

# MERGERS & ACQUISITIONS

## How to avoid contractual train wrecks

Properly drafted agreements can save deals threatened by inaccurate representations.

By Kenneth A. Adams  
SPECIAL TO THE NATIONAL LAW JOURNAL

IN TERMS OF THE CASE LAW it has produced, one of the murkier issues that arises in mergers and acquisitions (M&A) practice is whether a seller is liable for having made an inaccurate representation if the buyer knew about the inaccuracy before the deal closed.

The leading New York case on this issue is *CBS Inc. v. Ziff-Davis Publishing Co.*, 553 N.E.2d 997 (N.Y. 1990). This case involved a buyer that knew that a seller representation was inaccurate but nevertheless agreed to close. It subsequently sued the seller, and the court held that knowing that the representation was inaccurate did not preclude the buyer from seeking to be indemnified for damages arising from that inaccuracy.

But in three subsequent cases decided by federal courts applying New York law, the courts held that a buyer wasn't entitled to recover for representation inaccuracies that it knew about before closing. *Galli v. Metz*, 973 F.2d 145 (2d Cir. 1992); *Rogath v. Siebenman*, 129 F.3d 261 (2d Cir. 1997); *Coastal Power Int'l Ltd. v. Transcontinental Capital Corp.*, 10 F. Supp. 2d 345 (S.D.N.Y. 1998).

Given the case law, it's not clear what position the next court to consider this issue—under New York law or the law of any other state—will take.

One of the benefits of being a transactional attorney is that rather than waiting for a train wreck—in other words, waiting to see if a given transaction gives rise to a dispute and then considering how that dispute relates to the existing case law—one can draft a contract so as to reduce the risk of it occurring.

With that in mind, this article suggests how to address in a contract issues relating to preclosing knowledge of inaccurate representations, namely disclosure of any such knowledge and the effect, if any, that any such knowledge has on indemnification.

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## Two-step transactions coming back into fashion

Reappraisal of the best-price rule could revive a once-popular form of corporate courtship.

By Mark E. Betzen and Jeffrey D. Little  
SPECIAL TO THE NATIONAL LAW JOURNAL

IN THE 1980s and early 1990s, most cash acquisitions of U.S. public companies were structured as two-step transactions: a cash tender offer followed by a merger. This was primarily because, all else being equal, the first-step tender offer frequently could be completed (and control of the target company obtained) much more quickly than with a one-step merger. In addition, if the tender offer resulted in ownership of more than a statutorily prescribed minimum percentage of the outstanding shares of the target company (90% under Delaware law), the second-step merger could be completed immediately following the completion of the tender offer.

Since the mid-1990s, however, acquirers in-

gotiated acquisitions of U.S. public companies have all but abandoned this two-step process in favor of the one-step merger. This shift is largely attributable to judicial interpretations of the so-called best-price rule that present significant risks to acquirers that use tender offers. In general, these risks relate to the possible judicial characterization of

payments made to certain shareholders in the context of employment or commercial relationships as tender-offer consideration that must be paid to all tendering shareholders.

On October 18, the U.S. Securities and Exchange Commission (SEC) adopted simple, yet significant, changes to the best-price rule to clarify that it applies only to consideration paid for securities tendered in the tender offer, and not to consideration paid in connection with employment and certain other relationships. Although the final text of the amendment was not available at the time this article was written (it will be available soon on the SEC's Web site), if the agency acted as expected, tender offers likely will regain their prominence as the transaction structure of choice for many U.S. public-company acquisitions.

The best-price rule is codified as Securities Exchange Act Rule 14d-10(a)(2) for third-party tender offers, and as Securities Exchange Act Rule 13e-4 for issuer tender offers. In either case, the original best-price rule provided: "No bidder shall make a tender offer unless...the consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer."

The rule was designed to ensure fair and equal treatment of all shareholders of a target company. Since its adoption, how-

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Tact, candor are keys to retaining an acquired company's leaders. S2

# Contract language to save the deal

amount even though the target executive would stay on. Without a word of complaint, the acquirer changed the indication of interest to provide just that incentive. The executive was also given a country club membership and was courted by the acquirer's CEO, and the new regional manager sings the praises of the acquiring entity.

In another merger, the acquirer wanted to keep several executives of the target company. For a variety of reasons, the target executives were paid their severance in a way to avoid a tax gross-up, and their restricted stock and option grants were accelerated. The acquirer agreed to keep the target executive salaries at the same level, even though this meant that the target executives would be earning more than some senior acquiring company executives. However, the management of the acquirer then decided to communicate to the target executives that they would not be eligible for raises. While the executives remained with the company after the closing, they were unsurprisingly not great cheerleaders for the acquirer.

## The need to listen

To help retain both an executive and his or her goodwill, then, companies must suppress their instinct to enforce their legal rights to the letter and instead listen hard to determine what is most important to the executive. An acquirer may have to offer an executive sums not required by a change-in-control agreement, but the expenditure will both meet the executive's

## Companies need not enforce their legal rights to the letter.

economic and psychological needs and pave the way for a positive future relationship. If the acquirer fails to recognize and address these needs, the cost of finding a new executive may, in the long run, be more than the cost of satisfying the acquired executive's expectations.

The general counsel's leadership can be instrumental in favorably resolving these issues. When a merger is contemplated, the general counsel of the acquiring company will be called upon to review the change-in-control and employment agreements of the senior executives of the target and offer advice about them. Applying an analytical approach, the general counsel will review the agreements to determine whether the acquirer can allow the executive to depart without owing him or her any severance, the cost of allowing the executive to depart with a contractually mandated severance payment, and whether a departing executive could be made to execute a noncompete agreement.

If he or she only focuses on calculable economic elements, however, the GC may disserve the acquirer by neglecting the delicate but important intangibles that bind people into successful teams. "Thinking like a lawyer" in this context may alienate the good people who are often critical to the success of an acquisition because it disregards the simple truth that team members must feel satisfied, desired and listened to, and that acquisitions are hard transitions.

In this situation, the GC would do best to advise the acquirer to follow the lead of the character Vincent Vega of *Pulp Fiction* fame. When asked, "Do you listen, or do you wait to talk?" he replies, "I admit I usually wait to talk. But I'm trying harder to listen."

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It's relatively commonplace for an M&A contract to contain language that addresses disclosure—preclosing—of inaccuracies in the seller's representations. Such language can apply to the buyer, the seller or both.

It stands to reason that buyers would rather be informed promptly of any actual or potential inaccuracies in a seller's representations rather than wait until closing, or afterward, to find out.

In many agreements, the issue of the seller's preclosing disclosure of inaccuracies is addressed in terms of the seller's being required to update its disclosure schedules if any seller representation was inaccurate when made or

would be inaccurate at closing. In a number of respects, such provisions are problematic.

First, from a drafting perspective, rendering accurate an inaccurate representation might require amending that representation in addition to, or instead of, updating any disclosure schedules. For instance, if a given representation didn't provide for any scheduled exceptions, then fixing that inaccuracy by adding a schedule of exceptions would, strictly speaking, also require revising the representation itself to refer to that schedule.

Second, such provisions commonly require that the schedules be updated not only to reflect inaccurate representations but also any failure by the seller to

perform any obligation and any event that would prevent any condition to the buyer's obligations from being satisfied. Updating schedules to reflect the latter two categories of events or circumstances would require schedules to provide something other than their intended function, which is limited to stating factual information that supplements constitutes exceptions to a set of representations.

Third, while it could be argued that such provisions allow schedules to be updated to take into account ordinary course changes such as the seller entering into contracts between signing and closing, the better way to provide

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# Saving the deal from inaccurate representations

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 such changes would be to include the date of the agreement as a date of reference in any affected representations and to address preclosing change in either a preclosing obligation (if the change is under the control of the seller) or a condition (if it isn't).

And fourth, provisions that address the seller's updating of schedules usually go on to specify that updating the schedules serves merely to inform the buyer and has no effect on closing conditions or the seller's indemnification obligations. (Such language has broadly the same effect as the "indemnification-even-if-you-know" provisions discussed below.) In other words, the schedules are being updated, but not really. It would be simpler instead to incorporate the concept of updating in a way that leaves the schedules unaffected.

### Requiring seller disclosure

This can be accomplished by requiring the seller to notify the buyer of any relevant information. Such a provision would best be placed in an article stating various preclosing obligations.

Here's a recommended version of such a provision:

"Updates. The Seller shall promptly notify the Buyer of any event or circumstance as a result of which any of the conditions stated in section 5.1 [Conditions to the Buyer's Obligations] could not or would not reasonably be expected to be satisfied."

Here are some issues relating to how this provision is worded:

First, note that unlike many provisions calling for schedules to be updated,

the proposed section doesn't lump together inaccurate representations, obligations that haven't been performed and conditions that can't be satisfied. Instead, it refers only to any of the conditions to the buyer's obligations not being satisfied. One doesn't need to refer to inaccurate representations or obligations that haven't been performed, because they would be addressed by the bring-down condition and the performance-of-obligations condition, both of which would be included in a standard set of closing conditions. This is one reason why this version is much shorter than the analogous "Notification" section in the

## Buyers would rather know about problems than wait to find out.

American Bar Association Section of Business Law's Model Asset Purchase Agreement (2001) (at 166).

Second, because this provision refers to conditions that could not or would not "reasonably be expected to be satisfied," the seller would be required to disclose not only actual but also potential deal-breakers.

Third, there's the question of timing. Some updating provisions require that the seller notify the buyer no later than a stated number of days before the closing, but from the buyer's perspective it would be better to require that the seller notify the buyer promptly.

And fourth, assuming that the bring-down condition is qualified by materiality, the proposed language wouldn't require the seller to disclose any nonmaterial inaccuracy in a representation. That shouldn't trouble most buyers.

### Buyer disclosure

Agreements sometimes address the buyer's disclosure of any inaccuracies in the seller's representations that the buyer becomes aware of. The purpose of such provisions is presumably to give the seller the opportunity to rectify before closing any inaccuracy that it hadn't been aware of—the cost of doing so might well be less than any claim for indemnification arising from that inaccuracy.

The best way to address this issue would be by means of a representation with the signing date as the date of reference and a preclosing obligation.

The representation might state as follows: "No Knowledge of Inaccuracies. As of the date of this agreement, to the Buyer's Knowledge none of the representations made by the Seller in article 2 is inaccurate [ , except for any inaccuracies that would not reasonably be expected to result in a Seller Material Adverse Change]."

The preclosing obligation might state as follows: "Knowledge of Inaccuracies. The Buyer shall promptly notify the Seller if at any time before the Closing the Buyer acquires Knowledge, from any source other than the Seller or any of its representatives, of any inaccuracy in any of the representations made by the Seller in article 2 [ , except for any inaccuracies that would not reasonably be expected to

result in a Seller Material Adverse Change]."


These provisions use the defined term "Knowledge" to avoid any argument as to what "knowledge" means and whose knowledge is to be imputed to the buyer. The buyer might want to add a materiality qualifier to these provisions. Recommended language is shown in brackets.

There are two ways that the buyer might learn before a deal closes that one of the seller's representations is inaccurate. The seller might disclose the inaccuracy to the buyer post-signing but preclosing, possibly by means of a "last-minute dump." Or the buyer might uncover the inaccuracy in the course of its due diligence. In the latter instance, the buyer might elect to close without informing the seller of its knowledge, with the idea of bringing a claim for indemnification—in other words, with the idea of "sandbagging" the seller.


However the buyer came by its knowledge, the question arises whether it is entitled to seek to be indemnified for the inaccurate representation. Attorneys can greatly increase their odds of not adding to the mixed case law on this issue if they include in their contracts a provision addressing the consequences of such knowledge.

### Anti-sandbagging

The seller might want to include a provision to the effect that the buyer would not be entitled to be indemnified for an inaccurate seller representation if the buyer knew of that inaccuracy before the closing. Such provisions are commonly referred to as "anti-sandbagging" provisions, although they wouldn't apply only



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to sandbagging—one might just as well call them “pro-last-minute-dump” provisions. A less loaded term might be a “no indemnification if you know” provision. Here’s some recommended language:

“Knowledge of Inaccuracies. The Seller is not required under section 8.2 [Indemnification of the Buyer] to indemnify any Buyer Indemnified Party for any loss resulting from an inaccurate representation made by the Seller in article 2 if the Seller establishes that the Buyer had [ , or by reasonably diligent investigation could have obtained.] Knowledge of that inaccuracy before the Closing.”

An agreement might contain a narrow form of no-indemnification-if-you-know provision that only precludes the buyer from seeking indemnification for inaccuracies that the seller discloses preclosing—the buyer is still free to seek indemnification for other inaccuracies that it learns about. (Usually such language is tacked on to a provision of the sort discussed above regarding the seller’s updating of its disclosure schedules.) There doesn’t appear to be any logical basis for this distinction.

Buyers strongly resist no-indemnification-if-you-know provisions. For one thing, if the seller discloses inaccuracies after signing, the buyer could face an unpalatable choice between not closing and seeking indemnification, and closing and forgoing indemnification. If the buyer invested considerable resources in the transaction, walking away may not be an option. And the buyer will probably feel

## Some agreements discuss disclosure by the buyer.

that it should have the benefit of the bargain it made at signing.

Also, such provisions have the effect of adding an element—the buyer’s preclosing knowledge—to any claim for indemnification for an inaccuracy in a seller representation. In that regard, the no-indemnification-if-you-know provision above at least makes it clear that the burden is on the seller to demonstrate that the buyer had that knowledge.

The bracketed language in the above version of a no-indemnification-if-you-know provision would seem particularly unlikely—rare is the buyer that would accept being precluded from bringing a claim for indemnification for an inaccurate representation because it could have found out about the inaccuracy if it had been reasonably diligent.

The opposite approach is reflected in what might be called “indemnification-even-if-you-know” provisions. (Whereas such provisions are also referred to as “rights-reserving” provisions, that shorthand seems altogether too vague to be helpful.) Here’s a recommended form of indemnification-even-if-you-know provision:

“Knowledge of Inaccuracies. The Seller’s obligation under section 8.2 [Indemnification of the Buyer] to indemnify any Buyer Indemnified Party for any Loss resulting from an inaccurate representation made by the Seller in article 2 will not be affected if the Buyer has, or by reasonably diligent investigation could have obtained, Knowledge of that inaccuracy before the Closing.”

### Appellate affirmation

A recent 2d U.S. Circuit Court of Appeals case suggests that courts may be willing to enforce such provisions.

*Schwan-Stabilo Cosmetics GmbH & Co. v. PacificLink Int’l Corp.*, 401 F.3d 28 (2d Cir. 2005), concerned a buyer that had purchased shares representing a 67% interest in a company. The buyer sought to be indemnified by the seller for liabilities of that company that hadn’t been disclosed. In affirming the district court’s holding that the seller was required to indemnify the buyer, the court cited the indemnification-even-if-you-know provision in the share purchase agreement governing the transaction. It’s not clear how that provision was relevant, in that the buyer didn’t know when acquiring the shares that the company was subject to those liabilities. Instead, the buyer expressed to the seller concern about irregularities in the company’s financial statements and the seller assured the buyer that the company would not be subject to any liabilities. But it’s nevertheless noteworthy that the

## A court took an indemnification clause at face value.

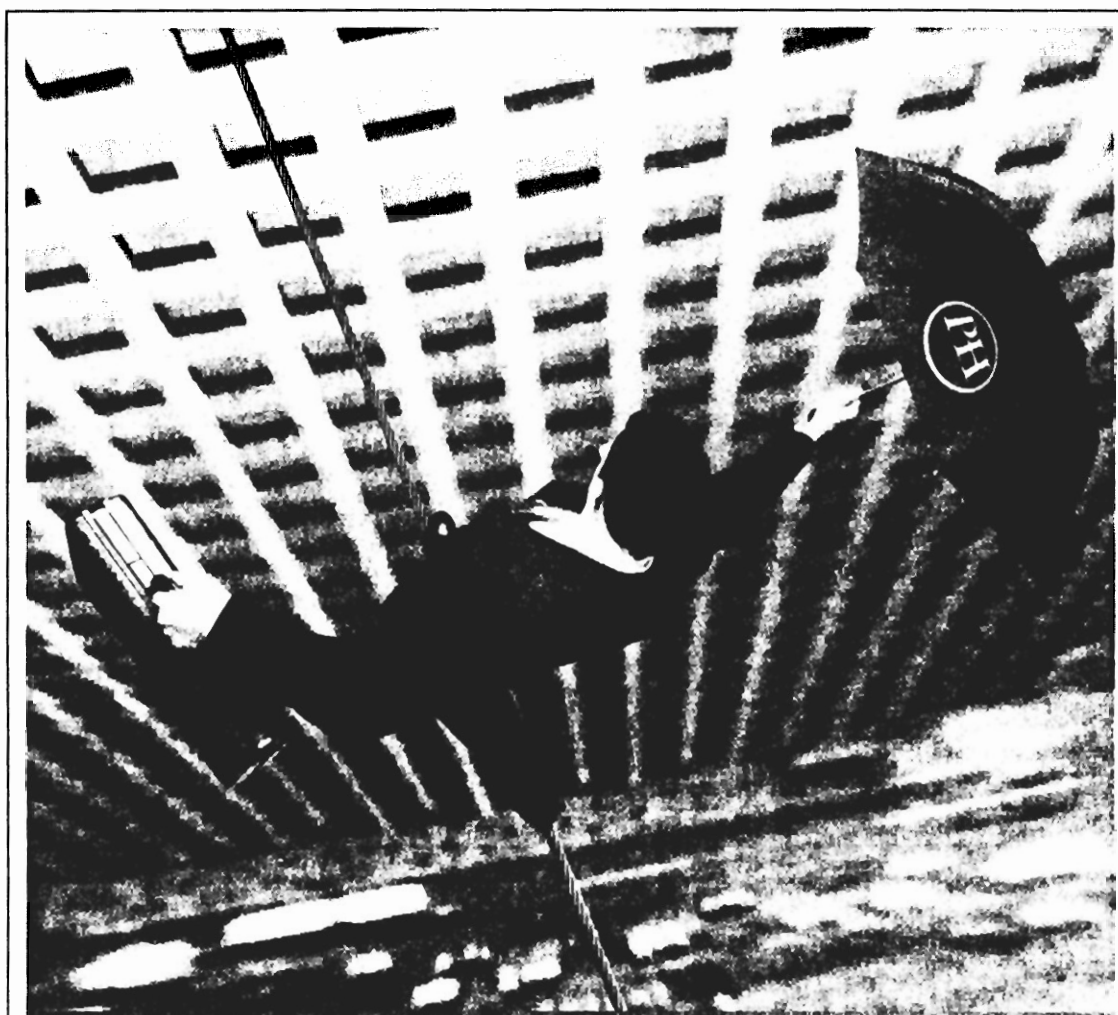
court took the indemnification-even-if-you-know provision at face value.

The buyer can’t assume that an indemnification-even-if-you-know provision would guarantee that it would be entitled to be indemnified for an inaccurate seller representation that it knows about at signing, as opposed to at closing. The buyer would be advised to use that inaccuracy to try to get the seller to reduce the purchase price or grant the buyer a specific indemnity. (And it should seriously

consider negotiating to the same end if the inaccuracy comes to light after signing.)

For the seller in fear of being sandbagged, an indemnification-even-if-you-know provision could be neutralized by including in the acquisition agreement the buyer representation and obligation regarding preclosing knowledge proposed above.

One could build in additional wrinkles. For instance, one sees agreements that provide that while the buyer is free to seek indemnification for inaccuracies disclosed preclosing, it cannot use those inaccuracies as a reason not to close. That would seem an unusual arrangement—in order for the seller to be able to negotiate such a provision, it would need significant bargaining power and would have to be more concerned with getting the deal done than avoiding claims for indemnification. **EW**



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