

DRAFTING AND NEGOTIATING THE PURCHASE AGREEMENT

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Stock Purchase Agreements

Key Provisions in Stock Purchase Agreements

> Preamble

- > The preamble dates and defines the agreement and identifies the parties.

> Recitals

- > The recitals provide the basic background to the deal and are a good place to explain any related transactions or other relevant information.

> Definitions

- > The definitions set out key terms used throughout the agreement.

> Purchase and Sale

- > This is where the parties agree to buy and sell the target's stock, define the purchase price and if there are multiple sellers, how they will divide the consideration.

Key Provisions in Stock Purchase Agreements

Purchase Price Adjustments and Earn-Outs

> Purchase Price Adjustments

- > A purchase price adjustment is a mechanism used to confirm the value of the target company as of the closing date. The most common purchase price adjustment is a working capital adjustment, which increases or decreases the purchase price after review of a specially prepared balance sheet of the target as of the closing date.
- > Because the financial information is not ready until after the closing (usually 30 to 90 days), the parties agree to adjust the purchase price after the closing date.

> Earn-Outs

- > Sometimes, future performance determines a portion of the purchase price. This is called an "earn-out," and it is commonly used when the buyer and seller cannot agree on the value of the target company. If there is an earn-out, the buyer pays part of the purchase price at closing and pays the rest in one or more stages if the target achieves certain financial or operational targets.

Key Provisions in Stock Purchase Agreements

Purchase Price Adjustments and Earn-Outs Continued

- > Escrow
 - > The buyers can pay the purchase price in full at closing or have part of it withheld in an escrow account. The escrow secures possible purchase price adjustments in favor of the buyer or indemnification obligations of the seller. The escrow is often released to the seller in a lump sum at the end of an agreed period, but may also be released in stages.
- > Indemnification
 - > The indemnification section allocates risk between the seller and the buyer.
- > Representations & Warranties
 - > More detail later in presentation.

Key Provisions in Stock Purchase Agreements

Termination and Break-up Fees

> Termination

- > A termination provision allows the parties to terminate the agreement under certain circumstances, especially if the agreement is signed before the closing date. Generally, a party cannot terminate the agreement if that party is in breach of its obligations.
- > Common Conditions that permit a third party to terminate the agreement include:
 - > Failure to obtain regulatory approvals or entry of a judgment which prohibits the transaction
 - > Failure to fulfill closing conditions
 - > Material breach of the agreement (often subject to a cure period)
 - > A seller's fiduciary obligation to accept a better offer from another buyer
 - > Failure to close by a specified date (known as the drop dead date)
 - > Mutual agreement of the parties

> Break-up Fees

- > Although more common in public mergers, in some cases the parties may agree to a break-up fee. Break-up fees are used to compensate a non-breaching party if the deal is terminated, and may be payable if the counterparty fails to fulfill its conditions, accepts a bid from another buyer, or is in material breach of the agreement.

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Asset Purchase Agreements

Key Provisions in Asset Purchase Agreements

- > In most asset acquisitions, the buyer only acquires the assets and liabilities it identifies and agrees to acquire and assume.
- > This is fundamentally different from a stock acquisition or merger where the buyer acquires all the assets and liabilities of the target (including unknown or undisclosed liabilities) as a matter of law.

Asset Purchase Agreements

Transfer Mechanics and Considerations

- > The asset purchase agreement will set out how the various assets are to be transferred (for example, by assignment) and the obligations of the parties before and after closing to perfect transfers and ensure the smooth transfer of the business.
- > A seller's closing documents typically include various documents to transfer legal title to assets. The asset purchase agreement typically also should include provisions that provide for assets that cannot be assigned at closing because necessary third party consents are not received (or some other reason).

Asset Purchase Agreements

Allocation of Purchase Price

- > The parties may have conflicting interests when it comes to the allocation.
- > Generally, sellers prefer allocations to assets that generate capital gain (which may be taxed at a preferential rate) and buyers prefer allocations to assets that generate depreciation and amortization deductions.
- > Often, the parties agree to a schedule which details the methodology used to allocate the purchase price and certain other costs among the assets.

Asset Purchase Agreements

Purchase Price Adjustments and Earn-Outs

- > Purchase price adjustments and escrow arrangements may operate identically to those in stock purchase agreements, adjusting the purchase price after payment as final financial statements are generated and withholding funds until certain conditions trigger. Generally, sellers prefer allocations to assets that generate capital gain (which may be taxed at a preferential rate) and buyers prefer allocations to assets that generate depreciation and amortization deductions.
- > Similarly, earn-outs may be used where the buyer is purchasing assets that comprise a business, as opposed to a discrete group of assets.

Asset Purchase Agreements

Third Party Consents

- > Asset acquisitions typically require numerous third party consents since most contracts contain anti-assignment clauses.
- > Often the buyer will require the seller to obtain certain material consents as a condition to closing.

Asset Purchase Agreements

Transfer Documents

- > Asset acquisitions generally require more formalities and documents than stock acquisitions and mergers.
- > Parties use ancillary documents to perfect the transfer of assets and assume liabilities, common ancillary documents related to transfer are:
 - > Bills of sale for the transfer of tangible assets
 - > Assignment and assumption agreements for the transfer of contracts
 - > IP assignment agreement
 - > Deeds for the transfer of real property

Asset Purchase Agreements

Successor Liability

- > As a general rule, an asset purchaser does not assume the seller's liabilities.
- > However, in certain circumstances, the buyer can be held responsible for the seller's liabilities if a court determines that the factors of one of the following exceptions are met:
 - > The buyer expressly or impliedly assumes the liabilities.
 - > The transaction is deemed a de facto merger under state law.
 - > The transfer was fraudulent or intended to defraud creditors.
 - > The buyer is a mere continuation of the seller.
 - > The buyer continues essentially the same operations or product line of the seller.

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Representation and Warranties

Representations and Warranties

- > Representations and warranties are material information about the parties and the target company, allocate risk, serve as the foundation for indemnification claims in case of breach, and impact a party's obligation to close the deal or right to terminate before closing.
- > Although representations and warranties are powerful terms, their scope can be limited in the following ways:
 - > *Materiality*: A representation or warranty can be qualified by what is material or what might cause a material adverse effect. For example, seller might represent and warrant that "the company is not a party to any material legal action."
 - > *Knowledge*: A representation or warranty can be qualified by what a party knows or should know. For example, seller might represent and warrant that "to the knowledge of seller, there is no legal action pending against the company."
 - > *Range*: A representation or warranty can be limited to certain materials. For example, the representation or warranty might be limited to the materials identified in the data room.
 - > *Time*: A representation or warranty can be made as of a specified date or time. For example, the seller might make a representation or warranty as of the signing date or as of the fiscal year end.
 - > *Scheduled information*: A representation or warranty can be limited by reference to the disclosure schedules. For example, the buyer may represent and warrant that "there is no broker's fee payable except as set forth on Schedule 3.5."

Seller's Representations and Warranties

Stock Sale

- > Common representations and warranties of the seller in a stock sale include:
 - > The seller has legal authority to consummate the transaction
 - > The target company is duly organized under the laws of its jurisdiction
 - > Information regarding the capitalization of the target company
 - > Whether the target company has subsidiaries
 - > The target company is in compliance with laws
 - > The financial statements fairly present the financial condition of the target company
 - > The target company has disclosed all liabilities
 - > Tax matters
 - > Litigation matters
 - > Information regarding the target company's material contracts
 - > Employee matters
 - > Environmental matters
 - > Intellectual property matters
 - > Real property matters
 - > The target company's assets are sufficient for the operation of its business
 - > Neither the seller nor the target company owes any broker fees in connection with the transaction
 - > Private placement representations and warranties if the seller receives stock as consideration

Seller's Representations and Warranties

Asset Sale

- > Common representations and warranties of the seller in a asset sale include:
 - > No third party consents are required for transfer of the assets
 - > The assets are in good working order
 - > The financial statements fairly present the financial condition of the business
 - > The seller has disclosed all liabilities
 - > The accounts receivable are reflected properly on the seller's books
 - > Tax matters
 - > Litigation matters
 - > Information regarding the seller's material contracts
 - > Employee matters
 - > Environmental matters
 - > Intellectual property matters
 - > Real property matters
 - > The assets are sufficient for the operation of its business
 - > The seller does not owe any broker fees in connection with the transaction
 - > Private placement representations and warranties if the seller receives stock as consideration

Buyer's Representations and Warranties

Asset Sale

- > Typically, the buyer only makes the following types of representations and warranties:
 - > The buyer has legal authority to consummate the transaction.
 - > The buyer does not owe any broker fees in connection with the transaction.
 - > The buyer has sufficient knowledge about the target company and that the buyer is acquiring the stock of the target company for its own account with no intent to resell the stock. The seller requires this representation and warranty as part of its compliance with securities laws. (stock sale).
 - > The buyer has sufficient funds to complete the transaction.



Indemnification

Indemnification

- > Indemnification is a post-closing remedy for losses incurred under the purchase agreement.
- > These losses can occur as a result of failure to perform a covenant, breach of/inaccuracy in a representation or warranty, or certain liabilities allocated to one party or the other.

Indemnification

Limitations

- > Common limitations include:
 - > Caps that limit a party's maximum aggregate recovery to a stated dollar amount.
 - > Thresholds, baskets or deductibles that require a party to reach an aggregate amount of losses before indemnification is available.
 - > Mini-basket or de minimis claims threshold that prohibit claims below a certain amount (which do not count toward thresholds, baskets or deductibles).
 - > Survival periods that provide an expiration time for indemnification claims.
- > Certain provisions are often excluded from the limitations stated above, such as:
 - > Legal authority to complete the transaction
 - > Title to shares
 - > Capitalization of the target company
 - > Certain matters set out on the disclosure schedules

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Closing

Covenants

Pre-Closing

- > A covenant is a promise to take an action (an affirmative covenant) or to refrain from taking an action (a negative covenant).

- > Pre-Closing Covenants
 - > Often, parties cannot sign and close a stock purchase at the same time because of regulatory, financing or third party consent issues. Pre-closing covenants bridge the gap between signing and closing. Typically, the seller covenants that it will conduct the business of the target company as usual until closing. Known as the interim operating covenant, this is a list of certain things which the seller must do or not do without the buyer's consent.
 - > Common pre-closing covenants include:
 - > Preserving the assets of the business
 - > Not entering into any long-term or material contracts
 - > Not dismissing any existing employees or engaging any new employees
 - > Not incurring indebtedness
 - > Not issuing shares
 - > Not making capital expenditures in excess of a certain amount
 - > Using best efforts to consummate the transaction
 - > Not soliciting other buyers for the target company (known as a no-shop)
 - > Allowing the buyer access to its employees and premises

Covenants

Post Closing

- > These covenants only apply after the deal closes and are often less extensive than pre-closing covenants. For example, the parties may include a mutual covenant to keep certain tax and business records of the target company for a period of time. The buyer may also require the seller to accept restrictive covenants for a defined period of time, including covenants not to compete with the company or to hire its employees.
- > Depending on the specifics of the transaction, the seller may also require the buyer to make post-closing covenants.
 - > Ex: the buyer may covenant to provide director and officer insurance to outgoing directors and officers of the target or change the name of the target if it contains the seller's trademark.

Closing Conditions

- > If there is a gap of time between signing and closing, each party will require the other to fulfill certain conditions before close.
- > Common closing conditions include:
 - > Obtaining necessary government approvals
 - > No injunctions or other legal constraint on the transaction
 - > Bring down of the accuracy of representations and warranties (discussed below)
 - > Compliance with all covenants
 - > A certificate of an officer of each party certifying the accuracy of representations and warranties and covenant performance
 - > Receipt of required documents and instruments
 - > No material adverse change in the target company
 - > Stockholder approval
 - > Receipt of legal or tax opinions
 - > Third party consents

Pre-Closing Process

Checklist

- > The first step towards a successful closing of a private M&A transaction is the preparation of a comprehensive closing checklist.
 - > This is a list assigning responsibility for actions to be taken and documents to be delivered at, on, or before close.
 - > Review the purchase agreement for closing conditions (also called conditions precedent).
 - > Make sure the closing checklist includes all documents required to affect the transfer of assets or stock or the merger.
 - > Review applicable regulations for any regulatory filings and consents that are necessary before the closing.
 - > Review due diligence findings for closing conditions and information contained in the disclosure schedules.
 - > Review applicable corporate statutes, organizational documents, stockholders' agreements, and other similar documents to determine what corporate consents or actions (such as board and stockholder consents) are necessary to effect the transaction.
 - > If any of the parties is a public company, review applicable securities laws and disclosure rules of any applicable stock exchanges for any filings or other disclosures that are necessary in connection with the transaction .

Transaction Documents

- > When each party executes and delivers the principal transaction document, the form of the other transaction documents is generally in final or close to final form. In most cases, the transaction documents just need to be finalized and executed for closing. These documents may include:
 - > Principal transaction document.
 - > The closing table should include executed copies of the principal transaction document (the purchase agreement.)
 - > Disclosure schedules.
 - > If permitted or required by the principal transaction document, the seller should update the disclosure schedules if any of the information contained therein changes between the signing of the principal transaction document and the closing.
 - > Ancillary agreements and documents.
 - > If ancillary agreements and documents are not attached as exhibits to the principal transaction document, they need to be negotiated and finalized before the closing.

Common Closing Documents

- > The following documents are commonly necessary at closing:
 - > Closing certificates (sometimes referred to as bring-down certificates or officer's certificates).
 - > These documents are fairly straightforward and do not require a lot of time to prepare and negotiate.
 - > Secretary's certificates.
 - > The certificate itself is easy to prepare and not usually negotiated, but enough time should be set aside to gather the attachments to the certificate (for example, copies of organizational documents and resolutions). If the secretary's certificate does not include incumbency of the officers authorized to sign the transaction documents, prepare a separate incumbency certificate for those officers to sign.
 - > Board and stockholder consents authorizing the transaction.
 - > Legal opinions.