

# **AGREEMENT STRUCTURE**

- Price and structure
- Reps and warranties
- Covenants
- Conditions
- Indemnification

# **PRICE**

- Multiple of earnings/balance sheet
- Negotiated working capital/fixed assets
- Post-closing audit

# **EARNOUT**

- **Complex**
- **Seller concerns: strategic control, cost control (allocation of corporate overhead, amortization, increased depreciation, extraordinary charges)**
- **Buyer concerns: cost of capital, paying for its contribution to post-closing success**
- **The higher up the income statement, the simpler the agreement**

# **REPS AND WARRANTIES - PURPOSES**

- **Disclosure, achieved through the schedules**
- **Provide an ability for Buyer to refuse to close, should subsequent due diligence show reps to be untrue**
- **Provide a basis for indemnity claims, either in the event there is no closing due to a breach, or after the deal closes**

# **REPS AND WARRANTIES - KNOWLEDGE**

- **To determine when a knowledge caveat is reasonable, decide whether Buyer is entitled to a guarantee or merely disclosure of known problems**
- **To the extent reps are limited to Seller's knowledge, whose knowledge counts?**
  - **Named persons; titleholders; persons with functional responsibility**

# **REPS AND WARRANTIES - MATERIALITY**

- **Recall the purposes:**
  - **Disclosure** – Some items really aren't worth listing in the Schedule (small contracts)
  - **Indemnity** – Deal with materiality in terms of the basket
  - **Conditions** – Deal with materiality in the conditions section (reps and warranties true in all material respects)
- **In short: Buyer should be firm on resisting materiality carve outs in the reps**

# **REPS AND WARRANTIES - EXAMPLES**

**[\_.\_] The Company has no liability *or obligation* (*absolute or contingent*) which must be accrued or disclosed on a balance sheet prepared in accordance with GAAP, except (a) such *liabilities or obligations* as are fully reflected, reserved against or disclosed in the Financial Statements, and (b) such *liabilities or obligations* as have been incurred in the ordinary course of business since the date of the Financial Statements.**

**[\_.\_] The Company has complied with all applicable laws, rules and regulations, except in those circumstances where non-compliance would not have a material adverse effect upon the Company; and provided that the representation contained in this Section[ . ] shall not apply to any matter as to which a more specific representation and warranty applies.**

# **COVENANTS**

- **Negative covenants restrict Seller from taking actions after signing which would change the business from its signing status**
  - **Payment of dividends; borrowing; sale of assets; salary increases; violations of law**
- **Affirmative covenants obligate the parties to take the actions required to satisfy the conditions to closing**
  - **Best efforts (payment of money?) vs. commercially reasonable efforts**
- **Breach of covenant gives rise to a claim for damages**



# **CONDITIONS**

- **Present if there is a deferred closing**
- **Purpose is to assure Buyer that the business is generally the same at Closing**
- **If conditions aren't met, no closing – but no breach**

# **CONDITIONS - CHANGES**

- **Reps should be updated to closing, and closing should constitute a waiver of claims**
- **Original reps should be restated at closing, without regard to any update, and should be materially true on the closing date**
- **Buyer may also ask for an out if there is a material adverse change between signing and closing**

# **INDEMNIFICATION**

- **Generally survives 12-24 months (at least through the first post-closing year-end audit); taxes survive for applicable limitation period; environmental and ERISA 3-5 years**
- **Basket ends up at 1-2% of price**
  - **deductible vs. threshold (or “trapdoor”)**
- **Seller seeks a ceiling; more Buyers are willing to accept this limitation, particularly if an escrow is involved**
- **Amount of escrow varies widely**
  - **Installment sale issues**

# **DRAFTING INDEMNIFICATION PROVISIONS**

- **The indemnification clause should be Buyer's exclusive remedy, except in the case of fraud**
- **Indemnity against "loss or damage" does not accrue until claim is paid; indemnity against "liability" requires that liability be fixed**
- **Language must include claims that are threatened, and require defense assumption**
- **Specifically include attorneys' fees incurred in enforcing the indemnity**