allocation and vesting of the right, title and interest in any particular item of real estate or other property or for the allocation of any liability or obligation of any party to the merger, such item shall be owned in undivided interest by, or such liability and obligation of, each of the surviving and new entities, pro rata to the total number of surviving and new domestic and foreign entities resulting from the merger;[61]

(i) a limited partner does not become personally liable as a result of the merger for a liability or obligation of another person that is a party to the merger unless the party consents to becoming personally liable by action taken in connection with the specific plan approved by the partner becoming liable. For purposes of determining the liability of partners in a domestic limited partnership that is a party to the merger for the obligations of other parties to the merger in which that partner otherwise was not or is not a partner or other owner of an interest:

(i) a partner who remains or enters a limited partner ship or other entity that survives or that enters a limited partnership or other entity created by the plan shall be treated as an incoming partner in the new or surviving partnership as of the effective date of the merger for the purpose of determining the partner's liability for a debt or obligation of the other partnership or other entities that are parties to the merger and in which the partner was not associated; and

(ii) a partner in a domestic partnership that does not survive shall be treated as a partner who withdrew from the nonsurviving domestic partnership as of the effective date.[62]

(j) "other entity" means any entity, whether organized for profit or not, that is a corporation, limited partnership (other than domestic or foreign limited partnership), general partnership, joint venture, joint stock company, cooperative, association, bank, insurance company, or other legal entity organized pursuant to the laws of this state or any other state or country to the extent such laws or the constituent documents of that entity, not inconsistent with such laws, permit that entity to enter into a merger or partnership interest exchange as permitted by this section.[63]

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60 TRLPA § 2.11 (g)(7).

61 TRLPA § 2.11 (g)(8).

62 TRLPA § 2.11 (g)(9).

63 TRLPA § 2.11(j).

## C. General Partnerships

### 1. Basics[64]

(1) Adoption of plan of merger for a general partnership is the same as for a limited partnership except for one question as to the meaning of TRPA § 9.02(a)(3) in which it appears that the word "if" was left out so that it appears that you have to have a foreign partnership or other entity as a party to the transaction. Practitioners have ignored that drafting glitch for years.

(2) The limitations on dealing with the limitation on liability of a limited partner are not contained in TRPA § 9.03, the drafters believing that there was no need to have such a provision since all partners are jointly and severally liable.

(a) However, when engaging in a merger of LLP's such a provision would give some comfort, but since the statute is clear as to the non-liability of partners in an LLP, there is no reason to believe that if a partner was not liable before the merger, the partner should be liable after a merger.

(b) If a merger is creating a new LLP out of several LLPs that are merging, care should be taken to have the LLP formed before the merger so that at least under Texas law the LLP shield will be in place.

(3) The contents of the plan of merger for a general partnership are essentially the same as for a limited partnership. In TRPA § 9.01 there is no provision for the amendment of the certificate of limited partnership.

(a) Important: Note that if there are only general partnerships party to the merger, the effective date and time of the merger must be specified in the plan of merger because no filing is required with the Secretary of State.

(3) The certificate of merger provisions are essentially the same as for the limited partnership with a major exception. It there are only general partnerships to the merger no certificate of merger needs to be executed.

(4) The effective date of the merger is the same as for a limited partnership, except in the case of the merger of only general partnerships. Since no certificate of merger needs to be filed the plan of merger is the document that determines the effective date of the merger.

(5) The effect of the merger is essentially the same as in the limited partnership provisions including the provision regarding the liability of an incoming partner.[65] Specifically TRPA § 9.02(g)(9) provides at subparagraph (A):

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[64] TRLPA § 9.02.

[65] TRLPA § 9.02(g)(9).

(A) a partner who remains in or enters a domestic or foreign partnership or other entity that survives a merger or that enters a domestic or foreign partnership or other entity created by the terms of the plan of merger shall be treated as an incoming partner in the new or surviving partnership as of the effective date of the merger; and

(B) a partner in a partner in a domestic partnership that is a party to the merger but that does not survive shall be treated as a partner who withdrew from the nonsurviving domestic partnership as of the effective date of the merger.

The language of the subparagraph (9)(A) quoted above appears to say that all partners who remain in the surviving general partnership will have liability for the ongoing debts and liabilities of the partnership as though they were incoming partners. This comment is based on the language "a partner who remains in *** partnership *** that survives a merger *** shall be treated as an incoming partner in the *** surviving partnership as of the effective date of the merger." From the view point of the existing partnership this appears to change the liability relationship of the partners to the creditors without the consent of the creditors. One wonders if a bankruptcy court will agree with the statutory language. However this language does the solve the issue of the liability partners of merging LLPs.

## III. ACQUISITIONS OF PARTNERSHIP INTERESTS

In a voluntary purchase of partnership interests, the acquiring person must generally negotiate with each selling partner individually. An exception to this is a mechanism known as the "interests exchange" permitted by certain state business partnership statutes under which the vote of holders of a requisite percentage of partnership interests can bind all of the partners to exchange their interests pursuant to the plan of exchange approved by such vote.[66]

**Appendix B** sets forth some operative provisions from a partnership interest purchase agreement.

### A. Interest Exchanges

The interest exchange provisions in both the TRPA and the TRLPA are similar to each other and are based on the interest exchange provisions contained in the TBCA.[67] Generally speaking, the TRPA and TRLPA provisions provide that one or more domestic or foreign partnerships may adopt a plan of exchange by which a domestic or foreign partnership or other entity acquires all of the outstanding partnership interests of one or more domestic partnerships in exchange for cash or securities of the acquiring domestic or foreign partnership or other entity.[68] This right is conditioned on the following:

(i) The partnership agreement of each domestic partnership whose partnership interests are to be acquired pursuant to the plan of exchange

66 TRLPA § 2.11(h) and TRPA § 9.03.

67 TBCA § 5.02.

68 TRLPA § 2.11(h); TRPA § 9.03(a).

authorizes the partnership interest exchange adopted by partnership. Further, if one or more foreign partnerships or other entities is to issue shares or other interests as part of the plan of exchange, the issuance of those shares or other interests must be either permitted by the laws under which that foreign partnership or other entity is formed or must not be inconsistent with those laws.[69]

(ii) Each domestic or foreign partnership whose interests are to be acquired approves the plan of exchange in the manner prescribed in the partnership agreement.[70]

(iii) Each acquiring domestic or foreign partnership or other entity takes all action that may be required by the laws of the state under which is was formed or incorporated and as required by its partnership agreement or other constituent documents in order to effect the exchange.[71]

No filing with the Texas secretary of state is necessary to evidence or effect an interest exchange for a domestic partnership that is a party to the interest exchange.[72] Upon the effectiveness of an interest exchange as provided in the plan of exchange, the partnership interest of each domestic partnership that is to be acquired is considered exchanged as provided in the plan.[73] The former holders of the partnership interests under the plan are entitled only to the exchange rights provided in the plan.[74] Conversely, the acquiring domestic or foreign partnership or other entity is entitled to all rights, title and interest with respect to the partnership interests so exchanged, subject to the terms of the plan.[75] For the foregoing purposes, an "other entity" includes any entity, whether organized for profit or not, that is a corporation, partnership, joint venture, joint stock company, cooperative, association, bank, insurance company or other legal entity to the extent that the laws of its formation or its constituent documents (not inconsistent with such laws) permit that entity to enter into a partnership interest exchange.[76]

B. Interest Purchases

A key difference between the acquisition of (x) interests in a general partnership or interests as a general partner in a limited partnership (***"GP Interests"***), on the one hand, and (y) shares of stock in a corporation or membership interests in a limited liability company, on the other hand, is that the partnership interests have attributable to them joint and several liability for the partnership's obligations (unlike stock or membership interests, the ownership of which does not render the holder personally liable for entity obligations).[77] Thus, careful consideration

69 TRLPA § 2.11(h)(1); TRPA § 9.03(a)(1).

70 TRLPA § 2.11(h)(2); TRPA § 9.03(a)(2).

71 TRLPA § 2.11(h)(3); TRPA § 9.03(a)(3).

72 TRLPA § 2.11(h)(3); TRPA § 9.03(b).

73 TRLPA § 2.11(h)(3); TRPA § 9.03(b)(1).

74 TRLPA § 2.11(h)(3); TRPA § 9.03(b)(2).

75 TRLPA § 2.11(h)(3); TRPA § 9.03(b)(3).

76 TRLPA § 2.11(i); TRPA § 9.03(c).

77 TRPA § 3.04.

needs to give by both the seller and buyer of GP Interests as to the treatment of liabilities. In general, in connection with a sale of a GP Interest:

(i) Absent an assumption by buyer of pre-closing liabilities attributable to the GP Interest (***"pre-closing liabilities"***), seller will retain personal liability for such liabilities. Buyer's liability for pre-closing liabilities will be limited to its interest in the partnership.[78]

(ii) Even if buyer assumes seller's pre-closing liabilities, seller will nonetheless retain liability therefore absent a release from the subject creditors.[79]

(iii) Buyer will have personal liability for liabilities attributable to the GP Interest arising after the closing.

In consideration of the foregoing, potentially difficult questions can arise as to whether a partnership liability falls into the pre-closing or post-closing category. For example, if an action giving rise to a lawsuit occurs prior to the sale but the lawsuit is not brought until after the sale, is the underlying liability a pre-closing or post-closing liability? Similarly, if a contract is entered into by a partnership prior to the closing but a default thereunder occurs after the closing, is the obligation for such default a pre-closing or post-closing liability. TRPA §3.07 provides guidance in that it states that a person admitted as a partner into an existing partnership does not have personal liability for an obligation of the partnership that (i) arose before the partner's admission to the partnership, (ii) relates to an action taken or omissions occurring before the partner's admission to the partnership or (iii) arises before or after the partner's admission under a contract or commitment entered into before the partner's admission to the partnership.[80] Obviously the most prudent course seller and buyer can take in this context is to sort through the various liabilities, commitments and obligations of the partnership (contingent or otherwise) and determine in writing their respective responsibilities therefore, keeping in mind that such determination will not be binding on a third party absent the agreement of such third party.

The foregoing discussion has focused on the acquisition by a buyer of all a partnership's interests. More often than not, however, a purchase and sale involves the sale by one or more, but not all, partners' interests in a partnership. If the acquisition is of a GP Interest, the foregoing discussion is applicable in the context of the liabilities attributable to such interest. If the acquisition is of a limited partner interest (a ***"LP Interest"***), there is generally less concern about third party liability issues since the owner of a LP Interest, unlike the owner of a GP Interest, does not have personal liability for limited partnership obligations.[81] As discussed more particularly below, a major concern that a buyer of a LP Interest will have from a liability standpoint is whether the transferor has satisfied its agreed upon capital commitment to the limited partnership to date and is otherwise in compliance with its material agreements under the limited partnership agreement. Further, a buyer of a LP Interest may also be interested in determining whether the seller has received any wrongful distributions from the limited

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[78] TRPA § 3.07.

[79] TRPA § 7.03(a).

[80] TRPA § 3.07.

[81] TRLPA § 3.03.

partnership (in general, a distribution that causes the liabilities of the limited partnership to exceed the fair value of its assets), in that a limited partner may have an obligation to return such distributions to the partnership under the TRLPA or other applicable law.[82]

In the context of a purchase and sale of one or more, but not all partners' interests in a partnership, consideration needs to be given to the applicable assignment and substitution provisions of the partnership statute or subject partnership agreement. In general, under the applicable partnership statutes:

> (i) A partnership interest is freely assignable, but an assignee is only entitled to the profits, losses and distributions attributable to the interest so assigned; unless the assignee becomes a partner, the assignor continues to be a partner, retains all powers as a partner and continues to be responsible for all capital commitments attributable to its interest.[83]
>
> (ii) An assignee has no liability as a partner solely as a result of an assignment.[84]
>
> (iii) An assignee may become a substituted partner if, and to the extent, that the partnership agreement so provides or all partners consent.[85]

Under the TRLPA, unless otherwise provided by a written partnership agreement, an assignee who becomes a limited partner also is liable for the obligations of the assignor to make its agreed upon capital contributions to the partnership, but is not obligated for liabilities unknown to the assignee at the time the assignee became a limited partner and which could not be ascertained from a written partnership agreement. The TRLPA also provides that an assignee is not liable for the obligations of the assignor under the provisions of the TRLPA governing wrongful distributions.[86]

Under the TRPA, even if an assignee is substituted in place of an assignor as a partner, the assignor is not necessarily released by the partnership for obligations owed by assignor to the partnership as a partner. Thus, careful consideration should be given by all parties (assignor, assignee and the partnership) as to what the responsibilities and obligations of assignor and assignee will have with respect to the GP Interest so transferred.

## C. Transferability of Partnership Interests

### 1. GP Interests

A GP Interest is transferable by a partner, but a partner's right to participate in the management of the partnership may not be assigned without the consent of the other partners.[87]

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[82] TRLPA § 6..07.

[83] TRLPA § 7.02(a)(3); TRPA § 5.03(b).

[84] TRLPA § 7.02(b); TRPA § 5.03(b).

[85] TRLPA § 7.04(a); TRPA § 4.01(g).

[86] TRLPA § 7.04(b).

[87] *See* TRPA § 5.03.

TRPA and partnership law in general differentiate between a transfer of a partner's GP Interest and the admission of a successor as a general partner. A transferee is neither able to participate in management nor liable as a partner solely because of a transfer unless and until he becomes a partner, but is entitled to receive, to the extent transferred, distributions to which the transferor would otherwise be entitled.[88] A transfer of a GP Interest is not considered an event of withdrawal and will therefore not by itself cause the winding up of the partnership business. The partnership agreement will often contain a provision prohibiting a partner from assigning even his economic rights associated with the partnership interest. Unless otherwise specified by the partnership agreement, all of the partners must consent to the substitution of the new partner. Under TRPA § 5.02, GP Interests may be evidenced by transferable certificates, but ordinarily there is no certificate issued to evidence general partnership interests.

2. LP Interests

Unless otherwise provided by the limited partnership agreement, an LP Interest is assignable in whole or in part and will not dissolve a limited partnership.[89] The assignment of an LP Interest will not, however, entitle the assignee to become, or to exercise the rights or powers of, a partner unless the partnership agreement provides otherwise.[90] Instead, the assignment will entitle the assignee to be allocated income, gain, loss, deductions, credits or similar items and to receive distributions to which the assignor was entitled. Under TRLPA § 7.02(a)(4), if a general partner assigns all of his or her rights as a general partner, a majority in interest of the limited partners may terminate the assigning general partner's status as a general partner. Until an assignee of a partnership interest becomes a partner, the assignee has no liability as a partner solely by reason of the assignment.

D. Securities Laws

Under the Securities Act of 1933, as amended (the ***"1933 Act"***) and the Securities Exchange Act of 1934 (and under most state blue sky laws), the term "security" is defined to include "investment contract." Neither federal securities act defines a partnership interest, whether general or limited, as a "security." However, by overwhelming precedent, limited partnership interests are investment contracts for purposes of securities laws. The question whether a general partnership interest is a security requires a case by case analysis. A general partner interest may be a security when the venture, though a general partnership de jure, functions de facto as a limited partnership (i.e. certain partners do not actively participate in management and rely primarily on the efforts of others to produce profits). In *Williamson v. Tucker*,[91] the court stated that a general partnership or joint venture interest may be categorized a security if the investor can show that

> (i) an agreement among the parties leaves so little power in the hands of the partner or venturer that the arrangement in fact distributes power as would a limited partnership; or (ii) the partner or venturer is so inexperienced and

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88 *See* TRPA §§ 5.02, 5.03 and 5.04.

89 TRPA § 7.02.

90 TRPA § 7.02(a)(4).

91 645 F.2d 404, 424 (5th Cir. 1981) *cert. denied*, 454 U.S. 897 (1981).

> unknowledgeable in business affairs that he is incapable of intelligently exercising his partnership or venture powers; or (iii) the partner or venturer is so dependent on some unique entrepreneurial or managerial ability of the promoter or manager that he cannot replace the manager of the enterprise or otherwise exercise meaningful partnership or venture powers.[92]

While quoting from the *Williamson* case, the *Rivanna* court stated further that when a "partnership agreement allocates powers to the general partners that are specific and unambiguous, and when those powers are sufficient to allow the general partners to exercise ultimate control, as a majority, over the partnership and its business, then the presumption that the general partnership is not a security can only be rebutted by evidence that it is not possible for the partners to exercise those powers" and the fact that some of the general partners may have remained passive or lacked financial sophistication or business expertise does not affect the result. The general rule is that no security is involved when a typical general partnership agreement is used.

The offer and sale of an interest that is a security must either be registered under applicable federal and state securities laws[93] or effected in a private[94] or other transaction

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92 *But cf.*, *Rivanna Trawlers Unlimited v. Thompson Trawlers, Inc.*, 840 F.2d 236 (4th Cir. 1988).

93 Section 5 of the 1933 Act provides that a registration statement must be in effect as to a non-exempt security before any means of transportation or communication in interstate commerce or of the mails may be used for the purpose of sale or delivery of such non-exempt security. The primary purpose of the 1933 Act is to provide a full disclosure of material information concerning public offerings of securities to investors. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 195 (1976). The registration statement is the primary means for satisfying the full disclosure requirement. The 1933 Act (particularly §§ 5-7 and Schedule A) and Regulations C and S-K thereunder contain the general registration requirements. The Securities and Exchange Commission ("SEC") has set forth a number of registration forms to be used under varying circumstances. Form S-1 is the basic form to be used by an issuer unless another form is specifically prescribed. There are basically three stages in the registration process: the pre-filing stage, the waiting period, and the post-effective stage. During the pre-filing stage, § 5(c) of the 1933 Act prohibits the use of interstate facilities (including telephones) or the mails to "offer to sell." Further, § 5(a) prohibits sales or deliveries at any time before the "effective" date of the registration statement, which includes the pre-filing stage. The term sale is defined to include "every contract of sale or disposition of a security or interest in a security, for value." During the waiting period, written offers are still prohibited, but oral offers are permitted. Since the registration statement is still not "effective," sales or deliveries are still forbidden. During the post-effective stage, sales may be made freely. A prospectus satisfying the requirements under the 1933 Act must accompany any interstate or mailed "delivery" of the security if the prospectus has not preceded the delivery. *See generally*, L. Loss, *Fundamentals of Securities Regulation 93-94* (1983). Unlike the federal statute that seeks full disclosure, many of the state "blue sky" acts are based on a concept known as "merit regulation." Under these systems, the state securities administrator can prohibit a particular security from being offered in that state if the administrator determines that the terms of the offering are not "fair, just and equitable." Most state acts do not define "fair, just and equitable." In the Blue Sky Cases the United States Supreme Court validated a number of state acts regulating securities on the basis that the acts neither violated the Fourteenth Amendment nor unduly burdened interstate commerce. *See Hall v. Geiger - Jones Co.*, 242 U.S. 539 (1917); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917); *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917).

94 Section 4(2) of the 1933 Act exempts from the registration requirements of the 1933 Act "transactions by an issuer not involving any public offering" -- generally referred to as "private placements." The U.S. Supreme Court has held that the § 4(2) exemption must be interpreted in light of the statutory purpose of the 1933 Act to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions" and that its applicability "should turn on whether the particular class affected need the protection of the Act." *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953). Subsequent court opinions have

enumerated a number of more specific factors to be considered in determining whether a transaction involves a "public offering," including the following:

> (a) the number of offerees (there is no number of offerees that always makes an offering either private or public; 25 to 35 is generally considered consistent with a private offering, but the sophistication of the offerees is more important; an offer to a single unqualified investor can defeat the exemption and an offering to a few hundred institutional investors can be exempt; note that the judicial focus is upon the number of persons to whom the securities are offered, not the number of actual purchasers);
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> (b) offeree qualification (each offeree should be sophisticated and able to bear the economic risk of the investment; a close personal, family or employment relationship should also qualify an offeree);
>
> (c) manner of offering (the offer should be communicated directly to the prospective investors without the use of public advertising or solicitation);
>
> (d) availability of information (each investor should be provided or otherwise have access to information comparable to that contained in a registration statement filed under the 1933 Act; commonly investors are furnished a "private offering memorandum" describing the issuer and the proposed transaction in at least as much detail as would be found in a registration statement filed with the SEC for a public offering registered under the 1933 Act); and
>
> (e) absence of redistribution (the securities must come to rest in the hands of qualified purchasers and not be redistributed to the public; securities sold in a private placement generally may be replaced privately, freely sold by a person who is not an affiliate of the issuer in limited quantities to the public pursuant to SEC Rule 144, 17 C.F.R. 230.144 (1999), after a one-year holding period (if the issuer files reports with the SEC, the securities may be sold in limited quantities to the public pursuant to Rule 144 after a one-year holding period), or sold to the public pursuant to a registration statement filed and effective under the 1933 Act; the documentation of a private placement normally includes contractual restrictions on subsequent transfers of the securities purchased).

*See* Schneider, The *Statutory Law of Private Placements*, 14 REV. SEC. REG. 869 (August 26, 1981); ABA Committee on Federal Regulation of Securities, "*Integration of Securities Offerings: Report of the Task Force on Integration*," 41 BUS. LAW. 595 (1986); Fletcher, "*Sophisticated Investors Under the Federal Securities Laws*," 1988 DUKE L. J. 1081 (1988).

SEC Regulation D ("Reg D"), 17 C.F.R. 230.501-506 (1999), became effective April 15, 1982 and is now the controlling SEC regulation for determining whether an offering of securities is exempt from registration under § 4(2) of the 1933 Act. Under Rule 506 of Reg D, there is no limitation on the dollar amount of securities that may be offered and sold, and the offering can be sold to an unlimited number of "accredited investors" (generally institutions, individuals with a net worth of over $1 million and officers and directors and general partners of the issuer) and to a maximum of thirty-five nonaccredited investors (there is no limit on the number of offerees so long as there is no general advertising or solicitation). Each of the purchasers, if not an accredited investor, must (either alone or through a representative) have such knowledge and experience in financial matters as to be capable of evaluating the risks and merits of the proposed investment. Unless the offering is made solely to accredited investors, purchasers must generally be furnished with the same level of information that would be contained in a registration statement under the 1933 Act. Resales of the securities must be restricted and a Form D notice of sale must be filed with the SEC. An offering which strictly conforms to the Reg D requirements will be exempt even if it does not satisfy all of the judicial criteria discussed above; however, since Reg D does not purport to be the exclusive means of compliance with § 4(2), a placement which conforms to the foregoing judicial standards also will be exempt from registration under § 4(2) of the 1933 Act, even if it does not strictly conform to Reg D.

structured to be exempt from those requirements.[95] This principle is applicable in business combinations.

## IV. ASSET PURCHASES

An acquisition might be structured as an asset purchase for a variety of reasons. It may be the only structure that can be used under applicable state law or where the buyer is only interested in purchasing a portion of the partnership's assets or assuming only certain of its liabilities.

**Appendix C** contains selected provisions from a hypothetical agreement for the purchase of assets from a partnership. These provisions were adapted from a draft of the ABA Model Asset Purchase Agreement, which was originally published in 1991.

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 partnership interests 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 partnership 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 negotiated partnership interest purchase or a merger or an interest exchange (***"statutory combination"***).

### A. Purchased Assets

Asset transactions are typically more complicated and more time consuming than partnership interest purchases and statutory combinations. In contrast to an interest 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.

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[95] Section 3(a)(11) of the 1933 Act exempts from the registration requirements of the 1933 Act "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or if a corporation, incorporated by and doing business within, such State or Territory." Consequently there are two principal conditions to the intrastate offering exemption: (a) that the entire issue of securities be offered and sold exclusively to, and come to rest in the hands of, residents of the state in question (an offer or sale to a single non-resident will render the exemption unavailable to the entire issue); and (b) the issuer be organized under the laws of and doing substantial business in the state. Rule 147 promulgated under the 1933 Act articulates specific standards for determining whether an offering is intrastate within the meaning of Section 3(a)(11).

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 interests or a statutory combination. However, some courts in the corporate context have held that a merger violates a nonassignment clause.[96] At least one court held that such a violation occurred in a merger where the survivor was the contracting party.[97] 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.

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.

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[96] *See, e.g., PPG Indus., Inc. v. Guardian Indus. Corp.*, 597 F.2d 1090 (6th Cir. 1979).

[97] *See SQL Solutions, Inc. v. Oracle Corp.*, 1991 WL 626458 (N.D. Cal. 1991).

Unlike an interest purchase or statutory combination, where the acquired partnership 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 partners of the seller become partners 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 partnership interests or a statutory combination, where the partners 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 partners 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.

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 an interest 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 partners 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. 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 partnership interests 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 partnership interests or a merger.

F. Employment Issues

A sale of assets may yield more employment or labor issues than a partnership interests 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, partnership interest purchase or statutory combination. In a partnership interest 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.

## V. 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 unforeseen liabilities differs markedly depending upon which of the three conventional acquisition structures has been chosen by the parties.

- In a partnership interest acquisition transaction, since the acquired entity simply has new owners of its partnership interests and has not changed in form, such entity 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 entity.

- In a merger transaction, where the acquired entity is merged out of existence, all of its liabilities are assumed, as a matter of state merger law, by the entity which survives the merger. Unlike the partnership interest acquisition transaction, a new entity will be responsible for the liabilities. However, the practical result is the same as in a partnership interest transaction; i.e. the buyer will have assumed all of the preclosing liabilities of the acquired partnership 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 partnership interest and merger transactions: the buyer will not assume liabilities of the selling partnership 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 partnership interests. 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 entity. 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.

There have been some recognized exceptions to the buyer's ability to avoid seller's liabilities by the terms of a contract between the seller and the buyer:

- Bulk sales laws have permitted creditors of the seller to follow the assets into the hands of the buyer if the bulk sales law procedures are not complied with. A discussion of bulk sales laws appears in the comment to Section 5.10 under Selected Asset Acquisition Agreement Provisions in **Appendix C**.

- Fraud - if the deal is really a sham and not a <u>bona fide</u> arm-length transaction, or if seller is insolvent and inadequate consideration is paid by the buyer, under the fraudulent transfer statutes described in the comment to Section 3.32 under Selected Asset Acquisition Agreement Provisions in **Appendix C**.

- Implied Assumption - really a matter of sloppy drafting coupled with some third-party beneficiary arguments which leave the buyer with an unexpected problem.

- Tax liens - some state tax statutes provide that taxing authorities can follow the assets to recover taxes owed by the selling partnership; generally a waiver from

the state or other accommodation can resolve. See Section 10.2 and related commentary under Selected Asset Acquisition Agreement Provisions in **Appendix C**.

None of these exceptions prevents a buyer from limiting the liabilities to be assumed from a selling partnership. By compliance with a statutory scheme (e.g. the bulk sales laws, state tax lien waiver procedure, etc.) or by careful drafting (implied assumptions, representations and structures that negate the elements of a fraudulent transfer), a buyer could structure an asset purchase transaction to protect the buyer against liabilities of the seller that the buyer does not intend to assume under the terms of the asset purchase agreement.

B. Successor Liability Doctrines Developed in Corporate Transactions

During the past two decades, courts have developed some theories which require buyers to be responsible for preclosing liabilities of a corporate seller 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 following subsections will briefly describe the principal theories of successor liability that have developed in the corporate context. That will be followed by a discussion of how those doctrines have been applied in respect of partnership. Finally, some of the techniques which asset purchase lawyers have used to deal with those problems will be addressed.

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 entity had dissolved right away and that the owners of the seller had received interests in the buyer. However, the *de facto* merger doctrine was expanded 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 corporation's interest against such a poor plaintiff, the plaintiff wins.[98] The elements of a *de facto* merger were set forth about 10 years later as follows:[99]

- There is a continuation of the enterprise of the seller entity, so that there is a continuity of management, personnel, physical location, assets and general business operations.
- There is a continuity of owners which results when the purchasing entity pays for the acquired assets with shares of its own equity interests, this partnership interest

[98] *Knapp v. North American Rockwell Corp.*, 506 F.2d 361 (3rd Cir. 1974).

[99] *Philadelphia Electric Co. v. Hercules, Inc.*, 762 F.2d 303, (3rd Cir. 1985).

ultimately coming to be held by the owners of the selling entity so that they become a constituent part of the purchasing entity.

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

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

Some states have endeavored to legislatively repeal the *de facto* merger doctrine for corporations.[100]

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.[101]

3. Product Line Exception

In 1977 California took a slightly different tack in holding a successor liable in a products liability case, in which 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

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[100] *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."

[101] 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 stockholder ownership.

liability for defects in units of the same product line previously manufactured and distributed by the entity from which the business was acquired.[102]

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 good will and the buyer's ability to enjoy the fruits of that good will.[103]

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, because choice of law principles, especially in the area of product liability, may find the law of a state in which an injury occurs to be applicable, the reach of those states which have embraced either the product line exception or the narrower continuity of interest doctrine may be beyond their respective borders.[104]

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.

C. Partnership Successor Liability

The issue of whether, and to what extent, an acquiring entity is subject to the liabilities of a partnership following a sale of assets is not settled law within the U.S., though there are multiple cases in a variety of jurisdictions that proffer some level of handling of the subject. The theme that resounds within the smattering of cases available is whether the traditional corporate

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102 *Ray v. Alad Corp.*, 560 P.2d 3 (Cal. 1977).

103 *See also Ramirez v. Amsted Industries, Inc.*, 431 A.2d 811 (N.J. 1981).

104 *See generally Ruiz v. Blentech Corporation*, 89 F.3d 320 (7th Cir. 1996) and *Nelson v. Tiffany Industries*, 778 F.2d 533 (9th Cir. 1985).

successor liability doctrine is applied to partnerships, along with the standard exceptions to that policy.

As discussed above, traditional corporate liability doctrine holds that purchasers of assets are not subject to the liabilities of the seller, save for four exceptions: (1) where the buyer expressly or impliedly assumes the liabilities; (2) when the transfer is a fraudulent attempt to circumvent a liability; (3) when the surviving entity is a mere continuation of the seller; and, (4) in cases of merger.[105] Some jurisdictions have also included a products liability exception, where a surviving entity that continues to produce the same products assumes the liability for such products.[106]

Some courts have directly stated the applicability of these traditional corporate successor liability theories to all non-incorporated entities, without specifying partnerships.[107] A few cases mention the specific relevance of those doctrines to partnerships.[108]

Other cases dealing with partnerships, while remaining silent on the lack of corporate status, have used that corporate reasoning to determine whether a surviving entity was a successor, and therefore, responsible for the outstanding obligations of the predecessor.[109]

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105 *LiButti v. U.S.*, 178 F.3d. 114, 124 (2d Cir. 1999); *Vernon v. Schuster*, 688 N.E. 2d 1172, 1175-6 (Ill. 1997); *Cashar v. Redford*, 624 P.2d 194, 195-6; *Tift v. Forage King Indus., Inc.*, 322 N.W.2d Wash. Ct. App. 14, 15 (Wis. 1982); *Soo Line R.R. Co. v. B.J. Carney & Co.*, 797 F. Supp. 1472, 1482 (D. Minn. 1992).

106 *Ray v. Alad Corp.*, 560 P.2d 3 (Cal. 1977).

107 *Graham v. Jones*, 144 F.3d. 229, 240 (2d Cir. 1998) (Applying New York law, the Court ruled that, in the case of an asset sale from a proprietorship to a corporation, "[t]he traditional rule of corporate successor liability and the exceptions to the rule are generally applied regardless of whether the predecessor or successor organizations was a corporation or some other form of business organization."); *LiButti v. U.S.*, 178 F.3d. at 124 (quoting *Graham v. Jones*, 144 F.3d 229, 240 (2d Cir. 1998)); *Baker v. David Alan Dorfman, P.L.L.C.*, 232 F.3d. 121, 122 (2d Cir. 2000) (quoting *Graham v. Jones*, 144 F.3d 229, 240 (2d Cir. 1998)).

108 *Tift v. Forage King Indus., Inc.*, 322 N.W.2d 14, 16 (Wis. 1982) ("[T]he responsibility of a subsequent business organization, irrespective of the nature of either the predecessor or successor, proprietorship, partnership, or corporation, cannot be facilely dismissed on the basis of the semantics of the rule."); *Case v. Paul Troester Maschinenfabrik*, 139 F. Supp. 2d 428, 432 (W.D.N.Y. 2001) (In denying the motion for summary judgment by the alleged successor company on the grounds that there existed a factual question as to whether the surviving entity was a mere continuation of the partnership, and as such, liable for its existing debts and obligations, the court wrote, "[t]he distinction in the present case, of course, is that partnerships, rather than corporations, are involved. Plaintiffs initially attempted to argue that this distinction renders any successor liability analysis inapplicable. I disagree."); *Pet Care Prof. Ctr., Inc. v. BellSouth Adver. & Pub. Corp.*, 464 S.E.2d 249, 251 (Ga. Ct. App. 1995) (In *Pet Care*, a partnership incorporated with three of the four partners, and the surviving entity was found to be a successor to the partnership, as only some continuity of ownership was required for a mere continuation exception, and was liable for the contract debts incurred by the predecessor partnership, with the Georgia court stating that, "the continuation theory has been held applicable in situations where, as here, the purchasing corporation succeeds to the assets of a business partnership."); *Soo Line R.R. Co. v. B.J. Carney & Co.*, 797 F. Supp. 1472, 1482 n.4 (D. Minn. 1992).

109 *M.I.G. Invs., Inc. v. Marsala*, 414 N.E.2d 1381, 1384-5 (Ill. Ct. App. 1981) (a partnership executed an asset sale to a sole proprietorship, and a third party sued both the partnership and the sole proprietorship for breach of contract; while the court found that the sole proprietorship was not a successor, it did apply the

At odds with the foregoing stream of analysis is the sole case in Texas that addresses successor liability for partnerships. In reviewing whether a law firm was a successor to another firm that was accused of legal malpractice, the Fort Worth Appeals Court held that "Texas law does not recognize that successor partnerships are liable for the tortious conduct of predecessor partnerships."[110]

D. 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 partnership 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 partnership to be acquired does sell products which 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 partnership. Obviously one can also rely 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 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

corporate test, remaining silent on the fact that the two entities were not incorporated, and held that the purchaser was not a successor, and that the seller partnership had not dissolved, in that it retained its rights under the UCC as a secured creditor); *see also Jackson v. New Jersey Mfrs. Ins. Co.*, 400 A.2d 81 (N.J. Super. Ct. App. Div. 1979) (in a sale of assets by a partnership, the Court applied the same corporate test in declining to hold that the surviving entity was a successor to that partnership).

110 *Med. Designs, Inc. v. Shannon, Gracey, Ratliff & Miller, L.L.P.*, 922 S.W.2d 626 (Tex. App.—Fort Worth 1996, writ denied) (the court cited no other Texas cases as precedent for this ruling, but did draw a distinction between succeeding to tort as opposed to contractual obligations, and stated that the existing liabilities of the partners individually were not discharged by the dissolution of the partnership); *see also Pendergrass v. Card Care, Inc.*, 424 S.E.2d 391 (N.C. 1993) (North Carolina Supreme Court did not apply the mere continuation corporate successor liability doctrine to a partnership that had sold its assets to a corporation under the premise that even when a partnership transfers its assets, the partners remain liable).

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 in Appendix A *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 in Appendix A *infra*.

4. Selling Partnership - Survival

The dissolution of the selling entity 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 entity 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.

## VI. TAX CONSEQUENCES OF PARTNERSHIP BUSINESS COMBINATIONS

### A. Taxable Sale of Assets by a Partnership

1. Partners Include Distributive Share of Partnership's Income, Gains, Losses, Deductions and Credits

Generally, a partnership is required to recognize gain or loss on the sale of property.[111] The Treasury regulations provide that the "[t]he general rule with respect to gain or loss realized upon the sale or exchange of property . . . is that the entire amount of gain or loss is recognized except in cases where specific provisions . . . provide otherwise." The gain or loss is measured by the difference between the amount realized from the sale or other disposition of property and the partnership's adjusted basis in the property.[112] For partners and partnerships, the adjusted basis for determining gain or loss from the sale is the basis determined under the partnership provisions (known as "subchapter K") of the Code.[113]

The purchaser of assets in a taxable sale by a partnership generally will take a cost basis in the assets.[114]

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111 I.R.C. § 1001(c); *see* Treas. Reg. § 1.1002-1(a); *see also* I.R.C. § 1060(a) (requiring allocation of purchase price in the case of certain transfers involving a group of assets constituting a trade or business).

112 I.R.C. § 1001(a).

113 I.R.C. § 1011(a).

114 I.R.C. § 1012.

For federal income tax purposes, the sale by a partnership of an interest in an entity that is disregarded should be treated as a sale of the assets of the disregarded entity.[115] If an entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch or division of the owner.[116]

The partners in a partnership, and not the partnership, are liable for income tax.[117] In determining the partner's income tax, each partner is required to take into account separately the partner's distributive share of (1) gains and losses from sales or exchanges of capital assets held for not more than 1 year; (2) gains and losses from sales or exchanges of capital assets held for more than 1 year; (3) gains and losses from sales or exchanges of Section 1231 property; (4) charitable contributions; (5) certain dividends; (6) foreign income taxes; (7) certain other items of income, gain, loss, deduction or credit prescribed by the regulations (including items of income, gain, loss, deduction or credit specially allocated under the partnership agreement); and (8) taxable income or loss, exclusive of the foregoing 7 items requiring separate computation.[118] The character of any item of income, gain, loss, deduction, or credit included in a partner's

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115 *See* Treas. Reg. §§ 301.7701-2, 301.7701-3; Rev. Rul. 99-5, 1999-1 C.B. 434 ("In this situation, the LLC, which, for federal tax purposes, is disregarded as an entity separate from its owner, is converted to a partnership when the new member, *B*, purchases an interest in the disregarded entity from the owner, *A*. *B*'s purchase of 50% of *A*'s ownership interest in the LLC is treated as the purchase of a 50% interest in each of the LLC's assets, which are treated as held directly by *A* for federal tax purposes. Immediately thereafter, *A* and *B* are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership."). The Service has held in several private letter rulings that a partnership with a single owner for federal income tax purposes is disregarded under the check-the-box regulations. *cf.* Priv. Ltr. Rul. 200201005 (Sept. 27, 2001) ("[Qualified subchapter S subsidiary X's] merger into Y, a state law limited partnership that is owned 1% by W, [a limited liability company] wholly owned by Z and 99% by Z will be disregarded for federal income tax purposes if no election is made under 301.7701-3(c) to treat W as an association because, at the end of the series of transactions, the assets of X continue to be held by Z for federal tax purposes."); Priv. Ltr. Rul. 200107025 (Nov. 17, 2000) ("[E]ach of the individual shareholders of X will be the sole owner of the limited partnership that the individual shareholder formed, owning m% through the respective individual's limited liability company, a disregarded entity, and n% directly. Because each of the limited partnerships are treated as owned by a single owner, they will be disregarded for federal tax purposes and each individual shareholder will be treated as directly owning the X stock held by their respective limited partnership."); Priv. Ltr. Rul. 199947001 (Dec. 7, 1998) ("If Company A [taxed as a partnership] makes an election under section 754, Company A's basis in its assets, including the assets of the Partnerships that are disregarded entities for federal income tax purposes, will be adjusted under section 743(b) as a result of the transaction."); Priv. Ltr. Rul. 199915030 (Jan. 12, 1999) ("Corporation B and Disregarded LLC1 organized a limited partnership, Disregarded Partnership. Corporation B owns the limited partnership interest and Disregarded LLC1 owns the general partnership interest. Corporation B and Disregarded LLC1 will not elect to treat Disregarded Partnership as a separate entity for federal income tax purposes * * * Disregarded LLC1, Disregarded Partnership . . . will not be treated for federal income tax purposes as entities separate from Corporation B . . . ."); Priv. Ltr. Rul. 9807013 (Feb. 13, 1998) ("Because each Replacement Entity will be disregarded as an entity separate from its owner for federal tax purposes, the assets of each Replacement Entity will be treated as assets of the Taxpayer."). Private letter rulings are not binding as "precedent," but they often represent a substantial indication of the position of the Revenue Service on an issue. While there does not appear to be any ruling directly on point, the same reasoning that applies to the sale of an interest in a disregarded limited liability company should apply to the sale of an interest in a disregarded partnership.

116 Treas. Reg. § 301.7701-2(a).

117 I.R.C. § 701.

118 I.R.C. §§ 702(a)(1), 702(a)(2).

distributive share under items (1) through (7) of the preceding sentence is determined as if such item were realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership.[119]

Generally, a partner's distributive share of income, gain, loss, deduction, or credit is determined by the partnership agreement.[120] One limitation on this rule is that a partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) is determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if (1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.[121]

The Code contains a rule to prevent the shifting of federal income tax consequences among partners with respect to precontribution gain or loss.[122] Income, gain, loss, and deduction with respect to property contributed to a partnership by a partner is shared among the partners so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution (the built-in gain or loss).[123]

A partner's distributive share of partnership loss (including capital loss) is allowed only to the extent of the adjusted basis of such partner's interest in the partnership at the end of the partnership year in which the loss occurred.[124] A partner's share of loss in excess of his adjusted basis at the end of the partnership tax year is not allowed for that year. Any loss so disallowed, however, may be carried forward and allowed as a deduction in a succeeding year to the extent that the partner's adjusted basis for his partnership interest at the end of any such year exceeds zero (before reduction by such loss for such year).[125]

2. Federal Income Tax Treatment of Partnership Distributions – An Overview.

(a) Treatment of Partners

In the case of a distribution by a partnership to a partner, generally gain is not recognized to the partner except to the extent that any money (which is defined to include marketable securities)[126] distributed exceeds the adjusted basis of the partner's interest in the partnership immediately before the distribution.[127] Generally, no loss is recognized by a partner on a

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119 I.R.C. § 702(b); Treas. Reg. § 1.702-1(b).

120 I.R.C. § 704(a).

121 I.R.C. § 704(b).

122 I.R.C. § 704(c)(1)(A).

123 I.R.C. § 704(c)(1)(A).

124 I.R.C. § 704(d).

125 Treas. Reg. § 1.704-1(d).

126 I.R.C. § 731(c)(1)(A).

127 I.R.C. § 731(a)(1); *but see* I.R.C. § 704(c)(1)(B) (triggers gain or loss to property of contributing partner on certain distributions); I.R.C. § 737 (recognition of precontribution gain in case of certain distributions to contributing partner). I.R.C. §§ 736 and 751(b) also provide special rules applicable to certain distributions.

distribution by a partnership to the partner.[128] In the case, however, of a distribution by a partnership in liquidation of a partner's interest in a partnership where no property other than money, unrealized receivables and inventory is distributed to the partner, loss is recognized to the extent of the excess of the adjusted basis of the partner's interest in the partnership over the sum of (A) any money distributed, and (B) the basis to the distributee of any unrealized receivables and inventory.[129] Gain or loss recognized pursuant to these rules is considered as gain or loss from the sale or exchange of the partnership interest of the distributee partner.[130]

The basis of property (other than money) distributed by a partnership to a partner other than in liquidation of the partnership interest is generally its adjusted basis to the partnership immediately before such distribution.[131] The basis to the distributee partner of property, however, is limited to the partner's adjusted basis in his partnership interest immediately before such distribution.[132]

The basis of property (other than money) distributed by a partnership to a partner in liquidation of the partner's interest is an amount equal to the partner's adjusted basis in his partnership interest, reduced by any money distributed in the same transaction.[133]

In determining the period for which a partner has held property (other than certain inventory items) received in a distribution from a partnership, there is included the holding period of the partnership with respect to the property.[134]

(b) Treatment of Partnership

No gain or loss is recognized by a partnership on a distribution to a partner of property, including money.[135] If the partnership has a Section 754 election in effect, or makes an election for the year of the distribution, the partnership is required to make certain adjustments to the basis of its undistributed property.[136]

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[128] I.R.C. § 731(a)(2).

[129] I.R.C. § 731(a)(2).

[130] I.R.C. § 731(a).

[131] I.R.C. § 732(a)(1).

[132] I.R.C. § 732(a)(2).

[133] I.R.C. § 732(b).

[134] I.R.C. § 735(b).

[135] I.R.C. § 731(b); *but see* I.R.C. § 751(b).

[136] I.R.C. § 734.

B. Contributions Of Property To A Partnership

1. Transfer of Unencumbered Property to a Partnership in Exchange for a Partnership Interest

(a) General Rules

(1) Nonrecognition. Generally, no gain or loss is recognized by a partnership or any of its partners upon the contribution of property to the partnership in exchange for a partnership interest.[137] This rule applies whether the contribution is made to a partnership in the process of formation or to a partnership which is already formed and operating.[138]

(2) Partnership's Tax Basis in Contributed Property. The partnership's tax basis in the contributed property is the adjusted basis of the property to the partner at the time of contribution.[139]

(3) Partnership's Holding Period in Contributed Property. The partnership's holding period in the assets contributed by a partner includes the period such assets were held by the contributing partner.[140]

(4) Contributing Partner's Tax Basis in His Partnership Interest. The contributing partner's initial tax basis in his partnership interest will be the amount of the money and the adjusted basis of the property to the contributing partner at the time of the contribution.[141]

(5) Contributing Partner's Holding Period in His Partnership Interest. In determining the holding period of a taxpayer who receives property in an exchange, there is included the period for which the taxpayer held the property exchanged if the property has the same basis in whole or in part in the taxpayer's hands as the property exchanged, and the property exchanged at the time of the exchange was a capital asset or property described in § 1231(b) (depreciable property and real property used in a trade or business and held for more than 1 year).[142] Thus, the holding period of a partnership interest received in exchange for a partner contributing to the partnership capital assets or property described in Section 1231(b) should include such partner's holding period for the property transferred to the partnership.[143] If, however, a partnership interest is received in exchange for assets that are neither capital assets

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137 I.R.C. § 721(a).

138 Treas. Reg. § 1.721-1(a).

139 I.R.C. § 723.

140 I.R.C. § 1223(2); Treas. Reg. § 1.723-1.

141 I.R.C. § 722.

142 I.R.C. § 1223(1).

143 I.R.C. § 1223(1).

nor section 1231(b) assets, the partner's holding period in the contributed assets should not "tack" onto the holding period of the partner's partnership interest.[144]

In the past, there has been some lack of clarity concerning the holding period of a partnership interest where a partner transfers both (1) capital assets or Section 1231(b) property, and (2) cash or property other than capital assets or Section 1231(b) property. There has also been some question concerning a partner's holding period in a partnership where a partner acquires interests in the partnership at different times.[145]

On September 21, 2000, the Internal Revenue Service issued final regulations relating to dividing the holding period of a partnership interest.[146]

(a) General Rule. The final regulations provide that a partner will not have a divided holding period in a partnership unless (1) the partner acquired portions of a partnership interest at different times; or (2) the partner acquired portions of the partnership interest in exchange for property transferred at the same time but resulting in different holding periods.[147]

(b) Accounting for Holding Periods of a Partnership Interest. The portion of a partnership interest to which a holding period relates is determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).[148] Special rules apply to contributions and distributions of cash by partners and to contributions of Section 751 property to the partnership.[149]

(c) Sale or Exchanges of All or a Portion of a Partnership Interest

(i) Sale or Exchange of Entire Interest in the Partnership. If a partner sells or exchanges the partner's entire interest in a partnership, any capital gain or loss recognized is divided between long-term and short-term capital gain or loss in the same proportions as the holding period of the partnership interest is divided between the portion of the interest held for more than one year and the portion of the interest held for one year or less.[150]

To illustrate, assume that A contributes $5,000 of cash and a nondepreciable capital asset A has held for two years to the PRS Partnership in

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144 *See* Treas. Reg. § 1.1223-1(a); *see generally* Banoff, "Partnership Interest Transfers Under the Holding Period Final Regs.: Opportunities and Traps Remain," 94 J. Tax'n 211 (April 2001).

145 *See* Notice of Proposed Rulemaking, REG-106527-98, 64 F.R. 43117-43123 (Aug. 9, 1999).

146 *See* T.D. 8902, 65 F.R. 57092-57101; Treas. Reg. § 1.741-1(f).

147 Treas. Reg. § 1.1223-3(a).

148 Treas. Reg. § 1.1223-3(b)(1).

149 *See* Treas. Reg. §§ 1.1223-3(b)(2)-(4).

150 Treas. Reg. § 1.1223-3(c)(1).

exchange for a 50 percent interest in PRS. A's basis in the capital asset is $5,000, and the fair market value of the asset is $10,000. After the exchange, A's basis in A's interest in PRS is $10,000, and the fair market value of the interest is $15,000. A received one-third of the interest in PRS for a cash payment of $5,000 ($5,000/$15,000). Therefore, A's holding period in one-third of the interest received (attributable to the contribution of money to the partnership) begins on the day after the contribution. A received two-thirds of the interest in PRS in exchange for the capital asset ($10,000/$15,000). Accordingly, A has a two-year holding period in two-thirds of the interest received in PRS.

Suppose that six months later, when A's basis in PRS is $12,000 (due to a $2,000 allocation of partnership income to A), A sells the interest in PRS for $17,000. Assuming PRS holds no inventory or unrealized receivables and no collectibles or Section1250 property, A will realize $5,000 of capital gain. As determined above, one-third of A's interest in PRS has a holding period of one year or less, and two-thirds of A's interest in PRS has a holding period equal to two years and six months. Therefore, one-third of the capital gain will be short-term capital gain, and two-thirds of the capital gain will be long-term capital gain.[151]

(ii) Sale or Exchange of a Portion of a Partnership Interest. If a partner has a divided holding period in a partnership interest, then the holding period of the transferred interest is divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the transferor partner would realize if the entire interest in the partnership were transferred in a fully taxable transaction immediately before the actual transfer.[152] A special rule applies to sales of interests in publicly-traded partnerships.[153]

(d) Distributions. Generally, under the final regulations, a partner's holding period in a partnership interest is not affected by distributions from the partnership.[154] If a partner is required to recognize capital gain or loss as a result of a distribution from a partnership, then the capital gain or loss recognized is divided between long-term and short-term capital gain or loss in the same proportions as the long-term and short-term capital gain or loss that the distributee partner would realize if such partner's entire interest in the partnership were transferred in a fully taxable transaction immediately before the distribution.[155]

To illustrate, assume that in 1997, A and B each contribute cash of $50,000 to form and become equal partners in the PRS Partnership. More than one year later, A receives a distribution worth $22,000 from PRS, which reduces

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[151] Treas. Reg. § 1.1223-3(f), Example 1.

[152] Treas. Reg. § 1.1223-3(c)(2)(ii).

[153] Treas. Reg. § 1.1223-3(c)(2)(i).

[154] Treas. Reg. § 1.1223-3(d)(1).

[155] Treas. Reg. § 1.1223-3(d)(2).

A's interest in PRS to 36 percent. After the distribution, B owns 64 percent of PRS. The holding periods of A and B in their interests in PRS are not affected by the distribution.

(b) Exceptions to the General Rule

The general rule of nonrecognition applicable to transfers of unencumbered property to a partnership does not apply (a) on a transfer of property to a partnership which would be treated as an "investment company" (if the partnership were incorporated);[156] (b) a partnership capital interest received in exchange for services;[157] and (c) transactions between a partnership and a partner not acting in his capacity as a partner.[158]

(1) Transfer of Property to a Partnership (That Would Be Treated as an Investment Company if the Partnership Were Incorporated). The general nonrecognition rule applicable to transfers of property to a partnership will not apply to gain realized on a transfer of property to a partnership which would be treated as an investment company (if the partnership were incorporated).[159] In the case of a transfer of property to a partnership that is classified as an investment company, the partner's basis in his partnership interest is the amount of the money and the adjusted basis of the property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized by the contributing partner at the time of contribution.[160] The partnership's basis in the contributed property is the adjusted basis of the property to the partner at the time of contribution increased by the amount (if any) of gain recognized by the contributing partner.[161]

(a) When Is a Transfer Considered a "Transfer to an Investment Company?" A transfer of property to a partnership will be considered to be "a transfer to an investment company" if: (i) the transfer results in diversification of the transferor's interests;[162] and (ii) more than 80% of the value of the partnerships assets are:

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156 I.R.C. § 721(b).

157 Treas. Reg. § 1.721-1(b)(1).

158 Treas. Reg. § 1.721-1(a); *see generally* I.R.C. 707(a).

159 I.R.C. § 721(b).

160 I.R.C. § 722.

161 I.R.C. § 723.

162 *See* Staff of the Joint Committee on Taxation, 105th Cong., *General Explanation of Tax Legislation Enacted in 1997*, 184 (1997) ("The bill is intended to change only the types of assets considered in the definition of an investment company in the present Treasury regulations (Treas. reg. sec. 1.351-1(c)(1)(ii)) and not to override the other provisions of those regulations. For example, the bill does not override (1) the requirement that only assets held for investment are considered for purposes of the definition (Treas. reg. sec. 1.351-1(c)(3)), (2) the rule treating the assets of a subsidiary as owned proportionately by a parent owning 50 percent or more of its stock (Treas. reg. sec. 1.351-1(c)(4)), (3) the requirement that the investment company determination consider any plan with regard to an entity's assets in existence at the time of transfer (Treas. reg. sec. 1.351-1(c)(2)), and (4) the requirement that a contribution of property to an investment company result in diversification in order for gain to be recognized (Treas. reg. sec. 1.351-1(c)(1)(i)." [footnote omitted]); *Cf.* Priv. Ltr. Rul. 200211017 (12 Dec 2001) ("The legislative history to the Taxpayer Relief Act of 1997 amendment to section 351(e)(1) makes clear that the 1997 amendments to

(i) Held for investment; and

(ii) Consist of money, stocks and other equity interests in a corporation, evidences of indebtedness, options, forward or futures contracts, notional principal contracts or derivatives, foreign currency, certain interests in precious metals, interests in real estate investment trusts, regulated investment companies, common trust funds and publicly-traded partnerships or other interests in non-corporate entities that are convertible into or exchangeable for any of the assets listed in the statute.[163] Other assets that count toward the 80-percent test are an interest in an entity substantially all of the assets of which are listed assets,[164] and to the extent provided in regulations, interests in other entities, but only to the extent of the value of the interest that is attributable to listed assets.[165]

(b) When Does a Transfer Result in Diversification of the Transferor's Interests? A transfer ordinarily results in the diversification of the transferors' interests if two or more persons transfer nonidentical assets in the exchange.[166] For this purpose, if any transaction involves the transfer of one or more transfers of nonidentical assets, which taken in the aggregate, constitutes "an insignificant portion"[167] of the total value of assets transferred, then such transfers are disregarded for purposes of determining whether diversification has occurred.[168] If a transfer is part of a plan to achieve diversification without recognition of gain, such as a plan which contemplates a subsequent transfer, however delayed, of the corporate assets (or of the stock or securities received in the earlier exchange) to an investment company in a transaction purporting to qualify for nonrecognition treatment, the original transfer will be treated as resulting in diversification.[169]

(c) When Is Investment Company Status Determined? The determination of whether a partnership is an investment company is ordinarily made immediately after the transfer.[170] If, however, the circumstances change

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section 351(e) do not override § 1.351-1(c)(4)."); Priv. Ltr. Rul. 199901028 (13 Oct 1998) ("[T]he Act is not intended to alter the requirement of section 1.351-1(c)(1)(i) that a transfer of property will be considered to be a transfer to an investment company under section 351(e) only if the transfer results, directly or indirectly, in the diversification of the transferors' interests.").

163 I.R.C. § 351(e)(1)(B).

164 I.R.C. § 351(e)(1)(vi).

165 I.R.C. § 351(e)(1)(vii).

166 Treas. Reg. § 1.351-1(c)(5).

167 The determination of what constitutes an "insignificant portion" of the total value of transferred assets is a factual issue. In Revenue Ruling 87-9, 1987-1 C.B. 133, the Revenue Service held that the transfer of a nonidentical asset (cash) constituting 11 percent of the total value of the transferred assets in a section 351 exchange was not an "insignificant portion." The regulations contain an example illustrating that in a situation where two percent of the total assets transferred are nonidentical, the two percent transfer is "insignificant" and therefore disregarded for purposes of determining whether diversification has occurred. Treas. Reg. § 1.351-1(c)(7), Example 1; *cf.* Priv. Ltr. Rul. 199901028 (13 Oct 1998).

168 Treas. Reg. § 1.351-1(c)(5).

169 Treas. Reg. § 1.351-1(c)(5).

170 Treas. Reg. § 1.351-1(c)(2).

thereafter pursuant to a plan in existence at the time of the transfer, this determination is made by reference to the later circumstances.[171]

(2) Partnership Capital Interest Received in Exchange for Services. The receipt of a partnership capital interest by a service partner for services provided to or for the benefit of the partnership is taxable as compensation.[172] The Internal Revenue Service defines a capital interest as "an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. This determination generally is made at the time of receipt of the partnership interest."[173]

(3) Transactions Between a Partnership and a Partner Not Acting in His Capacity as a Partner.[174] The general rule of nonrecognition applicable to transfers of property to a partnership does not apply to a transaction between a partnership and a partner not acting in his capacity as a partner.[175] For example, a partner may sell property to a partnership rather than contributing the property. As to sales between a partner and his partnership, if a partner engages in a transaction with a partnership, other than in his capacity as a partner, the transaction will be treated as occurring between the partnership and one who is not a partner.[176] Thus, if the transfer of property by the partner to the partnership results in the receipt by the partner of money or other consideration, the transaction will be treated as a taxable sale or exchange in which gain is recognized[177] rather than as a tax-free contribution.[178]

2. Transfer of Encumbered Property to a Partnership

The Code and regulations provide rules with respect to the transfer of encumbered property to a partnership.

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171 Treas. Reg. § 1.351-1(c)(2).

172 *Campbell v. Commissioner*, 943 F.2d 815, 820 (8th Cir. 1991) ("When a service partner receives an interest in partnership capital, the cases clearly hold that a taxable event has occurred. The receipt of the capital interest must be included in the service partner's income. *See, e.g. United States v. Frazell*, 335 F.2d 487, 489 (5th Cir. 1964), *cert. denied*, 380 U.S. 961 (1965) . . . As an interest in intangible personal property, the receipt of a capital interest appears to be taxable under the authority of Section 83 of the Internal Revenue Code. [Footnote omitted.] There is little, if any, dispute that such a transaction involves the recognition of income."); *Larson v. Commissioner*, 55 T.C.M. (CCH) 1637 (1988) ("Under Section 83, a compensatory transfer of a partnership capital interest results in taxable income to the transferee to the extent that the fair market value of the interest exceeds the amount paid for the interest, in the year that the rights to the interest are transferable or not subject to a substantial risk of forfeiture."); Rev. Proc. 93-27, 1993-2 C.B 343, 343 ("Under Section 1.721-1(b)(1) of the Income Tax Regulations, the receipt of a partnership capital interest for services provided to or for the benefit of the partnership is taxable as compensation.").

173 Rev. Proc. 93-27, § 2.01, 1993-2 C.B. 343.

174 Treas. Reg. § 1.721-1(a); *see generally* I.R.C. 707(a).

175 Treas. Reg. § 1.721-1(a); *see* I.R.C. § 707.

176 I.R.C. § 707(a).

177 *See* I.R.C. § 707(a); I.R.C. § 1001(c).

178 Treas. Reg. § 1.721-1(a); Treas. Reg. § 1.707-1(a); Treas. Reg. § 1.731-1(c)(3).

(a) Treatment of Decrease in Partner's Share of Liabilities

In the case of a transfer of property encumbered by debt to a partnership, any decrease in a partner's share of the partnership's liabilities, or any decrease in a partner's individual liabilities by reason of the partnership's assumption of such individual liabilities, is considered a distribution of money to the partner by the partnership.[179]

(b) Treatment of Increase in Partner's Share of Liabilities

Any increase in a partner's share of partnership liabilities, or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities, is considered a contribution of money by that partner to the partnership.[180]

(c) Property Subject to a Liability

If property is contributed by a partner to the partnership and the property is subject to a liability of the contributing partner, the partnership is treated as having assumed the liability, to the extent that the amount of the liability does not exceed the fair market value of the property at the time of the contribution.[181]

(d) Netting of Increases and Decreases in Liabilities Resulting From Single Transaction.

If, as a result of a single transaction, a partner incurs both an increase in the partner's share of the partnership liabilities (or the partner's individual liabilities) and a decrease in the partner's share of the partnership liabilities (or the partner's individual liabilities), only the net decrease is treated as a distribution from the partnership and only the net increase is treated as a contribution of money to the partnership.[182] Generally, the contribution to a partnership of property subject to a liability will require that increases and decreases in liabilities associated with the transaction be netted to determine if a partner will be deemed to have made a contribution or received a distribution as a result of the transaction.[183]

(e) Example

Assume that Baker contributes property (adjusted basis: $1,000) to a general partnership in exchange for a 33.33% interest in the partnership. At the time of the contribution, the partnership does not have any liabilities outstanding and the property is subject to a recourse debt of $150 and has a fair market value in excess of $150. After the contribution, Baker remains personally liable to the creditor and none of the other partners bears any of the economic risk of loss for the liability under state law or otherwise. Under the Code and regulations, the partnership is treated as having assumed the $150 liability. As a result, Baker's individual

179 I.R.C. § 752(b); Treas. Reg. § 1.752-1(c).

180 I.R.C. § 752(a).

181 Treas. Reg. § 1.752-1(e); *see* I.R.C. § 752(c).

182 I.R.C. § 1.752-1(f).

183 Treas. Reg. § 1.752-1(f).

liabilities decrease by $150. At the same time, however, Baker's share of liabilities of the partnership increases by $150. Only the net increase or decrease in Baker's share of the liabilities of the partnership and Baker's individual liabilities is taken into account. Since there is no net change, Baker is not treated as having contributed money to the partnership or as having received a distribution of money from the partnership. Baker will take a basis in his partnership interest equal to $1,000 (which is Baker's tax basis in the property contributed to the partnership).[184]

C. Sale of Partnership Interests

1. Character of Gain or Loss on Sale of Partnership Interest

(a) General Rule

In the case of a sale or exchange of a partnership interest, gain or loss is recognized by the transferor partner and, subject to certain exceptions, is considered as a gain or loss from the sale or exchange of a capital asset (and therefore capital gain or loss).[185] The gain or loss is measured by the difference between the amount realized and the adjusted basis of the partnership interest.[186] This treatment applies regardless of whether the interest is sold to other members of the partnership or to persons who are not members of the partnership.[187] This rule also applies even though the sale of the partnership interest results in a termination of the partnership.[188]

(b) Exception for Section 751 Property

Section 751 of the Code was enacted to prevent the conversion of certain potential ordinary income into capital gain upon the sale or exchange of a partnership interest.[189] Under this section, money or property received by a selling partner in exchange for all or any part of his partnership interest is subject to ordinary income treatment to the extent it is attributable to certain ordinary income assets of the partnership.[190] These items include (1) certain unrealized receivables of the partnership,[191] and (2) inventory items of the partnership.[192]

(1) Definition of "Unrealized Receivables". "Unrealized receivables" of a partnership include rights to payment for (1) goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as ordinary income,[193] or (2) services rendered or to be

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184 Treas. Reg. § 1.752-1(g), Example 1.

185 I.R.C. § 741.

186 Treas. Reg. § 1.741-1.

187 Treas. Reg. § 1.741-1(b).

188 Treas. Reg. § 1.741-1(b).

189 H.R. Rep. No. 1337, 83d Cong., 2d Sess. 70, 71 (1954) [hereinafter "H.R. Rep. No. 1337"]; S. Rep. No. 1622, 83d Cong., 2d Sess. 99 (1954) [hereinafter "S. Rep. No. 1622"].

190 I.R.C. § 751(a).

191 I.R.C. § 751(a)(1).

192 I.R.C. § 751(a)(2).

193 I.R.C. § 751(a)(1).

rendered.[194] Both types of rights are unrealized receivables only to the extent not previously includible in income under the partnership's method of accounting.[195] "Unrealized receivables" of a partnership also include a variety of recapture amounts with respect to partnership property.[196]

(2) Definition of "Inventory Items". The term "inventory items" means:

(a) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the tax year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business.[197]

(b) Any other property that, on sale or exchange by the partnership, would be considered property other than a capital asset and other than Section1231 property. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items, as do any unrealized receivables.[198]

(c) Any other property of the partnership that, if sold or exchanged by the partnership would result in gain taxable under Section1246(a) (relating to gain on foreign investment company stock).[199]

(d) Any other property held by the partnership that, if held by the selling or distributee partner, would be considered property of the type described above.[200]

(c) Exception for Sales of Partnership Interests in Partnership Holding Appreciated Collectibles or Section 1250 Property

On September 21, 2000, the Internal Revenue Service issued final regulations containing special rules applicable to capital gain or loss recognized when a partner sells or exchanges an interest in a partnership that holds appreciated collectibles or Section 1250 property with Section 1250 capital gain.[201] These regulations provide that when a partner sells or exchanges a partnership interest held for more than one year, the partner may recognize ordinary income (e.g., under Section 751(a)), collectibles gain, Section 1250 capital gain and residual long-term

194 I.R.C. § 751(a)(2).

195 I.R.C. § 751(c).

196 I.R.C. § 751(c).

197 I.R.C. § 751(d)(1); Treas. Reg. § 1.751-1(d)(2)(i).

198 I.R.C. § 751(d)(2); Treas. Reg. § 1.751-1(d)(2)(ii).

199 I.R.C. § 751(d)(3).

200 I.R.C. § 751(d)(4).

201 Treas. Reg. § 1.741-1(e).

capital gain or loss.[202] The regulations address to what extent a partner recognizes collectibles gain or Section 1250 gain when a partnership interest is sold or exchanged.[203]

2. Purchasing Partner's Basis in His Partnership Interest

(a) General Rule

A purchasing partner's basis in his partnership interest is generally his cost.[204] Generally, the basis of partnership property is not adjusted as the result of a transfer of a partnership interest by sale or exchange unless a "Section 754 election" is in effect with respect to such partnership.[205]

(b) Section 754 Election

(1) Adjustments to Basis of Partnership Property if Section 754 Election in Effect. If a partnership files a Section 754 election, the partnership adjusts the basis of partnership property in the case of a transfer of a partnership interest,[206] as follows:

> (a) The partnership increases the adjusted basis of partnership property by the excess of the transferee partner's basis in his partnership interest over the partner's proportionate share of the adjusted basis to the partnership of partnership property;[207] or
>
> (b) The partnership decreases the adjusted basis of partnership property by the excess of the transferee partner's proportionate share of the adjusted basis to the partnership of partnership property over the partner's basis in his partnership interest.[208]

The increase or decrease is an adjustment to the basis of partnership property with respect to the transferee partner only.[209] The Treasury regulations provide special rules for determining a transferee partner's proportionate share of the adjusted basis to the partnership of partnership property.[210]

(2) Allocation of Basis Adjustment. The amount of the basis adjustment made pursuant to an election under Section 754 is required to be allocated among partnership assets in a manner which has the effect of reducing the difference between the fair market value

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202 *See* Treas. Reg. §1.1(h)-1(a); T.D. 8902, 65 F.R. 57092-57101.

203 *See* Treas. Reg. §1.1(h)-1(a); T.D. 8902, 65 F.R. 57092-57101.

204 I.R.C. §§ 742, 1012; Treas. Reg. § 1.742-1.

205 I.R.C. § 743(a).

206 I.R.C. § 754.

207 I.R.C. § 743(b)(1).

208 I.R.C. § 743(b)(2).

209 I.R.C. § 743(b).

210 Treas. Reg. § 1.743-1(d).

and the adjusted basis of those assets, or in any other manner permitted by the regulations.[211] In applying the allocation rules, the basis adjustment is first allocated between (1) capital assets and property described in Section 1231(b) and (2) any other property of the partnership.[212] The portion of the basis adjustment allocated to each class is then allocated among the items within the class.[213]

(3) Section 754 Election. A Section 754 election applies with respect to all transfers of interests in the partnership during the taxable year with respect to which such election was filed and all subsequent years.[214] An election may be revoked only with the consent of the Service.[215]

3. Sale of Interest in Partnership with Liabilities

In determining the amount realized on a sale or exchange of a partnership interest, liabilities are treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships.[216] Thus, if a partnership interest is sold or exchanged, the reduction in the transferor partner's share of partnership liabilities is treated as an amount realized.[217] For example, if a partner sells an interest in a partnership for $750 cash and transfers to the purchaser the partner's share of partnership liabilities in the amount of $250, the sellers realizes $1,000 on the transaction.[218]

4. Installment Sales of Partnership Interests

Gain recognized on the sale of a partnership interest is generally reportable under the installment method.[219] The Service has concluded, however, that the portion of the gain that is attributable to Section 751 property is reportable under the installment method only to the extent that income realized on a direct sale of the Section 751 property would be reportable under such method. Thus, in Revenue Ruling 89-108, the Service determined that the installment method was not available on a sale of a partnership interest to the extent the income was attributable to the partnership's inventory. The Service reasoned that a direct sale of personal property constituting inventory in the hands of the partner would not be eligible for the installment method.[220]

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211 I.R.C. § 755(a).

212 I.R.C. § 755(b); Treas. Reg. § 1.755-1(a).

213 Treas. Reg. § 1.755-1(a).

214 I.R.C. § 754.

215 I.R.C. § 754; Treas. Reg. §§ 1.754-1(a), 1.754-1(c).

216 I.R.C. § 752(d).

217 Treas. Reg. § 1.752-1(h).

218 Treas. Reg. § 1.752-1(h).

219 Rev. Rul. 76-483, 1976-2 C.B. 131; *see* Rev. Rul. 89-108, 1989-2 C.B. 100.

220 Rev. Rul. 89-108; s*ee* I.R.C. § 453(b)(2)(B); *cf.* 1995 FSA LEXIS 124 (Sept. 11, 1995) ("With regard to the sale of a partnership interest, gain recognized is generally reportable under the installment sale provisions. The sale is treated, however, as a sale of proportionate shares of the partnership's assets. Section 453A(e)(2). Accordingly, installment sale treatment is not available to the extent the partnership assets represent unrealized receivables or inventory items. Sections 453(b)(2)(B) and 751(a); Rev. Rul. 89-

5. Sale of 50% or More of the Total Interest in Partnership Capital and Profits

A partnership terminates for federal income tax purposes when 50 percent or more of the total interests in partnership capital and profits is sold or exchanged within a period of 12 consecutive months.[221] The federal income tax consequences of this technical termination are discussed below.

(a) Sale or Exchange Requirement

For purposes of the partnership termination rules, a sale or exchange includes a sale or exchange to another member of the partnership.[222] A disposition, however, of a partnership interest by gift (including assignment to a successor in interest), bequest, or inheritance, or the liquidation of a partnership interest, is not a sale or exchange.[223] Moreover, if the sale or exchange of an interest in a partnership (upper-tier partnership) that holds an interest in another partnership (lower-tier partnership) results in a termination of the upper-tier partnership, the upper-tier partnership is treated as exchanging its entire interest in the capital and profits of the lower-tier partnership. If the sale or exchange of an interest in an upper-tier partnership does not terminate the upper-tier partnership, the sale or exchange of an interest in the upper-tier partnership is not treated as a sale or exchange of a proportionate share of the upper-tier partnership's interest in the capital and profits of the lower-tier partnership.[224]

(b) Taxable Year

A partnership taxable year closes with respect to all partners on the date on which the partnership terminates.[225]

(c) Form of Termination if a Partnership is Terminated by a Sale or Exchange

If a partnership is terminated by a sale or exchange of a partnership interest, the following is deemed to occur:

(1) The partnership contributes all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership; and, immediately thereafter,

(2) The terminated partnership distributes interests in the new partnership to the purchasing partner and the other remaining partners in proportion to their respective interests

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108."). For an in-depth discussion of the various federal income tax issues associated with selling a partnership interest on the installment basis, *see* Jackel, "Installment Sales of Partnership Interests: Aggregate or Entity," 95 TNT 202-75 (Oct. 16, 1995).

221 I.R.C. § 708(b)(1)(B); Treas. Reg. § 1.708-1(b)(2).

222 Treas. Reg. § 1.708-1(b)(2).

223 Treas. Reg. § 1.708-1(b)(2).

224 Treas. Reg. § 1.708-1(b)(2).

225 I.R.C. § 706(c)(1); Treas. Reg. § 1.708-1(b)(3).

in the terminated partnership in liquidation of the terminated partnership, either for the continuation of the business by the new partnership or for its dissolution and winding up.[226]

(d) Capital Accounts

The deemed contribution of assets to a new partnership and the distribution of the new partnership interests to the partners of the terminated partnership are disregarded for purposes of maintaining capital accounts.[227] As a result, the termination of a partnership does not change the capital accounts of the partners or the books of the partnership. The capital account of the transferee partner and the capital accounts of the other partners of the terminated partnership carry over to the new partnership that is formed as a result of the termination of the partnership.[228]

(e) Section 704(c) Property

The deemed contribution of assets to a new partnership does not create additional Section 704(c) property.[229] The new partnership is not bound by the Section 704(c) method used by the terminated partnership.[230]

(f) Employer Identification Number

The new partnership retains the Employer Identification Number of the terminated partnership.[231]

(g) Section 754 Election

If a partnership is terminated by a sale or exchange of an interest in the partnership, a Section 754 election (including a Section 754 election made by the terminated partnership on its final return) that is in effect for the taxable year of the terminated partnership in which the sale occurs, applies with respect to the incoming partner. Therefore, the bases of partnership assets are adjusted prior to their deemed contribution to the new partnership.[232]

(h) Example

Suppose that A and B each contribute $10,000 cash to form AB, a general partnership, as equal partners. AB purchases depreciable Property X for $20,000. Property X increases in value to $30,000, at which time A sells its entire 50 percent interest to C for $15,000 in a transfer that terminates the partnership. At the time of the sale, Property X had an adjusted tax basis of

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226 Treas. Reg. § 1.708-1(b)(4); *see generally* Grace, "Interaction of the Final Regs. on Partnership Technical Terminations with TRA '97," 14 J. Partnership Tax'n, 275 (Winter 1998) (detailed analysis of technical termination of a partnership).

227 *See* Treas. Reg. § 1.704- 1(b)(2)(iv)(l).

228 Treas. Reg. § 1.704-1(b)(2)(iv)(l).

229 Treas. Reg. § 1.704-3(a)(2).

230 Treas. Reg. § 1.704-3(a)(3)(i).

231 Treas. Reg. § 301.6109-1(d)(2)(iii).

232 Treas. Reg. § 1.708-1(b)(5).

$16,000 and a book value of $16,000 (original $20,000 tax basis and book value reduced by $4,000 of depreciation). In addition, A and B each had a capital account balance of $8,000 (original $10,000 capital account reduced by $2,000 of depreciation allocations with respect to Property X).

Following the deemed contribution of assets and liabilities by the terminated AB partnership to a new partnership (new AB) and the liquidation of the terminated AB partnership, the adjusted tax basis of Property X in the hands of new AB is $16,000. The book value of Property X in the hands of new partnership AB is also $16,000 (the book value of Property X immediately before the termination) and B and C each have a capital account of $8,000 in new AB (the balance of their capital accounts in AB prior to the termination). The deemed contribution and liquidation with regard to the terminated partnership are disregarded in determining the capital accounts of the partners and the books of the new partnership. New AB retains the taxpayer identification number of the terminated AB partnership.

Property X was not Section 704(c) property in the hands of terminated AB and is therefore not treated as Section 704(c) property in the hands of new AB, even though Property X is deemed contributed to new AB at a time when the fair market value of Property X ($30,000) was different from its adjusted tax basis ($16,000).[233]

6. Special Issues Relating to 2-Member Limited Liability Companies

The Revenue Service has recently issued guidance with respect to sales of interests in 2-member limited liability companies ("LLCs").

(a) Existing Member in 2-Member LLC Purchases All Ownership Interests Held by Other Member

In Revenue Ruling 99-6, the Revenue Service addressed the federal income tax consequences if an existing member of a 2-member domestic LLC (classified as a partnership) purchases all of the ownership interests in the LLC from the other member and thereby causes the LLC's status as a partnership to terminate.[234] Under the Ruling, the partnership terminates and the Ruling concludes that the selling partner should treat the transaction as the sale of a partnership interest and report the gain or loss, if any, resulting from the sale of their partnership interest in accordance with the general rules applicable to a sale of a partnership interest.[235] With respect to the purchasing partner, the Ruling holds that, for purposes of determining the tax treatment of the purchasing partner, the partnership is deemed to make a liquidating distribution of all of its assets to the purchasing partner and the selling partner, and following this distribution, the purchasing partner is treated as acquiring the assets deemed to have been distributed to the selling partner in liquidation of the selling partner's partnership interest.

To illustrate, assume that A and B are equal partners in TexLLC, a Texas limited liability company classified as a partnership for federal income tax purposes. TexLLC does not hold any

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233 *See* Treas. Reg. § 1.708-1(b)(4), Example.

234 Rev. Rul. 99-6.

235 Rev. Rul. 99-6.

unrealized receivables or inventory items. Suppose further that TexLLC is not liable for any indebtedness and none of its assets are subject to any indebtedness. Suppose that A sells A's entire interest in TexLLC to B for $10,000. After the sale, the business is continued by the LLC, which is owned solely by B.

Under Revenue Ruling 99-6, the AB partnership terminates when B purchases A's entire interest in AB. A must treat the transaction as the sale of a partnership interest[236] and report gain or loss, if any, resulting from the sale of A's partnership interest.

For purposes of determining the tax treatment of B, the AB partnership is deemed to make a liquidating distribution of all of its assets to A and B, and following this distribution, B is treated as acquiring the assets deemed to have been distributed to A in liquidation of A's partnership interest.[237] B's basis in the assets attributable to A's one-half interest in the partnership is $10,000, the purchase price for A's partnership interest.[238] B's holding period for these assets begins on the day immediately following the date of the sale.

Upon the termination of AB, B is considered to receive a distribution of those assets attributable to B's former interest in AB. B must recognize gain or loss, if any, on the deemed distribution of the assets to the extent required by the partnership distribution provisions of the Code.[239] B's basis in the assets received in the deemed liquidation of B's partnership interest is equal to B's basis in his partnership interest reduced by any money distributed in the same transaction.[240] B's holding period for the assets attributable to B's one-half interest in AB includes the partnership's holding period for such assets.[241]

(b) Third Party Purchases All Ownership Interests in 2-Person LLC

In Revenue Ruling 99-6, the Revenue Service addresses the federal income tax consequences if the two members in a 2-member LLC classified as a partnership for federal income tax purposes sell all of their LLC interests to a third party and thereby cause the LLC's status as a partnership to terminate. The Ruling holds that the selling partner should treat the transaction as the sale of a partnership interest[242] and should report gain or loss, if any, resulting from the sale of their partnership interest in accordance with the general rules applicable to a sale of a partnership interest.[243] The Ruling also concludes that, for purposes of classifying the acquisition by the third party, the partnership is deemed to make a liquidating distribution of its assets to the pre-sale partners. Immediately following this distribution, the third party purchaser is deemed to acquire, by purchase, all of the former partnership's assets.

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236 Treas. Reg. § 1.741-1(b).

237 Rev. Rul. 99-6.

238 I.R.C. § 1012.

239 *See* I.R.C. § 731(a).

240 I.R.C. § 732(b).

241 I.R.C. § 735(b).

242 Treas. Reg. § 1.741-1(b); Rev. Rul. 99-6.

243 Rev. Rul. 99-6.

To illustrate, assume that C and D are equal partners in CD, an LLC classified as a partnership for federal income tax purposes. C and D sell their entire interests in CD to E, an unrelated person, in exchange for $10,000 each. After the sale, the business is continued by the LLC, which is owned solely by E. Under the Ruling, CD's status as a partnership terminates when E purchases the entire interests of C and D in CD. C and D must report gain or loss, if any, resulting from the sale of partnership interests for federal income tax purposes. For purposes of classifying the acquisition by E, the CD partnership is deemed to make a liquidating distribution of its assets to C and D. Immediately following this distribution, E is deemed to acquire, by purchase, all of the former partnership's assets. E's basis in the assets is $20,000. E's holding period for the assets begins on the day immediately following the date of sale.[244]

## D. Merger of Partnerships

### 1. Background

#### (a) Treatment of Partnership Mergers in the Code

The Code neither defines what constitutes a partnership merger or consolidation nor prescribes a form for a partnership merger. It provides only that "[i]n the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of this section, be considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership."[245]

#### (b) Treatment of Partnership Mergers in the Treasury Regulations

In 1997, the Internal Revenue Service issued proposed regulations providing guidance with respect to the treatment of partnership mergers for federal income tax purposes. On January 3, 2001, the Service issued final regulations applicable to mergers occurring on or after January 4, 2001.[246] A partnership may, however, elect to apply the rules in the final regulations for mergers occurring on or after January 11, 2000.[247] These regulations address (a) how to identify the continuing and terminating partnerships in a partnership merger; (b) the closing of the tax year for partnerships that are considered terminated in a partnership merger and the federal income tax return filing requirements for such terminated partnerships; and (c) the form of a partnership merger.[248] The final regulations do not define what constitutes a partnership merger. Although the Preamble to the final regulations does not state why Treasury did not provide such a definition, the Preamble states that some tax practitioners have stated that the selectivity that would be created by attempting to draw lines in such definitions could lead to planning opportunities that would be adverse to the government's interest.[249]

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244 Rev. Rul. 99-6.

245 I.R.C. § 708(b)(2)(A).

246 Treas. Reg. § 1.708-1(c)(7).

247 Treas. Reg. § 1.708-1(c)(7).

248 *See* Treas. Reg. Sec. 1.708-1(c).

249 Preamble, T.D. 8925, 2001-1 C.B. 496, 499.

2. Resulting and Terminated Partnerships in a Partnership Merger; Closing of the Tax Year for Terminated Partnerships and Filing of Federal Income Tax Returns

(a) Identifying the Terminated Partnerships in a Partnership Merger

In the case of a merger or consolidation of two or more partnerships, the final regulations provide that the resulting partnership is, for federal income tax purposes, considered the continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.[250] If the resulting partnership can be considered a continuation of more than one of the merging partnerships, the resulting partnership is, unless the Commissioner permits otherwise, the continuation of the partnership that is credited with the contribution of the greatest fair market value (net of liabilities) to the resulting partnership.[251] Any other merging or consolidating partnerships is considered as terminated.[252] If the members of none of the merging or consolidating partnerships have an interest of more than 50 percent in the capital and profits of the resulting partnership, all of the merged or consolidated partnerships are terminated, and a new partnership results.[253]

(b) Closing of the Tax Year for Terminated Partnerships and Filing of Federal Income Tax Returns for Such Partnerships

Under the regulations, the tax years of the partnerships that are considered terminated in the merger are closed[254] and such partnerships are required to file their returns for the taxable year ending upon the date of termination (which is the date of merger or consolidation).[255] The resulting partnership in the merger is required to file a tax return for the tax year of the partnership that is considered to continue in the merger.[256] The resulting partnership uses the employer identification number ("EIN") of the continuing partnership on the return.[257] The return is required to state that the resulting partnership is a continuation of such merging or consolidating partnership, and must include the names, addresses, and EINs of the other merged or consolidated partnerships. The respective distributive shares of the partners for the periods prior to and including the date of the merger or consolidation and subsequent to the date of merger or consolidation are required to be shown as a part of the return.[258]

(c) Example

The regulations contain an example illustrating the closing of the tax year and filing requirements for the continuing and terminated partnerships in a merger. Assume that A and B,

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250 I.R.C. § 708(b)(2)(A).

251 Treas. Reg. § 1.708-1(c)(1).

252 Treas. Reg. § 1.708-1(c)(1).

253 Treas. Reg. § 1.708-1(c)(1).

254 Treas. Reg. § 1.708-1(c)(2); *see* I.R.C. § 706(c).

255 Treas. Reg. § 1.708-1(c)(2).

256 Treas. Reg. § 1.708-1(c)(2).

257 Treas. Reg. § 1.708-1(c)(2).

258 Treas. Reg. § 1.708-1(c)(2).

both calendar year taxpayers, each own a 50% interest in the capital and profits of the AB Partnership, a calendar-year partnership. Assume further that C and D, both calendar year taxpayers, each own a 50% interest in the capital and profits of the CD Partnership, a calendar-year partnership. The AB Partnership and the CD Partnership merge on September 30, 1999, and form the ABCD Partnership. After the merger, the partners have capital and profits interests as follows:

| | |
|---|---|
| A | 30% |
| B | 30% |
| C | 20% |
| D | 20% |

Since A and B together own an interest of more than 50% in the capital and profits of the ABCD Partnership, such partnership is considered a continuation of the AB Partnership and is required to continue to file returns on a calendar year basis. Since C and D own an interest of less than 50% in the capital and profits of the ABCD Partnership, the taxable year of the CD Partnership closes as of September 30, 1999, the date of the merger, and the CD Partnership is terminated as of that date. The ABCD Partnership is required to file a return for the taxable year January 1 to December 31, 1999, indicating thereon that, until September 30, 1999, it was the AB Partnership. The CD Partnership is required to file a return for its final taxable year, January 1 through September 30, 1999.[259]

3. Form of a Partnership Merger

(a) General Rules

Under the final regulations, the form of a partnership merger accomplished under applicable jurisdictional law generally will be respected if the partnership undertakes the steps of one of two forms prescribed for federal income tax purposes in the regulations: the assets-over form or the assets-up form.[260] Both of these forms are discussed in detail below. The default rule for partnership mergers is the assets-over form, so that if a transaction is effected without undertaking a form for the merger or the transaction is not characterized under the assets-up form, it will be characterized under the assets-over form (regardless of whether that form is followed).[261]

To accomplish a merger, partners in a terminating partnership may in certain cases desire to transfer their terminating partnership interests to the resulting partnership in exchange for resulting partnership interests, and then liquidate the terminating partnership into the resulting partnership (referred to as the "interests-over form"). Under the final regulations, the partnerships will be treated as following the assets-over form of merger for federal income tax purposes.[262]

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259 Treas. Reg. § 1.708-1(c)(5), Example 1.

260 Treas. Reg. § 1.708-1(c)(3)(i); Preamble, T.D. 8925, 2001-1 C.B. at 497.

261 Treas. Reg. § 1.703-1(c)(3)(i).

262 Notice of Proposed Rulemaking, REG-111119-99, 2000-2 C.B. 455, 460 [hereinafter "Partnership Merger Regs Notice"].

(1) Assets-Over Form.

(a) Description of Assets-Over Form. Under the assets-over form, a terminating partnership contributes its assets and liabilities to the resulting partnership in exchange for interests in the resulting partnership, and immediately thereafter, the terminated partnership distributes interests in the resulting partnership to its partners in liquidation of the terminating partnership.[263] The form of the merger for state law purposes does not override the mechanical rules of the Code dictating the continuing partnership for federal income tax purposes.[264] Thus, as noted by one commentator, if the partnership that in form receives assets is not the resulting partnership for federal income tax purposes, the state law "direction" of the merger will be "reversed" for tax purposes, and a partnership that in form transferred the assets may be treated as the resulting partnership.[265] This point is illustrated in the Example 1 below.

(i) Example 1. A and B own 40% and 60% interests, respectively, in the capital and profits of the X Partnership. B and C own 60% and 40% interests, respectively, in the capital and profits of the Y Partnership. The X Partnership and the Y Partnership merge on September 30, 1999. The fair market value of the X Partnership's assets (net of liabilities) is $100X, and the fair market value of the Y Partnership's assets (net of liabilities) is $200X. The merger is accomplished under state law by the Y Partnership contributing its assets and liabilities to the X Partnership in exchange for interests in the X partnership, with the Y Partnership then liquidating and distributing its interests in the X Partnership to B and C.

B, a partner in both partnerships prior to the merger, owns a greater than 50-percent interest in the resulting partnership following the merger. Accordingly, since the fair market value of the Y Partnership's assets (net of liabilities) was greater than that of the X Partnership, the X Partnership is considered to terminate in the merger. As a result, even though, for state law purposes, the transaction was undertaken with the Y Partnership contributing its assets and liabilities to the X Partnership and distributing X Partnership interests

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[263] Treas. Reg. § 1.708-1(c)(3)(i); *see also* Partnership Merger Regs. Notice, 2000-2 C.B. at 461 ("[U]nder the Assets-Over Form, gain under sections 704(c)(1)(B) and 737 is not triggered. See sections 1.704-4(c)(4) and 1.737-2(b)."); Treas. Reg. § 1.704-4(c)(4) ("Section 704(c)(1)(B) and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement."); Treas. Reg. § 1.737-2(b)(1) ("Complete transfer. Section 737 and this section do not apply to a transfer by a partnership (transferor partnership) of all of its assets and liabilities to a second partnership (transferee partnership) in an exchange described in section 721, followed by a distribution of the interest in the transferee partnership in liquidation of the transferor partnership as part of the same plan or arrangement.").

[264] *See*, *e.g.,* Treas. Reg. § 1.708-1(c)(5), Example 2; *See also* Sloan, Lipton, Frediani, "Final Regulations Under Section 708 Provide Expanded Guidance on Partnership Mergers and Divisions – Part 1," 496 PLI/Tax 1125, 1135 (June 2001) [hereinafter "Sloan"].

[265] *See* Sloan, 496 PLI/Tax at 1135.

to its partners, for federal income tax purposes, the transaction is treated as if the X partnership contributed its assets to the Y Partnership in exchange for interests in the Y Partnership and then liquidated, distributing interests in the Y Partnership to A and B.[266]

(ii) Example 2. The X Partnership and the Y Partnership merge when the partners of X transfer their X Partnership interests to Y in exchange for Y partnership interests. Immediately thereafter, X liquidates into Y. The resulting partnership is considered a continuation of Y, and X is considered terminated.

The partnerships are treated as undertaking the assets-over form because the partnerships undertook a form that is not the assets-up form. Accordingly, for federal income tax purposes, partnership X is deemed to contribute its assets and liabilities to partnership Y in exchange for interests in partnership Y, and, immediately thereafter, partnership X is deemed to have distributed the interests in partnership Y to its partners in liquidation of their interests in partnership X.[267]

(b) Treatment of Liabilities in Asset-Over Form. Upon the merger or consolidation of two or more partnerships, increases and decreases in partnership liabilities associated with the merger or consolidation are netted by the partners in the terminating partnership and the resulting partnership to determine the effect of the merger.[268]

The regulations provide an example illustrating the effect of liabilities in an assets-over form of merger. B owns a 70 percent interest in the T Partnership. T's sole asset is property X, which is encumbered by a $900 liability. T's adjusted basis in property X is $600, and the value of property X is $1,000. B's adjusted basis in its partnership interest in T is $420. B also owns a 20% interest in the S Partnership. S's sole asset is property Y, which is encumbered by a $100 liability. Partnership S's adjusted basis in property Y is $200, the value of property Y is $1,000, and B's adjusted basis in its partnership interest in S is $40.

Assume that the T and S Partnerships merge and that T is considered terminated and the resulting partnership is considered a continuation of partnership S. T and S undertake the assets-over form for the merger. T contributes property X and its $900 liability to S in exchange for an interest in S. Immediately thereafter, T distributes the interests in S to its partners in liquidation of their interests in T. B owns a 25% interest in S after T distributes the interests in S to B.

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266 Treas. Reg. § 1.708-1(c)(5), Example 2.

267 Treas. Reg. § 1.708-1(c)(5), Example 4.

268 Treas. Reg. § 1.752-1(g), Example 2.

B nets the increases and decreases in its share of partnership liabilities associated with the merger of T and S. Before the merger, B's share of partnership liabilities was $650 (B had a $630 share of partnership liabilities in T and a $20 share of partnership liabilities in S immediately before the merger). B's share of S's partnership liabilities after the merger is $250 (25% of S's total partnership liabilities of $1,000). Accordingly, B has a $400 net decrease in its share of S's partnership liabilities. Thus, B is treated as receiving a $400 distribution from partnership S. Since B's adjusted basis in its partnership S interest before the deemed distribution is $460 ($420 + $40), B will not recognize gain. After the merger, B's adjusted basis in its partnership S interest is $60.[269]

(2) Assets-Up Form.

(a) Description of Assets-Up Form. Under the assets-up form, the merged or consolidated partnership that is considered terminated distributes all of its assets to its partners (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) in liquidation of the partners' interests in the terminated partnership[270], and immediately thereafter, the partners in the terminated partnership contribute the distributed assets to the resulting partnership in exchange for interests in the resulting partnership.[271] The regulations provide that the form of this merger or combination will be respected "[d]espite the partners' transitory ownership of the terminated partnership's assets."[272] The Preamble to the final regulations states that a partnership can use the assets-up form for partnership mergers regardless of whether the partners could otherwise generally hold certain assets, such as undivided interests in goodwill, outside of a partnership.[273]

(i) Conveyance of Ownership of Assets. While the final regulations provide that the assets-up form will be respected in accomplishing partnership mergers, the Preamble to the final regulations states that the IRS and Treasury do not intend to establish a regime whereby partners essentially can elect between the assets-up form and the assets-over form by creating different documents that have the same legal effect. The Preamble states that if the assets-up form is to be respected, a partnership must actually undertake the steps that are necessary, under the laws of the applicable jurisdiction, to convey ownership of the assets that are distributed to the partners.[274] In the Preamble, the Service rejects the proposal that, rather than actually conveying ownership of the assets under applicable jurisdictional law, the partners be allowed to assign their rights

269 Treas. Reg. § 1.752-1(g), Example 2.

270 The Preamble to the proposed regulations cautions that under the assets-up form, partners could recognize gain under sections 704(c)(1)(B) and 737 when the terminating partnership distributes the assets to the partners. Partnership Merger Regs. Notice, 2000-2 C.B. at 460.

271 Treas. Reg. § 1.708-1(c)(3)(ii).

272 Treas. Reg. § 1.708-1(c)(3)(ii).

273 Preamble, T.D. 8925, 2001-1 C.B. at 496, 497.

274 Preamble, T.D. 8925, 2001-1 C.B. at 497.

to receive title to the assets in liquidation of the partnership, or direct the partnership to transfer title to the assets to the resulting partnership.[275]

Some commentators have questioned whether a transfer of assets to a single-member limited liability company ("LLC") followed by a distribution of interests in such LLC to the partners would qualify under the assets-up form since the partners would not actually be conveyed ownership of the assets under local law. Rather, the partners would be conveyed an interest in an LLC holding the assets.[276] These commentators have concluded that this result seems rather harsh and should be formally rejected by the Service.[277]

(ii) Liabilities. The Preamble to the final regulations provides that, while the IRS and Treasury believe that it should be necessary for a partnership to actually convey ownership of the partnership's assets to its partners in order to follow the assets-up form, it should not be necessary for the partners to actually assume the liabilities of the partnership in order to follow such form. The Preamble states that, under the Code and regulations,[278] a partner essentially is deemed to have directly incurred a share of the partnership's liabilities. The Service therefore concludes in the Preamble that requiring the partners to actually assume debt that they already are deemed to have incurred is unnecessary.[279]

(b) Example. A and B own 40% and 60% interests, respectively, in the capital and profits of the X Partnership. X is engaged in a trade or business and has, as one of its assets, goodwill. B and C own 60% and 40% interests, respectively, in the capital and profits of the Y Partnership. The X Partnership and the Y Partnership merge on September 30, 1999. The fair market value of the X Partnership's assets (net of liabilities) is $100X, and the fair market value of the Y Partnership's assets (net of liabilities) is $200X. The merger is accomplished under state law by having X convey an undivided 40% interest in each of its assets to A and an undivided 60% interest in each of its assets to B, with A and B then contributing their interests in such assets to the Y Partnership. Y also assumes all of the liabilities of partnership X.

B, a partner in both partnerships prior to the merger, owns a greater than 50-percent interest in the resulting partnership following the merger. Accordingly, since the fair market value of the Y Partnership's assets (net of liabilities) was greater than that of the X Partnership, X is considered to terminate

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275 Preamble, T.D. 8925, 2001-1 C.B. at 497.

276 *See* Hortenstine, Jackel, Ladin, "Final Partnership Merger and Division Regulations – Analysis, Commentary and Examples," 496 PLI/Tax 1043, 1049-50 (2001) [hereinafter "Hortenstine"].

277 *Id.*

278 *See generally* I.R.C. § 752 and the regulations thereunder.

279 Preamble, T.D. 8925, 2001-1 C.B. at 497.

in the merger. The form of the partnership merger will be respected so that X will be treated as following the assets-up form for federal income tax purposes.[280]

(b) Partner Buy-Out Rule

The final regulations contain a special buy-out rule to address the situation where one partner would prefer to be cashed out in an assets-over form of merger rather than becoming a partner in the resulting partnership.[281] This rule provides that a sale of all or part of a partner's interest in the terminated partnership to the resulting partnership as part of an asset-over form of merger or consolidation will be respected as a sale of a partnership interest if (1) the merger agreement (or another document) specifies that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is transferred for each interest sold; and (2) the selling partner in the terminated partnership, either prior to or contemporaneous with the transaction, consents to treat the transaction as a sale of the partnership interest.[282] The timing of the selling partner's consent is important. The regulations expressly require the selling partner in the terminated partnership to provide the requisite consent prior to or contemporaneous with the transaction.

The special buy-out rule allows a resulting partnership in a merger to fund the purchase of one or more partners' interests in a terminating partnership without triggering the disguised sale rules, which otherwise would cause all of the partners in the terminating partnership to recognize gain or loss as a result of the purchase.[283] This treatment will apply even if the resulting partnership sends the consideration to the terminating partnership on behalf of the exiting partner, so long as the designated language is used in the relevant document.[284]

(1) Form of Merger Transaction Under Special Buy-Out Rule. Under the special buy-out rule, the exiting partner is treated as separately selling a partnership interest in the terminating partnership to the resulting partnership (and the resulting partnership is treated as purchasing the partner's interest in the terminating partnership) immediately prior to the merger.[285] Immediately after this sale, the resulting partnership becomes a momentary partner in the terminating partnership.[286] The terminating partnership is then treated as contributing its assets and liabilities attributable to the continuing partners' interests to the resulting partnership in exchange for interests in the resulting partnership and, immediately thereafter, distributing such interests to the continuing partners in liquidation of their interests in the terminating partnership.[287] At the same time, the terminating partnership, as part of the merger, is treated as distributing assets to the resulting partnership in liquidation of the resulting partnership's interest

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280 Treas. Reg. § 1.708-1(c)(5), Example 3.

281 Partnership Merger Regs. Notice, 2000-2 C.B. at 457.

282 Treas. Reg. § 1.708-1(c)(4); For a discussion of the advantages and disadvantages of an exiting partner consenting to an interest sale as opposed to a partnership redemption, *see* Sloan, 496 PLI/Tax at 1140-47.

283 Treas. Reg. § 1.708-1(c)(4).

284 Partnership Merger Regs Notice, 2000-2 C.B. at 458.

285 Partnership Merger Regs Notice, 2000-2 C.B. at 459-460; Treas. Reg. § 1.708-1(c)(5), Example 5(iii).

286 Partnership Merger Regs Notice, 2000-2 C.B. at 460.

287 Treas. Reg. § 1.708-1(c)(5), Example 5(iii).

in the terminating partnership. The resulting partnership should take an exchanged basis in the distributed assets under Section 732(b).[288]

(2) Document Specifying Buy-Out and Consideration; Form of Consent from Selling Partner. The final regulations provide that the merger agreement or another document must specify that the resulting partnership is purchasing interests from a particular partner in the merging or consolidating partnership and the consideration that is transferred for each interest sold.[289] The Preamble clarifies that the exiting partner does not have to be a party to the merger agreement in order to obtain the benefit of the special buy-out rule. To ensure, however, that all partners to the transaction treat the transaction consistently when filing their returns, the final regulations require that, prior to or contemporaneous with the transfer, the exiting partner must consent to the sale treatment provided in the special buy-out rule.[290]

(3) Example of Application of Special Buy-Out Rule. The regulations contain an example illustrating the application of the special buy-out rule. Assume that A, B, and C are partners in the X Partnership. D, E, and F are partners in the Y Partnership. The X Partnership and the Y Partnership merge. Assume that the resulting partnership is considered a continuation of the Y Partnership and that the X Partnership is considered terminated. Under state law, X and Y undertake the assets-over form to accomplish the partnership merger. C does not want to become a partner in Y, and X does not have the resources to buy C's interest before the merger. C, X Partnership, and Y Partnership enter into an agreement specifying that Y Partnership will purchase C's interest in X Partnership for $150 before the merger, and as part of the agreement, C consents to treat the transaction in a manner that is consistent with the agreement. As part of the merger, X Partnership receives from Y Partnership $150 that will be distributed to C immediately before the merger, and interests in the Y Partnership in exchange for X Partnership's assets and liabilities.

Since the merger agreement satisfies the requirements of the buy-out provisions of the regulations and C provides the necessary consent, C will be treated as selling its interest in partnership X to partnership Y for $150 before the merger.[291] Moreover, since the merger agreement satisfies the requirements of the regulations, partnership Y is considered to have purchased C's interest in partnership X for $150 immediately before the merger.

Partnership X is treated as contributing its assets and liabilities attributable to the interests of A and B to partnership Y in exchange for interests in partnership Y and, immediately thereafter, distributing the interests in partnership Y to A and B in liquidation of their interests in partnership X. At the same time, partnership X is treated as distributing assets to partnership Y in liquidation of partnership Y's interest in partnership X. Partnership Y's bases in the distributed assets are determined under Section 732(b).

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[288] Preamble, T.D. 8925, 2001-1 C.B. at 499; *see, e.g.,* Treas. Reg. § 1.708-1(c)(5), Example 5(iv); For some insightful criticism of some aspects of Example 5 in Treas. Reg. § 1.708-1(c)(5), *see* Hortenstine, 496 PLI/Tax at 1054.

[289] Treas. Reg. § 1.708-1(c)(4).

[290] Preamble, T.D. 8925, 2001-1 C.B. at 499.

[291] Treas. Reg. § 1.708-1(c)(5), Example 5(ii).

(4) Sale of 50% or More of Total Interests in the Partnership. Although not discussed in the final regulations, the Preamble states that if exiting partners sell 50 percent or more of the total interests in the terminating partnership's capital and profits as part of a merger, then a partnership termination under Section 708(b)(1)(B) will occur immediately before the merger.[292]

(c) Treatment of Partnership Merger Utilizing More Than One Form

Under the final regulations, each partner must participate (or will be deemed to participate) in the partnership merger in the same manner (with the exception of those partners who are subject to the buy-out rule).[293] The Preamble to the final regulations offers some insight into the Service's thinking on this issue. It states that the final regulations were not intended to provide unlimited flexibility among the various structural alternatives for accomplishing merger or consolidation transactions. Instead, the regulations were intended to provide a set of administrable rules that taxpayers and the IRS could apply in characterizing these transactions. The IRS and Treasury do not believe it is appropriate for a partnership merger to be accomplished using both the assets-over form and the assets-up form when all the assets and liabilities of the terminated partnership are transferred to a single resulting partnership. Therefore, if the partners wish for a partnership merger to be characterized under the assets-up form, the terminated partnership must undertake the steps of the assets-up form for all of its assets when it distributes the assets to its partners. Otherwise, the transaction will be characterized under the assets-over form.[294]

The final regulations provide a caveat to the foregoing rule. Where more than two partnerships are combined, each combination will be viewed under the final regulations as a separate merger so that the characterization of a merger of one partnership into the resulting partnership under the assets-over form will not prevent a simultaneous merger of another partnership into the same resulting partnership from being characterized under the assets-up form.[295]

(d) Authority Granted to Revenue Service to Disregard Form of Transaction in Certain Cases

If a partnership merger is part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form, the final regulations give the Revenue Service the authority to disregard such form and to recast the larger series of transactions in accordance with their substance.[296]

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292 Preamble, T.D. 8925, 2001-1 C.B. at 499.

293 Treas. Reg. § 1.708-1(c)(3); Preamble, T.D. 8925, 2001-1 C.B. at 498.

294 Preamble, T.D. 8925, 2001-1 C.B. at 498.

295 Preamble, T.D. 8925, 2001-1 C.B. at 498; *see* Treas. Reg. § 1.708-1(c)(3).

296 Treas. Reg. § 1.708-1(c)(6).

E. Partnership Divisions

1. Effecting a Division

The Code neither defines what constitutes a partnership division nor prescribes a form for a partnership division. The Code provides that, in the case of a division of a partnership into two or more partnerships, the resulting partnerships (other than any resulting partnership the members of which had an interest of 50 percent or less in the capital and profits of the prior partnership) are considered a continuation of the prior partnership.[297] The regulations provide that any other resulting partnership is not considered a continuation of the prior partnership but is considered a new partnership.[298] If the members of none of the resulting partnerships owned an interest of more than 50 percent in the capital and profits of the prior partnership, the prior partnership is terminated.[299] Where members of a partnership that has been divided do not become members of a resulting partnership that is considered a continuation of the prior partnership, such partner's interest is considered liquidated as of the date of the division.[300]

2. Form of Partnership Division

Simultaneous with the issuance on January 3, 2001, of final regulations addressing the form of partnership mergers, the Revenue Service issued regulations addressing the form of partnership divisions.[301] These final regulations apply to partnership divisions occurring on or after January 4, 2001.[302] A partnership, however, may elect to apply the final regulations to partnership divisions occurring on or after January 11, 2000.[303]

The final regulations describe the tax consequences of a partnership division and the alternative forms of a division, but do not provide a comprehensive definition of what constitutes a partnership division.[304] The Preamble to the final regulations, however, provides some insight into the Service's thinking on the issue of what constitutes a partnership division. The Preamble states that "[t]o have a division, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction." As an illustration of this point, the Preamble provides the following example of a transaction that the Service concludes does not constitute a division: ABC partnership owns X business and Y business. A and B each own a 20-percent interest, and C owns a 60-percent interest in the ABC partnership. C does not want to continue in the partnership with A and B and would like to operate X business with D. Accordingly, ABC partnership distributes X business to C in liquidation of C's interest in partnership ABC. Subsequently, C forms a partnership with D and contributes X business to the

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297 I.R.C. § 708(b)(2)(B).

298 Treas. Reg. § 1.708-1(b)(2)(ii).

299 Treas. Reg. § 1.708-1(b)(2)(ii).

300 Treas. Reg. § 1.708-1(b)(2)(ii).

301 Preamble, T.D. 8925, 2001-1 at 496.

302 Treas. Reg. § 1.708-1(d)(7).

303 Treas. Reg. § 1.708-1(d)(7).

304 *See* Preamble, T.D. 8925, 2001-1 C.B. 496, 499; *see also* Treas. Reg. § 1.708-1(d)(4)(iv) (defining a resulting partnership as "a partnership resulting from the division that exists under applicable jurisdictional law after the division and that has at least two members who were partners in the prior partnership.")

CD partnership. After the distribution and contribution of X business, AB partnership owns Y business and CD partnership owns X business. In concluding that the transaction does not constitute a division, the Service reasoned that, for a division to occur, at least two members of the prior partnership must be members of each resulting partnership that exists after the transaction. In the above example, C is the only member of the ABC partnership in the CD partnership. Accordingly, the Preamble states that this transaction would not be treated as a division for federal income tax purposes.[305] Some commentators have observed that this still leaves many unanswered questions.[306] For instance, suppose A is already a partner in CD (or, alternatively, assume A contributes other assets to CD as part of this transaction). Would this constitute a division even though A did not receive a distribution from ABC as part of this transaction? The Preamble does not address this issue.

(a) Defined Terms Used in Treasury Regulations to Describe Form of Partnership Division

In describing the form of a partnership division, the final regulations use four defined terms: (1) prior partnership; (2) resulting partnership; (3) divided partnership; and (3) recipient partnership.[307] Knowing the meaning of these terms is key to understanding the form of a partnership division.

(1) Prior Partnership; Resulting Partnership. The terms prior partnership and resulting partnership describe partnerships that exist under the applicable jurisdictional law.

(a) Prior Partnership. The prior partnership is the partnership subject to division that exists under the applicable jurisdictional law before the division.[308]

(b) Resulting Partnership. A resulting partnership is a partnership resulting from the division that exists under the applicable jurisdictional law after the division and that has at least two partners who were partners in the prior partnership.[309] For example, where a prior partnership divides into two partnerships, both partnerships existing after the division are resulting partnerships.[310]

(2) Divided Partnership and Recipient Partnership. The terms divided partnership and recipient partnership are federal income tax concepts prescribed by the regulations.[311]

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305 Preamble, T.D. 8925, 2001-1 at 503.

306 Hortenstine, 496 PLI/Tax at 1057.

307 *See* Treas. Reg. § 1.708-1(d)(4).

308 Treas. Reg. § 1.708-1(d)(4)(ii).

309 Treas. Reg. § 1.708-1(d)(4)(iv).

310 Treas. Reg. § 1.708-1(d)(4)(iv).

311 *See* Preamble, T.D. 8925, 2001-1 C.B. at 503.

(a) Divided Partnership. A divided partnership is the continuing partnership which is treated, for federal income tax purposes, as transferring the assets and liabilities to the recipient partnership or partnerships, either directly (under the assets-over form) or indirectly (under the assets-up form).[312] The divided partnership must be a continuation of the prior partnership.[313] The rules in the regulations for identifying the divided partnership are as follows:

(i) If the resulting partnership that, in form, transferred the assets and liabilities in connection with the division is a continuation of the prior partnership, then such resulting partnership will be treated as the divided partnership.[314]

(ii) If a partnership divides into two or more partnerships and only one of the resulting partnerships is a continuation of the prior partnership, then the resulting partnership that is a continuation of the prior partnership will be treated as the divided partnership.[315] Although the divided partnership is considered one continuing partnership for federal income tax purposes, it may actually be two different partnerships under the applicable jurisdictional law (i.e., the prior partnership and a different resulting partnership that is considered a continuation of the prior partnership for federal income tax purposes).[316]

(iii) If a partnership divides into two or more partnerships without undertaking the assets over or asset up form for the division, or if the resulting partnership that had, in form, transferred assets and liabilities is not considered a continuation of the prior partnership, and more than one resulting partnership is considered a continuation of the prior partnership, the continuing resulting partnership with the assets having the greatest fair market value (net of liabilities) will be treated as the divided partnership.[317]

(b) Recipient Partnership. A recipient partnership is a partnership that is treated as receiving, for federal income tax purposes, assets and liabilities from a divided partnership, either directly (under the assets-over form) or indirectly (under the assets-up form).[318]

(b) General Rules Concerning Form of Partnership Division

The regulations respect for federal income tax purposes the form of a partnership division accomplished under laws of an applicable jurisdiction if the partnership undertakes the steps of either the assets-over form or the assets-up form as prescribed in the regulations. Thus, the same

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312 Treas. Reg. § 1.708-1(d)(4)(i).

313 Preamble, T.D. 8925, 2001-1 at 502.

314 Treas. Reg. § 1.708-1(d)(4)(i).

315 Treas. Reg. § 1.708-1(d)(4)(i).

316 Preamble, T.D. 8925, 2001-1 C.B. at 503.

317 Treas. Reg. § 1.708-1(d)(4)(i).

318 Treas. Reg. § 1.708-1(d)(4)(iv).

forms allowed for partnership mergers are allowed for partnership divisions. Consistent with partnership mergers, if a partnership divides using a form other than the two prescribed, it will be treated as undertaking the assets-over form.[319]

(1) Assets-Over Form.

(a) Assets-over form where at least one resulting partnership is a continuation of the prior partnership. In a division under the assets-over form where at least one resulting partnership is a continuation of the prior partnership, the divided partnership contributes certain assets and liabilities to a recipient partnership or recipient partnerships in exchange for interests in such recipient partnership or partnerships; and, immediately thereafter, the divided partnership distributes the interests in such recipient partnership or partnerships to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership.[320]

(i) Example 1. To illustrate, assume that the ABCD Partnership owns three parcels of property: property X, with a value of $500; property Y, with a value of $300; and property Z, with a value of $200. A and B each own a 40-percent interest in the capital and profits of the ABCD Partnership, and C and D each own a 10 percent interest in the capital and profits of the ABCD Partnership. On November 1, 1999, the ABCD Partnership divides into three partnerships (AB1, AB2, and CD) by contributing property X to a newly formed partnership (AB1) and distributing all interests in such partnership to A and B as equal partners, and by contributing property Z to a newly formed partnership (CD) and distributing all interests in such partnership to C and D as equal partners in exchange for all of their interests in the ABCD Partnership. While the ABCD Partnership does not transfer property Y, C and D cease to be partners in the partnership. Accordingly, after the division, the partnership holding property Y is referred to as partnership AB2.

The AB1 and AB2 Partnerships both are considered a continuation of the ABCD Partnership, while the CD partnership is considered a new partnership formed at the beginning of the day on November 2, 1999. The ABCD Partnership will be treated as following the assets-over form, with the ABCD Partnership contributing property X to the AB1 Partnership and property Z to the CD Partnership, and distributing the interests in such partnerships to the designated partners.[321]

(ii) Example 2. Suppose that the facts are the same as in Example 1 except that the ABCD Partnership divides into three partnerships by operation of state law, without undertaking a form. The AB1 Partnership will be treated as the resulting partnership that is the divided partnership. The ABCD

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319 Treas. Reg. § 1.708-1(d)(3)(i).

320 Treas. Reg. § 1.708-1(d)(3)(i)(A).

321 Treas. Reg. § 1.708-1(d)(5), Example 4.

Partnership will be treated as following the assets-over form, with the ABCD Partnership contributing property Y to the AB2 Partnership and property Z to the CD partnership, and distributing the interests in such partnerships to the designated partners.[322]

(iii) Example 3. Suppose the facts are the same as in Example 1, except that the ABCD Partnership divides into three partnerships by contributing property X to the newly-formed AB1 Partnership and property Y to the newly-formed AB2 Partnership and distributing all interests in each partnership to A and B in exchange for all of their interests in the ABCD Partnership. Because the resulting CD Partnership is not a continuation of the prior partnership (ABCD Partnership), the CD Partnership cannot be treated, for federal income tax purposes, as the partnership that transferred assets (i.e., the divided partnership), but instead must be treated as a recipient partnership. The AB1 Partnership will be treated as the resulting partnership that is the divided partnership. The ABCD Partnership will be treated as following the assets-over form, with the ABCD Partnership contributing property Y to the AB2 Partnership and property Z to the CD Partnership, and distributing the interests in such partnerships to the designated partners.[323]

(b) Assets-over form where none of the resulting partnerships is a continuation of the prior partnership. In a division under the assets-over form where none of the resulting partnerships is a continuation of the prior partnership, the prior partnership will be treated as contributing all of its assets and liabilities to new resulting partnerships in exchange for interests in the resulting partnerships; and, immediately thereafter, the prior partnership will be treated as liquidating by distributing the interests in the new resulting partnerships to the prior partnership's partners.[324]

(2) Assets-up Form.

(a) Assets-up form where the partnership distributing assets is a continuation of the prior partnership. Despite the partners' transitory ownership of some of the prior partnership's assets, the form of a partnership division will be respected for federal income tax purposes if the divided partnership (which must be a continuing partnership) distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the divided partnership, and immediately thereafter, such partners contribute the distributed assets to a recipient partnership or partnerships in exchange for interests in such recipient partnership or partnerships.[325] In order for such form to be respected for transfers to a particular recipient partnership, all

322 Treas. Reg. § 1.708-1(d)(5), Example 5.

323 Treas. Reg. § 1.708-1(d)(5), Example 6.

324 Treas. Reg. § 1.708-1(d)(3)(i)(B).

325 Treas. Reg. § 1.708-1(d)(3)(ii)(A).

assets held by the prior partnership that are transferred to the recipient partnership must be distributed to, and then contributed by, the partners of the recipient partnership.[326]

The regulations contain an example illustrating this form of division. Assume that the ABCD Partnership owns properties W, X, Y, and Z, and divides into the AB Partnership and the CD partnership. Assume further that the AB Partnership is considered a continuation of the ABCD Partnership and that the CD Partnership is considered a new partnership. The ABCD Partnership (i) distributes property Y to C and titles property Y in C's name and (ii) distributes property Z to D and titles property Z in D's name. C and D then contribute properties Y and Z, respectively, to the CD partnership in exchange for interests in the CD partnership. Properties W and X remain in partnership AB. The regulations conclude that the ABCD Partnership will be treated as following the assets-up form for federal income tax purposes.[327]

(b) Assets-up form where none of the resulting partnerships are a continuation of the prior partnership. If none of the resulting partnerships are a continuation of the prior partnership, then despite the partners' transitory ownership of some or all of the prior partnership's assets, the form of a partnership division will be respected for federal income tax purposes if the prior partnership distributes certain assets (in a manner that causes the partners to be treated, under the laws of the applicable jurisdiction, as the owners of such assets) to some or all of its partners in partial or complete liquidation of the partners' interests in the prior partnership, and immediately thereafter, such partners contribute the distributed assets to a resulting partnership or partnerships in exchange for interests in such resulting partnership or partnerships.[328] In order for such form to be respected for transfers to a particular resulting partnership, all assets held by the prior partnership that are transferred to the resulting partnership must be distributed to, and then contributed by, the partners of the resulting partnership.[329] If the prior partnership does not liquidate under the applicable jurisdictional law, then with respect to the assets and liabilities that, in form, are not transferred to a new resulting partnership, the prior partnership will be treated as transferring these assets and liabilities to a new resulting partnership under the assets-over form.[330]

(c) Treatment of Partnership Division Utilizing More Than One Form.

The final regulations require consistency in applying either the assets-over form or the assets-up form to characterize a transfer of assets to a resulting partnership.[331] Thus, the final

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326 Treas. Reg. § 1.708-1(d)(3)(ii)(A).

327 Treas. Reg. § 1.708-1(d)(5), Example 2.

328 Treas. Reg. § 1.708-1(d)(3)(ii)(B).

329 Treas. Reg. § 1.708-1(d)(3)(ii)(B)

330 Treas. Reg. § 1.708-1(d)(3)(ii)(A).

331 Preamble, T.D. 8925, 2001-1 C.B. at 498; see Treas. Reg. § 1.708-1(d)(3)(i).

regulations do not permit a partnership division to effect a transfer to a resulting partnership utilizing both the assets-over form and the assets up form.[332] If, however, a single partnership is divided in a transaction that involves a transfer of assets (either actual or deemed) to multiple partnerships, the regulations permit the transfer to each resulting partnership to be viewed separately. As with mergers involving more than two partnerships, Treasury believes it is consistent with the purposes of the regulations, in the context of divisions, to allow the transfer to one resulting partnership to be characterized under the assets-over form while characterizing the transfer to another resulting partnership under the assets-up form.[333]

(1) Example 1. The final regulations contain an example illustrating when a division accomplished under both the assets-over form and the assets-up form will not be respected. Assume that the ABCD Partnership owns properties W, X, Y, and Z, and divides into the AB Partnership and the CD partnership. Assume further that the AB Partnership is considered a continuation of the ABCD Partnership and that the CD Partnership is considered a new partnership. ABCD Partnership distributes property Y to C and titles property Y in C's name. C then contributes property Y to partnership CD. Simultaneously, the ABCD Partnership contributes property Z to the CD Partnership in exchange for an interest in the CD Partnership. Immediately thereafter, the ABCD Partnership distributes the interest in the CD Partnership to D in liquidation of D's interest in the ABCD Partnership.

The regulations conclude that since the ABCD Partnership did not undertake the assets-up form with respect to all of the assets transferred to the CD Partnership, the ABCD Partnership will be treated as undertaking the assets-over form in transferring the assets to the CD Partnership. Accordingly, for federal income tax purposes, the ABCD Partnership is deemed to contribute property Y and property Z to the CD Partnership in exchange for interests in the CD Partnership, and immediately thereafter, the ABCD Partnership is deemed to distribute the interests in the CD Partnership to partner C and partner D in liquidation of their interests in the ABCD Partnership.[334]

(2) Example 2. The final regulations provide an example that illustrates when a division accomplished under both the assets-over form and the assets-up form will be respected. Assume that the Partnership ABCDE owns Blackacre, Whiteacre, and Redacre, and divides into the AB Partnership, the CD Partnership, and the DE Partnership. Assume that the ABCDE Partnership is considered terminated (and, hence, none of the resulting partnerships are a continuation of the prior partnership) because none of the members of the new partnerships (AB Partnership, CD Partnership, and DE Partnership) owned an interest of more than 50 percent in the capital and profits of the ABCDE Partnership.

ABCDE Partnership distributes Blackacre to A and B and titles Blackacre in the names of A and B. A and B then contribute Blackacre to the AB Partnership in exchange for interests in the AB Partnership. The regulations conclude that the ABCDE Partnership will be treated as following the assets-up form for federal income tax purposes.

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[332] Treas. Reg. § 1.708-1(d)(3)(i).

[333] Preamble, T.D. 8925, 2001-1 C.B. at 498.

[334] Treas. Reg. § 1.708-1(d)(5), Example 3.

ABCDE Partnership distributes Whiteacre to C and D and titles Whiteacre in the names of C and D. C and D then contribute Whiteacre to the CD Partnership in exchange for interests in the CD Partnership. ABCDE Partnership will be treated as following the assets-up form for federal income tax purposes.

ABCDE Partnership does not liquidate under state law so that, in form, the assets in the new DE partnership are not considered to have been transferred under state law. ABCDE Partnership will be treated as undertaking the assets-over form for federal income tax purposes with respect to the assets of the DE Partnership. Thus, the ABCDE Partnership will be treated as contributing Redacre to the DE Partnership in exchange for interests in the DE Partnership, and, immediately thereafter, ABCDE Partnership will be treated as distributing interests in the DE Partnership to D and E in liquidation of their interests in the ABCDE Partnership. The ABCDE Partnership then terminates.[335]

(d) Authority Granted to Revenue Service to Disregard Form of Transaction in Certain Cases.

If a partnership division is part of a larger series of transactions, and the substance of the larger series of transactions is inconsistent with following the form, the final regulations grant the Revenue Service the authority to disregard such form and to recast the larger series of transactions in accordance with their substance.[336]

(e) Application of Sections 704(c)(1)(B) and 737 to Partnership Divisions.

The rules of Section 704(c)(1)(B) and 737 may be implicated in the context of partnership divisions and deserve careful consideration. Section 704(c)(1)(B) requires a contributing partner to recognize pre-contribution built-in gain if property contributed to a partnership is distributed by the partnership (other than to the contributing partner) within 7 years of being contributed to the partnership. Section 737(a) provides that a partner that contributed property to a partnership recognizes pre-contribution built-in gain if the partnership distributes property to him within 7 years of the contribution. Any portion of a distribution, however, that consists of property that had been contributed by the distributee partner to the partnership is not taken into account under section 737(a).[337]

The Preamble to the proposed regulations addressing partnership mergers and divisions discusses some of the Section 704(c)(1)(B) and 737 issues implicated in a partnership division.[338] The Service announced in the Preamble to the final regulations that it is studying these issues and is requesting comments on the application of Section 704(c)(1)(B) and 737 in situations where a division is non-pro rata as to the partners, where some property is extracted from or added to the

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335 Treas. Reg. § 1.708-1(d)(5), Example 7.

336 Treas. Reg. § 1.708-1(d)(6).

337 I.R.C. § 737(d)(1).

338 Partnership Merger Regs. Notice, 2000-2 C.B. at 499.

partnerships in connection with the division, or where new partners are added to the ownership group in connection with the division.[339]

3. Tax Return; Elections.

(a) Tax Returns.

The Treasury regulations provide that the resulting partnership that is treated as the divided partnership retains the EIN of the prior partnership and is required to file a return for the taxable year of the partnership that has been divided.[340] The return is required to include the information prescribed in Treas. Reg. § 1.708-1(d)(2)(i). All other resulting partnerships that are considered as continuing and all new partnerships (i.e., resulting partnerships that are not considered continuing) will file separate returns for the taxable year beginning on the day after the date of the division with new EINs for each partnership.[341] The return for a resulting partnership that is regarded as continuing and that is not the divided partnership is required to include the name, address, and EIN of the prior partnership.[342]

To illustrate, assume that the ABCD Partnership is in the real estate and insurance businesses. A owns a 40-percent interest, and B, C, and D each owns a 20-percent interest, in the capital and profits of ABCD. The partnership and the partners report their income on a calendar year. On November 1, 1999, they separate the real estate and insurance businesses and form two partnerships. AB Partnership takes over the real estate business, and CD Partnership takes over the insurance business. Because members of resulting AB Partnership owned more than a 50-percent interest in the capital and profits of ABCD Partnership (A, 40 percent, and B, 20 percent), AB partnership is considered a continuation of ABCD Partnership. AB Partnership is required to file a return for the taxable year January 1 to December 31, 1999, indicating thereon that until November 1, 1999, it was the ABCD Partnership. CD Partnership is considered a new partnership formed at the beginning of the day on November 2, 1999, and is required to file a return for the taxable year it adopts.[343]

(b) Elections.

All resulting partnerships that are regarded as continuing are subject to preexisting elections that were made by the prior partnership. A subsequent election that is made by a resulting partnership does not affect the other resulting partnerships.[344]

## VII. ETHICAL CONSIDERATIONS

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

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339 Preamble, T.D. 8925, 2001-1 C.B. at 499-500.

340 Treas. Reg. § 1.708-1(d)(2)(i).

341 Treas. Reg. § 1.708-1(d)(2)(i).

342 Treas. Reg. § 1.708-1(d)(2)(i).

343 Treas. Reg. § 1.708-1(d)(5), Example 1.

344 Treas. Reg. § 1.708-1(d)(2)(ii).

While a seller and its partners 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 partner 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 partners 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, embarrassment and recrimination with the potential for considerable harm to the interests of one or more of the clients.

# AGREEMENT AND PLAN OF MERGER

of

**ABC LIMITED PARTNERSHIP**
(a Texas Limited Partnership)

**BCD LIMITED PARTNERSHIP**
(a Texas Limited Partnership)

and

**CDE LIMITED PARTNERSHIP**
(a Texas Limited Partnership)

**WITH AND INTO**

**DEE LIMITED PARTNERSHIP**
(a Delaware Limited Partnership)

**Date: ____________**

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[REMAINDER OF TABLE OMITTED]

# AGREEMENT AND PLAN OF MERGER

**THIS AGREEMENT AND PLAN OF MERGER** ("Agreement") is made and entered into as of the _____ day of ______________, by and among **DEE LIMITED PARTNERSHIP**, a Delaware limited partnership ("Surviving Limited Partnership"), **ABC LIMITED PARTNERSHIP**, a Texas limited partnership ("ABC"), **BCD LIMITED PARTNERSHIP**, a Texas limited partnership ("BCD"), and **CDE LIMITED PARTNERSHIP**, a Texas limited partnership ("CDE"). ABC, BCD and CDE are herein sometimes referred to collectively as the "Existing Limited Partnerships" and individually as an "Existing Limited Partnership."

## W I T N E S S E T H:

**WHEREAS**, the Existing Limited Partnerships desire to merge into the Surviving Limited Partnership and to convert all of the outstanding general and limited partnership interests in the Existing Limited Partnerships into units of limited partnership interest in the Surviving Limited Partnership, and Surviving Limited Partnership desires to acquire the assets, liabilities and operations of the Existing Limited Partnerships by merging with the Existing Limited Partnerships into the Surviving Limited Partnership, all upon and subject to the terms and conditions set forth herein; and

**WHEREAS**, the Existing Limited Partnerships and the Surviving Limited Partnership desire to adopt a plan of merger.

**NOW, THEREFORE**, for the purpose of setting forth the terms and conditions of the merger of the Existing Limited Partnerships with and into the Surviving Limited Partnership and the method of carrying the same into effect, and in consideration of the premises and the representations, warranties, mutual covenants and agreements of the parties set forth herein, and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged by each party hereto, the parties hereto do hereby agree as follows:

## ARTICLE I
## DEFINITIONS

**Section 1.1 Certain Definitions**. Unless the context otherwise specifies or requires, the following terms shall have the meanings herein specified throughout this Agreement.

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| "Cash Items" | As defined in **Section 5.1** hereof. |
| "Closing" | As defined in **Section 2.5** hereof. |
| "Closing Date" | As defined in **Section 2.5** hereof. |
| "Code" | The Internal Revenue Code of 1986, as amended, or any corresponding provisions of any succeeding law. |
| "Common Stock" | The common stock of DEE, Inc., the general partner of Surviving Limited Partnership. |

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| "DRULPA" | Delaware Revised Uniform Limited Partnership Act, as amended. |
| "Effective Time" | As defined in **Section 2.3** hereof. |
| "Hotel(s)" | The hotels constructed on the Land. |
| "Hotel Contracts" | Collectively, all service contracts, maintenance agreements, equipment leases, room allocation agreements (including wholesale and barter arrangements) and other contracts and agreements providing for the furnishing of goods and services in connection with the maintenance and operation of the Projects. |
| "Land" | The real estate described on **Exhibits B-1** through **B-6** annexed hereto. |
| "License Agreements" | The existing license agreements, or commitments for license agreements, for each Hotel between X and the Existing Limited Partnership owning each Hotel relating to the operation of each Hotel as an "___________" hotel. |
| "Management Agreements" | The existing management agreements, as modified, between X and each of the Existing Limited Partnerships covering the Hotels. |
| "Merger" | As defined in **Section 2.1** hereof. |
| "Operating Supplies" | All operating supplies for a Hotel such as food, beverages (both nonalcoholic and, to the extent transferable under applicable law, alcoholic), fuel, soap, cleansing items, brochures, matches, folios, stationery and other consumable supplies, linens, glassware, chinaware, silverware, and other similar items of any kind intended to be used in connection with the operation of the Hotel. |
| "Personal Property" | With respect to each Hotel, (i) all machinery, equipment, furniture, furnishings, fixtures, appliances, motor vehicles (if any), and other tangible personal property (excluding Operating Supplies) owned by the Existing Limited Partnerships and located on, attached to, or used in connection with the operation or maintenance of the Hotel and the applicable Personal Property or any part thereof, and all replacements or additions thereto between the date hereof and the Closing Date, and (ii) to the extent in the Existing Limited Partnerships' possession or control, all drawings, plans or construction records for the Hotel. |

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|---|---|
| "Project(s)" | The Hotel, the Land upon which such Hotel is situated and the Personal Property applicable to such Hotel. |
| "TRLPA" | Texas Revised Limited Partnership Act, as amended. |
| "Unit" | A denomination of an interest as a general partner or a limited partner in the Surviving Limited Partnership. |
| "Unit of General Partnership Interest" | A denomination of interest as a general partner in the Surviving Limited Partnership. |
| "Unit of Limited Partnership Interest" | A denomination of interest as a limited partner in the Surviving Limited Partnership |

**Section 1.2 Additional Definitions**. All terms of this Agreement which are not defined in **Section 1.1** shall have the meanings set forth elsewhere in this Agreement.

**Section 1.3 Captions**. Article and section captions and headings contained in this Agreement are for convenience of reference only and in no way define, limit, prescribe, expand or otherwise alter the scope or intent of this Agreement or in any way affect this Agreement or any provision hereof.

**Section 1.4 Interpretation**. Words in the singular number shall be held to include the plural and vice versa and words of one gender shall be held to include the other genders as the context requires. The terms "hereof," "herein," and "herewith" and words of similar import shall be construed to refer to this Agreement in its entirety and not to any particular provision unless otherwise stated. The word "person" shall mean any natural person, partnership, corporation and any other form of business or legal entity.

**Section 1.5 Construction**. This Agreement shall be construed without regard to any presumption or rule requiring construction against the party drafting such instrument or causing such instrument to be drafted.

## ARTICLE II
## THE MERGER

**Section 2.1 Merger**. Upon and subject to the terms and conditions set forth in this Agreement and in accordance with the provisions of TRLPA and DRULPA, at the Effective Time, ABC, BCD and CDE shall be merged with and into Surviving Limited Partnership in accordance with the applicable provisions of Section 2.11 of TRLPA and of Section 17-211 of DRULPA (the "Merger").

**Section 2.2 Effects of the Merger**. From and after the Effective Time, the Merger shall have the following effects, in accordance with the terms of this Agreement and of Section 2.11(g) of TRLPA and Section 17-211(h) of DRULPA:

**(a) Termination of Existence**. The separate existence of ABC, BCD and CDE shall cease, and Surviving Limited Partnership shall continue in existence as the Surviving Limited Partnership and shall be governed by DRULPA.

**(b) Transfer of Assets**. All rights, title and interests to all real and other property owned by each of the Existing Limited Partnerships (other than the License Agreements, Operating Supplies, and Cash Items) shall be allocated to and vested in Surviving Limited Partnership, as the surviving limited partnership, without reversion or impairment, without further act or deed, and without any transfer or assignment having occurred, but subject to any existing liens or other encumbrances thereon.

**(c) Assumption of Liabilities**. All liabilities and obligations of each of the Existing Limited Partnerships shall be allocated to Surviving Limited Partnership, as the surviving limited partnership, which shall thereafter be the primary obligor therefor.

**(d) Certificate of Limited Partnership and Agreement of Limited Partnership of the Surviving Partnership**. The Certificate of Limited Partnership of

Surviving Limited Partnership, as in effect immediately preceding the Effective Time, shall be and remain the Certificate of Limited Partnership of the Surviving Limited Partnership, until amended in accordance with DRULPA. The Agreement of Limited Partnership of Surviving Limited Partnership, as in effect immediately preceding the Effective Time, shall be and remain the Agreement of Limited Partnership of the Surviving Limited Partnership until amended in accordance with the terms thereof and of DRULPA.

**(e)** **Name of Surviving Limited Partnership**. Dee Limited Partnership shall be and remain the name of the Surviving Limited Partnership.

**(f)** **General Partner**. Dee, Inc., the General Partner of Dee Limited Partnership, shall be and remain the General Partner of the Surviving Limited Partnership.

**(g)** **Conversion of Partnership Interests**. All of the general and limited partnership interests in each of the Existing Limited Partnerships shall be changed and converted into Units of Limited Partnership Interest in the Surviving Limited Partnership as set forth in **Section 2.4** hereof.

**(h)** **Operating Supplies.** Concurrently with the closing, upon the filing of the Certificate of Merger (i.e. effective immediately prior to the Effective Date of the merger) all operating supplies will be deemed to be conveyed and assigned, without the need for further action, by each of the Exiting Limited Partnerships to Dee Management Company, a wholly owned subsidiary of Dee Limited Partnership.

**(i)** **License Agreements.** Concurrently with the closing, upon the filing of the Certificate of Merger (i.e. effective upon the Effective Date of the merger) all License Agreement with X shall be cancelled.

(j) **Cash Items**. Concurrently with the closing, upon the filing of the Certificate of Merger (i.e. effective immediately prior to the Effective Date of the merger) all Cash Items will be deemed to be conveyed and assigned, without the need for further action, by each of the Existing Limited Partnerships to Dee Management Company, a wholly owned subsidiary of Dee Limited Partnership.

**Section 2.3 Effective Time**. The Merger shall become effective at such time (the "Effective Time") as all of the following events shall have occurred: (i) a Certificate of Merger with respect to the Merger setting forth the information required by, and otherwise in compliance with, DRULPA shall have been duly filed in the Office of the Secretary of State of Delaware; and (ii) a Certificate of Merger with respect to the Merger setting forth the information required by, and otherwise in compliance with, TRLPA shall have been duly filed in the Office of the Secretary of State of Texas and the Secretary of State of Texas shall have issued a Certificate of Merger with respect thereto.

**Section 2.4 Conversion of Partnership Interests in the Merger**. By virtue of the Merger and without any action on the part of any person, at the Effective Time:

**(a) Conversion of Interests in the Existing Limited Partnerships**. Each general or limited partnership interest held by a partner in ABC, BCD or CDE immediately prior to the Effective Time shall be automatically changed and converted into Units of Limited Partnership Interest to be issued by the Surviving Limited Partnership at the Effective Time (rounded to the nearest whole Unit) to the entities listed on **Exhibit A** attached hereto and hereby incorporated herein by reference in the percentages set forth opposite the name of such entities on **Exhibit A** attached hereto.

**(b) Conversion of Interests in the Surviving Limited Partnership**. Each general or limited partnership interest held by a partner in Surviving Limited Partnership immediately prior to the Effective Time shall be redeemed on and as of the Effective Time, and each such existing partner in Surviving Limited Partnership shall be entitled, from and after the Effective Time to receive, in cash, from the Surviving Limited Partnership only the amount of such partner's original capital contribution to Surviving Limited Partnership, without interest thereon or income therefrom.

**Section 2.5 Time and Place of Closing**. Subject to the provisions of **Articles VI** and **VII** hereof, the closing of the transactions contemplated hereby (the "Closing") shall take place on the date of, and concurrently with, the closing of the Initial Public Offering (the "Closing Date") at the offices of ____________________________., ____________________ ________________________________, or on such other date, and at such other time or place as the parties hereto may mutually agree. Subject to the provisions of **Articles VI** and **VII** hereof, at the Closing (i) the partners in the Existing Limited Partnerships shall deliver to the Surviving Partnership executed signature pages of the Agreement of Limited Partnership of the Surviving Limited Partnership, (ii) the Surviving Limited Partnership shall issue Units of Limited Partnership Interest in accordance with the percentage allocations set forth on **Exhibit A** attached hereto, (iii) the Surviving Limited Partnership shall deliver to the entities listed on **Exhibit A** attached hereto confirmation of the number of Units of Limited Partnership Interest recorded in the name of each such entities on the books and records of the Surviving Limited Partnership in accordance with percentage allocations set forth on **Exhibit A** attached hereto, and (iv) each of the parties hereto shall execute and deliver the agreements, certificates, documents and instruments required to be delivered by such party and make the payments required by such party under and pursuant to **Article V** of this Agreement.

## ARTICLE III
## REPRESENTATIONS AND WARRANTIES OF THE EXISTING LIMITED PARTNERSHIPS

Each of the Existing Limited Partnerships, as to itself, hereby represents and warrants to Surviving Limited Partnership, as of the date hereof and as of the Closing Date, that:

**Section 3.1 Organization and Good Standing**. Such Existing Limited Partnership is a limited partnership duly formed under TRLPA and is validly existing and in good standing under the laws of the State of Texas. Such Existing Limited Partnership is duly qualified or licensed to do business and is in good standing in each foreign jurisdiction where its ownership of property or conduct of business requires it to be so qualified or licensed, except where the failure to be so qualified or licensed and in good standing would not have a material adverse effect on the financial condition, assets or operations of the Existing Limited Partnerships, taken as a whole. Such Existing Limited Partnership has the requisite partnership power and authority to own and operate its properties and assets, to carry on its business as is presently conducted, to enter into and perform this Agreement, and to carry out the provisions of this Agreement and the transactions contemplated hereby. Such Existing Limited Partnership has in effect all requisite federal, state and local governmental authorizations, permits and licenses necessary to carry on its business as now being conducted, except where the failure to have such authorizations, permits and licenses would not have a material adverse effect on the financial condition, assets or operations of the Existing Limited Partnerships, taken as a whole. A true, correct and complete copy (including all amendments thereto) of the Certificate of Limited Partnership and of the Agreement of Limited Partnership of such Existing Limited Partnership (collectively, the "Existing Limited Partnership Documents") has been provided to Dee Limited Partnership, and is in full force and effect.

**Section 3.2 Authority**. The partnership agreement for each of the Existing Partnerships authorizes the merger of such Existing Partnership into and with another partnership or other entity (as defined in the TRLPA upon approval of the merger by limited partners holding at least 66-2/3% of the limited partner percentage interests and by the general partner. The execution, delivery and performance of this Agreement and the consummation of the transactions contemplated hereby have been duly authorized and approved by all necessary action on the part of such Existing Limited Partnership and its general partner and no other actions on the part of such Existing Limited Partnership or its general partner are necessary to authorize and approve this Agreement and the transactions contemplated hereby. This Agreement has been duly executed and delivered by, and constitutes a valid and binding obligation of, such Existing Limited Partnership, enforceable against such Existing Limited Partnership in accordance with its terms (except as enforceability may be limited by applicable bankruptcy, insolvency, reorganization, moratorium or similar laws affecting creditors' rights generally, or by the principles governing the availability of equitable remedies).

**PURCHASE AND SALE AGREEMENT**

**BY AND BETWEEN**

**________________________, AS SELLER,**

**AND**

**________________________, AS BUYER**

**Dated as of ___________________**

# PURCHASE AND SALE AGREEMENT

**THIS PURCHASE AND SALE AGREEMENT** (this **"Agreement"**) is made and entered into as of this _________ day of _____________, 200_, by and between ______________, a ____________ corporation (**"Seller"),** and _________________, a _______________ corporation (**"Buyer").**

## RECITALS:

A. ____________ is a _________ limited partnership (the **"Partnership")** formed in ____. The current sole general partner of the Partnership is Seller. Seller's interest in the Partnership as a general partner is herein called the **"Interest"**).

B. Buyer desires to purchase the Interest from Seller, and Seller desires to sell, transfer and assign the Interest to Buyer, on the terms and conditions set forth herein.

## [SAMPLE PURCHASE AND SALE PROVISION]

(a) At the Closing, and on the terms and subject to the conditions set forth in this Agreement, Seller shall sell, transfer and assign to Buyer, and Buyer shall purchase and accept from Seller, the Interest effective as of 7:00 a.m. local time on ____________, _________ (the **"Effective Date"**).

(b) In consideration of the sale of the Interests to Buyer, Buyer shall pay to Seller at the Closing the purchase price of $_____________ cash (the **"Purchase Price"**). The Purchase Price is subject to adjustment as hereinafter provided and shall be payable to Seller in immediately available funds by confirmed wire transfer to a bank account to be designated by Seller (such designation to occur no later than two business days prior to the Closing Date).

## [SAMPLE SELLER REPRESENTATIONS AND WARRANTIES]

(a) Seller is a corporation duly incorporated, validly existing and in good standing under the laws of the State of ______________.

(b) Seller has full legal right, power, and authority to execute, deliver, and perform this Agreement and to consummate the transactions contemplated hereby. This Agreement has been duly executed and delivered by Seller and constitutes, and each other agreement, instrument, or document executed or to be executed by Seller in connection with the transactions contemplated hereby has been, or when executed will be, duly executed and delivered by Seller and constitutes, or when executed and delivered will constitute, a valid and legally binding obligation of Seller, enforceable against Seller in accordance with their respective terms.

(c) The execution, delivery, and performance by Seller of this Agreement and the consummation by Seller of the transactions contemplated hereby do not and will not (i) conflict with or result in a violation of any provision of, or constitute (with or without the giving of notice or the passage of time or both) a default under, or give rise (with or without the giving of notice or the passage of time or both) to any right of termination, cancellation, or acceleration under, any contract, agreement, instrument, or obligation to which Seller is a party (including the Partnership Agreement) or by which Seller or any Seller's properties may be bound, (ii) result in the creation or imposition of any Encumbrance upon the properties of Seller, or (iii) assuming compliance with the matters referred to in Section __, violate any Applicable Law binding upon Seller.

(d) No consent, approval, order, or authorization of, or declaration, filing, or registration with, any Governmental Entity is required to be obtained or made by Seller in connection with the execution, delivery, or performance by Seller of this Agreement or the consummation by it of the transactions contemplated hereby, other than (i) as set forth on Schedule __; (ii) filings with Governmental Entities to occur in the ordinary course

following the consummation of the transactions contemplated hereby; and (iii) such consents, approvals, orders, or authorizations which, if not obtained, and such declarations, filings, or registrations which, if not made, would not, individually or in the aggregate, have a material adverse effect on the business, assets, results of operations, condition (financial or otherwise), or prospects of the Partnership considered as a whole or on the ability of Seller to consummate the transactions contemplated hereby.

(e) Except as set forth in Schedule __, all consents to the sale of the Interest by Seller have been obtained from those persons or entities whose consents are required, including the requisite consent of the partners under the Partnership Agreement. Except as set forth in Schedule __, all preferential rights or rights of first refusal to purchase all or a part of the Interest have been waived by those persons or entities whose waivers are required.

(f) Seller owns beneficially and of record the Interest and has good and marketable title the Interest, and has the absolute right to sell, transfer and assign the Interest to Buyer free and clean of all Liens. For purposes of this Agreement, the term **"Lien"** shall mean any mortgage, pledge, security interest, lien, option, right, restriction on transfer or encumbrance of any nature other than (i) restrictions on transfer that may be imposed by any federal or state securities laws or (ii) those that arise under the terms of the Partnership Agreement. Except by operation of this Agreement or as otherwise set forth in the Partnership Agreement, there are no existing options, warrants, calls, subscriptions or other rights or agreement or commitments or claims of any nature granted to or binding upon Seller granting or vesting in any party any claim or potential claim to the Interest.

(g) A true and correct copy of the Partnership Agreement was delivered to Buyer under cover of that certain transmittal letter from Seller to Buyer dated ______________. The Partnership Agreement has not been amended. The Partnership Agreement is a valid and binding agreement of the parties thereto enforceable against them in accordance with its terms. Seller is not in breach of or in default under, nor has any event occurred which (with or without the giving of notice or the passage of time or both) would constitute a default by Seller under, the Partnership Agreement, and Seller has not received any notice from, or given any notice to, any other party indicating that Seller is in breach of or in default under the Partnership Agreement. To the best knowledge of Seller, no other party to the Partnership Agreement is in breach of or in default under the Partnership Agreement, nor has any assertion been made by Seller of any such breach or default.

(h) Seller has paid all assessments, expenses or other charges for which it has received an invoice or other demand from the Partnership, attributable to or arising out of, or by virtue of, the Interest. Seller has not received any invoice or other demand from the Partnership with respect to liabilities or back charges, absolute or contingent, arising out of, or by virtue of, the Interest, and to Seller's best knowledge , there are no such liabilities or back charges.

(i) Seller has delivered to Buyer, under cover of Seller's letter dated ____, ________, accurate and complete copies of (i) the Partnership's audited consolidated balance sheet as of______________, and the notes and schedules thereto, together with the unqualified report thereon of _________, independent public accountants (the "**Audited Financial Statements**"), and (ii) the Partnership's unaudited consolidated balance sheet as of _________ (the "**Latest Balance Sheet**"), and the related unaudited consolidated statements of income, stockholders' equity, and cash flows for the three-month period then ended (the "**Unaudited Financial Statements**"), certified by Seller (collectively, the "**Financial Statements**"). The Financial Statements (i) represent actual bona fide transactions, (ii) have been prepared from the books and records of the Partnership in conformity with generally accepted accounting principles applied on a basis consistent with preceding years throughout the periods involved, except that the Unaudited Financial Statements are not accompanied by notes or other textual disclosure required by generally accepted accounting principles, and (iii) accurately, completely, and fairly present the Partnership's consolidated financial position as of the respective dates thereof and its consolidated results of operations and cash flows for the period then ended, except that the Unaudited Financial Statements are subject to normal year-end adjustments.

(j) The Partnership has no liability or obligation (whether accrued, absolute, contingent, unliquidated, or otherwise), except (i) liabilities reflected on the Latest Balance Sheet, (ii) liabilities described in the notes accompanying the Audited Financial Statements dated as of __________, (iii) liabilities which have arisen since the date of the Latest Balance Sheet in the ordinary course of business (none of which is a material liability for breach of contract, breach of warranty, tort, or infringement), (iv) liabilities arising under executory contracts entered into in the ordinary course of business (none of which is a material liability for breach of contract), (v) liabilities specifically set forth on Schedule ___, and (vi) other liabilities which, in the aggregate, are not material to the Partnership.

(k) Except as disclosed on Schedule ___ since _____________, (i) there has not been any material adverse change in, or any event or condition that might reasonably be expected to result in any material adverse change in, the business, assets, results of operations, condition (financial or otherwise), or prospects of the Partnership; (ii) the businesses of the Partnership has been conducted only in the ordinary course consistent with past practice; (iii) the Partnership has not incurred any material liability, engaged in any material transaction, or entered into any material agreement outside the ordinary course of business consistent with past practice; (iv) the Partnership has not suffered any material loss, damage, destruction, or other casualty to any of its assets (whether or not covered by insurance); and (v) the Partnership has not taken any of the actions set forth in Section ___ except as permitted thereunder.

(l) Except as disclosed on Schedule ___, the Partnership has complied with all Applicable Laws (including without limitation Applicable Laws relating to securities, properties, business products, manufacturing processes, advertising and sales practices, employment practices, terms and conditions of employment, wages and hours, safety,

occupational safety, health, environmental protection, product safety, and civil rights), except for noncompliance with such Applicable Laws which, individually or in the aggregate, does not and will not affect materially and adversely the business, assets, results of operations, condition (financial or otherwise), or prospects of the Partnership. The Partnership has not received any written notice, which has not been dismissed or otherwise disposed of, that the Partnership has not so complied. The Partnership is not charged or, to the best knowledge of Seller, threatened with, any violation of any Applicable Law relating to any aspect of the business of the Partnership, other than violations which, individually or in the aggregate, do not and will not have a material adverse effect on the business, assets, results of operations, condition (financial or otherwise), or prospects of the Partnership.

(m) Except as disclosed on Schedule ___, there are no Proceedings pending or, to the best knowledge of the Seller, threatened against or involving the Partnership or any of its partners in connection with the business or affairs of the Partnership or any properties or rights of the Partnership which, individually or in the aggregate, might reasonably be expected to have a material adverse effect on the business, assets, results of operations, condition (financial or otherwise), or prospects of the Partnership. Except as disclosed on Schedule 3.__ any and all potential liability of the Partnership under such Proceedings is adequately covered (except for standard deductible amounts) by the existing insurance maintained by the Partnership described in Section ____. No judgment, order, writ, injunction, or decree of any Governmental Entity has been issued or entered against the Partnership which continues to be in effect. The Partnership is not subject to any judgment, order, writ, injunction, or decree of any Governmental Entity which is reasonably likely to have a material adverse effect on the business, assets, results of operations, condition (financial or otherwise), or prospects of the Partnership. There are no Proceedings pending or, to the best knowledge of Seller, threatened seeking to restrain, prohibit, or obtain damages or other relief in connection with this Agreement or the transactions contemplated hereby.

(n) Schedule __ sets forth all agreements to which the Partnership, on the one hand, and Seller and its Affiliates , on the other hand, are a party.

(o) To Seller's best knowledge, the Partnership has been treated as a partnership for federal and state income tax purposes since its formation. Each of Seller and, to Seller's best knowledge, the Partnership has filed all required federal, state, and other income tax, franchise, employment and other tax returns which are required to be filed, has paid (or is contesting in good faith) all taxes when due and is not in default in the payment of taxes levied or assessed against it or any of its assets.

(p) From and after __________, Seller has not received any distributions from the Partnership except as set forth on Schedule __.

(q) All the books and records of the Partnership, including all personnel files, employee data, and other materials relating to employees, are substantially complete and correct have been maintained in accordance with good business practice and all Applicable

Laws, and, in the case of the books of account, have been prepared and maintained in accordance with generally accepted accounting principles consistently applied. Such books and records accurately and fairly reflect, in reasonable detail, all transactions, assets, and liabilities of the Partnership.

**[SAMPLE OF SELLER COVENANTS]**

(a) Except as contemplated by this Agreement, during the period from the date hereof to the Closing, Seller (i) shall cause the Partnership to conduct its operations according to its ordinary course of business consistent with past practice and in compliance with Applicable Laws, (ii) shall use its reasonable best efforts to preserve, maintain and protect the Partnership's properties, and (iii) shall use its reasonable best efforts to preserve intact the Partnership's business organization.

(b) Prior to the Closing Date, Seller shall not

i. Amend or otherwise change the Partnership Agreement (except as specifically contemplated herein) or any contract to which the Partnership is a party;

ii. Sell, pledge, dispose of or encumber, or authorize the sale, pledge, disposition or encumbrance of (A) all or any portion of the Interest or other right of any kind to acquire any interest in the Partnership or (B) any material assets of the Partnership, except for sales of in the ordinary course of business and in a manner consistent with past practices and except as disclosed in <u>Schedule ____</u>;

iii. Declare, set aside, make or pay any distributions to any of the partners of the Partnership other than distributions contemplated in Section ___;

iv. (A) Acquire (by merger, consolidation, or acquisition of stock or assets) any corporation, partnership or other business organization or division thereof; (B) incur any indebtedness for borrowed money or issue any debt securities or assume, guarantee or endorse or otherwise as an accommodation become responsible for, the obligations of any person or entity (provided that the Partnership shall be permitted to make borrowings set forth in Schedule ____; (C) enter into any material contract or agreement other than in the ordinary course of business and in a manner consistent with past practice; or (D) enter into or amend any contract, agreement, commitment or arrangement with respect to any of the matters set forth in this paragraph;

v. Increase the compensation payable or to become payable to any officers or employees of the Partnership, except for increases in the ordinary course of business and in a manner consistent with past practices, or grant any severance or termination pay to, or, enter into any employment, consulting or severance agreement with any present or former director, officer or other

employee of the Partnership, or establish, adopt, enter into or amend any collective bargaining, bonus, profit sharing, thrift, compensation, stock option, restricted stock, pension, retirement, deferred compensation, employment, termination, severance or other plan, agreement, trust, fund, policy or arrangement for the benefit of any directors, officers or employees;

vi. Take any action other than in the ordinary course of its business and in a manner consistent with past practice with respect to accounting policies or procedures (including, without limitation, procedures with respect to the payments of accounts payable and collection of accounts receivable);

vii. Cancel or terminate any current insurance (or reinsurance) policies relating to the Partnership or its assets or permit any of the coverage thereunder to lapse (except with respect to termination of insurance coverage, to be effective as of Closing, made as a result of the transactions contemplated hereby), unless simultaneously with such termination, cancellation or lapse, replacement policies providing coverage equal to or greater than the coverage remaining under those cancelled, terminated or lapsed are in full force and effect;

viii. Make any material tax election, other than in the ordinary course of business and in a manner consistent with past practice, or settle or compromise any federal, state, local or foreign income tax liability; or

ix. Except as set forth in Schedule __, pay, discharge or satisfy any material claims, liabilities or obligations (absolute, accrued, asserted or unasserted, contingent or otherwise), other than the payment, discharge or satisfaction in the ordinary course of business of liabilities reflected or reserved against in the Unaudited Financial Statements or on the Latest Balance Sheet or incurred in the ordinary course of business and in a manner consistent with past practice.

**[SAMPLE OF INDEMNIFICATION PROVISIONS]**

(a) Subject to the terms of this Section __, each party (in this Section _(a) called the **"Indemnitor"**) shall indemnify, defend and hold harmless the other party, each director, officer, shareholder, employee or agent of the other party and their respective heirs, legal representatives, successors and assigns, from and against any and all claims, actions, causes of action, demands, assessments, losses, damages, liabilities, judgments, settlements, penalties, costs and expenses (including reasonable attorneys', consultants' or experts' fees and expenses) of any nature whatsoever, whether actual or consequential, asserted against, relating to, imposed upon or incurred by any of them, directly or indirectly, based upon, arising out of or otherwise in respect of any breach by the Indemnitor of any of its representations, warranties, covenants or agreements contained in this Agreement or in any certificate, instrument or document delivered pursuant hereto.

[(b) [More Seller Friendly] Subject to the terms of this Section __, Buyer shall indemnify, defend and hold harmless Seller, its directors, officers, shareholders, employees and agents and their respective heirs, legal representatives, successors and assigns, from and against any and all claims, actions, causes of actions, demands, assessments, losses, damages, liabilities, judgments, settlements, penalties, costs and expenses (including reasonable attorneys', consultants' or experts' fees and expenses) of any nature whatsoever, whether actual or consequential, asserted against, relating to, imposed upon or incurred by any of them, directly or indirectly, based upon, arising out of or otherwise in respect of the ownership of the Interests, regardless of whether such claims, actions, causes of actions, demands, assessments, losses, damages, liabilities, judgments, settlements, penalties, costs and expenses arise or are otherwise attributable to events or circumstances arising prior to the Closing Date, and including (without limitation) any claims, actions, causes of actions, demands, assessments, losses, damages, liabilities, judgments, settlements, penalties, costs and expenses based upon, arising out of or otherwise in respect of (i) the violation or alleged violation of any Applicable Environmental Law, (ii) the presence of any hazardous substances on, under or from the oil, gas and mineral properties and assets of the Partnership (the **"Properties"**), (iii) any activity carried on or off the Properties, whether by the Partnership, Seller or any predecessor in title, or any employee, agent, contractor or subcontractor of the Partnership, Seller or any predecessor in title, or any person at any time occupying or present on the Properties, in connection with the handling, treatment, removal, storage, decontamination, cleanup, transportation or disposal of any hazardous substances or solid wastes at any time located or present on or under the Properties or (iv) any residue contamination on or under the Properties or any property of any other person, or affecting any natural resources, and any contamination of any property or natural resources arising in connection with the generation, use, handling, storage, transportation or disposal of any hazardous substances or solid wastes, irrespective of whether any of such activities were or will be undertaken in accordance with Applicable Environmental Law, including (without limitation) any of the foregoing arising from the negligence, whether sole or concurrent, on the part of Seller, its directors, officers or shareholders. As used above, the term "**hazardous substances**" shall have the meaning specified in CERCLA, and the term "**solid wastes**" shall have the meaning specified in RCRA, provided that to the extent the laws of any state in which the properties are located establish a meaning for "hazardous substances" or "solid waste" which is broader than that specified in either CERCLA or RCRA, such broader meaning shall apply with respect to the Properties.]

[(b) [More Buyer Friendly] Subject to the terms of this Section __, Seller shall indemnify, defend and hold harmless Buyer, its directors, officers, shareholders, employees and agents and their respective heirs, legal representatives, successors and assigns, from and against any and all claims, actions, causes of actions, demands, assessments, losses, damages, liabilities, judgments, settlements, penalties, costs and expenses (including reasonable attorneys', consultants' or experts' fees and expenses) of any nature whatsoever, whether actual or consequential, asserted against, relating to, imposed upon or incurred by any of them, directly or indirectly, based upon, arising out

of or otherwise in respect of the (i) ownership, operation or use, prior to the Closing, of the Partnership, (ii) any event, action or inaction which occurred prior to Closing relating to the Partnership or any of the Properties or (iii) the ownership, operation or other use, prior to the Closing, of any Property, provided, that Seller's indemnification obligations shall not apply to the liabilities disclosed on Schedule __.]

(c) In the event that any claim or demand for which Buyer, on the one hand, and Seller, on the other hand (each an **"Indemnifying Party"**), would be liable to the other, its directors, officers, shareholders, employees, agents and their respective heirs, legal representatives, successors and assigns (each an **"Indemnified Party"**) hereunder is asserted against or sought to be collected from an Indemnified Party by a third party, the Indemnified Party shall with reasonable promptness notify the Indemnifying Party of such claim or demand, but the failure so to notify the Indemnifying Party shall not relieve the Indemnifying Party except to the extent the Indemnifying Party demonstrates that the defense of such claim or demand is materially prejudiced thereby. The Indemnifying Party shall have 30 days from receipt of the above notice from the Indemnified Party (the **"Notice Period"**) to notify the Indemnified Party whether or not the Indemnifying Party desires, at the Indemnifying Party's sole cost and expense, to defend the Indemnified Party against such claim or demand; provided, that the Indemnified Party is hereby authorized prior to and during the Notice Period to file any motion, answer or other pleading that it shall deem necessary or appropriate to protect its interests or those of the Indemnifying Party and not prejudicial to the Indemnifying Party. If the Indemnifying Party elects to assume the defense of any such claim or demand, the Indemnified Party shall have the right to employ separate counsel at its own expense and to participate in the defense thereof. If the Indemnifying Party elects not to assume the defense of such claim or demand (or fails to give notice to the Indemnified Party during the Notice Period), the Indemnified Party shall be entitled to assume the defense of such claim or demand with counsel of its own choice, at the expense of the Indemnifying Party. If the claim or demand is asserted against both the Indemnifying Party and the Indemnified Party and there is a conflict of interest which renders it inappropriate for the same counsel to represent both the Indemnifying Party and the Indemnified Party, the Indemnifying Party shall be responsible for paying separate counsel for the Indemnified Party; provided, however, that if there is more than one Indemnified Party, the Indemnifying Party shall not be responsible for paying for more than one separate firm of attorneys to represent the Indemnified Parties, regardless of the number of Indemnified Parties. If the Indemnifying Party elects to assume the defense of such claim or demand, (i) no compromise or settlement thereof may be effected by the Indemnifying Party without the Indemnified Party's written consent (which shall not be unreasonably withheld) unless the sole relief provided is monetary damages that are paid in full by the Indemnifying Party and (ii) the Indemnifying Party shall have no liability with respect to any compromise or settlement thereof effected without its written consent (which shall not be unreasonably withheld).

**[SAMPLE FORM]**

**<u>ASSIGNMENT OF LIMITED PARTNERSHIP INTERESTS</u>**

**THIS ASSIGNMENT OF LIMITED PARTNERSHIP INTERESTS** (this **"Assignment"**) is made and entered into this ___ day of______, ______, by and between ____________, a ____________corporation (**"Seller"**), and _____________, a Delaware corporation (**"Buyer"**).

**1. <u>Defined Terms</u>.** All capitalized terms not otherwise defined herein shall have the respective meanings assigned to them in that certain **Acquisition Agreement** (as herein called) dated as of __________, __________, by and between Seller and Buyer.

**2. <u>Assignment</u>.** Seller hereby sells, transfers and assigns the Interest to Buyer effective the Effective Date, together with all of Seller's rights as a limited partner of the respective Partnership appurtenant thereto, it being the intention of Seller and Buyer that Buyer shall become a substituted limited partner of the Partnership in place of Seller with respect to the Interest.

**3. <u>Acceptance</u>.** Buyer hereby acquires the Interest effective the Effective Date and, in consideration therefor, hereby tenders to Seller the Purchase Price, agrees to become a substituted limited partner of the Partnership in place of Seller with respect to the Interest and agrees to be bound by all of the terms and provisions of the Partnership Agreement.

**4. <u>Acquisition Agreement</u>.** The representations, warranties, covenants and agreements of Buyer and Seller with respect to the sale, transfer and assignment of the Interest are set forth in the Acquisition Agreement, and this Assignment is being executed and delivered pursuant to, and is expressly subject to, the terms and provisions of the Acquisition Agreement.

**5. <u>Agreement of General Partner</u>.** By its signature below, ___________, in its capacity as the sole general partner of each Partnership (the **"General Partner"**), hereby acknowledges and agrees as follows: (a) the terms and provisions of the Partnership Agreement of each Partnership have either been complied with or waived with respect to the sale, transfer and assignment of the Interest in such Partnership by Seller to Buyer; (b) Buyer shall be substituted as limited partner of the Partnership in place of Seller with respect to the Interest (and the General Partner hereby grants its consent thereto for purposes of compliance with the Partnership Agreement); (c) the execution and delivery by Seller and Buyer of this Assignment shall be sufficient to effect the above described substitution and the agreement of Buyer, as assignee of the Interests, to be bound by all of the terms and provisions of the Partnership Agreement; (d) Seller shall be released from, and shall have no liability whatsoever for, all obligations attributable to the Interest (and the General Partner hereby grants its consent thereto for purposes of Section 9.01 of the Partnership Agreement); and (e) all of the conditions precedent to the effectiveness of the assignment of the Interest and the substitution of Buyer as a limited partner of the Partnership in place of Seller with respect to the Interest have been satisfied.

6. **Counterparts.** This Assignment may be executed in multiple counterparts, each of which shall be deemed an original and all of which shall constitute but one and the same instrument.

7. **Governing Law.** This Assignment shall be governed by the laws of the State of Texas.

**SELLER:**

______________________________
By:______________________________
Name:______________________________
Title:______________________________

**BUYER:**

______________________________
By:______________________________
Name:______________________________
Title:______________________________

**ACCEPTED AND AGREED TO FOR PURPOSES OF SECTION 5 HEREOF:**

**GENERAL PARTNER:**

______________________________
By:______________________________
Name:______________________________
Title:______________________________

**Appendix C**

# 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 adapted from a draft of the ABA Model Asset Purchase Agreement with Commentary. 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.


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# Asset Purchase Agreement

This Asset Purchase Agreement (**"Agreement"**) is made as of _________ ____ , 20___ by and among ___________, a ___________ partnership (**"Buyer"**); ___________, a ______________ partnership (**"Seller"**); ___________, a resident of San Antonio, Texas (**"A"**); and __________, a [Delaware] [Texas] corporation with its principal office in San Antonio, Texas (**"B"**) (with A and B referred to herein as **"Partners"**).

## RECITALS

Partners own all of the partnership interests in 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.

## 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.

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.

### 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); *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).

This 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.

***"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 Partners 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 this 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.

***"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, shareholders or partners 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' corporation laws require shareholder approval for a sale of all or substantially all of a partnership'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).

This 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 partner 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 corporate 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, this definition excludes any action requiring authorization by the parent of a seller not only for subsidiary actions requiring owner 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.

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

***"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, this 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 partner; 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.

***"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.

***"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.

# 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.

This 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. This 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 this Agreement, defined terms are used to cover categories of Assets where that defined term is used elsewhere in this 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 this 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 this 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 this 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 this Agreement assumes 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, this 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 Records regarding the ownership of interests in the Partnership;

(c) the partnership agreement of the Partnership and all rights thereunder;

(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, this 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), this 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 this Agreement provides that the Seller will retain all rights and assets relating to the Employee Plans. Correspondingly, Section 2.4(b)(vi) of this 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 entity after the closing of the transactions contemplated by this Agreement. The Seller should retain all of its rights under this 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. This Agreement provides that the Buyer will receive a copy of certain of these items in Section 2.1(g).

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 this 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 Partners 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.

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.

This 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 Partner 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 Partner 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 Partner or Related Person of Seller or any Partner;

(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 partners 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 partnership interest acquisitions is clearly seen in the area of liabilities. In a partnership interest acquisition, the buyer, in effect, acquires all assets of the partnership 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.

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.

The assumption and retention of liabilities set forth in the provisions of this 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.

This Agreement addresses the liabilities which the Buyer will assume in subsection 2.4(a). In defining the term "Assumed Liabilities," this 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 this Agreement.

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 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 this 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), this 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, 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 this 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 Partners 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. Section 2.6 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.

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 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 partner approval, 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 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, 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, this 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 Partners, 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 Partner (the **"Noncompetition Agreements"**);

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

(ix) a certificate executed by Seller and each Partner 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 Partners 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 Partners, 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 Partner 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, this 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 this 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.

<u>Parties' Closing Certificates</u>. 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).

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 partners 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. This 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.

Promissory Notes. 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, but 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. 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 partnership 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.

### 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**

This 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 this 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 partnership'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.

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. This 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. This 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 this Agreement. 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 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.

# 3. REPRESENTATIONS AND WARRANTIES OF SELLER AND PARTNERS

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

**COMMENT**

The Seller's representations and warranties are the Seller's and the Partners' 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. Separating them explicitly in an acquisition agreement is a drafting nuisance, and the legal import of the separation has been all but eliminated. The commentary to this 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). This 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 Partners' 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. This Agreement assumes that the Seller has no subsidiaries and the representations 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 partners (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 partners. 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 partners' indemnification obligations be joint and several; as to this and the allocation of responsibility among the partners, 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.

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 Partners. 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 Partners 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 partners 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. 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.

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). 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.

The Effect of "Knowledge" Qualifications in Representations: 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.

The Absence of "Materiality" Qualifications: The Seller's representations in this 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 Partners 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."

### 3.2 ENFORCEABILITY; AUTHORITY; NO CONFLICT

(a) This Agreement constitutes the legal, valid, and binding obligation of Seller and each Partner, enforceable against each of them in accordance with its terms. Upon the execution and delivery by Seller and Partners 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 Partners 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 Partners 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 partners. Each Partner has all necessary legal capacity to enter into this Agreement and the Seller's Closing Documents to which such Partner 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 Partners 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 Partner, 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; or

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

(c) Except as set forth in Part 3.2(c), neither Seller nor either Partner 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 partners.

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, 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 partners' 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 Partners. (Requirements binding upon the Buyer would be separately covered by the Buyer's "no conflict" representation elsewhere in the Agreement and the conditions to Seller's obligations to close.) The Partners may seek to eliminate the references to laws, regulations, orders, and contracts binding upon the Partners, arguing that violations of requirements applicable only to the Partners (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 Partners. The Buyer may respond to such an argument by pointing out that a violation of a law, regulation, order, or contract binding upon the Partners 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 Partners were to incur a significant financial liability as a result of such a violation, the Partners' 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).

## 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 partners' 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 partners' 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 partners' 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 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 partners' equity, and cash flows of Seller as at the respective dates of and for the periods referred to in such financial statements, all in accordance with GAAP. 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.

**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. This 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).

This 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. This form of Agreement assumes that the Seller has no subsidiaries. If the Seller did have 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 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 this 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.

This 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 are fairly presented in accordance with GAAP, 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 in accordance with GAAP 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 this representation.

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.

### 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 partners 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 this 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.

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 partners (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).

Even though the terms "liability" and "contingent liability" may be narrowly construed, other provisions in this Agreement protect the Buyer against various contingencies that may not actually constitute "contingent liabilities" as of the Closing Date. For example, this 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; 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; 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; and that the Seller knows of no facts that materially threaten its business (see Section 3.33). In addition, this Agreement requires the Seller and the Partners 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 partners 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.

## 3.15 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 *IBP, Inc. v. Tyson Foods, Inc. and Lasso Acquisition Corporation*, No. 18373, 2001 Del. Ch. LEXIS 81 (Del. Ch. June 15, 2001), 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.
>
> * * *
>
> 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.
>
> * * *
>
> 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/Tyson* will no doubt affect how attorneys think about material adverse change provisions. *But see* Glover, *The Impact of Tyson Foods on "MAC" Outs*, 5 The M&A Lawyer No. 6 (Dec. 2001), which concludes that to date the *IBP/Tyson* case appears not to have significantly changed the content of material adverse change provisions and summarizes the author's findings as follows:

> The list of events that would trigger a condition failure was virtually the same in each agreement reviewed. Moreover, the lists were very similar to the traditional pre-*Tyson Foods* list. The triggering events in the recent agreements included the following:
>
> - An event that is reasonably likely to be materially adverse to the business, financial condition or results of operations of an entity and its subsidiaries taken as a whole.
> - An event that is reasonably likely to materially adversely effect the ability of the other parties to complete the merger.
>
> Only one of the agreements provided that an out would be triggered by a material adverse change in a company's "prospects." Most of the agreements did not require certainty that a MAC "would" occur–instead, it was enough that a MAC "could reasonably be expected" or "would be reasonably likely" to occur.
>
> Most of the recent agreements reviewed included a list of events that would be treated as exceptions to the MAC definition. Although there was some variation from agreement to agreement, the exceptions were similar to the exceptions that merger parties have been relying on for years–*Tyson Foods* does not seem to have resulted in an effort to narrow the list of exceptions. In fact, the post-*Tyson Foods* agreements contained more rather than fewer carve-outs. The exceptions included the following:
>
> - Adverse effects resulting from compliance with the merger agreement.

- Adverse effects resulting from the announcement of the merger–subject to further exceptions for effects that would interfere with the completion of the transaction or impact the enforceability of the merger agreement.

- Declines in a company's stock price or trading volume.

- Adverse changes in the global economy, the U.S. economy or other economies in which a company operates.

- Adverse changes in the industry in which the company operates–unless the change has a disproportionate impact on the company.

- Changes attributable to GAAP.

- Changes attributable to the impact of the merger agreement on customers, suppliers or employees.

- Changes attributable to changes in legal, regulatory or business conditions–unless they affect the company disproportionately.

- Changes attributable to actions taken by the other party to fulfill its obligations under the merger agreement.

> The agreements reviewed did not include other special outs that might be viewed as a response to *Tyson Foods*. Instead, they included the standard list of conditions–for example, conditions requiring that representations and warranties remain true, that covenants be satisfied and that regulatory hurdles be crossed.

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."

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.

### 3.19 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 partnership interests, grant of any option or right to acquire partnership interests of Seller or issuance of any security convertible into partnership interests of Seller;

(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 partner, officer, or employee or entry into any employment, severance, or similar Contract with any partner, 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.

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.

### 3.32 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 partners 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.

Intent to Hinder, Delay, or Defraud Creditors. 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 Partner 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 Partners 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. 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 any Partner. Thus, this 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 partners 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.

# 5. COVENANTS OF SELLER PRIOR TO CLOSING

## 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 Partners 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 this 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. 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.

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. This 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 partners. There is case law, however, indicating that this may not be possible in some jurisdictions.

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 Partners 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 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 Partners 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 Partners 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 partners (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 Partners 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 Partners 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 partnership interest acquisitions, however, governmental notifications or approvals may be necessary if an entity 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 partner 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.

### 5.5 NOTIFICATION

Between the date of this Agreement and the Closing, Seller and Partners 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 Partners' 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 Partners also shall promptly notify Buyer of the occurrence of any Breach of any covenant of Seller or Partners 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 Partners 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 Partner 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 Partners of partnership interests in Seller, 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 Partners shall notify Buyer of any such inquiry or proposal within twenty four hours of receipt or awareness of the same by Seller or either Partner.

**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 partners to consummate the acquisition, subject only to the satisfaction of the various closing conditions. 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 partnership interest exchange, or a sale of substantially all of the assets of a partnership where the number of partners is small enough to obtain partner approval prior to the signing of the acquisition agreement or, as is the case in this Agreement, all of the principal partners sign the acquisition agreement.

## 5.7 BEST EFFORTS

Seller and Partners 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 Partners 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 Partners 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 Partners 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 Partners 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 Partners 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 Partners 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 | Arizona | District of Columbia | |
| Revised UCC 6: | California | Indiana | Virginia |
| Repeal of | Alabama | Louisiana | Ohio |
| UCC 6: | Alaska | Maine | Oklahoma |
| | Arkansas | Massachusetts | Oregon |
| | Colorado | Michigan | Pennsylvania |
| | Connecticut | Minnesota | Puerto Rico |
| | Delaware | Mississippi | South Dakota |
| | Florida | Montana | Tennessee |
| | Hawaii | Nebraska | Texas |
| | Idaho | Nevada | Utah |
| | Illinois | New Hampshire | Vermont |
| | Iowa | New Jersey | Washington |
| | Kansas | New Mexico | West Virginia |
| | Kentucky | North Dakota | 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 Partners) 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."

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 Partners. 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 Partners of a representation or covenant, the Seller and the Partners will not be liable to the Buyer for their failure to satisfy the condition. However, because of the Seller's and the Partners' 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 Partners, 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 Partners 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 Partners liable to the Buyer. If the Seller and the Partners 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).

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 Partners' 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 Partners (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 Partners, 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 Partners 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 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.

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. This 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 partners 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 partners 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 partners 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 partners 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).

## 7.2 SELLER'S PERFORMANCE.

All of the covenants and obligations that Seller and Partners 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 Partners to use their Best Efforts to cause the conditions to closing to be satisfied.

## 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 (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 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.

### 7.4 ADDITIONAL DOCUMENTS

Seller and Partners 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 partnership agreement 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 partnership 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 States of _________; 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 Partner of, or the compliance by Seller or either Partner with, any covenant or obligation required to be performed or complied with by Seller or such Partner,

(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 Partners have covenanted to deliver at the Closing. These documents include various instruments signed by the Seller and the Partners (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 Partners. 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 Partners 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 partner), resignations of officers and directors of any subsidiary the equity 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 other states in which it is doing business. 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 this 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 partner 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**

The WARN Act provision that deals with the sale of a business 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.

### 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 any Partner 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 any Partner to comply with its 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 Partners 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 this 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 partners 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.

### 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).

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 Partner 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 any Partner 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 and the application of the WARN Act.

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 this 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**

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.

### 10.8 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 partners, 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 entity'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 entity's customers or suppliers.

The activities which constitute a "Competing Business" are usually crafted to prohibit the sellers from competing in each of the entity's existing lines of business, and in areas of business into which, as of the date of the agreement, the entity 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 entity 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 entity'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.

### 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 this 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 this Agreement.

## 11. INDEMNIFICATION; REMEDIES

**COMMENT**

Article 11 of this Agreement provides for indemnification and other remedies. Generally, the buyer of a privately-held entity seeks to impose not only on the seller, but also on its partners, 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 partners' 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 this 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 this 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 Partners 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 partners 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. 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). Although no such case is known, the custom of explicitly providing for survival of representations in business acquisitions is sufficiently well established that it is unlikely to be abandoned.

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 Partner based upon a breach of any of the representations and warranties of Seller and Partners contained in this Agreement [or breach of any of Seller's or any Partners' 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 Partners' 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 partners cannot fully perform their obligations. If the seller and the partners 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) has 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 under Connecticut 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 the "[a] all 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.

Given the holdings of *Galli* and *Hendricks*, the effect of the survival and non-waiver language in Section 11.1 is uncertain. Section 11.1 protects the Buyer if, in the face of a known dispute, the Seller and the Partners 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 on waiver and non-reliance 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 PARTNERS

Seller and each Partner, jointly and severally, will indemnify and hold harmless Buyer, and its Representatives, partners, 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 Partner 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 Partners' 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 Partner pursuant to this Agreement;

(b) any Breach of any covenant or obligation of Seller or either Partner in this Agreement or in any other certificate, document, writing or instrument delivered by Seller or either Partner 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 Partner (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 entity 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 indemnification provisions of this Agreement may require significant adjustment before being applied to a merger or partnership interest 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 entity, 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 partners' 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 this 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. This 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.

Section 11.2(a)(i) provides for indemnification for any breach of the Seller's and the Partners' 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, this Agreement departs from customary practice by providing that, if a certificate delivered at Closing by the Seller or a Partner 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 Partners 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.

This 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 partners 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 provides for joint and several liability, which the buyer will typically request and the seller, seeking to limit the exposure of its partners to several liability (usually in proportion to each partner's percentage ownership), may oppose. Occasionally, different

liability will be imposed on different partners, 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 partners may separately agree to allocate responsibility among themselves in a manner different from that provided in the acquisition agreement (for example, a partner 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. 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 owner 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 officers and partners 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 this 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.

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 this 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 partners 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 this 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 Partner, 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 partners are individuals). The buyer may be reluctant to assume that the partners 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 partners' 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 partners 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 partners are likely to have several concerns with the indemnification provisions in Section 11.3, including 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 partners 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."

## 11.5 LIMITATIONS ON AMOUNT — SELLER AND PARTNERS

Seller and Partners 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 Partners' 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 Partner of any covenant or obligation, and Seller and the Partners will be jointly and severally liable for all Damages with respect to such Breaches.

**COMMENT**

Section 11.5 provides the Seller and the Partners 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 this Agreement, the Seller's and Partners' 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 partners' 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 partners may also seek to provide for a maximum indemnifiable amount. The partners' argument for such a provision is that they had limited liability as partners 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.

### 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 Partners 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 Partners 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 Partners notify Buyer of a claim specifying the factual basis of the claim in reasonable detail to the extent then known by Seller or Partners.

**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 partners 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 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. 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.

The buyer may contend seller's obligations with respect to retained liabilities should not be affected by any limitations on the time or amount of general indemnification payments, and the seller may argue otherwise.

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 partners 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 partners' indemnification obligations. These techniques shift bargaining power in post-closing disputes from the seller and the partners 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 partners and the buyer will have difficulty in obtaining jurisdiction over the partners or in collecting on the indemnity without an escrow. Partners who are jointly and severally liable may also favor an escrow in order to ensure that other partners 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 partners 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 partners 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 partners. 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 partner. 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 partners 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 partners 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 Partners against payments due to them under the promissory note without bearing the risk that, if the Seller and the Partners 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 Partner 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 Partners 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, this 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. This 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.

This 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, this 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. This 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.

<u>Indemnification for Indemnitee's Own Negligence</u>. 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).

Indemnification for Strict Liability. 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 this 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.

This 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 this 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 Partners 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 Partners 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 Partners 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**

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 Partners (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 Partners 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 Partners as the case may be, of the obligations of this Article 12 with respect to such information. Each of Buyer, Seller and Partners 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 Partner shall maintain as confidential any Confidential Information (including for this purpose any information of Seller or Partners of the type referred to in Sections 12.1(a)(i), (ii) and (iii), whether or not disclosed to Buyer) of the Seller or Partners 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 Partners relating to any of the Assets or the Assumed Liabilities.

**COMMENT**

Section 12.2(a) 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 this 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 Partner shall disclose any Confidential Information of Seller or Partners 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 describes the exceptions from the restrictions placed on confidential information. 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.

The last sentence 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.

### 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 describes when a Receiving Party may disclose Confidential Information due to legal compulsion. 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 describes the procedure for return or destruction of confidential information if this 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). 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 partnership employees and a partnership'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).

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 an entity and its counsel to the entity'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), which concludes that (i) in a statutory merger the surviving entity can assert the attorney-client privilege, (ii) in a stock-for-stock deal the privilege goes with the entity, although in some cases the buyer and seller may share the privilege, and (iii) in the case of an asset sale most cases hold no privilege passes because the corporate holder of the privilege has not been sold. The 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. 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. *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.

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 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.

## 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

this 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). 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, 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).

While courts have held that this right may be waived 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). 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 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." *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.

This 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 Partners 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 Partners 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.

The buyer may seek to enjoin a breach by the seller or the partners 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.

A seller may seek to exclude Article 11 from the provision in Section 13.6 that the rights of a party in respect of this 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 this 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 this 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. 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. This 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.

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 Partners 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 partners 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 Partner 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 Partners 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.

### 13.13 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**

This Section allows the parties to select the law that will govern the contractual rights and obligations of the Buyer, the Seller and the Partners. 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.