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Key Nonfinancial Elements in the Acquisition Agreement

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In the first installment of this two-part article, we explored the advantages of forming an Acquisition Planning Team to conduct pre-negotiation planning with a focus on financial issues. This article addresses the advantages of pre-negotiation planning with respect to nonfinancial issues. The focus will be on deal points that we can use to help "tailor" a transaction to assure our clients maximum "comfort."

After an "understanding" is reached as expressed in the Letter of Intent (LOI), attorneys for the purchaser are typically asked to make certain that the client actually receives everything he thinks he is going to acquire while covering every conceivable risk and uncertainty and resolve all issues not previously discussed in favor of the purchaser.

Assigned these tasks, the purchaser's attorney typically begins to fashion an Acquisition Agreement that covers points the parties had actually never considered. This process is often slow, inefficient and expensive given the negotiations involved, as well as multiple drafts agreements between the attorneys and their clients.

Even with a well-executed LOI strategy, there will usually be significant leeway for the purchaser's attorney to create an acquisition document that contains very strict and one-sided nonfinancial provisions about which the parties had never discussed. However, planning prior to the creation of the LOI can be very helpful in eliminating this problem.

Consider the following four interactive and complimentary sections of the typical acquisition agreement that are designed to protect the purchaser's understanding of the deal:

- Representations and Warranties
- Covenants
- Conditions
- Indemnities

These nonfinancial elements should influence the preparation, planning and negotiations for both the buyer and seller leading up to the negotiation and drafting of the LOI. Careful consideration of these points at this very early stage will likely provide a prospective buyer or seller with a much better deal – or at least an early, and therefore less costly, determination that there will be no deal.

Representations and Warranties – Representations are statements about a specific condition at a specific time much like a "snapshot," referring to the present or past. Warranties typically refer to how things will be at the moment of closing the deal.

Covenants – These are affirmative or negative undertakings relevant to preclosing behavior. They relate to a period of time much more like a movie rather than a snapshot. They indicate what a person will do or refrain from doing. Covenants are only relevant when the closing follows the execution of the acquisition agreement and is not simultaneous with the execution.

Conditions – These provide "walk" rights and are conditions precedent to the obligation to close.

Indemnities – These obligations apply after closing when there has been a breach of the agreement or where a representation or a warranty has been violated. The right of indemnification may apply even after a buyer has exercised "walk" rights under certain circumstances. Numerous refinements, variations and custom-made provisions are frequently employed to make the indemnification obligation fit a specific deal.

TAILORING NONFINANCIAL TERMS FOR A COMFORTABLE FIT

The representations and warranties, conditions and indemnity provisions are typically expanded, limited and otherwise tailored to the specific transaction through a number of devices and provisions provided for or found within the typical acquisition agreement. Below are some examples of such devices and provisions:

Disclosure Letter – This is a document that typically accompanies an acquisition agreement. The representations and warranties of the Seller are made and given subject to the disclosures in this letter. In some Acquisition Agreements, schedules are used rather than a disclosure letter. The effect is the same.

Supplement to Disclosure Letter – This is a formal disclosure of inaccuracies in the seller's prior representations and warranties presented by the seller to the buyer after the acquisition agreement has been signed but before closing. The Supplement to Disclosure Letter may limit the scope of the buyer's remedies arising from the matters disclosed to "walk" rights without right of indemnification.

"Walk" Rights – This remedy, with or without the right to indemnification, typically applies when a material condition has not been satisfied.

Indemnity Rights not Affected by Buyer's Knowledge – Provisions can be drafted stating that a buyer's knowledge of inaccuracies in the seller's representations and warranties is not a defense to the buyer's claim for indemnity. This is a matter upon which buyers and sellers may have legitimate

disagreement.

Indemnity Limits – These may include a dollar ceiling or "cap," time limitations within which an indemnity claim must be brought or thresholds consisting of a minimum amount that must be exceeded before indemnification is required after which buyer may then collect the excess, or in some deals, begin collection with the very first dollar.

Baskets – A group of items measured in the aggregate against indemnity caps or thresholds. Alternatively, limits may be applied on a claim-by-claim basis.

Covenant to Supplement – A seller's agreement to promptly update the disclosure letter prior to closing. It may or may not form the basis for indemnification where the buyer chooses to close.

Materiality Requirements – These are relevant for "walk" rights but not for representations and warranties. With representations and warranties, "caps" and "thresholds" are typically utilized.

Holdbacks and Setoffs – These are used as collection or security devices to help assure collectability as to indemnification claims. Deferral of payment with right of setoff and use of escrows are typical.

Definitions – Often bunched together at the start of an Acquisition Agreement or at the end. These key provisions are critical as they may greatly expand or limit significant provisions in the agreement.

ACQUISITION/SALE IMPLEMENTATION TEAM

Like the planning team recommended in part one of this article, buyers would do well to consider forming an implementation team comprised of business executives and outside experts such as attorneys. Working through the typical deal issues with experienced legal counsel and formulating desired outcomes, in advance of any negotiations, will likely lead to a better deal.

Sellers should consider developing a team that can study and troubleshoot the financial and nonfinancial issues involved in a particular transaction. A seller's negotiating leverage tends to lessen at each step as the deal negotiations move from confidentiality agreement to LOI to the negotiation of the acquisition agreement, so early focus on financial and nonfinancial issues is critical for a successful outcome.

Plunkett Cooney has had the privilege of working with countless businesses to develop and implement advantageous buy/sell strategies. The firm is ready to assist you by answering your questions or by joining your buy/sell planning and implementation team.

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