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Negotiating Strategic Acquisitions

Selected Provisions of the

Stock Purchase Agreement

Extracts from the *Model Stock Purchase Agreement with Commentary*

Prepared By

The Committee on Negotiated Acquisitions

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Copies of the *Model Stock Purchase Agreement with Commentary* can be purchased from the American Bar Association, at P.O. Box 10892, Chicago, IL 60610-0892, Attn.: Publication Orders, or by calling (312) 988-5522 or by sending a fax request to (312) 988-5568.

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Editor's Preface

The Model Stock Purchase Agreement, Exhibits, Appendices and accompanying Commentary are the products of a nine-year collaborative effort of the members of the Committee on Negotiated Acquisitions of the Section of Business Law of the American Bar Association. The members of the Committee on Negotiated Acquisitions are senior lawyers practicing throughout the United States and Canada who specialize in general corporate law and mergers and acquisitions, in particular. The Model Stock Purchase Agreement and accompanying Commentary were edited by the Editorial Subcommittee of the Committee on Negotiated Acquisitions. The members of the Editorial Subcommittee who rendered substantial assistance in the editing of the documents are listed below:

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Chair's Preface

Legal representation of a party to the acquisition of a business enterprise is a common role undertaken by the business lawyer. Although there is no requirement that parties to an acquisition be represented by counsel, because of the significant legal consequences of both buyers and sellers of business interests occasioned by such transactions, it is common practice today for lawyers to be involved in all but the most modest business acquisitions. This involvement is preferably from the time of initial discussions, but most often during the formal negotiations and documentation of the transaction through the closing of the acquisition.

It has been nearly a decade since a group of acquisition lawyers observed that no existing committee of the Section of Business Law dealt directly with the legal issues involved in a non- hostile, privately negotiated acquisition transaction. From the time of its formation, the Committee on Negotiated Acquisitions has focused on the development of a series of annotated "model" agreements that reflect generally accepted acquisition practices in the business and legal communities in the United States. The Model Stock Purchase Agreement set forth in this publication represents the first fruit of the Committee's deliberations and labors. It manifests the cumulative effort of more than 120 merger and acquisition practitioners, from law firms and corporations, large and small, practicing in financial centers as well as in smaller communities in 34 states and two provinces of Canada. Participation and comment were also sought from specialists in substantive areas such as taxation, labor, employee benefits, environmental, intellectual property and antitrust law, as well as from leading academics.

The hypothetical fact pattern around which the Model Stock Purchase Agreement was created--the acquisition of all of the capital stock of a private company--is one commonly encountered by acquisition counsel. This fact pattern also provided the Committee with the best opportunity to discuss in detail in the accompanying Commentary the intent and purpose of the terms and conditions contained in the Model Stock Purchase Agreement. In providing sample language for the provisions that customarily appear in an acquisition agreement, the Committee has selected provisions that are comprehensive in scope. It recognized that in less complex and relatively straightforward transactions, many of the operative provisions contained in the Model Stock Purchase Agreement will either not apply or may be scaled back substantially. The result is a model document that is intended to serve buyer's counsel as a starting point from which to fashion a fully-negotiated acquisition agreement. It should also serve as an effective educational tool for four distinct groups--lawyers who deal with acquisitions on an occasional basis, and who wish to sharpen their negotiation and representation skills; less experienced lawyers seeking to gain greater insight into the acquisition process and the documentation of business transactions; law professors desiring a more comprehensive vehicle for introducing law students to the subject of business transactions; and experienced acquisition counsel seeking to reflect on the intent and purpose of provisions that have become commonplace and familiar.

This publication is the first of what the Committee hopes will be a series of acquisition and transaction related documents that reflect the collective input from experienced private practitioners, corporate counsel and academicians. Future publications are expected to address asset acquisitions, mergers, joint venture agreements and other similar transactions. Since the documents produced by the Committee are intended to reflect a broad spectrum of current acquisition practice, your comments, suggestions and recommendations are welcome.

Karl J. Ege

Chair

Preliminary Note

ASSUMPTIONS

The Model Stock Purchase Agreement and its attachments are based on the hypothetical acquisition by a single corporate buyer (the "Buyer") of all of the outstanding stock of a privately- held United States company (the "Company"). The Company has two individual stockholders (the "Sellers"), engages in a full range of business activity, and has several subsidiaries (along with the Company, the "Acquired Companies"). The Buyer is offering a combination of cash and promissory notes in payment.

PERSPECTIVE

The Model Stock Purchase Agreement is a Buyer's reasonable first draft. The Buyer's counsel will usually prepare the first draft of an acquisition agreement unless the Sellers are conducting an auction with more than one potential buyer. As the Buyer's first draft, the provisions generally favor the Buyer and may not be typical of the final language in a fully negotiated and consummated transaction. The Sellers usually will not agree to all of the provisions, and the Sellers' counsel can be expected to negotiate for language less burdensome to the Sellers. The Commentary notes some sections that are likely to prompt objections by the Sellers. If the Buyer anticipates delicate negotiations with the Sellers--perhaps because competitive offers for the Company weaken the Buyer's negotiating position--the Buyer's counsel may not want to use all of the more aggressive provisions, or may want to temper them with qualifying language favorable to the Sellers, even in a first draft.

The Buyer obtains two benefits from submitting a first draft with provisions that may not survive detailed negotiations. First, the negotiations may force the Sellers to disclose significant information about the Acquired Companies, which aids the Buyer in assessing the benefits and risks of the acquisition and in pricing the transaction. In this respect, the Buyer's first draft serves as a request for information and a disclosure device. The Sellers' counsel should view it as such and respond accordingly.

Second, the first draft establishes the Buyer's position in negotiating the allocation of risk from contingencies such as future environmental or tort liability. A Buyer's reasonable first draft asks the Sellers to bear most of the risk associated with future events or discoveries that directly or indirectly relate to the period prior to the Buyer's acquisition of the Company--issues that may be material to the price of the acquisition. The Sellers may counter that unknown contingencies are risks inherent in operating any business and should be borne by the owner of the business at the time they arise. With the lines drawn in this manner, the negotiations begin.

There is no standard acquisition agreement applicable to all transactions. The Model Stock Purchase Agreement does not substitute for a lawyer's careful exercise of judgment in a specific transaction. Every provision in the Model Stock Purchase Agreement is subject to variation reflecting the facts and circumstances of a particular acquisition. Some of the provisions in the Model Stock Purchase Agreement may be unnecessary if the Company has a simple structure. The magnitude of the purchase price also will influence the time and effort spent on negotiating and drafting the acquisition agreement. If the Company is organized under the laws of, or has significant assets or operations in, a foreign jurisdiction, many of the provisions in the Model Stock Purchase Agreement will require modification to suit the laws of that jurisdiction.

ORGANIZATION

The structure of the Model Stock Purchase Agreement follows current practice. Section 1 is a glossary of defined terms. This section enhances ease of usage and organization of the acquisition agreement and includes cross-references to definitions in various places in the agreement. Section 2 contains the economic and operative terms of the acquisition, including the stock to be acquired, the consideration to be paid, and the

basic mechanics of the closing.

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

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

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

Section 9 outlines the circumstances in which each party may terminate the acquisition agreement and the effects of such termination. Section 10 contains indemnification provisions giving each party specific remedies for the other's breach of certain obligations under the acquisition agreement. These provisions cover matters such as the measure of damages, recovery of expenses and costs (including legal fees) in addition to damages (a right that may not exist absent an indemnification provision), and procedures for claiming damages. Section 11 contains general provisions such as notice, severability, and choice of law.

COMMENTARY

The Commentary to the various provisions of the Model Stock Purchase Agreement serves three main purposes. First, the Commentary explains the meaning and function of a provision and its relationship to other provisions. In some instances, the Commentary also provides a brief discussion of the law relevant to a provision, although such discussions are not comprehensive, do not identify variations from state to state, and will not reflect changes in the law that occur after the preparation of the Model Stock Purchase Agreement. Finally, the Commentary highlights provisions that are likely to be the subject of negotiation and the positions that the Buyer and the Sellers may take during these negotiations. In a few instances, the Commentary contains alternative language that the Buyer may want to include in the initial draft or that the Sellers may propose as a replacement to the provisions of the Model Stock Purchase Agreement. The Commentary reflects the years of collective experience in drafting and negotiating acquisition agreements of the members of Editorial Subcommittee of the Committee on Negotiated Acquisitions of the Section of Business Law of the American Bar Association.

EXHIBITS AND ANCILLARY DOCUMENTS

The Exhibits to the Model Stock Purchase Agreement are forms of the disclosure letter and various ancillary documents to be delivered at the closing of the acquisition (including the Promissory Note, the Release, the Employment Agreement, the Noncompetition Agreement, and the legal opinions). The Ancillary Documents include certain agreements (such as the Confidentiality Agreement and the Letter of Intent) which are executed prior to signing the Model Stock Purchase Agreement.

APPENDICES

Appendix A to the Model Stock Purchase Agreement presents nine hypothetical scenarios that illustrate the operation and interaction of certain of the Sellers' representations and warranties in Section 3, the Sellers' pre-closing covenants in Section 5, the closing conditions in Section 7, and the indemnification provisions in Section 10. A tabular summary of these hypothetical scenarios appears at the end of the Appendix.

Appendix B is the Reporter's Note to the Model Stock Purchase Agreement. Written by the law professor who served on the committee that prepared the Model Stock Purchase Agreement, the Reporter's Note discusses the significance of precise legal drafting of acquisition agreements in the light of cases construing and interpreting such agreements.

ACQUISITION REVIEW MANUAL

Attorneys engaged in acquisitions may also want to consult the *Manual on Acquisition Review*, which has also been published by the Section of Business Law of the American Bar Association. The *Manual on Acquisition Review* identifies factual inquiries and legal analyses regularly used in the Buyer's pre-closing review of the Acquired Companies. Each chapter of the *Manual on Acquisition Review* treats a substantive area of law that may be implicated by the Sellers' representations and warranties in the Model Stock Purchase Agreement. It describes the documents and other information that the Buyer should request from the Sellers, as well as the legal issues relevant in reviewing such information, to understand properly the legal consequences of the Acquired Companies' affairs. The inquiries described in the *Manual on Acquisition Review* include not only matters on which the Buyer generally relies upon its legal counsel, but also factual issues that usually are assigned to the Buyer's other professional advisors such as accountants and environmental consultants or, in some instances, to the Buyer's corporate staff. The *Manual on Acquisition Review* is designed to aid all of the Buyer's employees and advisors participating in the acquisition.

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STOCK PURCHASE AGREEMENT

between

____

and

____

Dated _______________, 199__

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STOCK PURCHASE AGREEMENT

This Stock Purchase Agreement ("Agreement") is made as of __________, 199__, by ____________, a ____________ corporation ("Buyer"), ____________, an individual resident in ____________ ("A"), and ___________, an individual resident in ____________ ("B" and, collectively with A, "Sellers").

COMMENT

Parties. The Buyer should ensure that the persons or entities that are the record owners of the shares are parties to the acquisition agreement. If the record owners of the shares are not the beneficial owners, the Buyer may want to include the beneficial owners as parties to the acquisition agreement.

The Model Stock Purchase Agreement does not include the Company as a party to the agreement. However, the Buyer often wants to include the Company as a party so that the Buyer will have an additional party against which to pursue its indemnification rights if the acquisition is not consummated because of a breach of any of the representations and pre-closing covenants provided for the Buyer's benefit.

Making the Company a party to the acquisition agreement will not benefit the Buyer if the acquisition is ultimately consummated, because the Company will become a wholly-owned subsidiary of the Buyer upon completion of the acquisition. Indeed, if the

Company is a party to the acquisition agreement, the Sellers could have a right of indemnification or contribution against the Company in an action brought by the Buyer after the closing based on a breach of representations that presumably were made, jointly and severally, by the Company and the Sellers. Therefore, when the Company is made a party to the acquisition agreement, the Buyer should be careful to protect the Company from any claims by the Sellers after consummation of the acquisition by providing that the Company's representations terminate at the closing and that the Sellers release the Company from all claims arising out of the acquisition based on indemnification or contribution.

The Buyer should be aware that if the Company is a party to the acquisition agreement, the acquisition agreement will not be enforceable against the Company unless there is adequate consideration. The Buyer may be able to demonstrate adequate consideration by showing that the acquisition would benefit the Company. For example, if the Buyer proposes to invest funds in the Company after the acquisition, the Buyer's proposed investment may be adequate consideration.

Finally, the Buyer may also want to consider adding the Sellers' spouses as parties to the acquisition agreement or, alternatively, obtaining spousal consents or waivers from the Sellers' spouses, even if the spouses do not own the shares. By having the Sellers' spouses acknowledge the sale of the shares to the Buyer and agree to look to the Sellers' other assets to satisfy any claims the spouses may have against the Sellers, the Buyer will be protected from claims by the Sellers' spouses against the shares in the event of a divorce.

Choice of Structure. The parties to an acquisition typically have a choice of several methods by which to accomplish the same goal--the Buyer's acquisition of the Company's business. Common forms of an acquisition include (i) a sale of stock by the

shareholders of the Company to the Buyer, (ii) a sale of substantially all of the Company's assets to the Buyer or a subsidiary of the Buyer, (iii) a merger of the Company into the Buyer or a subsidiary of the Buyer (a "forward merger") or a merger of the Buyer or a subsidiary of the Buyer into the Company (a "reverse merger"), and (iv) if permitted by the laws of the state in which the Company is incorporated, a binding share exchange in which the stock of the Company's shareholders is exchanged for the consideration the Buyer has agreed to pay. The Model Stock Purchase Agreement presupposes that the parties have determined that a stock acquisition is the best structure for the Buyer to acquire the businesses of the Acquired Companies.

The choice of structure of an acquisition is a function of the parties' analysis of a variety of tax, accounting, and other considerations, including risks of unknown liabilities, the ability of the Company to assign contract rights to third parties, and the availability of appraisal rights for dissenting shareholders. *See generally* Bangser & Sinanian, *Legal Considerations Relating to the Structuring, Planning and Negotiation of the Various Types of Acquisitions and Mergers*, in Herz & Baller, *Business Acquisitions* 3-36 (2d ed. Supp. 1986); Freund, *Anatomy of a Merger* ch. 4 (1975); Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* chs. 1-3 (1992); Guth, Tufts, Copeland, Hoffman, Shea & Binke, *Drafting Agreements for the Sale of Businesses* § 2.44 (2d ed. 1988). For a discussion of the tax considerations that may affect the choice of structure, see Ginsburg & Levin, *Mergers, Acquisitions and Leveraged Buyouts* (1993).

RECITALS

Sellers desire to sell, and Buyer desires to purchase, all of the issued and outstanding shares (the "Shares") of capital stock of ____, a _____ corporation (the "Company"), for the consideration

and on the terms set forth in this Agreement.

COMMENT

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

AGREEMENT

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

1. DEFINITIONS

COMMENT

It is useful, both to reduce the length of other sections and to facilitate changes during negotiations, to have a section of the acquisition agreement that lists all defined terms appearing in more than one section of the agreement. A common dilemma in drafting definitions is whether to include long lists of terms with similar but slightly different meanings. If the goal is to draft a comprehensive, all-inclusive definition, the tendency is to list every term that comes to mind. However, if too many terms are listed, the absence of a particular term may be accorded more significance than intended, even if a phrase such as "without limitation" or a catchall term beginning with "any other" is used. (The Model Stock Purchase Agreement avoids repetitive use of such a phrase and contains a general disclaimer in Section 11.12 instead.) Also, long lists of terms with similar meanings perpetuate a cumbersome and arcane style of drafting that many lawyers and clients find annoying at best

and confusing at worst. The Model Stock Purchase Agreement resolves this dilemma in favor of short lists of terms that are intended to have their broadest possible meaning.

For purposes of this Agreement, the following terms have the meanings specified or referred to in this Section 1:

"Acquired Companies"--the Company and its Subsidiaries, collectively.

COMMENT

The Buyer may want to expand this definition to include predecessors of the Company (such as a corporation that was merged into the Company) so that the Sellers' representations apply to predecessors as well. This is especially important for the representations concerning environmental matters and product liability because of the potentially large liability of the Company's predecessors that may be imposed on the Company.

* * * * * * *

"Breach"--a "Breach" of a representation, warranty, covenant, obligation, or other provision of this Agreement or any instrument delivered pursuant to this Agreement will be deemed to have occurred if there is or has been (a) any inaccuracy in or breach of, or any failure to perform or comply with, such representation, warranty, covenant, obligation, or other provision, or (b) any claim (by any Person) or other occurrence or circumstance that is or was inconsistent with such representation, warranty, covenant, obligation, or other provision, and the term "Breach" means any such inaccuracy, breach, failure, claim, occurrence, or circumstance.

COMMENT

The term "Breach" appears in Sections 5.5, 9.1, 9.2, 10.2, 10.4,

10.6, and 10.7.

* * * * * * *

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

COMMENT

The form and content of the Disclosure Letter 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. Exhibit 1 to the Model Stock Purchase Agreement contains a sample format for the Disclosure Letter. The Buyer or the Sellers may prefer to attach multiple schedules or exhibits to the acquisition agreement instead of using a disclosure letter.

* * * * * * *

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

COMMENT

The term "GAAP" appears in Sections 2.5, 3.4, 3.11, and 3.13. 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.

American Inst. of Certified Pub. Accountants, *Statement on Auditing Standards No. 69*, § 2 (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 charged to expenses as incurred.

GAAP permits the exercise of professional judgement 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 Company. The Buyer should examine the Company's financial statements from previous years to ensure their consistency from year to year. The Buyer should

also determine whether there are any pending FAS bulletins that would require a change in the Company's accounting practices, and the Buyer may want the Sellers 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 Company's accounting practices. For a further discussion of these issues, see the Commentary to Section 3.16.

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 of different nations. The Buyer should consider whether to require that foreign financial statements be restated to conform to United States GAAP or accompanied by a reconciliation to United States GAAP.

* * * * * * *

"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 concerning the existence of such fact or other matter.

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.

COMMENT

The term "Knowledge" appears in Sections 3.13, 3.15, 3.17, 3.19, 3.20, 3.21, 3.22, 3.23, 4.4, 10.1, and 10.6. The Sellers will attempt to use knowledge qualifications to limit many of their representations and warranties. The inclusion of a knowledge qualification in the representation concerning threatened litigation has become accepted practice. Otherwise, there is no standard practice for determining which representations, if any, should contain such qualifications. Ultimately, the issue is allocation of risk--should the Buyer or the Sellers bear the risk of the unknown? The Buyer will often argue that the Sellers have more knowledge of and are in a better position to investigate the Acquired Companies' businesses and therefore should bear the risk of unknown matters. The Sellers' frequent response is that they have made all information they have about the Acquired Companies available to the Buyer and that the Buyer is acquiring the Acquired Companies as an on-going enterprise with the possibility of either unexpected gains or unexpected losses. Resolution of this issue usually involves much negotiation.

The addition of a knowledge qualification to a representation made by the Sellers should not limit the Buyer's "walk rights." See the Commentary to Section 3 under the caption "The Effect of Knowledge Qualifications in Representations."

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 and to ensure that this group includes the people who are the most knowledgeable about the specific representation being qualified. The broader the group and the greater the knowledge of the people in the group, the

greater will be the risk retained by the Sellers.

The knowledge qualifications in Section 3 of the Model Stock Purchase Agreement refer not only to the knowledge of the individual Sellers, but also to the knowledge of the Acquired Companies. Because of the final sentence of the definition of "Knowledge," each reference to the knowledge of the Acquired Companies encompasses the knowledge of all of their current and former directors and officers. The Sellers may seek to narrow the definition of "Knowledge" by eliminating the reference to former directors and officers. The Buyer, however, may want to expand the scope of this definition to include the knowledge of *all* employees of the Acquired Companies (including non-officer employees).

The parties must also determine the scope of the investigation to be built into the definition of "Knowledge." Some acquisition agreements define knowledge as actual knowledge without any investigation requirement, while others (like the Model Stock Purchase Agreement) define it to require some level of investigation by the party making the representation.

* * * * * * *

"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:

(a) such action is consistent 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) such action is not required to be authorized by the board of directors of such Person (or by any Person or group of Persons exercising similar authority) [and is not required to be specifically authorized by the parent company (if any) of such Person]; and

(c) such action is similar in nature and magnitude to actions customarily taken, without any authorization by the board of directors (or by any Person or group of Persons exercising similar authority), 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

The term "Ordinary Course of Business" appears in Sections 3.6, 3.8, 3.9, 3.10, 3.16, 3.17, 3.25, 5.2, and 5.7. When the acquisition agreement is signed, the Buyer obtains an interest in being consulted about matters affecting the Acquired Companies. However, the Sellers need to be able to operate the Acquired Companies' 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. The Revised Model Business Corporation Act, Section 12.02, requires shareholder approval for a sale of all or substantially all of a corporation's assets other than in the regular course of business, and most states' general corporations laws contain similar provisions.

3. A regulation under the Securities Exchange Act allows management to omit a shareholder proposal from a proxy statement "[i]f the proposal deals with a matter relating to the conduct of the ordinary business operations of the [company]." *See* 17 C.F.R. § 14a- 8(c)(7) (1993).

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

The Model Stock Purchase Agreement definition distinguishes between major and routine matters based on the historic practices of both the Acquired Companies and others in the same industry

and on the need for board or shareholder approval. The definition is derived primarily from the analysis of "ordinary course of business" in bankruptcy, which examines both the past practice of the debtor and the ordinary practice of the industry. *See, e.g., In re Roth American, 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 Sellers. In doubtful cases, the Sellers may want to consult with the Buyer and obtain its approval.

The Buyer should be aware that its knowledge of transactions the Acquired Companies plan 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 Sellers' plans for operating the Acquired Companies 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 Acquired Companies and other companies in the same industries, the Buyer may want specifically to exclude such projects or transactions, and all related transactions, from the definition of "ordinary course of business."

Clause (b) of the definition has special significance in a parent-subsidiary relationship. State law does not normally require parent company authorization for actions taken by subsidiaries. Unless the certificate or articles of incorporation provide otherwise, most

state laws require shareholder approval only for amendments to the charter, mergers, sales of all or substantially all of the assets, dissolutions, and other major events. Therefore, the Model Stock Purchase Agreement definition excludes any action requiring authorization by the parent company not only for subsidiary actions requiring shareholder authorization under state law, but also for subsidiary actions requiring parent authorization under the operating procedures in effect between the parent and the subsidiary.

* * * * * * *

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

COMMENT

The term "Proceeding" appears in Sections 3.15, 4.4, 7.5, and 10.9.

* * * * * * *

"Threatened"--a claim, Proceeding, dispute, action, or other matter will be deemed to have been "Threatened" if any demand or statement has been made (orally or in writing) or any notice has been given (orally or in writing), or if any other event has occurred or any other circumstances exist, that would lead a prudent Person to conclude that such a claim, Proceeding, dispute, action, or other matter is likely to be asserted, commenced, taken, or otherwise pursued in the future.

COMMENT

The term "Threatened" appears in Sections 3.13, 3.15, 3.19, 3.21,

3.22, 4.4, 7.5, and 7.6. A typical representation concerning litigation, for example, will require the Sellers to represent that "To the knowledge of Sellers and the Acquired Companies, no proceeding [involving an Acquired Company] has been Threatened." The word "Threatened" connotes action that a prudent person would expect to be taken based either upon receipt of a written demand, letter threatening litigation, or notice of an impending investigation or audit or upon facts that a prudent person would believe indicate that action likely will be taken by another person (for example, a recent, well-publicized industrial accident likely to give rise to claims even though no claims have yet been filed). When the term "Threatened" is used in conjunction with a knowledge qualification, the Buyer will normally insist that the Sellers' knowledge be based upon some inquiry or process of investigation, while the Sellers may attempt to limit their knowledge of threatened action to the actual knowledge of the Sellers and perhaps the Acquired Companies' senior management (or a limited number of designated officers) without any independent investigation.

By comparison, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975) (the "Policy Statement") also contains standards for determining when threatened litigation must be disclosed. The Policy Statement examines the appropriateness of responses by lawyers to auditors' requests for information concerning loss contingencies of their clients. The Policy Statement is the result of a carefully negotiated compromise between the ABA and the American Institute of Certified Public Accountants. The compromise involved the balancing of the public interest in protecting the confidentiality of lawyer-client communications, as well as the attorney-client privilege, with the need for public confidence in published financial statements. Under the terms of the Policy Statement, only "overtly threatened" litigation need be disclosed. The customary threshold

for disclosure in a business acquisition is lower, and the Policy Statement is not considered an appropriate benchmark for the allocation of risk between the sellers and the buyers in business acquisitions.

In addition to the representations concerning pending or threatened litigation (see Section 3.15), other provisions of the acquisition agreement may require disclosure of items that the Sellers are aware of and may affect the Acquired Companies. For example, the expected effect of a possible catastrophe may be covered by representations concerning the financial statements (see Section 3.4) or the absence of certain changes and events (see Section 3.16) or provisions regarding disclosure (see Section 3.24). Even if such a matter does not warrant disclosure by means of a reserve, a provision, or a footnote in the Company's financial statements, and even if its significance cannot yet be fully assessed, the Sellers' failure to disclose it in the Disclosure Letter may give the Buyer the right to elect not to close or to seek indemnity.

* * * * * * *

2.4 CLOSING OBLIGATIONS

At the Closing:

(a) Sellers will deliver to Buyer:

(i) certificates representing the Shares, duly endorsed (or accompanied by duly executed stock powers), with signatures guaranteed by a commercial bank or by a member firm of the New York Stock Exchange, for transfer to Buyer;

(ii) releases in the form of Exhibit 2.4(a)(ii) executed by Sellers (collectively, "Sellers’ Releases");

(iii) employment agreements in the form of Exhibit 2.4(a)(iii), executed by Sellers (collectively, "Employment Agreements");

(iv) noncompetition agreements in the form of Exhibit 2.4(a)(iv), executed by Sellers (collectively, the "Noncompetition Agreements"); and

(v) a certificate executed by Sellers representing and warranting to Buyer that each of Sellers' representations and warranties in this Agreement was accurate in all respects as of the date of this Agreement and is accurate in all respects as of the Closing Date as if made on the Closing Date (giving full effect to any supplements to the Disclosure Letter that were delivered by Sellers to Buyer prior to the Closing Date in accordance with Section 5.5); and

(b) Buyer will deliver to Sellers:

(i) the following amounts by bank cashier's or certified check payable to the order of [or by wire transfer to accounts specified by] A and B, respectively: $__________ to A and $__________ to B;

(ii) promissory notes payable to A and B in the respective principal amounts of $________ and $________ in the form of Exhibit 2.4(b) (the "Promissory Notes");

(iii) the sum of $_________ to the escrow agent referred to in Section 2.4(c) by bank cashier's or certified check;

(iv) a certificate executed by Buyer to the effect that, except as otherwise stated in such certificate, each of Buyer's representations and warranties in this Agreement was accurate in all respects as of the date of this Agreement and is accurate in all respects as of the Closing Date as if made on the Closing Date; and

(v) the Employment Agreements, executed by Buyer.

(c) Buyer and Sellers will enter into an escrow agreement in the form of Exhibit 2.4(c) (the "Escrow Agreement") with

___________.

COMMENT

Many acquisition agreements list the documents that will be exchanged at the closing so that the parties have a checklist. In the interests of simplicity, the Model Stock Purchase Agreement does not independently list those documents because the principal documents to be delivered at the closing are identified in Sections 2, 7, and 8.

The parties should be aware of the distinction between deliveries to be treated as covenants, the breach of which will give the non-breaching party a right to damages, and 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. In Section 2.4, the parties covenant to make certain deliveries. Therefore, if the Sellers fail to deliver the certificates for the shares or the Buyer fails to make the specified payments, for example, the non-breaching party can pursue its damage remedy. In contrast, if the Sellers fail to deliver the legal opinion or consents (or other documents reasonably requested by the Buyer) contemplated by Section 7, the Buyer would have the right to terminate the acquisition, but it would not have the right to damages unless the Sellers breached their covenant in Section 5.8 to use their best efforts to obtain such documents. If, however, the Sellers covenanted to deliver a particular consent (because, for example, the Sellers or a party related to the Sellers was the lessor under a lease with one of the Acquired Companies that required a consent), the Sellers' 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 the second and third paragraphs of the Commentary to Section 7).

Guaranty of Endorsement of Stock Certificates. The guaranty of the Sellers' signatures on the certificates representing the shares provides the Buyer with additional protection. Under Section 8.312(1) of the UCC, a person guaranteeing the signature of an endorser warrants that the signature is genuine, that the signer is an appropriate person to endorse, and that the signer has the legal capacity to sign. Under Section 8.312(8) of the UCC, these warranties extend to any person taking the security (in this case, the stock certificate) in reliance on the guaranty, and the guarantor is liable to such a person for any loss resulting from a breach of these warranties.

Sellers' Closing Certificate. Section 2.4(a)(v) requires the Sellers to deliver a "bring down" certificate to the Buyer at the closing. In many acquisition agreements, the "bring down" certificate provides the basis for the Buyer's assertion of post-closing indemnification claims relating to representations that are inaccurate as "brought down" to the closing date. The Model Stock Purchase Agreement, however, contains a separate "bring down" provision in the indemnity section (see Section 10.2(b)) which enables the Buyer to assert such indemnification claims. Thus, the "bring down" certificate contemplated by Section 2.4(a)(v) is arguably superfluous. The Model Stock Purchase Agreement nonetheless requires the delivery of a "bring down" certificate so that the Sellers are required to reconsider whether their representations remain accurate at the closing and to confirm to the Buyer that this is the case.

Section 2.4(a)(v) provides that supplements to the Sellers' disclosure letter are always taken into account for purposes of determining the accuracy of the representations in the "bring down" certificate. The Sellers thus will not be required to sign a certificate that they know is false. In contrast, supplements to the Disclosure Letter are not always given effect in the context of other provisions of the Model Stock Purchase Agreement (see Sections 7.1 and

10.2 and the related Commentary).

In some circumstances, it may be desirable for the Sellers to include in their "bring down" certificate an express statement to the effect that the Buyer has a "walk right" as a result of a particular event disclosed in a disclosure letter supplement. See Section 10.2(b) and the related Commentary; see also Appendix A, scenario 5, and the Commentary to Sections 5.5 and 7.1.

For a further discussion of the use of "bring down" certificates in acquisition agreements, see Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* § 14.02[5] (1992).

Manner of Payment. The Model Stock Purchase Agreement provides for payment by bank cashier's or certified check, although it recognizes that the parties may agree that payment will be made by wire transfer. While all three forms of payment are commonly used and should be acceptable to the Sellers, the parties should be aware of certain differences in the Buyer's ability to stop payment and in the availability of the funds for use by the Sellers.

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* ¶¶ 1.01[1], 2.06[3], 3.02 (3d ed. 1990) (citing cases).

Unlike checks, which are instructions by a customer to its bank to debit an account in the amount of the check, wire transfers are transfers of credit through a series of contractual obligations, usually from one bank to another. As a result, in the case of a check, the drawer's ability to pay is not determined until the check is presented for payment, while in the case of a wire transfer, the customer's ability to pay is determined when the customer gives the payment order to its bank. Although the customer's ability to pay is determined earlier for wire transfers, Article 4A of the UCC (which governs wire transfers) and relevant case law recognize that wire transfers can be cancelled if the beneficiary's bank has not accepted the payment order (and even when the beneficiary's bank has accepted the payment order in the case of an unauthorized transfer or a mistake). Although cancellation of a wire transfer is analogous to a stop payment order for a check and may present some risks to the beneficiary, the risk to the Sellers is limited if receipt of the wire transfer in the correct amount to the correct account is confirmed at the closing. *See* Clark, *The Law of Bank Deposits, Collections and Credit Cards* ¶¶ 13.01-13.03 (3d ed. 1990) (citing cases).

The form of payment may also affect the time when funds become available to the Sellers. For example, a wire transfer over the Fedwire operated by the Federal Reserve Board is commonly referred to as "immediately available" because it is immediately credited to the payee bank when received by that bank, while a wire transfer over the Clearing House Interbank Payments System (CHIPS) is commonly referred to as "same day availability" because it is not credited until the end of the business day during which the wire was received. In the case of cashier's checks and certified checks, a bank into which such checks are deposited is required to make the funds available to the payee or beneficiary no later than the business day following the deposit. Therefore, if the Sellers want immediate use of the funds, the acquisition agreement

should specify that payment will be made by a wire transfer of immediately available funds or delivery of a check drawn on a federal reserve bank. *See generally* Clark, *The Law of Bank Deposits, Collections and Credit Cards* ¶¶ 6.01-6.24 (3d ed. 1990). If there is any possibility of ambiguity, the agreement should specify the currency in which amounts are stated and payments are to be made.

Promissory Notes. Exhibit 2.4(b) of the Model Stock Purchase Agreement contains a form of the Buyer's Promissory Notes to be delivered to the Sellers. The Promissory Notes are subject to rights of set-off in favor of the Buyer, which provide some security to the Buyer for the enforcement of the Sellers' post-closing indemnification obligations. The Promissory Notes bear interest, are subject to prepayment without penalty, and may be accelerated following the occurrence of an event of default.

The Promissory Notes are neither subordinated to the rights of other creditors of the Buyer nor secured by a security interest in favor of the Sellers. Whether such features are included depends on the amount of cash funds being raised, who is providing cash funds, and the bargaining position of the parties. When the Promissory Notes are 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 notes 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 the Buyer.

Sellers in a strong bargaining position may demand collateral for the Buyer's Promissory Notes, especially if the Buyer is weak financially. Such collateral could be a pledge of all or a portion of the shares of the Company. The collateral could be perfected as a

pledge by depositing the stock certificates representing the shares acquired by the Buyer, along with stock powers endorsed in blank by the Buyer, with the Sellers or an escrow agent. To prevent the value of the collateral from being unduly diminished, the Sellers may also seek certain covenants from the Buyer regarding the operation of the Acquired Companies after the closing.

The security agreement can provide for the Sellers to have all of the remedies of a secured party under the provisions of the UCC upon the occurrence of an event of default. Alternatively, the enforcement rights of the Sellers as secured parties can be subordinated to those of other secured creditors and require the Sellers to take no action until those creditors exercise their rights or for a specified period of time. If the stock certificates representing the transferred shares being acquired are pledged to the Sellers and held by an escrow agent, the Escrow Agreement should provide for delivery of the stock certificates to the Sellers following an event of default (although the escrow agent is likely to "freeze" and retain the collateral in the event of a dispute) and for the Sellers, rather than the escrow agent, to exercise the remedies. The pledge agreement should also contain provisions regarding voting rights with respect to regular and extraordinary matters, receipt of dividends and distributions, and adjustments for stock splits, recapitalizations, and mergers.

The Promissory Notes are non-negotiable to protect the Buyer's set-off rights. 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 set-off 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 notes that once were 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. v. InterFirst Bank Gateway, N.A.*, 894 F.2d 750 (5th Cir.), *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); *RTC v. Oaks Apartments Joint Venture*, 966 F.2d 995 (5th Cir. 1992). Therefore, if the Buyer gives the Sellers non-negotiable Promissory Notes and those notes ever come into the possession of a bank that later fails, the Buyer could lose its set-off rights under the acquisition agreement unless the failed bank had reflected in its records the acquisition agreement and the Buyer's set-off rights. The Buyer could issue notes that can be transferred only to persons who agree in writing to recognize in their official records both the acquisition agreement and the Buyer's set-off rights.

Escrow Agreement. The Escrow Agreement provides for an escrow to assist the Buyer in realizing on any successful indemnification claims that it may have under the acquisition agreement for matters such as breaches of the Sellers' representations (see Section 10).

* * * * * * *

3. REPRESENTATIONS AND WARRANTIES OF SELLERS

Sellers represent and warrant to Buyer as follows:

COMMENT

The Sellers' representations and warranties are the Sellers' formal description of the Acquired Companies and their businesses. The technical difference between representations and warranties--representations are statements of past or existing facts and warranties are promises that existing or future facts are or will be

true--has proven unimportant in acquisition practice. *See* Freund, *Anatomy of a Merger* 153 (1975). Separating them explicitly in an acquisition agreement is a drafting nuisance, and the legal import of the separation has been all but eliminated. *See Reliance Finance Corp. v. Miller*, 557 F.2d 674, 682 (9th Cir. 1977) (the distinction between representations and warranties is inappropriate when interpreting a stock acquisition agreement). The Commentary to the Model Stock Purchase Agreement generally refers only to representations, although the Model Stock Purchase Agreement follows common practice and refers to both representations and warranties.

Bare representations, if false, may support claims in tort and for federal securities act violations and also claims for breach of an implied warranty, breach of an implied promise that a representation is true, or breach of an express warranty if the description is basic to the bargain. *Cf.* U.C.C. § 2-313. *See generally Business Acquisitions* ch. 31 (Herz & Baller eds., 2d ed. 1981). The Model Stock Purchase Agreement, following common practice, stipulates remedies for breaches of representations that are equivalent to those provided for breaches of warranties (see Sections 1 (definition of "Breach"), 7.1 (conditions to the Buyer's obligations to complete the acquisition), and 10.2(a) and (b) (the Sellers' indemnification obligations)).

Purposes of the Sellers' Representations: The Sellers' representations serve three overlapping purposes. First, they are a device for obtaining disclosure about the Acquired Companies before the signing of the acquisition agreement. A thorough Buyer's draft elicits information about the Acquired Companies and their businesses relevant to the Buyer's decision to buy the Company.

The Sellers' 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 Acquired Companies. Detailed Sellers' 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 Commentary).

Finally, the Sellers' representations provide a basis for the Buyer's right to indemnification (and other remedies) if the Buyer discovers after the closing that the Sellers have breached one or more of the representations (see Section 10.2 and the related Commentary). In this regard, the Sellers' representations serve as a mechanism for allocating economic risks between the Buyer and the Sellers.

Considerations When Drafting "Adverse Effect" Language in Representations: The importance of the content and detail of the Sellers' representations cannot be understated. As noted above, the Sellers' representations provide the foundation for both the Buyer's "walk rights" in Section 7.1 and the Buyer's indemnification rights in Section 10.2. The specific wording of the representations can be quite important because of this dual purpose.

Consider, for example, the following simplified version of the Sellers' litigation representation: "There is no lawsuit pending against the Company that will have an adverse effect on the Company." The phrase "that will have an adverse effect on the Company" clearly provides adequate protection to the Buyer in the context of a post-closing indemnification claim against the Sellers--if there is a previously undisclosed lawsuit against the Company that has an adverse effect on the Company (because, for example, a judgment is ultimately rendered against the Company in the lawsuit), the Buyer will be able to recover damages from the Sellers because of the Sellers' breach of the

litigation representation (see Section 10.2(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 Sellers), the Buyer will have to demonstrate, on the scheduled closing date, that the lawsuit "will have an adverse effect on the Company" (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, the 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 Company (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--even if the lawsuit ultimately has an adverse effect on the Company, the Sellers 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 Company (see Section 3.15(a)). If the Sellers object 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 Company.

Considerations When Drafting Representations Incorporating Specific Time Periods: Representations that focus on specific time periods require careful drafting due to the expectations of the "bring down" clause in Sections 7.1 and 10.2(b) (the clauses

focusing on the accuracy of the Sellers' representations as of the closing date). For example, consider the representation in Section 3.14(a)(iii), which states that no Acquired Company has received notice of any alleged legal violation "since" a specified date. 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" or an indemnification right if an Acquired Company 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) and Section 10.2(b), because the notice would not have been received "prior to" the date of the agreement. In contrast, if the representation were drafted as in Section 3.14(a)(iii), the representation would be materially inaccurate as "brought down" to the scheduled closing date (because the notice of the alleged violation would have been received "since" the date specified in Section 3.14(a)(iii)), and the Buyer therefore would have a "walk right" pursuant to Section 7.1(a) and a basis for claiming indemnification pursuant to Section 10.2(b).

The Effect of "Knowledge" Qualifications in RepresentatIons: Sections 3.13, 3.15, 3.17, 3.19, 3.20, 3.21, 3.22, and 3.23 contain knowledge qualifications. The addition of knowledge qualifications to the Sellers' representations in Section 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, prior to the closing, the Buyer learns of a fact (not already known to the Sellers) that is inconsistent with a representation containing a knowledge qualification, the Buyer should simply disclose this fact to the Sellers. The Sellers will thus acquire knowledge of the fact,

and the representation will be inaccurate despite the knowledge qualification. For further discussion of knowledge qualifications, see the Commentary to the definition of "Knowledge" in Section 1 and to the sections listed above.

The Absence of "Materiality" Qualifications: The Sellers' representations in the Model Stock Purchase 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 Commentary to Section 7.1 under the caption "Absence of Materiality Qualification in Section 7.1(b)"). The indemnification provisions replace a general and open-ended materiality qualification with a quantified "basket" in Section 10.6 that exonerates the Sellers from liability for breaches resulting in damages below a specified amount.

The Sellers may object to the absence of materiality qualifications in their representations by arguing that, in light of the comprehensive and detailed nature of the representations, it is unrealistic to expect that every representation will be accurate in all respects. They might point out, for example, that the Company undoubtedly will have been a few days late in making a payment due under one of the routine contracts to which it is a party, and that this insignificant delay in making a contractual payment will place the Sellers in breach of the "no default" representation in Section 3.17(b)(i). The Sellers may be reluctant to sign a document containing representations that are not completely accurate.

The Buyer may respond by pointing out that, because of the limited purposes served by the Sellers' representations, the Sellers should not be concerned about the presence of immaterial inaccuracies in these representations. Under the Model Stock Purchase

Agreement, the only remedies available to the Buyer for a breach of the Sellers' representations are the Buyer's "walk rights" and indemnification rights, neither of which may be exercised if the breach is not material (see above). Also, to exercise its indemnification rights on the basis of a breach by the Sellers, the Buyer must be able to demonstrate that it was actually damaged by the breach (see Section 10.2). If the Buyer accedes to the Sellers' request that specific materiality qualifications be added to each representation, the Buyer could be left without any remedies if a series of individually insignificant inaccuracies in the Sellers' representations causes damages that are material when measured on a cumulative basis. See the Commentary to Section 7.1 under the captions "Materiality Qualification in Section 7.1(a)" and "Absence of Materiality Qualification in Section 7.1(b)"; see also the second paragraph of the Commentary to Section 10.6 (relating to the indemnification "basket").

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

* * * * * * *

3.4 FINANCIAL STATEMENTS

Sellers have delivered to Buyer: (a) [unaudited] consolidated balance sheets of the Acquired Companies as at ____________ in each of the years ___ through ___, and the related [unaudited] consolidated statements of income, changes in stockholders' equity, and cash flow for each of the fiscal years then ended, [together with the report thereon of ____________, independent certified public accountants,] (b) a consolidated balance sheet of the Acquired Companies as at __________ (including the notes thereto, the "Balance Sheet"), and the related consolidated statements of income, changes in stockholders' equity, and cash

flow for the fiscal year then ended, together with the report thereon of ____________, independent certified public accountants, and (c) an unaudited consolidated balance sheet of the Acquired Companies as at ____________ (the "Interim Balance Sheet") and the related unaudited consolidated statements of income, changes in stockholders' equity, and cash flow for the ___ months then ended, including in each case the notes thereto. Such financial statements and notes fairly present the financial condition and the results of operations, changes in stockholders' equity, and cash flow of the Acquired Companies as at the respective dates of and for the periods referred to in such financial statements, all in accordance with GAAP [, 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 materially adverse) and the absence of notes (that, if presented, would not differ materially from those included in the Balance Sheet)]; the financial statements referred to in this Section 3.4 reflect the consistent application of such accounting principles throughout the periods involved [, except as disclosed in the notes to such financial statements]. No financial statements of any Person other than the Acquired Companies are required by GAAP to be included in the consolidated financial statements of the Company.

COMMENT

This representation, which requires the delivery of specified financial statements of the Acquired Companies and provides assurances regarding the quality of those financial statements, is almost universally present in an acquisition agreement. Financial statements are key items in the evaluation of nearly all potential business acquisitions. The Model Stock Purchase 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 Acquired Companies' 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). However, specific line item representations may 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,* 112 S. Ct. 1671 (1992).

The Model Stock Purchase Agreement representation requires the delivery of (1) annual financial statements for a period of years, which may or may not be audited, (2) audited annual financial statements as of the end of the most recent fiscal year, and (3) unaudited financial statements as of the end of an interim period subsequent to the last audited financial statements. The determination of which financial statements should be required will depend upon factors such as availability, relevance to Buyer's commercial evaluation of the acquisition, and the burden and expense on the Sellers that the Buyer is willing to impose and the Sellers are willing to bear. Especially when the Acquired Companies have been operated as part of a larger enterprise and do not have a history of independent financing transactions, separate audited financial statements may not exist and, although the auditors that expressed an opinion concerning the entire enterprise's consolidated financial statements will of necessity have reviewed the financial statements of the Acquired Companies, that review may not have been sufficient for the expression of an opinion about the financial statements of the Acquired Companies

by themselves. This occurs most frequently when the Acquired Companies 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 Acquired Companies' financial statements. Although it is not unusual to require the Sellers to cause the Acquired Companies' auditors to do the necessary additional work to express an opinion on one recent set of financial statements for the Acquired Companies, it may not be practical to seek this comfort for earlier periods (for instance, the auditors might not have observed physical inventories in the prior periods). In such a case, the representation concerning the accuracy of the Acquired Companies' books and records (see Section 3.5) is critical because these books and records are the Buyer's main tool for assessing the financial health of the Acquired Companies' businesses (under Section 5.1, the Buyer has a right to inspect these books and records).

The Buyer also may request audited consolidating financial statements, which contain separate financial statements for each of the Acquired Companies and the eliminations necessary to produce the consolidated financial statements. The Sellers can be expected to object to the additional accounting and audit work required to produce those statements, in which materiality judgments reflect the size of the smallest of the Acquired Companies, and to argue that Buyer should be concerned about the financial aspects of the Acquired Companies' business as a whole, not on an entity-by-entity basis. If the Buyer insists on receiving audited consolidating financial statements, the Buyer should be prepared to demonstrate to the Sellers the relevance of that information to the Buyer's evaluation of the acquisition.

If the Buyer is a public company, its counsel should consider the requirements in SEC Regulation S-X, 17 C.F.R. § 210, if any, that apply to post-closing disclosure of audited financial statements for

the Acquired Companies; in general, these requirements depend on the relative size of the Buyer and the Acquired Companies.

The Model Stock Purchase Agreement representation does not attempt to characterize the auditors' report; the Buyer's counsel should determine at an early stage whether the report contains any qualifications regarding conformity with GAAP, the auditors' examination having been in accordance with the generally accepted auditing standards, 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 (1985); *Ultramares Corp. v. Touche,* 255 N.Y. 170 (1931); *see also Security Pacific Credit, Inc. v. Peat Marwick Main & Co.*, 586 N.Y.S.2d 87 (1992) (explaining the circumstances in which accountants may be held liable to third parties); *Gretcas 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 Sellers will likely 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 Sellers 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 (such as the absence of a full set of notes to financial statements). The Model Stock Purchase Agreement representation contains an example of a qualification that may be appropriate. 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 & Ten Eyck, *Financial Statement Representations in Business Transactions,* 47 Bus. Law. 157 (1991). The Buyer is unlikely to accept this view, especially in its first draft of the acquisition agreement.

The Sellers may be willing to represent only that the financial statements have been prepared from, and are consistent with, the books and records of the Acquired Companies. The Buyer should be aware that this representation provides far less comfort to the Buyer than that provided by the Model Stock Purchase Agreement representation.

Many of the representations in Sections 3.5 through 3.26 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 Acquired Companies are 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,* 112 S. Ct. 1671 (1992). The specific content of these representations will vary greatly depending on the nature of the Acquired Companies' businesses and assets.

See Chapter V, "Financial Statements," of the *Manual on Acquisition Review*.

* * * * * * *

3.10 NO UNDISCLOSED LIABILITIES

Except as set forth in Part 3.10 of the Disclosure Letter, the Acquired Companies have no liabilities or obligations of any nature (whether known or unknown and whether absolute, accrued, contingent, or otherwise) except for liabilities or obligations reflected or reserved against in the Balance Sheet or the Interim Balance Sheet and current liabilities incurred in the Ordinary Course of Business since the respective dates thereof.

COMMENT

This representation assures the Buyer that it has been informed of all liabilities (including "contingent" liabilities) of the Acquired Companies. The Sellers may seek to add a knowledge qualification to this representation, arguing that they cannot be expected to identify every conceivable contingent liability to which the Acquired Companies may be subject. The Buyer will typically resist the addition of such a qualification, pointing out that the risk of unknown liabilities is more appropriately borne by the Sellers

(who presumably have considerable familiarity with the past and current operations of the Acquired Companies) than by the Buyer.

The Sellers may also seek to narrow the scope of this representation by limiting the types of liabilities that must be disclosed. For example, the Sellers 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 Acquired Companies, regardless of whether such liabilities are sufficiently definite to merit disclosure in the Acquired Companies' financial statements.

Even if the Buyer successfully resists the Sellers' 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), the representation 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. 1986), the court concluded that a company's defective product does not represent a "contingent liability" of the company 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.

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 (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"); *Grant- Howard Assocs. v. General Housewares Corp.*, 482 N.Y.S.2d 225, 227 (1984) ("An uninjured party simply is not a `contingent liability' . . . .").

Even though the terms "liability" and "contingent liability" may be narrowly construed, other provisions in the Model Stock Purchase Agreement protect the Buyer against various contingencies that may not actually constitute "contingent liabilities" as of the closing date. For example, the Model Stock Purchase Agreement contains representations that no event has occurred that may result in a

future material adverse change in the business of an Acquired Company (see Section 3.12); that no undisclosed event has occurred that may result in a future violation of law by an Acquired Company (see Section 3.14); that the Sellers have no knowledge of any circumstances that may serve as a basis for the commencement of a future lawsuit against an Acquired Company (see Section 3.15); that no undisclosed event has occurred that would constitute a future default under any of the contracts of the Acquired Companies (see Section 3.17); and that the Sellers know of no facts that materially threaten the Acquired Companies' businesses (see Section 3.24). In addition, the Model Stock Purchase Agreement requires the Sellers to indemnify the Buyer against liabilities that may arise in the future from products manufactured by the Acquired Companies prior to the closing date (see Section 10.2(d)).

If the Buyer seeks even broader protection against undisclosed contingencies, the Buyer should consider proposing a definition of the term "liability" that expressly includes not only "contingent" liabilities, but also "unmatured," "unaccrued," "unliquidated," "unasserted," "conditional," "secondary," "potential," and other similar categories of liabilities. The Buyer should also consider expanding the scope of the Sellers' indemnity obligations under Section 10.2 so that the Sellers 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.

See Chapter V, "Financial Statements," of the *Manual on Acquisition Review*.

* * * * * * *

3.12 NO MATERIAL ADVERSE CHANGE

Since the date of the Balance Sheet, there has not been any

material adverse change in the business, operations, properties, prospects, assets, or condition of any Acquired Company, and no event has occurred or circumstance exists that may result in such a material adverse change.

COMMENT

In light of the materiality qualification in this representation, the Sellers would prefer to make this representation on behalf of all Acquired Companies as a whole, rather than with respect to each Acquired Company separately. The Buyer, however, will want to know if any Acquired Company has suffered serious recent setbacks so that it can judge the significance of such problems for the entire acquisition. Similarly, if significant lines or segments of an Acquired Company's business are conducted in divisions (rather than subsidiaries), the Buyer may request this representation for one or more of those divisions.

For a discussion of the advisability of including a separate "no material adverse change" condition in the acquisition agreement, see the Commentary to Section 7.1 under the caption "Desirability of Separate `No Material Adverse Change' Condition." For a discussion of the implications of various methods of drafting a phrase such as "that may result in such a material adverse change" (which appears at the end of Section 3.12), see the Commentary to Section 3 under the caption "Considerations When Drafting `Adverse Effect' Language in Representations."

In addition to Section 3.12, which deals generally with material adverse changes affecting the Acquired Companies, Section 3.16 covers several specific matters that are considered significant (though not necessarily adverse) events for the Acquired Companies and may, individually or in the aggregate, constitute material adverse changes. Section 3.16 requires disclosure of such events that occurred after the date of the Company's balance

sheet but before the signing of the acquisition agreement, and Section 5.3 requires the Sellers 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 date (for further discussion, see the Commentary to Section 3.16). Together, Sections 3.12 and 3.16 require the Sellers to disclose to the Buyer updated information concerning important developments in the Acquired Companies' businesses after the date of the balance sheet.

* * * * * * *

3.15 LEGAL PROCEEDINGS; ORDERS

(a) Except as set forth in Part 3.15 of the Disclosure Letter, there is no pending Proceeding:

(i) that has been commenced by or against any Acquired Company or that otherwise relates to or may affect the business of, or any of the assets owned or used by, any Acquired Company; or

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

To the Knowledge of Sellers and the Acquired Companies, (1) no such Proceeding has been Threatened, and (2) no event has occurred or circumstance exists that may give rise to or serve as a basis for the commencement of any such Proceeding. Sellers have delivered to Buyer copies of all pleadings, correspondence, and other documents relating to each Proceeding listed in Part 3.15 of the Disclosure Letter. The Proceedings listed in Part 3.15 of the Disclosure Letter will not have a material adverse effect on the business, operations, assets, condition, or prospects of any Acquired Company.

(b) Except as set forth in Part 3.15 of the Disclosure Letter:

(i) there is no Order to which any of the Acquired Companies, or any of the assets owned or used by any Acquired Company, is subject;

(ii) neither Seller is subject to any Order that relates to the business of, or any of the assets owned or used by, any Acquired Company; and

(iii) [to the Knowledge of Sellers and the Acquired Companies,] no officer, director, agent, or employee of any Acquired Company is subject to any Order that prohibits such officer, director, agent, or employee from engaging in or continuing any conduct, activity, or practice relating to the business of any Acquired Company.

(c) Except as set forth in Part 3.15 of the Disclosure Letter:

(i) each Acquired Company is, and at all times since ______, 19__ has been, in full compliance with all of the terms and requirements of each Order to which it, or any of the assets owned or used by it, is or has been subject;

(ii) no event has occurred or circumstance exists that may constitute or result in (with or without notice or lapse of time) a violation of or failure to comply with any term or requirement of any Order to which any Acquired Company, or any of the assets owned or used by any Acquired Company, is subject; and

(iii) no Acquired Company has received, at any time since __________, 19__, any notice or other communication (whether oral or written) from any Governmental Body or any other Person regarding any actual, alleged, possible, or potential violation of, or failure to comply with, any term or requirement of any Order to which any Acquired Company, or any of the assets owned or used by any Acquired Company, is or has been subject.

COMMENT

Section 3.15(a) contains the Sellers' representations concerning pending and potential lawsuits and other legal proceedings that may affect the Acquired Companies or the consummation of the acquisition. The Sellers may seek to limit the scope of these representations in several respects. For example, the Sellers may point out that the representations in Section 3.15(a) are so broad that they require the Sellers to disclose an acquisition-related lawsuit in which the *Buyer* is the only named defendant. The Sellers may request that these representations be limited to legal proceedings in which the Sellers or the Acquired Companies are actually named as parties or are otherwise directly involved. In making this request, the Sellers may remind the Buyer that they are not proposing to modify the Buyer's ability to terminate the acquisition under Section 7.5, which provides the Buyer with a "walk right" in the event of certain lawsuits against the Buyer.

The Sellers may also point out that the last sentence of Section 3.15(a) effectively requires the Sellers to bear the litigation risks associated with each of the legal proceedings disclosed by the Sellers in their disclosure letter, including routine lawsuits brought against the Acquired Companies in the normal course of their operations. The Sellers may insist that the parties determine, on a case-by-case basis, which of the disclosed proceedings should remain the Sellers' responsibility and which should become the Buyer's responsibility following the closing.

The Buyer should carefully evaluate each disclosed proceeding to determine the probability of an adverse determination and the magnitude of the potential damages. The Buyer should examine both the information provided in the Disclosure Letter and the Company's financial statements and accompanying notes, as well as attorneys' responses to auditors' requests for information. However, if the Buyer reviews privileged materials relating to legal proceedings in which the Acquired Companies are involved, there may be a waiver of the attorney-client privilege (see the fifth

paragraph of the Commentary to Section 5.1). For each proceeding, the Buyer should determine whether the potential liability justifies a holdback of a portion of the purchase price or whether indemnification is sufficient. Finally, the Buyer and the Sellers must agree on the manner in which all such proceedings will be conducted up to and after the closing (issues such as who will designate lead counsel and who is empowered to effect a settlement must be resolved).

Section 3.15(b) contains the Sellers' representation concerning the existence of judicial and other orders affecting the operations of the Acquired Companies, and Section 3.15(c) focuses on violations of those orders. Although the representation in Section 3.15(c) is relatively broad, it does not address:

• violations of laws or other legal requirements of general application (see Section 3.14(a));

• violations of the terms of governmental licenses or permits held by the Acquired Companies (see Section 3.14(b));

• contractual violations by the Acquired Companies (see Section 3.17(b)); or

• violations of judicial or other orders that would be triggered by the acquisition (see Section 3.2(b)).

The representation in Section 3.15(c) focuses on four overlapping categories of violations of judicial and other orders:

1. past violations (clause (i));

2. pending violations (clause (i));

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

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

The Sellers may object to the provision in clause (i) of Section 3.15(c) that requires disclosure of past violations, arguing that the Buyer should not be concerned about historical violations that have been cured and are no longer pending. The Buyer may respond by pointing out that it has a legitimate concern that the Acquired Companies' operations have not been based on and do not entail a pattern of legal violation that the Buyer will be unwilling to continue. In addition, without this provision, the Sellers may be able to circumvent the representation by radically altering the Acquired Companies' operations immediately prior to the signing and closing dates in order to bring the Acquired Companies into temporary compliance with applicable orders. The parties may compromise on this point by selecting a relatively recent date to mark the beginning of the period with respect to which disclosure of past violations is required.

In some acquisition agreements, the phrase "since ____19_" (which appears in both clause (i) and clause (iii) of Section 3.15(c)) is replaced with the phrase "during the ____-year period prior to the date of this Agreement" (or a similar phrase). For an explanation of why the use of this alternative language may be disadvantageous to the Buyer, see the Commentary to Section 3 (under the caption "Considerations When Drafting Representations Incorporating Specific Time Periods").

For a discussion of the significance of the phrase "with or without notice or lapse of time" (which appears in clause (ii) of Section 3.15(c)), see the fifth paragraph of the Commentary to Section 3.2.

Although clause (iii) of Section 3.15(c) (which requires disclosure of notices received from governmental authorities and third parties concerning actual and potential violations) overlaps to some extent with clauses (i) and (ii), clause (iii) is not redundant. Clause (iii) requires disclosure of violations that have been asserted by other parties. The Sellers are required to disclose such asserted

violations pursuant to clause (iii) even if there is some uncertainty or dispute over whether the asserted violations have actually been committed.

The parties should recognize that, if information regarding an actual or potential violation of a court order is included in the Sellers' disclosure letter, this information may be discoverable by adverse parties in the course of litigation involving the Acquired Companies. Accordingly, it is important to use extreme care in preparing the descriptions included in part 3.15 of the Disclosure Letter (see the seventh paragraph of the Commentary to Section 3.2).

See Chapter VII, "Litigation," of the *Manual on Acquisition Review*.

* * * * * * *

3.24 DISCLOSURE

(a) No representation or warranty of Sellers in this Agreement and no statement in the Disclosure Letter omits to state a material fact necessary to make the statements herein or therein, in light of the circumstances in which they were made, not misleading.

(b) No notice given pursuant to Section 5.5 will contain any untrue statement or omit to state a material fact necessary to make the statements therein or in this Agreement, in light of the circumstances in which they were made, not misleading.

COMMENT

These representations assure the Buyer that the specific disclosures made in the Sellers' representations and in the Disclosure Letter do not, and no supplement to the Disclosure Letter will (see Section 5.7), contain any misstatements or omissions. There is no materiality qualification (except for omissions) because the representations elsewhere in Section 3

contain any applicable materiality standard-- to include an additional materiality standard here would be redundant. For example, Section 3.1 represents that the Company is qualified to do business in all jurisdictions in which the failure to be so qualified would have a material adverse effect; if Section 3.24(a) provided that there is no untrue statement of a "material" fact, one would have to determine first whether the consequences of a failure to qualify were "material" under Section 3.1, and then whether the untrue statement itself was "material" under Section 3.24. Section 3.24 contains no requirement of knowledge or scienter by the Sellers (any such requirements would be in the representations elsewhere in Section 3) and no requirement of reliance by the Buyer. As a result, Section 3.24 imposes a higher standard of accuracy on the Sellers than the applicable securities laws.

Section 3.24(a) contains a materiality standard with respect to information omitted from the representations in the acquisition agreement and from the Disclosure Letter because the representations concerning omitted information are independent from the representations elsewhere in Section 3. Although the omissions representations are derived from Section 12(2) of the Securities Act and Section 10b- 5 of the Securities Exchange Act of 1934, 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 either Seller. Thus, the acquisition agreement imposes a contractual standard of strict liability, in contrast with (i) Section 10b-5, which predicates liability for misrepresentation or nondisclosure on reliance by the Buyer and conduct involving some form of scienter by the Sellers to be held responsible, (ii) Section 12(2) of the Securities Act, which provides a defense to the Sellers if they can prove that they "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission," and (iii) common law fraud, which is usually predicated upon the Sellers' actual intent to

mislead the Buyer. *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 Sellers insist 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 any disclosures it finds objectionable in its sole discretion. *See* Freund, *Anatomy of a Merger* 171-72 (1975).

(c) There is no fact known to either Seller that has specific application to either Seller or any Acquired Company (other than general economic or industry conditions) and that materially adversely affects [or, as far as either Seller can reasonably foresee, materially threatens,] the assets, business, prospects, financial condition, or results of operations of the Acquired Companies (on a consolidated basis) that has not been set forth in this Agreement or the Disclosure Letter.

COMMENT

Section 3.24(c) is a representation that there is no material information regarding the Acquired Companies that has not been disclosed to the Buyer. This representation is common in the Buyer's first draft of the acquisition agreement. The Sellers 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 Sellers are in a better position to

evaluate the significance of all facts relating to the Acquired Companies.

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7. CONDITIONS PRECEDENT TO BUYER'S OBLIGATION TO CLOSE

Buyer's obligation to purchase the Shares 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

Section 7 sets forth the conditions precedent to the Buyer's obligation to consummate the acquisition of the Sellers' shares. If any one of the conditions in Section 7 is not satisfied as of the scheduled closing date, the Buyer may decline to proceed with the acquisition (without incurring liability to the Sellers) and may terminate the acquisition agreement in accordance with Section 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 Sellers 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 Section 7 do *not* constitute representations or covenants of the Sellers. If the Sellers fail 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 Sellers of a representation or covenant, the Sellers will not be liable to the Buyer for their failure to satisfy the condition. However, because of the Sellers' obligation (in Section 5.8) to use their best efforts to satisfy all of the conditions in Section 7, even if a particular closing condition does not constitute a representation or covenant of the Sellers, the Sellers will be liable if they fail to use their best efforts to satisfy the condition.

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 Sellers fail to obtain the estoppel certificates referred to in Section 7.4(b). Because the delivery of the estoppel certificates 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 Sellers' failure to procure the certificates. However, the delivery of the estoppel certificates is not an absolute *covenant* of the Sellers. Accordingly, the Sellers' failure to obtain the estoppel certificates will not, in and of itself, render the Sellers liable to the Buyer. If the Sellers made no attempt to obtain the estoppel certificates, however, the Sellers could be liable to the Buyer under Section 5.8 for failing to use their best efforts to satisfy the applicable closing condition. For an excellent discussion 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. Examples of additional conditions that the Buyer may want to add to Section 7 include:

• a "due diligence out" (making the Buyer's obligation to purchase the Sellers' shares subject to the Buyer's satisfactory completion of a "due diligence" investigation relating to the business of the Acquired Companies); and

• a "financing out" (making the Buyer's obligation to purchase the Sellers' shares subject to the Buyer's receipt of a third-party loan or other financing in an amount sufficient to enable the Buyer to complete the purchase of the shares).

The Buyer may find it difficult to persuade the Sellers to include additional conditions of this type, because such conditions 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 Sellers' shares. For a discussion of "due diligence outs" and "financing outs," see Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* §§ 14.10, 14.11[4] (1992). A number of other closing conditions that the Buyer may seek to include in Section 7 are discussed in the Commentary to Sections 7.1 and 7.4.

The Buyer may waive any of the conditions to its obligation to close the acquisition. However, the Buyer will not be deemed to have waived any of these conditions unless the waiver is in writing (see Section 11.7). This requirement avoids disputes about whether a particular condition has actually been waived.

7.1 ACCURACY OF REPRESENTATIONS

(a) All of Sellers' representations and warranties in this Agreement (considered collectively), and each of these representations and warranties (considered individually), must have been accurate in all material respects as of the date of this Agreement, and must be accurate in all material respects as of the Closing Date as if made on the Closing Date, without giving effect to any supplement to the Disclosure Letter.

(b) Each of Sellers' representations and warranties in Sections [3.3, 3.4, 3.12, and 3.24] must have been accurate in all respects as of the date of this Agreement, and must be accurate in all respects as of the Closing Date as if made on the Closing Date, without giving effect to any supplement to the Disclosure Letter.

COMMENT

Pursuant to this section, all of the Sellers' representations function as closing conditions. Thus, the Sellers' representations serve a dual purpose -they provide the Buyer with a possible basis not only for recovering damages against the Sellers (see Section 10.2), but also for exercising "walk rights." See the Commentary to Section 3 under the caption "Purposes of the Sellers' Representations."

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 Sellers' representations. A materiality qualification is needed in Section 7.1 because most of the Sellers' representations do not contain any such qualification (see the Commentary to Section 3 under the caption "The Absence of `Materiality' Qualifications"). The materiality qualification in Section 7.1(a) prevents the Buyer from using a trivial breach of the Sellers' representations as an excuse for terminating the acquisition (see Appendix A, scenarios 4, 8, and 9).

Section 7.1(a) provides that the materiality of any inaccuracies in the Sellers' 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 10.6.

Absence of Materiality Qualification in Section 7.1(b): A few of the Sellers' representations (such as the "no material adverse change" representation in Section 3.12 and the "disclosure" representation in Section 3.24) 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 among the representations that must be accurate in all respects under Section 7.1(b) 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] (1992).

In addition, some of the Sellers' 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 *any* respect. Consider, for example, the Sellers' capitalization representation in Section 3.3, which states that the Company has no stock outstanding other than the stock owned by the Sellers. Assume that the Sellers hold 100,000 shares of the Company's stock and that, shortly before the scheduled closing date, the Buyer discovers that a third party owns a single share of the Company's stock. The Buyer may consider it highly undesirable to acquire shares of a company that will have even one minority stockholder, no matter how insignificant the size of the minority stockholder's interest. Accordingly, the Buyer may want to

terminate the acquisition in this situation. However, the Sellers will likely argue that their representation concerning the Company's capitalization is accurate in all *material* respects (because their shares comprise more than 99.99% of the outstanding shares of the Company) and that the Buyer must proceed with the acquisition. To avoid a dispute about the meaning of the term "material" in such a situation, the Buyer may seek to include the capitalization representation (and other fundamental representations made by the Sellers) among the representations that must be accurate in *all* respects pursuant to Section 7.1(b).

Even though there is no materiality qualification in Section 7.1(b), a court might establish its own materiality standard to prevent the Buyer from terminating the acquisition because of a trivial inaccuracy in one of the representations identified in Section 7.1(b). *See Business Acquisitions* ch. 31, n.24 (Herz & Baller eds., 2d ed. 1981).

Time as of Which Accuracy of Representations Is Determined: Each paragraph in Section 7.1 contains two clauses. The first clause focuses on the accuracy of the Sellers' representations on the date of the acquisition agreement, while the second clause refers specifically to the closing date. Pursuant to this second clause--referred to as the "bring down" clause--the Sellers' representations are "brought down" to the closing date to determine whether they would be accurate if made on that date.

Although it is unlikely that the Sellers 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 Sellers' 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 scheduled closing date (see Appendix A, scenario 3). If the Sellers object to this clause,

the Buyer may point out that the elimination of this clause would permit the Sellers 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 Sellers' representations (see the Commentary to Section 3 under the caption "Purposes of the Sellers' Representations"). *See generally* Kling & Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* § 14.02[1] (1992).

Effect of Disclosure Letter Supplements: Section 7.1 specifies that supplements to the Disclosure Letter have no effect for purposes of determining the accuracy of the Sellers' representations. This ensures the Buyer that its "walk rights" will be preserved notwithstanding any disclosures made by the Sellers 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 Company after the signing date and that the Sellers promptly disclose 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 3.15(a) (which states that, except as disclosed in the Disclosure Letter, there are no legal proceedings pending against any Acquired Company) 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 (see Appendix A, scenario 5). 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 effect (in some circumstances) for purposes of determining whether the Buyer has a right to indemnification after the closing (see Sections 2.4(a)(v) and 10.2(b) and Appendix A, scenario 5).

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 Acquired Companies' financial statements. This representation states that the financial statements "fairly present the financial condition . . . of the Acquired Companies 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 Acquired Companies' 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 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, the Sellers may insist that the language of this clause be modified to include a specific exception for representations "expressly made as of a particular date."

The Sellers 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 Sellers may be concerned that the representation in Section 3.17(a)(i) (which states that the Disclosure Letter accurately lists all of the Acquired Companies' contracts involving the delivery of goods worth more than a specified dollar amount) would be rendered inaccurate as of the closing date if the Acquired Companies were to enter into a significant number of such contracts as part of their 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 Sellers' disclosure letter, the Sellers 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 the Buyer a "walk right" tied to routine actions taken in the normal course of the Acquired Companies' business operations, the Sellers may request that the representation in Section 3.17(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 Acquired Companies' businesses, the representation in Section 3.17(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.

The Sellers 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 Sellers' representations is rendered inaccurate as a result of an occurrence specifically contemplated by the acquisition agreement. The requested modification entails inserting the words "except as contemplated or permitted by this Agreement" (or some similar qualification) in Section 7.1. To illustrate the appropriateness of the requested modification, the Sellers may point to the representation concerning the absence of encumbrances affecting their shares (see Section 3.3), which might be technically inaccurate on the closing date as a result of encumbrances arising from the Buyer's own right to acquire the shares pursuant to the acquisition agreement. Thus, the Sellers would argue, unless the requested qualification is included in the "bring down" clause, the Buyer may have the right to terminate the acquisition as a result of the inaccuracy in the Sellers' "no encumbrances" representation--an

obviously inappropriate result.

The Buyer may object to the qualification requested by the Sellers 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 Sellers are truly concerned about technical inaccuracies in their representations, they should bear the burden of specifically disclosing these inaccuracies in their disclosure letter, rather than relying on a potentially overbroad qualification in the "bring down" clause.

"Bring Down" of Representations That Include "Adverse Effect" Language: See the Commentary to Section 3.

"Bring Down" of Representations Incorporating Specific Time Periods: See the Commentary to Section 3.

Desirability of Separate "No Material Adverse Change" Condition: Some acquisition agreements contain a separate closing condition giving the Buyer a "walk right" if there has been a "material adverse change" in the Acquired Companies' businesses since the date of the agreement. The Model Stock Purchase Agreement does not include a separate condition of this type because the Buyer receives comparable protection by virtue of the Sellers' "no material adverse change" representation in Section 3.12 (which operates as a closing condition pursuant to Section 7.1).

The Buyer should be aware, however, that there is a potentially significant difference between the representation in Section 3.12 and a typical "no material adverse change" condition. While the representation in Section 3.12 focuses on the time period beginning on the date of the most recent audited balance sheet of the Acquired Companies (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 by adding a separate "no material adverse change" condition to Section 7.

The following example illustrates the extra protection that the Buyer can obtain by including a separate "no material adverse change" condition. Assume that the Company's business has improved between the balance sheet date and the signing date, but has deteriorated significantly between the signing date and the scheduled closing date. Assume further that the net cumulative change in the Company's business between the balance sheet date and the scheduled 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 scheduled 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 3.12.

If a separate "no material adverse change" condition is included in the acquisition agreement, the Sellers may seek to ensure that the "no material adverse change" representation speaks only as of the signing date and is not separately "brought down" to the closing date through the condition that certain representations be true in all respects on the closing date as if made on the closing date. This can be accomplished by replacing the phrase "Since the date of the Balance Sheet" (which appears at the beginning of Section 3.12) with the phrase "From the date of the Balance Sheet through the date of this Agreement." See the Commentary to Section 7.1 under the caption "Operation of the `Bring Down' Clause"; see also

the Commentary to Section 3 under the caption "Considerations When Drafting Representations Incorporating Specific Time Periods."

Supplemental "Bring Down" Representation: The Buyer may seek to supplement the "bring down" clause in Section 7.1 by having the Sellers make a separate "bring down" representation in Section 3. By making such a representation, the Sellers 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 (without taking into account any disclosure letter supplement delivered by the Sellers to the Buyer between the signing date and the closing date).

The Sellers will likely resist the Buyer's attempt to include a "bring down" representation because such a representation could subject them to liability for events beyond their control. For example, assume that there is a major earthquake a short time after the signing date, and that the earthquake materially and adversely affects the Acquired Companies' properties within the meaning of Section 3.16(v). If there were a "bring down" representation in Section 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 earthquake, but also would be entitled to sue and recover damages from the Sellers for their breach of the "bring down" representation (in other words, the Buyer would have the right to "walk and sue" in this situation). Although the Sellers 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 Sellers' control. Thus, the Buyer would argue, the Sellers 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 Sellers may be left in a vulnerable position. Even when the Sellers notify the Buyer before the closing that one of the Sellers' representations has been rendered materially inaccurate as of the closing date because of a post-signing event beyond the Sellers' control, the Buyer would retain the right to "close and sue"--the right to consummate the purchase of the Sellers' shares and immediately bring a lawsuit demanding that the Sellers indemnify the Buyer against any losses resulting from the Sellers' 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 Commentary to Section 10.1).

Although the Model Stock Purchase Agreement does not include a separate "bring down" representation in Section 3, it does include a separate "bring down" provision as part of the Sellers' indemnification obligations in Section 10.2(b). The "bring down" provision in Section 10.2(b), however, does not have the same effect as a typical "bring down" representation. While supplements to the Sellers' disclosure letter are not given effect in the context of a typical "bring down" representation, such supplements *are* given effect under Section 10.2(b) if the Sellers concede in their "bring down" certificate (delivered pursuant to Section 2.4(a)(v)) that the Buyer has a "walk right" under Section 7.1. See Section 10.2(b) and the eighth paragraph of the Commentary to Section 10.2; see also Sections 2.4(a)(v), 5.5, and 7.1 and the related Commentary.

Effect of "Knowledge" Qualifications in Representations: See the Commentary to Section 3.

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7.5 NO PROCEEDINGS

Since the date of this Agreement, there must not have been commenced or Threatened against Buyer, or against any Person affiliated with 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, 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 material litigation relating to the acquisition is commenced or threatened against the Buyer or an affiliated party.

Section 7.5 relates only to litigation against the Buyer and its affiliates. Litigation against an Acquired Company or the Sellers is separately covered by the "bring down" of the Sellers’ litigation representation in Section 3.15(a) pursuant to Section 7.1(a). The Sellers’ litigation representation in Section 3.15(a) is drafted very broadly so that it extends not only to litigation involving the Acquired Companies or the Sellers, but also to litigation brought or threatened against other parties (including the Buyer) in connection with the acquisition. Thus, the "bring down" of Section 3.15(a) overlaps with the Buyer’s "litigation out" in Section 7.5. However, the Sellers may object to the broad scope of the representation in Section 3.15(a) and may attempt to modify this representation so that it covers only litigation against the Acquired Companies and the Sellers (and not litigation against other parties). If the Sellers succeed in so narrowing the scope of Section 3.15(a), the Buyer will not be able to rely on the "bring down" of the Sellers’ 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 affiliates 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 Sellers 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 Sellers may take the extreme position that the Buyer should be required to purchase their shares even if there is a significant pending lawsuit challenging the Buyer’s acquisition of the shares--in other words, the Sellers may seek to ensure that the Buyer will not have a "walk right" unless a court issues an injunction prohibiting the Buyer from purchasing their shares. If the Buyer accepts the Sellers’ 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.

Section 7.5 covers threatened as well as pending litigation. Under the broad definition of the term "Threatened" in Section 1, a lawsuit may be deemed to have been threatened against the Buyer even if the Buyer has not received any formal written notice of the

prospective plaintiff's intention to file suit.

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 the 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 Sellers that no such lawsuit relating to the acquisition was brought against the Buyer before the signing date (see Section 4.4).

The 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 Sellers originally identified in their Disclosure Letter as pending against any of the Acquired Companies as of the signing date.

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10. INDEMNIFICATION; REMEDIES

COMMENT

Section 10 of the Model Stock Purchase Agreement provides for indemnification and other monetary remedies. Generally, the Buyer of a privately- held company seeks to impose on the Sellers financial responsibility for breaches of the Sellers' representations 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 Sellers' desire not to have continuing responsibility for a business that they no longer

own often results in intense negotiation. Thus, there is no such thing as a set of "standard" indemnification provisions. However, there is a standard set of issues to be dealt with in the indemnification provisions of an acquisition agreement. Section 10 of the Model Stock Purchase Agreement addresses these issues in a way that favors the Buyer. The Commentary identifies areas in which the Sellers may propose a different resolution.

The organization of Section 10 of the Model Stock Purchase Agreement is as follows. Section 10.1 provides that the parties' representations survive the closing of the acquisition 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 10.2 defines the matters for which the Sellers will have post-closing monetary liability. It is not limited to matters arising from inaccuracies in the Sellers' representations. In one respect, identified in the Commentary to Section 10.2, Section 10.2 suggests a change in existing practices. Section 10.3 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 10.4 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. Section 10.5 defines the time periods during which post-closing monetary remedies may be sought. Sections 10.6 and 10.7 define de minimis levels of damage for which post-closing monetary remedies are not available. Section 10.8 provides collection techniques for the Buyer; an escrow of a portion of the purchase price and setoff rights against notes delivered as part of the purchase price. Section 10.9 provides procedures to be followed in seeking monetary remedies for, and in the defense of,

third party claims. Section 10.10 provides the procedure for seeking monetary remedies for matters not involving third party claims.

The Commentary in Section 10 uses the term "indemnification" to refer to indemnification and other monetary remedies, without distinction.

10.1 SURVIVAL; RIGHT TO INDEMNIFICATION NOT AFFECTED BY KNOWLEDGE

All representations, warranties, covenants, and obligations in this Agreement, the Disclosure Letter, the supplements to the Disclosure Letter, the certificate delivered pursuant to Section 2.4(a)(v), and any other certificate or document delivered pursuant to this Agreement will survive the Closing. The right to indemnification, payment of Damages or other remedy based on such representations, warranties, covenants, and obligations will not be affected by any investigation 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, payment of Damages, or other remedy based on such representations, warranties, covenants, and obligations.

COMMENT

The representations made by the Sellers in acquisitions of private companies are typically, although not universally, intended to provide a basis for post-closing liability if they prove to be inaccurate. In acquisitions of public companies without controlling

stockholders, the Sellers' representations typically terminate at the closing and thus serve principally as information gathering mechanisms, closing conditions, and a basis for liability if the closing does not occur (see the Commentary to Section 3 under the caption "Purposes of the Sellers' Representations"). If the Sellers of a private company are numerous and include investors who have not actively participated in the Company's business (such as venture capital investors in a development stage company), they may analogize their situation to that of the stockholders of a public company and argue that their representations should not survive the closing.

If the Sellers' representations are intended to provide a basis for post-closing liability, it is common for the acquisition agreement to include an express survival clause 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 shares 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.

Even in the relatively rare cases in which the Sellers of a private company are able to negotiate an acquisition agreement that provides that their representations will not survive the closing and otherwise expressly excludes any right to indemnification based on those representations, the Sellers may still be subject to post-closing liability based on those representations under the antifraud provisions of the federal securities laws and under principles of common law fraud. The sale of the stock of a privately held company is a sale of securities for purposes of the federal securities laws. *See Landreth Timber Co. v. Landreth,* 471 U.S. 681 (1984). The actions of a corporate officer or other agent in

negotiating a merger or sale may be imputed to the Sellers to establish the scienter required for a cause of action under the antifraud provisions of the federal securities laws and for common law fraud. *See Reinfeld v. Riklis,* 722 F. Supp. 1077 (S.D.N.Y. 1990).

Section 10.1 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. The Sellers may argue that the Buyer should be required to disclose a known breach of the Sellers' 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 Sellers should not be able to limit the Buyer's options to waiving the breach or terminating the acquisition agreement. The Buyer can argue that it has purchased the Sellers' 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.

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 Sellers' 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 senior officers having responsibility for the transaction). Aggressive Sellers 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. The Buyer should be wary of such a provision, which prevents it from making its decision on the basis of the cumulative effect of all inaccuracies discovered before the closing.

The Buyer's ability to assert a fraud claim based on federal or state securities laws or the common law after the closing may be adversely affected if the Buyer discovers an inaccuracy before the closing but fails to disclose the inaccuracy to the Sellers until after the closing. In such a case, the Sellers 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 Sellers cannot fully perform their obligations. If the Sellers offer to perform, albeit imperfectly, can the Buyer accept without waiving its right to sue on the Sellers' 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 (1984); *Restatement, (Second) of Contracts* § 278, comment a. Thus, if the Sellers offer to close on the condition that the Buyer waive its right to sue on the Sellers' 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 the Sellers for indemnification.

The survival of an indemnification claim after the Buyer's discovery during pre-closing investigations of a possible inaccuracy in the Sellers' 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 representation. 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 the representation. 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 representation 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 a representation by the buyer and the seller's assertion that no breach existed and 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 recent decision of the 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 Sellers do 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 10.1 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 Sellers' 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).

Given the holdings of *Galli* and *Hendricks*, the effect of the survival and non- waiver language in Section 10.1 is uncertain. Section 10.1 protects the Buyer if, in the face of a known dispute, the Sellers 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 10.1 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.

In a typical negotiated business acquisition, which involves knowledgeable principals represented by sophisticated counsel, a court should give effect to an acquisition agreement provision that the Buyer is entitled to rely on its right to indemnification and payment of damages based on the Sellers' 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 acquisition agreement is ambiguous with respect to the effect of the Buyer's knowledge.

10.2 INDEMNIFICATION AND PAYMENT OF DAMAGES BY SELLERS

Sellers, jointly and severally, will indemnify and hold harmless

Buyer, the Acquired Companies, and their respective Representatives, stockholders, controlling persons, and affiliates (collectively, the "Indemnified Persons") for, and will pay to the Indemnified Persons the amount of, any loss, liability, claim, damage (including incidental and consequential damages), expense (including costs of investigation and defense and reasonable attorneys' fees) or diminution of value, whether or not involving a third-party claim (collectively, "Damages"), arising, directly or indirectly, from or in connection with:

(a) any Breach of any representation or warranty made by Sellers in this Agreement (without giving effect to any supplement to the Disclosure Letter), the Disclosure Letter, the supplements to the Disclosure Letter, or any other certificate or document delivered by Sellers pursuant to this Agreement;

(b) any Breach of any representation or warranty made by Sellers in this Agreement as if such representation or warranty were made on and as of the Closing Date without giving effect to any supplement to the Disclosure Letter, other than any such Breach that is disclosed in a supplement to the Disclosure Letter and is expressly identified in the certificate delivered pursuant to Section 2.4(a)(v) as having caused the condition specified in Section 7.1 not to be satisfied;

(c) any Breach by either Seller of any covenant or obligation of such Seller in this Agreement;

(d) any product shipped or manufactured by, or any services provided by, any Acquired Company prior to the Closing Date;

(e) any matter disclosed in Part _____ of the Disclosure Letter; or

(f) 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 any such Person with

either Seller or any Acquired Company (or any Person acting on their behalf) in connection with any of the Contemplated Transactions.

The remedies provided in this Section 10.2 will not be exclusive of or limit any other remedies that may be available to Buyer or the other Indemnified Persons.

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 a privately held company for the Buyer to be given a clearly specified right of indemnification for breaches of representations, 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 Acquired Companies. The Model Stock Purchase Agreement indemnification provisions may require significant adjustment before being applied to a merger or asset purchase, because the transfer of liabilities by operation of law in each case is different. Other adjustments may be required for a purchase from a consolidated group of companies, a foreign corporation, or a joint venture, because in each case there may be different risks and difficulties in obtaining indemnification. Still other adjustments will be required to address risks associated with the nature of the Acquired Companies' businesses and their past manner of operation.

Certain business risks and liabilities may not be covered adequately by traditional representations and may be covered by

specific indemnification provisions (such as Section 10.2(d)). Similar provision may also be made for indemnification for the liability arising from a disclosed lawsuit or other contingency affecting an Acquired Company, which, as a result of its disclosure in response to Section 3.15(a), would not give rise to a claim for breach of a representation (see Section 10.2(e)). The extent to which these types of provisions are included depends on the circumstances of each acquisition and is often subject to negotiation.

In the absence of explicit provision to the contrary, the Buyer's remedies for inaccuracies in the Sellers' representations may not be limited to those provided by the indemnification provisions; the Buyer may also have causes of action based on breach of contract, fraud and misrepresentation, federal securities laws, and other federal and state statutory claims until the expiration of the applicable statute of limitations. The Sellers therefore may want to add a clause providing that the indemnification provisions are the sole remedy for any claims relating to the sale of the shares. This clause could also limit the parties' rights to monetary damages only, at least after the closing. The Model Stock Purchase Agreement states that indemnification is not the exclusive remedy, but the limitations on when claims may be asserted (Section 10.5) and the deductible or "basket" provisions (Sections 10.6 and 10.7) apply to the parties' liability "for indemnification or otherwise."

Liabilities arising under the federal securities laws cannot be waived by an exclusivity clause. *See* Section 14 of the Securities Act of 1933, 15 U.S.C. § 77n (1988); Section 29 of the Securities Exchange Act of 1934, 15 U.S.C. § 78cc (1988). Other claims, including those based on common law fraud, may also survive an exclusivity clause under applicable state law.

The scope of the indemnification provisions is important. The 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 10.2(a) provides for indemnification for any breach of the Sellers' representations in the acquisition agreement and the Disclosure Letter as of the signing date. The Sellers may seek to exclude from the indemnity a breach of the representations in the original acquisition agreement if the breach is disclosed by a supplement to the Disclosure Letter before the closing. This provides an incentive for the Sellers 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 Sellers (see Appendix A, scenario 2). For a discussion of related issues, see the Commentary to Section 10.1.

Section 10.2(b) provides for indemnification for an undisclosed breach of the Sellers' representations as of the closing date (see Appendix A, scenario 7). This represents customary practice. However, the Model Stock Purchase Agreement departs from customary practice by providing that, if a disclosure letter supplement discloses inaccuracies in the Sellers' representations as of the closing date, this disclosure will be disregarded for purposes of an indemnification claim (that is, the Sellers will still be subject to indemnification liability for such inaccuracies) unless the Sellers concede that these inaccuracies resulted in failure of a condition to the Buyer's obligations and thus permit the Buyer to elect not to close (see Appendix A, scenarios 5 and 9). Although

unusual, this structure is designed to protect the Buyer against changes that occur after the execution of the acquisition agreement and before the closing. Without such a provision, the Buyer would be obligated to acquire a business that did not at the time of the closing conform to the Sellers' representations, and the Buyer would have no right to indemnification for these adverse changes. If the Sellers concede that the condition was not satisfied and the Buyer nevertheless elects to close, the disclosed inaccuracies as of the closing date will not provide a basis for indemnification.

The Model Stock Purchase 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 Sellers 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 Sellers be factually accurate, or to require the Sellers to correct inaccuracies in them, places unrealistic demands on the Sellers and would needlessly hamper the due diligence process. As an alternative, the Sellers 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 10.2 provides for joint and several liability, which the Buyer will typically request and the Sellers, seeking to limit their exposure to several liability (usually in proportion to each Seller's percentage ownership), may oppose. Occasionally, different liability will be imposed on different Sellers, depending on the representations at issue. For example, the Sellers may be jointly and severally liable for representations concerning the Acquired Companies, but only individually liable for the representations concerning their respective ownership of the stock being sold. The Sellers may separately

agree to allocate responsibility among themselves in a manner different from that provided in the acquisition agreement (for example, a Seller 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 an indemnity. If one of the Sellers is part of a consolidated group of companies, that Seller 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 of the Seller (for example, an individual who is the sole shareholder of a Seller that is a thinly capitalized holding company). For other ways of dealing with an indemnitor whose credit is questionable, see the Commentary to Section 10.8.

The persons indemnified may include virtually everyone on the Buyer's side of the acquisition, including directors, officers, and stockholders who may become defendants in litigation involving the Acquired Companies or who may suffer a loss resulting from their association with problems at the Acquired Companies. 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 Sellers to indemnify such persons, and Section 11.10 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 definition of "Damages" is very broad and includes, among other things, losses unrelated to third-party claims. However, 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 "indemnify" (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,* 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 10.2 of the Model Stock Purchase 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 Sellers) 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 Sellers often argue 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 Sellers may also argue that the acquisition agreement should 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. Aggressive Sellers may also seek to reduce the damages to which the Buyer is entitled by any so-called "found assets" (assets of an Acquired Company not reflected on its financial statements). The problems inherent in valuing such assets and in determining whether they add to the value of the Acquired Company in a way not already taken into account in the purchase price lead most Buyers to reject any such proposal.

Occasionally, the 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 Sellers’ incentive to dispute the claim for purposes of delay.

If the acquisition agreement contains post-closing adjustment mechanisms, the Sellers should ensure that the indemnification provisions do not require the Sellers to compensate the Buyer for matters already taken into account through the post-closing adjustment process. This can be done by providing that the damages subject to indemnification for a matter that was also the subject of a post-closing adjustment are reduced by the amount of the corresponding purchase price reduction.

Generally, indemnification is not available for claims made that later prove to be groundless (for example, a groundless allegation by a Company employee that before the closing she was promised a large bonus). 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 in many acquisition agreements provide less protection than indemnities given in other situations such as securities underwriting agreements. The definition of "Breach" in Section 1, which is used in Section 10.2, takes a more aggressive approach by including "any claim (by any Person) . . . that is . . . inconsistent with such representation." Section 10.2(f) takes a similar approach with respect to brokerage claims.

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10.5 TIME LIMITATIONS

If the Closing occurs, Sellers will have no liability (for indemnification or otherwise) with respect to any representation or warranty, or covenant or obligation to be performed and complied with prior to the Closing Date, other than those in Sections 3.3, 3.11, 3.13, and 3.19, unless on or before ________________ Buyer notifies Sellers of a claim specifying the factual basis of that claim in reasonable detail to the extent then known by Buyer; a claim with respect to Section 3.3, 3.11, 3.13, or 3.19, or a claim for indemnification or reimbursement not based upon any representation or warranty or any covenant or obligation to be performed and complied with prior to the Closing Date, may be made at any time. If the Closing occurs, Buyer will have no liability (for indemnification or otherwise) with respect to any representation or warranty, or covenant or obligation to be performed and complied with prior to the Closing Date, unless on or before ________ Sellers notify Buyer of a claim specifying the factual basis of that claim in reasonable detail to the extent then known by

Sellers.

COMMENT

It is customary for an acquisition agreement to specify the time period within which a claim for indemnification must be made. The Sellers 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 audit and because, as a practical matter, many hidden liabilities will be uncovered within two years. However, an extended or unlimited time period for stock ownership, capitalization, products liability, taxes, ERISA issues, and environmental issues is not unusual.

The appropriate standard for some types of liabilities may be the period of time during which a private or governmental plaintiff could bring a claim for actions taken or circumstances existing prior to the closing. For example, indemnification for tax liabilities often extends for as long as the relevant statute of limitations for collection of the tax extends. If this approach is taken, the limitation should be drafted to include extensions of the statute of limitations (which are frequently granted in tax audits), situations in which there is no statute of limitations (such as those referred to in Section 6501(c) of the Internal Revenue Code of 1986), and a brief period after expiration of the statute of limitations to permit a claim for indemnification to be made if the tax authorities act on the last possible day.

If the Sellers are to retain certain specified liabilities (such as ERISA claims), the provisions pursuant to which they agree to retain or assume such liabilities should not be affected by any limitations on the time or amount of general indemnification payments, although any expenses relating to recovery against the Sellers could be subject to the limitations of time and amount.

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 shares 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 10.8).

In drafting time limitations, the Buyer’s counsel should consider whether they should apply only to claims for indemnification (see the Commentary to Section 10.2).

10.6 LIMITATIONS ON AMOUNT--SELLERS

Sellers will have no liability (for indemnification or otherwise) with respect to the matters described in clause (a), clause (b) or, to the extent relating to any failure to perform or comply prior to the Closing Date, clause (c) of Section 10.2 until the total of all Damages with respect to such matters exceeds $_______________, and then only for the amount by which such Damages exceed $___________. Sellers will have no liability (for indemnification or otherwise) with respect to the matters described in clause (d) of Section 10.2 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 10.6 will not apply to any Breach of any of Sellers' representations and warranties of which either Seller had Knowledge at any time prior to the date on which such representation and warranty is made or any intentional Breach by either Seller of any covenant or obligation, and Sellers will be jointly and severally liable for all Damages with respect to such Breaches.

COMMENT

Section 10.6 provides the Sellers with a safety net, or "basket," 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 "threshold" deductible is to recognize that representations concerning an ongoing business are unlikely to be perfectly accurate and to avoid disputes over insignificant amounts.

In the Model Stock Purchase Agreement, the Sellers' 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 the Sellers contend 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 Sellers' 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 the basket has been filled; otherwise, the immaterial items may be material in the

aggregate, but not applied to the basket.

The Buyer may want the Sellers' obligation to fund certain types of indemnities to be absolute and not subject to the basket. For example, the Buyer may insist that the Sellers pay all tax liabilities from a pre-closing period or the damages resulting from a disclosed lawsuit without regard to the basket. The parties also may negotiate different baskets for different types of liabilities; the Buyer should consider the aggregate effect of those baskets (the Model Stock Purchase Agreement includes a separate basket for product liability claims).

The Sellers may also seek to provide for a maximum indemnifiable amount, which is frequently the purchase price. The Sellers' argument for such a provision is that they had limited liability as stockholders and should be in no worse position having sold the Company than they were in when they owned it; this argument may not be persuasive to a Buyer that views the Acquired Companies as a component of its overall business strategy, intends to invest additional capital in the Acquired Companies, or is unwilling to see its subsidiaries' obligations dishonored. 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 stock. 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 a Seller had knowledge or a willful failure by a Seller to comply with a covenant or obligation--the rationale is that the Sellers 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 Sellers who engage in intentional wrongdoing.

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10.8. ESCROW; RIGHT OF SET-OFF

Upon notice to Sellers specifying in reasonable detail the basis for such set-off, Buyer may set off any amount to which it may be entitled under this Section 10 against amounts otherwise payable under the Promissory Notes or may give notice of a Claim in such amount under the Escrow Agreement. The exercise of such right of set-off by Buyer in good faith, whether or not ultimately determined to be justified, will not constitute an event of default under the Promissory Notes or any instrument securing a Promissory Note. Neither the exercise of nor the failure to exercise such right of set-off 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 Sellers 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 note, an earn-out, or payments under consulting or non-competition agreements) with a right of set-off, or obtains other security (such as a letter of credit) to secure performance of the Sellers' indemnification obligations. These techniques shift bargaining power in post-closing disputes from the Sellers to the Buyer and usually will be resisted by the Sellers.

An escrow provision may give the Buyer the desired security, especially when there are several Sellers and the Buyer will have difficulty in obtaining jurisdiction over the Sellers or in collecting on the indemnity without an escrow. Sellers who are jointly and

severally liable may also favor an escrow in order to ensure that other Sellers 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 Sellers 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 Sellers that claims against the escrow be the Buyer's exclusive remedy.

The Buyer may also seek an express right of set-off against sums otherwise payable to the Sellers. The Buyer obtains more protection from an express right of set-off 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 and thus gives the Buyer more leverage in resolving disputes with the Sellers. The Buyer may also want to apply the set-off against payments under employment, consulting, or non-competition agreements (although state law may prohibit set-offs against payments due under employment agreements). The comfort received by the Buyer from an express right of set-off depends on the schedule of the payments against which it can withhold. Even if the Sellers agree to express set-off rights, the Sellers may attempt to prohibit set-offs 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 set-off. Also, the Sellers may seek to require that the Buyer exercise its set-off rights on a pro rata basis in proportion to the amounts due to each Seller. If the promissory note is to be pledged to a bank, the bank as pledgee will likely resist set-off rights (especially because the inclusion of express set-off rights will make the note

non-negotiable). As in the case of an escrow, the suggestion of an express right of set-off often leads to discussions of exclusive remedies.

Rather than inviting counterproposals from the Sellers by including an express right of set-off 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 counterclaim and set-off. Even without an express right of set-off 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 Sellers under the acquisition agreement or the related documents on the ground that the Buyer is entitled to indemnification for these amounts from the Sellers under the acquisition agreement. The question then is whether, if the Sellers sue the Buyer for its failure to make full payment to the Sellers, the Buyer will be able to counterclaim that it is entitled to set off the amounts for which it believes it is entitled to indemnification.

The common law of counterclaim and set-off varies from state to state, and when deciding whether to include or forgo an express right of set-off 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. 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"). For example, a counterclaim might not be permitted if the Sellers have consulting agreements with the Company (which after the acquisition is a wholly-owned subsidiary of the Buyer) and the Company, at the direction of the Buyer, withholds from consulting payments because the Buyer is entitled to indemnification from the Sellers under the acquisition agreement (note, however, that Section 10.2 of the Model Stock Purchase Agreement provides that both the Buyer and the Company have indemnification rights against the Sellers).

An express right of set-off should address the possible consequences of an unjustified set-off. Section 10.8 allows the Buyer to set off amounts for which the Buyer in good faith believes that it is entitled to indemnification from the Sellers against payments due to the Sellers under the promissory note without bearing the risk that, if the Sellers ultimately prevail on the indemnification claim, they will be able to accelerate the promissory note or obtain damages or injunctive relief.

10.9 PROCEDURE FOR INDEMNIFICATION--THIRD PARTY CLAIMS

(a) Promptly after receipt by an indemnified party under Section 10.2, 10.4, or (to the extent provided in the last sentence of Section 10.3) Section 10.3 of notice of the commencement of any Proceeding against it, such indemnified party will, if a claim is to be made against an indemnifying party under such Section, give notice to the indemnifying party of the commencement of such claim, but the failure to notify the indemnifying party will not relieve the indemnifying party of any liability that it may have to any indemnified party, except to the extent that the indemnifying party demonstrates that the defense of such action is prejudiced by the indemnifying party's failure to give such notice.

(b) If any Proceeding referred to in Section 10.9(a) is brought against an indemnified party and it gives notice to the indemnifying party of the commencement of such Proceeding, the indemnifying party will, unless the claim involves Taxes, be entitled to participate in such Proceeding and, to the extent that it wishes (unless (i) the indemnifying party is also a party to such Proceeding and the indemnified party determines in good faith that joint representation would be inappropriate, or (ii) the indemnifying party fails to provide reasonable assurance to the indemnified party of its financial capacity to defend such Proceeding and provide indemnification with respect to such Proceeding), to assume the defense of such Proceeding with counsel satisfactory to the indemnified party and, after notice from the indemnifying party to the indemnified party of its election to assume the defense of such Proceeding, the indemnifying party will not, as long as it diligently conducts such defense, be liable to the indemnified party under this Section 10 for any fees of other counsel or any other expenses with respect to the defense of such Proceeding, in each case subsequently incurred by the indemnified party in connection with the defense of such Proceeding, other than reasonable costs of investigation. If the indemnifying party assumes the defense of a Proceeding, (i) it will be conclusively established for purposes of this Agreement that the

claims made in that Proceeding are within the scope of and subject to indemnification; (ii) no compromise or settlement of such claims may be effected by the indemnifying party without the indemnified party's consent unless (A) there is no finding or admission of any violation of Legal Requirements or any violation of the rights of any Person and no effect on any other claims that may be made against the indemnified party, and (B) the sole relief provided is monetary damages that are paid in full by the indemnifying party; and (iii) the indemnified party will have no liability with respect to any compromise or settlement of such claims effected without its consent. If notice is given to an indemnifying party of the commencement of any Proceeding and the indemnifying party does not, within ten days after the indemnified party's notice is given, give notice to the indemnified party of its election to assume the defense of such Proceeding, the indemnifying party will be bound by any determination made in such Proceeding or any compromise or settlement effected by the indemnified party.

(c) Notwithstanding the foregoing, if an indemnified party determines in good faith that there is a reasonable probability that a Proceeding may adversely affect it or its affiliates other than as a result of monetary damages for which it would be entitled to indemnification under this Agreement, the indemnified party may, by notice to the indemnifying party, assume the exclusive right to defend, compromise, or settle such Proceeding, but the indemnifying party will not be bound by any determination of a Proceeding so defended or any compromise or settlement effected without its consent (which may not be unreasonably withheld).

(d) Sellers hereby consent to the non-exclusive jurisdiction of any court in which a Proceeding is brought against any Indemnified Person for purposes of any claim that an 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

Sellers with respect to such a claim anywhere in the world.

COMMENT

It is common to permit an indemnifying party to have some role in the defense of the claim. There is considerable room for negotiation of the manner in which that role is implemented. Because the Buyer is more likely to be an indemnified party than an indemnifying party, the Model Stock Purchase Agreement provides procedures that are favorable to the indemnified party.

The indemnified party normally will be required to give the indemnifying party notice of third-party claims for which indemnity is sought. The Model Stock Purchase 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. The Sellers may want to require notice of threatened proceedings and of claims that do not yet involve proceedings and to provide that prompt notice is a condition to indemnification; the Buyer likely will be very reluctant to introduce the risk and uncertainty inherent in a notice requirement based on any event other than the initiation of formal proceedings.

The Model Stock Purchase 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 is not entitled to participate in or assume the defense of proceedings involving taxes, because these proceedings frequently involve multiple issues--of which only some may be subject to indemnification--that the Buyer will want to be able to manage and settle without interference. This may not be acceptable to the Sellers, and acquisition agreements often provide elaborate procedures for

dealing with tax claims. 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 Sellers 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 Sellers' counsel should carefully consider in whose interest they are acting if they specify themselves). The Sellers may also seek to require that, in cases in which they do not assume the defense, all indemnified parties be represented by the same counsel (subject to conflict of interest concerns).

The Sellers 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 Sellers may request a right to assume the defense of the proceeding at a later date and a requirement for advance notice of a proposed settlement.

An indemnified party usually will be reluctant to permit an indemnifying party to assume the defense of a proceeding while reserving the right to argue that the claims made in that proceeding are not subject to indemnification. Accordingly, the Model Stock Purchase Agreement excludes that possibility. However, the Sellers may object that the nature of the claims could be unclear at the start of a proceeding and may seek the right to reserve their rights in a manner similar to that often permitted to liability insurers.

An indemnifying party that has assumed the defense of a

proceeding will seek the broadest possible right to settle the matter. The Model Stock Purchase 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 10.9(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 Acquired Companies' 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 10.9(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 Acquired Companies' businesses. These matters are often dealt with in separate provisions (see Section 10.3).

10.10 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.

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 Commentary to Section 10.2.

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IN WITNESS WHEREOF, the parties have executed and delivered this Agreement as of the date first written above.

Buyer: Sellers:

By: ____________________ ____________________

A

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B

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