MERGERS & ACQUISITIONS QUICK REFERENCE GUIDE

McKenna Long & Aldridge LLP
Attorneys at Law

M&A is on its way back. We saw a steady stream of deals over the course of 2009, and in the fourth quarter we saw a large uptick in deals. This increase in deal activity continued in 2010, and as the economy continues to slowly recover, we expect to see deal activity continue to increase in 2011. It may not be in the form of a "boom" that M&A professionals were hoping for; sellers' expectations are still high and credit remains relatively tight. Instead, deals continue to be focused on those who "have to sell" – family businesses without a succession plan, business divorces, sellers concerned about possible tax law changes and distressed companies. There also are numerous businesses still facing refinancings that cannot be accomplished in today's credit markets. Some of those companies will be forced to sell or recap, leading to increased deal flow in the remainder of 2010 and continuing into 2011. We believe the growth will be more gradual, though some industries (for example, health care, energy and technology) will likely see a larger number of deals.

Back in June 2006, MLA first released our M&A Quick Reference Guide. The Guide, which received rave reviews, was the product of much thought and hard work by members of our Corporate Department, each of whom proudly refers to himself or herself as a "deal lawyer," and all of whom have worked on numerous M&A transactions over the years and around the globe. ***Our M&A practice is ranked among the nation's top firms in M&A league tables and is one of ten firms in the U.S. to be ranked "Tier One" for Mergers, Acquisitions and Buyouts for deals up to $500 million by The Legal 500***. The publication observed that the practice is "an excellent choice for middle-market companies seeking practical advice in a wide variety of legal matters. Service is always good and the attorneys' industry knowledge makes them indispensable."

The M&A Guide is comprised of several chapters that focus, from a business perspective, on key aspects, issues and documents involved in a merger or acquisition (or disposition) transaction. It is intended to provide a general framework and understanding of the issues that often arise in the context of these transactions. We recognize, of course, that every deal is unique, presenting its own issues and challenges. Our collective experience, however, is that there is a significant amount of commonality among M&A deals, regardless of the parties, size or complexity.

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We are now issuing updates to our M&A Guide. Specifically, we have included updated chapters on: ***Letters of Intent, Engagement Letters and Non-Disclosure Agreements; Representations and Warranties; Disclosure Letters; Taxation of M&A Transactions; ERISA Concerns; and Unique Aspects of the Acquisition of a Division.*** Additionally, we have added new chapters on ***Cross-Border Transactions and Intellectual Property Considerations***.

As with our initial release of the M&A Guide, we have attempted to make the M&A Guide straightforward and user-friendly; we do not intend it to be an exhaustive discussion of the subject matter.

We welcome your thoughts on the M&A Guide. Please feel free to contact any of the lawyers at our firm with whom you regularly communicate. On behalf of our entire "deal team," we hope you find the M&A Guide an informative and helpful tool to better understand the various issues that can arise in M&A transactions.

Wayne Bradley
Corporate Department Chair
McKenna Long & Aldridge LLP
October 2010

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LETTERS OF INTENT

Reasons for Negotiating and Executing a Letter of Intent

For buyers and sellers alike, a letter of intent serves a number of important purposes and is a pre-cursor to the serious negotiation of most M&A transactions. As discussed below, although most of its provisions typically are not legally binding on the parties, a letter of intent nonetheless serves as a useful outline of the parties' preliminary agreement on material transaction points prior to the negotiation of definitive documents. The discussion of these key terms at the beginning of the process should bring to light any significant problems or disagreements prior to the parties spending significant time, effort and money engaged in the deal process. Moreover, despite the non-binding character of most letter of intent terms, the negotiation and reduction to writing of primary deal points minimizes the possibility that either party may later attempt to deviate from these terms. For reputational reasons, among others, most parties are reluctant to depart from fundamental letter of intent terms (e.g., purchase price) in the absence of a significant change in circumstances. The letter of intent also creates an outline that can expedite the drafting and negotiation of the definitive transaction documents, such that the investment of time at the letter of intent stage will often save time later in the negotiation process.

Executing of a letter of intent also may enable the parties to start the process of obtaining necessary consents and approvals for the transaction. For example, in circumstances where governmental approval is required under the Hart-Scott-Rodino Antitrust Improvements Act, the parties may submit an executed letter of intent to start the running of the statutory waiting period. A signed letter of intent may also be helpful if the parties desire to approach other third parties, such as landlords and lenders, for approvals prior to the execution of a definitive purchase agreement.

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The terms of a letter of intent that typically are binding, as discussed below, can facilitate the exchange of information and commitment of resources that are necessary to reach a deal. For example, the letter of intent will set forth the manner in which information and access will be made available to a prospective buyer so that its due diligence process can be completed, while protecting the seller from the misuse of that information and access. Many buyers will be reluctant to commit significant expense and resources (e.g., lawyers, accountants, etc.) until they have the comfort that comes from an exclusivity provision. Moreover, a buyer who requires financing for the potential transaction may need a letter of intent to facilitate discussions with potential lenders, who are also reluctant to invest time and resources unless they believe both parties are committed to the potential transaction.

Additionally, by addressing in writing the specific circumstances under which the parties will be deemed to have entered into a binding agreement – the execution of definitive documents – the parties reduce the possibility of a court determining that the parties have (perhaps unknowingly) entered into a binding oral agreement or that a contractual arrangement exists by virtue of partial performance by the parties.

When a transaction timeline is extremely short and the deal terms are uncomplicated, the parties may decide that their time is best spent bypassing the letter of intent and going "straight to the documents," but parties to most complex transactions are still well-served by starting the process with the negotiation of a letter of intent.

It should be noted that in transactions involving public companies – particularly public targets – additional attention should be paid to disclosure requirements, fiduciary duties of boards of directors, and other matters that may be impacted by the execution of a letter of intent. While the discussion below focuses on issues relevant for all buyers and sellers (public and private), certain typical letter of intent provisions (i.e., publicity and exclusivity) may require consideration of additional issues in the public company context.

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Typical Components of a Letter of Intent

Letters of intent typically include a majority of the terms described below.

- **Non-Binding Provisions.** The following letter of intent provisions typically are non-binding:
  - **Structure of Transaction.** The letter of intent should specify whether the deal is to be structured as an asset purchase, stock purchase or merger. To the extent known, any assets or liabilities of the acquired business that are to be excluded from the transaction should be identified as well.
  - **Price and Payment Terms.** The letter of intent should describe the purchase price (or, if the purchase price is not determined, the method for determining it), as well as the manner of payment. Specifically, the letter of intent should describe whether the purchase price would be payable in cash, securities, a promissory note or some combination of these elements. It should also delineate whether the purchase price is payable entirely at closing, or if any portion of the purchase price is subject to deferral, such as an escrow or holdback arrangement. Any earn-out arrangements or other post-closing adjustments – such as working capital or net worth adjustments – also should be delineated in the letter of intent.
  - **Conditions to Closing.** The letter of intent will usually specify any known material conditions to the closing of the contemplated transaction, such as governmental (i.e., Hart-Scott-Rodino) or material third party consents, financing arrangements, completion of due diligence and board and shareholder approvals. Buyers should expressly note any financing contingencies to the transaction.
  - **Employment and Restrictive Covenant Agreements.** If the buyer intends to enter into employment agreements with any particular individuals or categories of individuals in connection with the transaction, these should be detailed in the letter of intent. Also, the letter of intent should identify the buyer's requirements with respect to non-competition and non-solicita-

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tion agreements to be entered into with the selling shareholders. To the extent either the buyer or the seller have an expectation regarding treatment of the sellers' existing employee benefit plans, the letter of intent should address those expectations.

- **Representations and Warranties and Indemnification.** The letter of intent will almost always include at least some general statement that the seller will be required to make certain representations and warranties regarding the state of the business and operations as of the closing, and to indemnify the buyer in the event those statements are not true and, as a result, the buyer suffers a loss. As further discussed below, it may be in the seller's interest to delve into the details of these provisions at the letter of intent stage, and particularly to negotiate limitations on these provisions directly in the letter of intent, since the seller's negotiating leverage may be at its highest point prior to granting the buyer exclusive negotiating rights. Oftentimes, however, the parties agree to postpone specific negotiation of these provisions for the definitive documents.

- **Binding Provisions.** A letter of intent will typically include the following binding provisions:
  - **Access/Due Diligence.** The letter of intent will typically establish general parameters for the buyer's access to information about the selling company in order to facilitate ongoing due diligence. In most cases, a confidentiality agreement is already in place with a prospective buyer at this stage of the deal, but if not, confidentiality restrictions should be included in the letter of intent. Depending on particular deal circumstances, it may be helpful to address details regarding the buyer's access to the seller's employees and customers. A seller will want to maintain strict controls on this level of communication, particularly as relates to customers, including by permitting these discussions only after the deal negotiation process has advanced to near-completion and requiring that a seller representative be present for all such discussions. In addition, some sellers will seek a commitment

from the buyer not to solicit the seller's employees and/or customers to whom the buyer has access during due diligence if the parties do not consummate the transaction. In negotiating these kinds of provisions, buyers should be mindful of their own ability to abide by these terms, particularly in large organizations where different divisions may be unaware of the potential transaction and the related restrictions.

- **Exclusivity.** From the standpoint of the buyer, the most critical binding provision of the letter of intent is perhaps the exclusivity provision, commonly known as a "no shop" provision, whereby the selling company and its shareholders agree to not engage in discussions with any other party regarding a potential sale or similar transaction during some specified period. Depending on the negotiating posture and leverage of the parties, additional timing and financial parameters may be included in the exclusivity provision. With respect to timing, sellers may attempt to include certain progress requirements in this provision in an effort to keep the buyer on track with the intended transaction schedule. For instance, the letter of intent could specify that continued exclusivity is contingent on the delivery of a draft purchase agreement by some specified date, with a subsequent requirement that executed financing term sheets (or perhaps commitment letters) be delivered in order for exclusivity to continue. In circumstances where the seller has numerous prospective buyers (and, as a result, significant negotiating leverage), the seller may require financial consideration for the granting of exclusivity. This could take the form of an up-front non-refundable deposit by the prospective buyer to the seller if the transaction does not proceed to a successful conclusion. If a buyer is willing to agree to such a provision at all, it will want to negotiate exceptions to the requirement that a break-up fee be paid or identify circumstances where the deposit would be refunded, such as if financial results of the seller do not meet specified expectations. Importantly, in the circumstance where the prospective seller (or its parent) is a public company, the

seller should seek to include an exception that enables the target to comply with its fiduciary duties in the event that another party makes a superior offer to acquire the seller.

- **Publicity.** It is likely to be in the interest of both parties to include a binding provision in the letter of intent that prohibits any unilateral public disclosure of the parties' discussions or the potential transaction. The seller typically is more concerned about news of the deal leaking prematurely due to potential negative consequences on customer, supplier and employee relationships and resulting impact on the not-yet-completed deal. In some cases, however, publicity may create market pressure for the buyer to close the transaction, which can be advantageous to the seller. Buyers also have an interest in ensuring that key business partners learn of the transaction through a controlled process, as opposed to the rumor mill or, in the worst case, from competitors of the seller and/or buyer.

- **Operations of the Seller.** The buyer will typically seek to impose certain restrictions on the seller's operations during the period between the execution of the letter of intent and the consummation of the transaction. This may take the form of a general requirement that the seller operate in the ordinary course of business and not undertake any extraordinary transactions during the relevant period, or it may address more specific restricted conduct, such as hiring and termination of employees or capital expenditures over some set level. Sellers will seek to limit any restriction until the buyer has made a firm financial commitment to the deal and may try to tie any operational restrictions to a monetary deposit or break-up fee.

- **Responsibility for Expenses.** The letter of intent should clearly specify the parties' respective responsibility for transaction expenses.

- **Termination.** The letter of intent should state the circumstances under which it will expire or may be terminated, which is most significant as relates to the binding provisions (particularly

exclusivity and access). Depending on the seller's termination rights, the buyer may negotiate to have the exclusivity restriction survive termination for a specific period of time (e.g., 90 days) in order to prevent the seller from unilaterally terminating the letter of intent to immediately pursue another opportunity.

- **Binding Provisions.** It is critical that the letter of intent explicitly address whether and to what extent its provisions are intended to be binding on the parties. As further discussed below, volumes have been written on the subject of when a letter of intent may constitute a binding agreement for the purchase and sale of a business. Although courts have identified other relevant factors, the plain language of the letter of intent will be weighed most heavily in this determination. For that reason, parties should include an express statement regarding which provisions are intended to be binding and/or divide the letter of intent into clearly marked binding and non-binding sections. In addition, as a drafting point, it may be helpful to use conditional language in the non-binding provisions – e.g., "The buyer would pay $____ in cash at the closing of the transaction" – and more definitive language in the binding provisions.

Common Issues and Concerns Arising in Connection with Negotiating and Drafting Letters of Intent

- **Binding Versus Non-Binding Provisions.** Perhaps the most common and critical issue arising in connection with negotiating letters of intent relates to which provisions are binding or non-binding. In order for the parties to ensure that their intentions at the outset are enforced, the letter of intent should include express statements regarding which provisions of the letter of intent are and are not intended to be binding on the parties. In the absence of a clear and unambiguous statement in the document, courts may look to factors such as whether there has been partial performance of the obligations of the parties or whether the essential contractual terms are sufficiently described in the letter of intent so as to eliminate any ambiguity and, therefore, create an enforceable contract. Although in

extreme circumstances a court still may analyze the conduct of the parties and other factors, in most cases, if the language of the letter of intent clearly addresses the binding versus non-binding issue, the risk of an accidental binding agreement is low.

- **General Versus Specific Terms – Differing Perspectives of Buyers and Sellers.**

  Most practitioners and commentators agree that a seller's negotiating leverage is greatest prior to the execution of the letter of intent. Most fundamentally, before the letter of intent is executed, the seller likely has multiple suitors and no limitations on its ability to engage in discussions with all of them. The moment the letter of intent is executed (assuming that it includes an exclusivity provision), this dynamic changes dramatically. In addition, notwithstanding confidentiality provisions or specific prohibitions on the disclosure of negotiations or the potential transaction, it is extremely difficult to retain a cone of silence regarding the potential deal for an extended period of time. At a minimum, the core management of the seller will be aware of the deal due to their role in facilitating the buyer's due diligence. Once the sale process has started, it will become increasingly difficult for the seller to turn back without damaging its relationships with customers, suppliers and employees. Moreover, if a letter of intent is executed and the deal is not consummated, other prospective buyers may view the seller as "damaged goods" and assume that there is some problem with the business that may dampen their enthusiasm to acquire it. For these reasons, the seller may try to be as specific as possible in the letter of intent in detailing the core deal terms, including as relates to price, payment terms, adjustment provisions, representations and warranties and indemnification obligations and limitations. The seller's best opportunity to negotiate limitations on indemnification – i.e., baskets, caps and limited recourse – may be at this preliminary stage. Although these provisions will not be binding on either party, they will set a level of expectation that the buyer will be hesitant to disturb barring a significant negative due diligence finding or other material changed circumstances.

From the buyer's standpoint, the most critical components of the letter of intent are likely the core deal terms – such as the amount and form of the purchase price and the structure of the transaction – and the provisions addressing access to due diligence information and exclusivity with respect to the negotiations. The corollary of the discussion above is that the buyer's interests may be best served by including fewer details in the letter of intent as relate to purchase price adjustments, representations and warranties and indemnification. The buyer's ability to successfully negotiate these terms may improve as it gains additional knowledge about the business and, at least as significantly, the field of prospective buyers is reduced to one.

INVESTMENT BANK ENGAGEMENT LETTERS

Sellers and buyers frequently engage the services of an investment bank in connection with potential M&A transactions. For sellers, an investment bank can play a critical role in preparing the company for sale and marketing it to potential buyers. For parties interested in identifying acquisition targets, investment banks may be able to utilize its market knowledge and contacts to identify possible acquisition candidates otherwise unknown to the prospective buyer. At the outset of any investment bank representation, it is in the interest of both the client and the investment bank to document their relationship and related arrangements in an engagement letter or other binding agreement. Clients should anticipate that the investment banker will proffer its form of engagement letter as a starting point for the discussions. These forms tend to be very consistent among reputable investment banks, and investment banks are typically very reluctant or unwilling to negotiate significant departures from their document. However, prospective investment bank clients should carefully consider certain provisions and seek to negotiate where circumstances allow.

- **Structure of the Fee.** Investment banks generally require a non-refundable retainer at the commencement of an engagement, but do not typically receive any other fee unless and until the relevant transaction is consummated. This transaction fee is almost always tied to the consideration received or paid in the relevant transaction. The engagement letter should clearly state the fee to be paid

to the investment bank or, more typically, the formula or other means for calculating the fee. The engagement letter should also make clear whether the retainer is credited against the transaction fee otherwise due at closing. Several fee structures are typical for seller/banker relationships. Under the so-called Lehman formula, the investment bank receives a higher percentage of the initial portion of consideration paid to the seller with the fee percentage going down as the incremental consideration increases. More typically, the fee percentage increases as the purchase price increases, which serves to align the investment banker's incentives with the seller's -- specifically, to maximize the purchase price. Many investment banks will include some provisions for a minimum fee in the calculation formula. In some cases, the seller may be able to negotiate a reduced fee if the transaction involves a buyer with whom the seller had substantive discussions prior to engaging the investment bank. The investment bank will also require that the client reimburse the firm for its out-of-pocket expenses incurred in connection with the representation. The client should consider imposing a requirement that it pre-approve expenses over some threshold (per expense and/or overall).

- **Definition of Consideration and Covered Transactions.** The investment bank will seek to include a very broad definition of "consideration" for purposes of calculating the fee formula, as well as a broad description of the types of transactions that, if consummated, would result in the payment of a fee. In terms of the scope of the covered deal, the investment bank will want to ensure that it is compensated for its efforts even where the process leads to a transaction other than what might have initially been anticipated – i.e., the seller undertakes a leveraged recapitalization transaction rather than an outright sale – but the investment bank plays a key role in identifying the other party and facilitating the transaction.

  With respect to covered consideration, the investment banker will propose a definition that includes not only cash payable at closing, but also any securities received as consideration, promis-

sory notes and other deferred amounts, as well as consulting fees, restrictive covenant payments and any other amounts potentially payable in the deal. Clients may be able to negotiate on the margins of these parameters. For example, fees tied to deferred or contingent payment amounts may be postponed until the seller actually receives the related consideration (although investment bankers will protect themselves from reductions in payments (such as escrows) resulting from indemnification or other offsets). Where securities or other non-cash consideration are included in the formula, some method for valuing those items should be delineated in the engagement letter. With respect to employment or consulting agreements, sellers may be able to provide that at-market consideration for future services to be rendered be excluded from the fee formula, but the investment banker will insist that above-market payments more appropriately characterized as purchase price be included for purposes of the fee.

The engagement letter should be clear regarding the treatment of dividends or other distributions paid by the seller to its shareholders between the time the investment bank is engaged and the closing of a transaction. For example, interim tax distributions and other ordinary course payments to shareholders are often excepted from any fee.

- **Decision to Consummate the Transaction.** The client should always insist on retaining absolute control over the decision to do (or not do) any deal. Toward that end, the engagement letter should include an express provision acknowledging that this decision is reserved exclusively to the client and that the investment bank is not entitled to any fee - other than any agreed retainer or other minimum consideration - if the client ultimately determines not to undertake a transaction.
- **Termination/Tail.** The client should be able to terminate the engagement with the investment bank unilaterally, without cause and with minimal notice. However, the investment bank will want to ensure that its pre-termination efforts are compensated if the

client ultimately realizes a benefit from those efforts. Accordingly, the investment bank will propose that it receive a fee if any transaction is undertaken within some period after termination - typically one year or less. The client may be able to limit the applicability of this provision to a transaction involving a party introduced to the client by the investment bank. For this reason, it may be helpful to provide that, at the conclusion of the engagement, the investment bank will provide a definitive list of the client of potential buyers with respect to which the tail provision would apply. In addition, the seller may successfully negotiate for the tail to not apply if the seller terminates the engagement for cause or if the investment bank terminates the engagement.

- **Indemnification.** Investment banks will always request – and clients should be prepared to provide – indemnification for losses incurred by the investment bank in connection with the potential transaction. In a sell-side representation, for example, these provisions protect the investment bank if a buyer later claims that due diligence information was inaccurate or if a prospective buyer undertakes significant expenditures in anticipation of a deal, only to have the seller back out late in the process. Although the client should accept that any reputable investment bank will demand these protections, it may be possible to include exceptions for gross negligence or willful misconduct of the investment bank, and to tailor the mechanics of the indemnification provisions in a manner that is more client-friendly.

NON-DISCLOSURE AGREEMENTS

Product specifications, manufacturing processes, business plans, customer lists, employee information, financial information and other types of proprietary information are some of the most valuable assets of a business. A business could be severely damaged if such information is misused or widely disseminated, but it is typically necessary to disclose this information in order to further the M&A transaction. In order to guard the proprietary information of the business, it is generally best practice to enter into a contractual relationship with any party to whom such infor-

mation is being disclosed, prior to initial disclosure. Parties should be mindful of the following considerations when negotiating such arrangements:

- Confidentiality is a state law issue, so protection and enforceability varies from state to state.
- General Considerations:
  - **Who is disclosing information?** Non-disclosure agreements (NDAs) can take many forms. If both parties are disclosing information, the parties may wish to enter into a mutual agreement. If only one party is disclosing information, a one-sided agreement may be appropriate. Mutual agreements typically include more balanced restrictions than those found in one-sided agreements, since a disclosing party may be more aggressive in the types of restrictions it desires to impose if it is not agreeing to those same restrictions.
  - **Who is receiving information?** It is important for the disclosing party to know who will be receiving its information and who will be responsible for unauthorized use or disclosure. The scope of the NDA may differ depending on whether information is being disclosed to a party that is now or may some day enter into the disclosing party's business.
  - **Secondary recipients: To whom may the recipient disclose the information?** Typically, additional disclosure is limited to those individuals who need to know the information in order to evaluate a potential transaction. In particularly sensitive circumstances, the NDA may limit disclosure to, and discussions among, a specific list of individuals. Secondary recipients should either be made aware of the company's confidentiality obligations or execute a non-disclosure agreement specific to the current disclosure. Because the disclosing party may not be in privity of contract with a secondary recipient, the NDA should provide that the initial recipient will be generally be responsible for any violation of the use and disclosure limitations by its secondary recipients.

- **What is the scope and purpose of the disclosure?** In particularly sensitive circumstances, it may be appropriate to include heightened protections, such as customer non-solicitation, employee non-solicitation or non-competition provisions.
- **What information is being disclosed?** Recipients will generally prefer that the discloser clearly label confidential information as such, or otherwise clearly identify confidential information disclosed orally (e.g. follow up with a letter or email memorializing the general scope of a particular disclosure). Disclosers will prefer to define confidential information more broadly, so as not to leave any particular disclosure unprotected.
- **How much of the disclosed information is really confidential?** NDAs typically exclude the following categories of information from restriction on use and disclosure:
  - information already known by the recipient;
  - information not known by the recipient at the time of disclosure, but later received from a third party; AND
  - information developed independently.

  NDAs may include a variety of standards and limitations for each of the above. For example, an exclusion may only be applicable if recipient has written records demonstrating such exclusion prior to the receipt of information from the disclosing party. Similarly, the exception in bullet two above may only apply if the third party was not under a confidentiality obligation to the disclosing party. It is typical in the M&A context for an NDA to specifically restrict disclosure of the fact that the parties are in discussions regarding a potential transaction.
- **What restrictions are being imposed?** Generally, NDAs should limit the ability to disclose information, as well as the ability to use information. NDAs may include a "reasonable care" standard or a standard based on how recipient handles its own informa-

tion. Specific restrictions on reverse engineering may be appropriate in certain circumstances. As noted above, if the recipient is allowed to disclose the information to others, the NDA may explicitly hold the initial recipient responsible for any unauthorized use or disclosure by the secondary recipients.

- **What remedies exist if the recipient breaches the agreement?** Because the harm caused by an unauthorized disclosure can be irreversible if not immediately continued, a disclosing party will most likely need the right to seek immediate injunctive relief. NDAs often contain explicit acknowledgments regarding the availability of injunctive relief to the disclosing party. The parties may attempt to negotiate a standard for the availability of injunctive relief in the NDA. In particularly sensitive situations, the disclosing party may also request contractual indemnification for breach.
- **How long do the restrictions remain in effect?** Some states will not enforce an indefinite confidentiality restriction. In such circumstances, the longer the term of restriction, the less likely a court may be to enforce such term (but see Trade Secrets below). A disclosing party should consider how long the information would have value, while the recipient should consider the ability and need to maintain confidentiality from a practical perspective. Many NDAs include a restrictive period based on some period of time following the date of disclosure (or the date of the last disclosure) of information between the parties. To avoid complications in determining or agreeing upon the date of disclosure, the parties may wish to use a specific term of restriction. This may be accomplished by tying the restrictive term to either the date of the agreement itself or the end of a pre-defined disclosure period.
- **Securities law issues:** U.S. securities laws prohibit any person who has material, non-public information about a company from purchasing or selling securities of such company, or from communication such information to any other person under circumstances in which it is reasonably foreseeable that such person is likely to purchase or sell securities of such person.

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Depending on the circumstances, it may be appropriate to include a specific provision acknowledging the applicability of U.S. securities laws if the discloser is a public company or is in the process of going public.

- **Return of information:** The disclosing party should be entitled to return of its confidential information at some point in the relationship. It is typical to provide for return of information after some period of time (at which point the parties would know whether they will pursue a transaction) or at any time upon the disclosing party's request. It is not uncommon for the recipient to make notes, analyses or extracts of the disclosing party's information. The disclosing party will be sensitive to recipient's retention of such materials, but at the same time it may be inappropriate or impractical to deliver all of these types of materials to the disclosing party since they may contain the buyer's own information. In such cases it may be appropriate for the recipient to destroy all such materials containing confidential information received from the disclosing party. The disclosing party may request that the recipient certify that all such materials have been destroyed. In some cases a recipient may need to retain some minimal level of information about the discussions (e.g., a creditor may need to be able to justify credit decisions, and investment funds may need to justify investment decisions). In such cases a disclosing party will want to limit the scope of retained information as much as possible and maintain restrictions on the retained information as long as reasonably possible. A recipient may be willing to place retained information in the hands of its counsel in order to minimize the risk of misappropriation. A recipient may request a "residual knowledge" clause in an attempt to allow future use of information "retained in the unaided memory" of the recipient. Depending on the language used, recipient's use may be limited to the general concepts underlying the confidential information, or recipient may be able to use anything recipient can remember after returning the tangible forms of confidential information. A disclosing party will be justifiably concerned that a residual knowledge clause might swallow the restrictions otherwise spelled out in the NDA.

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- **Choice of law:** Because confidentiality is a state law issue, the NDA should indicate the law by which the NDA is to be governed.
- **Choice of venue:** Contracting parties often wish to identify in advance the courts in which the contract will be examined. Choice of venue provisions can be particularly important in the NDA setting, as a disclosing party may need to move swiftly for injunctive relief in the event of actual or threatened misuse of its confidential information. A disclosing party should be alert to choice of venue provisions that would impede its ability to quickly obtain relief. Once information is disclosed publicly (especially where included in a press release or posted on the internet), it is virtually impossible to stop further dissemination of the information.

- Trade Secrets
  - Trade secrets are essentially a subset of confidential information that is subject to a heightened level of protection. Trade secrets are typically defined as information that:
    - derives economic value (actual or potential) from not being generally known and not being readily ascertainable using proper means by others who can obtain economic value from disclosure or use of such information; AND
    - is the subject of reasonable efforts to maintain its secrecy.
  - Examples of trade secrets are financial data, financial plans, price lists, customer lists (actual and potential), product formulas (e.g., the Coke formula), manufacturing techniques.
  - While some states limit ability to protect other forms of general confidential indefinitely, trade secrets are generally protectible as long as such information remains a trade secret. Most states have adopted the Uniform Trade Secrets Act (or variations of the UTSA), which provides more specific protection and remedies for misappropriation than otherwise provided under common law.

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OVERVIEW

Due diligence involves an investigation and evaluation of the business, legal and financial affairs of a target company by or on behalf of the buyer for the purpose of providing information with which to assess the advantages and risks associated with the target. Its scope will vary depending on the nature of the contemplated transaction, *e.g.*, the known areas of risk, the size of the deal, the industry involved, the timing of the proposed transaction and the structure (stock or assets). Performing due diligence allows the buyer and the buyer's advisors to understand the nature of the business being acquired, and to identify potential opportunities and issues. It also allows the buyer and buyer's advisors, particularly its legal counsel and auditors, the opportunity to understand and plan the transaction.

The due diligence process should be conducted by a potential buyer and the buyer's advisors in anticipation of the acquisition of the business, but the basic information must be assembled by the seller. This assembly often results in a "data room." The "data room" refers to the central location where all of the underlying due diligence materials are located. It may be physical office space or virtual/online space, and the contents and access of the data room should be controlled by the seller but must be responsive to reasonable buyer requests (normally, subject to a confidentiality agreement). The data room should be maintained by the seller, the seller's advisors or a combination of both. A formal data room is not always necessary; it is invariably used in an auction setting where there are multiple potential buyers. In instances where there is no formal data room, a potential buyer may receive files or boxes of information directly from the seller. Whether a data room is used, it is critical for both the buyer and the seller to monitor all documents provided (and in the virtual context, any documents that are subsequently added), typically in the form of an annotated index or log.

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BENEFITS OF DUE DILIGENCE

Due diligence provides a number of benefits to the buyer and the buyer's advisors during a transaction. First and foremost, it allows the buyer to discover issues early in acquisition process, which includes an ability to:

- Gain knowledge of the organizational and capital structure of the seller (*e.g.*, number of shareholders, debt terms, etc.);
- Determine assignability and/or transferability of assets;
- Ascertain required consents and approvals for sale or components of the sale (governmental, shareholder, third party).

Due diligence also permits the buyer to establish basis for fundamentals of transaction, including deal structure; purchase price (including whether any adjustment, holdback or escrow arrangement is necessary); necessary representations and warranties (discussed in Chapter 5); indemnifications (discussed in Chapter 7); and additional covenants.

In addition, there are a number of legal benefits that flow from due diligence. For example, failure to do due diligence can defect a common law claim for fraud. In that regard, a buyer generally cannot recover on a fraud claim if the alleged material misstatement or omission could have been discovered through the exercise of "due diligence." In other words, if the buyer could have uncovered, through reasonable inquiry, then normally the buyer cannot successfully bring a fraud claim. Thus, due diligence requirements can limit remedies on the types of damages as well as on rescission of the contract, including the buyer's ability to seek recourse from a seller.

Separately, having done an appropriate amount of due diligence process provides certain benefits to buyers under specific U.S. laws including:

- Securities Laws
  - Section 11 of the Securities Act, which imposes liability for untrue statements or omissions of material fact in a registration statement. Due diligence during the purchase process helps ensure proper preparation of registration statements and can be

an affirmative defense for certain classes of defendants in a Section 11 claim. Section 11 also provides a standard for "Due Diligence" defense – "had, after reasonable investigation, reasonable ground to believe, and did believe, that the statements in the registration statement were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading."

- Section 12(a)(2) of the Securities Act which provides for civil liability in connection with prospectuses and communications;
- Section 17(a) of the Securities Act which governs fraudulent interstate transactions; and
- Section 10(b) of the Securities Exchange Act and Rule 10b-5 which contains various anti-fraud provisions;
- Due diligence also may afford the buyer protection under other Laws (*e.g.*, Patriot Act, Trading with the Enemy Act).

Types of Due Diligence

Due diligence broadly falls into three categories: Legal, Business and Financial. The focus is on the legal underpinnings of the business. It involves an examination of the status of the corporation under various federal and state laws (*e.g.*, incorporation statutes, regulatory regimes, securities law, tax law).

- Legal due diligence affords a review of the various contractual relationships that comprise the business (customers, suppliers, lenders, third parties, employees, etc.). It is typically conducted by attorneys, both in-house and outside of the company.
  - The "diligence team" should be staffed based on the size, scope and risk of the potential transaction.
  - There should be an *ex ante* determination of whether specialists (*e.g.*, taxation, employee benefits, environmental) should be included.

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- The contents and mechanics of legal due diligence are discussed in more detail under "The Due Diligence Process."

- Business due diligence focuses on the operational aspects of the business itself, including finance, and the mechanics of product/service delivery. It is typically conducted by the buyer's acquisition team and provides an opportunity for the acquiring team to determine whether to complete the transaction. Business due diligence often involves:
  - Visiting facilities and getting to know the management;
  - Contacting customers, suppliers and business partners; and
  - Giving the team an opportunity to "kick the tires" of the target business.

- The financial due diligence process focuses on the financial health, performance and future prospects of the business in question, and is normally led by the accountants and financial advisors for the buyer.

  The purpose of financial due diligence is to focus on the balance sheet and invoice statements of the business and to understand the revenues, expenses, financing, inventories, accounts receivables, etc. During this procedure, the team should review financial statements (especially footnotes), any existing projections and analyze the reasonableness of assumptions made by the business. The team will need to make its own projections as well.

  In many contexts financial due diligence can be treated as a subset of business due diligence.

DILIGENCE PERSPECTIVES: BUYER VS. SELLER

Buyer Due Diligence

- Buyer due diligence permits a buyer to make an informed investment decision by:

  - Examining a complex organization comprised of a legal entity, assets, a bundle of contract rights, people who run the business, liabilities to others, etc.;
  - Understanding the business;
  - Identifying obstacles to the transaction and the future health of the acquired business;
  - Negotiating deal terms;
- Due diligence findings may alter the purchase price, the structure, or lead the buyer to abandon the deal altogether.
- Typically, the seller will only provide limited information before execution of a confidentiality agreement or letter of intent with a confidentiality provision.

Seller Due Diligence

Before the buyer performs its due diligence, the seller should review its own internal affairs. The seller should organize materials and plan to make relevant employees available for discussion. Further, the seller may need to provide legal opinions in connection with the sale. In addition, if the purchase price includes stock or debt of the buyer, the seller may need to perform its own due diligence on the buyer; this diligence should include all the same elements as buyer due diligence because the seller is "buying" buyer's stock with the seller's business.

THE DUE DILIGENCE PROCESS

Typical Due Diligence Mechanics of the Buyer

A buyer typically will take the following steps in conducting the diligence process:

- Formulate a due diligence request list;
- Send the initial information requests;
- Review materials received;

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- Catalog documents received/reviewed;
- Send follow-up information requests;
- Prepare a due diligence memorandum (usually prepared by members of diligence team):
  - The memorandum should summarize the scope of the review as well as the findings;
  - The organization is critical: it should be thorough, but "user friendly;"
  - For a long memorandum, include an executive summary:
    - Highlight the key findings and issues;
    - Include an analysis of the impact and potential resolution(s) of such findings and issues.
- Communicate the findings to all appropriate parties.

Common Legal Due Diligence Areas

- The topics that should be covered during the course of a diligence review will vary based on the type of transaction (*e.g.*, stock or asset purchase, public or private seller). It is advisable to organize the due diligence process in a manner reflective of the organization of the representations and warranties contemplated to be in the purchase agreement so that the due diligence process more effectively captures the information utilized in drafting the representations and warranties and the accompanying disclosure schedules. At a minimum, however, the following diligence topics should be considered:
  - Corporate Review
    - Organizational Documents
      - An analysis of the legal organization of the seller, typically focusing on the Articles/Certificate of Incorporation (including any amendments thereto) and the Bylaws.
    - Minute Books

- Review to ensure that the contents of the minute books are up to date;
- Acquire insight as to the historical operating style and organization of company;
- Examine resolutions and minutes of meetings, stock record and transfer ledger.

- Qualifications to Do Business
  - Determine the states in which the seller is legally qualified to do business;
    - Qualifications are often evidenced by a certificate issued by the applicable Secretary of State.
- Good Standing Certificates & Tax Clearance Letters
  - Typically issued by the state of incorporation;
  - If a tax clearance letter is not available during diligence (and will be required to complete the transaction), the buyer should request a clearance letter in the early stages of the transaction as there may be considerable delay in obtaining the clearance letter.
- Capital Structure
  - Debt
    - Determine amounts and holders of any debt, including credit facilities, bonds and notes;
    - The buyer should pay particular attention to any restrictions on transfer and assignment. Noteholder or bondholder consent to transfer is typically required;
    - Determine whether debt will have to be paid-off by the seller prior to or at closing or will be assumed by the buyer.
  - Equity
    - Determine classes and types of stock issued by the company,

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including any rights (*e.g.*, options, warrants, conversion rights, Stock Appreciation Rights (SARs));

- Assess the number, types and characteristics of shareholders (*e.g.*, family owned business, venture capitalists, other corporate entities);
- Determine whether a shareholder agreement or other restrictions on shareholder activity are in place;
- Review past transactions (issuances, purchases, sales).

- Taxation
  - Review federal, state and local tax returns;
  - Assess any special tax characteristics that may be beneficial/detrimental to the sale (*e.g.*, net operating losses, deferred tax assets, special state/local tax treatments of business).
- Licenses/Permits/Regulatory Matters
  - Determine whether licenses and permits are transferable upon sale;
  - Review the remaining term and renewal requirements.
- Real & Personal Property
  - Location and condition of property;
  - Leases and other property-related agreements, such as easements, restrictive covenants, etc.:
    - Conduct a review of all critical terms of such agreement, including:
      - Renewal terms
      - Rent escalation clauses
      - Hidden/unexpected liabilities
      - Consent requirements/change of control restrictions
      - Restrictions on ability to compete or expand the business

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  - ★ Termination rights/penalties
  - ★ Unusual terms
- ▲ Liens (Landlord & UCC)
  - ★ Generally perform a UCC filing search in any state where the seller has real or personal property

- Insurance
  - Determine what types and amounts of coverage the seller has and whether they will need to be replaced at closing.
- Intellectual Property
  - Review all patents, copyrights, trademarks, service marks, and trade secrets, including pending applications;
  - Review steps taken to protect intellectual property and any disputes concerning intellectual property owned by the seller or used by the company (*i.e.*, are there any infringements against the seller AND is the seller infringing on anyone else's intellectual property).
- Litigation
  - Review the types and amounts of claims, including any historical claims that have been settled or are no longer pending;
  - On significant matters, request any available pleadings and/or other court documents.
- Employment/Employee Benefits
  - Review any employment contracts, focusing in particular on provisions affecting the sale (*e.g.*, change in control, parachutes, acceleration of vesting for certain benefits);
  - Obtain copies of all benefit plan documents, including summary plan descriptions ("SPDs");

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    - Have an ERISA and an employment law specialist review any critical diligence materials.
  - Environmental Compliance
    - Thorough review is critical due to the buyer's potential successor liability issues and the potential size of fines and clean-up costs.
    - Environmental compliance can be an issue whether the seller owns or leases real property.
  - Material Contracts
    - Conduct a review of all key terms, including:
      - Renewal terms
      - Hidden/unexpected liabilities
      - Consent requirements/change of control restrictions
      - Restrictions on ability to compete or expand the business
      - Termination rights/penalties
      - Unusual terms

SPECIAL DUE DILIGENCE ISSUES

Impact of Due Diligence on Transaction and Transaction Documents

The results of the due diligence process form a basis for a number of the component parts of the transaction structure and documentation:

- Purchase price (discussed in Chapter 3)
  - Actual amount
  - Earn-outs
  - Holdbacks
- Representations and Warranties (discussed in Chapter 5)

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- Factual representations
- Covenants and provisions
- Closing conditions
- What types of representations, covenants and indemnifications is the client getting in the Purchase Agreement, and how good is the protection afforded?
- Knowledge and Materiality Qualifiers

- Disclosure Letters and Schedules (discussed in Chapter 6)
- Indemnification (discussed in Chapter 7)
    - Caps on claims
    - Claim thresholds, including baskets and deductibles
    - Buyer protections, such as funds held in escrow

Benefits and Challenges of the "Virtual" Data Room

A virtual data room is a secure, online site that houses electronic copies of all of the diligence materials for a particular transaction. They are becoming more common, particularly in the auction context with a large number of bidders in different locations from the seller.

- Benefits of the virtual data room include:
    - Document security and access control;
    - Accessible from any location 24-hours a day;
    - Easily organized and updated; and
    - Lower transaction costs due to less travel.
- Challenges of the virtual data room include:
    - Electronic documents are more difficult to review;
    - Documents may not be reproducible (*i.e.*, copied, printed, etc.); and
    - Limited employee availability to answer questions.

EARN-OUTS

In many instances whether the sale of a business is actually consummated depends upon whether the buyer and the seller can agree upon the value of the target. In instances where the buyer and the seller differ in their legitimate assessment of the current and future value of the target, utilization of an earn-out provision may help bridge that valuation gap. In a transaction involving an earn-out, a portion of the purchase price is deferred at closing and is paid based upon the target's achievement of future goals, such as post-closing revenues, earnings, or some other measure of performance. If the target achieves these goals, then the additional purchase price is paid to the seller. If the target does not perform as anticipated, then payment of some or all of the additional purchase price is excused.

While earn-outs appear to be the natural solution to disagreements relating to the purchase price for a target, they require a great deal of thought and negotiation between the parties. Given the many variables involved in operating a business, even the most precisely crafted earn-out provision can produce unintended post-closing consequences when applied to M&A transactions. From the seller's viewpoint, earn-outs work best when the seller's management plays a significant role in the future operation and management of the target in order to maximize the seller's chances to achieve the earn-out. Unfortunately, that may negatively impact the buyer's ability to realize the synergies and other benefits that it hopes to achieve from the transaction.

The following is a brief discussion of various considerations involved in structuring earn-outs:

- **Carefully Define the Earn-Out Formula.** There are many ways to structure an earn-out; for that reason, it is important at the outset to carefully define the earn-out formula. An earn-out formula should have four basic components:
  - the performance measurement;
  - a discrete entity, unit or activity with respect to which that performance is measured;

  - the amount of the earn-out and the method of payment; and
  - termination provisions.

- **Performance Measurement.** A critical aspect of any earn-out provision is selecting the performance categories and the accounting methods by which the target's performance will be measured. (The impact of accounting principles is discussed later in this outline.)
  - **Financial Measures.** Financial earn-out measures typically are framed in terms of revenues, net income, or some derivation of cash flow (such as EBITDA).
    - **Revenue.** This is perhaps the easiest financial measurement, and probably the one most preferred by sellers. Yet, even with this simple measurement, the seller will want assurances that post-closing, the target will be operated to maximize revenue. As a result, the seller will likely seek to negotiate limitations on post-closing changes in the target's business (such as reductions in force, elimination of services or product lines, and integration of the business with the buyer's), which in turn may limit the synergies or other benefits and opportunities that the buyer hopes to achieve from the acquisition. From the buyer's perspective, additional concerns include the target engaging in less profitable (or unprofitable) transactions solely for the sake of revenue, channel-stuffing, product returns, and uncollectible accounts receivable.
    - **Net Income.** Buyers generally prefer to use net income as a performance measurement because it is based upon the target's profitability and may reflect more accurately the future economic performance of the target. If the buyer and the seller agree to use net income as the performance measure, then it is important for the seller to ensure that budgets for the target's capital expenditures, research and development, advertising, maintenance and other overhead costs are established ahead of time or, in the alternative, require the seller's prior approval. Otherwise, the buyer may be in a position to front-load expenses and employ similar measures to artificially depress the profitability

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of the target. At the same time, the buyer may chafe at limitations placed upon its ability to run the business as it sees fit post-closing because the earn-out incentivizes the seller to maximize short-term profit.

- **EBITDA/EBIT.** Using EBITDA/EBIT as a performance measure has the same positives and negatives as profit-based earn-outs, with the added challenge of agreeing upon the ever-elusive definition of EBITDA or EBIT (both of which are non-GAAP measures), and any carve-outs or carve-ins to such definitions that the seller or the buyer will seek to negotiate (*e.g.*, extraordinary gains or losses).

- **Non-Financial Measures.** If the target is in the start-up stage and/or has yet to generate revenue, then use of a non-financial performance measure, such as the development of a core product, the execution of a material contract, the obtaining of a certain number of customers or customer contracts, the completion of a clinical trial, etc., may be a more appropriate performance measure. Of course, unlike financial measures where the parties can agree that partial achievement of goals can (but does not always) result in partial payment of the earn-out, these non-financial measurements tend to be more of an "all or nothing" nature, with the complications that may entail.

- **Basis for the Earn-Out.** An earn-out also should specify the operational unit upon which the earn-out measure is to be based. Generally, the nature of the business or asset being sold should dictate the basis for the earn-out. The most typical basis for an earn-out payment, however, relates to revenues, income or cash flow generated from:
  - A division or a subsidiary of the target or the entire target;
  - A product, product line or service of the target that exists as of the closing; or
  - Sales or provision of services to existing or future customers of the target.

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- **Amount of the Earn-Out/Method of Payment.** Once the operational unit is established, the parties need to determine the amount of the earn-out. For financial performance measures, the amount of the earn-out is typically a percentage or a multiple of the performance measure; for non-financial performance measures, the amount of the earn-out will typically be fixed and will be paid if the measurement event occurs (*e.g.*, the milestone is achieved). In either case, an earn-out is usually paid in cash, stock or a combination of cash and stock. (Given the fact that the earn-out payments are already deferred, promissory notes are not typically used.)

  Regardless of the method chosen, the buyer should attempt to negotiate for sliding scale payments (*i.e.*, if 75 percent of the performance measure is achieved, then the buyer receives 75 percent of the earn-out amount), while a seller will generally negotiate for "all or nothing" payments. Frequently, the parties negotiate a threshold amount which must be achieved before any earn-out payments are made. Payments are typically capped at a certain amount or at a percentage of the performance measure (*e.g.*, 110 percent).

- **Termination Provisions.** The three most common termination provisions in any earn-out arrangement are the achievement of the goal, the passage of time and the happening of a specified event.

  - **Achievement of the Goal.** Once the maximum earn-out is achieved and paid to the seller, the earn-out generally terminates, as opposed to further rewarding the seller for better-than-expected performance.

  - **Pre-Determined Time Period.** Earn-outs generally extend for a period of from one to four years and then terminate, regardless of whether the earn-out has been met. The longer the duration of the earn-out period, the more time is available to determine whether the buyer's or the seller's assessment of the value of the target was correct. As time passes, however, the success of a business can be increasingly attributed to the management of the target or any synergies or economies of scale created by buyer's changes to the target or its existing businesses, rather than the intrinsic value of the target at the time of the sale. If a shorter period of time is

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chosen, however, the earn-out may be impacted by a one-time event which distorts the target's true ability to meet the established performance measures.

- **Occurrence of an Event.** The happening of a specified event often triggers the acceleration of an earn-out payment. At a minimum, a seller should ensure that payment of the earn-out is accelerated if the buyer:

  - ceases to operate the target consistent with past practice;
  - terminates certain key members of seller's former management; or
  - sells the target.

  For its part, the buyer will seek to ensure that it has the ability to buy out the remaining earn-out obligation at a discounted rate if it is approached by a *bona fide* buyer for the target. The buyer's ability to control the target on a short-and long-term basis, while not an "event," profoundly affects the earn-out. The seller will seek to limit that control, while the buyer will seek to maximize it.

Don't Forget About the Details. Even if the earn-out amount is agreed upon and the formula established, other significant issues can impact the successful implementation of an earn-out. Some of these issues include tax and accounting matters and the treatment of indemnification claims.

- **Tax Treatment of Earn-Outs.** For tax and accounting purposes, an earn-out payment can be characterized as payment of deferred contingent purchase price, payment of ordinary compensation for the seller's services or part compensation and part purchase price. Income treated as compensation will be taxed as ordinary income, while income treated as deferred contingent purchase price will be taxed at the lower capital gains rate. A portion of the earn-out payment will likely be deemed compensation if the seller provides continuing services or enters into an employment agreement or a non-compete agreement with the buyer. Additionally, if an earn-out which extends for a substantial period of time does not expressly provide for interest payments, then the Internal Revenue Service

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may deem a portion of the earn-out payment to be imputed interest, which is taxed as ordinary income.

- **Accounting Principles.** As discussed above, earn-outs are tied to financial or other performance goals regarding a target. That begs the question, what accounting standards will be followed? Many sellers do not follow GAAP. If the buyer does follow GAAP, how does that impact the earn-out? Most sellers naively presume that if the purchase agreement provides that the financial statements of the target are prepared in accordance with GAAP, then the buyer will not be able to manipulate the financial statements of the target. Yet, GAAP principles are not static and encompass a wide variety of accounting practices (such as LIFO vs. FIFO and cost vs. market in connection with inventory) and can be applied either conservatively or aggressively. In cross-border transactions, the non-U.S. party may want to follow its country's accounting principles instead of U.S. GAAP. The choice of various accounting principles will have a considerable impact on whether the target's performance measures are met. Therefore, it is important that the seller and buyer clearly state in the purchase agreement the accounting principles that will be used to determine whether the target has met the established performance measures and any exceptions or deviations from those accounting principles.

- **Indemnification Claims.** The buyer will want the unilateral right to offset against any earn-out payments any indemnification claims that it has against the seller (subject to any deductibles and caps), prior to the final adjudication or settlement of such claims. Of course, the seller will not want the buyer to offset claims against earn-out payments until the final adjudication or settlement of claims, by which time all earn-out payments may have been made. Here, regardless of what the earn-out provision actually specifies, the buyer practically has the leverage, as it can exercise its "self-help" right and refuse to pay the earn-out until the indemnification claims are resolved to its satisfaction.

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Make Sure there is a Method for Dispute Resolution. Ultimately, no purchase agreement can provide complete protection to the parties, as there are many variables inherent in the operation of a business and the dynamics of an earn-out. As such, parties to a transaction involving an earn-out all too often find themselves embroiled in disputes. Therefore, the earn-out agreement should contemplate the procedure (mediation, arbitration or litigation) for handling disputes.

Post-Closing Considerations of Buyer and Seller: Particularly where the seller will not provide management services to the target or the buyer post-closing, various post-closing considerations need to be addressed in the purchase agreement:

- **Seller Beware.** Perhaps the most difficult obstacle for a seller to overcome in an earn-out scenario is the seller's perception (real or imagined) that the buyer has little incentive to maximize the income or profitability of the target during the earn-out period, since doing so would result in increased payments to the seller. Therefore, the seller will want to retain as much control over the management and operations of the target following the sale as it can. The following are items that the seller should negotiate to maximize its ability to achieve its earn-out:
  - Require that the target is operated as a distinct business entity or division and provide clear accounting standards for its separate financial results.
  - Structure the earn-out to allow the seller, after the sale, to exercise a certain degree of control over the assets, hiring, marketing, budgets, etc. of the target and to have a veto right with respect to material decisions and actions. Typically, the seller's management/owners will want employment agreements with the buyer for the term of the earn-out.
  - Structure the earn-out to allow the acceleration of the earn-out payment upon a sale of assets or a change in the business processes and operations of the target that will materially impact the seller's chances of meeting the established performance measures.

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    - Require that the seller has access to the post-acquisition financial statements of the target.
    - Structure the earn-out to provide for a guaranteed minimum earn-out payment.
    - Structure the earn-out to allow the seller to have veto rights on major decisions affecting the target.

- **Buyer Beware.** While an earn-out is a useful tool for the buyer to keep a sale alive, several drawbacks exist:
    - Most negotiated earn-out provisions will provide for a number of restrictions on the operations of the target post-closing, such as limitations upon changes to the business and capital expenditures and the selection of target's management. Further, the seller's management, if also part of ownership to whom the earn-out is being paid, will want employment agreements with the buyer that may last the length of the earn-out period. As a result, the buyer may not be able to manage the target or utilize the target's assets in the manner that it originally intended or to take advantage of synergies, economies of scale or other benefits and opportunities for which the buyer acquired the target.
    - Businesses hampered by the restrictions listed above under "Seller Beware" are less attractive to future buyers. Therefore, it is imperative that the buyer negotiate for the option of buying-out the earn-out obligations in a lump sum payment upon the occurrence of certain events, such as the receipt of a *bona fide* offer to purchase the target.

As noted above, the operation of any business is subject to a number of unforeseen events that are often not contemplated in an earn-out formula. Therefore, the seller and the buyer should be prepared to engage in a significant amount of negotiation prior to the closing, as well as discussions during the implementation and pay-out stage of the earn-out. Such negotiations will most likely be less painful than arbitrating or litigating an earn-out that has not met expectations.

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PURCHASE PRICE ADJUSTMENTS

- Unlike an earn-out, a purchase price adjustment is utilized when the buyer and seller have agreed upon a purchase price, but there is a substantial period of time that will pass between the signing of a letter of intent (or the definitive purchase agreement) and the closing of the transaction, and the buyer wants to ensure that the target's balance sheet to be delivered at closing will not have deteriorated (or, if it has, then the purchase price will be reduced accordingly). A post-closing purchase price adjustment allows for the purchase price to be adjusted to account for the target's financial condition at the time of the closing of the transaction.

- The most common purchase price adjustment is a net working capital adjustment, although net asset value, net worth and net book value measurements are also utilized. Typically, a purchase price adjustment calls for a dollar-for-dollar adjustment to the purchase price, up or down, to reflect changes in the net working capital (or other measurement established by the parties) between some date, such as the execution of the letter of intent or the definitive agreement, the end of a fiscal quarter or year, or some other relevant date (the Threshold Date) and the date upon which the transaction closes, and is established by comparing the balance sheet of the target on the Threshold Date against the balance sheet on the closing date. A purchase price adjustment can ensure that the seller manages the target in the ordinary course of business consistent with past practice between the Threshold Date and the closing of the transaction, and also to places, squarely on the seller any economic risk (and sometimes reward) involved in the operation of the target during the pre-closing period.

- The following are issues to consider when deciding whether to include a purchase price adjustment:
  - **Be Careful What You Ask For.** A common misconception of purchase price adjustments is they benefit only the buyer. While this is generally the case, it is typical for a seller to negotiate for a two-way purchase price adjustment, and to seek to negotiate a favorable Threshold Date. This means that if there is a positive

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change in working capital or other established measure, then the buyer will be required to pay the seller more than the agreed upon purchase price. Therefore, it is imperative that a buyer thoroughly conduct financial due diligence so that it will have some sense of whether the working capital (or other measure) of the target is likely to increase or decrease before the closing. This potential change is of particular importance when the business of the target is seasonal and there are significant variances in working capital from period to period.

- **Preparation of the Closing Date Financial Statements.** A critical question regarding purchase price adjustments is whether the buyer or the seller will prepare the closing date financial statements. The common belief is that the preparer of the closing date financial statements will have an advantage in dictating the amount, if any, of the purchase price adjustment. Accordingly, both the buyer and the seller will argue that it should be responsible for the preparation of the closing date financial statements. The seller will argue that because it prepared the financial statements for previous periods and operated the business during these periods, it should prepare the closing date financial statements. The buyer will argue that it should prepare the closing date financial statements because it will be the owner of the target at the time those financial statements are to be prepared. As each argument has merit, a common solution is for the seller and the buyer to retain a third-party accounting firm to prepare the closing date financial statements. Even then, however, the buyer and the seller will seek to influence the accounting firm in such preparation.

- **Accounting Issues.** As discussed above under "Earn-outs," the purchase agreement should clearly state the accounting principles to be utilized in the preparation of the closing date financial statements. As described above, stating merely that the financial statements will be prepared in accordance with GAAP is not sufficient, as GAAP principles are not static and encompass a wide variety of accounting practices. For purposes of consistency, the buyer and seller should agree that so long as the target's

financial statements for previous periods were prepared in accordance with GAAP, the accounting principles historically applied to the target will be utilized in the preparation of the closing date financial statements. Where previous financial statements were not prepared in accordance with GAAP, the parties should consider re-calculating the previous period financial statements in accordance with GAAP and using the same accounting principles utilized in the recalculation for preparation of the closing date financial statements. Finally, the parties should not blindly follow GAAP. There may be instances where the nature of the target's business, or the transaction in which the target is being sold to the buyer, dictates an exception to GAAP to fairly reflect the change in an asset or liability.

- **Materiality Threshold/Caps and Floors.** Often, the seller and buyer will agree to a materiality threshold that must be met before a purchase price adjustment will be made. The purchase agreement may provide that once the threshold is met, the seller or buyer will pay any amount in excess of the threshold or the entire amount. Although not typical, purchase agreements also provide for caps and floors which limit the amount by which the purchase price will be increased or reduced, respectively.

- **Errors/Purchase Price Adjustments and Indemnification.** The seller should seek to ensure that the purchase agreement addresses the interplay between purchase price adjustments and the indemnification provisions contained in the purchase agreement. The purchase agreement should be drafted in a manner that ensures that the buyer is not able to recover under the purchase price adjustment as well as be indemnified for a related breach of a representation. For example, if there is an error in the financial statements relating to accounts receivable which triggers a purchase price adjustment, then the buyer should be prohibited from seeking indemnification for a breach of the seller's financial statement or accounts receivable representations and warranties (at least to the extent that the buyer was able to recover for such error under the purchase price adjustment). There may be

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instances, however, where a dollar-for-dollar decrease in the purchase price does not fully redress the damage suffered by the buyer from such misrepresentation.

- **Dispute Resolution.** If the closing date financial statements are prepared by either the seller or buyer, then the likelihood increases that the party who did not prepare the financial statements will dispute the presentation and the amount, if any, of the purchase price adjustment. Most purchase agreements provide that the party not responsible for preparing the closing date financial statements will have a period of time in which to review and object to the results. Therefore, it is important that the purchase agreement contain a mechanism for dispute resolution. A purchase agreement standard is to provide that if a dispute arises in connection with the calculation of the purchase price adjustment, then an independent accounting firm (other than the firm that prepared the closing date financial statements) will be retained to review the closing date financial statements and such firm's determination of the proper resolution of the dispute will be binding upon both the seller and the buyer. The purchase agreement should identify the independent accounting firm to be utilized or set forth the procedure for selecting one, and which party will bear the cost of that review.

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OVERVIEW

The Buyer's Perspective

A buyer often will want to set aside or hold back a portion of the purchase price in order to satisfy post-closing claims it may have against the seller, particularly with respect to purchase price adjustment claims and indemnification claims. If a portion of the purchase price is represented by a note, the note can be readily adjusted to reflect buyer's post-closing claims. Similarly, a holdback provides a source of recovery for the buyer that is not dependent on the potentially cumbersome process of tracking down the seller (who, for example, may have moved and become difficult to locate, or who may be too numerous to track down efficiently), and collecting from the seller (who may become insolvent or otherwise unable or unwilling to pay the claims).

For the buyer, the best approach is to seek a true holdback of the purchase price. In such a scenario, the buyer will retain possession of a portion of the purchase price until the holdback period has expired, at which point the buyer will return any remaining portion of the holdback amount (*i.e.*, the amount of the holdback that has not been used to satisfy buyer's claims under the Purchase Agreement) to the seller. Typically, any interest earned on the holdback amount will become the property of the seller upon the termination of the holdback period, although that point is sometimes negotiated. Also, if all amounts in the escrow fund have been paid to buyer, then buyer will often be entitled to the interest as well.

The Seller's Perspective

The seller will usually object to a true holdback of the purchase price. More often than not, if the seller agrees to any kind of purchase-price holdback, the seller will require that the holdback amount be placed in a third-party escrow account so that the seller has comfort that, assuming that the amount of claims is less than the holdback amount, the seller will be paid the remaining portion of the purchase price (*i.e.*, the seller does not have to worry about whether the buyer will be "good for it").

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PRACTICE CONSIDERATIONS

Proposing A Holdback or Escrow Arrangement

- In proposing a holdback or escrow arrangement, the buyer should anticipate that the seller will propose that the escrow or holdback amount be the buyer's sole post-closing remedy and that the liability of the seller will not exceed the amount of the holdback amount.
- That issue, along with the related issues of the amount of the holdback and the length of time before the remaining funds are released to the seller, can be the subject of intense negotiation.
- Quite frequently, these negotiations tie in with the negotiations of the time periods and limitations on indemnification claims, discussed in Chapter 7.
- The buyer will typically resist the seller's efforts to make the holdback or escrow the exclusive remedy on the grounds that the buyer should not be at risk for liabilities discovered post-closing exceeding the amount of such holdback or escrow.
- If the holdback arrangement covers both working capital adjustments and indemnification claims, it is not uncommon for a portion of the holdback amount to be released following the final working capital calculation, and the remaining holdback amount to be released after the expiration of the indemnification period.

The Escrow Arrangement

- If the parties agree to an escrow arrangement, it is important for the buyer to note that, unlike in a true holdback arrangement, the existence of the escrowed funds does not necessarily mean that those funds will be immediately available in the event that the buyer makes a claim.
- The escrow agent will require certain certifications prior to releasing any funds in the escrow.

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- In the event of any disagreement between the buyer and seller with respect to such funds held in escrow, quite often the escrow agent will not release the funds and will instead retain its own advisors, at the expense of the parties, to help the escrow agent determine the proper actions in such a situation, or even wait until receiving a final court order or judgment. This scenario could lead to a significant delay in a party receiving the funds from the escrow agent.

The Escrow Agent

- Whenever the parties agree to an escrow arrangement, it is important for them to identify who the escrow agent will be as soon as possible.
- Assuming the parties choose a bank or another institutional agent, that escrow agent will typically have its own preferred form of escrow agreement to start with, which will include its own indemnification and other exculpatory provisions that have been approved by the escrow agent's attorneys.
- It is not a good idea for the parties to start with their own escrow agreement, because the escrow agent will likely either retain separate counsel to review the proposed escrow agreement to make sure that it conforms with the agent's policies or simply refuse to use the other escrow agreement and require the parties to use the escrow agent's form, adding delays and extra expense in either case.
- Retaining an escrow agent early in the transaction also allows the buyer and the seller to determine the fees and allow the parties to negotiate how the fees will be split.
- Escrow fees for banks can range anywhere from $1,000 to upwards of $10,000, depending on the size and location of the bank and how much money is held in the escrow.
- The escrow agent's fees are quite frequently split between the buyer and seller.
- As an alternative to using a bank or other institution as an escrow agent, sometimes a law firm of one of the parties will act in the role as escrow agent. However, most law firms shy away from acting

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in this role, because it could create a conflict for the law firm if a dispute arises between the buyer and the seller as to how the escrow funds are distributed.

STRUCTURE OF A TYPICAL ESCROW AGREEMENT

A typical escrow agreement has the following sections:

- **Establishment and amount of the escrow**, pursuant to which a portion of the purchase price is delivered to the escrow agent.
- **Investment of funds**, which specifies how the escrowed funds will be invested. In the vast majority of cases, the escrow funds are required to be invested only in highly liquid, short-term, and safe investments. As mentioned above, typically, if any amount of the escrow remains after the termination of the escrow, any interest earned will be paid to the seller.
- **Disbursements of funds**, which specifies how funds are disbursed from the escrow account. Typically the parties are required to deliver joint written notice to the escrow agent directing where and when the funds are to be disbursed. As mentioned above, in the event of a dispute between buyer and seller as to disbursement, the escrow agent will be entitled to continue to hold the escrow amount until the escrow agent is comfortable with the disbursement (either through joint instructions from buyer and seller, advice from its own counsel or final court order or judgment).
- **Duration of the escrow agreement**, which specifies when any remaining funds will be distributed to the seller.
- **Duties and indemnification of escrow agreement**, which typically clarifies that the duties of the escrow agent are intended to be ministerial only and also sets forth the exculpatory provisions for the escrow agent. Typically the buyer and the seller are required to jointly and severally indemnify the escrow agent for all activities arising out of the escrow agreement, except with respect to the gross negligence or willful misconduct of the escrow agent.
- **Miscellaneous provisions**, including notices and governing law.

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Quite often the escrow agent will require that the governing law be the jurisdiction in which it is located, even if that governing law is different from the governing law for the other transaction documents.

Note: While the foregoing chapter contemplates a cash escrow arrangement, occasionally the parties will place stock in escrow, particularly when stock is part of the purchase consideration. In such a scenario, the parties should pay particular attention to applicable tax and securities law.

OVERVIEW

Representations and warranties are statements of fact made as of a particular time. In the M&A context, the seller is asked to make representations and warranties about itself and its business. This provides the buyer with a clear picture of the seller and allows the buyer to predict and minimize the risks involved with the acquisition. If a representation and warranty turns out to be inaccurate, the party to whom the representation is made may enjoy a number of remedies, including indemnification and/or being entitled to "walk away" from a deal that has not yet closed. Representations and warranties are usually negotiated quite heavily. In most transactions, the buyer will insist on a very comprehensive set of representations and warranties to be given by the seller. However, in an auction context the seller typically will offer more limited representations and warranties. This forces the potential buyer to factor the potential risk of unknown liabilities into the offered purchase price.

Representations and warranties of the seller are often given by both the seller and its owners (particularly if the seller is a private company with few owners). Depending on the form of transaction and the consideration being offered, the buyer typically also makes representations and warranties. For instance, in an all-cash transaction, the buyer generally gives limited representations, such as corporate existence, authority and power to enter into the transaction. However, where consideration such as stock or promissory notes is given, or when payments are otherwise deferred, such as in an earn-out provision, the seller will typically seek more detailed representations regarding the buyer's capitalization and financial condition. Also, regardless of the type of consideration, the buyer may be asked to represent that it has the financing and/or funds in place to consummate the transaction. The buyer generally will resist such a statement and instead suggest that either the seller gain comfort through due diligence or that procurement of acceptable financing be a condition to the seller's obligation to close.

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Given the recent economic downturn and the perceived lack of available financing, sellers are wary of buyers requiring financing and thus may require the buyer to pay a reverse break-up fee if financing is not obtained. In response, buyers are likely to define tightly the financing requirements so that their obligation to close, or to pay a fee if the transaction does not close, is limited to a specific set of identified terms. Alternatively, in all-cash deals, while there is not a risk of financing, there is a risk that the representation by buyer that the available cash listed on its balance sheet is "sufficient" and "immediately available" to consummate the transaction at closing may not be true due to the recent lack of liquidity of certain cash equivalents in the market. To mitigate that risk, sellers may decide to include specific language in the buyer's representations regarding the type and amount of cash held by buyer.

TRENDS

- Prior to the recent economic downturn, private equity and other private transactions were trending toward public company-type deal terms such as:
  - fewer conditions to closing that are more restrictive in their terms;
  - appearance of reverse break-up fees;
  - less buyer protection;
  - more materiality qualifiers on representations and warranties; and
  - limited survival of representations and warranties and limited indemnification.
- Key drivers of the trend were the competitive market generally and the increased prevalence of the auction process. The larger the deal, the more pervasive the influence of these trends on the terms.
- Due to the current economic climate, buyers and sellers are now more closely attuned to the allocation of risk, including those risks that were once considered too remote to ever occur. The pendulum therefore appears to be swinging from seller-friendly representations and warranties to more heavily negotiated representations and warranties with a very careful allocation of risk between the parties.

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DRAFTING CONSIDERATIONS

Qualifications

- Knowledge Qualification
  - The seller will often try to limit disclosure solely to matters that it "knows," whereas the buyer prefers the disclosure not be qualified.
  - Knowledge qualification can be subjective – actual knowledge of a person at a given time – or objective – the knowledge a person would have had after reasonable investigation.
  - When drafting a knowledge qualifier, it is important to specifically identify whose knowledge is imputed to the seller. For instance, "knowledge" often includes the knowledge of officers, directors, executives and key employees.
- Materiality and Material Adverse Effect
  - Materiality
    - The seller also often attempts to qualify representations and warranties to exclude small, unimportant inaccuracies; in other words, to make a representation and warranty that is true "in all material respects."
    - Materiality may be defined in various ways, including a certain aggregate value, a fixed percentage or the omission of a certain fact that if known would significantly alter the overall picture of information. However, often the term is left undefined in the agreement.
    - Where the materiality limitation is placed within the representation and warranty is critical. For example, the meaning of the following statements differs significantly: ***The company is in material compliance with all laws*** versus ***The company is in compliance with all material laws.***

- Material Adverse Effect
  - Materiality may be coupled with the concept of adverse effect to further qualify the seller's disclosure (the "Material Adverse Effect" concept). For instance, the seller may represent that it has all permits and licenses other than those permits and licenses, the absence of which would not be reasonably expected to have a Material Adverse Effect on the seller. In this way, virtually any specific representation and warranty can be qualified. Note that this qualification is generally more favorable (to the seller) than a regular "materiality" qualification.
  - The material adverse effect concept can also be incorporated as a separate representation (e.g., "Since December 31, 2005, the company has not suffered a Material Adverse Effect"). As a separate representation, it provides disclosure about any events that have occurred since a certain date, usually the date of the most recent balance sheet. Generally, the buyer will list a number of specific items relating to the operations of the seller (i.e., contracts over a certain dollar amount, increases in salaries of executives, etc.).
  - Currently, there is much debate as to what qualifies as a material adverse effect. Recent decisions in Delaware and New York have interpreted material adverse effect clauses quite narrowly. Therefore, when drafting a material adverse effect clause, the buyer should include references to specific objective concerns/events to the extent known rather than relying on a general material adverse effect clause to cover every possible event. As a result of the fluctuating economy, buyers should also consider including specific thresholds and quantitative metrics to define a material adverse effect.
  - In addition, due to recent economic events buyers are well advised to narrow the typical broad exceptions to the material adverse effect clauses that are often included by sellers whereas sellers should consider whether the typical exceptions are broad enough to cover their risks or should be further delineated. For instance, take the typical carve-out for "general

business, economic and market conditions." The buyer will argue that the risk of changes due to industry issues should be borne by the seller and thus the carve-out should be narrowed. Sellers, on the other hand, may want to expand the scope of the clause by further identifying certain risks (e.g. ,"…including, but not limited to, changes generally in credit markets, etc.").

Timing

- If the transaction is structured so that a period of time lapses between the execution of the agreement and the closing, the acquisition agreement will include a closing condition requiring that, in order for the buyer to be obligated to close the transaction, the seller's representations and warranties must be accurate as of both the execution and the closing. This is commonly referred to as a "bring-down." Its purpose is to provide the buyer with reassurance that the business it seeks to purchase has not changed in the period between signing and closing.
- Some representations are made as of a certain date (for instance, the financial statements), and typically the bring-down does not apply to such representations. Therefore, to prevent an unintended interpretation of the bring-down, the seller will want to include an exception in the closing condition for any representation made "expressly as of a particular date."
- Because of the bring-down and the "date certain" exception, it is particularly important for both the buyer and the seller to pay close attention to the timing of a representation given. For instance, if the acquisition agreement contains the bring-down with this exception, and the seller represents that there is no pending litigation against it "as of the date of the agreement," the buyer would not have the right to terminate the transaction in the event litigation is brought against the seller after the date of the agreement but before closing.
- See Chapter 6 for a discussion of timing and disclosures related to representations and warranties.

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Common Representations and Warranties

The most common, and most important, representations and warranties are:

- Financial Statements
  - The buyer typically requests that this representation state that the seller's financial statements are "true, complete and correct" and "present fairly" the financial condition and results of operations of the seller for relevant periods. The seller may resist the "true, complete and correct" portion on the basis that those items that are judgment-based and determined in accordance with GAAP, such as reserves, may not ultimately meet such a standard.
  - In addition to audited financial statements, the buyer often requires representations and warranties to interim unaudited financial statements. With regard to the representations made about these interim statements (especially the "fairly presents" portion), the seller may seek to include a materiality qualification to protect the seller in the event the future audited financials of the seller differ from the interim financial statements in any non-material way, or for customary year-end adjustments.
- No Undisclosed Liabilities
  - Even if the seller's financial statements are completely accurate, the buyer still risks exposure for liabilities that arose since the date of those financial statements or liabilities. As a result, the seller is often asked to represent that other than any liabilities (i) set forth on the appropriate schedule, or (ii) reflected or reserved against in the applicable balance sheet, the seller has no liabilities that have arisen since the date of its most recent financial statements.
  - The seller will usually want to include another exception to exclude liabilities it incurs in the ordinary course of business.
  - The seller will also want to include a knowledge qualifier to provide protection for itself if there are any potential liabilities unknown to it.

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- Because many schedules only require the listing of items over a certain threshold, the seller should attempt to limit this representation to those thresholds or create a schedule of those additional liabilities.

- Corporate Organization, Authority, and Capitalization
  - The seller should limit its representation to having all "corporate" power and authority to enter into the transaction in order to limit the representation to only corporate law requirements. Omitting the word "corporate" means that the seller is representing that it has authority under any applicable law and regulation, which is covered in the "No Conflict" representation. Of course, if the seller is not a corporation, it will need to omit the word "corporate" and replace it with another appropriate qualification.
  - In the capitalization portion of the representation, besides representing that the outstanding equity of the seller is validly issued, the seller should be asked to disclose any third party rights to any securities of the seller.

- Taxes
  - The goal of the tax representation is to provide coverage to the buyer in the event of any future claims by governmental entities for taxes. The buyer will often attempt to negotiate a breach of the tax representation out from under any indemnity cap and any survival limitation (See Chapter 7).
  - If the representation regarding past tax returns relates to the date of incorporation of the seller, the seller will attempt to negotiate a more limited time frame to limit exposure if the seller has been in existence for some time.
  - The seller should insist on knowledge qualifications, particularly when asked to make representations that the government will or will not take certain actions with respect to the seller.

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  - The structure of the seller should be incorporated into any tax representations (e.g., Does the seller have subsidiaries? Is it an S corporation? Is it party to a tax sharing agreement?). Involving tax counsel is very important.

- Title and Rights to Assets, Leased Property and Real Property

  - These representations and warranties essentially stand for the seller's affirmation that, with respect to owned real and personal property, it has a "good and marketable" title "free and clear" of all liens unless disclosed. A comprehensive lien search normally catches most exceptions to title.

  - The seller will want to exclude any title problems that do not have a material adverse effect on the value or use of the asset as well as other "permitted" liens such as materialmen's and mechanics' liens.

  - The buyer generally requests a representation that the assets, both owned and leased, are sufficient to operate the company. The seller often will argue that the statement is too subjective. However, the seller may agree to give the representation only if a qualification is added providing that the assets are sufficient to operate the company ***as it is currently being operated.***

- Employee Benefit Plans

  - Even in an asset sale where the buyer does not assume any benefit plans, the buyer has potential risk for liens on the purchased assets which can arise pursuant to applicable federal tax law. Therefore, the buyer may want to include extensive representations regarding all employee benefit plans in order to understand any potential exposure.

  - The buyer may also insist that the seller represent that all employee plans have funding sufficient to cover all plan liabilities as of closing. Because providing such funding is often prohibitively expensive, the seller may refuse to give that representation and instead include separate indemnification coverage for the buyer.

- A specialist should review all benefit plans such as 401(k), insurance, health care, etc. and modify the representation to match his/her findings.

- Compliance with Laws
  - The buyer typically will request a representation that the seller has been, and currently is, in compliance with all laws. The buyer often requests a separate representation regarding environmental laws because of the potential for enormous liability exposure for noncompliance.
  - When looking at the past, the seller will want to limit this representation to a certain time, perhaps the last several years, particularly with respect to environmental laws.
  - The seller will also want to add in qualifiers which can be used in a variety of ways. For instance, the seller could represent that ***to its knowledge***,
    - it is compliant with all laws; or
    - it is in ***material*** compliance with all laws; or
    - it is in compliance with all ***material*** laws; or
    - it is compliant except where any noncompliance would not be reasonably expected to have a ***material adverse effect*** on the seller.

- No Violation; Approvals
  - The "no conflict" representation assures the buyer that the acquisition will not violate or trigger material consequences in connection with any legal or contractual requirement applicable to the seller.
  - The buyer should request that the seller disclose any violations that would occur ***with or without notice or lapse of time*** in order to obtain protection from any potential violation that could occur due to consummation of the transaction.

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- The seller should limit this representation to exclude any violation that occurs or will occur due to actions taken by the buyer in consummating the transaction.

Insurance

- Depending on the potential exposure, the seller may seek to purchase representation and warranty liability insurance which provides protection for breaches of certain seller representations and warranties. Parties should be mindful that the insurance provider will likely conduct independent due diligence and comment on transaction documents.

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INTRODUCTION

- Disclosure letters, often referred to as disclosure schedules or schedules, are an integral part of almost every purchase or merger agreement. Figuratively speaking, schedules are the flesh on the skeleton of the agreement and thus should be considered extensions of and part of the agreement itself.
- Schedules are one method by which a buyer obtains information from a seller; therefore, they assist the buyer with both its legal and business due diligence.
- Schedules should not be thought of as exhibits, which are typically ancillary agreements or certificates that are also part of the transaction. Instead, schedules customarily contain information deemed too lengthy, awkward or detailed to be included in the body of the agreement.
- Perhaps most importantly, schedules provide a convenient method of taking exceptions to substantive representations and warranties in the purchase agreement, thereby allowing the seller to represent accurately to the buyer. For example, the buyer may request the seller to represent that the company being sold is not in breach of any material contracts. If the company is in breach of any contracts, the seller will list those contracts on a schedule. From the seller's point of view, the representation is now true, and the buyer, upon signing the purchase agreement, cannot use the inaccuracy of the representation (due to the omission of the reference to the agreements as to which the seller is in material breach) as either a basis for collecting damages post-closing pursuant to an indemnification provision or as a reason not to close, potentially coupled with a breach of contract action.
- Consequently, in addition to being a source of information, schedules are a means of allocating risk between the parties and imputing knowledge to the buyer. Once the seller discloses information on the schedules to qualify or explain a representation in the purchase agreement, any liability related to that disclosure shifts to the buyer. Accordingly, the importance of schedules to both parties cannot be overemphasized.

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STRUCTURE AND CONTENT OF SCHEDULES

In General

- Schedules typically follow the same order as the purchase agreement and are often designated by the paragraph to which they refer. For example, if Section 2.1(a) of the purchase agreement covers the assets being sold, then Schedule 2.1(a) lists those specific assets.
- Because schedules follow the section headings of the purchase agreement, they often begin with the assets or shares being acquired and then proceed in the order of the agreement, which typically includes representations and warranties, covenants, conditions to closing and other related matters. Because the representations and warranties differ depending on whether the transaction is an asset or a stock deal, the schedules for each type of transaction will similarly differ.
- The seller usually seeks to negotiate the representations and warranties to some extent prior to compiling the schedules because by negotiating for narrower representations and warranties, the seller can disclose less information on the schedules.

Typical Disclosures

- Affirmative disclosures in schedules denote specific information required by the purchase agreement, such as a list of all assets being acquired.
- Negative disclosures in schedules list exceptions to general statements in the purchase agreement, such as exceptions to the seller's compliance with all laws and regulations.
- The schedules in most purchase agreements address the following disclosures:
  - the seller's capitalization and organizational structure (if a stock purchase transaction);

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- included and excluded assets and liabilities (in an asset purchase transaction, but excluded assets may also be included in stock purchase transactions);
- purchase price allocation or earnout formulas for complicated purchase prices;
- clarifying examples and sample calculations related to the transaction;
- tax allocation of the purchase price;
- the seller's insurance policies;
- any litigation involving the seller;
- the seller's intellectual property;
- the material contracts to which the seller is a party and whether the seller is in default in any of those contracts;
- listing of consents and approvals required for the transaction;
- the seller's assets and any related liens;
- employment and labor issues related to the seller, including lists of the seller's employees and their compensation and benefit plans;
- the seller's real property; and
- the seller's compliance with environmental and safety laws.

PERSPECTIVES

Seller's View

- The seller must balance the benefits and drawbacks of competing factors related to the transaction, including the following:
  - maintaining credibility with the buyer;
  - protecting against the possibility that the buyer will withdraw from the deal because of problems identified in draft schedules;

- refusing to permit the buyer, especially a competitor, to know more than is necessary; and
- keeping the buyer interested in the transaction.

- The seller's attorneys should negotiate ardently regarding knowledge and materiality qualifiers. The seller should aim to qualify certain disclosures with knowledge, i.e., the disclosure should not be made as if it were a fact existing in the world but should be limited "to the knowledge of the seller."
- Materiality qualifiers in schedules are often in addition to materiality qualifiers in the agreement. Limiting the scope of disclosures in the agreement itself can significantly reduce the seller's disclosures, and including materiality qualifiers in the schedules provides a further limitation on the scope of the seller's disclosures.
- The seller should also qualify the schedules by what the buyer already knows. For example, the buyer may have discovered negative information about the seller prior to closing. The seller's non-disclosure constitutes an automatic breach, possibly allowing the buyer to bring a claim for breach of a representation. To prevent this outcome, the seller should seek for the buyer to waive claims for damages based on innocent misrepresentations or breaches already known by the buyer. This waiver offers only limited protection, however, because the seller must still prove what the buyer knew prior to closing.
- The seller must be careful to disclose all information everywhere it should be disclosed. Disclosure on one schedule does not automatically mean such information is disclosed everywhere. To avoid the consequences of such a mistake, the seller should state that information disclosed on one schedule is disclosed on all schedules and cross-reference other schedules where appropriate.

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- Schedules permit the seller to disclose sensitive information without including it in the purchase agreement. Because the purchase agreement may become publicly available (whether under the securities laws or by other means), excluding sensitive information from the body of the purchase agreement and including it in schedules limits the likelihood of such information being made public. Importantly though, any disclosure on the schedules is still potentially discoverable by third parties, including the government, and could be used as an admission of the seller in litigation.

Buyer's View

- The most important rule for the buyer is to scrutinize the schedules as carefully as the purchase agreement itself. The buyer should also review and understand all items listed on the schedule whenever possible. For example, if a material agreement is listed on a schedule, the buyer, with counsel's assistance, should review the agreement's terms.
- The buyer should note that if a representation is made true by the inclusion of information in the schedules, the seller has satisfied its disclosure obligations and any liability related to such disclosure is shifted to the buyer.
- The buyer should resist materiality or knowledge qualifiers, if at all possible. Such limitations pose difficulties to the buyer because (1) it is virtually impossible to prove the inaccuracy of such a representation, and (2) to the extent the disclosure affects pricing or earnings, the real issue is not knowledge but risk allocation.
- The buyer should resist any provision proposed by the seller that disclosure on one schedule constitutes disclosure everywhere. Instead, the buyer should insist that information be disclosed on every schedule for which it is relevant.

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- The buyer should negotiate for substantive indemnification provisions covering the schedules, which provide the most effective guarantee that the schedules will be complete and accurate.
- Schedules are generally delivered at the time the purchase agreement is executed. Sometimes though, a period of time may elapse between signing and closing. In that case, the buyer will be interested in any item that arises during such time period which, had it occurred or existed prior to signing, would have been disclosed on a schedule. Purchase agreements often contain a provision requiring the seller to promptly supplement its schedules; however, the buyer's position should be that the supplementary material should not be given effect for purposes of the closing condition that the seller's representations and warranties must be true at closing. If that were the case, then the seller would merely list any negative events that occurred post-signing, and the buyer would have no ability to abandon the transaction because the representations, with the supplemented schedules, would then be correct as of the closing. One compromise the buyer may make is to allow the supplementing of schedules for purposes of the closing condition that the seller's representations be true at the closing, but also to include a closing condition that supplementary items must not be materially adverse to the seller or the seller's business.

Role of Attorneys

- As with the transaction agreements, schedules are legally enforceable and should be drafted and reviewed by counsel; however, barring exceptional circumstances, the decisions about the substantive content of the schedules should be left to the parties.
- Specifically, the seller's management and financial advisors should verify that the contents in the schedules are complete because they possess the most knowledge about the business. The buyer's advisors also should review the schedules to ensure that the disclosures are sufficiently complete to put them at ease.

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PRACTICAL CONSIDERATIONS IN SCHEDULE DRAFTING

- Schedule drafting begins early in a transaction, essentially when the seller prepares the initial offering memorandum or assembles materials to be examined by a prospective buyer.
- The seller's counsel, working with the client, usually drafts the schedules based on the buyer's requests in the purchase agreement.
- Preparing schedules often dovetails with the seller's due diligence efforts. The seller's counsel should begin drafting schedules after or during its due diligence while paying careful attention to the negotiations regarding the representations and warranties, which dictate the required disclosures.
- The model "face-page" of the seller's schedules would include the following language:

  > "The disclosures on these Schedules may be over inclusive, considering the materiality standard contained in, and the disclosures required by, the provisions of the Purchase Agreement corresponding to the respective Schedules, and the fact that any item or matter is disclosed on these Schedules shall not be deemed to set or establish different standards of materiality or required disclosures from those set forth in the corresponding provisions. Any information disclosed on one Schedule will be deemed disclosed and incorporated into each other Schedule for all purposes to the extent the Agreement requires such disclosure. Unless the context otherwise requires, all capitalized terms in the following Schedules shall have the respective meanings as set forth in the Asset Purchase Agreement."

- The buyer should resist language specifying that disclosures made on one schedule are deemed disclosed on every other schedule.

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OVERVIEW

The basic concept of indemnification is that it is a contractual mechanism whereby one party agrees to make another party "whole" against losses that may arise before, during or after the transaction that is the subject of the agreement. In most M&A deals, the seller (and/or its shareholders) will indemnify the buyer from and against certain losses arising out of the transaction. Indemnification provisions are often heavily negotiated, reflecting the conflict between the seller wishing to have minimal continuing responsibility and the buyer seeking protection.

Certain clauses in an agreement may be separately actionable (*e.g.*, breaches of covenants, representations or warranties), but indemnification provides structure and process not otherwise found in an agreement. Indemnity also provides protection against certain types of losses that otherwise may not be protected (*e.g.*, attorneys' fees). As a counterbalance, the indemnity may provide a floor and ceiling, as well as other limits on the exposure and obligation of the indemnitor. Establishing a floor may serve other purposes as well. In many cases, there are practical advantages to both parties in finality of the purchase price, unless the amount involved is substantial.

DRAFTING CONSIDERATIONS

- **Who**
  - **Who** is indemnified – the buyer, but it is frequently extended to its officers, directors, employees and others. The seller is also frequently indemnified, generally with a narrower scope but often with the same process of handling indemnity claims.
  - **Who** is indemnifying – generally indemnification is a joint and several obligation of all indemnifying parties, meaning that the indemnified party can proceed against ***any*** indemnifying party for the full amount of the claimed loss. In some instances, indemnification may be a several (meaning individual) obligation. Sellers not active in running the business may insist on several liability with percentage limitations based on stock ownership. The creditworthiness of the indemnitors is also a factor in

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determining who should be the indemnifying party. When the seller is being indemnified, consider who the proper indemnifying party should be: if the seller ends up with a large percentage of the buyer, the seller may be paying part of the cost of indemnifying itself if the indemnity comes from the buyer.

- **What** is covered – losses, claims, damages (including attorneys' fees) from:
  - Breaches of representations and warranties in the acquisition agreement and the disclosure schedules and certificates delivered at closing, excluding items disclosed in closing supplements to disclosure schedule if that is negotiated.
  - Breaches of covenants.
  - Environmental concerns – while it may be covered in the general indemnity, depending on the type of business, the risk allocation and methods of dealing with environmental claims may justify environmental claims being separately treated.
  - Pending litigation, claims or other matters that may be excluded from the representations and warranties under the disclosure schedule.
  - Events that occur during the period between signing the agreement and closing.
  - Other special concerns.
  - Note: Consider whether ancillary agreements (*e.g.*, non-competition or service agreements) entered into at closing will also be covered by indemnity, or will scope be limited to primary acquisition agreement and schedules?
  - Note: Consider role of knowledge. The buyer will want its right to indemnification to be unaffected by any knowledge the buyer may obtain during the due diligence process. The seller may negotiate for the knowledge of buyer to limit the buyer's claim – in other words, so that the buyer is barred from making an indemnification claim relating to matters it had knowledge of and "closed over."

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- Note: Consider including a non-reliance clause as an additional method to limit the seller's liability. A non-reliance clause provides that the buyer is solely relying on representations contained in the agreement and not on information obtained otherwise (such as through due diligence). If a non-reliance provision is included, the buyer should obtain broad representations from the seller on all topics important to the buyer.

- **How much** is covered:
  - Generally, the entire amount of the loss is covered. However, note that in situations where a multiple is used in determining the purchase price, reimbursement for an out-of-pocket loss does not really make the buyer "whole."
  - A basket is frequently negotiated – the size varying with the size of the transaction and the bargaining position of the parties. Claims which, in the aggregate, fail to fill the basket do not get paid. Once the basket is filled, some agreements provide that the indemnitor is liable for (but only for) the excess (a "non-tipping basket"); others provide that the indemnitor is liable from first dollar – covering the amount in the basket and the amount in excess of the basket (a "tipping basket"). Often certain types of claims (*e.g.*, representations as to capital structure and taxes and claims for breaches of covenants) have no basket and are paid from the first dollar. Consider disregarding materiality qualifiers in the representations and warranties for the purpose of determining whether claims count toward the basket or there may be a "double dip."
  - A cap or ceiling also may be negotiated. This is the maximum amount for which the indemnitor can be held responsible. This negotiation is driven by the relative strength of the bargaining positions. Some sellers argue that the maximum worst case is a return of all consideration received by the sellers; many sellers insist on a much lower cap; some buyers insist that there be no cap, at least for some types of liabilities where the potential liability may be very large (*e.g.*, environmental, ERISA, fraud).

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- Limits of liability – indemnitors often negotiate an exclusion of certain types of damages such as indirect, consequential or punitive damages.
- Exclusivity – the limitations noted above may have little effect if the buyer may disregard the indemnification provisions entirely and instead sue directly on representations and warranties or for breaches of covenants. Thus, the indemnitor may insist that all claims be made under the indemnification provisions so that all are subject to the limitations provided. Note: some types of claims (*e.g.*, securities claims or state fraud claims) cannot be limited by exclusivity clauses.
- Fraud of the indemnitor is commonly carved out of limitations including baskets, caps, limits of liability and exclusivity. However, even if the seller and the buyer agree to allow the indemnification section to cover fraud, a Delaware case has recently upheld the principle that fraud can, in some circumstances, trump contractually agreed restrictions on liability.

- **How** to collect – the process:
  - Prompt notice is required but is often subject to an exception that a delay is not fatal unless the indemnitor is prejudiced by the delay.
  - Cure right – the indemnitor may require a cure period to make the fix before the indemnification applies, unless the matter is one which by its nature cannot be cured.
  - Who speaks for the indemnitor or indemnitee? In situations with multiple indemnitors/indemnitees, some person or entity needs the power to act on their behalf. Often an agent is appointed with the power to bring, defend or settle on behalf of the indemnitor or indemnitee group.
  - Power to resolve claims – if an indemnified claim is the claim asserted by a third party, normally indemnitors insist on the right to defend and select counsel, with the selection of counsel subject to the indemnitee's approval, not to be unreasonably withheld.
  - Indemnitee retains the right to participate at its own cost.

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- Indemnitee may insist on the right to approve settlement of third party claims, not to be unreasonably withheld.
- Set off or escrow – the indemnified party would prefer that any sums owed can be set off against sums thereafter coming due or look to an escrow for recovery. In situations in which the seller is public or has a large number of shareholders, there may be no other practical way to recover.

- **When** is it covered?
  - Customarily, a time period is provided during which indemnity claims can be made. The time is generally tied to the period during which issues may reasonably be expected to become known (*e.g.*, one to two years). The buyer may insist that some types of claims (*e.g.*, stock ownership, capitalization, products liability, taxes, ERISA and environmental issues) have time limits that extend much longer, such as for the period of the applicable statute of limitation.

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OVERVIEW

Taxes are an important factor to consider in evaluating the economics of any potential M&A transaction. From the seller's standpoint, there are major economic differences among:

- a transaction in which taxation of gain may be deferred (commonly referred to as "tax-free reorganization");
- a transaction in which the seller recognizes long-term capital gain (which, for individuals, currently would be taxed at a 15 percent federal long-term capital gains rate, and, assuming for purposes of this discussion, a 6 percent state tax rate with deductibility of state taxes at a 35 percent federal income tax rate, yielding an 18.9 percent combined federal and state income tax rate); and
- a transaction in which gain is subject to double tax, both at the corporate seller level (at a 35 percent federal income tax rate or 38.9 percent combined federal and state income tax rate) and at the individual shareholder level (at a 15 percent federal income tax rate or 18.9 percent combined federal and state income tax rate) resulting in a possible combined corporate and shareholder income tax of 50.45 percent at the federal and state levels.

From the buyer's standpoint, the economics of the acquisition become more attractive to the extent cost-recovery deductions (such as depreciation and amortization) are available for the purchase price that generate a tax benefit to the buyer at a federal tax rate of up to 35 percent or a 38.9 percent combined federal and state rate.

Other tax considerations in a typical transaction include evaluating and allocating pre existing tax exposures of the target and preserving and maximizing the benefit of favorable tax attributes (such as credits and net operating loss or capital loss carryforwards) of the target. The parties should consider the potential tax consequences of the transaction in the early stages of structuring the transaction and, together with their tax and other counsel, seek to create and implement a structure that best accomplishes their business objectives.

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Due to space and practical constraints, these materials address only certain of the basic tax considerations in structuring a corporate M&A transaction. **You are strongly urged to seek tax advice early in the process in connection with structuring M&A transactions.**

References herein to the "Code" are to the Internal Revenue Code of 1986, as amended through the date of this publication, and references to "Regulations" are to the Treasury Regulations promulgated under the Code, also as amended through the date of this publication.

The following table shows the most common corporate merger and acquisition structures:

	Asset Acquisition	Stock Acquisitions
Taxable	Taxable asset purchase (or cash merger or forward subsidiary cash merger)	Taxable stock purchase
	Stock acquisition with 338(h)(10) election treated as asset sale for tax purposes	Reverse subsidiary cash merger
Non-Taxable	Nontaxable asset acquisitions Type "A", "C and"(a)(2)(D)" reorganizations	Nontaxable stock acquisitions Type "B" and "(a)(2)(E)" reorganizations

There are many potential tax and non-tax considerations that may cause the parties to choose a particular form of transaction. Some of the drivers include:

- For the seller:
  - maximizing overall deal return (after-tax);
  - liquidity of consideration; or
  - limiting or eliminating future exposure.
- For the buyer:
  - available forms of consideration/financing;
  - minimizing exposure to liabilities;
  - allocating risk; or
  - maximizing the future profitability of the acquired business (after-tax).

TAXABLE PURCHASE OF ASSETS

- **Generally.** This basic structure involves the purchase of all or part of the sellers's assets for cash and/or notes.
- **Tax Consequences to Seller and Target Shareholders**
  - The target must recognize a gain or loss on a sale of its assets. In addition, the shareholders may pay a second tax on their receipt of the proceeds in a liquidation of the target or as a dividend from the target.
  - This potential double taxation is an impediment to the target agreeing to sell assets. However, in the following situations the target may be amenable to an asset sale:
    - target (or the consolidated group including the target) has net operating losses with which to offset its gain;
    - target is an S corporation which is not subject to Code Section 1374 built-in gains tax;
    - target is a member of a consolidated group and proceeds will be reinvested by the parent; or

- target will not be liquidating or distributing the proceeds but instead will be reinvesting the proceeds.

- Installment Sale Reporting May Be Available
  - Under Code Section 453, deferral of gain may be possible under the installment method to the extent any of the consideration (including contingent payments) will be received in more than one taxable year.
  - The installment method of reporting will not be available to the target with respect to the gain on the sale of certain of its assets. Such assets include loss assets, inventory, personal property if the target regularly sells personal property of the same type on the installment basis, real property held by the target for sale in the ordinary course of its business and stocks or securities traded on an established securities market.
  - Installment reporting does not apply to the extent of depreciation recapture under Code Sections 1245 and 1250.
  - Code Section 453A imposes an interest charge on the deferred tax to the extent the taxpayer holds installment obligations at the end of its taxable year in excess of $5 million.
  - Because the $5 million threshold requirement under Section 453A applies on a seller by seller basis; the interest charge on the seller's deferred tax liability may be more likely to apply to a sale of assets (one seller) than to the sale of the target's stock by its shareholders.

- Planning Techniques to Mitigate Double Tax
  - Most often, consideration is given to techniques that allow payment of consideration directly to target shareholders with one level of tax. These may involve consulting agreements or covenants not to compete. In such cases, the payments will be taxable to the shareholders as ordinary income.
  - Under Code Section 197, payments made by a buyer pursuant to a covenant not to compete are deductible by the buyer over 15 years.

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- Consulting payments generally may be deductible when paid or accrued unless they have substantially the same effect as a covenant not to compete, in which case they will be treated as a covenant not to compete.
- With appropriate facts, it may be possible for a shareholder to sell "Personal Goodwill" and recognize capital gain if, because of the circumstances, the "Personal Goodwill" is not considered an asset of the target.

- **Tax Consequences to Buyer**
  - The buyer will take a cost ("stepped-up") basis in the purchased assets.
  - To the extent that the buyer pays an amount to the target for the assets in excess of the target's basis in such assets, that premium will generate additional tax deductions to the buyer in the form of depreciation or amortization, or a lower taxable gain in the event the assets are resold.
  - This premium is often attributable to goodwill (going concern value, workforce in place) in which the target has no basis.
  - Purchased goodwill generally is amortizable over 15 years under Code Section 197.
  - Allocation of Purchase Price
    - Code Section 1060 provides that in the case of an "applicable asset acquisition," the purchase price must be allocated among the acquired assets pursuant to the "residual method" prescribed in Section 338(b)(5) of the Code and the Regulations thereunder.
    - Generally, purchase price is allocated to various categories of assets to the extent of their respective fair market values and the remainder (residual) is allocated to goodwill. The buyer's and the target's interests are not always aligned in making these allocations.

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- ◐ The buyer will want to maximize the allocation to assets that generate the most rapid cost recovery deductions. The target may want to minimize depreciation recapture, maximize allocations that generate capital gain rather than ordinary income (particularly if the target is a pass through entity such as an S corporation or partnership whose gain is taxed to its owners at individual tax rates) and minimize state taxes triggered by allocations in the case of a multi-state business.
- ◐ The buyer and target may negotiate and agree to the purchase price allocation though their agreement is not binding on the IRS.

- **Non-Tax Considerations in Taxable Asset Sale**
  - May allow the buyer to purchase only specific assets and assume only specific liabilities (although there are legal exceptions to the ability to avoid the target's liabilities).
  - May involve voluminous transfer documentation to effectively transfer each asset.
  - Certain licenses or contract rights may not be transferable or may require third-party consents.

- **Cash Merger Treated as Asset Purchase**
  - Rather than the target selling its assets to the buyer and subsequently distributing the proceeds to its shareholders, the target may merge into the buyer or a subsidiary of the buyer with the target's shareholders receiving cash and/or notes for their stock. The IRS will view this taxable merger as if the target had sold its assets to the buyer (or its subsidiary) and then undergone a complete liquidation. (Rev. Rul. 69-6, 1969-1 C.B. 104).
  - The merger route may be appropriate, however, only if the buyer is willing to assume all of the target's contingent liabilities and the target desires to sell all of its assets. This liability concern may be mitigated by merging the target into a single member limited liability company owned by the buyer (which is disregarded as a separate entity from the acquirer for tax purposes).

- A merger usually avoids the more difficult documentation and consent requirements applicable to an asset sale. A merger may also avoid state transfer taxes that may be applicable to a sale of assets.

SECTION 338(H)(10) ELECTION – STOCK PURCHASE TREATED AS AN ASSET PURCHASE

Code Section 338(h)(10) allows an eligible buyer and target to make a joint election for each of the target and buyer to treat a stock purchase as an asset purchase, followed by a deemed liquidation of the target. This election is available only if the buyer is a corporation and the target either is an S corporation or a member of an affiliated or consolidated group. This might be used as an alternative to an asset sale where assets include licenses and contract rights that are difficult to transfer.

- **Tax Consequences of Section 338(h)(10) Election**
  - Stock sale is disregarded.
  - Deemed sale of assets by target; gain or loss recognized by target as if it had sold all of its assets.
  - An allocation of purchase price among the target's assets (using the residual method) is required.
  - There is a deemed liquidation of the target following the deemed sale of assets. Generally, there will be no second tax on this deemed liquidation. In the case of an S corporation, the target's gain passes through to its shareholders and increases the basis in their stock so no additional gain is triggered. In the case of a deemed liquidation of a member of an affiliated or consolidated group, the liquidation is generally tax-free under Code Section 332.
  - The target's basis in the newly acquired assets is stepped-up to reflect purchase price as if they had been purchased in an asset acquisition.
  - The target may use net operating losses against its gain on asset sale.

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- Tax attributes (net operating losses, credits) remain with selling group.

TAXABLE PURCHASE OF STOCK

- **Generally**
  - This basic structure involves the purchase of all or part of the target's stock from its shareholders for cash and/or notes.
- **Tax Consequences for Target Shareholders**
  - Each target shareholder may be entitled to capital gains treatment on the sale of his or her target stock.
  - Currently, for individual taxpayers, the maximum federal tax rate on long term capital gain is 15 percent (14 percent for gain on the sale of certain qualified small business stock under Code Section 1202).
  - For corporations, there is no rate differential for long term capital gain; the top corporate income tax rate is 35 percent for amounts of taxable income over $10 million.
  - Again, installment sale reporting may be available to the extent consideration is payable to shareholders in more than one taxable year.
- **Tax Consequences for Buyer**
  - The target will retain its existing basis in its assets.
  - Because the buyer thus takes a "carryover" basis, it gets no tax benefit for any premium it may have paid for the target's stock.
  - The target's tax attributes, such as net operating loss carryforwards and credits remain intact, and may be used by the buyer and/or the target after the acquisition, subject to limitation under Code Sections 269, 382, 383, and 384.

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- **Non-Tax Considerations in Taxable Stock Sale**
  - All of the target's liabilities are indirectly assumed.
  - All shareholders may need to agree to sell stock.
- **Reverse Subsidiary Merger Alternative**
  - The parties can achieve the same results as a purchase of stock by having the buyer form a subsidiary and merge that subsidiary with the target, with the target as the surviving corporation (a reverse subsidiary merger).
  - Pursuant to the merger agreement, the target's shareholders will receive cash and/or notes and the buyer will receive the target's stock, so that after the transaction the target is a wholly owned subsidiary of the buyer.
  - The reverse subsidiary merger is treated as a purchase of stock under Rev. Rul. 73-427, 1973-2 C.B. 301. This structure may be preferable where the target has a large number of shareholders and it is impractical to secure the agreement of each to sell his or her stock.

ACQUISITIVE REORGANIZATIONS UNDER CODE SECTION 368

Requirements For All Section 368 Reorganizations

- **Continuity of Proprietary Interest**
  - Generally, at least 40 to 50 percent of consideration must be buyer stock. Rev. Proc. 77-37, 1977-2 C.B. 568 (50 percent for advance ruling purposes).
  - Target shareholders generally can immediately dispose of the buyer stock except by transfer back to the buyer without failing to satisfy the continuity of proprietary interest requirement. Treas. Reg. Section 1.368 1(e).
- **Continuity of Business Enterprise**
  - The buyer must continue the target's historic business or use its historic assets in business. Treas. Reg. Section 1.368-1(d).

- **Business Purpose**
  - "The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms." Treas. Reg. Section 1.368-1(b).

TAX-FREE REORGANIZATION – ASSET ACQUISITIONS

- **Type "A" Reorganization**
  - An "A" reorganization, so called because it is described in Code Section 368(a)(1)(A), is the most flexible form of reorganization. This is a merger under state law (or foreign law under recently finalized regulations).
  - An "A" reorganization also includes a merger into a disregarded entity (such as a single member limited liability company) owned by the acquiring corporation. The basic requirements applicable to all reorganization transactions apply.
  - Again, at least 40 to 50 percent of the consideration payable to the target shareholders should be buyer stock.
- **Type "C" Reorganization - Stock For Assets**
  - A "C" reorganization, i.e., a reorganization described in Code Section 368(a)(l)(C), is one in which an acquiring corporation acquires the assets of the target in exchange for voting stock. The requirements of Code Section 368(a)(1)(C) are as follows:
    - The buyer must acquire "substantially all" of the target's assets.
      - For IRS ruling purposes, "substantially all" means at least 90 percent of the fair market value of the target's net assets and at least 70 percent of the fair market value of the target's gross assets. Rev. Proc. 77-37. The target may

however "substitute" newly acquired assets or sale consideration for other assets and get credit toward the 90/70 test. Rev. Rul. 88-48, 1988-1 C.B. 117.

- The consideration must be solely buyer voting stock (or voting stock in a corporation in control of the buyer), except:
  - 20 percent other property ("boot") is allowed, provided that, if there is any boot, liabilities assumed also count as boot for purposes of applying the 20 percent boot exception. Code Section 368(a)(2)(B).
- The target must liquidate and distribute the buyer voting stock pursuant to the plan of reorganization. Code Section 368(a)(2)(G).

- **"(a)(2)(D)" Forward Triangular Merger**
  - In a forward triangular merger pursuant to Code Sections 368(a)(2)(D) and (a)(1)(A), the buyer forms a subsidiary which merges with the target. The subsidiary is the surviving corporation in this merger. Target shareholders receive buyer stock. The requirements of Code Section 368(a)(2)(D) are:
    - No stock of the subsidiary is used in the transaction.
    - At least 40 to 50 percent of the consideration received by target shareholders is stock of the buyer.
    - The subsidiary acquires "substantially all" of the target's assets in the transaction.

- **Tax Consequences of Asset Reorganization for Target Shareholders**
  - Target shareholders recognize no gain or loss to the extent that buyer stock (including stock in a corporation in control of the Buyer in the cases of "C" reorganizations or (a)(2)(D) forward triangular mergers) is received in the reorganization. Code Section 354. However, target shareholders recognize gain (taxed as either capital gain or as a dividend) to the extent of any "boot" received. Code Section 356.

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- Nonqualified Preferred Stock Treated as Boot. Code Section 351(g) treats as "boot" certain types of preferred stock with debt-like characteristics – nonqualified preferred stock received by target shareholders in a reorganization. Nonqualified preferred stock is defined as preferred stock which is limited and preferred as to dividends and does not participate in corporate growth to any significant extent and with respect to which, subject to certain exceptions:
  - the holder has a right to require the issuer (or a related person) to redeem or purchase the stock;
  - the issuer (or a related person) is required to redeem or purchase the stock;
  - the issuer (or a related person) has the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that the call right will be exercised; or
  - the dividend rate on the stock varies in whole or in part with reference to interest rates, commodity prices, or other similar indices.

- **Tax Consequences for Buyer**
  - The buyer (or an acquiring subsidiary) takes a basis in the assets equal to the basis of such assets in the hands of the target. Code Section 362(b). (Basis is stepped-down to fair market value in the case of built-in loss assets received from a transferor whose gain or loss from such assets would not be subject to tax. The target's tax attributes such as net operating losses and tax credits carry over to the buyer (subject to limitations under Code Sections 269, 382, 383 and 384). Code Section 381.

- **Non-tax Considerations**
  - Assumption of Liabilities
    - "A" Reorganization. Following the merger of the target into the buyer, the target's liabilities are assumed by the buyer and all of the buyer's assets are subject to those liabilities. Note that a merger into a single member limited liability company owned

by the buyer avoids subjecting all of the buyer's assets to the target's liabilities.

- "C" Reorganization. The buyer has the ability to assume only selected liabilities.
- "(a)(2)(D)" Forward Triangular Merger. The target's liabilities are assumed by the subsidiary. However, the buyer's assets are not subject to those liabilities.

- **Transferability of Assets**
  - In the "A" reorganization or "(a)(2)(D)" Forward Triangular Merger, the target's assets are transferred by operation of law. In the "C" reorganization, the assets must be assigned.
- Flexibility of Consideration
  - The "A" reorganization and "(a)(2)(D)" Forward Triangular Merger are the most flexible. The "C" reorganization limits the consideration to solely or principally voting stock.

TAX-FREE REORGANIZATION – STOCK ACQUISITIONS

- **Type "B" Reorganization – Stock For Stock**
  - A "B" reorganization, i.e., a reorganization described in Code Section 368(a)(1)(B), is one in which an acquiring corporation acquires the stock representing "control" of the target solely in exchange for voting stock. The requirements of Code Section 368(a)(1)(B) are as follows:
    - The buyer must acquire "control" of the target.
      - "Control" for this purpose means stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the number of shares of all other classes of stock of the corporation.
    - The consideration must be solely buyer voting stock (or voting stock in a corporation in control of the buyer), without exception.

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- **"(a)(2)(E)" Reverse Triangular Merger**
  - In a reverse triangular merger pursuant to Code Sections 368(a)(2)(E) and 368(a)(1)(A), the buyer forms a subsidiary which merges with and into the target. The target is the surviving corporation in this merger. Target shareholders receive buyer voting stock in the merger. The requirements of Code Section 368(a)(2)(E) are:
    - In the transaction, the target shareholders must exchange stock representing control of the target (80 percent, as defined above) for buyer voting stock. (Thus, the maximum amount of boot that may be permitted is 20 percent of the consideration.)
    - After the transaction, the target must hold "substantially all" of the target's and the merged subsidiary's assets.
- **Tax Consequences of Stock Reorganization for Target Shareholders**
  - Target shareholders recognize no gain or loss to the extent that buyer stock (including stock in a corporation in control of the buyer in the case of a "B" reorganization) is received in the reorganization. Code Section 354. Again, target shareholders recognize gain (taxed as either capital gain or as a dividend) to the extent of any "boot" received. Code Section 356.
- **Tax Consequences for Buyer**
  - The target retains its existing basis in its assets. In a "B" reorganization, the buyer takes a basis in the target stock equal to the basis of such stock in the hands of the target shareholders. Code Section 362(b).
  - In an "(a)(2)(E)" reverse triangular merger, the buyer's basis in the target stock is determined by reference to the target's asset basis as though the target had been merged in a forward triangular merger. Treas. Reg. Section 1.358-6(c)(2)(i).
  - The target's tax attributes such as net operating losses and tax credits remain intact (subject to limitation under Code Section 269, 382, 383 and 384).

- **Non-tax Considerations**
  - **Assumption of Liabilities:** The target's liabilities remain with the target. The buyer's assets, however, are not subject to those liabilities.
  - **Transferability of Assets:** No target assets are specifically assigned.
  - **Flexibility of Consideration:** The "(a)(2)(E)" Reverse Triangular Merger may allow up to 20 percent non-voting stock consideration. The "B" reorganization limits the consideration to solely voting stock.

LIMITATIONS ON USE OF TARGET TAX ATTRIBUTES FOLLOWING ACQUISITION

The following highlights the Code Sections that may limit the utilization of tax attributes (particularly, net operating losses and credits) following an acquisition. These rules, particularly Code Section 382, are complex and merit detailed investigation if a target with net operating losses is being acquired. In addition to the following Code Sections, consolidated return regulations may impact the utilization of tax attributes following an acquisition.

- **Code Section 269.** Section 269 grants authority to the IRS to disallow deductions or credits where any person acquires assets of a corporation in a tax-free transaction or control of a corporation if the principal purpose of the transaction is acquiring the tax benefits.
- **Code Section 382**
  - This Section limits the use of net operating loss carryovers following an ownership change.
  - An ownership change occurs when 5 percent shareholder(s) increase ownership by more than 50 percentage points during the testing period (testing period generally equals 3 years).
  - Special aggregation, segregation and option rules may apply in determining whether an ownership change has occurred.

- An ownership change limits the amount of net operating losses that can be utilized each year to the Section 382 limitation (the product of the IRS long-term tax-exempt rate multiplied by the equity value of target at the change date).

- **Code Section 383.** This section is an analogue to Section 382 and limits the utilization of credits following an ownership change.
- **Code Section 384.** This Section limits the use of the buyer's pre-existing losses to offset built-in gains in the target's assets following an acquisition of assets under Code Sections 368(a)(1)(A), (a)(l)(C) or (a)(1)(D).

TAX INDEMNIFICATION

Buyers should be extremely careful in drafting tax indemnification language. In many cases, indemnity agreements are construed in favor of the indemnitor (i.e., no indemnity), and the burden may rest upon the party asserting an obligation of indemnification to establish that the obligation exists. In 2008, a court in Texas refused to enforce a tax indemnity provision against a seller where a target's NOLs were reduced by a governmental authority after the closing. As a result, the buyer had unexpected taxable income after the closing and sought an indemnity.

The buyer claimed a right to indemnification based on the theory that the NOLs had a sufficient relationship to pre-closing tax years and that "but for" the reduction in the NOLs, the buyer would not have owed taxes in a post-closing tax year. The court disagreed reasoning that NOLs were "tax attributes," not "taxes," and thus they were not covered by the indemnity provision. Accordingly, buyers should be very careful to distinguish between the treatment of "taxes" and "tax attributes" and the extent to which the indemnity provision covers the two.

STATE TAX CONSIDERATIONS

The following is a brief summary of various state and local tax issues that are often encountered in M&A deals.

- **Corporate Income Tax**

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- The overwhelming majority of states impose some form of tax on the net income of corporations. Most states have adopted the federal income tax base, with certain specified adjustments. Because few states have adopted specific provisions addressing corporate mergers and acquisitions, the federal tax rules will generally govern for state income tax purposes.
- There are important distinctions, however, in many states. For instance, some states disallow net operating loss carrybacks, and some states limit net operating loss carryforwards following stock sales or reorganizations. Also, while most states respect a Section 338(h)(10) election, some states modify the tax treatment. Parties should always carefully examine state law where a Section 338(h)(10) election is contemplated.
- Due to constitutional constraints, states may only tax the income of corporations that have "substantial nexus" with the taxing state. The law relating to nexus is not well developed, and states have adopted inconsistent positions. It is generally accepted, however, that certain factors such as ownership of real property or operation of a business establish "substantial nexus" with a state. Purchasers should understand that acquiring an asset in a state in which the purchaser is not presently engaged in business may expose the purchaser to the corporate income tax of that state.
- Where a corporation conducts business in more than one state, the corporation's business income is apportioned among the states according to state apportionment formulas. Business income includes income from tangible personal property if the disposition of the property is an integral part of the taxpayer's regular business operations.
- On the other hand, nonbusiness income is allocated to a single state according to the type of income. Capital gains and losses on the transfer of real and personal property are allocated to the state in which the property is located, and capital gains and losses from the transfer of intangible property (e.g., stock) are allocated to the state of the corporation's commercial domicile.

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- A planning opportunity may exist where a stock or asset sale results in nonbusiness income potentially allocable to a low tax or no tax jurisdiction.

- **Sales and Use Tax**
  - A retail sales tax is generally imposed on the transfer of ownership or possession of tangible personal property for consideration for any purpose other than resale and on certain service transactions specified under state law. Sales of real property and intangible property (including stock) are generally not subject to the sales and use tax. Also, the sale of inventory is treated as a sale for the purpose of resale and, therefore, does not generally result in sales or use tax.
  - A use tax generally applies to the first-time use of tangible personal property in a state if that property was purchased outside the state and was not subject to retail sales tax. The use tax is complementary to the sales tax and is intended to prevent consumers from avoiding the sales tax burden by purchasing goods in a state that does not impose sales tax.
  - While state statutes provide numerous exemptions from the tax, the exemptions differ from state to state. Some states provide an exemption for the sale of business assets, and some states provide an exemption for specific corporate transactions such as incorporations, reorganizations, and liquidations. Other states, however, have no specific exemptions for M&A transactions. Parties should carefully review the relevant state statutes and regulations in the early stages of planning a transaction.

- **Gross Receipts Tax**
  - In addition to the sales and use tax, some states such as Washington also impose a "gross receipts tax" for the privilege of conducting business in the state. This tax is imposed on gross receipts from specified business activities (e.g., retail sales, wholesale sales, etc.).

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- **Franchise Tax**
  - Some states tax the apportioned net worth of a multi-state corporation. Note that a tiered corporate structure may subject the corporate group to double tax.
- **Property Tax**
  - The purchase of real property may cause the property to be reassessed for ad valorem tax purposes. Thus, purchasers should be cognizant of the potential for increased property tax exposure.
  - In addition to ad valorem taxes, states often impose a stamp or recording tax on the transfer of real estate.
- **Successor Liability**
  - Most states impose successor liability on the purchaser of a business unless the state is notified of the sale and issues a tax clearance certificate. Generally, the purchaser is required to withhold state taxes from payment to the seller until notification by the state of the tax liability. Failure to withhold results in personal liability for the purchaser.

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OVERVIEW

Whenever there is a transfer of ownership of an employer, significant liabilities can arise in the employee benefits and executive compensation areas. This is true whether the transfer involves stock or assets, whether there is only one facility or a group of facilities or whether the employer entity merges into another entity or is the survivor. Liabilities associated with benefit plans and compensation arrangements can be staggering. It is important to note that many benefit plan liabilities can trigger personal liability for members of boards of directors, compensation committees and other plan fiduciaries.

WHAT BENEFITS AND COMPENSATION LIABILITIES CAN BE TRIGGERED BY M&A TRANSACTIONS?

The broadest potential for liability occurs in **ownership transactions**, such as mergers and stock purchases. In an ownership transaction, the successor entity, or buyer, steps into the shoes of the predecessor entity, or seller, with respect to all past and present liabilities related to its benefits and compensation arrangements. In the case of a merger, or where one party is receiving equity of another entity as part of the transaction consideration, each party to the transaction may have a legitimate interest in investigating the liabilities of the other.

On the other hand, **asset transactions** cover everything from mere purchases of the machinery of a business to the purchase of a large operating division of an existing entity, in each case usually followed by separate hiring of some or all of the workers associated with the assets. One of the advantages of an asset transaction is that the buyer can minimize its assumption of the liabilities and obligations of the seller by purchasing assets free and clear of existing liabilities, other than those the buyer specifically agrees to assume. However, asset transactions are rarely so "clean." For various reasons, the buyer may agree to assume, or may be deemed by law to have successor liability with respect to, one or more of the existing benefit plans or compensation arrangements of the seller. If a plan is assumed, the potential liability considerations are similar to those described in connection with ownership transactions, at least with respect to the assumed plan.

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EXAMPLES OF POTENTIAL LIABILITIES

- **Qualified Retirement Plans** – (e.g., 401(k) and pension plans)
  - Non-compliance of plan documents or operations with ERISA and the Internal Revenue Code (e.g., execution of plan document and required amendments, plan qualification, etc.)
  - Breach of fiduciary duties
  - Plan funding errors
  - Actuarial assumptions used to determine plan assets and funding liabilities
  - Withdrawal liability (or partial withdrawal liability) for collectively-bargained pension plans
  - Correction of errors, including potential restitution to the plan and participants
  - Cost of professional services to maintain the plans and programs
  - Testing failures (e.g., nondiscrimination testing, coverage testing, testing of qualified separate line of business, etc.)
  - Form 5500 Annual Reports and other annual notices
  - Compliance of participant-directed investments with ERISA
  - Improper distribution of required notices and disclosures
- **Welfare Benefit Plans** – (e.g., health, life and disability)
  - Violations of COBRA (health care continuation coverage) HIPAA (portability, privacy and security) and cost of post-closing COBRA obligations
  - Taxation of discriminatory benefits to highly-paid employees
  - Improper funding of deductions
  - Unfunded benefit liabilities owed to current and future retirees and former employees

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- Non-compliance of plan documents or operations of cafeteria plans and flexible spending accounts
- Improper distribution of required disclosures and notices
- Testing failures (e.g., nondiscrimination testing and coverage testing)
- Form 5500 Annual Reports and other annual notices
- Inconsistencies between plan documents and insurance policies
- Stop loss coverage issues

- **Nonqualified Deferred Compensation** – (e.g., SERP, unfunded plans for select management or highly compensated employees, individual agreements to defer compensation)
  - Potential acceleration or termination of obligations under these arrangements because of the transaction
  - Cost of benefits promises
  - Impact of accounting standards
  - Code Section 409A non-compliance (nonqualified deferred compensation rules)
  - Code Section 162(m) non-compliance (performance-based compensation for public companies)
- **Executive Employment Arrangements** – (e.g., employment, change of control agreements)
  - Costs associated with "golden parachute" arrangements (including loss of tax deductions for payment, tax gross-ups and coverage of employee excise tax)
  - Severance obligations that could be triggered by the transaction or the termination (including "good reason" resignation) or reassignment of the executive after the transaction
  - Salary and benefits mandates after the transaction

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- Acceleration of vesting in equity grants or improper promises of qualified plan vesting due to the transaction
- Code Section 409A non-compliance

- **Equity-Based Incentive Plans** – (e.g., employment, change of control agreements)
  - Required payouts under existing equity incentive plans
  - Acceleration of vesting and/or extension of exercise periods
  - Substitution of stock awards
  - Code Section 409A non-compliance
- **Collectively Bargained Benefits** – (e.g., multiemployer pension plans)
  - Ongoing contribution obligations, including increases for plans in critical or endangered status
  - Withdrawal liability or partial withdrawal liability
- **Collectively Bargained Benefits** – (e.g., multiemployer pension plans)
  - Ongoing contribution obligations, including increases for plans in critical or endangered status
  - Withdrawal liability or partial withdrawal liability
- **Workforce** –
  - Loss of desired key employees
  - Costs of terminating or retaining workforce (e.g. benefits, salaries, bonuses)
  - Costs of vesting benefits under the seller's plan
  - Transitional administrative responsibilities

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- Making up lost deductible and out-of-pocket limits in insurance policies and forfeited FSA balances
- Compliance with federal requirements regarding notice of plant closures or layoffs

STEPS TO MINIMIZE LIABILITY

Early consideration is crucial to minimize possible liabilities from benefit plans and compensation arrangements. The following basic steps should be included at the beginning of any transaction process:

- **Identify all benefit plans and compensation arrangements of each party**
  - Perform due diligence to determine which types of plans exist:
    - *Qualified retirement plans*: Are there 401(k), profit sharing, money purchase, employee stock option or pension plans?
    - *Welfare plans and programs*: Are there medical, dental, prescription, vision, life, disability or AD&D insurance or self-insured programs; vacation or PTO programs; or severance policies or programs, offered to active workers and/or retirees?
    - *Executive compensation arrangements*: Are there plans providing equity or equity equivalents, such as stock options, restricted stock, phantom stock, SARs, or RSUs? Are there short or long-term performance-based compensation or other bonus arrangements? Change in control agreements? Employment contracts?
    - *Other documents*: Do other arrangements mandate or otherwise impact benefits, such collective bargaining agreements, employee leasing or PEO arrangements, employee handbooks, employment offer letters and contracts or government contracts?

- Determine the total annual expense of each arrangement and when contributions to and payments from the arrangement become due
- Involve HR personnel and others who know what to look for and are involved in the administration of the arrangements

- **Discuss benefits and compensation goals early in negotiations**
  - Determine your goals for the post-closing company's compensation and benefits package:
    - *No Impact on Workforce*: Do you intend for the workforce to see no change in its compensation and benefits package? If there will be other members of a controlled group of entities post-closing, will different benefits violate applicable laws?
    - *Workforce Treated the Same as Others within the Surviving Group of Entities*: Should the workforce be brought into the fold and treated the same as everyone else (for better or worse)? If so, how will existing benefits and compensation arrangements be transitioned? Can they be terminated?
    - *Leave the Workforce in Parent Plans and worry about Changing Benefits at Year-End*: Does the applicable plan document allow this and is the parent willing to consent? How will related liabilities be apportioned between the parties? Are appropriate insurer consents and protections in place? Does the purchaser want to be liable for post-closing severance obligations under existing employment contracts?
  - Solicit input from HR personnel charged with managing the affected workers and the benefit plans and compensation arrangements under review.

- **Identify key aspects of the transition of benefit plans and compensation arrangements**

  Asset Transactions

  - Will there be an assignment of insurance policies and insurer consents? If so, will the insurer credit workers with year-to-date health care deductibles and out-of-pocket maximums?

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- Should flexible spending arrangement balances be transferred so they are not forfeited to the seller?
- Can 401(k) loans be transferred in-kind? Will they default?
- Do continuing workers have non-competes or severance payouts that should be waived?
- Are change-in-control provisions triggered?
- Do equity interests exist and how will they be handled?
- Could withdrawal liability be triggered in union plans?

Stock Transactions

- Do qualified retirement plans need to be terminated pre-closing to avoid liabilities?
- Are change-in-control provisions triggered?
- Do equity interests exist and how will they be handled?
- Do prior problems exist for which specific indemnification or escrow is needed?

- **Allocate responsibilities between the parties in the transaction**

Based on the goals and the key aspects of the transition:

- Decide whether and when to terminate a plan, merge plans into one or have a successor employer sponsor an existing plan
- Assess the consequences of terminating, merging or continuing benefit plans and compensation arrangements
- Consider federal and state regulatory and tax schemes that govern employee benefits and executive compensation arrangements
- Determine which liabilities are allocated pursuant to law and which can be allocated within the transaction documents

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- Be aware that assumption of benefit plans and compensation arrangements, whether by operation of law (e.g. through a stock purchase) or by contract, also means assumption of any past compliance issues and operational violations ("past sins")
- Determine who will pay for transferring liabilities and whether escrows, working capital adjustments or other credits will be needed
- If government contracts exist, determine if government approvals are needed in order to modify benefit plans or compensation arrangements

- **Draft (or revise) the agreement**
  - *Seek advice of legal counsel familiar with the benefits and compensation issues*
  - *Draft (or revise) the representations and warranties*
    - Tailor representations and warranties to the particular circumstance and business (e.g., law compliance, tax qualification, no prohibited transactions, etc.) and the potential liabilities that exist
    - Tie up loose ends or unanswered questions by including specific reps
    - Include special provisions to avoid large liabilities, such as multiemployer plan withdrawal costs and 280G gross-ups
  - *Draft Covenants*
    - Ensure the availability and/or future protections for the workforce (e.g. non-solicitations, guaranteed compensation and benefit levels)
    - Allocate responsibility for actions that address benefits and compensation requirements
    - Allocate post-closing responsibilities, such as COBRA
    - Include special provisions to avoid multiemployer plan withdrawal liabilities

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- *Draft Indemnities*
  - Consider tax and benefits rules limiting disclosures, mandating records retention and setting the maximum period for claims

- **Perform all necessary actions pre- and post-closing**
  - Assume the necessary insurance policies, plans and other arrangements
  - Compute and record accruals to date of transaction

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Intellectual property issues can be an important consideration in many M&A transactions. While transactions involving some businesses (e.g., software companies) plainly implicate these issues, they can also be important in less obvious circumstances. Frequently, the parties to a transaction do not realize the significance of the target's intellectual property rights and assets until the due diligence process or the negotiation of the definitive purchase agreement.

OVERVIEW

There are four basic areas of intellectual property law which can be relevant in a transactional context. This section will briefly discuss each in turn.

- **Trademark** - A trademark is anything that identifies the source of goods or services and distinguishes them from the goods or services of others. Trademarks usually include the name of a company, product or service, a slogan, logo, domain name, packaging and/or product design (e.g., "Microsoft," "Crest," "What Can Brown Do For You?", the Toyota emblem, the Coke bottle, Amazon.com, etc.). Trademark law generally prohibits the use of similar marks by different companies in connection with related businesses, such that consumers are likely to become confused and mistakenly believe that two mark owners are the same company or have a relationship with each other. The non-confusing use of famous marks is also prohibited.

  Trademark registration confers important benefits, such as nationwide rights and a presumption that the mark is valid. Trademark owners are generally required to prevent third parties from infringing their marks and to monitor the quality of goods and services sold under their marks by their licensees. Problems often arise in these areas in M&A transactions -- for instance, a target may fail to obtain or maintain a trademark registration, may inadequately enforce its rights to its mark against third parties or may practice inadequate quality control over its licensees. We discuss ways to address these issues in the "Practice Tips" section below.

- **Copyright** - Copyright law protects original works of authorship, such as reports, marketing materials and computer code (software). The copyright owner has the exclusive right to copy, modify, distribute, publicly display and publicly perform the work. The creator of copyrightable work normally owns the copyright to that work, unless the work was created by an employee for the employer within the scope of the employee's employment, or the creator expressly assigns the copyright, in writing, to a third party.

  Frequently, due diligence may reveal that a copyrighted work was created for the target by an independent contractor without a written assignment to the target. In that circumstance, the contractor -- not the target -- owns the work and can often license it to anyone else, including the target's competitors. At best, the target will only own a non-exclusive license to use the work.

- **Patent** - A patent generally protects useful methods, formulas or devices that are novel and non-obvious. A patent grants a temporary monopoly to the patent owner, potentially prohibiting competition and/or positioning the owner to receive licensing revenue.

  With patents, it is important to pay attention to the "bar date." If a party makes, sells, offers to sell or makes certain disclosures of a patentable invention, that party has one year to file a patent application or else lose all possible U.S. patent rights. However, most foreign countries do not provide this one-year grace period. For example, if the target has been selling an innovative new product in the U.S. for over a year without filing a patent application, all of the target's patent rights in that product are lost. This is an important area to explore in due diligence.

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Patent ownership involves issues and recommendations similar to those discussed with copyrights above. Targets should obtain intellectual property assignments, in writing and up front, from all individual inventors, regardless of whether those inventors are employees or contractors. Patent assignment language in the transaction documents also needs to be carefully drafted because of some counterintuitive rules regarding the right to sue and/or recover damages for past patent infringement.

- **Trade secrets** - Trade secret protection generally covers information that is valuable because it is not publicly available. Common examples include client or customer lists, pricing details and contact information of customers, suppliers, distributor relationships, etc.

  A common pitfall here is the target's failure to adequately protect its trade secrets. If this occurs, the information can lose its legal status as a trade secret and thus lose the special protections afforded by trade secret law. Buyers should conduct thorough due diligence to determine the extent to which the target has protected information that may qualify as a trade secret, including the routine use of nondisclosure agreements and limiting access to sensitive information.

INTELLECTUAL PROPERTY LICENSING

Intellectual property licensing can be a critical issue in M&A transactions. Often, the target uses a third party's intellectual property under a license agreement to run its business, but that license will either not survive the acquisition, will expire shortly thereafter or will otherwise not provide any benefit to the buyer. In other circumstances, the target may have licensed its own intellectual property to third parties in a way that is inconsistent with the buyer's post-acquisition strategy, including granting exclusive licenses that will prohibit the buyer from subsequent licensing to third parties, or granting broad licenses to third parties that allow those licensees to compete with the buyer and/or the target.

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PRACTICE TIPS FOR M&A TRANSACTIONS INVOLVING IP ASSETS

In all deals involving intellectual property assets:

- Intellectual property–specific due diligence should be conducted, including a review of:
  - the relevant records of the U.S. Patent and Trademark Office, the U.S. Copyright Office, court records, and if applicable, foreign governmental authorities;
  - all license agreements in which the target obtains or grants intellectual property rights; and
  - all agreements between the target and any employees or contractors who may have developed intellectual property for the target.
- The transaction documents should be carefully drafted to address areas of risk identified in the due diligence process. This is most frequently accomplished in the target's representations, warranties, indemnification obligations and/or pre- and post-closing covenants. From the target's perspective, of course, it is important to avoid provisions that are overly broad or that might require the target to assume unreasonable risks.

IDENTIFYING ASSETS TO BE SOLD

In a transaction involving the sale and purchase of an entire company, the particular assets being sold are easily identifiable. On the other hand, in a transaction involving the sale or purchase of a discrete division of a company, identifying the assets of the business carried on by the division is usually the key to structuring a successful transaction.

Shared Assets

From a buyer's perspective, it is very important to know which assets of the division are shared with the seller's other business units, in order to determine the (a) cost of replacing these shared assets or (b) cost of continued sharing (if possible).

- Software is one of the most common shared assets among a company and its various divisions.
- If it is not possible (or very expensive) for the buyer to acquire a necessary "shared asset" post-divestiture, then the buyer should determine whether sublicensing from the seller (either on a royalty free or low royalty basis) is possible, and, if it is, should seek to negotiate such an agreement as part of the acquisition.
- As part of its diligence, the buyer should also verify whether continued use (through sublicense) of the "shared asset" requires consent of the original licensor/provider.

Shared Services

It is also important to determine which services are provided by the seller to the acquired division. The most common shared services are:

- Tax/Accounting
- Legal
- Human Resources
- Information Services
- Insurance

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- Central Purchasing/Supply
- Marketing

For at least a certain period of time, the buyer may want to continue to have the seller provide these services through a Transition Services Agreement (discussed further below).

Shared Operations

In many cases, a division shares the same facilities as its parent or with other divisions, where sharing such space allows the division to operate more cost-effectively than if it were in a stand-alone space. In addition, the division may be supplying raw materials or other products to its parent or is selling products "jointly" with other products sold by the parent and/or other divisions as a package to certain customers (whether or not at reduced package rates). In most cases, buyers will want to seek to have existing shared operations arrangements continue for some period of time post-divestiture.

Purchase Agreement Considerations

- Assets being acquired should be listed with as much specificity as possible. Depending on the circumstances, the description of the transferred assets may include phrases such as:
  - all assets used "exclusively" in the business (which may be further listed on a schedule);
  - all assets used "primarily" in the business (which may be further listed on a schedule); and
  - only those assets specifically listed on a schedule.
- The buyer should require a representation that all assets being acquired are those necessary to conducting the business of the division as previously conducted.

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LIABILITIES TO BE ASSUMED

Where a public company divests a division, in most cases, the surviving entity has both the financial and administrative capability of bearing unknown liabilities, therefore, a buyer can negotiate with the seller to retain such liabilities. In a private company context, this negotiation is a bit more tenuous, and it is more likely that certain unknown liabilities will be picked up by the buyer as part of the negotiation. In most division sales by private companies, the buyer should, and normally does, require monetary escrows to cover some of these liabilities. As with all M&A deals, environmental and product liability may, by law, flow through to a buyer, so the buyer should negotiate appropriate indemnities with the seller and consider purchasing liability insurance to cover potential costs of these assumed liabilities.

NON-COMPETITION AGREEMENTS

Since the seller will likely survive the divestiture of one of its divisions, it is important that a buyer negotiate, either in the purchase agreement or in a separate agreement, a non-competition agreement with the seller and, if appropriate, certain key personnel/shareholders. Key provisions that are normally negotiated between the buyer and seller include:

- scope of the business activity that is subject to the non-compete;
- duration of the non-compete and other restrictive covenants;
- geographic scope of the restrictive covenants; and
- persons/entities to be bound by these covenants.

In many cases, governing law of the agreement may also dictate how broad or narrow these terms may be in order to be enforceable under the laws of that jurisdiction.

EMPLOYEE ISSUES

There are a number of employee related issues that can arise with the sale of a division.

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Employment Agreements/Severance

A seller should make sure that any employment agreements are terminated and any severance benefits or change-of-control payments (whether by agreement or company policy) are waived by any employees who will be hired by the buyer.

Benefits

In many instances, the benefit plans provided by the seller of a division are not entirely consistent with the plans proposed to be offered by the potential buyer. Further, the seller's plans may cover employees across multiple divisions. As a result, benefit accruals, pension plan transfers, multiemployer plan issues and other employee-related liabilities are often the most negotiated piece of a division sale. In most cases, buyers should try to avoid responsibility for liabilities in respect of current and former employees (including retirees). The buyer should compare the potential liabilities incurred when assuming any of the seller's benefit plans to the advantages of assuming any of those plans (vendor pricing, etc.). If assuming plans, the buyer should get indemnification from the seller for potential plan liabilities such as underfunded plans.

AUDITED FINANCIALS

Because regular audits are not typically performed on divisions, a seller may not want to provide a separate audit to the buyer. Such an audit normally takes six to eight weeks to complete. If a fast closing is imperative, a buyer may negotiate a post-closing covenant to receive the audited financials coupled with an adjustment mechanism to the purchase price if the audited financials are materially different from the unaudited financials provided prior to closing.

Of particular importance in reviewing separate division financials is the review of the allocation of corporate charges. In most cases, these will not be actual costs, and will therefore not reflect the ongoing cost of running the business post-closing. The buyer will need to take this into account when developing projections of corporate overhead to keep the business running after the acquisition is complete.

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TAX CLEARANCE

The buyer should be aware that in most states, it could be liable for certain of the seller's outstanding tax liabilities (typically capped at the purchase price) if it pays the purchase price prior to obtaining tax clearance certificates from all relevant jurisdictions. Potential liability varies from state to state, but may relate to outstanding sales/use taxes, employment taxes, franchise taxes and/or other taxes and could extend beyond the tax liabilities of the acquired division to tax liabilities of other parts of the seller's business. The best way to protect against this is to have the seller obtain these certificates prior to closing. If a closing must occur without these for any reason (e.g., seller may resist buyer's request for a tax clearance inquiry for fear of triggering an audit), the buyer can protect against this liability by getting an indemnity from the seller and/or escrowing a portion of the purchase price.

INSURANCE/RISK MANAGEMENT

Insurance for most divisions is held at the parent company level, so the buyer will need to make sure that it has new insurance policies in place immediately upon closing. Historic coverage applicable to the division should be carefully reviewed (preferably by experienced internal or third party risk managers) prior to the acquisition to determine appropriate coverage levels.

PERMITS/LICENSES

A division may be operating under licenses or permits held by the parent company, and not all licenses or permits held by the parent company may be applicable to the division. Therefore, it is important that early in the transaction, the buyer work with the seller to determine which permits/licenses will be required to operate the business going forward and determine what is required of the buyer to obtain those licenses. In many states, a company may need employees with specific technical expertise, education or licenses to obtain certain permits, so it is important to determine these requirements, to the extent possible, prior to consummating the acquisition.

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TRANSITIONAL SERVICES

In many cases, it will be beneficial to both parties to enter into a "transition services agreement" or other similar arrangement for a period of time post-closing (which will vary based on the services). An acquired division may need to purchase raw materials from the selling parent company (or vice versa) as part of its continuing business. It may also have to continue to share facilities for a period of time or need back-up office support until new hires can be made. Both the seller and buyer should consider these items at the time of the acquisition, rather than post-closing when one of the parties may have less leverage to negotiate favorable pricing.

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OVERVIEW

The purchase and sale of distressed companies involves certain unique aspects that are distinct from transactions involving financially healthy businesses. Distressed companies often face cash flow challenges due to an over-leveraged balance sheet, poor operating performance or a combination of both. Resolving cash flow issues, meeting the needs of customers and vendors and satisfying debt service requirements places significant pressure on the distressed business.

Fiduciaries of distressed companies, with the assistance of their financial and legal advisors, may determine that a sale of all or part of the business is a viable strategic alternative that both preserves going concern value and resolves the liquidity crisis.

Such dispositions can either occur through a court-supervised process (typically in Federal Bankruptcy Court) or without court supervision. This chapter focuses on issues involved in the decision by distressed businesses to take companies into a court-supervised bankruptcy process and how a sale of a business in a bankruptcy context differs from a non-bankruptcy context.

INITIAL INQUIRY: SELLER'S SOLVENCY

- Once directors determine that their business is in financial distress, they need to make a further determination of whether the company meets the legal definition of insolvency. Fiduciaries of insolvent businesses have obligations to their creditors that override their normal obligations to their shareholders. These obligations can impact the methods of selling a distressed business.
- While there are many possible definitions of insolvency, U.S. courts tend to rely on three measures. One method, the balance sheet test, involves an assessment of the debtor's assets and liabilities – if the debtor's liabilities exceed its assets, then the debtor is insolvent. Another method, the cash flow insolvency test, focuses on the debtor's ability to pay its debts as they become due. The last method focuses on whether the debtor's capitalization is sufficient for it to conduct its business as a going concern.

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Fiduciary Obligations

- Under ordinary circumstances, directors owe fiduciary duties of care, loyalty and good faith to their corporation and its stockholders. When a corporation becomes insolvent, however, the relationship changes and the directors owe fiduciary duties to the corporation's creditors – namely, to be loyal, to act for the financial benefit of the creditors in all matters and to enhance the financial interest of the insolvent corporation.
  - Under Delaware law, Delaware courts have fashioned a "quasi trust fund doctrine" whereby corporate directors must do everything in their power to protect the remaining assets of the corporation for the benefit of creditors.
  - A small minority of courts have taken the view that even though insolvency shifts the directors' fiduciary duties primarily to creditors, the directors continue to owe a duty to the corporation's stockholders. This complicates the obligations of directors by imposing potentially conflicting fiduciary obligations.
- This extension of fiduciary duties to creditors of an insolvent corporation may occur prior to liquidation or commencement of bankruptcy proceedings. In the seminal Delaware case in this area, the Delaware Chancery Court held that when a debtor is operating in what is known as the "zone of insolvency," the directors owe a duty to the creditors.

Director or Officer Liability

- Under certain circumstances, directors or officers can have personal liability for a breach of their fiduciary obligations to all creditors. Most often liability occurs when directors or officers have diverted corporate assets for the benefit of insiders or preferred creditors. In the sale of business context, certain transactions can be the subject of intense scrutiny by creditors including transactions that do not involve fair consideration.

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- These fiduciary obligations and the risk of personal liability often lead the seller to file for the protection of bankruptcy. Upon the commencement of a bankruptcy case, new corporate governance mechanisms are imposed with court supervision and potentially the appointment of a trustee to oversee the case.

DISTRESSED TRANSACTIONS: BANKRUPTCY

- Both the buyer and the seller may prefer for the sale of the seller's business to occur in a court-supervised process. Generally, there are two bankruptcy methods. A buyer may acquire assets from the debtor seller as part of a confirmed Chapter 11 plan of reorganization or liquidation. More typically, asset sales under Section 363 of the U.S. Bankruptcy Code involve a Chapter 11 debtor seller and a prospective buyer presenting a fully negotiated asset purchase agreement to the Bankruptcy Court for approval. Section 363 sales are subject to a court-supervised auction process. Other methods include a friendly foreclosure of assets, an assignment for the benefit of creditors or a Chapter 7 Trustee liquidation sale.

Benefits of Bankruptcy Process

- There are several benefits to purchasing a distressed business in a bankruptcy context as compared to a non-court-supervised transaction. These benefits include:
  - **Elimination of Fraudulent Conveyance Risk.** The buyer of assets from a debtor seller in bankruptcy eliminates fraudulent conveyance risk that might otherwise exist in a purchase prior to bankruptcy.
  - **Elimination of Successor Liability Except for Future Claims.** Typically, the transfer of assets through a Section 363 sale is *free and clear of all liens, claims and interests*, and thus eliminates successor liability. The ability to be relieved of all future claims is more uncertain and depends upon the facts and circumstances.
  - **Certainty.** Bankruptcy supervised sales have the benefit of a known process. The sale process can, and often does, occur very

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rapidly because the debtor seller is usually severely cash constrained and must sell its business before losing all going concern value for the estate. In order to have a Section 363 sale of substantially all of the debtor seller's assets outside of a bankruptcy plan context, the debtor seller must show that either exigent circumstances exist or that there is a compelling business justification to necessitate the sale.

- **Finality.** The sale of assets pursuant to Section 363 to a good faith buyer for value cannot be set aside, modified or reversed on appeal and thus ensures the buyer finality.
- **Access to Due Diligence Information.** A buyer of assets from a debtor seller in bankruptcy will have complete access to financial and other information of the debtor seller. The debtor seller is required to file, under penalty of perjury, detailed schedules of all of its assets and liabilities, a detailed statement of its financial affairs and monthly detailed operating reports.
- **Treatment of Executory Contracts and Leases.** In bankruptcy, a debtor seller may reject burdensome contracts. Further, a debtor seller may assume and assign favorable contracts and leases to a buyer without the consent of the non-debtor party to such agreement; notwithstanding any anti-assignment provision contained in such an agreement.
- **Additional Seller Benefits.** The debtor seller also benefits from the automatic stay protections of the Bankruptcy Code, allowing time to hold off creditors from taking precipitous actions against the property of the debtor seller, which in turn fosters creditor negotiations.

Disadvantages of Bankruptcy to the Seller

- There are certain disadvantages to the seller in electing to file for bankruptcy protection.
  - **Loss of Control.** Outside of bankruptcy, the seller controls its own affairs. Once in bankruptcy, the Court ultimately controls

the activities of the debtor seller, and the Court may appoint a trustee to supervise the operations and strategic decisions of the debtor seller.

- **Risk of Loss in Value.** The expense of a bankruptcy process, coupled with the market impact on the business, can lead to an erosion in value of the business.
- **Reputation Loss.** Some business executives worry about the professional or market stigma associated with the bankruptcy process.

Disadvantages of Bankruptcy to the Buyer

- Generally, there are two principal disadvantages to a buyer in buying assets in a bankruptcy context. First, the Bankruptcy Court will ***require an auction sale of the debtor seller's assets*** to ensure that the debtor seller is realizing the highest price possible. Thus, the buyer has the unavoidable risk that it may be outbid at the auction or that it may be forced to bid a higher price then it had fairly negotiated. Second, the assets will usually be sold "as is, where is" with few representations and warranties, leaving the buyer with little or no recourse against the debtor seller.
- There are ways of mitigating these risks:
  - **Break-up Fees; Control of Auction Rules.** With respect to the auction problem, the initial buyer can attempt to negotiate a *break-up fee,* usually ranging from 1 to 5 percent of the purchase price, to compensate the initial buyer (*i.e.* the "stalking horse") in the event that it is not the highest bidder. The initial buyer can also request that it receive expense reimbursement up to a cap and that the bidding process imposes minimum increments for an over-bid. The Bankruptcy Court does not always allow break-up fees or other stalking horse protections, however, so there can be no certainty at the beginning of the process.

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- **Limited Recourse.** The buyer can attempt to negotiate a "hold-back" of a portion of the purchase price to secure certain limited representations and warranties or attempt to negotiate a purchase price based upon post-acquisition gross sales or net profits. Again, these methods are the subject of vigorous negotiation and must be approved by the Bankruptcy Court.

DISTRESSED TRANSACTIONS: NON-BANKRUPTCY

Seller Issues

The seller's principal concerns outside of bankruptcy relate to its fiduciary obligations (as discussed above) and the lack of finality associated with a non-bankruptcy sale. Unless the proceeds from the sale transaction are enough to satisfy all creditors of the seller, the seller will continue to face creditor issues and potential claims and litigation. While the sale transaction might be completed outside of bankruptcy, the potential need for a voluntary bankruptcy filing and the risk of an involuntary filing will continue to exist.

Buyer Issues

Buyers of troubled companies outside of the Bankruptcy Courts face two major risks: successor liability and fraudulent conveyance.

- Successor Liability
  - Most buyers of troubled businesses will structure their transaction as an asset purchase, thereby attempting to avoid assuming liabilities associated with the troubled business. As a general matter, buyers of assets are not liable for any liabilities of the seller, however, there are a number of important exceptions that will require consideration in connection with a troubled business.
    - **Contractual Assumption.** The buyer will have successor liability if it expressly or impliedly agrees to assume the liabilities of a seller. The purchase agreement will need to very carefully establish what liabilities are being excluded from the purchase and what liabilities are being assumed. Even a carefully

drafted purchase agreement, however, will not absolutely limit successor liability due to various state and federal doctrines described below.

- **De Facto Merger/Mere Continuation.** The buyer will also have successor liability if the buyer is deemed to have engaged in a "de facto merger" with the seller. The most critical factor implicating the "de facto merger" exception is whether the shareholders of the buyer are the same as the shareholders of the seller. While this doctrine is a creature of state law, generally four elements must be present:
  - there must be a continuation of the enterprise of the seller (continuity of management, personnel, physical location, assets and general business operations);
  - there must be a continuity of shareholders such that the shareholders of the seller become shareholders of the buyer;
  - the seller must cease its ordinary business operations, liquidate and dissolve as soon as legally possible; and
  - the buyer must assume those liabilities and obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller.

  In addition to "de facto mergers," the buyer can also have successor liability under the legal theory of "mere continuation of the business," which theory has many of the same elements as a "de facto merger."

- **Bulk Transfer Laws.** The buyer will also have successor liability if it fails to comply with any applicable state bulk transfer laws. Generally, a bulk transfer involves a sale, not in the ordinary course of business, but of a substantial portion of the ***inventory*** of the seller. Some, but not all, states have eliminated their bulk transfer statutes. Compliance with these statutes requires notice to all of the seller's creditors (in some states by registered mail or by publication) and other specified procedures. Failure to comply with these statutes generally permits the seller's creditors

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to sue the buyer (at least up to the fair value of the assets acquired) for six to twelve months following the transaction.

- **Special Statutes.** Certain federal and state statutes can also override the intention of the parties in an asset transaction regarding successor liability. If the seller has existing federal labor and employment claims, environmental claims and/or product liability tort claims, a buyer needs to be especially cautious, since these claims can have their own "successor" standard.

- Fraudulent Conveyance
  - The doctrine of fraudulent conveyance can also be applied to impose liability on buyers. The applicability of this doctrine turns on the facts and circumstances giving rise to the transaction. Generally there are two types of fraudulent transactions:
    - **Actual Fraud.** These are transactions in which there is an actual intent to hinder, delay and defraud creditors of the seller.
    - **Failure of Due Consideration.** These are transactions made by an insolvent seller, where the seller does not receive fair consideration.
  - A successful fraudulent transfer claimant may, among other things, set aside the transfer or obligation to the extent necessary to satisfy the creditor's claims. Such a remedy can include the recovery of any fraudulently transferred property or its monetary value. In particular, highly leveraged transactions may be worth scrutinizing to avoid the risk of these claims being made.
  - There are several possible ways of structuring transactions to avoid facing significant fraudulent conveyance risk. Due care must be taken to ensure that the surviving entity has reasonable expectations of meeting its fixed obligations following the leveraged transaction. Generally, leveraged transactions will not be fraudulent conveyances if some of the following elements are present:
    - no prejudice to existing creditors;

- the seller is solvent following the transaction and has adequate capital;
- the transaction involves adequate consideration; or
- the seller practiced good faith.

DISTRESSED TRANSACTIONS: SPECIAL CONSIDERATIONS

Business and Due Diligence Concerns

- All distressed transactions (whether inside or outside of a bankruptcy process) involve certain special circumstances that need to be carefully addressed in the negotiation and documentation of the deal. A critical component of any distressed transaction involves the need to do comprehensive due diligence on the business. Determining the underlying root causes of the insolvency is vital to understanding the viability of the business under new ownership. A distressed business places pressure on all of the seller's key constituents, including customers, vendors and employees.
  - **Customers.** Distressed businesses often will have delivery or quality problems in their product areas. Key customers may find alternative suppliers and thus erode the seller's business.
  - **Vendors.** Often, distressed businesses create short-term financing by stretching the terms of their trade payables. Even following a sale to a new owner, existing vendors may be unwilling to extend terms or may require significant monetary or other assurances to continue supply. Often there has been a lack of communication or a loss of trust that impacts long-term relationships and cannot be addressed merely through a change in ownership.
  - **Employees; Culture.** Distressed businesses often run the risk of losing key employees who have more promising alternatives. The use of retention bonuses is one means of ensuring continuity of employment. The seller's business culture may also be damaged due to various attempts to achieve short-term liquidity objectives at the expense of good business practices. The buyer should understand what methods were utilized during the financial

crises and the resulting impact upon the business culture of the troubled enterprise.

Definitive Agreements

- The definitive agreements for a purchase of a distressed business have certain common features.
  - **Limited Representations and Warranties.** The scope of the representations and warranties is likely to be less comprehensive than in a non-distressed deal.
  - **Limited Value of the Indemnities/Purchase Price Holdback.** There is typically limited value in the seller indemnities received in a distressed transaction. The contractual remedy for this problem is to reserve purchase price as a holdback against future indemnity claims. The purchase agreement should also provide for strong set-off rights for the buyer. The purchase price holdback can be jeopardized in the event that there is a future, near-term bankruptcy of the distressed seller.
  - **Earnouts.** There may be significant disagreement over the valuation of the troubled business due to the current financial distress. Earnings and revenues may be artificially depressed. Earnouts present a way to bridge the valuation gap in a transaction, although creditors will often resist any conditions to consideration. See Chapter 3.
  - **Tax, Environmental and Product Liability Issues.** These substantive areas pose particular challenges due to the risk of successor liability as discussed above.

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Additional Bankruptcy Concerns

- In bankruptcy, certain additional problems occur on a fairly regular basis.
  - **Interim Operating or Management Agreement.** Sometimes the debtor seller requires that the buyer take over operation or management of the business for sale ***prior to the sale being approved***. The buyer may view this as an advantage given the opportunity to conduct pre-acquisition due diligence from within the debtor seller's business. A principal disadvantage, however, is that the buyer is potentially exposed to claims from the debtor seller or the debtor seller's creditors that the buyer's management damaged the debtor's business further or resulted in the further deterioration of the value of the debtor's assets. The buyer should thus seek clearly defined limits on its financial exposure. The interim management agreements that govern these relationships will be the subject of much negotiation and court approval.
  - **Insider Payments.** Insiders, such as management or shareholders of the debtor seller, often desire to receive cash consideration as part of the sale transaction. Usually, however, there are not enough net proceeds to satisfy all of the existing obligations owed to creditors. These payments sometimes take the form of consulting agreements or covenants not to compete. These arrangements face intense court and creditor scrutiny.
  - **Insider Purchases.** Occasionally, the former management or shareholders of the debtor seller attempt to acquire the assets for less than the amount necessary to satisfy all of the existing obligations owed to creditors. Insider buyers will need to be prepared to make a compelling showing to creditors and the Bankruptcy Court about the fairness and appropriateness of such a transaction in order to gain court approval.

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OVERVIEW

Even after the transaction closes – after the documents have been signed and the champagne corks popped – certain important tasks remain. Post-closing matters are usually not controversial or the subject of acrimony between the parties, but failure to properly attend to such issues in a timely manner can impact both the buyer and the seller.

POST-CLOSING CHECKLIST

A post-closing checklist is critical for ensuring that post-closing matters are properly completed. Most post-closing matters are the responsibility of the buyer, but some, such as following-up on purchase price adjustments or earn-out obligations, are the concern of the seller, or both buyer and seller.

The following is a list of typical post-closing tasks, with the party or parties usually responsible for such tasks shown in parentheses. Of course, there is no feasible way to list all such post-closing tasks, as they necessarily differ from transaction to transaction.

- Correcting or amending ancillary documents that were not completed before closing (buyer and seller).
- Obtaining executed consents and approvals not obtained before closing (seller's obligation, but critical for buyer).
- Obtaining consents of landlords (buyer and seller).
- Finalizing and executing any ancillary documents required by the purchase documents which were not completed at closing, but which the buyer agreed in writing would be completed post-closing (buyer).
- Filing deeds or instruments of assignment or transfer of real and personal property (buyer).
- Filing Articles of Amendment or other documentation with the appropriate state authority, typically the Secretary of State (buyer).

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- Obtaining final title insurance commitments or policies, where real estate is involved in the transaction (buyer).
- Recording of mortgages and perfecting security interests (buyer).
- Filing UCC-1 Financing Statements (buyer), and UCC-3 Termination Statements (seller).
- Obtaining release of mortgages (seller).
- Completing and documenting any purchase price adjustment required to finalize the purchase price, including documenting a closing-date audit for balance sheet pricing purposes (buyer and seller).
- Monitoring compliance with earn-out provisions where a portion of the purchase price is dependent on the future success of the company (seller).
- Collecting receivables owed to the seller pursuant to the Purchase Agreement and transmitting such collected amounts to seller (buyer).
- Contributing acquired assets to buyer's subsidiaries, if applicable (buyer).
- Allocating the purchase price among the assets for income tax purposes and filing a proper asset allocation statement with the Internal Revenue Service (buyer and seller).
- Completing government filings such as with the Patent and Trademark Office, Securities and Exchange Commission, etc. (buyer).
- Filing reports with the SEC or state securities authorities (buyer).
- Terminating or amending pension plans of the acquired company (buyer and seller).
- Terminating the selling company or changing its name (seller).
- Monitoring covenants not to compete and/or non-solicitation contracts (buyer).
- Releasing any escrowed funds pursuant to the Purchase Agreement, following expiration of any indemnification period (buyer and seller).

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- Sending pertinent documents to interested third parties, such as lenders, mortgagees, landlords, government agencies (buyer and seller).
- Sending original documents to the appropriate parties and distributing a complete set of transaction documents to all parties (buyer).

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OVERVIEW

In mergers and acquisitions involving private companies, the parties primarily are concerned with compliance with state corporate statutes in their respective states of incorporation. However, where mergers and acquisitions involve public companies, the parties must also consider compliance with federal securities laws and other considerations uniquely applicable to public companies.

The primary federal securities laws to be considered are the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934 (Exchange Act), together with the rules, regulations and forms adopted under these acts by the Securities and Exchange Commission (SEC). The Securities Act primarily covers the registration requirements for securities and related disclosure requirements. The Exchange Act primarily covers disclosure and reporting requirements for public companies.

This Chapter provides a brief summary of the principal filing and disclosure requirements and related considerations under the Securities Act and the Exchange Act affecting mergers and acquisitions.

Additional filing and disclosure requirements apply to international cross-border transactions and going-private transactions; however, these requirements are not addressed in this Chapter. For additional information concerning requirements and other considerations applicable to public companies, please see our Corporate Governance Quick Reference Guide.

REGISTRATION STATEMENTS

- In general, securities issued in connection with a merger or acquisition involving a public company, including exchange offers, are considered securities being sold to target shareholders. These securities must be registered under the Securities Act unless an exemption is available. In this regard, an exchange offer for securities will generally not be permitted to close until a registration statement covering the securities has been filed and declared effective by the SEC.

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- For shares issued in connection with business combinations and exchange offers, the parties must deliver a prospectus to target shareholders and to accomplish that, must generally file a registration statement on Form S-4. Part I of the Form S-4 includes information required in a prospectus, and Part II of the Form S-4 includes information that is not required in a prospectus and is only filed with the SEC.
- The prospectus must include information about the transaction, the registrant and the company being acquired, including relevant financial information. **Please see Form S-4 for more detail about the disclosure requirements.**
    - The prospectus must include a summary of the material features of the transaction, including:
        - a brief summary of the terms of the acquisition agreement;
        - each party's reasons for engaging in the transaction;
        - a description of the registrant's securities;
        - an explanation of any material differences between the rights of security holders of the company being acquired and the rights of holders of the securities being offered;
        - a brief statement of the accounting treatment of the transaction; and
        - the federal tax consequences of the transaction.
    - If a third party has provided an appraisal, fairness opinion or similar report relating to the transaction, and the report is referenced in the prospectus, the prospectus must include:
        - the identity of the third party providing the report;
        - the qualifications of the third party;
        - the method of selection of the third party;

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        - any material relationship that existed during the past two years and any compensation received or to be received as a result of the relationship between the third party and the company;
        - if the report relates to the fairness of the consideration, whether the company determined the amount of consideration to be paid or whether the third party recommended the consideration to be paid; and
        - a summary of the appraisal, fairness opinion or other report.
    - The prospectus must contain *pro forma* financial information with respect to the transaction, prepared in accordance with Article 11 of Regulation S-X.
    - For disclosure requirements relating to the use of non-GAAP financial measures, please see Chapter 8 (Use of Non-GAAP Financial Measures) of our Corporate Governance Quick Reference Guide.
- Under certain circumstances described in Form S-4, the registrant may be entitled to incorporate by reference information about the registrant or the company being acquired. In that case, the prospectus must be sent to security holders no later than 20 business days prior to the date on which the meeting of security holders is held or, if no meeting is held, at least 20 business days prior to either:
    - the date of the vote, consent or authorization of those security holders or
    - the date the transaction is consummated or the votes, consents or authorizations may be used to effect the transaction.
- If either party submits a proposal to its security holders entitled to vote on or consent to the transaction, and that party's submission of that proposal is subject to Regulation 14A or 14C under the Exchange Act, then the provisions of those Regulations apply in all respects, except that (a) the prospectus may be in the form of a proxy or information statement and may contain the information required by Form S-4 in lieu of the information required by Schedule 14A or Schedule 14C and (b) copies of the preliminary and definitive proxy

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or information statement, the form of proxy or other material filed as part of the registration statement will be deemed filed pursuant to that party's obligations under Regulation 14A or Regulation 14C. Generally, these filings are done in a joint proxy statement/prospectus. For additional information concerning Regulation 14A, please see "Proxy Solicitations and Information Statements" below.

PROXY SOLICITATIONS AND INFORMATION STATEMENTS

Proxy Statements

- Certain mergers and acquisitions, such as a one-step transaction pursuant to which the target company merges into the buyer, require approval or consent of the security holders of the target company and possibly the acquirer under applicable state law and/or the corporation's governing documents. To obtain approval or consent, the acquirer and/or the target company generally holds a shareholder meeting and solicits proxies from security holders. The Exchange Act contains specific requirements, in Regulation 14A, for the solicitation of a proxy or consent from holders of publicly-held securities, including a number of disclosure requirements.
- No solicitation for approval or consent with respect to any registered securities may be made unless each person solicited is furnished:
  - a publicly-filed preliminary or definitive written proxy statement containing the information specified in Schedule 14A **or**
  - a publicly-filed preliminary or definitive written proxy statement included in a registration statement on Form S-4 filed under the Securities Act.
- In addition, no person conducting a solicitation with respect to registered securities may deliver a form of proxy, consent or authorization to any security holder unless the security holder concurrently receives, or has previously received, a publicly-filed *definitive* written proxy statement.
- A preliminary proxy statement must be filed with the SEC at least 10 calendar days prior to the date definitive copies of that proxy

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statement are intended to be first sent or given to security holders. The SEC then has the opportunity to review the proxy statement prior to distribution to security holders, and will notify the filing company of its intent to review in that 10 day period. If the SEC decides to review the proxy statement and provide comments, the review process usually ranges from 45 days to several months, with the first comments from the SEC arriving approximately 30 days after filing, followed by a series of company response letters (usually accompanied by amendments to the proxy statement reflecting the SEC comments) and additional SEC comment letters on those amendments. Once the comment process is complete, the company can file its definitive proxy statement and mail it to security holders.

- The definitive proxy statement must be filed with the SEC no later than the date that proxy statement is first sent or given to security holders.
- Disclosure in the proxy statement relating to mergers, consolidations, acquisitions and similar matters is generally set forth in Item 14 of Schedule 14A. The disclosure requirements vary depending on whether the consideration offered consists solely of registered securities, consists solely of cash or consists of some other form of consideration (for example, a combination of cash and securities).
- Preliminary and definitive proxy statements filed with the SEC in connection with mergers and acquisitions are generally available for public review in the SEC's EDGAR system. Confidential treatment of these proxy statements generally only applies where the parties to the transaction have limited their public communications to the information specified in Rule 135 under the Securities Act, and disclosure will generally not be limited to that information.

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Information Statements

- If a company does not solicit proxies in connection with any merger or acquisition (because, for example, a controlling shareholder holds sufficient shares to approve the merger under state law), an information statement may be required that satisfies the SEC's disclosure requirements under Regulation 14C.
- In connection with every meeting of holders of registered securities, including action by written consent, the public company must transmit to every security holder entitled to vote or consent but from whom a proxy is not solicited:
  - a written information statement containing the information specified in Schedule 14C **or**
  - a written information statement included in a registration statement on Form S-4 filed under the Securities Act.
- The information statement must be sent or given at least 20 calendar days prior to the meeting date or, in the case of corporate action taken pursuant to a consent without a meeting, at least 20 calendar days prior to the earliest date on which the corporate action may be taken.
- A preliminary information statement must be filed with the SEC at least 10 calendar days prior to the date definitive copies of that information statement are first sent or given to security holders. As with the proxy statement, the SEC has the opportunity to review and comment on the information statement.
- The definitive information statement must be filed with the SEC not later than the date it is first sent or given to any security holders.
- The content required for an information statement on Schedule 14C is similar to that required for a proxy statement on Schedule 14A.

OTHER SECURITY HOLDER COMMUNICATIONS

- Communications with security holders concerning business combinations and tender offers (other than by means of a registration statement, proxy statement or information statement) are permitted

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from the first public announcement of the transaction through the closing of the transaction as long as certain requirements are satisfied.

- Written communications with security holders prior to the distribution of a definitive proxy statement to security holders must be filed with the SEC no later than the date the material is first published, sent or given to security holders. However, no form of proxy may be provided to security holders until delivery of the definitive proxy statement, and all written communications must include a prominent legend in clear, plain language advising security holders to read the proxy statement when it is available. Furthermore, any other soliciting materials must be filed with the SEC no later than the date they are first sent or given to security holders, even if the definitive proxy statement has already been sent.
- Likewise, written communications with security holders prior to or after the filing of a registration statement must be filed with the SEC as a prospectus on the date of first use. Each communication must contain a prominent legend that urges security holders to read the relevant documents filed with the SEC. If the communication is made in connection with an exchange offer, it must also satisfy the SEC's tender offer rules, and if the communication is made in connection with a transaction involving the vote of security holders, it must also satisfy the SEC's proxy rules.
- Pursuant to the amendments to the Securities Act in connection with the recent Securities Offering Reform, effective December 1, 2005, the proxy solicitation rules described above do not apply to publications or distributions of research reports by brokers and dealers during transactions in which a broker or dealer participates in an advisory role.

TENDER OFFERS

Tender Offer Statements

- A tender offer is generally characterized by a public bid by a person or persons to buy shares of a public company's securities, typically at a price in excess of the current market price for those shares.

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- Any person who, either directly or indirectly, makes a tender offer for any class of registered or covered securities must file with the SEC a Tender Offer Statement on Schedule TO if that person would directly or indirectly beneficially own more than 5 percent of any such class following the offer. The Schedule TO must be filed as soon as practicable on the date of the commencement of the tender offer, as defined below.
- Any interested person, such as the target company or a beneficial owner of securities, that makes a solicitation or recommendation to the security holders with respect to any tender offer must file Schedule 14D-9 with the SEC.
- The Schedule TO and any solicitation or recommendation statement on Schedule 14D-9 must generally furnish the information required in Regulation M-A, discussed below in this Chapter.
- Financial statements must be provided with the Schedule TO when the bidder's financial condition is material to a security holder's decision whether to sell, tender or hold the securities sought; however, in certain specified circumstances, the financial statements may be incorporated by reference from other documents filed with the SEC. Financial statements are *not* considered material when:
  - the consideration offered consists solely of cash;
  - the offer is not subject to any financing condition; **and**
  - either (i) the bidder is a public reporting company that files reports electronically on EDGAR or (ii) the offer is for all outstanding securities of the subject class.
- A tender offer commences on the date when the bidder has first published, sent or given the means to tender to security holders, including the transmittal form or a statement regarding how the transmittal form may be obtained.
- Pre-commencement communications by the bidder are permitted if:
  - the communication does not include the means for security holders to tender their shares into the offer;

- all written communications relating to the tender offer, from and including the first public announcement, are filed on Schedule TO with the SEC no later than the date of the communication; **and**
- each written communication includes a prominent legend in clear, plain language advising security holders to read the tender offer statement when it is available and advising investors that they can get the tender offer statement and other filed documents for free at the SEC's web site.

  The bidder also must deliver to the target company and any other bidder for the same class of securities the first communication relating to the transaction that is filed, or required to be filed, with the SEC.

- Alternative rules and schedules apply to "going private" transactions pursuant to which a public company generally makes a tender offer for all of a class of its own securities.

Tender Offer Practices

- The tender offer must conform with the rules and regulations of the SEC, including the requirements set forth in Regulation 14E.
- A tender offer must be held open for at least 20 *business* days from the date of the commencement of the offer.
- A bidder may not increase or decrease the percentage of the class of securities being sought, the consideration offered or the dealer's solicitation fee unless the tender offer remains open for at least 10 *business* days from the date that notice of the increase or decrease is first published, sent or given to security holders.
- A bidder may not extend the length of the tender offer without issuing a notice of the extension by press release or other public announcement.

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- No later than 10 *business* days from the date the tender offer is first published or sent or given, the target company must send or give to its security holders a statement on Schedule 14D-9 disclosing that the target company:
  - recommends acceptance or rejection of the bidder's tender offer,
  - expresses no opinion and is remaining neutral toward the bidder's tender offer, **or**
  - is unable to take a position with respect to the bidder's tender offer.

  If any material change occurs in the target company's disclosure statement, it must promptly publish, send or give a statement disclosing that material change to security holders.

- Purchases of the subject security outside of the tender offer may be proscribed. As a general rule, the bidder and its affiliates may not directly or indirectly purchase or arrange to purchase any subject securities or any related securities except as part of the tender offer from the time of public announcement of the tender offer until the tender offer expires. The exercise of options, purchases pursuant to contractual obligations and certain other transactions may be exempt from the foregoing restriction if designated conditions are satisfied.

- No person may publicly announce that the person plans to make a tender offer that has not yet commenced if the person:
  - is making the announcement of a potential tender offer without the intention to commence the offer within a reasonable time and complete the offer,
  - intends, directly or indirectly, for the announcement to manipulate the market price of the stock of the bidder or target company, **or**
  - does not have the reasonable belief that the person will have the means to purchase securities to complete the offer.

- The target company must make additional disclosures to the SEC and security holders if, pursuant to any arrangement or understanding with the bidder, any persons are to be elected or designated as directors of

the target company otherwise than at a meeting of security holders and the persons so elected or designated will constitute a majority of the directors of the target company. This disclosure must be made not less than 10 calendar days prior to the date any such person takes office.

REGULATION M-A

- The disclosure requirements for certain business combinations are set forth in Regulation M-A. This regulation includes disclosure requirements for any tender offer statement on Schedule TO and any solicitation or recommendation statement on Schedule 14D-9. This regulation also includes disclosure requirements for a proxy statement on Schedule 14A for any merger, consolidation, acquisition or similar transaction.

Disclosure for Schedule TO

- A third-party bidder in a tender offer filing a Schedule TO must generally disclose the following information:
  - A summary term sheet written in plain English and in bullet-point format describing the most material terms of the proposed transaction;
  - Name and address of the target company, a description of the target company's outstanding shares of the subject class of equity securities, and information concerning the trading market and price of those securities;
  - Name and address of the bidder and other background information;
  - The material terms of the transaction, including the total number and class of securities sought, the type and amount of consideration offered, the scheduled expiration date for the tender offer, the procedures for tendering and withdrawing securities and the manner in which securities will be accepted for payment;

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- A description of the nature and approximate dollar amount of certain designated transactions that have occurred in the past two years between the bidder and the target company or its affiliates, directors or officers;
- A description of any negotiations, transactions or material contacts during the past two years between the bidder and the target company or its affiliates concerning any tender offer, merger, acquisition, sale of material amount of assets or other significant transactions;
- A description of the purpose of the transaction and any plans, proposals or negotiations that relate to any merger, liquidation, sale or purchase of significant assets, change in the board of directors or management, change in the company's corporate structure or business, or other extraordinary event or transaction;
- A description of the specific sources and total amount of funds or other consideration to be used in the transaction, any material conditions to the financing for the transaction and a summary of any loan or other financing used for the consideration required for the transaction;
- A description of the bidder's beneficial ownership of the target company's securities and any transactions by the bidder in the target company's securities during the past 60 days;
- Identification of all persons that are directly or indirectly employed, retained or to be compensated to make solicitations or recommendations in connection with the transaction;
- Designated financial information and, if material, *pro forma* financial information disclosing the effect of the transaction on the target company's financial position; and
- Any additional information as may be necessary to make the required statements, in light of the circumstances under which they are made, not materially misleading.

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Disclosure for Schedule 14D-9

- A person filing a tender offer solicitation or recommendation statement on Schedule 14D-9 must generally disclose the following information:
  - Name and address of target company and information about the target company's outstanding shares of the subject class of equity securities;
  - Name and address of each person filing the Schedule 14D-9, the name and address of the bidder and the identification of the tender offer and the class of securities to which the offer relates;
  - A description of any actual or potential conflict of interest between the filing person and its affiliates and:
    - the target company, its executive officers, directors or affiliates or
    - the bidder, its executive officers, directors or affiliates.
  - The nature of the solicitation or recommendation, including whether the filing person is advising holders to accept or reject the tender offer or to take other action with respect to the tender offer, whether the filing person is expressing no opinion and remaining neutral, the reasons for the position of the filing person and, if known, whether the filing person or any of its executive officers, directors or affiliates intends to tender, sell or hold the subject securities held by any of them;
  - Identification of all persons that are directly or indirectly employed, retained or to be compensated to make solicitations or recommendations in connection with the transaction;
  - Description of any transaction in the subject securities during the past 60 days by the filing person or any of its executive officers, directors or affiliates;
  - Description of whether the filing person, if the target company, is undertaking or engaged in any negotiations in response to the tender offer that relate to designated items; and

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- Any additional information as may be necessary to make the required statements, in light of the circumstances under which they are made, not materially misleading.

Disclosure for Proxy Statement on Schedule 14A

- A person filing a proxy statement on Schedule 14A must generally disclose the following information under Regulation M-A (in addition to all other information required to be disclosed in Schedule 14A):
  - A summary term sheet written in plain English and in bullet-point format describing the most material terms of the proposed transaction;
  - A brief description of the transaction together with the consideration offered to security holders, the reasons for engaging in the transaction, the vote required for approval of the transaction, an explanation of any material differences in the rights of security holders as a result of the transaction, a brief statement as to the accounting treatment for the transaction, and the federal income tax consequences of the transaction;
  - A description of any negotiations, transactions or material contacts during the past two years between the filing person and the subject company or its affiliates concerning any tender offer, merger, acquisition, sale of material amount of assets or other significant transactions;
  - A description of the purpose of the transaction and any plans, proposals or negotiations that relate to any merger, liquidation, sale or purchase of significant assets, change in the board of directors or management, change in the subject company's corporate structure or business, or other extraordinary event or transaction;
  - Information concerning any other present or proposed material agreement or relationship between the parties or any of their executive officers, directors, controlling persons or subsidiaries; and

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- If a third party has provided an appraisal, a fairness opinion or similar report relating to the transaction,
  - the identity of the third party providing the report;
  - the qualifications of the third party;
  - the method of selection of the third party;
  - any material relationship that existed during the past two years and any compensation received or to be received a result of that relationship between the third party and the company;
  - if the report relates to the fairness of the consideration, whether the company determined the amount of consideration to be paid or whether the third party recommended the consideration to be paid; and
  - a summary of the appraisal, fairness opinion or other report.

FORM 8-K REQUIREMENTS

- The public company must file a current report on Form 8-K upon certain events, including:
  - the company's entry into a material definitive agreement not made in the ordinary course of business;
  - termination of material definitive agreements;
  - material impairment of assets; and
  - the completion of the acquisition or disposal of a significant amount of assets.
- If an agreement for any merger, acquisition or other transaction constitutes a material definitive agreement for the public company, the Form 8-K must disclose:
  - the date on which the agreement was entered into;
  - the identity of the parties to the agreement;

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- a brief description of any material relationship between the public company, or its affiliates, and the other parties to the agreement; and
- a brief description of the terms and conditions of the agreement that are material to the public company.

- If the transaction involves the completion by the public company of the acquisition or disposition of a significant amount of assets (including by means of merger), the Form 8-K must disclose
  - the date of completion of the transaction;
  - a brief description of the assets involved;
  - the identity of the person from whom the assets were acquired or to whom they were sold;
  - the nature of any material relationship between that person and the public company or its affiliates, directors or officers;
  - the nature and amount of the consideration given or received for the assets; and
  - under designated circumstances, the source of the funds used in the acquisition.

  In addition, financial statements for any business acquired and *pro forma* financial information are required to be set forth as exhibits to the Form 8-K. The financial statements can generally either be filed with the original Form 8-K, or filed by amendment no later than 71 calendar days after the date that the original Form 8-K was due. Additional disclosure rules, including rules relating to financial statements, apply to certain shell companies.

- Generally, the Form 8-K must be filed within four business days after the happening of a triggering event.
- For additional information regarding Form 8-K requirements, including the applicable filing deadlines, please see Chapter 13 (New Form 8-K Disclosure Requirements) of our Corporate Governance Quick Reference Guide.

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DISCLOSURE OF BENEFICIAL OWNERSHIP OF SECURITIES

Schedule 13D and Schedule 13G

- Any person who acquires, directly or indirectly, beneficial ownership of more than 5 percent of any class of any registered equity security must generally file a statement on Schedule 13D with the SEC; however, that person may be eligible to file a short-form statement on Schedule 13G, in lieu of Schedule 13D, if that person:
  - has not acquired the securities with any purpose, or with the effect of, changing or influencing the control of the company, or in connection with or as a participant in any transaction having that purpose or effect, **and**
  - such person is not directly or indirectly the beneficial owner of 20 percent or more of the class.
- The Schedule 13D or the Schedule 13G must generally be filed within 10 calendar days after the acquisition of more than 5 percent beneficial ownership of any class of registered equity securities.
- Any person previously reporting on Schedule 13G must generally file a statement on Schedule 13D within 10 calendar days of the date on which:
  - that person's beneficial ownership equals or exceeds 20 percent of the class of registered equity securities **or**
  - that person has acquired or holds securities with the purpose or effect of changing or influencing the control of the company, or in connection with or as a participant in any transaction having that purpose or effect.
- Schedule 13D requires that the reporting person describe the purpose or purposes of the acquisition of the securities, including any plans or proposals the reporting person may have which relate to an extraordinary corporate transaction, such as a merger or reorganization of the company or any of its subsidiaries or the sale or transfer of a material amount of assets of the company or any of its subsidiaries.

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- Alternative filing requirements apply for registered brokers, dealers and investment advisers, certain banks and insurance companies, certain employee benefit plans, and certain other similar persons identified in the SEC's regulations.

Form 3, Form 4 and Form 5

- Any person that acquires beneficial ownership of more than 10 percent of any class of registered equity securities must also file a Form 3 pursuant to the requirements of Section 16 of the Exchange Act. (Certain officers and directors must do the same.) The Form 3 must be filed within 10 calendar days after the transaction or other event pursuant to which the person acquires beneficial ownership of more than 10 percent of any class of registered equity securities (or becomes a director or reporting officer).
- Persons subject to the Section 16 reporting requirements must also file a Form 4 reporting each transaction resulting in a change in beneficial ownership of any class of equity securities of the public company. The Form 4 must be filed before the end of the second business day following the date on which the change in beneficial ownership occurred. Practically, the two business day filing requirement for the Form 4 often means that it is due before the Form 3, effectively shortening the time period for filing the Form 3.
- Persons subject to the Section 16 reporting requirements must also file an annual statement on Form 5 on or before the 45th day after the end of the public company's fiscal year if there are any transactions that have not previously been reported, either due to an exemption or a failure to file. If all transactions have been reported, no Form 5 is required.

Beneficial Ownership

- A "beneficial owner" of a security includes any person who, directly or indirectly, through any contract, arrangement, understanding or otherwise has or shares voting power and/or investment power.

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- A person will be deemed to be the beneficial owner of an equity security if that person has the right to acquire beneficial ownership of the equity security within 60 days, including through the exercise of any option, warrant or similar right or the conversion of any other security.
- When two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of equity securities of a public company, the group may be deemed to have acquired beneficial ownership of all equity securities of that company beneficially owned by any of those persons for purposes of the disclosure requirements under Regulation 13D and Regulation 13G.

Applicability in Mergers and Acquisitions

- Disclosure on Schedule 13D and Form 3 may be required in advance of a potential merger or acquisition. For example, in "creeping" acquisitions pursuant to which one or more persons seeks to acquire control of a public company by purchasing securities on the open market, that person or persons will, upon obtaining 5 percent beneficial ownership of any class of equity securities, generally be required to file a statement on Schedule 13D describing that purpose. A Form 3 will be required upon obtaining 10 percent beneficial ownership of any class of equity securities, and disclosure on Form 4 will be required thereafter for any changes in beneficial ownership of equity securities. In addition, amendments to the Schedule 13D must be promptly filed upon any material change in the facts in the original filing, including any material increase (or decrease) in the percentage of the class of securities owned. Any acquisition or disposition of one percent or more of the class of securities is deemed material.
- Disclosure on Schedule 13D or Schedule 13G may be required for certain holders of securities following a merger or acquisition if those persons hold beneficial ownership of more than 5 percent of any class of equity securities following the transaction.

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- Disclosure on Form 3 will be required for new directors and executive officers following a merger or acquisition and may be required for certain holders of securities following a merger or acquisition if those security holders hold beneficial ownership of more than 10 percent of any class of equity securities following the transaction. Disclosure on Form 4 will be required thereafter for any changes in the beneficial ownership of the securities for anyone required to file a Form 3.

SPECIAL HAZARDS FOR DIRECTORS AND OFFICERS

- Any profit realized by any director or officer from any non-exempt purchase and sale, or sale and purchase, occurring within a six month period, of any equity security of the public company may be subject to recovery by the public company under Section 16(b) of the Securities Act. This rule is referred to as the "short swing profit" rule.
- Officers and directors of both the target and the buyer often engage in transactions in equity securities of the respective companies in connection with the business combination transaction, including the exchange of options or shares held for shares of the acquirer, or the grant of new equity securities in connection with the business combination. Rule 16b-3 under the Exchange Act provides an exemption from the short swing profit rule for these transactions **if they are approved in advance by the board of directors, or a committee of non-employee directors, of the issuer. The SEC has issued guidance in a no-action letter that provides specific requirements for the content of this approval, including the names of the officers or directors, the securities to be exchanged or issued, the material terms of any derivative securities (subject to certain exceptions) and the fact that the approval is being granted for purposes of exempting the transaction under Rule 16b-3. Both the target company and acquirer's boards of directors, or board committees, should adopt the appropriate resolutions to ensure the protection of this exemption.**

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In these days of increasing globalization, it is only natural that transactions themselves shall take on an increasingly global character. Thus a cross-border transaction – one involving one or more jurisdictions – is increasingly on the menu for concerns that once only dealt within national boundaries.

Cross-border transactions are at root no different than those that involve just one jurisdiction. Indeed, while the earlier chapters of this M&A Guide are necessarily focused upon U.S. transactions, most of the fundamentals herein apply with largely equal force to a cross-border transaction. Make no mistake however; there are differences, profound and small alike. While issues will vary not only from transaction to transaction but jurisdiction to jurisdiction, we believe there are certain themes that pervade all cross-border transactions.

WHAT IS A "CROSS-BORDER" TRANSACTION?

While the concept of a "cross-border" transaction could be used to describe a number of different corporate merger and acquisition activities, it has a specific meaning in today's common parlance: a transaction involving more than one national jurisdiction (and accordingly, more than one legal system).

- "Cross-border" defines only the nature and scope of the parties involved in the transaction and not the essence or substance of the transaction itself.
- Any number of transaction genres could be a cross-border endeavor:
  - merger;
  - acquisition;
  - divestiture;
  - joint venture;
  - strategic alliance;
  - outsourcing arrangement; or
  - other transaction.

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APPRECIATE THE DIFFERENCES

The first step in preparing for a cross-border transaction is recognizing the critical differences between cross-border and single-jurisdiction transactions:

- At their most basic level, cross-border transactions are similar, if not identical, to transactions that involve just one jurisdiction. The fundamental building blocks of a transaction apply.
- BUT there are notable differences (and typically additional concepts and requirements) in negotiating and consummating a cross-border transaction.

Appreciating and, perhaps more importantly, respecting these differences, will establish a solid foundation for a successful cross-border deal.

Ignoring or failing to account for these differences may (and in all honesty likely will) result in delays, frustration and misunderstandings that may jeopardize the success of the transaction.

INITIAL LOGISTICS: KEY TO MAXIMIZING SUCCESS IN CROSS-BORDER TRANSACTIONS

Before addressing some of the major differences in performing cross-border transactions, it is important to focus on initial planning steps that a party can take to mitigate the marginal risk appurtenant to cross-border deals and to realizing the full potential of any given transaction.

Put Together the Right Team

The deal team is always critical, but the joy and challenge of a cross-border team is that there will be that many more participants and team members:

- Domestic transactions may often involve substantive experts focusing on various substantive aspects of any given transaction (tax, real estate, ERISA and employment, environmental, perhaps a litigation assessment, etc.).

- Cross-border transactions will involve at least incrementally more such "experts" and perhaps exponentially more based on the number of involved jurisdictions.

Strong leadership is critical:

- At the business level (e.g., as due diligence teams assess their country by country findings).
- At the transaction negotiation and execution level.

The legal and tax team must be well organized and well-led. In that regard, a party typically has three options:

- Manage the team in-house (typically via the general counsel or business development advisor).
- Look for a one-stop shop to manage resources within its own geographic footprint (e.g., a Big Four accounting firm or a "global" law firm).
- Rely on an experienced outside mergers and acquisition advisor (typically with whom the business has a longstanding relationship).

Select the Right Local Advisors

It is hard to go wrong with a brand-name, international firm to handle the diverse needs of a cross-border transaction. However, it can often be helpful to consider more local alternatives, hand-picked jurisdiction by jurisdiction:

- Local contacts can be invaluable, and recognizing that local advisors can assist (or imperil) in this respect is critical.
- Local advisors will be the principal conduit to the local market, local rules and the local regulator.
- A large global firm (especially based in the U.S. or UK) may encounter local bias.

The selection of appropriate, skilled local counsel is a critical initial step in bringing about a successful cross-border transaction. Simply put, a party protects itself, the deal and the company by selecting and engaging qualified and experienced local counsel.

Once local counsel has been selected and engaged, it is almost always a mistake to confine them to performing one or two discrete tasks (such as due diligence, document translation or responding to specific queries that arise throughout the course of the transaction).

Like any other advisor, local counsel are most useful and create the most value when you actively involve them with the lead deal counsel in considering and structuring the transaction as a whole and spotting and resolving the myriad issues that may (and invariably do) arise in international transactions.

Process and Communication Matter More in the Cross-Border Context

Experience suggests that communication, or lack of effective communication, is consistently a challenge in cross-border transactions:

- The sheer number of participants and advisors necessarily will be greater than for a domestic transaction.
- Essential that the entire team is well-informed and moving properly and timely toward the shared goal.
- Transactions typically are fluid, with new issues emerging at any given moment, identifying such issues and their implications, as well as fanning this out to the farthest reaches of the team, is critical.
- Leadership and the accompanying accountability are so important.

Frequent updates, both by email (and, we believe, this is exceptionally important), via individual, one-on-one phone calls, are critical. Individual phone calls are so very important because:

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- While the world admittedly appreciates the ease and efficiency of email communication with near unanimity, it is too easy for gradations of emphasis, tone, importance, nuance and the like to be not fully understood or perhaps lost entirely.
- It creates a personal connection and the client can hear either doubt (‘*she doesn’t seem to be getting it*’) or confidence (‘*she understands completely*’).

UNDERSTAND THE IMPACT OF CULTURE AND LOCAL “NORMS”

While mastering the process implications for a cross-border transaction provides a strong foundation for success, assembling the right team and achieving the right communication and process strategy can only go so far. If not understood and appreciated, cultural and substantive law differences can derail even the most experienced, well-functioning team.

Cultural differences may be among the most significant factors in international transactions and may influence business negotiations in both significant and unexpected ways. In some cases, the culture gap may be a simple matter of ignorance or unknowing disrespect, and in other situations it may be much more substantive (though often subtle) arising from cultural tendencies that influence interaction among the parties.

Negotiation process may be impacted by culture:

- How people view the dynamics of the individual interacting with the group in negotiations.
- Differences in understanding about the impact of time (e.g., deal timelines) and relationships (e.g., lawyer-client roles).
- The decision making and governance processes that determine a “yes” or “no” response.
- The parties who will be involved in the negotiations.
- The person who has decision making authority.
- The influences on the parties that may drive or influence the outcome of the transaction.

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A cross-border deal, and the counterparties and the market(s) in which the transaction takes place, may have processes, norms and styles all their own – with which the parties may not be familiar.

- Some of these differences may be obvious (knowledge of the bow in Japan is seemingly universal and the subject of numerous books on business culture).
- Others are more nuanced (gamesmanship, drafting tricks and 'gotchas' are all part of the sport that seems to inform the deal making techniques of lawyers in certain jurisdictions).

Understanding these differences is critical, and longstanding sensibilities about timing, style of negotiation, process and other "deal flow" characteristics may be inapplicable.

In assessing these local norms, rely on local counsel to assess both cultural and market issues, as well as where regulatory constraints, approvals and the like may be brought to bear. Approvals, notifications and their timing are all critical – as is appreciating the manner in which they may impact your deal, its timing its certainty.

APPRECIATE THE EFFECT OF LOCAL SUBSTANTIVE LAW

Assess your deal and the business(es) involved and appreciate how they are governed and regulated (if at all) may well be different depending on the jurisdiction.

Common Law and Civil Law Jurisdictions

The jurisdiction in which the transaction occurs, and whether it is civil law or common law based, can have a big effect on the documents, their form and content. If in a common law jurisdiction such as Ireland, the UK or Canada (excluding Quebec), a U.S. dealmaker should be familiar with the length, detail and content of deal documents (even if some of the norms that operate within that document are decidedly different). But if that dealmaker moves to a civil law jurisdiction, the familiarity will likely wane. The basics will largely be the same, but the detail and, frankly, length at which concepts are expressed will be decidedly different (which is to say, shorter).

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Appreciating the differences in a civil law jurisdiction is critical:

- The various civil codes will inform the meaning and interpretation of contractual relations and contractual provisions to a much greater extent than in common law jurisdictions.
- The agreements can be shorter because there are codes that help give meaning to what the contracting parties have agreed.
- However, the unwritten hazard here is that civil codes can, in certain instances, imperil the ability of the unwary to affect their intended deal.

In a civil law jurisdiction, it is critical to talk specifically – and frequently – with local counsel to ensure the impact that civil code provisions may have on your deal:

- Certain of these aspects may be overcome by specifying provisions in the transaction documents (e.g. certain civil law jurisdictions may impute all knowledge derived in a data room to a purchaser, unless clearly stated otherwise in the document).
- Other provisions will apply regardless of what the contracting parties may indicate in the documents. For an example of the latter, consider the German law termination right for wichtiger Grund ("an important reason") that exists regardless of what the parties may indicate in the documents (clearly a challenge and risk that needs to be understood if trying to effect a contract with limited termination rights). The right exists irrespective of whether it is specifically stated in the documents.

Disclosure, Schedules and "Bundles"

In any sale transaction, disclosure will be a critical vehicle by which the parties assess their transaction and allocate risk. If the baseline paradigm is a system of disclosure like that found in the U.S., then the onus of disclosure is all on the seller:

- Getting as much disclosure on the schedules is critical for a seller.

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- Conversely, fighting imprecise, over-inclusive disclosure is the buyer's primary objective in reviewing the disclosures.
- Some buyers – while conducting good diligence – rely to a certain extent on disclosures against the representations to flesh out their diligence, surface issues and generally act as further confirmation of nature and character if the business being acquired.

If accustomed to this model, a buyer must appreciate that it does not necessarily prevail elsewhere:

- In Europe, for example, diligence and disclosure are perceived much more as a joint enterprise with shared responsibility. In such a context, a buyer cannot necessarily rely on representations or the specific disclosures against those representations.
- Any document or relevant information that may be disclosed during the course of transaction – whether in data rooms, on schedules or as part of a UK style "Disclosure Bundle" – by operation of law or the transaction documents may be attributed to the buyer and modify the protection otherwise afforded in the representations.

Understanding the approach to disclosure in a given jurisdiction is an element that needs to inform the approach to diligence and the contract negotiations from the outset. Further, the approach needs to inform expectations with one's counter-party as well. For example, if one is doing an acquisitive transaction in the UK, one can expect that the seller will start with the proposition that all disclosures made in any data room, and related knowledge derived therefrom, will be attributed to the purchaser. If a buyer is accustomed to tidy, specific disclosures allocated sheet by sheet or schedule by schedule, against each individual representation, abandoning that expectation will be helpful from the outset in order to focus on other areas of the transaction. The Disclosure Bundles – and it is no exaggeration to say that they often fill a shelf of a bookcase with binders of documents – can be a sight to behold and, to the unwary, can absolutely eviscerate hard fought representations.

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Formalities of Doing Business

The level of formality required to commence, record or otherwise engage in a transaction varies greatly from jurisdiction to jurisdiction. More than perhaps any other issue, these differences can have a profound impact on the pace and timing of a transaction:

- A buyer who is debating whether to establish a U.S. shell or holding company to commence an acquisition enjoys tremendous flexibility in the timing of finalizing that decision because an entity (corporation, limited liability company, etc.) can be created in a matter of minutes via electronic filing systems.
- In other jurisdictions, however, it can take weeks to acquire a shelf company (much less incorporate a company from scratch) due to notarization requirements, notice publication, registration with the appropriate local and national commercial registries and management confirmations.

In many countries, certain documents must be notarized to constitute legally binding documents:

- These documents may include purchase agreements, share transfer agreements, debt instruments or contributions to capital and shareholder equity (both initial and subsequent increase and relating to either cash or in-kind contributions).
- The notary is not just a stamp and a signature (which is the common practice in the U.S.); rather, it involves engaging a notary and, often, actually reading aloud the entire document.

Organizing the notarial process, and appreciating the time and coordination required, is an important, necessary mechanical feature to any signing. Further, while a representative can be appointed to attend the notarial session and sign the documents, this appointment process may be onerous and time consuming in and of itself, requiring, for instance, formalized powers of attorney and apostilles issued under the Hague Convention.

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Taxes

Inevitably, local, national or supranational tax issues that are unique to the locality in which the transaction takes place will play a major role in structuring your transaction. In particular, the taxes payable on funds moving from jurisdiction to jurisdiction (whether in or out) and the overlay of Value Added Tax, otherwise known as "VAT," are features of many cross-border transactions that dealmakers may not be familiar with on the basis of domestic experience alone. Early engagement of local counsel and/or sophisticated tax advisers can help spot these issues and highlight ways to structure the transaction in a tax efficient manner.

If forced to pick only three letters that most dramatically capture the difference between, say, a transaction in the U.S., and one that crosses borders into Europe, Canada or Asia, for example, those letters would be V-A-T (or in certain jurisdictions (e.g., Canada and some Asian countries), G-S-T):

- Without appropriate planning, VAT may wreak havoc on the financial underpinnings of a transaction and provide costly surprises as well.
- With experienced, creative counsel, the costs that VAT – or other value added tax – may bring to bear on any given transaction or relationship can often be mitigated and, at times, eliminated entirely.

VAT has the potential to single-handedly turn a profitable transaction into an unprofitable one and shave valuable basis points off an IRR:

- To realize a company must bear a cost, and then further realize that with some creativity those costs may have been avoided in the first instance, is a bitter pill (not to mention one that can absolutely destroy a financial model and turn a well performing transaction into a loser).
- For example, consider a transaction with a set purchase price – of however many millions of Euro – and then arriving at the realization that VAT, at roughly 17 to 21% depending on the jurisdiction, is now payable on the purchase price.

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- Allocating this cost is critical to realizing the benefits of a particular transaction.

Employment and Labor Law

Employment issues are always at the fore and can hold particular hazards to a cross-border dealmaker. Moving from an employment at-will environment to one (e.g., most of Europe) where employment is much more a right/entitlement has an impact on deals in many ways.

There are two key areas, at least within Europe, to understand before entering into a cross-border transaction. The first is the mechanics of employee transfer (whether intentional or otherwise). The second is applicability of local labor regimes.

Focusing first on employee transfer, consider transfer of undertaking type legislation (or "TUPE"), perhaps originally conceived to prevent employers from architecting around their obligations to employees. TUPE can affect a business in unexpected ways.

In the context of the purchase of a business, all employees relating to that business will have a legal right to follow the business (irrespective, for instance, whether such employees appear on a schedule of "Transferred Employees"). Assessing the risk of this occurring, and allocating the related costs among the parties, is important. This is especially true where a transaction may create redundancies and potential layoffs may follow.

TUPE may be applicable in far more unexpected circumstances.

- For instance, in the context of an outsourcing relationship, the nature of the relationship may be deemed so akin to employer/employee that TUPE may apply.
- And a contracting party who understood – indeed may have sought outsourcing precisely not to have to deal with employment issues – that, at the end of an outsourcing, it simply could terminate the employee relationship and "walk away" may find that legally the employees that previously served them may have rights to continued employment.

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Additionally, a potential buyer or similar entrant into a new market should engage in careful planning to understand the potential impact of local labor requirements on the business:

- Employee rights and entitlements will vary significantly from jurisdiction to jurisdiction and can cause fundamental shifts in an employer's cost/benefit model.
- Employer should understand the impact of local labor organizations and unions on the work environment, including understanding whether the employer will be subject to a mandatory collective bargaining agreement simply by virtue of performing a particular business activity within the jurisdiction.
- Employer also should evaluate whether any steps can be taken to limit exposure to such agreements. For example, in some instances, restricting or eliminating a particular type of business or choosing not to join a particular industry or trade association may cause the employer to fall outside the scope of the collective bargaining agreement.
- In addition to these types of agreements, an employer must be cognizant of the impact that employee representative groups (whether works councils, employee forums or similar groups) may have on the operation and conduct of the business. Indeed, these groups often may have a significant role in corporate decision making, particularly in the context of a potential sale transaction.

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