United States

Negotiated M&A Guide

Corporate and M&A Law Committee

Contact

Donald E. Batterson

Jenner & Block LLP
Chicago, USA

dbatterson@jenner.com

Legal Framework

The statutory law and common law (that is, case law) of the individual states of the United States (for example, California, Delaware, Illinois and New York) supply the basic legal framework with respect to M&A activity in the US. However, parties to an acquisition agreement are generally free to negotiate terms and conditions (such as representations and warranties, covenants, closing conditions and indemnification provisions) with very few restrictions under state law.

As a general rule, the statutory law of the state in which the target corporation or other business entity is formed will govern many important aspects of the affairs of such entity, including with respect to acquisition transactions. State statutory laws establish certain requirements that must be satisfied for target corporations to validly enter into and consummate such transactions. For example, state statutory laws generally require that the sale of a target corporation by way of merger or sale of all or substantially all of its assets must be approved by both the board of directors and the stockholders of the target corporation. State statutory law also supplies the minimum stockholder vote requirement, which is usually expressed as the holders of a majority of the outstanding stock entitled to vote thereon.

State common law supplies many other rules and principles that impact acquisition transactions. These rules and principles are either not expressed in state statutory law or state statutory law can only be fully understood by reference to such common law. For example, courts in Delaware have developed an extensive body of law with respect to the fiduciary duties applicable to boards of directors, including in the acquisition context. As a general matter, the directors of the target corporation must act in good faith, on an informed basis and in the best interests of stockholders, and are viewed as having duties of care and loyalty, all of which are understood primarily by reference to state case law. Further, while state statutory law may require stockholder approval upon a sale of all or substantially all of the assets of a corporation, state case law supplies various principles that must be analyzed to determine whether a particular sale of assets amounts to "all or substantially all" of the assets of a corporation.

Because corporations and other business entities are most commonly formed in the State of Delaware, this discussion will focus on Delaware law. Delaware has developed a robust and well-respected body of corporate common law, and the courts of other states often look to Delaware case law for guidance on corporate law issues. We also assume for purposes of this discussion that the target entity is a corporation, as opposed to a limited liability company or other entity, except as noted.

Though largely beyond the scope of this discussion, US federal securities laws, in particular the Securities Act of 1933 (the "Securities Act") and the Securities Exchange Act of 1934 (the "Exchange Act"), and the rules and regulations of the US Securities and Exchange Commission (the "SEC") thereunder, contain requirements that affect the structure and process of many acquisition transactions. For example, when a publicly-traded or privately-held company proposes to use stock or other securities as acquisition currency, the Securities Act likely applies and will require the company issuing such securities to register such stock or securities with the SEC, unless a private placement exemption or other exemption from registration is available. Further, if a publicly-traded company is required to obtain stockholder approval in connection with a proposed acquisition transaction, and such target company is soliciting proxies in connection with its stockholder meeting to vote upon such transaction, the Exchange Act will apply and generally require that a proxy statement be filed with the SEC that satisfies numerous disclosure rules related to the content of such proxy statement. Again, while beyond the scope of this discussion, publicly-traded companies in the US with "listed" securities are subject to the rules and regulations of the subject exchange, such as the New York Stock Exchange and Nasdaq. These rules and regulations affect certain aspects of acquisition transactions if the potential buyer or target company is exchange listed.

Attention may need to be given to state securities laws, known as "blue sky" laws, although in many instances such state laws have largely or entirely been preempted by federal securities laws. In particular, state securities laws should be considered where stock or other securities of a private company buyer are being used as acquisition currency.

Finally, the parties should consult with counsel to determine whether a proposed transaction requires compliance with other applicable federal, state or foreign laws and regulations. For example, certain regulated industries, such as those involving defense or telecommunications, may present special challenges and approval requirements. Other federal rules must be considered where foreign persons make investments in the US, which rules are discussed below.

Confidentiality Agreements

At the outset of acquisition negotiations, it is routine for the parties to enter into a confidentiality agreement to protect information exchanged during the course of due diligence and negotiations. Among other things, the confidentiality agreement will typically (i) restrict disclosure of information that a potential buyer receives from the target, (ii) restrict use of such information by the buyer except in connection with structuring and negotiating the transaction and (iii) impose non-disclosure terms with respect to the existence and status of the negotiations and the potential transaction. Where the target company will perform at least some due diligence on the potential buyer or otherwise receive confidential information of the potential buyer, such as where buyer securities are being used as consideration, the confidentiality agreement should include reciprocal protections. The negotiation of confidentiality agreements tends to center around a few key issues, and the target company will often have heightened concerns with strategic buyers.

The information protected by a confidentiality agreement is typically very broadly defined, including information with respect to financial condition, technology and operations, trade secrets and assets and liabilities, and information is usually covered even if the materials shared are not labeled as confidential or are delivered prior to execution of the confidentiality agreement. A potential buyer will expect certain exclusions from the definition of confidential information, such as (i) information that is (or becomes) generally available to the public, which is a very common exception, and (ii) information that the potential buyer has obtained or developed independently, which is a more controversial (but common) exception that the target may try to qualify by imposing a burden of proof requirement on the buyer or by requiring that independent development be demonstrated by written materials. In addition, disclosures required by law are generally allowed.

Restrictions on who may receive and use confidential information (on the buyer side) can be a sticking point. For example, the target company may want to protect its confidential information by limiting the scope and type of individuals permitted to receive such information, and will at times block certain types of persons from receiving such information or portions of such information (such as sources of debt and equity financing) or being contacted by the buyer (such as suppliers and customers of the target company) without the consent of the target company. When a strategic buyer is present, highly confidential information may be supplied only late in the process, in redacted form, and special procedures may be imposed on buyer review, such as review by only special counsel to the buyer.

The confidentiality agreement will usually provide that the buyer is responsible for any breach of the confidentiality agreement by its employees and agents, and that such employees and agents must be informed about the confidential nature of the information before being provided any information. Occasionally, the confidentiality agreement will block the sharing of confidential information with third parties unless the third party enters into a confidentiality agreement directly with the target company.

An important issue when negotiating a confidentiality agreement is the duration of its restrictions. Potential buyers often request a duration of between 12 and 24 months. Target companies often request perpetual duration or a duration between 2 and 5 years, depending on the sensitivity of the information to be disclosed and whether the potential buyer is a strategic as opposed to financial buyer. A period of 18 to 24 months is common.

Confidentiality agreements usually provide that monetary damages are insufficient if a breach of the confidentiality agreement occurs and will include a provision that allows the target to obtain injunctive

relief (specific performance) in addition to any other remedies available at law or equity (monetary damages) in the event of a breach.

Finally, given that the potential buyer will become aware of and have access to key employees of the target company, the confidentiality agreement typically will include covenants that prevent the potential buyer from soliciting or hiring employees of the target company. As solicitation of employees can be difficult to prove, in part because the employee that may have been solicited is now an employee of the buyer, and given that there are often solicitation related exceptions for general advertisements (and sometimes headhunter searches) not directed at employees of the target company, it is fairly common for confidentiality agreements to prohibit hiring of employees and not just solicitation. The scope of target employees protected varies widely and is often heavily negotiated, and may include among various options (i) only officers or selected key employees of the target, (ii) all employees of the target and its subsidiaries, including recently departed employees and (iii) employees that the potential buyer becomes aware of (or is introduced to) as part of the negotiation process. The duration of a non-solicitation provision is frequently tied to the duration of the confidentiality agreement. At times the non-solicitation provision is mutual and will also protect the potential buyer.

Letters of Intent

During the preliminary negotiating phase of a potential acquisition the parties often enter into a letter of intent in order to memorialize certain fundamental terms, such as the basic structure of the transaction and the form and amount of consideration. However, parties frequently prefer to focus time and resources on preparing the definitive acquisition agreement in lieu of negotiating a letter of intent that is not binding. Further, some parties may strategically avoid letters of intent so as not to make concessions on key points too early in the negotiating process.

Not surprisingly, letters of intent usually mirror the content and structure of acquisition agreements, but with much less detail, and frequently refer to customary terms and conditions. Letters of intent generally are not binding upon the parties, at least insofar as they address the terms of the proposed transaction. The parties should make clear whether and to what extent the provisions of a letter of intent (such as confidentiality or exclusivity terms) are intended to be binding.

Exclusivity

Potential buyers often request exclusivity from the target company, either as a binding provision in an otherwise non-binding letter of intent or in the form of a stand-alone agreement. The typical exclusivity arrangement will block the target company from (i) soliciting offers for the subject business, (ii) sharing information and (iii) engaging in discussions with other potential buyers. Buyers often attempt to obtain exclusivity to avoid serving as a “stalking horse” for other bidders and where the buyer is unwilling to incur the significant time and expense associated with due diligence and transaction negotiations without exclusivity. However, target companies typically strongly resist and are able to avoid exclusivity.

The grant of exclusivity by the target company should be extended only with significant caution to avoid claims that the directors of the target company breached their fiduciary duties. Target companies are typically counseled to grant exclusivity only for a limited period, such as 30 to 90 days, and where the offer by the potential buyer is very compelling and other potential buyers are not reasonably likely to surface with better terms.

Auction Process and Indications of Interest

When a target company is to be sold for cash (or for both stock and cash where the cash represents a material part of the consideration) the duty of the target company board is to achieve the highest price reasonably attainable. Delaware courts have expressed the view that in most cases the best evidence that a price is the highest reasonably attainable is that such price resulted from a thorough canvass of the available market, such as through an auction process. However, courts have not mandated that an

auction be conducted in every case. That said, the sale of target companies in the US pursuant to an auction process is very common.

If an auction process is being conducted for a target company, the investment banker engaged by the target company normally will pursue a fairly structured process to sell the target company. For example, the investment banker or target management may prepare an offering memorandum and then make initial contacts with potentially interested parties, preliminary due diligence is conducted by the potential bidders, potential buyers submit non-binding indications of interest, approved bidders are permitted to conduct more extensive due diligence, potential buyers submit final bids on a specified date, including a markup of the proposed acquisition agreement, and then final negotiations occur with the most attractive bidder. In this auction process context, indications of interest and markup of the definitive acquisition agreement usually takes the place of a letter of intent, and exclusivity is not granted (even in the latter stages of the process) absent exceptional circumstances.

Due Diligence

Before a buyer commits to acquire a target company, it will routinely perform due diligence on the target business by gathering all relevant and material information available to evaluate (among other things) the business and financial condition of the target company. Due diligence will focus on the material potential risks associated with the target business, including those risks that could prevent the transaction from closing or that could negatively impact the target company following closing. Often the target company will have prepared a "data room" or "data site" (a physical location or website where due diligence materials can be reviewed by the buyer's due diligence team), and the buyer and its representatives will be given access to such materials only after it has signed a confidentiality agreement. It is not uncommon for the economic and legal terms of the transaction (as expressed in a letter of intent or other indication of interest) to be modified after due diligence has been conducted.

The type of information shared (for example, strategic plans and price and cost data) can raise serious antitrust issues, especially if the transaction involves two actual or potential rivals. In addition, caution should be exercised about what is reduced to writing (such as studies, analyses and reports) regarding the reasons for transaction, competition, competitors, markets, market shares and potential for sales growth or expansion into product or geographic markets, because if the transaction is reportable to competition authorities, such materials will need to be produced as part of the required filing.

Possible Transaction Structures

In order to prepare a definitive acquisition agreement, the parties will need to determine the structure of the proposed transaction. There are three basic transaction structures for US acquisitions: asset purchase transactions, stock purchase transactions and merger transactions. Each of the following factors may be important considerations in the selection of the transaction structure:

- tax considerations;
- capital structure of the target company;
- risk exposure;
- board of directors and stockholder approvals;
- third-party consents and approvals;
- regulatory approvals; and
- dissenters/appraisal rights.

Where a business is acquired by way of an asset purchase transaction, the buyer (or a wholly-owned subsidiary of the buyer) takes title to assets of the target company and may agree to assume specified liabilities, but does not acquire ownership of the target corporation. An asset transaction allows the buyer to select the assets it desires to acquire and the liabilities it desires to assume. Put another way, all liabilities other than specified liabilities can be left behind with the target company. That said, there is a risk that certain liabilities retained in the target company can be imposed on the buyer under state law theories.

In a stock purchase transaction, the buyer becomes the owner of the stock of the target company, thereby indirectly acquiring all of the assets and liabilities of the target company. A stock transaction is feasible where there are a limited number of stockholders of the target company and all stockholders desire to sell to the buyer on the same terms and conditions.

While asset and stock purchase transactions are a matter of contract, a merger is a creature of state statutory law that enables two or more entities to consolidate. Typically, one corporation merges into another, with all of its assets and liabilities becoming the assets and liabilities of the surviving corporation by operation of law. A merger is useful where there is a relatively large number of stockholders and less than all stockholders desire to sell to the buyer or it is not feasible to arrange for each stockholder to enter into a stock purchase agreement. Merger statutes generally require that holders of a majority of the outstanding stock entitled to vote thereon approve of the merger transaction. That is, unanimity is not required.

Because of the limited liability nature of corporations and certain other business organizations, holding an acquired business in a subsidiary can help protect upstream and affiliate assets from third party claims. To the extent subsidiaries are adequately capitalized and follow required corporate formalities, courts will generally respect the shield on liability that such structures afford. Consequently, a buyer will often form a subsidiary entity in connection with the acquisition to obtain the benefit of such limited liability shield. In an asset sale, for example, a corporation may form a new shell subsidiary to acquire the assets and assume any agreed liabilities from the target. A similar result can be achieved through a "forward triangular merger," where the target corporation merges with and into a newly-formed subsidiary of the buyer, and as a result the assets and liabilities of the target are transferred to the newly-formed subsidiary of the buyer. When an acquiring party forms a subsidiary to merge with the target company, but the target company is the entity that survives such merger, this so-called "reverse triangular merger" results in an outcome like a stock purchase in that the target company becomes a wholly-owned subsidiary of the buyer.

Structuring a transaction to limit liability exposure to the buyer is an important consideration, but tax considerations can dominate the decision. A transaction structured as a stock acquisition or as a reverse merger or reverse triangular merger (both of which are generally treated as a stock acquisition for income tax purposes) normally results in a tax basis in the acquired stock that reflects the acquisition price and leaves the target with its historic "inside" asset basis. Accordingly, if the target is acquired at a premium, the "outside" stock basis will be high and the "inside" asset basis of the target will remain at historic levels. In such case, this acquisition premium cannot be amortized to offset income and will not be realized for tax purposes until a disposition of target stock. Therefore, in situations where the target has appreciated in value, the buyer generally will require either an asset transaction or a transaction that can be "deemed" an asset acquisition for tax purposes.

An asset transaction generally will permit the acquisition premium to be allocated either to existing identifiable assets or to a new "goodwill" intangible and depreciated or amortized over time to offset taxable income. An asset acquisition normally is viewed as less desirable from the perspective of the target because it usually entails two layers of tax: one at the level of the target-seller and another at the shareholder level when the corporation distributes the proceeds. As a result, there will usually be a negotiation of price that takes into account the structure of the transaction and economics of the different tax treatment to both buyer and seller. In a limited set of situations, a stock sale can be treated as an asset transaction without significant negative tax aspects to either party. This is generally limited to transactions involving either a target corporation that meets certain specific requirements under the U.S.

tax code called an “S corporation” or a target that is a consolidated subsidiary of the seller, where other requirements are also met.

Transaction structures that do not eliminate minority stockholders of the target are usually avoided, as US state laws protect the rights of minority stockholders in ways that may impose difficult obligations on majority stockholders, increase the cost of operating the target business after the closing and allow the minority stockholders to obtain the rewards of the capital, efforts and risk incurred by the buying company.

The choice of transaction structure may affect the availability of dissenters/appraisal rights. In most jurisdictions, stockholders of the target corporation who object to the consummation of a merger and who adhere to strict procedural requirements may be able to dissent from the consummation of the merger and exercise appraisal rights, even if the transaction is otherwise approved by the required vote of the target stockholders. In these jurisdictions, dissenting stockholders that adhere to the required procedures will be entitled to commence a proceeding for appraisal of the “fair value” of their shares in state court (often an expensive and time-consuming process). These stockholders forgo the consideration otherwise payable in connection with the merger, and instead receive the fair value of their shares, as determined in the appraisal proceeding. Dissenters/appraisal rights are generally not available in connection with stock and asset purchase transactions.

Each party will need to assess what corporate, third party and governmental approvals might be required to consummate a transaction given its proposed structure and further evaluate whether it is feasible to obtain such consents. For example, under most state statutes, mergers and sales of all or substantially all of the assets of a corporation require the target corporation to obtain the approval of the holders of a majority of its outstanding shares. Furthermore, key contracts may not be assignable to the buyer in an asset purchase transaction absent the consent of the other party to such contract. In general, asset transactions will require more third party consents and approvals and could give rise to transfer type taxes not otherwise applicable. Similarly, the choice of transaction structure may dictate whether any regulatory or governmental approvals are necessary.

The Acquisition Agreement

After the transaction structure has been determined, the other terms and conditions of the transaction will need to be negotiated and documented in a definitive acquisition agreement. Although US acquisition agreements vary in many respects, most will share the same basic components, including the following:

- economic provisions;
- representations and warranties;
- pre-closing and post-closing covenants;
- closing conditions;
- termination provisions;
- indemnification provisions; and
- dispute resolution mechanisms.

Economic Provisions

The key economic terms, such as the purchase price, the form of consideration to be paid and the mechanics of payment, should be unambiguously reflected in the purchase agreement.

The purchase price may have a variable aspect or measure used to adjust the payment to be made by the buyer. For example, a mechanism is often included to adjust the purchase price for certain changes in the financial condition of the target company, to ensure the buyer takes a balance sheet consistent with its expectations, and to protect against the target company accelerating accounts receivable, delaying the payment of accounts payable and stripping cash from the target company. This is most commonly accomplished by use of a net working capital adjustment (that is, current assets less current liabilities) and establishing a target net working capital amount, but other balance sheet measures may be used. Net working capital type adjustments are commonly proposed and accepted. The consideration paid by the buyer at closing is typically adjusted (downward or upward as appropriate) based on a good faith estimate by the target company of net working capital (or other balance sheet measure) as of the closing. A balance sheet is required to be prepared within a specified number of days after the closing (such as 30 or 60 days) and the adjustment amount is finalized, with a corrective or "true up" payment being required. While dollar-for-dollar adjustments for these net working capital type provisions (based on the target amount) are common, the parties at times negotiate an acceptable "band" of variation (around the target net working capital or other balance sheet number) within which no adjustment is made. The parties may also provide that the purchase price will be adjusted (dollar for dollar) for other variable components, such as the outstanding amount of indebtedness assumed by the buyer.

Holdbacks, Escrows and Earnouts

The acquisition agreement may include provisions withholding a portion of the purchase price from the seller for a negotiated period of time following the closing of the transaction. The amount of such "holdback" is then available for the buyer to satisfy certain obligations of the seller, such as indemnity obligations for breach of the agreement and post-closing purchase price adjustments as described in the preceding paragraph. The holdback consideration (cash or securities of the buyer company) is usually placed in an escrow account that is managed by a neutral third-party escrow agent, but is sometimes retained by the buyer until payable.

In order to recover funds from the escrow account, the buyer must assert a claim for indemnification or other recovery under the acquisition agreement, and if undisputed by the seller, the escrow agent will release from escrow the amount of such claim to the buyer. If the seller disputes the claim, the escrow agent will retain the amount of the pending claim in escrow until the resolution of the dispute, by settlement, litigation or arbitration. If no claims are outstanding upon the termination date of an escrow arrangement, the remaining amount in escrow will be distributed to the seller. To the extent there are unresolved escrow claims on such date, it is common for agreements to provide that any amounts in excess of the outstanding claims (valued in the amount demanded by the buyer) will be distributed to the seller.

Holdback arrangements reduce the risk that selling parties will transfer sale proceeds to jurisdictions where enforcement of claims for recovery may be impracticable or impossible. They also guard against the transfer of sale proceeds to persons or entities against whom enforcement of claims for recovery may otherwise be difficult. For these reasons, buyers frequently insist on some form of holdback or escrow arrangement, particularly in transactions involving multiple sellers and where the buyer or sellers are located in a foreign jurisdiction. As a result, a majority of private company M&A transactions in the US incorporate a holdback or escrow arrangement, although target companies typically strongly resist such provisions.

The economics of the transaction can be affected by an "earnout" arrangement, where a portion of the purchase price for the acquired business is determined based upon the achievement of financial or other performance measures by the target business following the closing of the transaction. Earnouts are often used in connection with the acquisition of a target business with a relatively short and/or volatile operating history and significant uncertainty regarding future performance. The primary appeal of an earnout is that it can be used to bridge differences of opinion regarding the value of the target business and can help to overcome purchase price related deadlocks. Earnouts can provide an incentive for the former owners of the target business to stay with the business and perform at a high level following the closing of the transaction.

Earnouts present special drafting concerns and frequently give rise to disputes. They almost always raise difficult issues of performance measurement and may create perverse incentives for the recipients of the earnout payments that remain employed with the business, and for the buying company. The negotiation of earnouts frequently leads to complicated formulas and arrangements for measuring the success of the target business following the closing, and protection against manipulation by the buying company. Furthermore, in order to accurately gauge performance against earnout measures, it may be necessary to isolate the target business from the other businesses of the buyer. Sellers often attempt to vest target management with significant control of and discretion over the continued operation of the target business for some period of time after the closing, which can inhibit the integration of the target business into the corporate organization of the buyer. Buyers typically resist restrictions on their control and operation of the acquired target business.

Typical performance measures for earnouts include target company pre-tax earnings, EBITDA and gross revenues. Most earnouts are based on gross revenue, although many focus on earnings related measures. The general view is that earnouts based on gross revenues are less subject to manipulation by the buyer. Earnout payments can also be based on the attainment of non-financial milestones, such as the successful development of new products. The typical length of an earnout arrangement is 1 to as long as 5 years, although performance is at times measured and payments made on an annual or sometimes quarterly basis.

Overall, earnouts are likely to be more successful where (i) the parties agree upon performance measures that will not be negatively affected by post-closing integration of the target business into the other businesses of the buyer, (ii) the parties agree upon relatively simple and unambiguous performance measures that are easy to measure and (iii) the parties choose realistic performance criteria, agree upon partial payments for partial achievement of these measures and provide a fair mechanism to adjust these measures to adapt to changing business circumstances.

Representations and Warranties

Representations and warranties require the target to present the state of its business as it exists on the date the acquisition agreement is signed and (in the case of a staggered signing and closing, which is typical) on the closing date. The representations and warranties section is often the lengthiest portion of an acquisition agreement. From the perspective of the buyer, representations and warranties provide several key protections: (i) they cause the target to identify specific issues and risks and explain the facts surrounding those issues and risks; (ii) they enable the buyer to "walk away" from the transaction (that is, not close the transaction) if facts develop that make the transaction materially less favorable; and (iii) they apportion liability among the parties in the event that the representations and warranties prove inaccurate.

As a general matter and subject to exceptions in certain cases, if an exception or qualification to a representation and warranty is disclosed to the buyer in a disclosure schedule attachment to the acquisition agreement, the buyer will not be able seek indemnification against the sellers based on the resulting losses incurred by the buyer.

While the type and scope of representations and warranties of the target company will vary based upon the circumstances of the particular transaction and the business of the target, typical examples of target company representations and warranties include the following:

- Financial Statements. The representations and warranties relating to the financial statements of the target contain important protections for the buyer. Representations are made concerning recent financial statements, usually the most recent audited annual financial statements and unaudited financial statements for the most recently completed quarterly period, including that such financial statements fairly present in all material respects the financial position of the target company and its subsidiaries, and have been prepared in accordance with US generally accepted accounting principles ("GAAP").

- Undisclosed Liabilities. The buyer will frequently request that the target represent that its business is not subject to undisclosed liabilities of any nature (including contingent liabilities) other than those set forth on the financial statements referenced in the definitive acquisition agreement, and certain types of liabilities incurred subsequent to the period covered by such financial statements in the ordinary course of business. The target company may attempt to create further exceptions to such representation, such as limiting such representation to material liabilities or liabilities that would (individually or in the aggregate) have a material adverse effect on the target, limiting such representation to liabilities that would be required to be recorded on a balance sheet in accordance with GAAP or making such representation only to the knowledge of the target company. A reference to only GAAP based liabilities is not uncommon but a knowledge qualifier is unusual.

In addition to those described above, the representations and warranties of the target company likely will include many of the representations with regard to the following matters:

- organization and authorization;
- no violation or conflict;
- capitalization of the target company and ownership of subsidiaries;
- required third party consents and approvals;
- title to and condition of assets;
- absence of certain changes or events;
- material contracts and commitments;
- compliance with laws and regulations;
- environmental matters;
- intellectual property matters;
- material claims and litigation and threats thereof;
- accounts receivable and accounts payable;
- affiliated party transactions;
- insurance policies and claims;
- tax matters;
- significant customers and suppliers;
- labor and employee benefit matters; and
- commitments to pay brokerage or investment banker fees and expenses.

Buyers often seek a “full disclosure” representation from the target company, which is referred to as a “10b-5” representation since it is usually based on the language of Rule 10b-5 of the Exchange Act. The representation typically requires the target to represent that none of the representations or warranties

made by the target in the acquisition agreement (sometimes, more broadly, any statement made in connection with the transaction) contains any untrue statement or omits to state a material fact necessary to make such representations and warranties, in light of the circumstances in which they were made, not misleading. Whether a 10b-5 representation is included is usually a contentious negotiating point, with target companies often resisting (usually successfully) on the basis that the buyer should negotiate for and rely upon the other more specific representations and warranties.

The buyer will also make certain representations and warranties, albeit significantly less expansive than those of the target in most cases. If the transaction involves stock or other securities of the buyer as acquisition currency, in whole or in part, the representations and warranties of the buyer will take on greater significance. Typically, buyers make representations and warranties mirroring those of the target with respect to basic "corporate" matters and "no violation of law" matters and it is not uncommon for a buyer to agree to represent that it has (and will have at the time of closing) sufficient funds to consummate the transactions contemplated by the acquisition agreement, or as to its financing commitments.

Negotiating representations and warranties is an exercise in risk allocation. Most buyers seek broad and comprehensive representations from the target that will enable the buyer to allocate as much risk as possible to the target. Buyers will argue that the target is in the best position to know the condition and risks about its own business and, consequently, should assume full risk for any misrepresentations. Conversely, a target company will seek to limit and qualify its representations in order to reduce the potential for inaccuracy and claims of breach.

A target will seek to limit the scope of individual representations and warranties in a variety of ways. For example, target companies often seek to include materiality qualifiers (or material adverse effect qualifiers) in many or most representations and warranties. Buyers frequently accept many such materiality qualifiers, although this is usually a subject of considerable negotiation. In addition to materiality qualifiers, the target may seek to limit its duty to disclose certain information by including a knowledge qualifier with respect to certain representations and warranties, thereby forcing the buyer to bear the risk of unknown liabilities or matters. The inclusion of knowledge qualifiers is usually the subject of considerable negotiation, although the use of such a qualifier is fairly typical for certain types of representations, such as with respect to threatened litigation and as to whether parties other than the target company are in breach of agreements with the target company. If a knowledge qualifier is included, the parties should define (i) whether the term "knowledge" is actual knowledge or constructive knowledge (that is, the knowledge an individual should have if a reasonable investigation was performed) as well as (ii) those employees of the target who will be included within the "knowledge group." Occasionally, a target will attempt to qualify all of its representations and warranties by knowledge and/or materiality, which is usually an inappropriate risk allocation given the nature of most corporate transactions, but may be appropriate where the buyer is an insider or otherwise has particular knowledge of the acquired business.

Buyers resist most materiality and knowledge qualifiers. Such qualifiers force the buyer to demonstrate that the breach was material and/or that the target company had knowledge of the breach before the buyer is entitled to recovery on its claim, which can be difficult to establish.

Because a target company can rarely make most representations and warranties unconditionally, it will create schedules to the acquisition agreement to disclose any known exceptions. The parties will need to negotiate the extent to which a disclosure in one section of the disclosure schedule is deemed to apply for purposes of all of the representations and warranties, and whether disclosure of a portion of a matter or document is deemed to include all relevant details of such matter or document whether or not disclosed.

Pre-Closing Covenants

Pre-closing covenants are promises made by the parties that obligate them to take specified actions (or refrain from taking specified actions) during the period between execution of the acquisition

agreement and closing of the transaction. The burdens imposed by such covenants fall more heavily on the target. Examples of pre-closing covenants include the following:

- Access to Information and Notification. The target typically grants the buyer access to the personnel, properties, financial and operating records of the target, and other pertinent information, to enable the buyer to verify satisfaction of closing conditions, among other things. Each party also typically agrees to notify the other regarding certain events, including the discovery of untrue representations and warranties, breaches of covenants and events that would or could prevent the consummation of the transaction.

- Interim Operations. This covenant typically requires the target to operate its business only "in the ordinary course of business," consult with the buyer concerning material operational matters and obtain the written consent of the buyer for any actions outside the ordinary course of business, although the parties should consult with counsel to confirm such provisions will not raise antitrust issues in a strategic buyer context. The target will also typically be prohibited from taking the following actions without the prior written consent of the buyer:

    - amend its charter, bylaws or other organizational documents;

    - invest in or acquire new businesses or form joint ventures;

    - declare or pay cash dividends;

    - increase employee compensation or increase compensation beyond specified levels, or enter into employment or severance arrangements;

    - expand into new lines of business;

    - settle or satisfy liabilities and obligations outside the ordinary course of business;

    - make capital expenditures in excess of a specified dollar amount or in excess of amounts set forth in a referenced budget;

    - transfer or license certain intellectual property;

    - change material accounting practices or policies; or

    - incur indebtedness or material obligations or grant certain liens.

- Further Assurances and Required Approvals. The further assurances covenant will require each party to use its reasonable best efforts (or commercially reasonable efforts) to cause its closing conditions to be satisfied. Aspects of the required approvals covenant may be heavily negotiated. The target may insist that the buyer agree to take any actions required by any governmental authority in order to consummate the transaction (such as obtaining antitrust approval, discussed further below), which may include intensive litigation and/or significant divestitures (or restrictions on) by the buyer pursuant to antitrust laws. At the same time, the buyer will seek to curtail or eliminate its obligations to take such actions.

Post-Closing Covenants

The acquisition agreement will contain various obligations to be performed after the closing has occurred. The most significant are those by which the target company (where only a portion of the target is being sold) or the parent or certain key stockholders of the target agree not to compete with the buyer in certain businesses and geographic areas following the closing for a specified period of time. The buyer will likely

seek to prevent the target or such parent or stockholders from competing in the same businesses or industries as the acquired business following the closing of the transaction. Furthermore, if key individuals associated with the target business remain as employees with the business after the closing, non-competition covenants will likely be included in their employment agreements. The buyer will likely seek to include additional restrictions on the ability of the target or parent to disclose or use confidential information of the target and/or solicit customers of the target company after the closing.

Historically, non-competition covenants have been viewed as agreements in restraint of trade and, therefore, have been disfavored by US courts. However, US courts today are likely to enforce non-competition covenants to the extent they are reasonable in scope and duration (with 1 to 3 years being fairly common) and are appropriate to protect trade secrets, goodwill or other important interests of the parties. Many states have adopted statutes (and there is frequently extensive common law) specifically dealing with the permissible scope of non-competition covenants. A non-competition covenant entered into in connection with the sale of a business is more likely to be enforceable than a similar covenant contained in an employment agreement.

In addition to non-competition agreements and covenants with respect to earnout arrangements, the following post-closing covenants are often included in acquisition agreements:

- covenants not to solicit employees of the acquired business;
- confidentiality and non-disclosure covenants regarding information of the target business and the terms of the acquisition agreement;
- covenants to cooperate with respect to litigation, tax inquiries and similar matters arising out of the transaction;
- covenants by the buyer relating to the compensation of employees of the target business and maintenance of comparable employee benefit plans;
- covenants allocating responsibility for any transfer taxes; and
- parent or affiliated entity guarantees of the obligations of the parties.

Closing Conditions

When there is a lapse of time between the signing of the acquisition agreement and the closing of the transaction, which is typical, the obligation of each party to consummate the transaction will be subject to the satisfaction of certain conditions precedent. Failure to satisfy a closing condition may give the other party the right to terminate the acquisition agreement. The following are several key closing conditions:

Accuracy of Representations and Warranties. The representations and warranties of the other party must be true and accurate in all material respects (or subject to an overall material adverse effect standard) as of closing.

Compliance with Covenants. The other party shall have complied in all material respects with its covenants required to be performed prior to the closing.

No Material Adverse Change. The buyer often requests and obtains the right not to close if the target has experienced a material adverse change or material adverse effect (often called a “MAC” or an “MAE” clause) to its results of operations, financial condition, assets, liabilities, properties, personnel, operations and at times prospects. The target may limit the effect of this MAC or MAE condition by excluding specific matters that it believes should not give the buyer a right to walk from the transaction. For example, target companies often seek and obtain exceptions for events and changes caused by general

economic or industry conditions that do not disproportionately impact the target business and for changes in law and government regulations. It can be advantageous for the buyer to include specific financial tests or conditions rather than rely on general MAC language, especially where the buyer is aware of specific problems or risks at the target company and thus may be deemed to have assumed such problems and risks. As might be expected, target companies heavily resist (and are usually successful in resisting) such objective and specific tests.

Antitrust Approvals. In certain circumstances, the parties may not close the transaction until applicable antitrust approvals have been obtained. The Hart-Scott-Rodino Antitrust Improvements Act (the "HSR Act") allows the US federal government to evaluate the antitrust implications of proposed acquisition transactions. Under the HSR Act, the parties must make certain "pre-merger notification" filings and disclose certain information that is reviewed by the government to evaluate whether a transaction may adversely affect competition in violation of the Clayton Act. Such disclosures are required to be made by the target and the buyer to the Federal Trade Commission ("FTC") and the Department of Justice ("DOJ") prior to closing certain transactions. Where the information disclosed reveals the transaction may have substantially anticompetitive consequences, the FTC or DOJ may request additional disclosures, seek to enjoin the transaction in federal district court or impose conditions to approval on the buyer and acquired business. Whether a given transaction must be reported under the HSR Act often involves the application of technical rules and various exceptions and exemptions.

Whether a particular transaction is subject to the HSR Act requirements depends on the value of the transaction and the size of the parties, as measured by their sales and assets. For 2009, the HSR Act disclosure regulations apply if, as a result of the transaction, the buyer will hold more than $65.2 million worth of voting securities and assets of the target and the parties meet the so-called "size-of-the-person" test. A party meets the "size-of-the-person" test if it has $130.3 million or more of total assets or annual net sales and is proposing to acquire a company with $13.0 million or more of total assets or annual net sales. A party with $13.0 million or more of total assets or annual net sales that is attempting to acquire a company with $130.3 million or more of total assets or annual net sales also meets the "size-of-the-person" test. Additionally, the HSR Act disclosure requirements will apply if the buyer, as a result of the transaction, will hold more than $260.7 million worth of voting securities and assets of the target, even if the parties do not meet the size-of-the-person test. These thresholds are adjusted annually for inflation.

The HSR Act prescribes a waiting period (typically 30 days) during which the parties may not close the transaction. The FTC and DOJ use the waiting period to analyze the effect the proposed transaction may have on the relevant market. Upon expiration of the waiting period, if the transaction raises no competitive issues and the FTC and DOJ do not seek any further disclosures from the parties (usually in the form of a "second request" for information), the parties may close the transaction. Additionally, parties may request early termination of the waiting period upon the filing of their initial disclosures. If early termination is requested and granted, the grant usually comes two to three weeks after all filings required for the transaction are received and reviewed by the FTC and DOJ. If the parties attempt to close the transaction before the waiting period has expired (or if they fail to provide the necessary pre-merger notifications), they can face severe consequences, including substantial monetary penalties or an injunction on consummating the transaction. The DOJ and FTC also may (and do) challenge consummated transactions, regardless whether subject to HSR Act reporting requirements (for example, a transaction that falls below the size of the transaction test), and may seek divestitures or to unwind the entire transaction.

While government antitrust review of the transaction is pending, there are limits on what the parties can do to integrate their businesses. In general, the parties may plan to integrate certain operations (for example, IT and human resources) but cannot implement such plans. Likewise, only a discrete group of persons from each company (and who do not have pricing authority or responsibility) should participate in such planning.

CFIUS Approvals. Section 721 of the Defense Production Act, known as the "Exon-Florio Amendment," authorizes the Committee on Foreign Investment in the United States ("CFIUS") to review all acquisition transactions that could result in the control of a US business by a foreign person. CFIUS is headed by

the US Secretary of State and focuses on national security issues resulting from these transactions. CFIUS has wide discretion to initiate an investigation of a proposed or consummated transaction based on national security concerns and may take any necessary actions in connection with the transaction to protect US national security. Among the factors considered in these investigations are projected production of domestic national defense needs, the potential national security-related effects on critical infrastructure or technologies and long-term protection of US energy sources.

Typically, where the target business touches on national security concerns, a voluntary notice will be submitted to CFIUS. When CFIUS receives notification of a proposed transaction, it conducts a 30-day review to determine whether a full investigation is necessary. If so, a full 45-day investigation is conducted. CFIUS then decides whether to allow the transaction, block the transaction or suggest modifications to the structure of the transaction. If such a voluntary filing is not made, the buyer may be forced to (among other things) divest the acquired business.

Stockholder Approvals. Corporate law statutes in the US generally require that a merger be approved by the stockholders of the merging companies. Under the applicable Delaware statute, a majority of the outstanding shares of each corporation participating in the transaction must approve a merger. Typically, the ownership of one share entitles the holder to one vote, but companies may create different voting arrangements in their charters.

Indemnification

Indemnification provisions allow the parties, usually the buyer, to recover damages for (i) breaches of the representations, warranties and covenants of the other party and (ii) liabilities that the indemnifying party (usually the seller in an asset purchase transaction), has agreed to retain. When a breach of the acquisition agreement occurs, even in the absence of an indemnification provision, parties may have several remedies available, including asserting an action in contract law or a common law claim of fraud. However, by negotiating specifically tailored indemnification provisions, the parties can limit or expand and clarify the remedies that would otherwise be available. Indemnification is typically specified to be the exclusive remedy of the parties.

Buyers will often insist on indemnification for specific matters of concern. For example, a buyer may request indemnification for specified litigation or contingent liabilities that the target disclosed in its disclosure schedules. It is customary to provide for lawyer fees in the definition of "losses" that may be recovered under the indemnification provisions, which would not typically be recovered in US courts in the absence of a contractual right. Recoverable losses are often reduced by certain tax benefits realized by the party suffering the loss (the indemnified party) and insurance policy recoveries, but it is common for acquisition agreements to provide that recoverable losses are measured without regard to any materiality qualification included in the breached contractual provision.

Targets often seek to incorporate and usually obtain limitations within the indemnification provisions. These limitations include the following:

- Baskets/Deductibles. Baskets and deductibles are minimum thresholds that must be exceeded by the aggregate amount of all losses claimed by an indemnified party before it is entitled to receive an indemnification payment. Baskets and deductibles allow the target to avoid having to indemnify the buyer for relatively minor claims. A basket provision allows an indemnified party to recover damages only if damages exceed the specified amount, but once damages meet such threshold amount, basket provisions allow for the recovery of all losses, even those below the threshold amount. A deductible is similar to a basket except that the indemnified party is only allowed to recover losses in excess of the agreed upon threshold amount. The vast majority of transactions include basket or deductible provisions, more often in the form of a deductible rather than a basket. Both baskets and deductibles tend to be set at approximately 1% or less of the purchase price.

- De Minimis Amount. Baskets and deductibles are sometimes accompanied by provisions that prevent an individual claim from being eligible for indemnification unless it exceeds a specified "de minimis" amount, which is set at an amount below which the parties consider the claim a nuisance to deal with. De minimis thresholds are less common than baskets and deductibles, especially in smaller transactions, and are frequently successfully resisted by buyers.

- Caps. A "cap" or "ceiling" is the maximum aggregate amount that an indemnified party can recover from the indemnifying party. Caps generally range from between 5% to 50% of the purchase price, with such percentage often being higher in transactions with lower purchase prices, but it is not unusual for the cap to be set as high as 100% of the purchase price.

- Exceptions to Baskets and Caps. Certain matters are often excluded from the limitations of baskets, deductibles and caps. These commonly include breaches of covenants and also a subset of representations and warranties referred to as "fundamental representations," which usually include the representations and warranties of the target relating to (among other things) due authorization, no violation and capitalization or ownership of the assets being transferred.

There is typically a time limitation imposed (so-called "survival periods") on the ability of the buyer to recover for certain types of claims. It is common for survival periods to range from 12 to 24 months, although longer periods are not infrequent. Despite the inclusion of a survival period, representations involving fundamental representations as well as tax, ERISA and environmental matters often extend until the expiration of the underlying statute of limitations for such claims or perpetually. Claims for breach of covenant are typically not subject to survival periods.

Anti-Sandbagging

An "anti-sandbagging" provision prohibits indemnification claims with respect to any matter that a buyer had knowledge of prior to signing or closing. While buyers often heavily resist their inclusion and are usually successful in this regard, if an anti-sandbagging provision is included, buyers will often attempt to mitigate the effect of the provision by limiting the scope of the definition of "knowledge" to actual knowledge (as opposed to implied or constructive knowledge), ensuring that the burden to prove such knowledge falls on the target and providing that knowledge is tested as of signing as opposed to closing. If the target does not request or gives up including an anti-sandbagging provision, a buyer will commonly still insist upon including a "pro-sandbagging" acknowledgement (that is, an acknowledgement that the knowledge of the buyer with respect to a breach of representation or warranty does not preclude the buyer from bringing an indemnification claim) in the acquisition agreement. Such a provision is common.

Indemnification Procedures

The indemnification section will include a procedure for bringing indemnification claims and resolving disputes related thereto. For disputes involving third parties, the indemnifying party will usually seek to control the defense of the indemnification claim, as the indemnifying party will bear the cost and expense of an adverse ruling or decision. However, any settlement that involves non-monetary relief affecting the indemnified party should be approved in advance by such indemnified party. This control of litigation provision is frequently heavily negotiated.

Dispute Resolution

The parties will need to agree whether disputes should be resolved by litigation or an alternative dispute resolution process, in particular arbitration. Arbitration of disputes has several advantages and is commonly used when the transaction involves parties from different countries. In international transactions, such advantages include greater enforceability of arbitration awards as compared to court judgments, greater confidentiality with respect to the proceeding, neutral and mutually agreed venue and

the appointment of an arbitrator with particular expertise or experience. Many of these advantages, including the probability of a faster or less costly process, also pertain to domestic transactions. In the US, the use of arbitration clauses in acquisition agreements is common. Often, such clauses will require mediation and/or negotiation between the parties as a mandatory prior step. If the parties do not agree upon arbitration, it is typical to include a forum selection clause in the acquisition agreement, whereby the parties agree upon the jurisdiction and court in which disputes can be resolved, and often trial by jury is waived. The parties will also normally include a “governing law” clause specifying the substantive law to be applied by a court or arbitral tribunal.

Lock-Up Agreements

A seminal case by a court in Delaware held that a set of "deal-protection" measures agreed upon by the target board of directors was unenforceable because the provisions effectively precluded alternative bids for the target. In this case, the target board agreed to submit the proposed merger agreement to its shareholders for approval, even if the board itself changed its recommendation to approve the merger. Because the target board had also approved voting agreements with a majority of the stockholders of the target, it became "mathematically impossible" for an alternative superior proposal to succeed. However, absent these particular circumstances, lock-up agreements with key stockholders are often utilized, and in certain circumstances an agreement may be approved by written consent of the requisite stockholders concurrent with the signing of the acquisition agreement.

Fiduciary Duties

No discussion of US M&A activity would be complete without touching on the important subject of fiduciary duties. Under state statutory law and common law principles, the members of a board of directors of a corporation owe a set of fiduciary duties to the corporation and its stockholders. Fiduciary duties are particularly important in the context of corporate transactions due to the significant impact such transactions may have on the economic interests of stockholders and, consequentially, the importance of the decisions and actions to be taken by the boards of directors of the companies involved in such transactions. These duties primarily consist of the duty of care and the duty of loyalty. A violation of these duties may result in litigation by the stockholders, or a derivative suit brought on behalf of the corporation, against the directors of the corporation.

The duty of care requires directors to act on an informed basis. Under this duty, directors must carry out their functions only after sufficient investigation and inquiry. When contemplating an acquisition transaction, in order to satisfy its duty of care, the board of directors should have a sufficient working knowledge of the business and financial condition of the target company, review significant information and relevant documents related to the transaction and, as necessary, obtain outside expert advice and opinions (for example, a fairness opinion).

The duty of loyalty requires that directors act in accordance with the best interests of the subject corporation instead of the personal interests of such directors. This duty restricts director self-dealing and usurpation of the business opportunities of the corporation and further requires the disclosure of any conflicts of interest. In the event a director is in a relationship or position that might influence the decision regarding a potential transaction, all relevant information should be fully disclosed to the entire board of directors in order to comply with the requirements of the duty of loyalty. In some instances, it may be desirable to establish a “special committee” of disinterested and independent directors to negotiate and/or approve the terms of a potential transaction.

Notwithstanding the foregoing, the common law principles of most states grant directors significant deference in their decision-making process. Most notably, the so-called “business judgment rule” is a common law defense to claims against directors for breaches of fiduciary duties. This defense allows a court to presume that directors have complied with their fiduciary duties where their actions were not wasteful, grossly negligent or taken in bad faith. The purpose of the business judgment rule is to allow informed directors to make calculated business judgments without interference or second-guessing from courts that are not well-suited to evaluate such matters.

In US private company M&A transactions, use of “no-shop” and “go-shop” and “fiduciary out” provisions are unusual, although such are typical for acquisitions of public companies. Under a “no-shop” provision, the target agrees not to solicit or initiate discussions with or supply confidential information to other bidders. However, this provision is usually accompanied by a “fiduciary out” clause that grants the target permission to communicate with and possibly enter into an alternative agreement with another acquirer if the target board of directors determines that its fiduciary duties require such. Taking this concept a step further, under a “go-shop” provision, a target board of directors is allowed to actively solicit higher bids for a period of time, helping to ensure that the target board has satisfied its fiduciary duties.

Donald E. Batterson is a partner with Jenner & Block LLP, based in the Chicago office. He is a member of the Corporate, Mergers & Acquisitions and Securities Practices. He is also Co-Chair of the Opinion Letter Committee of the Firm. Mr. Batterson has a practice focused on mergers, acquisitions and related transactions, public and private securities transactions, securities registrations and regulations (both 1933 and 1934 Act) and general corporate matters. He has handled numerous large and complex transactions for a wide range of leading publicly and privately held companies. He can be reached at (312) 923-2607 or dbatterson@jenner.com.