Chapter 9

Building Blocks in Detail

§ 9:1 Introduction
§ 9:2 Enforceability Representations
§ 9:2.1 Organization
§ 9:2.2 Power and Authority
§ 9:2.3 Necessary Action
§ 9:2.4 Due Execution and Delivery
§ 9:2.5 No Conflict
§ 9:2.6 Governmental Approvals
§ 9:2.7 Enforceability
§ 9:3 Credit-related Provisions
§ 9:3.1 Representations
[A] Financial Statements
[B] Projections
[C] Material Adverse Change
[D] Litigation
[E] Compliance with Law
[F] Payment of Taxes
[G] True and Complete Disclosure
[H] Other Representations
§ 9:3.2 Affirmative Covenants
[A] Reporting Covenants
[B] Books and Records
[C] Inspections
[D] Compliance with Law
[E] Maintenance of Insurance
[F] Payment of Taxes
[G] Corporate Existence
[H] Payment of Claims
§ 9:3.3 Negative Covenants
[A] Debt
[B] Liens
[C] Asset Sales
[D] Restricted Payments
[E] Investments
[F] Transactions with Affiliates

[G] Payment Restrictions Affecting Subsidiaries
[H] Amendments to Other Documents
[I] Mergers
[J] Capital Expenditures
[K] Financial Covenants
§ 9:3.4 Events of Default
§ 9:4 Acquisition-related Provisions
§ 9:4.1 Representations
[A] The Purpose of Representations
[B] Representations and the Disclosure Process
[C] Timing of Representations
[D] Representation Qualifiers
[E] Corporate Existence, Power and Authority
[F] Consents; No Violations
[G] Financial Statements; No Undisclosed Liabilities
[H] Material Adverse Change
[I] Books and Records
[J] Title to Assets
[K] Capitalization
[L] Litigation, Full Disclosure, Etc.
[M] Other Representations
§ 9:4.2 Covenants
[A] Interim Operations of the Target
[B] Actions Relating to the Closing
[C] Notification of Certain Matters
[D] Post-closing Covenants
§ 9:4.3 Conditions Precedent: Chickens, Eggs and Big Fat Moments in Time
[A] Payment and Transfer
[B] Legal Impediments
[C] Litigation
[D] Representations
[E] Performance of Covenants
[F] Officer's Certificate
[G] Financing
[H] Legal Opinions
§ 9:4.4 Remedies
[A] Termination
[B] Indemnification

§ 9:1 Introduction

In this chapter we look in detail at the way certain of the building block provisions are used in two different types of transactions: a bank loan and an acquisition of one company by another. Together, they provide an opportunity to explore a broad array of important contract provisions. Both transactions involve one party making a significant investment in another, but are quite different in terms of the nature of the business relationship that they create. The credit agreement creates contractual obligations that run between the parties for years, while under the acquisition agreement the business relationship ends (for the most part) at the closing. By examining the way that representations, covenants, conditions and remedy provisions are used in typical credit and acquisition transactions, the reader will develop a deeper understanding of the ways that these provisions are used to address particular business objectives and concerns.

First, however, this chapter will discuss a set of representations that are familiar to every practitioner who works with contracts, regardless of type.

§ 9:2 Enforceability Representations

Many contracts contain representations relating to facts that could affect the enforceability of the contract (referred to here as "enforceability representations"). Whether or not these representations are made is usually a matter of custom and negotiating leverage. In addition, where performance is only required from one party, usually only that party will make these (or any other) representations.

It is also important to understand the specific purpose of a subset of the enforceability representations: the representations regarding organization, power and authority and corporate or other action (sections 9:2.1 through 9:2.3 below). These representations go to the *capacity* of an entity (as opposed to a natural person) to enter into the contract. A corporation, limited liability company, limited partnership or other entity has not validly executed and delivered an agreement unless (a) it validly exists as an artificial legal person, (b) it has the legal power and authority to enter into the agreement and (c) all necessary organizational action has been taken to authorize the entity's entering into the agreement. Not only are these representations

usually required of contracting entities, they are often the subject of legal opinions and closing conditions as well.

§ 9:2.1 Organization

> The Company is a duly organized and validly existing corporation in good standing under the laws of the jurisdiction of its organization and is duly qualified and authorized to do business and is in good standing in all jurisdictions where it is required to be so qualified and where the failure to be so qualified would reasonably be expected to have a Material Adverse Effect.

This representation goes to whether the party making the representation has been properly organized, is validly existing as an entity and is in good standing.[1] Due diligence for this representation would include ordering a certified certificate of incorporation (or analogous filing for a limited partnership or limited liability company) and a good standing certificate from the state where the entity is organized. This representation is requested to avoid the risk that an entity does not legally exist as an artificial person.

This provision often also covers the entity's good standing in its state of organization and qualification to do business in states other than its state of organization. Failure to be so qualified in a state doesn't affect the entity's capacity to enter in the contract, but may impair its ability to appear in the courts of that state to enforce the contract. Often this portion of the representation is subject to a materiality qualification, as in the above example.

§ 9:2.2 Power and Authority

> The Company has the corporate power and authority to (a) own its property and assets and to transact the business in which it is engaged and presently proposes to engage and (b) execute, deliver and perform this Agreement.

---

1. An entity's being properly organized depends on whether all legal requirements were properly followed in connection with its creation. Being validly existing goes to the *present* valid existence of the entity. This technical distinction is often the subject of debate in the context of legal opinions, but not contract representations.

An entity's ability to enter into and perform different kinds of contracts may be limited by its organizational documents or, in the case of regulated entities, by statute or regulation. This representation is a statement that there are no such restrictions on the party's ability to conduct its business or to execute, deliver and perform the contract. Enforcement of an agreement against an entity that lacks the legal right or power to enter into the agreement may be subject to an *ultra vires* defense. The due diligence required to ensure that this representation is made correctly is a review of the organizational documents and, if the party is a regulated entity, of all applicable statutes and regulations.

§ 9:2.3 Necessary Action

> The Company has taken all necessary action to authorize the execution, delivery and performance of this Agreement.

This is another representation that applies only to entities. It states that all actions required by its organizational documents and by applicable law in connection with the execution, delivery and performance of the contract by the entity have been properly taken. In the case of a corporation, this representation would be correct if the corporation's board of directors had duly adopted a resolution authorizing it to enter into the agreement. In the case of a limited or general partnership, a general partner must execute and deliver the agreement. The partnership agreement must be reviewed to determine whether other actions or consents may be required. If the general partner is itself an entity, there must be appropriate action taken by such entity. For example, if the general partner is a corporation, its board of directors must adopt a resolution authorizing its execution and delivery of the contract on behalf of the partnership, in its capacity as general partner.

Limited liability company statutes provide a great amount of latitude to the organizers of an LLC as to how acts of the LLC may be authorized. The limited liability company agreement may grant this power to each member, a single member, a board of members, or one or more managers.

§ 9:2.4 *Due Execution and Delivery*

The Company has duly executed and delivered this Agreement.

This representation states, first, that the agreement has been properly *executed* by or on behalf of the party making the representation. In the case of an entity, it means that the agreement was signed by an officer or representative who was properly authorized to do so. To ensure that this representation is true, the lawyers should (a) review the organizational documents to ascertain whether there are any specific requirements relating to execution and delivery of contracts (for example, a requirement that certain kinds of contracts be signed by specific officers), (b) determine whether the officer or representative signing on behalf of the entity is authorized to do so, by inspecting the organizational documents and any authorizing resolutions, and (c) obtain evidence that the signer's signature is genuine, usually in the form of an incumbency certificate, in which the secretary (or other officer) of the entity certifies the authenticity of the signatures of the individual signers. See section 3:5.1[A].

The representation also covers due *delivery* of the agreement. An executed contract is not enforceable until it has been delivered by each of the parties. Deal-specific delivery requirements may exist. For example, in the case of an agreement signed by the parties and placed in escrow subject to the satisfaction of stated conditions, valid delivery of the contract would not occur until the conditions to delivery of the agreement out of escrow were satisfied.

§ 9:2.5 *No Conflict*

The execution, delivery and performance by the Company of this Agreement do not (i) contravene any applicable provision of any law, statute, rule or regulation, or any order, writ, injunction or decree of any court or governmental instrumentality, (ii) conflict with or result in any breach of any agreement to which the Company is a party or (iii) violate any provision of the Company's Certificate of Incorporation or By-Laws.

This is a representation that the execution, delivery and performance of the contract does not violate or conflict with other legal restrictions or arrangements to which the representing party is subject. It cannot be made if there are any provisions in the entity's organization-

al documents or other agreements that would prohibit, or impose conditions that have not been satisfied on, the execution, delivery or performance of the agreement. The representation also cannot be made if there are restrictions on the party's ability to execute, deliver or perform[2] the agreement under statutes, rules, regulations, judgments or orders. To ensure that this representation is correct requires a careful analysis of organizational documents, contracts and applicable laws, rules, regulations, judgments and orders. It should be obvious why this is a standard representation: the party receiving the representation wants to be certain that entering into the contract is not going to give rise to a conflict which could be the basis for litigation or worse.[3]

§ 9:2.6 Governmental Approvals

> No authorization or approval or other action by, and no notice to or filing with, any governmental authority or regulatory body is required for the due execution, delivery and performance by the Company of this Agreement, other than those that have been duly obtained or made and are in full force and effect.

This representation covers governmental approvals required in connection with the party's entering into the contract or performing under it. The representing party must determine whether any such approvals are required and, if so, obtain them. Examples of governmental approvals that may be required in connection with particular transactions include the following: Federal Communications Commission approval of a contract to sell a radio station; the passage of the necessary waiting period under the Hart-Scott-Rodino Antitrust Improvements Act in connection with certain mergers and acquisitions; and the receipt of a necessary zoning variance in connection with an agreement to purchase and develop real property.

---

2. It is possible for performance to be restricted even if execution and delivery are not. For example, a company enters into an agreement requiring it to do A, B and C. The company is subject to regulation prohibiting it from doing C. The regulation is not violated by the company executing and delivering the contract, nor is it violated when the company performs its A and B obligations. Because of the potential conflict created by its obligation to perform C, however, the company would not be able to make the representation.
3. See section 6:3.4[C], note 3.

The provision contains an exclusion for approvals "that have been duly obtained or made and are in full force and effect." Without this language, the representation would be untrue if necessary approvals had already been obtained. Of course, this representation may require exceptions on the date that an agreement is signed if approvals are required for performance (as opposed to execution and delivery). In this case, obtaining the approvals would be added as a condition precedent.

§ 9:2.7 *Enforceability*

> This Agreement constitutes the legal, valid and binding obligation of the Company enforceable against the Company in accordance with its terms, except to the extent that the enforceability thereof may be limited by applicable bankruptcy, insolvency, reorganization, moratorium or similar laws affecting creditors' rights generally and by equitable principles (regardless of whether enforcement is sought in equity or at law).

This representation states a legal conclusion that in part depends on each of the other representations discussed above. In other words, the enforceability of a contract may be impaired if a party doesn't exist; if it doesn't have the necessary power and authority; if it hasn't taken the necessary organizational actions to enter into the contract; if the contract hasn't been duly executed and delivered; if the contract conflicts with other contracts to which it is a party or with its organizational documents or other legal requirements; or if the contract requires governmental consents that aren't obtained. Additionally, the enforceability representation constitutes a conclusion that the necessary legal elements of a valid contract formation—consideration, mutuality, offer and acceptance and the like—are present, and that no other defenses to enforcement exist.

The qualifications at the end are known as the bankruptcy and equitable principles exceptions. The bankruptcy exceptions recognize that a contract may be wholly or partly unenforceable if the promisor is the subject of a bankruptcy proceeding, notwithstanding that all enforceability requirements have been satisfied. Bankruptcy law provides, among other things, for the application of the automatic stay, which prevents enforcement of contract claims against the bankruptcy debtor except through specific procedures provided for under the Bankruptcy Code. The equitable principles exception is needed because it is often impossible to get a court to specifically enforce contract obligaitons.

The representations discussed in this section are often the subject of legal opinions required as a condition precedent to the effectiveness or closing of the agreement in which they are contained. Since the subject matter of these representations consists primarily of legal conclusions, it is appropriate for these legal opinions to be requested. Whether or not these opinions are given is usually a matter of custom. For example, opinions are almost always provided by borrower's counsel in connection with a loan agreement, but are not usually required in connection with an employment agreement.

§ 9:3 Credit-related Provisions

Specific representations, covenants and remedial provisions have evolved to protect a party to a contract against the credit risk of its counterparty. Credit risk, the risk that the obligor will become financially unable to perform its payment obligations when required under the contract, is present any time a party has an ongoing contractual obligation to make payments to another party.

An understanding of the fundamental principles of bankruptcy law is necessary to understand credit risk. In a bankruptcy liquidation, the value of assets subject to liens goes first to satisfy the claims secured by those liens. Any excess value attributable to such assets plus the value of all unencumbered assets is shared ratably by all unsecured creditors. In a bankruptcy reorganization, where the debtor in possession keeps its assets, the value that each creditor is entitled to receive under the reorganization plan is based in part on the value that such creditor would have received in a liquidation. So, it is easy to see why a creditor with a contractual claim against a debtor has an ongoing interest in the credit or financial health of the debtor. A financial failure by the debtor could result in its bankruptcy and the creditor's inability to recover all or a portion of its claim, depending on the existence and amount of other secured and unsecured claims and the value of the debtor's assets.

The magnitude of credit risk is a function of the amount that is at stake at any one time. Take a supply contract that requires the purchaser to pay for each shipment within 15 days of delivery. The contract further provides that the seller is not obligated to make any shipments if payment for any previous shipment is in arrears. If the purchaser fails to pay for a shipment, the seller can limit its credit risk

to the amount of that payment by not making any additional deliveries until the delinquent account has been settled. By allowing the seller to limit the credit risk, this type of arrangement is likely to result in the seller requiring fewer provisions in the contract relating to the purchaser's financial condition.

On the opposite end of the spectrum is a term loan agreement under which a loan is made at closing, which the borrower promises to repay in installments, with interest, over a stated term. Once the term loan is made, the money is gone—typically, having been spent by the borrower on capital assets or acquisitions. Before making the loan, the lender will have reached a conclusion that the borrower's financial condition over the term of the loan should enable it to meet its principal and interest obligations. However, the lender will add provisions to the contract that protect it against the borrower's financial deterioration. These may include provisions that (a) require the borrower to provide regular financial information, (b) restrict the borrower's ability to act in a manner that would make it less creditworthy, and (c) give the lender certain legal rights in the event that the borrower gets into financial (or other) trouble.

A well-made credit decision will take into account the separate financial characteristics of each entity that is part of the credit. Two critical rules[4] apply in this context:

- In a bankruptcy, separate legal entities are treated separately.
- A creditor with a claim against a company does not by virtue thereof obtain a claim against any of the company's subsidiaries, parents or sister companies.

Many businesses are comprised of more than one entity. A creditor making a credit decision as to a multiple-entity business will want a combination of covenants relating to the entities, covenants limiting intercompany transactions, and guarantees—herein called the "credit package"—that protects the creditor from the loss of the value on which its credit decision was based.

4. These rules may not apply if there is a piercing of the corporate veil, either through the application of the bankruptcy principle of substantive consolidation or otherwise.

Let's work with an example: suppose a lender is making a loan to Company A, which runs three business lines. The assets and operations of one business line are owned by Company A, and the assets and operations of the other two business lines are owned by Company A's subsidiaries, Company B and Company C. The following chart illustrates the different levels of credit protection the lender can create by the use of loan documentation. In reading this chart, the basic rules of bankruptcy distribution discussed above must be kept in mind.[5]

Least Protection

No covenants	The lender has no protection against actions of Company A and its subsidiaries that would reduce their creditworthiness.
No guarantees from subsidiaries	The lender has no claim against the subsidiaries. In the event of a bankruptcy, the only economic benefit to the lender of each subsidiary's business is the remaining value after satisfaction of the claims of such sub sidiary's creditors (and the lender must share such value with other creditors of Company A).

Better Protection

Covenants applicable to Company A only	The lender is protected against Company A's directly-owned business becoming less creditworthy. Because the covenants don't apply also to the subsidiaries, there is no similar protection as to the subsidiaries' businesses.
No guarantees from subsidiaries	Same as above.

5. Each of the following scenarios can be improved to a great extent, from the lender's perspective, by causing the obligors to grant a lien on some or all of their assets to secure their obligations.

Better Protection

Covenants generally applicable to Company A and its subsidiaries	The lender is protected against actions by any of the entities that would result in a diminution of its creditworthiness.
No covenants restricting intercompany transactions	The lender is not protected against transactions that result in value moving from Company A to its subsidiaries. Any such transaction impairs the lender's credit position because the lender has no recourse to the value transferred to the subsidiary.
No guarantees from subsidiaries	Same as above.

Better Protection

Covenants generally applicable to all entities	Same as above.
Covenants restricting intercompany transactions	The lender is protected against intercompany transfers of value.
No guarantees from subsidiaries	Same as above.

Best Protection

Covenants generally applicable to all entities	Same as above.
Covenants restricting intercompany transactions	Same as above; may not be necessary be cause of protection afforded by existence of guarantees.
Guarantees from subsidiaries	These provide a direct claim by the lender against the subsidiaries and their assets. As a result, the lender is more likely to permit intercompany transactions by which value migrates from one entity to another.

This demonstrates that a creditor is best protected by requiring guarantees from each entity that makes up its credit. The next-best protection is having covenants that prevent value from being transferred to a non-guarantor.

The remainder of this section is a detailed discussion of the other most common credit-related representations, covenants and remedial provisions. These provisions are found in debt agreements but may also be included in any other agreement where credit concerns need to be addressed.

§ 9:3.1 Representations

A party entering into a contractual relationship involving credit risk will normally undertake financial due diligence before entering into the contract. This would include reviewing the debtor's business plan, financial statements and projections, reviewing the debtor's key contracts, analyzing the collection history of its accounts receivable and so forth. This due diligence is usually buttressed by credit-related representations which, taken together, provide a snapshot of the debtor's financial condition. Some of these credit-related representations are discussed below.

[A] Financial Statements

> The audited consolidated balance sheet of the Debtor for the fiscal year ended December 31, 2007, the unaudited consolidated balance sheet of the Debtor for the fiscal period ended March 31, 2008, and the related consolidated statements of operations and cash flows of the Debtor for the fiscal periods ended as of said dates (which annual financial statements have been examined by Big Accounting Firm LLP, certified public accountants), present fairly in all material respects the financial position of the Debtor on a consolidated basis at the date of such financial statements and the results for the periods covered thereby. All such financial statements have been prepared in accordance with GAAP, consistently applied and subject, in the case of the March 31, 2008 financial statements, to normal year-end audit adjustments.

The purpose of this representation is to have the debtor stand behind the accuracy of its historical financial statements. Since financial statements are probably relied on by a creditor more than any other due diligence item in making a credit decision, this representation is

extremely important. It will always cover the debtor's most recent annual financial statements, as well as the most recent quarterly (and, if available, monthly) financial statements. Because consistency of presentation is fundamental to the reliability of financial statements, the representation usually includes a statement that the financial statements have been prepared in accordance with generally accepted accounting principles (GAAP), consistently applied. The key statement is that the financial statements "fairly present the financial condition and results of operations" of the debtor. This statement is not true if the financial statements are incorrect.

Note the distinction between audited and unaudited financial statements. Typically, a company's annual financial statements are audited by certified public accountants who issue an auditor's report that states that the financial statements fairly present the company's financial position and results of operations in accordance with GAAP. Interim financial statements—those prepared on a quarterly, and sometimes monthly, basis—are usually not audited and are therefore, as the last sentence of the representation indicates, subject to being retroactively adjusted as a part of the year-end audit process.

[B] Projections

> The financial projections attached hereto as Exhibit P have been prepared on a basis consistent with the Debtor's financial statements and are based on good faith estimates and assumptions made by the Debtor. On the date hereof the Debtor believes that the projections are reasonable and attainable, provided, however, that projections as to future events are not to be viewed as facts and the actual results during the periods covered may differ from the projected results.

This representation addresses projected financial information, as opposed to historical financial statements. Projections are predictions as to a party's financial condition and results of operations in the future, and therefore cannot be the subject of a representation that is expressed with the same level of certainty as a representation regarding historical financial results. The representation above is typical: the debtor states that it believes in the projections, and that the assumptions that went into the development of the projections were reasonable. The creditor could allege a breach of this representation by asserting that the debtor didn't actually believe, at the time the representation was made, that the projections were attainable; howev-

er, the mere fact that the results set forth in the projections are not achieved would not by itself constitute a breach.

[C] Material Adverse Change

> Since December 31, 2007, there has been no material adverse change to the business, assets, liabilities, financial condition or prospects of the Debtor and its subsidiaries, taken as a whole.

This is an extremely important representation from a credit standpoint. It is premised on the creditor's reliance on the debtor's financial statements, and constitutes assurance by the debtor to the creditor that nothing significant has happened to it or its financial position since the date of the financial statements. The date in this provision will typically be the date of a set of financial statements reviewed by the creditor. There may be a discussion as to whether the date should be the most recent audited statements, or available subsequent unaudited statements. The creditor will usually prefer the date of the audited statements, since the accountants' audit provides it with a more certain baseline. The debtor may advocate the use of more recent audited statements, particularly if the trend of the business between the date of the unaudited and subsequent unaudited financial statements was negative. A material adverse change test is always easier to meet if the starting point is lower.

[D] Litigation

> There are no actions, suits or proceedings pending or, to the knowledge of the Debtor threatened, against the Debtor or any of its subsidiaries that (a) relate to this Agreement or any of the transactions contemplated hereby, or (b) are reasonably likely to be determined adversely to the Debtor or such subsidiary, and, if so adversely determined, could reasonably be expected to have a material adverse effect.

Why should the existence of litigation be part of a credit decision? Because a judgment resulting from litigation becomes a financial claim that might interfere with the debtor's ability to satisfy its other financial obligations. In addition, a judgment can be converted into a lien on the debtor's assets. In an extreme case, a large judgment might trigger a bankruptcy filing by the debtor.

The litigation representation set forth above is typical. The first part addresses actions, suits and other proceedings that relate to the transaction pursuant to which the contract is being entered into. In other words, if there is any litigation at all related to the transaction it must be disclosed here.[6]

The second part of the representation relates to all other litigation (*i.e.*, litigation *not* relating to the transaction). The above language limits the representation to litigation that satisfies two criteria. The first is that the litigation is reasonably likely to be adversely determined. Thus, if the debtor has been sued on a claim that it believes to be spurious, it may conclude that such claim is not reasonably likely to be adversely determined and therefore not covered by the representation. The second criterion is that the litigation is reasonably likely to have a material adverse effect if adversely determined. Even if the debtor believes it will lose the case, the litigation will not be picked up by the representation if the claim is for an amount of damages that is not material. This approach allows the debtor to make subjective determinations regarding the merits and materiality of the litigation. The other approach is to require the representation to be made "flat"—that is, draft the representation to cover *all* litigation. The benefit of this approach to the creditor is that there is no subjective element and therefore no possibility of a surprise. The problem is that it will result in the debtor having to disclose *all* litigation, and the creditor will then have to perform its own examination and draw its own conclusions as to the materiality of each disclosed item of litigation.

Note also that the representation as to threatened litigation is subject to a knowledge qualification. This is one of the few instances where such a qualification is generally accepted, on the basis that it would be unfair to hold a party accountable for a breach of this representation due to third party threats that aren't known to the debtor.

---

6. This part of the representation is not strictly a credit-related provision. Even where there are no ongoing payment obligations, a contract party will want to be aware of all litigation relating to the contract itself or the related transactions.

[E] Compliance with Law

The Debtor and each of its subsidiaries are in compliance with all applicable statutes, rules, regulations, orders and decrees, except where the failure to be in compliance could not reasonably be expected to have a Material Adverse Effect.

This representation is designed to elicit disclosure of any violations of law or judicial orders or decrees. The material adverse effect qualifier is usually the only part of this representation that is negotiated. It may be resisted by the creditor on the basis that there shouldn't be *any* violations of law, material or otherwise. The debtor's counterargument is that the materiality standard does not deprive the recipient of the protection that it wants against violations of law that could result in some material reduction to the debtor's creditworthiness. Without a materiality qualifier the representation could be untrue as a result of some insignificant infraction. (See section 5:2.1.)

[F] Payment of Taxes

The Debtor and its subsidiaries have paid all material taxes, assessments and governmental charges or levies imposed upon them or their income or profits, or upon any properties owned by them, prior to the date on which penalties attach thereto, except for any such tax, assessment, charge or levy being diligently contested in good faith and with respect to which reserves have been established in accordance with GAAP.

This reflects the creditor's general concern about the existence of claims against the debtor. Tax claims are a particular issue, because taxing authorities may obtain liens securing their claims that in certain circumstances may take priority over the creditor's.

There are two customary qualifiers in the above language. First, the limitation of the covenant to material taxes allows the debtor to make the representation despite a delinquency in the payment of an immaterial amount of taxes. Second, the provision allows the debtor to make the representation even if it has not paid taxes, so long as the debtor is contesting the validity of the tax and has entered on its books any reserve required by GAAP. Without this carveout, the debtor would be required to pay even wrongfully asserted taxes.

[G] True and Complete Disclosure

All factual information (taken as a whole) delivered in writing by or on behalf of the Debtor to the Creditor for purposes of or in connection with this Agreement or the transactions contemplated hereby is true and accurate in all material respects and does not omit any material fact necessary to prevent such information (taken as a whole) from being misleading in any material respect.

This representation is designed to counteract the principle of *caveat emptor*, that a contracting party is under no obligation to volunteer information not otherwise required to be disclosed by the agreement. It reflects the reality that even an exhaustive set of representations may not be effective to uncover some adverse fact that may be relevant to the creditor's credit decision. It is a difficult representation to object to, because doing so creates the impression that there is something to hide. This representation is often referred to as a "10b-5 representation" because it is modeled on the disclosure standard set forth in Rule 10b-5 under the Securities Exchange Act of 1934.

[H] Other Representations

There are numerous other more specialized credit-related representations that regularly appear in credit-related documentation. These representations cover subjects such as environmental, ERISA and intellectual property matters. In addition, individual transactions often give rise to representations that are specially tailored to address specific risks and circumstances.

§ 9:3.2 Affirmative Covenants

Affirmative covenants in credit documentation are sometimes referred to as the housekeeping covenants: they require the debtor to do the kinds of things that good companies ordinarily do, such as pay its taxes, insure its operations, and so on. Accordingly, there is usually a limited amount of negotiation of these covenants.

[A] Reporting Covenants

Just as the primary basis for a creditor's initial credit decision is to review the debtor's financial statements, the primary means for con-

tinued oversight of the credit is the regular review of financial statements over the life of the contract. This is less of an issue where the debtor is a public company whose quarterly and annual financial statements will be publicly available.[7] A private company, on the other hand, has no obligation to deliver financial reports or other information to its creditors absent a contractual obligation to do so.

▶ *Interim Financial Statements*

> The Debtor shall deliver to the Creditor, within (a) 30 days after the end of each fiscal month of the Debtor (other than the last fiscal month in any fiscal quarter), the consolidated and consolidating balance sheets of the Debtor and its subsidiaries as at the end of such month and the related consolidated and consolidating statements of income and of cash flows for such month and for the elapsed portion of the fiscal year ended with the last day of such month, in each case setting forth comparative figures for the corresponding month in the prior fiscal year, and (b) 45 days after the close of each fiscal quarter of the Debtor (other than the last fiscal quarter of the fiscal year), the consolidated and consolidating balance sheets of the Debtor and its subsidiaries as at the end of such fiscal quarter and the related consolidated and consolidating statements of income and of cash flows for such fiscal quarter and for the elapsed portion of the fiscal year ended with the last day of such fiscal quarter, in each case setting forth comparative figures for the corresponding quarter in the prior year, which shall be in reasonable detail and be accompanied by a certification by the chief financial officer of the Debtor that they fairly present in all material respects the financial condition of the Debtor and its subsidiaries as of the dates indicated and the results of their operations and changes in their cash flows for the periods indicated, subject to normal year-end audit adjustments.

There are several things to note here. The monthly and quarterly financial statements must be delivered 30 and 45 days, respectively, from the last day of the reporting period. These time periods are fairly standard, but may be subject to negotiation. (Under the securities laws, the time period for a public company to report its quarterly financial statements is 45 days.) Monthly statements are only required for the first two months in any quarter, and quarterly statements are

7. However, if the covenant is omitted for this reason and the debtor fails to comply with its securities law disclosure obligations, the lender will not have any remedy.

only required for the first three quarters of a fiscal year. This is intended to avoid duplicative reporting, but is often negotiated (for example, by a party who wants to receive financial information as soon as possible).

The description of the financial statements to be delivered (here, a balance sheet, income statement and cash flow statement) should conform to the financial statements that the reporting company actually produces. The above language refers to consolidated and consolidating statements—the former are combined for the reporting entity and its subsidiaries, while the latter are broken out separately for each entity in the group. There is a requirement for comparative statements, which show comparisons to the same financial statements in the corresponding period of the preceding year. The debtor is also required to deliver year-to-date statements—statements for the period commencing at the beginning of the present fiscal year end and ending with the period being reported on. Lastly, there is a requirement that the chief financial officer certify the financial statements as fairly presenting in all material respects the financial condition of the entities being reported on, subject to year-end adjustments required by the auditors.

▶ *Annual Financial Statements*

> The Debtor shall deliver to the Creditor, within 75 days after the end of each fiscal year of the Debtor, the consolidated and consolidating balance sheets of the Debtor and its subsidiaries as at the end of such fiscal year and the related consolidated and consolidating statements of income and of cash flows for such fiscal year, setting forth comparative figures for the preceding fiscal year and (in the case of such consolidated financial statements) accompanied by a report by independent certified public accountants of recognized national standing as shall be reasonably acceptable to the Creditor, which report shall contain no going-concern or similar qualification and shall state that such statements fairly present in all material respects the financial condition of the Debtor and its subsidiaries as of the dates indicated and the results of their operations and changes in their financial position for the periods indicated in conformity with GAAP applied on a basis consistent with prior years.

Many of the same concepts apply to this covenant regarding annual financial statements as applied to the interim financial statements. The most important difference is that the annual consolidated financial statements must be audited by independent accountants; typically

the consolidating numbers are not audited. The accountants' report must not contain any going-concern qualification, a statement that the accountants are unable to conclude that the company can survive as a going concern. The time by which the audited annual financial statements must be delivered (here 75 days, the time period applicable to most public companies under securities laws) is longer than for the interim statements, due to the length of time it takes the accountants to complete their audit.

▶ *Projections*

> Not more than 30 days after the commencement of each fiscal year of the Debtor, the Debtor shall deliver financial projections of the Debtor and its subsidiaries (on a consolidated basis) in reasonable detail for each of the four fiscal quarters of such fiscal year and on an annual basis for the next three fiscal years thereafter, as customarily prepared by management for its internal use setting forth, with appropriate discussion, the principal assumptions upon which such projections are based.

A creditor that is carefully monitoring its debtor's credit situation will, in many cases, want to receive not only the debtor's financial statements (which show its historical financial performance) but also its current financial projections. Also known as a forecast or a budget, these set forth the debtor's best estimate as to its expected financial performance during the period(s) covered by the projections. Projections will often be on a monthly or quarterly basis for the first year, and annually thereafter. This covenant usually requires the assumptions on which the projections are based to be included with the projections and to be reasonable.

▶ *Compliance Certificate*

> At the time of the delivery of its quarterly and annual financial statements, the Debtor shall deliver a certificate of its chief financial officer stating that no Default or Event of Default exists, or, if any such Default or Event of Default does exist, specifying the nature thereof, which certificate shall set forth detailed computations required to establish whether the Debtor was in compliance with the financial covenants for the periods covered by such financial statements.

The purpose of this covenant is to require the chief financial officer of the debtor to certify that there is no default,[8] and to provide calculations showing compliance (or non-compliance) with the financial covenants. Because most credit documents require the debtor to provide notice every time that a default occurs, this certificate may appear redundant. Most creditors, however, believe that a responsible financial officer will not sign a certificate without some investigation, and that the discipline of requiring such a certificate regularly improves the chances that problems won't be overlooked.

▶ *Notice of Default*

The Debtor shall deliver, within two business days of the occurrence of any Default or Event of Default, notice thereof specifying the nature and duration thereof and what action the Debtor intends to take with respect thereto.

Some would argue that this provision lacks teeth, inasmuch as the failure to comply with it results in a default at a time that another default already exists. The creditor's remedies are typically the same whether there is one default or a number of defaults. Notwithstanding this argument, this is a standard reporting covenant.

▶ *Notice of Litigation*

Within three business days of the commencement of, or the occurrence of any significant development in, any litigation or governmental proceeding or investigation pending against the Debtor or any of its subsidiaries that could reasonably be expected to have a Material Adverse Effect, the Debtor shall deliver notice thereof to the Creditor.

This covenant reflects the creditor's continuing interest in litigation affecting the debtor, because any judgment would represent a competing claim and possibly a competing lien. The material adverse effect standard will be the subject of negotiation: for a sizable company that is subject to hundreds of lawsuits annually, the standard is a sensible one for both debtor and creditor. As burdensome as it would

---

8. The distinction between "Default" and "Event of Default" is discussed in section 9:3.4, note 13.

be for the debtor to provide so many notices, it would be equally or more burdensome for the creditor to review and evaluate them all. For this reason, sometimes notice is only required of those proceedings where damages in excess of some stated dollar amount are claimed.

▶ *Other Information*

> The Debtor shall promptly deliver such other information and documents (financial or otherwise) as may be reasonably requested by the Creditor.

This is a customary provision in most credit agreements; however, many debtors may find it objectionably open-ended. It illustrates the importance of information as one of the linchpins of the credit-monitoring process.

In addition to the foregoing reporting covenants, many agreements contain requirements as to reporting of other categories of information, most notably tax, ERISA and environmental matters.

[B] Books and Records

> The Debtor shall, and shall cause each of its subsidiaries to, keep proper books and records in which full, true and correct entries in conformity with GAAP and all requirements of law shall be made.

Without proper and accurate bookkeeping, there is no ability to monitor a company's financial performance or to understand its financial condition at any point in time. This covenant gives the creditor a remedy in the event that the debtor fails to keep its books and accounts properly in accordance with GAAP. Of course, the typical covenants and representations regarding annual and interim financial statements would also be breached if the debtor's accounting practices failed to meet this standard. Without the books and records covenant, however, the creditor would have to wait until the next financial statement delivery, instead of having an immediate remedy.

[C] Inspections

> The Debtor shall permit, and shall cause each of its subsidiaries to permit, upon reasonable prior written notice, representatives of the

> Creditor to visit and inspect any of the properties of the Debtor or its subsidiaries, to examine the books and records of the Debtor and its subsidiaries, and to discuss the affairs, finances and accounts of the Debtor and its subsidiaries with their respective employees, officers and independent accountants, all at such reasonable times and intervals as the Creditor may reasonably request.

This covenant goes hand-in-hand with the covenant that allows the creditor to request any information not specifically required to be delivered under the other covenants. This provision goes one step further, and permits the creditor to directly go through the debtor's books and records and discuss them with the debtor's officers and employees. Although seldom used, this right is an important one to creditors when there is a concern that there is either a systemic accounting problem or possible fraud.

[D] Compliance with Law

> The Debtor shall, and shall cause each of its subsidiaries to, comply with all applicable statutes, regulations and orders of, and all applicable restrictions imposed by, all governmental bodies, domestic or foreign, in respect of the conduct of their business and the ownership of their property except for such non-compliance as would not reasonably be expected to have a Material Adverse Effect.

This is similar to the representation regarding compliance with law, but in this context it is an ongoing obligation rather than a mere statement of fact that is made at a particular point in time. For that reason, a materiality qualification is even more important here. Often there are also detailed covenants requiring compliance with specific bodies of law, such as ERISA and environmental law.

[E] Maintenance of Insurance

> The Debtor shall, and shall cause each of its subsidiaries to, maintain at all times in full force and effect insurance with reputable insurance carriers in such amounts, covering such risks and liabilities, and with such deductibles and self-insurance as are consistent with normal industry practice. Such insurance shall name the Creditor as additional insured with respect to liability coverage and loss payee with respect to casualty coverage. All policies or certificates with respect to such insurance shall state that such insurance policies shall not be cancelled or materially changed without at least 30 days' prior written notice thereof by the respective insurer to the Creditor.

The need for this covenant from a credit-protection standpoint should be obvious. If the debtor incurs a significant uninsured loss or liability, its credit is impaired to the extent of such loss or liability, which must be paid for out of the debtor's cash flow. To prevent this, a creditor will often insist on a covenant requiring the maintenance of insurance. The above provision is relatively loose, in that there are no specific requirements as to the identity of the insurers or the insurance coverage levels; it merely requires the debtor to maintain insurance in accordance with normal industry practice. The insurance covenant can also be extremely detailed and specify types and minimum amounts of coverage, and minimum credit ratings of the insurance carriers. The latter approach is more typical in fixed asset financings, such as real estate and project finance transactions, where the credit decision is tied closely to the value of the debtor's property.

Several other important points regarding insurance are contained in this provision. There is a requirement that the creditor be named as "additional insured" in respect of liability insurance and "loss payee" in respect of casualty insurance. By being named as additional insured, the lender will be covered by the debtor's liability insurance to the same extent that the debtor is covered under the policy. For example, an adjoining landowner claiming damages due to a hazardous waste spill from a plant financed by a creditor may sue both the debtor and the creditor. With an additional insured endorsement, the creditor is insured to the same extent as the debtor. The covenant also requires that the creditor is named as loss payee under casualty insurance policies. As a result, any payment made by the insurer on account of damage to the debtor's property would be paid directly to the creditor. This provision is always required when the creditor has a security interest in tangible assets—it ensures that the creditor receives the cash proceeds of its collateral in the event it is damaged or destroyed.

The covenant also requires each policy to provide that it cannot be materially modified or cancelled without prior notice to the creditor. This goes one step further than having the debtor agree to this requirement: it creates an affirmative obligation on the part of the insurer. This gives a further level of assurance to the creditor that the insurance that was a part of its credit decision won't disappear or change in a way that is adverse to it.

[F] Payment of Taxes

By now, the reader may have detected a pattern: matters that are the subject of representations are also often the subject of covenants. The reason is that the representation states one or more facts in respect of a certain area of the debtor's business at closing, but without the covenant there would be nothing to prevent the debtor from making significant changes in that area after the closing. So, for example, the debtor that is current on all of its taxes at closing might, in the absence of a tax covenant of the type set forth below, thereafter build up tax arrears that could impair its creditworthiness.

> The Debtor shall pay, and shall cause each of its subsidiaries to pay, all material taxes, assessments and governmental charges or levies imposed upon them or their income or profits, or upon any properties owned by them, prior to the date on which penalties attach thereto, provided, however that neither the Debtor nor any of its subsidiaries shall be required to pay any such tax, assessment, charge or levy being diligently contested in good faith and with respect to which reserves have been established in accordance with GAAP.

Note also the difference in the wording of this tax covenant and the tax representation at section 9:3.1[F]. The covenant also requires the debtor to *cause its subsidiaries* to pay their taxes. Why doesn't the covenant directly require each subsidiary to pay its taxes? This is because each subsidiary is not a party to the agreement; only the debtor is. The debtor does not have the legal power to bind its subsidiaries. On the other hand, it does have the power to agree to cause its subsidiaries to act in a specified way. In the case of the representation, in contrast, the debtor does have the power to make factual statements regarding its subsidiaries.

[G] Corporate Existence

> The Debtor shall do, and shall cause each of its subsidiaries to do, or cause to be done, all things necessary to preserve and keep in full force and effect their existence and their material rights, franchises and qualifications to do business, except for rights, franchises and qualifications to do business the loss of which (individually or in the aggregate) would not reasonably be expected to have a Material Adverse Effect.

This is a relatively uncontroversial covenant that requires the debtor to maintain its corporate (or partnership or limited liability company) existence, and to maintain its qualification to do business where such authorization is required. As with the corresponding representation discussed above at section 9:2.1, the requirement to maintain qualification to do business is often subject to a materiality standard.

[H] Payment of Claims

> The Debtor shall, and shall cause each of its subsidiaries to, pay all material claims against them when due and payable, except where the failure to pay such claims, individually or in the aggregate, would not reasonably be expected to have a Material Adverse Effect.

The failure by a debtor to pay its obligations as they become due is often the first sign of financial difficulty. If a debtor is having cash flow problems, its first reaction is often to "stretch the trade"—that is, to defer the payment of its accounts payable and other short-term obligations. This is why this provision is often included in credit documentation. The debtor, on the other hand, will argue that the provision prevents it from delaying payments either to address a bona fide dispute or some legitimate and unthreatening cash flow imbalance. The normal middle ground is to insert a material adverse effect qualification, as in the above example, and/or to exclude payments that are not made as a result of a bona fide dispute.

§ 9:3.3 Negative Covenants

Negative covenants are the primary battleground of credit documentation. Their purpose is to prevent the debtor from taking actions that may tend to worsen its credit; however, the negative covenants proposed by the creditor are often perceived by the debtor as overbroad and impairing the flexibility needed to take advantage of opportunities and to react to changing market conditions. The process of negotiating negative covenants involves finding an appropriate balance between the creditor's desire for control and the debtor's desire for autonomy and flexibility.

[A] Debt

The incurrence of additional debt is one of the primary ways that a debtor can make itself less creditworthy. The additional principal and interest payment obligations create further claims on the debtor's cash flow, making a liquidity problem more likely to occur. Furthermore, the additional debt represents another claim that will compete with the claim of the prior creditors in the event of a bankruptcy proceeding. Last, the existence of other debt means that there is another creditor with acceleration rights, the exercise of which could precipitate a financial crisis. These factors result in the inclusion of debt covenants in credit documentation for all but the most creditworthy debtors.

There are two basic types of debt covenants: maintenance covenants and incurrence covenants. Maintenance covenants are found most often in bank credit agreements and permit specified levels of debt to remain outstanding from time to time. Incurrence covenants are found most often in private and public offerings of debt securities, and permit the incurrence of additional debt if a specified financial test is satisfied, after giving pro forma effect to both the incurrence of the debt and the use of the proceeds thereof. Public and private debt indentures also usually permit the maintenance of debt under carveouts and baskets, in addition to debt that can be incurred under an incurrence covenant. The remainder of this discussion describes typical debt provisions in a bank credit agreement; however, many of the provisions are often also found in debt covenants in other agreements.

The starting point of any debt covenant is the definition of "debt" or "indebtedness." Here is a typical definition:

> "Debt" shall mean (i) indebtedness for borrowed money, (ii) obligations evidenced by bonds, notes or similar instruments, (iii) the deferred purchase price of assets or services but excluding trade payables incurred in the ordinary course of business, (iv) the face amount of all letters of credit and all drafts drawn thereunder, (v) all indebtedness of another Person secured by a lien on property, whether or not such indebtedness has been assumed, (vi) all capitalized lease obligations, and (vii) all guarantees of the obligations of another Person.

The purpose of this definition is to isolate those liabilities that another creditor will want to control. The foundation of the definition is actual borrowings (clause (i)) and obligations under instruments that are normally considered debt obligations (clause (ii)). The next gen-

eral area is obligations that are incurred to finance the acquisition of property. Clause (iii) describes purchase money financing, in which the acquisition of an asset is financed by the seller's agreement to be paid the purchase price over time. Clause (vi) covers the obligations of the debtor under "capitalized leases," which are leases treated as a financing on the debtor's balance sheet—that is, the leased asset is recorded as being owned by the debtor and the lease payment obligations are treated as a liability. Note the exclusion of trade payables in clause (iii): trade payables are created when inventory or services are purchased on credit terms in the ordinary course of business. They are carried on a balance sheet as current liabilities and typically not considered debt. Thus, financings of fixed assets through direct borrowing, purchase money financing or capitalized leases are treated as debt, whereas the ordinary financing of inventory or services is not.

Obligations under letters of credit (clause (iv)) are also normally treated as debt. A drawing under a letter of credit creates a reimbursement obligation to the issuing bank that is considered the functional equivalent of a direct borrowing from the bank. Clauses (v) and (vii) cover arrangements where the debtor provides credit support for a third party's obligations, either by pledging its assets or providing a guarantee.

Now that we have examined the definition, let's look at the body of a typical debt covenant:

> The Debtor shall not, nor shall it permit its subsidiaries to, create, incur, suffer to exist or permit any Debt, except:

The simplicity, and breadth, of this language demonstrates a basic paradigm of negative covenants: they generally start as a flat prohibition on a broadly-defined range of activities. The key to the negotiation of this and other covenants will be the provisions that follow the "except" at the end—the baskets and carveouts that allow the debtor room for certain types and amounts of debt during the term of the agreement. The following are some of the usual exceptions contained in debt covenants, though the types and amounts permitted will depend on the particular circumstances of the transaction and the credit status of the debtor.

▶ *Purchase Money/Capitalized Lease Obligations*

Financing of assets by means of capitalized lease or purchase money financing will frequently be permitted, subject to separate or combined baskets permitting specified amounts of such financing to be outstanding at any time. The negotiation of these and other covenant baskets will often focus on whether the need for the requested amounts is reflected in the debtor's projections.

▶ *Existing Debt*

Debt that exists at the time the credit agreement is entered into must be permitted or repaid. It is usually described on an attached schedule. This exception is not necessary if the covenant restricts only the creation or incurrence of new debt.

Let's examine the interplay between debt that is permitted by this exception and debt that is permitted by other exceptions. Assume, for instance, that a debtor has a $10 million capitalized lease in place on the closing date that is inadvertently omitted from the schedule of existing debt. If there is also a basket for up to $50 million of capitalized leases, there is no breach because $10 million of the basket can be utilized. If the debt had been scheduled, the basket would not have been unnecessarily diminished. This same issue arises in connection with any covenant, such as the lien and investment covenants, that permit items that exist at the time of closing.

▶ *Intercompany Debt*

Companies and their subsidiaries often have a need to make loans to each other. Often this is a result of a parent borrowing under a credit facility and in turn lending to its subsidiaries to provide them with necessary working capital. Sometimes one entity will generate extra cash flow that is shared with its affiliates in the form of intercompany loans. Because these loans constitute debt, they must be specifically carved out of the covenant in order to be permitted. Put another way, transactions among the members of a corporate group are, as a general rule, treated no differently for covenant purposes than transactions with third parties. Such a carveout may be open-ended, or may be subject to a basket, most likely depending on whether the subsidiaries are part of the credit package by virtue of be-

ing covered by covenants and/or having guaranteed the debt (see section 9:3).

▶ *Intercompany Guarantees*

Frequently, one member of a corporate group may be requested to guarantee the obligations of another member of the group—for example, a lessor may require a parent company's guarantee of its subsidiary's lease obligations, particularly where the parent is more creditworthy than the subsidiary. Accordingly, debt covenants will often permit this type of intercompany guarantee.

▶ *Subsidiary Debt*

Sometimes it is anticipated that the debtor's subsidiaries will incur debt. This situation arises most often in the case of foreign subsidiaries whose financing needs are not provided for under the parent's credit facilities. Because debt of U.S. companies is usually not guaranteed by its foreign subsidiaries,[9] any debt incurred by a foreign subsidiary is structurally senior to a creditor of the U.S. debtor. This means that the foreign creditor has a claim to the foreign subsidiary's assets, in contrast to the parent company's creditor, which has no such claim. As a result, the parent company's creditor will want to restrict the amount of debt that can be incurred by its foreign subsidiaries.

▶ *Acquired Debt*

Debtors that expect to make acquisitions may want a basket for debt existing at an acquired company that is not refinanced or paid off at the time of the acquisition. There are usually two reasons why an acquiror may want to leave such debt outstanding: (a) the debt may not permit, or may impose expensive penalties on, prepayment, or (b) the debt may have favorable economic terms that the acquiror wants to keep in place.

This carveout will require that the acquired debt was not created in anticipation of the acquisition transaction. This protects the creditor

9. Guarantees of this type create taxable deemed dividends under Section 956 of the Internal Revenue Code and for this reason are usually avoided.

against the intentional creation of debt at the target before its acquisition.

▶ *General Debt Basket*

Depending on the needs and credit of the debtor, there may be a general basket for permitted additional debt. Sometimes this basket will be limited to subordinated debt.

▶ *Refinancing Debt*

This exception permits the refinancing and extension of maturity of other permitted debt. The usual language refers to the "refinancing, replacement or extension" of specified categories of debt. This provision is usually not applicable to debt permitted under a basket, because the nature of a basket permits the debt incurred thereunder to be repaid and reborrowed, subject to the overall dollar cap. The categories of debt that are usually covered by the refinancing exception are debt existing at the time the agreement is entered into and other specific items of permitted debt. Often, this exception specifies that the refinancing, replacement or extension may not result in the increase in the principal amount of the debt. Additionally, there may be a requirement that the new debt may not have an earlier maturity or a shorter average weighted life[10] than the original debt. This prevents the refinancing from worsening the debtor's cash flow by creating more onerous repayment requirements. Sometimes there is a requirement that the terms of the new debt cannot be less favorable to the debtor than those of the debt being refinanced.

[B] Liens

The interest of a creditor in restricting its debtor's ability to create liens on its assets is driven by the basic bankruptcy principle that se-

10. "Average weighted life" tests the average due date of scheduled principal payments on a loan weighted by the amount of time such principal payments are outstanding. An amortization schedule that requires more principal payments to be made in later years will have a greater average weighted life than one that is front-end loaded.

cured creditors are paid prior to unsecured creditors, to the extent of the value of the encumbered assets. Thus, by prohibiting liens an unsecured creditor avoids coming behind a new secured creditor, and a secured creditor avoids having to share the value of its collateral.

A typical definition of "lien" is:

> "Lien" shall mean any mortgage, pledge, security interest, encumbrance, lien or charge of any kind, including any agreement to give any of the foregoing, any conditional sale or other title retention agreement, any financing or similar statement or notice filed under the Uniform Commercial Code or any similar recording or notice statute, and any lease having substantially the same effect as the foregoing.

This definition covers consensual liens such as mortgages (liens on real property), pledges (liens on securities) and security interests (liens on all other personal property), as well as all other liens and encumbrances. Further, it includes the filing of all financing statements (the filing of which does not create, but merely perfects, security interests), and leases that have the effect of creating a lien. As with the debt covenant, the lien covenant usually prohibits the creation or existence of all liens that are not specifically permitted. Following is a discussion of frequently appearing carveouts to the lien covenant.

▶ *Tax Liens*

There is customarily a limited carveout for tax liens. Because some tax obligations that are not yet due and payable result in inchoate liens, a customary exception to the lien covenant covers liens securing tax obligations that are not yet due and payable. Another typical exception permits liens in respect of taxes that are being contested by the debtor. Without this, a debtor would be required to pay when due all taxes that would otherwise give rise to a lien, even if it had a bona fide dispute as to the imposition of the tax.

▶ *Ordinary Course Liens*

There are a variety of liens that arise in the ordinary course of business in commercial arrangements. For example, under the laws of some states (and under some leases) a landlord has a lien on property at the leased premises that secures unpaid rent obligations. Similar liens include those in favor of mechanics, materialmen, warehouse-

men and carriers. Sometimes the carveout specifies that obligations secured by the permitted liens cannot be overdue beyond some stated period of time, unless contested in good faith.

▶ *Workers Compensation Security Arrangements*

State workers compensation, unemployment insurance and similar programs often require the employer to post security for its obligations. There must be a carveout to the lien covenant to permit such security.

▶ *Deposits*

A variety of commercial arrangements require cash deposits. The most common example of this is the security deposit required in connection with a real estate lease. Deposits of this type fall under the broad definition of lien above, because the depositor is pledging its cash to secure its payment obligations. The typical lien covenant exception allows deposits in connection with leases, trade contracts, bids, performance bonds and insurance obligations.

▶ *Easements, etc.*

There are a number of restrictions on real estate that arguably fall within the definition of "lien" that shouldn't trouble a creditor and are therefore excluded from the lien prohibition. The usual exception is along these lines:

> Easements, rights-of-way, restrictions, reservations, permits, servitudes and other similar encumbrances on real property that do not materially interfere with the ordinary conduct of business at the affected property.

Of course, if the affected real property is the subject of the transaction (as would be the case, for example, in a mortgage loan), these issues are negotiated much more closely.

▶ *Leases and Subleases*

If the debtor anticipates leasing (as lessor) or subleasing (as sublessor) any of its property, there must be an exception for these activi-

ties. A lease or sublease creates an encumbrance (the interest of the lessee or sublessee) on the property of the debtor, so a carveout is required.

▶ *Capitalized Leases and Purchase Money Financing*

To the extent the debt covenant permits the creation of capitalized leases or the incurrence of purchase money debt, there must be an equivalent carveout to the lien covenant to permit the liens securing these obligations. Generally speaking, a capitalized lease is treated as a secured financing for accounting and creditors' rights purposes. Thus, the leased asset appears on the lessee's balance sheet as an owned asset, and would be treated as part of the lessee's estate in a bankruptcy proceeding. A purchase money lender often takes a security interest in the asset being financed.

Permitted purchase money and capitalized lease liens may be subject to limitations. The exception may specify that the liens can't cover property other than the assets that are the subject of the financing (in other words, the debtor can't grant a lien to the financer of an item of equipment on any assets other than that item of equipment). Also, the provision may specify that the lien must be created at the time that the purchase money debt is incurred or the capitalized lease is entered into. This is to ensure that the lien is granted to facilitate the financing, not granted after the fact to assuage an insecure creditor.

▶ *Existing Liens*

As with existing indebtedness, liens that are in place at the time that the agreement becomes effective are typically scheduled and permitted. Liens that secure refinancings, extensions and replacements of the debt that is secured by these liens will also be permitted, subject to a restriction that such liens cannot cover any new or additional property as a result of the refinancing, extension or replacement.

▶ *Liens Securing Acquired Debt*

If the debtor is permitted by the debt covenant to assume or acquire debt in connection with acquisitions, there should be a corresponding carveout to the lien covenant to permit liens securing such indebtedness. There will usually be a requirement that the liens may

not extend to any assets other than those originally covered by the lien—this protects against a blanket lien spreading to cover the assets of the other party to a merger transaction, for example.

▶ *Judgment Liens*

In many states, a judgment that is docketed or delivered to the sheriff for execution results in a lien in favor of the judgment creditor on the judgment debtor's property located in that state. Without an exception for this type of lien, a borrower would be required to pay immediately any judgment entered against it, or risk being in breach of its lien covenant. For this reason, most lien covenants permit judgment liens, so long as the enforcement of the judgment is stayed within 30 or 60 days after its entry. Such a stay will occur when the judgment is appealed. Thus, under this provision the borrower will have 30 to 60 days to either pay or appeal the judgment. If the appeal is lost, the stay of judgment will be lifted and the judgment will have to be satisfied in order to avoid a breach of the covenant.

▶ *Precautionary Financing Statements*

If the prohibition on liens includes the filing of any financing statements, there should be an exception for the filing of precautionary financing statements filed pursuant to section 9-505 of the Uniform Commercial Code. This section permits the lessor under an operating lease or a consignor under a consignment to file a financing statement as a precaution in the event that the lease or consignment is subsequently recharacterized as a secured transaction.

[C] Asset Sales

Credit agreements restrict the debtor's ability to sell assets in order to prevent significant changes to the business on which the creditor's credit decision was made. Asset sales not contemplated by a debtor's business plan could indicate, for example, that the debtor is cannibalizing its property to make up for a cash flow shortfall. The asset covenant sale typically starts with a broad prohibition:

> The Debtor shall not, and shall not permit its subsidiaries to, sell, transfer, convey, assign, lease or otherwise dispose of any of their assets, except:

Following is a discussion of the most typical exceptions to the asset sale covenant.

▶ *Sale of Inventory*

This is an essential exception for any company that sells merchandise. Often it is limited to sales of inventory *in the ordinary course of business*, which allows for normal sales but prohibits bulk sales and other extraordinary transfers.

▶ *Sales Subject to Debt Repayment*

A creditor's resistance to the sale of productive assets is lessened when the cash proceeds of the sale are used to repay debt. Accordingly, there is often a basket for a certain amount of asset sales, if the net cash proceeds are used to permanently repay the debt. "Net cash proceeds" is usually defined as the total proceeds of the sale, after deducting the actual costs of the sale (including brokers', investment bankers' and lawyers' fees, sales commissions, debt payments required to be paid with such sale proceeds and tax costs). This basket may be limited to a maximum amount over the life of the agreement, a per annum amount, or an aggregate amount that does not exceed some stated percentage of the debtor's total assets. This provision often requires a specified percentage of the consideration for the sale to be in cash. The non-cash consideration will usually consist of a note (a "seller note") or other payment obligation. The creditor will want to maximize the portion of the sale consideration that is in cash and to minimize the non-cash consideration, which represents an exchange of operating assets for an investment (the investment by the debtor in the seller note) of uncertain quality.[11]

---

11. The debtor may not take back a seller note as partial consideration for an asset sale if it is subject to a covenant restricting investments that doesn't have an applicable exception.

▶ *Sales of Assets that Are Replaced*

Operating companies often sell equipment with an expectation of replacing it. One example of this is where existing equipment is traded in as new equipment is acquired. Accordingly, there is generally an exception for trade-ins and sales where the proceeds are used to acquire replacement equipment within some period of time. Sometimes the reinvestment requirement is not limited to the replacement of specific assets but refers to fixed or other assets that are "useful in the business of the debtor." This is an especially broad exception, particularly if it's not limited to fixed assets, in which case the debtor is able, for example, to sell real estate and use the proceeds to acquire inventory.

▶ *Dispositions of Obsolete Equipment*

Another standard exception is one that permits the disposition of equipment that is obsolete, worn out or otherwise uneconomic. The creditor has no legitimate reason not to permit the debtor to dispose of assets that are no longer productive. Sometimes, this exception is open-ended, other times limited to an annual or overall dollar amount.

▶ *Sale of Specified Assets*

If a debtor is expecting to sell certain property at the time that it enters into a credit agreement, it will ask for a carveout permitting those sales. Often the carveout will specify how the proceeds of these sales must be applied. Sometimes the creditor will want the carveout to specify a minimum sales price, but if the credit agreement is going to be publicly available (as an exhibit to SEC filings, for example), the debtor will resist this because of the negative impact disclosure would have on its ability to negotiate price with potential purchasers.

▶ *Leases, Subleases and Licenses*

Where the asset sale covenant is drafted very broadly, many transactions that are not typically thought of as "sales" are swept in. Among these are transactions in which the debtor leases or subleases out property as lessor or sublessor, or licenses intellectual property as

licensor. In each of these cases, the debtor is transferring a partial interest in its rights to property. Such transfers, to be permitted, must be carved out of the covenant.

▶ *Intercompany Sales*

There are several reasons why a debtor may want to have the flexibility to conduct sales among itself and its subsidiaries. One of the subsidiaries may be a marketing arm that sells product to customers that it in turn purchases from another subsidiary. One subsidiary may manufacture and sell raw materials that are used by the debtor in its manufacturing process. There may be a perceived need, for tax, operational or other purposes, to move fixed assets around among different members of a corporate group. The creditor's willingness to provide this flexibility will depend primarily on the credit status of the entities that would be permitted transferors and permitted transferees under such arrangements—in other words, are the subsidiaries part of the credit package by virtue of being covered by the covenants and/ or having guaranteed the debt (see section 9:3).

▶ *Sale-Leasebacks*

In a sale-leaseback, a fixed asset is sold to a third party, who simultaneously enters into a lease with the seller that gives the seller the right to the continued use of the asset in exchange for ongoing lease payments. This has the effect of generating immediate cash for the seller in exchange for the incurrence of a long-term payment obligation. As such, it is usually considered by creditors as the economic and functional equivalent of a borrowing secured by assets. Because sale-leasebacks are often used as a last-ditch means of generating cash by companies that are suffering cash flow problems, they are often prohibited or tightly restricted in credit documentation.

There may be circumstances where companies that lease equipment are forced, for timing reasons, to purchase the equipment in anticipation of the lease being entered into. A useful provision to address this circumstance is a carveout for sale-leasebacks that occur within some relatively short period of time (say, 90 days) of the initial acquisition of the property. A creditor that otherwise would be willing to permit the lease of this equipment should be willing to permit such a sale-leaseback.

[D] Restricted Payments

"Restricted payments" are typically defined as follows:

> Any (a) dividend payments on the equity interests of the Debtor or its subsidiaries, (b) other distributions on account of the equity interests of the Debtor or its subsidiaries, or (c) payment on account of, or setting aside any payment for, or establishment of a sinking fund for, the purchase, redemption, defeasance, retirement or other acquisition of the equity interests of the Debtor and its subsidiaries.

A creditor often looks negatively on restricted payments by its debtor: if the debtor is generating enough free cash to be making distributions to its equityholders, it should, at least in the creditor's view, instead be using the cash to reduce its debt. Each dollar paid out to equity is a dollar reduction to the debtor's net worth and a dollar less that the creditor has recourse to. Accordingly, restricted payments are often the subject of very tight covenants.

▶ *Non-cash Dividends*

Dividends paid in additional equity are usually freely permitted, since this type of dividend has no effect on the debtor's cash or other assets. On the other hand, dividends of property other than cash are usually restricted to the same extent as cash dividends.

▶ *Subsidiary Dividends*

Dividends that are paid to the debtor or a wholly-owned subsidiary of the debtor are typically permitted, because the cash or other property that is dividended continues to be part of the consolidated assets of the debtor. On the other hand, a different issue is raised where a subsidiary is not wholly-owned. In such a case, a prorated amount of any dividend or other distribution must be paid to third-party shareholders. As a result, dividends of this type are looked on with disfavor by creditors.

▶ *Equity Buybacks*

Stock bonus and other stock incentive plans offered to a company's management often require the company to repurchase the stock upon the death, resignation or termination of the employee. A restricted

payments covenant will block such payments, unless a carveout permits them. To the extent these payments aren't fully permitted by the covenant, the document providing for such payments must provide for their nonpayment or deferral—otherwise the debtor may be forced to breach either its credit agreement or its stock plan.

▶ *Tax Distributions*

Many partnerships and limited liability companies are not taxed as entities; instead, their partners or members are taxed directly on the entity income that is attributable to their equity interests in the entity. As a result, these entities typically make distributions in a minimum amount sufficient to cover their investors' income tax liabilities arising as a result of their investments. These distributions should be carved out of any restricted payments covenant. The creditor's normal antipathy to cash dividends should be overcome by the fact that if the debtor were structured as a corporation, these amounts would be payable directly by the debtor as taxes.

▶ *Indenture Restricted Payments Covenants*

The restricted payments covenant that appears in debt indentures differs from the typical credit agreement covenant. Rather than being structured as a flat prohibition subject to carveouts, the indenture covenant permits restricted payments in an amount (the "restricted payments basket") determined by a formula. This basket is usually equal to 50% of the debtor's consolidated net income from the date of the indenture through the date of the restricted payment, plus 100% of the cash proceeds of new equity issuances, less the aggregate amount of all restricted payments previously made under the basket. Thus, the debtor's ability to pay dividends and make other restricted payments increases with its profitability. In addition, there are often specific baskets similar to those found in credit agreements.

[E] Investments

Unlike dividends, which from a creditor's standpoint is money out the door, an investment potentially creates value that may strengthen the debtor financially and thereby inure to the creditor's benefit. Accordingly, investments are usually not proscribed as narrowly as re-

stricted payments. On the other hand, the creditor will want to restrict investments that either represent a deviation from the debtor's business plan, involve excessive risk or result in cash or assets being removed from its credit package. A typical definition of investments includes:

> Any advance, loan, extension of credit or capital contribution, any purchase of any stock, bonds, notes, debentures or other debt or equity securities, and any purchase of assets constituting a business unit of any person.

The first thing to note is that the definition covers both debt and equity investments, and is written broadly so that loans and other advances are included in addition to debt securities such as notes and bonds. The definition also picks up asset purchases that constitute a "business unit," since acquisitions can be effected by purchasing either the stock or assets of the target. Sometimes the provision will instead cover purchases of all or substantially all of the assets of any entity.

▶ *Investments in Subsidiaries*

It is very common for a consolidated group to need to move cash among the constituent entities, in connection with normal cash management functions as well as for strategic reasons. The creditor's willingness to permit these investments will be primarily driven by the potential effect on its credit package. For example, a creditor may be relatively indifferent to an investment by one subsidiary that is a guarantor of the debt in another subsidiary guarantor. On the other hand, the creditor will view an investment in a subsidiary that is not a guarantor as an impairment of its credit package, because it results in cash moving to an entity against which it has no claim.[12] (See section 9:3.)

▶ *Investments in Joint Ventures*

An investment by a debtor in a joint venture is usually looked at with disfavor by a creditor. Typically, an investor in a joint venture

12. An intercompany investment consisting of a loan or advance will also need to be permitted as debt under the debt covenant.

doesn't have the same level of control that it would exercise over a subsidiary. In addition, amounts invested in joint ventures are outside the credit package because a joint venture will almost never guarantee the debt of one of its investors. As a result, baskets for investments in joint ventures are usually the subject of significant negotiation.

▶ *Acquisitions*

Tension arises in negotiating carveouts for acquisitions between the debtor's desire for freedom to make acquisitions based on its own business judgment and the creditor's desire to make its own determination on the merits of each proposed acquisition. The middle ground usually involves a basket with some additional bells and whistles. For example, a frequently occurring requirement is that the debtor demonstrate pro forma compliance with its financial covenants (or other specified financial ratios), after taking the acquisition into account.

▶ *Loans and Advances to Officers and Employees*

Companies often make loans and advances to their officers and employees for travel expenses, relocation, and for other purposes. These must be carved out of the investment covenant, subject usually to an overall cap.

▶ *Bankruptcy Investments*

A debtor may be issued securities in satisfaction of an outstanding claim against a customer or other person in a bankruptcy proceeding. A carveout for this type of investment is usually not subject to a dollar cap, because it is outside of the debtor's control.

▶ *Existing Investments*

Any investments that exist on the closing date are usually scheduled and permitted under a separate carveout.

▶ *Cash Investments*

As a matter of sound cash management, a company that has cash will want to invest it rather than have it sit idle. Therefore, a custom-

ary exception to the investment covenant is one that permits the investment of cash in liquid securities. This category of permitted investments usually includes the following short-term investments (referred to as "cash equivalents"): government securities, certificates of deposit and commercial paper, subject in many cases to minimum rating requirements.

[F] Transactions with Affiliates

A creditor worries about transactions between the debtor and the debtor's affiliates because of the risk that the transaction will result in value escaping from the debtor. For example, the debtor could sell assets to its sole shareholder for a below-market price. This concern does not come up in the case of transactions with non-affiliates because it is assumed that in this circumstance the debtor will behave in an economically sensible way and obtain equivalent value. However, in the case of transactions with affiliates this same assumption isn't made, due to the possibility that the debtor's self-interest will be subordinated to its affiliates' needs. "Affiliate" is usually defined as a person or entity that directly or indirectly controls, is controlled by, or is under common control with the debtor, with "control" often defined as the power to vote 5% or 10% of the affiliate's equity interests. Under this definition, a company's affiliates include (a) its parent company, (b) investors owning the specified amount of voting equity, (c) its sister companies (companies that are owned by its parent company), (d) its subsidiaries and (e) entities in which it has the requisite voting equity investment (including most joint ventures).

The typical transactions with affiliates covenant is worded:

> The Debtor shall not, and shall not permit its subsidiaries to, enter into any transaction with its Affiliates, unless such transaction is upon terms no less favorable to the Debtor or such subsidiary than it would obtain on an arm's-length basis with a Person that is not an Affiliate.

The covenant does not prohibit affiliate transactions; it merely requires that such transactions have terms that are equivalent to those that would be obtained from an independent party. There is often a carveout for transactions among affiliates that are each part of the credit package. Sometimes, there is a requirement that affiliate transactions with a value above a stated dollar threshold must be specifi-

cally approved by the debtor's board of directors or an investment banking or valuation firm as being on arm's-length terms. Requirements of this type appear more frequently in agreements relating to high-yield and other debt securities.

[G] Payment Restrictions Affecting Subsidiaries

Conceptually, this is one of the hardest covenants to grasp. A simple version of this covenant (referred to here as the "payment restrictions covenant") reads as follows:

> The Debtor shall not, and shall not permit any of its subsidiaries to, enter into any agreement restricting any subsidiary's right to (a) pay dividends or make other restricted payments to the Debtor or any other subsidiary, (b) sell, transfer or otherwise dispose of assets to the Debtor or any other subsidiary, (c) make loans or advances to the Debtor or any other subsidiary, or (d) repay any loans or advances made by the Debtor or any other subsidiary.

This covenant ensures that there is no impediment to the upstreaming of money to a debtor from its subsidiaries. This is important to a creditor, who wants to make sure there is a clear pathway for the subsidiaries' cash and other assets to be available to the debtor, if the debtor's financial condition requires it. One of the reasons that this covenant is confusing is that, unlike other covenants that restrict *actions*, this covenant restricts the existence of other *contractual provisions*. It restricts the ability of a debtor's subsidiaries to enter into certain transactions in a way that sometimes gets overlooked. In the case where a subsidiary is proposing to incur debt, for example, most lawyers will realize that such incurrence must be permitted under the debtor's debt covenant. But they sometimes forget that restrictions applicable to the subsidiary under its debt agreement must be analysed under this covenant as well.

Some of the typical exceptions to this covenant are the following:

▶ *Existing Restrictions*

Existing payment restrictions must be permitted. Usually, they are required to be listed on a schedule. Similar restrictions in agreements that refinance or replace the scheduled agreements are commonly permitted as well, as long as the new provisions aren't more restrictive

than the ones being replaced. Sometimes, the lender will insist that existing restrictions be eliminated. For example, if there are restrictions of this type in existing debt of a subsidiary of the debtor, the lender may require that the debt be paid off or amended at the closing.

▶ *Anti-assignment Provisions*

Many contracts restrict the parties' ability to assign their rights under the contract. For contracts and contract rights constituting "accounts," "chattel paper," "promissory notes," "payment intangibles," "letter of credit rights," or "healthcare insurance receivables," as defined in the Uniform Commercial Code, such provisions may not be enforceable. (See section 10:2.10.) To the extent the anti-assignment provision is in another type of contract and is enforceable, such a provision in a contract of a subsidiary runs afoul of the payment restrictions covenant because it prevents the subsidiary from transferring the contract, or its rights to receive payments under the contract, to its parent company or other subsidiaries. An exception for transfers to affiliates is often negotiated and avoids this problem. But since this exception may not always be available, there should be a carveout to the payment restrictions covenant that permits these restrictions.

▶ *Subsidiary Debt*

Agreements governing debt are likely to contain all of the restrictions that are proscribed by the payment restrictions covenant. Thus, if it is anticipated that there will be a need for a subsidiary to incur its own debt, a carveout to the payment restrictions covenant will be useful. A creditor will likely only agree to this covenant if the assets and cash flow of the subsidiary are not part of its credit decision.

▶ *Secured Financing*

Agreements governing secured financings prohibit the sale or other disposition of collateral. If a credit agreement permits the debtor and its subsidiaries to incur secured debt (for example, purchase money debt and capitalized leases), it must also contain a carveout to the payment restrictions covenant to permit the restrictions on sale that will appear in such debt agreements.

▶ *Agreements to Sell Assets*

Agreements for the sale of assets, for obvious reasons, prohibit the seller from selling the assets to someone else. Accordingly, the payment restrictions covenant should permit such prohibitions in asset sale agreements to which a subsidiary of the debtor is a party. (Of course the asset sale itself must also be allowed under the asset sale covenant.)

[H] Amendments to Other Documents

This covenant restricts the debtor's ability to amend specified agreements and, often, its charter, by-laws or other organizational documents. The agreements covered by this restriction are those that the creditor feels are important to its credit decision. Sometimes, the covenant will apply to "all material contracts" but this is a difficult line to draw. Sometimes the covenant will only restrict amendments that "could reasonably be expected to be adverse to the creditor's interests." Under this standard, a modification to a debtor's charter that changes notice provisions for its annual meeting, for example, would be permitted, whereas a modification providing for the issuance of preferred stock with mandatory redemption provisions would not, because such a redemption would be a drain on the company's cash flow.

[I] Mergers

This covenant will read something like this:

> The Debtor shall not, and shall not permit its subsidiaries to, liquidate or dissolve, consolidate with, or merge into or with any other entity.

The reason for the restriction on liquidation and dissolution is self-evident in the case of the debtor: the creditor wants to ensure that the debtor continues to exist as a legal entity as long as its credit obligations remain outstanding. The creditor's interest in preventing the dissolution or liquidation of subsidiaries is not as strong, particularly since a liquidation or dissolution of a subsidiary results in the subsidiary's assets being distributed to its direct parent, normally a good result for the creditor. Accordingly, there is often a carveout for voluntary liquidations and dissolutions of subsidiaries.

The restriction on mergers should dovetail with the investment covenant. If the investment covenant permits acquisitions in the form of stock and asset acquisitions, there should be an exception to the merger covenant permitting any such permitted transaction to be effected by merger as well.

[J] Capital Expenditures

Capital expenditures are defined as expenditures that are required to be included as property, plant and equipment on the debtor's consolidated balance sheet. A debtor's projections will forecast how much it expects to spend on capital assets during the period covered by the projections. If the actual expenditures significantly exceed the forecasted amounts, there may be undue strain on the debtor's cash flow. Accordingly, many credit agreements limit the debtor's annual capital expenditures. These limits are usually set at the level of the debtor's projected capital expenditure needs, plus a negotiated cushion. Often, there is a carryover provision, which allows amounts that aren't used under one year's basket to be used in the subsequent year.

[K] Financial Covenants

A key component of a credit decision is the debtor's projections. The amortization of the principal of a loan is often structured to match the debtor's projected cash flow. The total amount of debt permitted will be based on the sufficiency of the debtor's cash flow to cover interest and principal payments. In many cases, the overall capitalization (*i.e.*, the mix of debt and equity) of the debtor will cease to make economic sense if the debtor's actual operating results fall significantly short of those that have been projected. Compliance by the debtor with all of the affirmative and negative covenants discussed above may prevent certain credit-impairing behavior, but they cannot protect the creditor from the debtor's operating results taking a nosedive.

Financial covenants allow the creditor to monitor the debtor's financial performance and to exercise remedies in the event that such performance falls below required levels. Each financial covenant measures one or more elements of the debtor's actual financial condition or performance against projected levels (with negotiated cushions). If any area of the debtor's business subject to a financial covenant falls

short of the required level, the covenant is breached, an event of default occurs and the creditor is entitled to exercise remedies. There are different types of financial covenants, some of which are tailored to a specific company or a specific industry. Discussed below are several of the most frequently recurring financial covenants.

▶ *Minimum EBITDA*

EBITDA is an acronym for "earnings before interest, taxes, depreciation and amortization." It is computed by taking a company's net income for a particular period and adding back the amount of interest expense, tax expense, depreciation and amortization for such period, all of which, under GAAP, have been deducted in arriving at the net income figure. Financial analysts consider EBITDA to be one of the most important measures of a company's operating financial performance.

A minimum EBITDA test requires the debtor to reach certain EBITDA levels at the end of specified periods. The test can look at EBITDA on a quarter-by-quarter basis, but it is much more common for the test to be on a "trailing four quarter" basis. This means that at the end of each quarter, EBITDA for the four-quarter period then ending will be measured. The difference between testing EBITDA (or any other measurement of financial performance) for one quarter instead of four quarters is that a one-quarter test is more volatile—one bad quarter can result in a breach, whereas with a four-quarter test bad quarters can be offset with good quarters.

▶ *Interest Coverage Ratio*

This test measures the ratio of the debtor's EBITDA to its interest expense, over some specified period of time (again, usually four quarters). This is an important ratio, because it demonstrates the sufficiency of the debtor's cash flow to cover its interest payment obligations.

▶ *Fixed Charge Coverage Ratio*

Similar to the interest coverage ratio, this measures the sufficiency of EBITDA to cover interest as well as other specified payments, usually including scheduled principal payments on debt, preferred stock dividends and capital expenditures.

▶ *Leverage Ratio*

There are actually two different ratios that are called "leverage ratio." The first is the ratio of (a) debt to (b) debt plus net worth. This test measures leverage by determining what portion of the debtor's capital structure consists of debt. It is a so-called "balance sheet test" because it measures items on the balance sheet, which reflects a company's *financial condition* as of a particular time (as opposed to the EBITDA-based tests discussed above, which are derived from the company's income statements and test *financial performance*). The other financial covenant referred to as a leverage ratio is the ratio of EBITDA to debt. In the same way that an interest coverage ratio looks at the level of cash flow that is available for the payment of interest, this leverage ratio measures the level of cash flow available to cover principal. It is a hybrid covenant, measuring an income statement item, EBITDA, against debt, a balance sheet item.

▶ *Net Worth*

A company's net worth is equal to its assets minus its liabilities. Profits increase net worth, losses reduce it. A net worth covenant is designed to measure the changes to net worth over time as a result of profits and losses. It does this by measuring, at the end of each quarter, the debtor's actual net worth against an amount equal to the debtor's net worth at closing, plus 50% (usually) of net income in each quarter thereafter, less 100% of net losses in each such quarter. The effect of this approach is that the cushion built into the target level increases by 50 cents for each dollar of profits and shrinks by 100 cents for each dollar of losses.

§ 9:3.4 Events of Default

This section of a credit agreement has two distinct parts: first, a list of the events that constitute events of default, and second, a description of the remedies available to the creditor if an event of default occurs. We will not examine in detail all of the events of default that appear in credit agreements, but instead focus on the events of default relating to the building block provisions discussed in this chapter: representations and covenants.

Credit agreements provide that it is an event of default if one of the debtor's representations was not true when made. The principle behind this is that the credit decision was based in part on the facts covered by the representations, and, if a representation turns out to be false, the creditor should be able to reverse its credit decision. Because representations are only made at specific points in time, an event of default is caused only if a representation was false at the time that it was made. Changes in facts or circumstances occurring after the date a representation is made cannot make the representation false retroactively. Frequently, an event of default does not occur unless a representation was untrue when made "in any material respect." Because the potential results of the occurrence of an event of default can be so significant, the materiality qualifier is an appropriate protection against a hair-trigger default.

The breach of a covenant will also constitute an event of default. Specified covenant defaults may be subject to negotiated grace periods, in which case the breach will not constitute an event of default unless it remains uncured for a specified number of days.[13] The purpose of the grace period (also referred to as a cure period) is to give the debtor the opportunity to return to compliance by fixing the problem that gave rise to the breach. Some grace periods are drafted to commence only after the debtor has knowledge of the breach.

A breach by the debtor of its representations or covenants results in an event of default because it signals an event or condition that could result in the creditor's wanting to reverse or modify its original credit decision. Without the remedies that are made available to the creditor upon the occurrence of an event of default, judicial remedies would be the creditor's sole recourse in the event of a breach.

The primary remedy for an event of default is acceleration of the debt, so that principal, accrued interest and all other outstanding obligations of the debtor under the credit agreement immediately become due and payable. In most cases, the debtor will be unable to pay the accelerated obligations (if it had that much cash on hand, it probably wouldn't have any loans outstanding). As a result, acceleration

13. Many agreements characterize breaches that have not yet become "events of default," because required notices have not been given or required cure periods have not yet run, as "defaults." The existence of a default may trigger lesser remedies, such as the creditor's refusal to make additional advances.

the transaction. Third, if the buyer discovers after closing that a representation of the seller was untrue when made, it may have an indemnification claim or a claim for breach of contract against the seller.[20]

The scope of the representations in an acquisition agreement is typically much broader than in credit documentation, because a buyer's need to understand all aspects of the business being acquired is much more extensive than a creditor's need to know facts that may affect its credit decision. The primary business term in any acquisition is price, which may be affected significantly by any issues or problems relating to the target. The buyer will also have operational and management considerations that require a close understanding of the business that it intends to acquire.

[B] Representations and the Disclosure Process

A buyer's first step in determining the necessary facts to make its investment decision and inform its pricing analysis is the completion of its own due diligence. Many representations made in the acquisition agreement force the seller to stand behind the information provided to the buyer in the due diligence process. They also tend to smoke out facts that may not have surfaced during due diligence.

The way that the negotiation of representations results in disclosure is as follows. The acquisition agreement, which is normally drafted by counsel to the buyer, will contain, for example, a representation that the target is not the subject of any litigation which could reasonably be expected to have a material adverse effect on the target. (Sometimes the material adverse effect qualifier will not be included in the first draft but will be added as a result of negotiation.) If the target does have such potentially material litigation, it cannot make this representation truthfully unless the litigation is carved out of the representation. This is typically done in the disclosure schedules that are attached to the acquisition agreement. By disclosing facts that are inconsistent with the representations in the disclosure schedules, the seller eliminates the buyer's ability to walk away from the transaction or to bring claims for breach or indemnification on the basis of the

---

20. *See* KLING AND NUGENT, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS, 11-2–11-8 (2000) [hereafter, "Kling and Nugent"].

fact that is disclosed. The risk of the disclosed information is thus shifted from the seller to the buyer by virtue of disclosure. The buyer, on the other hand, receives information that allows it to make a fully-informed investment decision and to price the deal accordingly.

[C] Timing of Representations

Representations are often made at the time that the acquisition agreement is signed, and again at the closing. In cases where there is a long gap between these two points in time, the facts represented to by the seller may change. Accordingly, there should be a mechanism allowing the seller to update its representations so as to be true at closing. The buyer, despite its interest in knowing all the relevant facts, will not want to be forced to close after the seller has disclosed unfavorable facts between signing and closing. This is usually addressed by allowing the seller to terminate prior to closing if additional facts are disclosed by the seller; often this right is conditioned on the additional disclosure being material or resulting in a material adverse effect on the target.

[D] Representation Qualifiers

The scope of a representation will dictate the amount and detail of disclosure that must be made by the seller in order to make the representation true. Consider the following two variations of the same representation made in an agreement to acquire a large chemical company:

> Except as disclosed in the Disclosure Schedule, the Target and its subsidiaries are in compliance with all environmental laws, rules, regulations, orders and decrees.
>
> Except as disclosed in the Disclosure Schedule, the Target and its subsidiaries are in compliance with all environmental laws, rules, regulations, orders and decrees, noncompliance with which could reasonably be expected to have a material adverse effect on the Target and its subsidiaries, taken as a whole.

This hypothetical target and its subsidiaries regularly run afoul of environmental requirements. Sometimes the noncompliance is immaterial—the target cures the problem by performing routine and in-

expensive remediation. Sometimes the issue is material, involving potentially significant fines and remediation costs. Under the first variation of the environmental compliance representation, the seller is required to disclose all violations, material or otherwise. Although preparing such a long schedule may be more work, the seller will be off the hook for all matters that are disclosed. The buyer, on the other hand, will have gotten more information than may be useful to it. In order to understand the potential exposure resulting from these environmental issues, it must understand and analyze every item disclosed on this long schedule.

On the other hand, if the second representation is used a burden is placed on the seller to differentiate between material and immaterial events of noncompliance. The result of this is twofold. First, failure by the seller to include any material violations will result in the representation being breached. Second, the buyer's review and analysis will be better focused, and the risk of the target's noncompliance with environmental requirements will be shifted to the seller only with respect to those matters that are disclosed.

In addition to materiality qualifiers, the other main device used by sellers to soften their representations is the qualification that a representation is made "to the best of the seller's knowledge." An example of this is the following:

> To the best knowledge of the Seller, the Target has good, valid and marketable title to the property it purports to own, free and clear of all encumbrances.

After the closing the buyer learns of an existing easement in favor of a state agency running through the center of the target's main operating facility, and the state's plans to exercise its rights under the easement in connection with a road-building project. The buyer will have recourse against the seller only to the extent that it can show that the seller knew about the easement.

The use of a knowledge standard may have a negative impact on the value of the seller's representations, and therefore is usually vigorously resisted by buyers. The issue for the buyer as to most representations is not whether adverse facts are known by the seller, but rather which party should bear the risk they represent. The use of a knowledge standard effectively shifts the risk of unknown problems from the seller to the buyer.

Following is a discussion of some of the representations most often made by the seller in acquisition agreements.[21]

[E] Corporate Existence, Power and Authority

In a stock acquisition or a merger, the buyer will want to know that the acquired companies have all the necessary attributes of corporate existence. The language of this representation is as follows:

> Each of the Target and its subsidiaries (i) is a corporation duly organized, validly existing and in good standing under the laws of its state of incorporation; (ii) has full corporate power and authority to carry on its business as it is now being conducted and to own the properties and assets it now owns; and (iii) is duly qualified or licensed to do business as a foreign corporation in good standing in every jurisdiction in which such qualification is required.

The only part of this that is likely to be negotiated is clause (iii). The impact of failing to be qualified in a particular state may be small; accordingly, this representation is often subject to a materiality qualification. Additionally, if the entity being acquired is some form of entity other than a corporation, the representation must be modified accordingly.

Note that the representation covers not only the target but also the target's subsidiaries, as the acquisition of a target with subsidiaries results in the acquisition of the subsidiaries as well. Consider an acquisition of a holding company, the only assets of which are the equity interests in a number of operating subsidiaries. An acquisition agreement that provides for representations only as to the entity that is being directly acquired (the parent holding company) will fail to provide the buyer with comfort as to the real guts of the business. Therefore, the buyer will always want representations that cover both the target and the target's subsidiaries.

---

21. For a more exhaustive discussion of acquisition agreement representations, see Kling and Nugent § 11.04. Enforceability representations (see section 9:2) will always be made by both the buyer and the seller; they are not discussed here.

[F] Consents; No Violations

If an acquisition results in the target's violation of a legal or contractual requirement, the buyer may be purchasing a headache. For example, if the target has an important lease with a change of control provision that isn't discovered by the buyer until after the closing, the buyer may find itself with a landlord that has the right to terminate or renegotiate the lease. Or, the target could be in violation of a law or order because of the transaction and as a result be facing criminal sanctions or penalties. Obviously, no buyer wants to walk unknowingly into a situation like this, and therefore the following representation is standard.

> The consummation of the transactions contemplated hereby will not (i) conflict with or result in the breach of any provision of the certificate of incorporation, by-laws or similar organizational documents of the Target or any of its subsidiaries, (ii) require any filing with, or permit, authorization, consent or approval of, any Governmental Entity or other Person (including consents from parties to agreements to which the Target or any of its subsidiaries is a party), (iii) require any consent, approval or notice under, or result in a violation or breach of, or constitute (with or without notice or the passage of time or both) a default (or give rise to any right of termination, amendment, cancellation or acceleration) under, any agreement to which the Target or any of its subsidiaries is a party, or (iv) violate any order, writ, injunction, decree, statute, rule or regulation applicable to the Target, any of its subsidiaries or any of their properties or assets.

The buyer will probably require, as a condition to closing, that the seller obtain any consents that are necessary to make this representation true. Sometimes a materiality qualifier is negotiated with respect to conflicts with agreements. For example, a target that is a retailer with 500 leased locations may have a handful of leases that contain change-of-control provisions that aren't waived. A materiality qualifier would prevent this situation from blowing up the deal.

[G] Financial Statements; No Undisclosed Liabilities

This is an extremely important representation: the financial statements of the target are probably the single most crucial document to a buyer in making its investment decision. The representation will be similar in form and substance to that discussed above in connection

with credit agreements (see section 9:3.1[A]). This representation may need to be significantly modified in the context of an asset sale or the sale of a subsidiary. If the acquisition involves all of the assets of a business that has its own financial statements, there is no issue: the seller will make the normal representations with regard to these financial statements. If, however, the assets being sold are the assets of a division or a subsidiary of a larger business, it is likely that separate financial statements with respect to the business represented by these assets will not exist. In this case, the representation will have to be tailored to cover the financial information that was actually delivered to the buyer in its due diligence. So, for example, if such financial information was not audited by accountants, no representation can be requested as to the existence of an audit.

[H] Material Adverse Change

The buyer protects itself against target problems or financial deterioration after the date of the financial statements by getting a representation that there has been no material adverse change after the statement date. Thus, if the target's sales had fallen significantly since the period covered by the financial statements delivered to the buyer, the seller fails to disclose this as a material adverse change at its own risk.

[I] Books and Records

In many cases, the effectiveness of the buyer's due diligence will depend on the soundness of the target's books and records (including accounting records, minute books and stock transfer records). Therefore, the seller will be expected to make the following representation:

> The books of account, minute books, stock record books and other records of the Target and its subsidiaries are complete and correct in all material respects and have been maintained in accordance with sound business practices, including the maintenance of an adequate system of internal controls. The minute books of the Target contain accurate and complete records of all meetings of, and corporate action taken by, the shareholders of the Target and its board of directors and all committees thereof.

[J] Title to Assets

> The Target and each of its subsidiaries has good, valid and marketable title to all the properties and assets that they purport to own (tangible and intangible) free and clear of all Encumbrances.

This representation will be worded differently depending on whether the transaction is an asset purchase or a stock purchase. In an asset deal, the seller will make this representation as to the assets that are being sold to the buyer. In a stock deal or a merger, the representation will be made with respect to the assets that are owned by the target and each of its subsidiaries.

A buyer is trying to mitigate two important risks by asking for this representation: first the buyer's plans to operate the acquired assets may be impaired by a claim or encumbrance. For example, trademarks might be subject to a long-term license agreement that would prevent their use by the buyer, or an encumbrance may represent an economic cost that should be factored into the purchase price. The second risk addressed by this representation is a financial one. If, for instance, as a result of disclosure under this representation the buyer learns that a plant of the target is subject to a $1 million mechanics' lien, the buyer will probably require either a corresponding reduction to the purchase price or satisfaction of the lien by the seller as a condition to closing.

[K] Capitalization

This representation will be required in stock acquisition and merger transactions. Since in each of these transactions the buyer is acquiring the target by acquiring the target's shares directly (or indirectly, in the case of certain mergers), it is important for the buyer to fully understand the characteristics of these shares.

> The authorized capital stock of the Target consists of ______ Shares of common stock (of which ______ shares are issued and outstanding) and _____ shares of preferred stock, par value $___ per share (of which ____ shares are issued and outstanding). All the outstanding shares of the Target's capital stock have been duly authorized and validly issued and are fully paid and non-assessable. Except as set forth above, (i) there are no shares of capital stock of the Target authorized, issued or outstanding; (ii) there are no existing options, warrants, calls, preemptive rights, subscriptions or other rights,

agreements, arrangements or commitments of any character, relating to the issued or unissued capital stock of the Target, obligating the Target to issue, transfer or sell or cause to be issued, transferred or sold any shares of capital stock, or other equity interest in, the Target or securities convertible into or exchangeable for such shares or equity interests, or obligating the Target to grant, extend or enter into any such option, warrant, call, preemptive right, subscription or other right, agreement, arrangement or commitment; and (iii) there are no outstanding contractual obligations of the Target to repurchase, redeem or otherwise acquire any capital stock of the Target.

The buyer's overriding concern is to ensure that it is acquiring 100% of the voting and economic interests in the target. This goal could be defeated if there are shares owned by someone other than the seller, if there are options, conversion rights or preemptive rights pursuant to which third parties may be able to obtain shares or if there are voting agreements relating to such shares. The existence of present or future minority shareholders may affect buyer's view as to the appropriate value of the transaction or whether the potential nuisance of dealing with other shareholders makes the deal undesirable. The buyer will also want to know the details of any preferred or other non-voting stock, because such securities raise a potential economic (as opposed to control) issue. If the buyer expects to have the target pay dividends or make distributions to it, the existence of other classes of capital stock that would be required to share therein will be significant. Outstanding preferred stock may have dividend requirements that have to be satisfied before common dividends may be paid. The provisions of the preferred stock may give the holders thereof veto power over specified transactions or contain other contract-like provisions that may be adverse to the buyer's interests.

[L] Litigation, Full Disclosure, Etc.

Acquisition agreements contain a number of representations that are similar to, and serve the same purpose as, certain of the representations discussed above in the context of credit agreements. These include representations regarding litigation (section 9:3.1[D]), compliance with law (section 9:3.1[E]), and full disclosure (section 9:3.1[G]).

[M] Other Representations

The typical acquisition agreement will also contain a number of additional representations regarding specific aspects of the target's business. They will often be tailored to the specific transaction. These representations may cover, among other matters, the following:

- Environmental matters—has the target complied with all applicable rules and regulations? Are there any pending or threatened claims relating to environmental matters? Have all relevant environmental activities been disclosed?
- Accounts receivable—how timely are they being paid? Are there disputes with customers?
- Inventory—have all necessary writedowns and reserves been taken on the books?
- Real property—have all appropriate title documents been delivered to the buyer? Are there any condemnation or similar proceedings pending or threatened? Are any properties under lease?
- Leases—have they all been disclosed? Are there any defaults under any leases?
- Contracts and commitments—have all material items been disclosed? Are there any defaults? Do employment agreements provide for severance payments? Do any agreements provide for the payment of liquidated damages in the event of breach or termination?
- Insurance—is the property of the target properly insured? Are there any unsettled insurance claims outstanding?
- Employee benefit plans—have they all been disclosed? Will any plans be terminated as a result of the acquisition, and, if so, at what cost?
- Tax matters—has the target filed all tax returns and paid all taxes? Are there any disputes with any taxing authority?
- Intellectual property—are all items disclosed? Are there any disputes with respect to ownership or use? Are there any

third-party infringement claims? Have all actions been taken to maintain validity and effectiveness?

- Labor matters—are there any strikes or labor problems? Has the target complied with all applicable labor laws?

§ 9:4.2 Covenants

Unlike covenants imposed on a debtor by a creditor (see sections 9:3.2 and 9:3.3), which tend to regulate a broad range of business activities, covenants under an acquisition agreement impose requirements that generally relate only to the transaction itself. They can be distinguished by the period of time that they cover: some apply during the period between signing and closing and others apply after closing. The pre-closing covenants, as a general rule, require the seller to take actions that will either facilitate the closing or will prevent the target's business from being changed or impaired in any meaningful way. The buyer's recourse for a breach of the seller's covenants are (a) termination by the buyer of the acquisition agreement (if the breach occurs and is discovered before closing), (b) action by the buyer against seller for breach of contract, or (c) indemnification, to the extent provided under the agreement.

[A] Interim Operations of the Target

A recurring theme in acquisition documentation is the buyer's interest in protecting itself against changes that would result in the target's being a different company in some sense from the one the buyer initially decided to acquire. This objective is addressed by including covenants that restrict the seller and target from engaging in certain activities between signing and closing that the buyer considers detrimental to its potential investment in the target. These covenants generally prohibit the target and its subsidiaries from engaging in activities outside the ordinary course of business during the period from the signing of the acquisition agreement through the closing date. Often, this general restriction will be supplemented by a number of specific restrictions on the target and its subsidiaries doing any of the following:

- changing accounting practices
- amending its organizational documents
- creating subsidiaries
- amending or terminating material contracts or insurance policies
- incurring or prepaying debt
- changing compensation levels or modifying benefit plans
- entering into new leases or licensing agreements
- entering into material contracts
- paying dividends
- entering into transactions with affiliates
- making investments
- issuing or selling capital stock
- making capital expenditures
- disposing of assets
- settling claims or litigation

The tension in negotiating this covenant is between the buyer's interest in tightly restricting the target's behavior in order to preserve its value, and the seller's (and the target's) interest in having an adequate amount of operating flexibility. This tension increases in direct correlation to the expected length of time between signing and closing.

There are a number of methods to soften these covenants to satisfy the need for flexibility. First, the parties can exclude transactions in the ordinary course of business that are consistent with past practices. This approach works as long as the target has a demonstrable track record as to the activity at issue that the buyer understands and is comfortable with. A second approach is to permit the restricted action up to a negotiated level. This is appropriate as to actions that can be quantified—for example, a restriction on entering into new supply contracts can apply only to contracts that involve payments in excess of some specified dollar amount.

[B] Actions Relating to the Closing

The buyer's obligation to purchase will be subject to a number of conditions precedent that must be satisfied by the seller. If the seller fails to satisfy any of these, the buyer will be able to walk away from the transaction. Why, then, does the buyer need a covenant requiring the seller to cause such conditions to be satisfied? Because, without this covenant, the seller would be able to get out of the transaction without cost merely by failing to satisfy these conditions (unless the buyer was willing to waive them). This covenant allows the buyer to assert a breach of contract claim against a seller that has failed to diligently pursue closing.[22]

> Prior to the Closing, the Seller shall use its [reasonable] [best] efforts to take all actions, and to do all things necessary, to consummate the Closing as promptly as practicable.

In many cases, this general language will be supplemented by specific requirements as to particular closing conditions. For example, if a governmental permit is required, the buyer may propose a provision not only requiring the seller to use its best efforts to obtain the permit, but also requiring the seller to file its application for the permit by a specific date.

[C] Notification of Certain Matters

The buyer will want to be made aware of any new facts or developments arising prior to closing that are pertinent to its investment decision. This is addressed by the following covenant:

> The Seller shall promptly supplement or amend the Disclosure Schedule with respect to any matter arising after the date of this Agreement that, if existing or occurring on the date of this Agreement, would have been required to be included on the Disclosure Schedule. No supplement or amendment of the Disclosure Schedule pursuant to this section shall be deemed to cure any breach of representation hereunder.

---

22. This issue runs both ways: the seller will also want to be able to drag a reluctant buyer to the altar. Accordingly, this covenant is often written to apply to both parties.

When new facts arise or are discovered after the signing date that would have originally been disclosed under the seller's representations, the seller is obligated to disclose them under this covenant. If the facts existed on the signing date and their omission resulted in the representation's being incorrect, the buyer will usually have the right to terminate the agreement. In other words, the buyer can't be forced to close in the face of facts that could have affected its original investment decision. The seller may argue that this covenant is not really necessary: the new facts will prevent the seller from satisfying the closing condition that it bring down all of its representations. This will allow the buyer to terminate the transaction. The buyer, however, doesn't want to be kept in the dark as to adverse facts or developments while the seller is furtively trying to make them go away. Particularly when there is a long gap between signing and closing, the buyer will want the ability to evaluate the situation when it arises, not at a much later date.

[D] Post-closing Covenants

The perfect acquisition transaction ends in a neat closing and a happy buyer and seller who shake hands, go their separate ways and never speak to each other again. Unfortunately, this ideal is seldom, if ever achieved. Often, there are post-closing purchase price adjustments. There may be loose ends that must be tied up, such as closing conditions that weren't satisfied at closing and were converted into post-closing covenants. There may be a transitional period during which the seller is required to continue to provide services to the target. In addition, there are certain common post-closing covenants. Following is a brief discussion of some of these.

▶ *Confidentiality*

As a result of their due diligence the buyer and the seller may have obtained confidential information relating to the other. Under a confidentiality provision each party agrees to maintain the confidentiality of non-public information. There are a number of customary exceptions to the confidentiality obligation, including:

- Confidentiality need not be maintained for information that is made public through no fault of the covenanting party.

- Confidential information may be shared with counsel, accountants and other advisors in connection with the transaction.
- Information may be disclosed if required by process of law (subject to the other party being given notice and an opportunity to obtain a protective order blocking public disclosure of the information).

▶ *Covenant Not to Compete*

A buyer will often want to ensure that the seller does not start up a new business to compete with the business that it just sold to the buyer. This is accomplished by the inclusion of a covenant not to compete in the acquisition agreement. Broad covenants not to compete are carefully scrutinized by the courts, so it is important to narrowly describe the scope of the restricted business and the duration and geographical coverage of the covenant.

▶ *Anti-poaching Covenant*

Both the seller and the buyer may have an interest in protecting against the other party hiring away its employees. This covenant protects against that behavior.

§ 9:4.3 Conditions Precedent: Chickens, Eggs and Big Fat Moments in Time

Most acquisition agreements are signed well in advance of the actual closing. As a result, the conditions precedent to closing are the subject of careful scrutiny and negotiation. If the buyer isn't careful in negotiating the conditions, it may be forced to purchase a company that is less attractive than the one it thought it was getting or be subject to an action for damages by the seller. By the same token, the seller will do its best to avoid conditions that are so open-ended that the buyer will be able to walk on the basis of some technicality. Both parties will want to protect themselves against unforeseen risks that may be triggered by the consummation of the acquisition—for example, claims by third parties for tortious interference.

The obligation of each of the buyer and the seller to close is subject to a different (although in some respects overlapping) set of conditions. If each of the conditions to the seller's performance isn't satisfied, the seller is not required to close (unless it chooses to waive the unsatisfied conditions). The same is true for the buyer if the conditions to its performance are not satisfied. From the perspective of the parties' lawyers, the conditions of both parties fall into two categories: those that the lawyers can help to satisfy and those completely outside of the lawyers' control. Once an acquisition agreement is signed, the lawyers will begin to work towards the closing of the acquisition. Each lawyer will take primary responsibility for certain items that must be delivered to get the opposing party to perform. For example, the conditions to the seller's performance will include delivery to the seller of the buyer's certified charter and by-laws, board resolutions and one or more officer's certificates: buyer's counsel will be responsible for producing these. At the same time, the seller's counsel will have responsibility for similar documents with respect to its client that must be delivered to the buyer. Each lawyer will review the items prepared and delivered by the other. Notwithstanding the occasional skirmish, the preparation for the closing is essentially a collaborative effort.

What happens if a closing condition isn't satisfied? There are several potential results:

- The closing does not occur.
- The closing is delayed until the condition has been satisfied.
- The failure of the condition to be satisfied is waived in exchange for a concession (such as an adjustment to the purchase price).
- The condition is converted into a covenant to be performed after closing.
- The condition is waived and the closing occurs.

Questions of timing are often the subject of intense focus. Imagine two boys involved in the swap of baseball cards where neither will give up possession first; the exchange can be consummated only with a simultaneous snatch and release. Commercial and corporate transactions are, in essence, no different. The seller will not risk delivering title to the assets without receiving payment. The buyer does not want to pay before delivery. In a simple acquisition this is generally ad-

dressed without much fuss through the mechanics of closing. Each closing document is executed and placed on the closing table. Included among these will be the key documents for transferring title: stock certificates and stock powers, in the case of a stock deal; bills of sale and other transfer documents in the case of an asset deal; and a signed merger agreement, in the case of a merger. When the parties and their counsel are in agreement that all conditions have been satisfied (or waived) other than the payment of the purchase price, the buyer instructs its bank (usually over the phone) to wire transfer the purchase price to the seller's bank account. At that point, the parties will agree that the transaction is closed. This is a modest fiction: at that point, the seller will not have yet received the money, because wire transfers are not instantaneous.

As transactions become more complicated, with a greater number of parties, more steps and more payments to be made, the mutual suspension of disbelief inherent in the scenario described above becomes harder to sustain. Frequently, one of the parties will insist that its performance must be the last step in the closing process, leading to a metaphysical discussion that practitioners refer to as the chicken-and-egg debate. Eventually, the parties will inevitably get comfortable with the (also metaphysical) notion that all the steps are occurring simultaneously in a "big fat moment in time."

The remainder of this section examines some specific acquisition agreement conditions.

[A] Payment and Transfer

The primary condition to a buyer's performance is the seller's transfer to it of the acquired assets or stock. The primary condition to a seller's obligation to effect such transfers is the buyer's payment of the purchase price and delivery of any non-cash consideration.

[B] Legal Impediments

Neither party will want to close if doing so violates a law or a court order. Both parties' performance will therefore be conditioned on there being no statute, rule, regulation order, decree or injunction that prohibits the consummation of the closing. The buyer will also seek a separate condition that there are no pending governmental

proceedings that could impair the acquired business or the buyer's ownership thereof—for example, antitrust proceedings that may result in the buyer being forced to divest part of the acquired business. In addition, neither party will be willing to close if any required governmental approval is not delivered.

[C] Litigation

Each party will want to have its performance of the acquisition agreement conditioned to some extent on the absence of litigation relating to the transaction itself. No one wants to close a transaction under a cloud of litigation. The issues arising in the negotiation of this condition are usually the materiality level of the litigation and how and by whom such materiality is quantified. Without a materiality qualification, the existence of any litigation as to the transaction, no matter how spurious, will give each of the parties a free walk. This is of particular concern if one of the transaction parties is a public company, given the possibility of strike suits.

The buyer will also want a condition relating to litigation affecting the target. The buyer will want the right to assess litigation against the target seeking money damages or injunctive relief that could be disruptive or harmful to the target's business. The mechanism to provide for this is a condition to the buyer's performance that there is no litigation against the target. Often this condition will be subject to a materiality qualification.

[D] Representations

The buyer will not be required to close unless the seller's representations are true on the closing date.[23] Without this condition, the buyer could be forced to acquire a target that is substantially different from the one described in the seller's original representations. True, the buyer may have an indemnification claim or a claim for breach of contract, but most buyers would not willingly purchase damaged goods and an indemnification claim.

---

23. The remainder of the discussion of conditions precedent will, for simplicity's sake, address only conditions to the buyer's performance.

An often-negotiated issue is whether the condition requires the representations merely to be "true and correct" or "true and correct in all material respects." The seller will make all of the usual arguments in favor of the materiality standard. The buyer will argue that certain of the representations already are subject to a materiality standard. According to the buyer, the addition of a general materiality standard to the condition will have two improper results: the representations that were originally made flat will become subject to materiality, and the representations that were originally made with a materiality standard will become subject to two materiality standards (with whatever mysterious effect that may have).

[E] Performance of Covenants

Another condition to the buyer's performance will be compliance by the seller with all of its covenants. As discussed above, the covenants applicable to the seller prior to closing generally prevent actions that could result in significant changes to the target. If the seller has breached one of these covenants the buyer will be able to walk away from the deal, but in most circumstances this will not be the result. Unless the harm to the target is extremely significant, the failure of the condition to be satisfied will instead give rise to a negotiation, most often relating to a purchase price adjustment.

[F] Officer's Certificate

The seller will usually be required to deliver a certificate signed by one of its officers stating that (i) its representations in the acquisition agreement are true and correct at closing, and (ii) it has performed all of its covenants in the acquisition agreement. While this seems duplicative of the conditions discussed in sections 9:4.3[D] and [E] above, there is a technical but important difference. If no certificate is delivered, there is no actual bring-down of the representations and no statement that all of the covenants have been satisfied at closing to provide the basis for an indemnification claim by the buyer. On the other hand, if the representation and covenant conditions are omitted and only the condition requiring the officer's certificate is included, the buyer will be forced to close if the officer delivers the required certificate, even if the buyer is aware of representation or covenant breaches. A further benefit of getting an officer's certificate, in this as

well as other circumstances, is that an individual officer will be likely to investigate the correctness of the statements in a certificate that he is required to sign.

[G] Financing

The inclusion of a financing condition permits a buyer to terminate the transaction if it is not able to obtain financing for the purchase price. The seller who accepts this condition to the buyer's performance assumes a potentially large risk of non-closure. Often, one of the seller's primary criteria in choosing a buyer is whether the buyer has the financial ability to close. A seller may even be willing to accept a lower purchase price in exchange for greater certainty of closing. Conversely, a buyer lacking the financial ability to consummate the acquisition that enters into an acquisition agreement without a financing out, also assumes a significant risk. If the closing fails due to the buyer's inability to pay, the buyer will be subject to a claim by the seller for damages.[24]

In some cases, the seller may be willing to accept a financing condition if at the time the acquisition agreement is signed there is some indication that the buyer has a reasonable expectation of lining up the financing. This usually involves the delivery by the buyer of a financing commitment from a third party, indicating the third party's agreement to provide all or a portion of the necessary financing. The seller and its counsel will examine any such commitment carefully: the more conditions there are to the commitment, the less comfort will be obtained by the seller.

[H] Legal Opinions

A legal opinion is a letter by a lawyer setting forth legal conclusions regarding his client and the transaction documents to which the client is a party. The primary subjects of legal opinions delivered in connection with transactions are similar to those that are covered by the "enforceability representations" (see section 9:2). Legal opinions are re-

24. The parties will sometimes agree to a "break-up fee" to be paid in the event one of the parties terminates the transaction.

quested to assure the opinion recipient that the necessary legal due diligence relating to these representations has been undertaken. It is generally a mistake to view the opinion as something akin to an insurance policy, such that, if the statements made by the lawyer in an opinion turn out to be false, a claim may be asserted against the lawyer. Instead, such claims are subject to a professional negligence standard—the statements made by lawyers in legal opinions do not give rise to strict liability if determined to be wrong.

Whether or not opinions are delivered as a condition to closing a particular transaction is a function of custom and negotiating leverage. In acquisition transactions, the trend has been away from the use of opinions. Of course, opinions may be requested to provide comfort as to a particular legal issue in a transaction.

§ 9:4.4 Remedies

The remedies that are available to a party under an acquisition agreement are usually the following:

- Termination of the agreement in the event of the other party's breach of representations or covenants.
- Indemnification from the other party for its breach of representations or covenants.
- An action for damages resulting from the other party's breach of representations or covenants (unless the agreement provides that indemnification is the sole remedy).
- An action for damages resulting from the other party's failure to close notwithstanding the satisfaction of all of the conditions precedent to its performance.
- Payment of a break-up fee.

Only the first two of these, which are explicitly provided for in the agreement, will be discussed here.

[A] Termination

The remedy of termination is relatively straightforward: if one party breaches its representations or warranties, the other party may terminate the agreement. This remedy is available only before the clos-

ing of the acquisition, since its primary effect is to prevent the closing from occurring. This may raise a question as to the need for this remedy, given that the breach will also cause the failure of a closing condition. But most agreements provide for an outside date for the closing to occur, and without a termination provision a party would have to wait for that date before it could assert the other's breach as a basis for ending the agreement. The termination provision allows the party to walk away immediately upon the discovery of a breach by the other party.

[B] Indemnification

Indemnification is usually the sole remedy for breaches of an acquisition agreement that occur or are discovered after closing.[25] Although the indemnification provisions are generally mutual, the vast majority of indemnity claims are by the buyer against the seller and relate to the breach by the seller of representations or covenants relating to the target. In other words, the typical indemnification claim is based on a buyer that has received, in its view, damaged goods. Other indemnification claims may seek compensation for out-of-pocket expenses incurred as a result of the other's breach. Indemnification may also be provided for specific claims without regard to the existence of a breach. For example, a seller may agree to indemnify a buyer against all liability and attorneys' fees in connection with a specified litigation to which the target is a party at the time of the closing.

Here is the basic indemnification provision by a seller in favor of a buyer:

> The Seller shall indemnify and hold harmless the Buyer from and against all losses, damages, penalties, disbursements, costs and expenses (including without limitation attorneys' fees and expenses) incurred by the Buyer as a result of any breach by the Seller of any of its representations or covenants under this Agreement.

25. As additional features are introduced to a simple acquisition, additional remedies may be added as well. If a part of the purchase price is to be paid by the buyer over time, breach by the buyer may result in the seller having the right to accelerate such obligations, for example.

What is the difference between a buyer asserting a claim for indemnification under this provision and asserting a claim for damages in an action for fraud or breach of contract? First, a party's right to indemnification may be subject to negotiated limitations. Second, the type of damages provided for in an indemnification provision may be different from those available in a legal proceeding—for example, attorney's fees might not be awarded to the plaintiff in a contract action. Having said this, the inclusion of indemnification provisions does not avoid the need for the indemnitee to prove the breach and its damages. Put a different way, indemnification is not self executing: in other words, if the indemnitor refuses to pay, the indemnitee must judicially enforce the promise.

There are a number of techniques to limit exposure under an indemnification provision. The first is a basket, which is similar to an insurance deductible. The indemnitee may not receive indemnity payments except to the extent its indemnity claims exceed a stated dollar amount. In addition, sometimes any claim beneath a specified dollar amount will neither give rise to an indemnity claim or count against the basket. Another negotiated approach in this context may be that indemnity claims are not paid until they aggregate a stated dollar amount, at which point they are all paid. Sometimes a buyer will agree to cap the maximum aggregate amount of indemnity payments that it is entitled to receive. These provisions often contain detailed procedures with respect to claims for indemnification for legal claims. The basic rule is that the indemnitor, being responsible for paying a judgment or settlement in respect of a claim against the indemnitee, is entitled to control the defense of such claim, including the selection of counsel.