3. Representations and Warranties of Seller and Shareholders

Seller and each Shareholder represent and warrant, jointly and severally, to Buyer as follows:

COMMENT

Seller's representations and warranties are Seller's and Shareholders' formal description of Seller and its business. The technical difference between representations and warranties—representations are statements of past or existing facts, and warranties are promises that existing or future facts are or will be true—has proven unimportant in acquisition practice. *See* FREUND, ANATOMY OF A MERGER 153 (1975). Separating them explicitly in an acquisition agreement is a drafting nuisance, and the legal import of the separation has been all but eliminated. *See* Reliance Fin. Corp. v. Miller, 557 F.2d 674, 682 (9th Cir. 1977) (the distinction between representations and warranties is inappropriate when interpreting a stock acquisition agreement). The commentary to the Model Agreement generally refers only to representations.

Representations, if false, may support claims in tort and also claims for breach of an implied warranty, breach of an implied promise that a representation is true or breach of an express warranty if the description is basic to the bargain. *Cf.* U.C.C. § 2-313. *See generally* BUSINESS ACQUISITIONS ch. 31 (Herz & Baller eds., 2d ed. 1981). The Model Agreement, following common practice, stipulates remedies for breaches of representations that are equivalent to those provided for breaches of warranties (see Sections 1.1 (definition of "Breach"), 7.1 and 7.2 (conditions to Buyer's obligations to complete the acquisition) and 11.2(a) (Seller's and Shareholders' indemnification obligations)).

Purposes of the Seller's Representations. The seller's representations serve three overlapping purposes. First, they are a device for obtaining disclosure about the seller before the signing of the acquisition agreement. A thorough buyer's draft elicits information about the seller and its business relevant to the buyer's willingness to buy the assets. For example, the Fact Pattern assumes that Seller has no subsidiaries, and the

representations reflect this assumption. If a seller has subsidiaries, the buyer's draft should elicit information regarding the subsidiaries.

The seller's representations also provide a foundation for the buyer's right to terminate the acquisition before or at the closing. Between the signing of the acquisition agreement and the closing, the buyer usually undertakes a due diligence investigation of the seller. Detailed representations give the buyer, on its subsequent discovery of adverse facts, the right not to proceed with the acquisition, even if the adverse facts do not rise to the level of common law "materiality" defined by judges in fraud and contract cases (see Section 7.1 and the related Comment).

Finally, the seller's representations affect the buyer's right to indemnification by the seller and the shareholders (and other remedies) if the buyer discovers a breach of any representation after the closing (see Section 11.2 and the related Comment). In this regard, the seller's representations serve as a mechanism for allocating economic risks between the buyer and the seller and the shareholders. Sellers often resist the argument that representations simply allocate economic risk on the basis that civil and criminal liabilities can result from making false statements. The buyer typically will request that the shareholders' indemnification obligations be joint and several. See the Comment to Section 11.2 and the Contribution Agreement attached as Ancillary Document 5 as to this and the allocation of responsibility among the shareholders.

Scope of the Seller's Representations. The scope and extent of the seller's representations and warranties largely will be dependent upon the relative bargaining power of the parties. Where there is competition for a seller, or the acquisition presents a particularly attractive opportunity, the buyer might scale down the representations so as not to adversely affect its ability to make the acquisition. In scaling down the representations, consideration must be given to their relative benefit to the buyer in terms of the degree and likelihood of exposure and their materiality to the ongoing business operations.

The representations and warranties will also reflect particular concerns of the buyer. In some cases, these concerns can be satisfied through the conduct of due diligence without having to obtain a specific representation. In other cases, the buyer will insist upon additional comfort from the seller through its representations backed up by indemnification.

The representations in the Model Agreement are based upon the Fact Pattern, which characterizes Seller as a manufacturer with a full range of business activities, including advisory and consulting services. The representations would look somewhat different if Seller were strictly a service provider. Similarly, representations often are added to address specific concerns that pertain to the industry in which the seller operates. For example, representations concerning the adequacy of reserves would be appropriate for an insurance company, and representations concerning compliance with certain federal and state food and drug laws would be appropriate for a medical device or drug manufacturer. The Fact Pattern indicates that Seller has no subsidiaries. If it were to have subsidiaries that are part of the Assets to be acquired by Buyer, the representations should be expanded to include their organization, capitalization, assets, liabilities and operations. An example of the incorporation of subsidiaries in the representations and in certain other provisions of an acquisition agreement can be found in the *Model Stock Purchase Agreement with Commentary.* Similar changes should be made for any partnerships, limited liability companies or other entities owned or controlled by Seller. The scope of the representations also changes over time to address current issues. Examples are the extensive environmental representations that began to appear in the late 1980s and the Year 2000 representations that were commonly sought by buyers in the late 1990s. See Section 3.26 and the related Comment.

Considerations When Drafting "Adverse Effect" Language in Representations. The importance of the specific wording of Seller's representations cannot be emphasized

enough because they provide the foundation for both Buyer's "walk rights" in Section 7.1 and Buyer's indemnification rights in Section 11.2.

Consider, for example, the following simplified version of the litigation representation: "There is no lawsuit pending against Seller that will have an adverse effect on Seller." The phrase "that will have an adverse effect on Seller" clearly provides adequate protection to Buyer in the context of a post-Closing indemnification claim against Seller and Shareholders. If there is a previously undisclosed lawsuit against Seller that has an adverse effect on Seller (because, for example, a judgment is ultimately rendered against Seller in the lawsuit), Buyer will be able to recover damages from Seller and Shareholders because of the Breach of the litigation representation (see Section 11.2(a)). The quoted phrase may not adequately protect Buyer, however, if Buyer is seeking to terminate the acquisition because of the lawsuit. In order to terminate the acquisition (without incurring any liability to Seller), Buyer will have to demonstrate, on the scheduled Closing Date, that the lawsuit "will have an adverse effect on Seller" (see Section 7.1). Buyer may find it difficult to make this showing, especially if there is doubt as to the ultimate outcome of the lawsuit.

In order to address this problem, a buyer might be tempted to reword the litigation representation so that it covers lawsuits that "could reasonably be expected to have" an adverse effect on the seller (as distinguished from lawsuits that definitely "will" have such an effect). Although this change in wording clearly expands the scope of the buyer's walk rights, it may actually limit the buyer's indemnification rights because, even if the lawsuit ultimately has an adverse effect on the seller, the seller and its shareholders may be able to avoid liability to the buyer by showing that, as of the closing date, it was unreasonable to expect that the lawsuit would have such an effect.

In order to protect both its indemnification rights and its walk rights in the context of undisclosed litigation, the buyer may propose that the litigation representation be reworded to cover any lawsuit "that *may* have an adverse effect" on the seller (see Section 3.15(a)). If a seller objects to the breadth of this language, the buyer may propose, as a compromise, that the litigation representation be reworded to cover lawsuits "that will, or that could reasonably be expected to," have an adverse effect on the seller.

Considerations When Drafting Representations Incorporating Specific Time Periods. Representations that focus on specific time periods require careful drafting because of the "bring-down" clause in Section 7.1 (the clause stating that Seller's representations must be accurate as of the Closing Date as if made on the Closing Date). For example, consider the representation in Section 3.17(a)(iii), which states that Seller has not received notice of any alleged legal violation "since" a specified date. Absent a cut-off date, this would require disclosure of all violations since the organization of Seller. In some acquisition agreements, this representation is worded differently, stating that no notice of an alleged violation has been received at any time during a specified time period (such as a five-year period) "prior to the date of this agreement." If the representation were drafted in this manner, Buyer would not have a walk right if Seller received notice of a significant alleged violation between the signing date and the closing date—the representation would remain accurate as brought down to the scheduled closing date pursuant to Section 7.1(a) because the notice would not have been received "prior to" the date of the agreement. In contrast, if the representation were drafted as in Section 3.17(a)(iii), the representation would be materially inaccurate as brought down to the scheduled Closing Date (because the notice of the alleged violation would have been received "since" the date specified in Section 3.17(a)(iii)), and Buyer, therefore, would have a walk right pursuant to Section 7.1(a).

The Effect of "Knowledge" Qualifications in Representations. Sections 3.14, 3.16, 3.18, 3.20, 3.22, 3.23, 3.24, 3.25, 3.33 and 4.3 contain "Knowledge" qualifications.

The addition of Knowledge qualifications to the representations in Article 3 can significantly limit Buyer's post-Closing indemnification rights (by shifting to Buyer the economic risks of unknown facts). However, such qualifications should not affect Buyer's walk rights under Section 7.1. If, before the Closing, Buyer learns of a fact (not already known to Seller) that is inconsistent with a representation containing a Knowledge qualification, Buyer should simply disclose this fact to Seller. Seller will thus acquire Knowledge of the fact, and the representation will be inaccurate despite the Knowledge qualification. For further discussion of knowledge qualifications, see the Comments to the definition of "Knowledge" in Section 1.1 and to the sections listed above.

The Absence of "Materiality" Qualifications. Seller's representations in the Model Agreement generally do not contain materiality qualifications. Rather, the issue of materiality is addressed in the remedies sections. Section 7.1(a) specifies that only material breaches of representations give Buyer a walk right. Section 7.1(b) covers the few representations that contain their own materiality qualification (see the Comment to Section 7.1). The indemnification provisions replace a general and open-ended materiality qualification with a carefully quantified "basket" in Section 11.5 that exonerates Seller and Shareholders from liability for breaches resulting in damages below a specified amount. Alternatively, Buyer could acquiesce to some materiality qualifications in Article 3 but eliminate or reduce the "basket" to prevent "double dipping."

The Absence of a Bring-Down Representation. For a discussion of the absence of a bring-down representation in the Model Agreement, see the discussion of the bring-down clause in the Comment to Section 7.1.

3.1 ORGANIZATION AND GOOD STANDING

(a) Part 3.1(a) contains a complete and accurate list of Seller's jurisdiction of incorporation and any other jurisdictions in which it is qualified to do business as a foreign corporation. Seller is a corporation duly organized, validly existing and in good standing under the laws of its jurisdiction of incorporation, with full corporate power and authority to conduct its business as it is now being conducted, to own or use the properties and assets that it purports to own or use, and to perform all its obligations under the Seller Contracts. Seller is duly qualified to do business as a foreign corporation and is in good standing under the laws of each state or other jurisdiction in which either the ownership or use of the properties owned or used by it, or the nature of the activities conducted by it, requires such qualification.

(b) Complete and accurate copies of the Governing Documents of Seller, as currently in effect, are attached to Part 3.1(b).

(c) Seller has no Subsidiary and, except as disclosed in Part 3.1(c), does not own any shares of capital stock or other securities of any other Person.

COMMENT

In an asset acquisition, the buyer's primary concern is that the business of the seller has been operated properly prior to the execution of the acquisition agreement and will continue to be so operated between the signing and the closing. Moreover, the buyer (or the subsidiary that will own the assets and conduct the business post-closing) may need to qualify to do business in each state where that business will be conducted. A list of all states where qualification of the seller is required gives the buyer a checklist of states where it must be qualified on or before the closing date.

The representation concerning the seller's power and authority is generally qualified by a reference to "corporate" power and authority. Use of the word "corporate" limits the representation to mean that the seller is authorized to conduct its business (as it is currently conducted) under applicable business corporation laws and its charter and by-laws—that is, such action is not "ultra vires." If the word "corporate" is omitted, the term "power and authority" could be interpreted to mean "full power and authority" under all applicable laws and regulations; that the seller has such authority is a much broader representation.

The representation concerning qualification of the seller as a foreign corporation in other jurisdictions occasionally contains an exception for jurisdictions in which "the failure to be so qualified would not have a material adverse effect on the business or properties of Seller." Requiring a list of foreign jurisdictions does not limit or expand the breadth of the previous sentence but forces the seller to give proper attention to this matter.

The representation that the seller does not have a subsidiary is included to confirm that the business of the seller is conducted directly by it and not through subsidiaries. If the seller had conducted business through subsidiaries, the documentation for the transfer of the assets may need to be modified to transfer the stock or assets of the subsidiaries and, depending upon the materiality of the subsidiaries, the buyer would want to include appropriate representations and covenants regarding the subsidiaries. See the *Model Stock Purchase Agreement with Commentary* for examples of representations that could be adapted and added to the Model Asset Purchase Agreement to deal with a sale of stock of a subsidiary.

To the extent that capital stock or other securities are included among the assets, the contemplated transactions would involve the sale of a security within the contemplation of the Securities Act and applicable state securities statutes. This would necessitate the parties structuring the transaction to comply with the applicable securities registration and other requirements or structure the contemplated transactions to be exempt from their registration requirements. See the Comments to Sections 3.2 and 3.31.

See Chapter 2, "Basic Corporate Documents," of the *Manual on Acquisition Review*.

3.2 ENFORCEABILITY; AUTHORITY; NO CONFLICT

(a) This Agreement constitutes the legal, valid and binding obligation of Seller and each Shareholder, enforceable against each of them in accordance with its terms. Upon the execution and delivery by Seller and Shareholders of the Escrow Agreement, the Employment Agreement, the Noncompetition Agreement and each other agreement to be executed or delivered by any or all of Seller and Shareholders at the Closing (collectively, the "Seller's Closing Documents"), each of Seller's Closing Documents will constitute the legal, valid and binding obligation of each of Seller and the Shareholders, enforceable against each of them in accordance with its terms. Seller has the absolute and unrestricted right, power and authority to execute and deliver this Agreement and the Seller's Closing Documents to which it is a party and to perform its obligations under this Agreement and the Seller's Closing Documents, and such action has been duly authorized by all necessary action by Seller's shareholders and board of directors. Each Shareholder has all necessary legal capacity to enter into this Agreement and the Seller's Closing Documents to which such Shareholder is a party and to perform his obligations hereunder and thereunder.

(b) Except as set forth in Part 3.2(b), neither the execution and delivery of this Agreement nor the consummation or performance of any of the Contemplated Transactions will, directly or indirectly (with or without notice or lapse of time):

- **(i) Breach (A) any provision of any of the Governing Documents of Seller or (B) any resolution adopted by the board of directors or the shareholders of Seller;**
- **(ii) Breach or give any Governmental Body or other Person the right to challenge any of the Contemplated Transactions or to exercise any remedy or obtain any relief under any Legal Requirement or any Order to which Seller or either Shareholder, or any of the Assets, may be subject;**
- **(iii) contravene, conflict with or result in a violation or breach of any of the terms or requirements of, or give any Governmental Body the right to revoke, withdraw, suspend, cancel, terminate or modify, any Governmental Authorization that is held by Seller or that otherwise relates to the Assets or to the business of Seller;**
- **(iv) cause Buyer to become subject to, or to become liable for the payment of, any Tax;**
- **(v) Breach any provision of, or give any Person the right to declare a default or exercise any remedy under, or to accelerate the maturity or performance of, or payment under, or to cancel, terminate or modify, any Seller Contract;**
- **(vi) result in the imposition or creation of any Encumbrance upon or with respect to any of the Assets; or**
- **(vii) result in any shareholder of the Seller having the right to exercise dissenters' appraisal rights.**

(c) Except as set forth in Part 3.2(c), neither Seller nor either Shareholder is required to give any notice to or obtain any Consent from any Person in connection with the execution and delivery of this Agreement or the consummation or performance of any of the Contemplated Transactions.

COMMENT

A seller may seek an exception to the representations in the first sentence of Section 3.2(a) to the extent that enforceability is limited by bankruptcy, insolvency or similar laws affecting creditors' rights and remedies or by equitable principles. Such an exception is almost universally found in legal opinions regarding enforceability, and some buyers may allow it in the representations. Other buyers will respond that the exception would be inappropriate because the risk of such limitations should fall on the seller and the shareholders.

In most states, shareholder approval of an asset sale has historically been required if the corporation is selling all or substantially all of its assets. Delaware courts have used both "qualitative" and "quantitative" tests in interpreting this phrase, as it is used in Section 271 of the Delaware General Corporation Law. *See* Gimbel v. The Signal Co., 316 A.2d 599 (Del. Ch. 1974) (assets representing forty-one percent of net worth but only fifteen percent of gross revenues held not to be "substantially all"); Katz v. Bregman, 431 A.2d 1274 (Del. Ch. 1981) (fifty-one percent of total assets, generating 44.9 percent of gross sales, held to be "substantially all"); Thorpe v. Cerbco, Inc., 676 A.2d 436 (Del. 1996). For a comprehensive discussion of the Delaware cases, *see*

BALOTTI AND FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §10.2 (1997). In *Story v. Kennecott Copper Corporation,* 394 N.Y.S. 2d 253, Sup. Ct., 1977, the court held that, under New York law, the sale by Kennecott of its subsidiary Peabody Coal Company, which accounted for approximately fifty-five percent of Kennecott's consolidated assets, was not a sale of "substantially all" Kennecott's assets requiring shareholder approval even though Peabody had been the only profitable operation of Kennecott for the past two years.

Difficulties in determining when a shareholder vote is required have led some states to adopt a bright-line test. TEX. BUS. CORP. ACT ANN. arts. 5.09 and 5.10 provide, in essence, that shareholder approval is required under Texas law only if it is contemplated that the corporation will cease to conduct any business following the sale of assets. A 1999 revision to the Model Business Corporation Act (MBCA) excludes from the requirement of a shareholder vote any disposition of assets that would not "leave the corporation without a significant continuing business activity." MBCA § 12.02(a). The revision includes a safe-harbor definition of significant continuing business activity: at least twenty-five percent of the total assets and twenty-five percent of either income (before income taxes) or revenues from pretransaction operations.

If shareholder approval is required, the buyer may want to require that it be obtained before or contemporaneously with execution of the asset purchase agreement if possible. Although the buyer can include a no-shop provision (see Section 5.6 of the Model Agreement) in the acquisition agreement, the seller may want a fiduciary out to the no-shop provision, and, with or without a fiduciary-out provision, there is the possibility that the shareholder vote will not be obtained if a better offer comes along before the vote is held. Moreover, without an adequate fiduciary out, the no-shop may be invalid. *See* Ace Limited v. Capital Re Corp., No. Civ. A 17488, 1999 WL 1261372 (Del. Ch. Oct. 28, 1999). That case involved a publicly held company, but the courts have not generally made a distinction between publicly and closely held companies in discussing directors' fiduciary duties.

The parties should consider the applicability of the Securities Act and state securities laws to the contemplated transactions, notwithstanding receipt of the requisite shareholder vote. A sale of assets, even if it involves the sale of a business, to a sophisticated financial buyer who will use the assets as part of a business which it will manage and control ordinarily does not implicate the registration provisions of the Securities Act. The inclusion of the promissory note as part of the purchase price (see Section 2.3) may, however, result in the contemplated transactions involving the sale of a security requiring structuring to comply with the Securities Act and applicable state securities laws. See Section 3.31 and the related Comment.

Section 3.2(b) contains Seller's "no-conflict" representation. The purpose of this representation is to assure Buyer that, except as disclosed in the Disclosure Letter, the acquisition will not violate (or otherwise trigger adverse consequences under) any legal or contractual requirement applicable to Seller or either Shareholder. In connection with clause (iv) of Section 3.2(b), Seller's counsel should consider sales and transfer taxes. See the Comment to Section 10.2.

The purpose served by the no-conflict representation differs from that served by the more general representations concerning Legal Requirements, Governmental Authorizations, Orders and Contracts (see Sections 3.17, 3.18 and 3.20), which alert Buyer to violations and other potential problems unconnected to the acquisition. The no-conflict representation focuses specifically on violations and other potential problems that would be triggered by the consummation of the acquisition and related transactions.

The term "Contemplated Transactions" is defined broadly in Section 1.1. The use of an expansive definition makes the scope of the no-conflict representation very

broad. A seller may argue for a narrower definition and may also seek to clarify that the no-conflict representation does not extend to laws, contracts or other requirements that are adopted or otherwise take effect after the closing date. In addition, the seller may seek to clarify that the no-conflict representation applies only to violations arising from the seller's and the shareholders' performance of the acquisition and related transactions (and not to violations arising from actions taken by the buyer).

The no-conflict representation relates both to requirements binding upon Seller and to requirements binding upon the Shareholders. (Requirements binding upon Buyer are separately covered by Buyer's no-conflict representation in Section 4.2 and by the closing condition in Section 8.1.) The Shareholders may seek to eliminate the references to laws, regulations, orders and contracts binding upon the Shareholders, arguing that violations of requirements applicable only to the Shareholders (and not also applicable to the seller) should be of no concern to the buyer because the buyer is not making an investment in the Shareholders. The buyer may respond to such an argument by pointing out that a violation of a law, regulation, order or contract binding upon the shareholders can be of substantial concern to the buyer if such a violation would provide a governmental body or a third party with grounds to set aside or challenge the acquisition. The buyer may also point out that, if the shareholders were to incur a significant financial liability as a result of such a violation, the shareholders' ability to satisfy their indemnification obligations and other post-closing obligations to the buyer could be impaired.

The phrase "with or without notice or lapse of time," which appears in the introduction to the no-conflict representation, requires Seller to advise Buyer of any "potential" or "unmatured" violations or defaults (circumstances that, although not technically constituting a violation or default, could become an actual violation or default if a specified grace period elapses or if a formal notice of violation or default is delivered) that may be caused by the acquisition or related transactions.

Clause (ii) of the no-conflict representation focuses specifically on Legal Requirements and Orders that might be contravened by the acquisition or related transactions. The broad language of this provision requires disclosure not only of legal violations but also of other types of adverse legal consequences that may be triggered by the Contemplated Transactions. For example, the "Exon-Florio" regulations, 31 C.F.R. § 800.101 et seq., provide for the submission of notices to the Committee on Foreign Investment in the United States in connection with acquisitions of U.S. companies by "foreign persons." Because the filing of an Exon-Florio notice is voluntary, the failure to file such a notice is not a regulatory violation. The filing of such a notice, however, shortens the time period within which the President can exercise divestment authority and certain other legal remedies with respect to the acquisition described in the notice. Thus, the failure to file such a notice can have an adverse effect on Seller. Clause (ii) alerts Buyer to the existence of regulatory provisions of this type.

The parties may face a troublesome dilemma if both Buyer and Seller are aware of a possible violation of law that might occur as a consequence of the acquisition or related transactions. If the possible violation is not disclosed by Seller in the Disclosure Letter, as between the parties, Seller will bear the risks associated with any violation (see Section 11.2(a)). If Seller elects to disclose the possible violation in the Disclosure Letter, however, it may be providing a discoverable "road map for a lawsuit by the government or a third party." KLING & NUGENT SIMON, NEGOTIATED ACQUISITIONS OF COMPANIES, SUBSIDIARIES AND DIVISIONS § 11.04(7) (1992).

Although clause (iii) (which addresses the possible revocation of Governmental Authorizations) overlaps to some extent with clause (ii), clause (iii) is included because a Governmental Authorization may become subject to revocation without any statutory or regulatory "violation" actually having occurred.

Clause (iv) is important because the sale of the assets will trigger state and local tax concerns in most states. In many states, the sale of assets may routinely lead to a reassessment of real property and may increase taxes on personal property. For example, if rolling stock is to be transferred, the transfer will, in some cases, lead to increased local taxes. Seller's counsel should resist any representation to the effect that the sale of assets will not lead to a reassessment.

Clause (v) deals with contractual defaults and other contractual consequences that may be triggered by the acquisition or related transactions. Many contracts provide that the contracts may not be assigned without the consent of the other parties thereto. Hence, without such consents, the contracts would be breached upon the transfer at the closing. Clause (v) alerts Buyer to the existence of any such contracts.

Clause (v) applies to "Seller Contracts," the definition of which extends both to contracts to which Seller is a party and to contracts under which Seller has any rights or by which Seller may be bound. The inclusion of the latter type of contracts may be important to Buyer. For example, Buyer will want to know if Seller's rights under a promissory note or a guaranty given by a third party and held by Seller would be terminated or otherwise impaired as a result of the acquisition. Because such a promissory note or guaranty would presumably be signed only by the third party maker or guarantor (and would not be executed on behalf of Seller in its capacity as payee or beneficiary), Seller might not be considered a party to the note or guaranty.

Other examples of contracts that may be covered by the expansive definition of "Seller Contract" include the following:

- contracts under which Seller is a third-party beneficiary;
- contracts under which a party's rights or obligations have been assigned to or assumed by Seller;
- contracts containing obligations that have been guaranteed by Seller;
- recorded agreements or declarations that relate to real property owned by Seller and that contain covenants or restrictions "running with the land"; and
- contracts entered into by a partnership in which Seller is a general partner.

Seller is required to provide (in Part 3.2 of the Disclosure Letter) a list of governmental and third-party consents needed to consummate the acquisition. Some of these consents may be sufficiently important to justify giving Buyer (and, in some cases, Seller) a "walk right" if they are not ultimately obtained (see Sections 7.3 and 8.3 and the related Comments).

Clause (vii) deals with appraisal rights. MBCA § 13.02(a)(3) confers upon certain shareholders not consenting to the sale or other disposition the right to dissent from the transaction and to obtain appraisal and payment of the fair value of their shares. The right is generally limited to shareholders who are entitled to vote on the sale. Some states, such as Delaware, do not give appraisal rights in connection with sales of assets. The MBCA sets forth procedural requirements for the exercise of appraisal rights that must be strictly complied with. A brief summary follows:

1. If the sale or other disposition of the assets of a corporation is to be submitted to a meeting of the shareholders, the meeting notice must state that shareholders are or may be entitled to assert appraisal rights under the MBCA. The notice must include a copy of the section of the statute conferring those rights. MBCA § 13.20(a). A shareholder desiring to exercise those rights must deliver to the corporation *before* the vote is taken a notice of his or her intention to exercise dissenters' rights and must not vote in favor of the proposal. MBCA § 13.21(a).
2. Following the approval of the sale or other disposition, a specific notice must be sent by the corporation to the dissenting shareholders who have given the re-

quired notice, enclosing a form to be completed by those shareholders and specifying the date by which the form must be returned to the corporation and the date the shareholders' stock certificates must be returned for deposit with the corporation. The notice must also state the corporation's estimate of the fair value of the shares and the date by which any withdrawal must be received by the corporation. MBCA § 13.22.

3. Following the receipt by the corporation of the completed form from a dissenting shareholder and the return and deposit of his or her stock certificates, the corporation must pay to each shareholder who has complied with the appraisal requirements and who has not withdrawn his or her demand for payment, the amount of the corporation estimates to be the "fair value" of his or her shares, plus interest, and must accompany this payment with copies of certain financial information concerning the corporation. MBCA § 13.24. Some jurisdictions only require an offer of payment by the corporation, with final payment to await acceptance by the shareholder of the offer.
4. A dissenting shareholder who is not satisfied with the payment by the corporation must timely object to the determination of fair value and present his or her own valuation and demand payment. MBCA § 13.26.
5. If the dissenting shareholder's demand remains unresolved for sixty days after the payment demand is made, the corporation must either commence a judicial proceeding to determine the fair value of the shares or pay the amount demanded by the dissenting shareholder. The proceeding is held in a jurisdiction where the principal place of business of the corporation is located or at the location of its registered office. The court is required to determine the fair value of the shares plus interest. MBCA § 13.30. Under the prior MBCA, it was the shareholder's obligation to commence proceedings to value the shares. Currently forty-six jurisdictions require the corporation to initiate the litigation, whereas six put this burden on the dissenting shareholder.

Many jurisdictions follow the MBCA by providing that the statutory rights of dissenters represent an exclusive remedy and that shareholders may not otherwise challenge the validity or appropriateness of the sale of assets except for reasons of fraud or illegality. In other jurisdictions, challenges based upon breach of fiduciary duty and other theories are still permitted.

Although the material set forth above contains a general outline of the MBCA provisions as they relate to shareholders' rights to dissent from a sale of all or substantially all of a corporation's assets, counsel should consult the specific statute in the state of domicile of the seller to confirm the procedures that must be satisfied.

As to the impact of dissenters' rights on other provisions of the Model Agreement, counsel should bear in mind the potential for some disruption of the acquisition process as a result of the exercise of those rights and might consider adding a closing condition to permit a quick exit by Buyer from the transaction if it appears that dissenters' rights will be exercised.

See Chapter 3, "Contracts," of the *Manual on Acquisition Review*.

3.3 CAPITALIZATION

The authorized equity securities of Seller consist of _____ (_____) shares of common stock, par value _____ dollars ($_____) per share, of which _____ (_____) shares are issued and outstanding, _____ (_____) and _____ (_____) of which are owned by A and B, respectively. Shareholders are and will be on the Closing Date the record and beneficial owners and holders of the shares owned

by each of them, free and clear of all Encumbrances. There are no Contracts relating to the issuance, sale or transfer of any equity securities or other securities of Seller. None of the outstanding equity securities of Seller was issued in violation of the Securities Act of 1933, as amended (the "Securities Act"), or any other Legal Requirement.

COMMENT

This representation may be helpful to the buyer even in an asset transaction because it enables the buyer to verify that the necessary shareholder action has been properly taken and assists the buyer in determining whether there has been compliance with applicable securities laws. If the seller, for example, has violated state securities laws in connection with a private placement, the buyer could face a dispute over successor liability for those violations in a remote forum. The seller may want to specify that this information is as of a given date, such as the date of the acquisition agreement. This may be acceptable if the issuance of any additional shares between the date of the acquisition agreement and the closing is prohibited, thus rendering this representation correct at all relevant times.

The buyer should also obtain assurance that no other party has any right to shares of the seller either from the shareholders or from the seller itself.

See Chapter 2, "Basic Corporate Documents," of the *Manual on Acquisition Review*.

3.4 FINANCIAL STATEMENTS

Seller has delivered to Buyer: (a) an audited balance sheet of Seller as at _____, 20___ (including the notes thereto, the "Balance Sheet"), and the related audited statements of income, changes in shareholders' equity and cash flows for the fiscal year then ended, including in each case the notes thereto, together with the report thereon of _____, independent certified public accountants; (b) [audited] balance sheets of Seller as at _____ in each of the fiscal years _____ through _____, and the related [audited] statements of income, changes in shareholders' equity and cash flows for each of the fiscal years then ended, including in each case the notes thereto [together with the report thereon of _____, independent certified public accountants]; and (c) an unaudited balance sheet of Seller as at _____, 20___, (the "Interim Balance Sheet") and the related unaudited statement[s] of income, [changes in shareholders' equity, and cash flows] for the _____ (___) months then ended, including in each case the notes thereto certified by Seller's chief financial officer. Such financial statements fairly present (and the financial statements delivered pursuant to Section 5.8 will fairly present) the financial condition and the results of operations, changes in shareholders' equity and cash flows of Seller as at the respective dates of and for the periods referred to in such financial statements, all in accordance with GAAP. The financial statements referred to in this Section 3.4 and delivered pursuant to Section 5.8 reflect and will reflect the consistent application of such accounting principles throughout the periods involved, except as disclosed in the notes to such financial statements. The financial statements have been and will be prepared from and are in accordance with the accounting Records of Seller. Seller has also delivered to Buyer copies of all letters from Seller's auditors to Seller's board of directors or the audit committee thereof

during the thirty-six (36) months preceding the execution of this Agreement, together with copies of all responses thereto.

COMMENT

This representation, which requires the delivery of specified financial statements of Seller and provides assurances regarding the quality of those financial statements, is almost universally present in an acquisition agreement. Financial statements are key items in the evaluation of nearly all potential business acquisitions. The Model Agreement representation requires financial statements to be delivered and provides a basis for contractual remedies if they prove to be inaccurate. Other provisions of the typical acquisition agreement also relate to the financial statements, including representations that deal with specific parts of the financial statements in greater detail and with concepts that go beyond GAAP (such as title to properties and accounts receivable), serve as the basis for assessing the quality of the financial statements (such as the representation concerning the accuracy of the seller's books and records) or use the financial statements as a starting or reference point (such as the absence of certain changes since the date of the financial statements).

The Model Agreement representation requires the delivery of (a) audited annual financial statements as of the end of the most recent fiscal year; (b) annual financial statements for a period of years, which Buyer will probably require be audited unless audited financial statements for those years do not exist and cannot be created; and (c) unaudited financial statements as of the end of an interim period subsequent to the most recent fiscal year. The Fact Pattern assumes that Seller has no subsidiaries. If Seller did have subsidiaries, the Agreement would refer to consolidated financial statements and could call for consolidating financial statements.

The determination of which financial statements should be required, and whether they should be audited, will depend upon factors such as availability, relevance to the buyer's commercial evaluation of the acquisition and the burden and expense on the seller that the buyer is willing to impose and the seller is willing to bear. Especially if the acquired assets have been operated as part of a larger enterprise, and the seller does not have a history of independent financing transactions with respect to such assets, separate financial statements (audited or otherwise) may not exist and, although the auditors that expressed an opinion concerning the entire enterprise's financial statements will, of necessity, have reviewed the financial statements relating to the acquired assets, that review may not have been sufficient for the expression of an opinion about the financial statements of the business represented by the acquired assets alone. This occurs most frequently when the acquired assets do not represent a major portion of the entire enterprise so that the materiality judgments made in the examination of the enterprise's financial statements are not appropriate for an examination of the financial statements relating to the acquired assets. The representation concerning the accuracy of the seller's books and records (see Section 3.5) is critical because these books and records are the buyer's main tool for assessing the financial health of the business utilizing the acquired assets and guarding against fraud in the financial statements (under Section 5.1, Buyer has a right to inspect these books and Records).

Many of the representations in the Model Agreement relate to the period since the date of the Balance Sheet because it is assumed that the Balance Sheet is audited and is, therefore, a more reliable benchmark than the Interim Balance Sheet, which is assumed to be unaudited.

If the buyer is a public company, its counsel should consider the requirements in SEC Regulation S-X, 17 C.F.R. § 210 (1999), if any, that apply to post-closing disclosure of audited financial statements for the assets to be acquired. In general, these requirements depend upon the relative size of the buyer and the assets to be acquired.

The Model Agreement representation does not attempt to characterize the auditors' report. The buyer's counsel should determine at an early stage whether the report contains any qualifications regarding (a) conformity with GAAP, (b) the auditors' examination having been in accordance with generally accepted auditing standards or (c) fair presentation being subject to the outcome of contingencies. Any qualification in the auditors' report should be reviewed with the buyer's accountants.

In some jurisdictions, including California and New York, auditors cannot be held liable for inaccurate financial reports to persons not in privity with the auditors, with possible exceptions in very limited circumstances. *See* Bily v. Arthur Young & Co., 11 Cal. Rptr. 2d 51 (1992); Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 546, 547 (1985); Ultramares Corp. v. Touche, 255 N.Y. 170 (1931); *see also* Sec. Pac. Bus. Credit, Inc. v. Peat Marwick Main & Co., 586 N.Y.S.2d 87, 90–91 (1992) (explaining the circumstances in which accountants may be held liable to third parties); Greycas Inc. v. Proud, 826 F.2d 1560, 1565 (7th Cir. 1987) (holding that, although privity of contract is not required in Illinois, the plaintiff must still demonstrate that a negligent misrepresentation induced detrimental reliance). If the audited financial statements were prepared in the ordinary course, the buyer probably will not satisfy the requirements for auditors' liability in those jurisdictions in the absence of a "reliance letter" from the auditors addressed to the buyer. Requests for reliance letters are relatively unusual in acquisitions, and accounting firms are increasingly unwilling to give them.

Issues frequently arise concerning the appropriate degree of assurance regarding the quality of the financial statements. The buyer's first draft of this representation often includes a statement that the financial statements are true, complete and correct in an effort to eliminate the leeway for judgments about contingencies (such as to the appropriate size of reserves for subsequent events) and materiality inherent in the concept of fair presentation in accordance with GAAP. The seller may object that this statement is an unfair request for assurances that the financial statements meet a standard that is inconsistent with the procedures used by accountants to produce them. In addition, the seller may be reluctant to represent that interim financial statements are fairly presented in accordance with GAAP, either because of some question about the quality of the information contained (for example, there may be no physical inventory taken at the end of an interim period) or because of the level of disclosure included in the interim financial statements (such as the absence of a full set of notes to the financial statements). A qualification that may be appropriate could be inserted at the end of the second sentence of Section 3.4 as follows: "subject, in the case of interim financial statements, to normal recurring year-end adjustments (the effect of which will not, individually or in the aggregate, be significant) and the absence of notes (that, if presented, would not differ materially from those included in the Balance Sheet)." It has been suggested that the representation concerning fair presentation in accordance with GAAP should also be qualified with respect to audited financial statements. *See* Augenbraun & Eyck, *Financial Statement Representations in Acquisition Transactions*, 47 BUS. LAW. 157, 166 (1991). The buyer is unlikely to accept this view, especially in its first draft of the acquisition agreement.

The seller may be willing to represent only that the financial statements have been prepared from, and are consistent with, its books and records. The buyer should be aware that this representation provides far less comfort to the buyer than that provided by the Model Agreement representation.

Many of the representations in Article 3 reflect Buyer's attempt to obtain assurances about specific line items in the financial statements that go well beyond fair presentation in accordance with GAAP. Reliance on GAAP may be inadequate if the seller is engaged in businesses (such as insurance) in which valuation or contingent liability

reserves are especially significant. Specific line-item representations, however, could lead a court to give less significance to the representation concerning overall compliance with GAAP in the case of line items not covered by a specific representation. *See, e.g.*, Delta Holdings, Inc. v. National Distillers & Chem. Corp., 945 F.2d 1226 (2d Cir. 1991), *cert. denied*, 503 U.S. 985 (1992). The specific content of these representations will vary greatly depending upon the nature of the seller's businesses and assets.

See Chapter 5, "Financial Statements," of the *Manual on Acquisition Review*.

3.5 BOOKS AND RECORDS

The books of account and other financial Records of Seller, all of which have been made available to Buyer, are complete and correct and represent actual, bona fide transactions and have been maintained in accordance with sound business practices and the requirements of Section 13(b)(2) of the Exchange Act (regardless of whether the Seller is subject to that Section or not), including the maintenance of an adequate system of internal controls. The minute books of Seller, all of which have been made available to Buyer, contain accurate and complete Records of all meetings held of, and corporate action taken by, the shareholders, the board of directors and committees of the board of directors of Seller, and no meeting of any such shareholders, board of directors or committee has been held for which minutes have not been prepared or are not contained in such minute books.

COMMENT

The books of account of the seller are the basis of the financial statements. If the books of account are inaccurate or incomplete, the information provided to the seller's auditors (or the buyer's auditors) will be suspect, and the financial statements will be of little value to the buyer. Therefore, the buyer often seeks to go behind the financial statements by requesting representations concerning the quality of the seller's record-keeping. Such representations are especially important when separate audited financial statements have not been prepared for the seller relating to the business represented by the assets to be acquired, such as when the seller is a subsidiary or division of a larger enterprise. The buyer may want to inquire about these matters by requesting the seller to deliver copies of management letters and other reports received from the seller's auditors over a specified period of time. The seller may seek to limit representations regarding its books and records to avoid giving financial representations that go beyond those of Section 3.4.

Section 13(b)(2) of the Securities Exchange Act of 1934 (15 U.S.C. § 78m(b)(2) (1988)) was added by the Foreign Corrupt Practices Act (FCPA) and applies only to public companies; the parenthetical phrase that follows the reference to that Act is necessary if that portion of the representation is to have any meaning in the case of private companies. See the Comment to Section 3.27 for a more detailed discussion of the FCPA.

Some acquisition agreements omit the portion of the representation relating to the minute books. Such a representation could be especially troublesome if the seller is closely held and has conducted its affairs informally. It is in those instances, however, that this representation is most important to the buyer. The seller may seek to limit the representation to matters that are material. The buyer may want to ask the seller to also represent that, other than certain listed committees, there have been no other committees of the seller's board of directors.

See Chapter 2, "Basic Corporate Documents," of the *Manual on Acquisition Review*.

3.6 SUFFICIENCY OF ASSETS

Except as set forth in Part 3.6, the Assets (a) constitute all of the assets, tangible and intangible, of any nature whatsoever, necessary to operate Seller's business in the manner presently operated by Seller and (b) include all of the operating assets of Seller.

COMMENT

The purpose of the representation in Section 3.6(a) is to confirm that the various assets to be purchased by the buyer constitute all those necessary for it to continue operating the business of seller in the same manner as it had been conducted by the seller. See the Comments to Sections 2.1 and 2.2. If any of the essential assets are owned by the principal shareholders or other third parties, the buyer may want assurances that it will have use of these assets on some reasonable basis before entering into the transaction with the seller. The representation in Section 3.6(b) is to help confirm the availability of sales tax exemptions in certain states. See the Comment to Section 10.2.

3.7 DESCRIPTION OF OWNED REAL PROPERTY

Part 3.7 contains a correct legal description, street address and tax parcel identification number of all tracts, parcels and subdivided lots in which Seller has an ownership interest.

COMMENT

In order to effectively perform its due diligence, the buyer will need correct legal descriptions to confirm that title is vested in the seller (or the seller's landlord, see Section 3.8) and to perform lien searches and will need street addresses in many instances to confirm zoning, land use and building code compliance as well as the possible existence of municipal liens. The importance of the tax parcel identification number is twofold. With this information, the buyer can confirm not only the status of payment of real estate taxes but also whether the real property to be acquired is a separately taxed parcel. If the real property to be acquired is part of a larger tax parcel, the failure of the owner of the remainder to pay its portion of the taxes could result in a lien against the acquired real estate. If the real property to be acquired is significant, the buyer should not rely on the title company with respect to the verification of separate tax parcel status. This is the issuing agent's task, and the level of due diligence routinely performed by issuing agents can vary greatly.

3.8 DESCRIPTION OF LEASED REAL PROPERTY

Part 3.8 contains a correct legal description, street address and tax parcel identification number of all tracts, parcels and subdivided lots in which Seller has a leasehold interest and an accurate description (by location, name of lessor, date of Lease and term expiry date) of all Real Property Leases.

COMMENT

To the extent the buyer is acquiring rights under a lease, it will be assuming the obligations under the lease as well. Consequently, it is important for the buyer to know what its obligations are and that the lessor, under the lease, will not be looking to the buyer to cure existing defaults. Additionally, the buyer may want to confirm that the relationship between the seller and the lessor is a good one because the buyer will have to deal with the lessor going forward. Most importantly, the buyer needs to confirm that the lease it expects to acquire will not terminate or be altered in any material way due to the transfer from the seller to the buyer. By obtaining a copy of the lease at this time, the buyer will be able to determine if the lessor's consent is required in order to effect the transfer when there is adequate time to address the consent issue. The seller should be required to obtain any necessary consents as a condition to closing.

As drafted, Section 3.8 addresses only Leases pursuant to which Seller is the lessee. Depending upon the facts and circumstances of each particular transaction, Section 3.8 may also need to address leases pursuant to which the seller is the lessor if the lease is a desirable one and included in the Assets. In addition, the seller may be in possession of premises used in the operations to be acquired by the buyer pursuant to a sublease, requiring another level of due diligence to be performed by the buyer.

See Chapter 4, "Real and Personal Property," of the *Manual on Acquisition Review*.

3.9 TITLE TO ASSETS; ENCUMBRANCES

(a) Seller owns good and marketable title to its respective estates in the Real Property, free and clear of any Encumbrances, other than:

(i) liens for Taxes for the current tax year which are not yet due and payable; and

(ii) those described in Part 3.9(a) ("Real Estate Encumbrances").

True and complete copies of (A) all deeds, existing title insurance policies and surveys of or pertaining to the Real Property and (B) all instruments, agreements and other documents evidencing, creating or constituting any Real Estate Encumbrances have been delivered to Buyer. Seller warrants to Buyer that, at the time of Closing, the Real Estate shall be free and clear of all Real Estate Encumbrances other than those identified on Part 3.9(a) as acceptable to Buyer ("Permitted Real Estate Encumbrances").

(b) Seller owns good and transferable title to all of the other Assets free and clear of any Encumbrances other than those described in Part 3.9(b) ("Non-Real Estate Encumbrances"). Seller warrants to Buyer that, at the time of Closing, all other Assets shall be free and clear of all Non-Real Estate Encumbrances other than those identified on Part 3.9(b) as acceptable to Buyer ("Permitted Non-Real Estate Encumbrances" and, together with the Permitted Real Estate Encumbrances, "Permitted Encumbrances").

COMMENT

This representation is important to confirm that the various assets to be purchased by the buyer are not subject to liens or encumbrances that will restrict or prohibit the

use or subsequent sale of the assets. With respect to real property, these could be easements or rights-of-way that would restrict or materially interfere with the use of the property and improvements or judgments recorded against the seller that may constitute a lien against the seller's assets. Liens on personal property typically would be in the form of security interests in favor of a lender, all of which must be removed prior to closing unless the buyer is assuming related loans, and the assets will remain encumbered. In acquisitions involving significant real property, or real property intended for development, the buyer may wish to consider the appropriateness of a representation concerning the seller's history of zoning and other land use disputes involving the real property. The seller should consider whether exceptions are necessary for existing use and other restrictions, including environmental matters that may restrict the use or development of the property (the acquisition agreement will often include separate representations concerning environmental matters, such as Section 3.22), but disclosure of environmental restrictions may be necessary here as well.

The level of due diligence conducted by the buyer (i.e., the degree to which the buyer may wish to go behind the seller's representations) will vary depending upon the significance of the real property and the strength of the seller's indemnity. If there is significant real property and the seller's indemnity is of questionable value, the buyer may wish to search the real estate and U.C.C. records for evidence of liens or judgments affecting the real property. The records to be searched will vary from jurisdiction to jurisdiction. The buyer may be able to obtain copies of such searches from the seller, who will often conduct its own due diligence before giving such a representation. From the seller's perspective, the representation should exclude all matters of record and any other matters, whether or not of record, that do not adversely affect the full use and enjoyment of the real property for the purposes for which it is currently used or that detract from its value (e.g., the rights of tenants under leases).

3.10 CONDITION OF FACILTIIES

(a) Use of the Real Property for the various purposes for which it is presently being used is permitted as of right under all applicable zoning legal requirements and is not subject to "permitted nonconforming" use or structure classifications. All Improvements are in compliance with all applicable Legal Requirements, including those pertaining to zoning, building and the disabled, are in good repair and in good condition, ordinary wear and tear excepted, and are free from latent and patent defects. No part of any Improvement encroaches on any real property not included in the Real Property, and there are no buildings, structures, fixtures or other Improvements primarily situated on adjoining property which encroach on any part of the Land. The Land for each owned Facility abuts on and has direct vehicular access to a public road or has access to a public road via a permanent, irrevocable, appurtenant easement benefiting such Land and comprising a part of the Real Property, is supplied with public or quasi-public utilities and other services appropriate for the operation of the Facilities located thereon and is not located within any flood plain or area subject to wetlands regulation or any similar restriction. There is no existing or proposed plan to modify or realign any street or highway or any existing or proposed eminent domain proceeding that would result in the taking of all or any part of any Facility or that would prevent or hinder the continued use of any Facility as heretofore used in the conduct of the business of Seller.

(b) Each item of Tangible Personal Property is in good repair and good operating condition, ordinary wear and tear excepted, is suitable for immediate use in the Ordinary Course of Business and is free from latent and patent defects. No item of Tangible Personal Property is in need of repair or replacement other than as part of routine maintenance in the Ordinary Course of Business. Except as disclosed in Part 3.10(b), all Tangible Personal Property used in Seller's business is in the possession of Seller.

COMMENT

This representation seeks comfort about the condition and sufficiency of the seller's tangible assets. Such matters normally do not involve precise, objective criteria, and both the seller and the buyer should be somewhat uncomfortable with this representation. The seller may argue that the buyer should obtain whatever comfort it needs by appropriate inspection, whereas the buyer may want to seek comfort from both inspection and the seller's representations. The buyer also may want a representation concerning transactions with related persons (see Section 3.29) to avoid surprises about key assets that are used by the seller but will not be available after the closing (because, for example, they are owned by the seller or a related person).

See Chapter 4, "Real and Personal Property," of the *Manual on Acquisition Review*.

3.11 ACCOUNTS RECEIVABLE

All Accounts Receivable that are reflected on the Balance Sheet or the Interim Balance Sheet or on the accounting Records of Seller as of the Closing Date represent or will represent valid obligations arising from sales actually made or services actually performed by Seller in the Ordinary Course of Business. Except to the extent paid prior to the Closing Date, such Accounts Receivable are or will be as of the Closing Date current and collectible net of the respective reserves shown on the Balance Sheet or the Interim Balance Sheet or on the Closing Financial Statement (which reserves are adequate and calculated consistent with past practice and, in the case of the reserve on the Closing Financial Statement, will not represent a greater percentage of the Accounts Receivable reflected on the Closing Financial Statement than the reserve reflected on the Interim Balance Sheet represented of the Accounts Receivable reflected thereon and will not represent a material adverse change in the composition of such Accounts Receivable in terms of aging). Subject to such reserves, each of such Accounts Receivable either has been or will be collected in full, without any setoff, within ninety (90) days after the day on which it first becomes due and payable. There is no contest, claim, defense or right of setoff, other than returns in the Ordinary Course of Business of Seller, under any Contract with any account debtor of an Account Receivable relating to the amount or validity of such Account Receivable. Part 3.11 contains a complete and accurate list of all Accounts Receivable as of the date of the Interim Balance Sheet, which list sets forth the aging of each such Account Receivable.

COMMENT

Accounts receivable are assets in the form of balance sheet accounts reflecting amounts due from other parties that were incurred in the ordinary course of business.

Typically, the term "accounts receivable" designates trade debtors' accounts; other receivables are separately designated and recorded as special receivables. Accounts receivable due within one year are classified under the "current assets" caption on the balance sheet.

The representation concerning accounts receivable provides line-item support to the more general representations regarding the financial statements as a whole. A buyer should demand this representation when accounts receivable comprise a significant component of the acquired assets. If the seller argues that adequate protection is provided by the financial statement representations, the buyer can respond that, by the time of the closing, a substantial portion of the accounts receivable reflected in the most recent balance sheet will have been paid and that a specific accounts receivable representation is needed to cover the accounts that the buyer will acquire at the closing.

The Model Agreement begins with an assurance that Seller's accounts receivable represent valid obligations arising from sales actually made or services actually performed by Seller. This is essentially an antifraud provision and should be construed as a representation that the accounts receivable reflected on Seller's balance sheets and in the books of account are genuine and not fabricated.

In addition to assurances regarding the validity of the seller's accounts receivable, a buyer may seek representations concerning their ultimate collectibility so that the buyer will be adequately compensated if the accounts receivable do not ultimately result in cash equal to the amounts reflected on the seller's balance sheets. The seller may resist making assurances regarding collectibility by arguing that the buyer should conduct a thorough pre-closing investigation of the status of the receivables. Similarly, the seller may assert that the acquisition is the sale of a going concern and that the possibility of uncollectibility of genuine accounts receivable is simply a risk of doing business that should be transferred to the buyer at the closing. As a compromise, the parties may negotiate a discount to be applied to the value of the accounts receivable shown on the most recent balance sheet; the purchase price would be reduced by the amount of the discount, and the entire risk of noncollectibility would shift to the buyer at the closing. In such cases, old accounts are typically discounted more than new accounts.

If the seller agrees to give assurances of collectibility, it should be sure that the representation relates to the accounts receivable net of any established reserve for uncollectible accounts. The reserve for uncollectible accounts (also known as the allowance for doubtful accounts or the bad debt reserve) is a reserve established to estimate the proportion of the gross amount of the accounts receivable that will not be collected.

Methods of providing the buyer assurances regarding the collectibility of accounts receivable include (1) a representation of collectibility, net of the corresponding reserve, backed by the seller's and the shareholders' indemnification obligations, (2) a guaranty that the seller will repurchase all pre-closing accounts receivable that remain unpaid after a specified period (such as 90 days) elapses after their creation or after the closing, and (3) an arrangement in which title to the accounts receivable does not pass, and the buyer collects the accounts on behalf of the seller. Regardless of the method selected, the quality of the buyer's collection efforts will affect the seller's post-closing obligations. Because of the inconsistent (and relatively infrequent) interpretations courts have placed on these provisions, precise drafting is critical.

Collectibility Representations Coupled with Indemnification. In the Model Agreement representation, Seller warrants that the aggregate amount of transferred Accounts Receivable will be "current and collectible" as of the Closing, net of the reserve for uncollectible accounts. The representation further provides that each account will be

collected in full, subject to the reserve, without setoff, within ninety days after the date on which it first becomes payable. The indemnification provisions of Article 11 provide that Seller will be responsible to Buyer for any Breach of this representation (see Section 11.2). A buyer should keep in mind that the seller's indemnification obligations may be subject to limitations such as thresholds that must be achieved before indemnification is owed and time periods during which claims for indemnification must be made (see Sections 11.5 and 11.7).

Courts have placed various interpretations on contractual representations concerning the collectibility of accounts receivable. *See, e.g.,* Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F.2d 930, 934 (2d Cir. 1975); Forms, Inc. v. Am. Standard, Inc., 546 F. Supp. 314, 321–22 (E.D. Penn. 1982); *see also* Resort Car Rental Sys., Inc. v. Chuck Ruwart Chevrolet, Inc., 519 F.2d 317, 320 (10th Cir. 1975); REA Express, Inc. v. Interway Corp., 410 F. Supp. 192, 203–04 (S.D.N.Y. 1976), *rev'd*, 538 F.2d 953 (2d Cir. 1976); Rocky Mountain Helicopters v. Air Freight, 773 P.2d 911 (Wyo. 1989). In order to avoid the kinds of ambiguities that give courts difficulty, the acquisition agreement should specify whether the reserve for uncollectible accounts will be applied on an aggregate or account-by-account basis. The Model Agreement specifies that the reserve will be applied on an aggregate basis. The acquisition agreement should also indicate the mechanism for establishing the amount of such reserves (whether by reference to particular financial statements, receivables schedules or the seller's books and records). *See* Armco Inc. v. Glenfed Fin. Corp., 746 F. Supp. 1249 (D.N.J. 1990); Carolet Corp. v. Garfield, 157 N.E.2d 876, 880 (Mass. 1959).

Repurchase of Uncollected Accounts by Seller. An alternative method of providing assurances of collectibility is the seller's guaranty that, after a stipulated period of time, it will pay to the buyer the amount that has not been collected on any account. Such a guaranty typically requires that the seller repurchase accounts that remain uncollected, at a price that is net of applicable reserves, after the passage of the predetermined period of time from the creation of the accounts. In deciding whether to use the repurchase method, the parties should keep in mind that the quality of the buyer's collection efforts will affect the seller's repurchase obligations and that the seller's collection efforts after the reassignment could interfere with the buyer's conduct of the newly acquired business, especially with ongoing customer relations.

A sample accounts receivable repurchase provision is set forth below. Note, however, that where such a provision is used, certain adjustments to the purchase price will be necessary. For example, if there is no buy back because all accounts receivable are collected, the purchase price provisions should provide a mechanism for payment to the seller of the held-back amount.

ACCOUNTS RECEIVABLE REPURCHASE

(a) Buyer shall have the right, by written notice (the "Receivables Notice") to Seller given on or after ninety (90) days following the Closing Date (the "Repurchase Date"), to require Seller to repurchase for cash and without recourse, within five (5) days of the date of the Receivables Notice, all of the Accounts Receivable of Seller reflected on the books and records of the Seller on the Closing Date that are at the Repurchase Date uncollected. Seller shall repurchase uncollected Accounts Receivable for a purchase price equal to their aggregate face value, and Seller shall purchase and pay for such Accounts Receivable as provided herein.

(b) At the Closing, Buyer shall deduct _____ dollars ($____) from the amount otherwise payable pursuant to Section 2.3(i) and place it

in an account (the "Holdback Account"). The repurchase price of the receivables shall first be paid in whole or in part by reducing the amount in the Holdback Account. Seller hereby acknowledges and agrees that, if the repurchase price of the uncollected Accounts Receivable exceeds the amount in the Holdback Account, Seller shall, without further demand from Buyer, pay to Buyer an amount equal to the difference between the total repurchase price of the uncollected receivables and the amount in the Holdback Account. On the date 180 days after the Closing, Buyer shall close the Holdback Account and pay any balance remaining in the Holdback Account to Seller.

(c) **Buyer shall execute and deliver to Seller all instruments as shall be reasonably necessary to effectively vest in Seller all of the right, title and interest of Buyer with respect to any uncollected Accounts Receivable repurchased by Seller pursuant to this subsection without representation or recourse.**

If the parties use the repurchase method, they should consider how to credit and allocate the reserve for uncollectible accounts. The buyer may want to allocate the reserve to individual accounts so that each repurchase obligation is of the net amount; the seller, however, may insist that its repurchase obligation should begin only when the entire reserve has been exhausted. The parties should also agree on specific procedures for reassignment of uncollected accounts to the seller. In particular, they should decide whether the seller will be allowed to set off amounts that the buyer owes the account debtor. *See* Hilton v. CET/DDT Corp., 1990 WL 6312 (Tenn. Ct. App. Jan. 30, 1990).

Collection by Buyer for Seller's Account. A third alternative provides that title to the accounts receivable remains in the seller, and the buyer covenants to collect the accounts on the seller's behalf. This method reduces the importance of the accuracy of the financial statements with respect to accounts receivable (including the magnitude of the reserve) because any inability to collect the accounts will not directly affect the buyer. Nevertheless, the buyer may want to analyze historical trends in collection of accounts receivable for purposes of pricing the acquisition. This method, as well as the repurchase method, is usually implemented not through a representation but through a provision elsewhere in the acquisition agreement containing collection and other mechanics and is, thus, not subject to the indemnification "basket."

Collection Efforts. In each of the three alternatives discussed above, the quality of the buyer's collection efforts will affect the seller's post-closing liability for uncollected accounts. Thus, the seller may want to specify the collection efforts, policies and procedures required of the buyer. In particular, the seller should insist that the buyer cannot simply allow the accounts to age and thereby force the seller to respond in damages or compromise the seller's ability to pursue collection after repurchasing the accounts. *See* Kominsky, *A Primer on Acquisition Hold Harmless Clauses*, 34 PRAC. LAW. 27, 32 (1988). When procedures are established, the buyer generally is required to use best efforts to collect in the ordinary course of business but is not required to resort to collection agencies or litigation. *See* Rocky Mountain Helicopters v. Air Freight, 773 P.2d 911 (Wyo. 1989); BUSINESS ACQUISITIONS ch. 5, at 173 (Herz & Baller eds., 2d ed. 1981). The buyer, in return, can negotiate for the option of bringing suit for collection of delinquent receivables and charging the seller for any collection and litigation costs. In this case, the seller should seek assurances that it will be notified of material proceedings and afforded the opportunity to participate.

The parties may want to outline the parameters of the buyer's ability to settle or compromise accounts. Although it is usually impractical to require that the buyer clear individual returns of merchandise with the seller, the seller may want to prohibit the buyer from forgiving large outstanding accounts to foster good relations with continuing customers and charging the seller with the remaining deficiencies.

The parties may also want to specify procedures to be followed upon receipt of payments on accounts. This issue is of particular concern with respect to ongoing relationships with regular customers. The seller may insist that the buyer be required to apply payments to the invoices of pre-closing accounts before applying such payments to current, post-closing invoices. The buyer could respond that, if a customer disputes one invoice but pays another, the customer has not paid the disputed invoice, even though it was incurred before the closing. The seller may demand some formal method of monitoring the buyer's allocation of payments to invoices to ensure an equitable payment process and to prevent collusion with the customer in paying certain invoices and disputing others.

A related concern involves the customer that is a questionable credit risk because it is unable to make current payments without continued business with the buyer, presumably on similar credit terms. *See* McGAFFEY, BUYING, SELLING AND MERGING BUSINESSES 39 (2d ed. 1989). The seller will prefer to give the customer every opportunity to make payments on the account, but the buyer may not want to risk extending new credit to facilitate payment of old credit, only to end up with a new uncollectible account.

Finally, complex issues arise if all or a portion of the accounts receivable are secured by collateral. The acquisition agreement should specify which party has the right of repossession during what time periods and whether the other party has any interest or right to the collateral that must be respected by the repossessing party. In addition, the parties should decide whether the repossessing party has any obligation to repossess and possibly to sell the collateral before charging the other party with any deficiency and whether the repossessing party must act within established time constraints.

See Chapter 5, "Financial Statements," of the *Manual on Acquisition Review*.

3.12 INVENTORIES

All items included in the Inventories consist of a quality and quantity usable and, with respect to finished goods, saleable, in the Ordinary Course of Business of Seller except for obsolete items and items of below-standard quality, all of which have been written off or written down to net realizable value in the Balance Sheet or the Interim Balance Sheet or on the accounting Records of Seller as of the Closing Date, as the case may be. Seller is not in possession of any inventory not owned by Seller, including goods already sold. All of the Inventories have been valued at the lower of cost or [market] [net realizable] value on a [last in, first out] [first in, first out] basis. Inventories now on hand that were purchased after the date of the Balance Sheet or the Interim Balance Sheet were purchased in the Ordinary Course of Business of Seller at a cost not exceeding market prices prevailing at the time of purchase. The quantities of each item of Inventories (whether raw materials, work-in-process or finished goods) are not excessive but are reasonable in the present circumstances of Seller. Work-in-process Inventories are now valued, and will be valued on the Closing Date, according to GAAP.

COMMENT

Inventories may take many forms. A manufacturing company's inventories can generally be classified into three broad categories: raw materials, work in process and

finished goods. The Model Agreement representation covers all three categories and provides that all inventory (including raw materials) is useable and all finished goods are saleable in the Ordinary Course of Business.

The Model Agreement representation assumes that the audited financial statements and the accompanying audit reports do not comment adversely on the seller's inventory procedures. If an independent audit has not been performed, the buyer may want to add as a condition to its obligations at the closing either a physical inventory or the existence of minimum or maximum inventory levels. In some circumstances, the buyer may need lists of inventory and a breakdown among raw materials, work in process, finished goods, etc.

In examining the inventory values shown on the seller's financial statements, the buyer should keep the following considerations in mind. Under GAAP, inventories are usually valued at the lower of cost or market value. A critical factor in calculating financial statement income and the balance sheet value of inventories is the assumption of inventory flow used in inventory accounting. Acceptable methods include First-In-First-Out (FIFO), Last-In-First-Out (LIFO), and average cost. The buyer should completely understand the reason for any recent changes in the method used by the seller—variations between compared periods may call for restating financial statements to aid comparisons.

Under any method of accounting for inventory flow, inventory valuation requires subjective judgments. The buyer should attempt to determine whether inventory values have been overstated or understated. Overstatement or understatement may occur because, within the boundaries of GAAP, different kinds of costs can be included either in the cost of goods sold or in general administrative and selling expenses, and whether such costs are included in the cost of goods sold affects the stated value of inventory and the amount of income reported. Also, the preparer of the financial statements must make judgments about the realizable value of obsolete items and the point at which goods in inventory become obsolete. Because of such variables involving inventories, the buyer may want a post-closing purchase-price adjustment based upon changes in inventory values after a specified period of time, which gives the buyer a chance to work with the purchased inventories after the sale but prior to the final settlement of accounts. The Model Agreement provides for a post-closing purchase-price adjustment.

Whether a buyer should seek comfort beyond the financial statement representations will depend upon the relative importance of the inventories to the business of the seller. The buyer should carefully review the seller's internal records if significant amounts of finished goods are consigned (consigned goods are assets owned by one firm but kept at another location). In this case, the buyer may want to specify the location of major inventory stocks. Even without significant consigned inventory, the buyer's first draft of the acquisition agreement can include a representation concerning the location of inventories.

In acquisitions in which the acquired assets will be used as collateral, the lender will typically require specific inventory representations from the borrower. If the buyer will use borrowed funds to pay the purchase price, the buyer may want to ask the seller to make inventory representations similar or equivalent to those expected to be made by the buyer to its lender. The buyer should consider the impact on available credit if the seller refuses to make satisfactory representations.

Some industries present special concerns when the acquisition agreement includes provisions requiring inventory verification prior to the closing or a post-closing purchase-price adjustment. Special methods are used to estimate inventory values in industries with significant natural resource inventories (such as gas, oil and timber), and the buyer may want the additional comfort of an independent confirmation of inven-

tory values. In service industries, the inventory consists of unbilled services or time, and the buyer may want to modify the inventory representation to provide for a minimum amount of dollars to be realized from unbilled amounts as of a specific date.

The representation that inventories are recorded at the lower of cost or market assumes that the seller does not have significant operations in nations with high inflation. In severely inflationary economies, nonmonetary inventories are valued at current replacement cost or restated historical cost. Acquisitions involving inventories in such nations will require more specialized inventory representations.

See Chapter 5, "Financial Statements," of the *Manual on Acquisition Review*.

3.13 NO UNDISCLOSED LIABILITIES

Except as set forth in Part 3.13, Seller has no Liability except for Liabilities reflected or reserved against in the Balance Sheet or the Interim Balance Sheet and current liabilities incurred in the Ordinary Course of Business of Seller since the date of the Interim Balance Sheet.

COMMENT

Transferee liability may be imposed on a buyer by the bulk sales statutes, the law of fraudulent conveyance and various doctrines in areas such as environmental law and products liability. Consequently, the buyer will have an interest not only in the liabilities to be assumed under Section 2.4(a) but also in the liabilities of the seller that are not to be assumed. This representation assures the buyer that it has been informed of all Liabilities (which, as the term is defined in the Model Agreement, includes "contingent" liabilities) of the seller.

The seller may seek to narrow the scope of this representation by limiting the types of liabilities that must be disclosed. For example, the seller may request that the representation extend only to "liabilities of the type required to be reflected as liabilities on a balance sheet prepared in accordance with GAAP." The buyer will likely object to this request, arguing that the standards for disclosing liabilities on a balance sheet under GAAP are relatively restrictive and that the buyer needs to assess the potential impact of *all* types of liabilities on the seller, regardless of whether such liabilities are sufficiently definite to merit disclosure in the seller's financial statements.

If the seller is unsuccessful in limiting the scope of this representation to balance-sheet-type liabilities, additional language changes might be suggested. Many liabilities and obligations (e.g., open purchase and sales orders and employment contracts) are not required to be reflected or reserved against in a balance sheet or even disclosed in the notes to the financial statements. For example, most of the disclosures made in the Disclosure Letter, particularly those with respect to Leases and other Contracts (see Section 3.20), involve Liabilities or obligations of Seller. In addition, Liabilities or obligations arise from other Contracts not required to be included in the Disclosure Letter because they do not reach the dollar threshold requiring disclosure. This might be addressed by adding another exception to this representation for "Liabilities arising under the Seller Contracts disclosed in Part 3.20(a) or not required to be disclosed therein."

The seller may also seek to add a knowledge qualification to this representation, arguing that it cannot be expected to identify every conceivable contingent liability and obligation to which it may be subject. The buyer will typically resist the addition

of such a qualification, pointing out that, even in an asset purchase, any exposure to unknown liabilities is more appropriately borne by the seller and the shareholders (who presumably have considerable familiarity with the past and current operations of the seller) than by the buyer.

Even if the buyer successfully resists the seller's attempts to narrow the scope of this representation, the buyer should not overestimate the protection that this representation provides. Although the representation extends to "contingent" liabilities (as well as to other types of liabilities that are not required to be shown as liabilities on a balance sheet under GAAP), it focuses exclusively on existing liabilities—it does not cover liabilities that may arise in the future from past events or existing circumstances. Indeed, a number of judicial decisions involving business acquisitions have recognized this critical distinction and have therefore narrowly construed the term "liability" (or "contingent liability"). For example, in *Climatrol Indus. v. Fedders Corp.*, 501 N.E.2d 292 (Ill. App. Ct. 1986), the court concluded that a seller's defective product does not represent a "contingent liability" of the seller unless the defective product has actually injured someone. The court stated:

> As of [the date of the closing of the acquisition in question], there was no liability at all for the product liability suits at issue herein, because no injury had occurred. Therefore, these suits are not amongst the "liabilities . . . whether accrued, absolute, contingent or otherwise, which exist[ed] on the Closing Date," which defendant expressly assumed.

Id. at 294. Earlier in its opinion, the court noted:

> Other courts have sharply distinguished between "contingencies" and "contingent liabilities": A contingent liability is one thing, a contingency the happening of which may bring into existence a liability is another, and a very different thing. In the former case, there is a liability which will become absolute upon the happening of a certain event. In the latter there is none until the event happens. The difference is simply that which exists between a conditional debt or liability and none at all.

Id. (citations omitted); *see also* Godchaux v. Conveying Techniques, Inc., 846 F.2d 306, 310 (5th Cir. 1988) (an employer's withdrawal liability under ERISA comes into existence not when the employer's pension plan first develops an unfunded vested liability but when the employer actually withdraws from the pension plan; therefore, there was no breach of a warranty that the employer "did not have any liabilities of any nature, whether accrued, absolute, contingent, or otherwise"); East Prairie R-Z School Dist. v. U.S. Gypsum Co., 813 F. Supp. 1396 (E.D. Mo. 1993) (cause of action for property damage based upon asbestos contamination had not accrued at time of assumption of liabilities); Grant-Howard Assocs. v. Gen. Housewares Corp., 482 N.Y.S.2d 225, 227 (1984) (there is no contingent liability from a defective product until the injury occurs).

Even though the terms "liability" and "contingent liability" may be narrowly construed, other provisions in the Model Agreement protect Buyer against various contingencies that may not actually constitute "contingent liabilities" as of the Closing Date. For example, the Model Agreement contains representations that no event has occurred that may result in a future material adverse change in the business of Seller as carried on by Buyer (see Section 3.15); that no undisclosed event has occurred that may result in a future violation of law by Seller (see Section 3.17); that Seller has no Knowledge of any circumstances that may serve as a basis for the commencement of a future lawsuit against Seller (see Section 3.18); that no undisclosed event has occurred that would constitute a future default under any of the Contracts of Seller

assigned to or assumed by Buyer (see Section 3.20); and that Seller knows of no facts that may materially adversely affect its business (see Section 3.33). In addition, the Model Agreement requires Seller and Shareholders to indemnify Buyer against Liabilities that may arise in the future from products manufactured by Seller prior to the Closing Date (see Section 11.2).

If a buyer seeks even broader protection against undisclosed contingencies, it should consider expanding the scope of the seller's indemnity obligations under Section 11.2 so that the seller and the shareholders are obligated to indemnify the buyer not only against future product liabilities but also against other categories of liabilities that may arise after the closing date from circumstances existing before the closing date.

See Chapter 5, "Financial Statements," of the *Manual on Acquisition Review*.

3.14 TAXES

(a) ***Tax Returns Filed and Taxes Paid.*** **Seller has filed or caused to be filed on a timely basis all Tax Returns and all reports with respect to Taxes that are or were required to be filed pursuant to applicable Legal Requirements. All Tax Returns and reports filed by Seller are true, correct and complete. Seller has paid, or made provision for the payment of, all Taxes that have or may have become due for all periods covered by the Tax Returns or otherwise, or pursuant to any assessment received by Seller, except such Taxes, if any, as are listed in Part 3.14(a) and are being contested in good faith and as to which adequate reserves (determined in accordance with GAAP) have been provided in the Balance Sheet and the Interim Balance Sheet. Except as provided in Part 3.14(a), Seller currently is not the beneficiary of any extension of time within which to file any Tax Return. No claim has ever been made or is expected to be made by any Governmental Body in a jurisdiction where Seller does not file Tax Returns that it is or may be subject to taxation by that jurisdiction. There are no Encumbrances on any of the Assets that arose in connection with any failure (or alleged failure) to pay any Tax, and Seller has no Knowledge of any basis for assertion of any claims attributable to Taxes which, if adversely determined, would result in any such Encumbrance.**

(b) ***Delivery of Tax Returns and Information Regarding Audits and Potential Audits.*** **Seller has delivered or made available to Buyer copies of, and Part 3.14(b) contains a complete and accurate list of, all Tax Returns filed since _____, 19/20____. The federal and state income or franchise Tax Returns of Seller have been audited by the IRS or relevant state tax authorities or are closed by the applicable statute of limitations for all taxable years through _____, 20____. Part 3.14(b) contains a complete and accurate list of all Tax Returns of Seller that have been audited or are currently under audit and accurately describe any deficiencies or other amounts that were paid or are currently being contested. To the Knowledge of Seller, no undisclosed deficiencies are expected to be asserted with respect to any such audit. All deficiencies proposed as a result of such audits have been paid, reserved against, settled or are being contested in good faith by appropriate proceedings as described in Part 3.14(b). Seller has delivered, or made available to Buyer, copies of any examination reports, statements or deficiencies or similar items with respect to such audits. Except as**

provided in Part 3.14(b), Seller has no Knowledge that any Governmental Body is likely to assess any additional taxes for any period for which Tax Returns have been filed. There is no dispute or claim concerning any Taxes of Seller either (i) claimed or raised by any Governmental Body in writing or (ii) as to which Seller has Knowledge. Part 3.14(b) contains a list of all Tax Returns for which the applicable statute of limitations has not run. Except as described in Part 3.14(b), Seller has not given or been requested to give waivers or extensions (or is or would be subject to a waiver or extension given by any other Person) of any statute of limitations relating to the payment of Taxes of Seller or for which Seller may be liable.

(c) ***Proper Accrual.*** **The charges, accruals and reserves with respect to Taxes on the Records of Seller are adequate (determined in accordance with GAAP) and are at least equal to Seller's liability for Taxes. There exists no proposed tax assessment or deficiency against Seller except as disclosed in the [Interim] Balance Sheet or in Part 3.14(c).**

(d) ***Specific Potential Tax Liabilities and Tax Situations.***

(i) ***Withholding.*** **All Taxes that Seller is or was required by Legal Requirements to withhold, deduct or collect have been duly withheld, deducted and collected and, to the extent required, have been paid to the proper Governmental Body or other Person.**

(ii) ***Tax Sharing or Similar Agreements.*** **There is no tax sharing agreement, tax allocation agreement, tax indemnity obligation or similar written or unwritten agreement, arrangement, understanding or practice with respect to Taxes (including any advance pricing agreement, closing agreement or other arrangement relating to Taxes) that will require any payment by Seller.**

(iii) ***Consolidated Group.*** **Seller (A) has not been a member of an affiliated group within the meaning of Code Section 1504(a) (or any similar group defined under a similar provision of state, local or foreign law) and (B) has no liability for Taxes of any person (other than Seller and its Subsidiaries) under Treas. Reg. § 1.1502–6 (or any similar provision of state, local or foreign law), as a transferee or successor by contract or otherwise.**

(iv) ***S Corporation.*** **Seller is not an S corporation as defined in Code Section 1361.**

ALTERNATIVE No. 1:
Seller is an S corporation as defined in Code Section 1361, and Seller is not and has not been subject to either the built-in-gains tax under Code Section 1374 or the passive income tax under Code Section 1375.

ALTERNATIVE No. 2:
Seller is an S corporation as defined in Code Section 1361, and Seller is not subject to the tax on passive income under Code Section 1375 but is subject to the built-in-gains tax under Code Section 1374, and all tax liabilities under Code Section 1374 though and including the Closing Date have been or shall be properly paid and discharged by Seller.

INCLUDE WITH BOTH ALTERNATIVE NO. 1 AND NO. 2:
Part 3.14(d)(iv) lists all the states and localities with respect to which Seller

is required to file any corporate, income or franchise tax returns and sets forth whether Seller is treated as the equivalent of an S corporation by or with respect to each such state or locality. Seller has properly filed Tax Returns with and paid and discharged any liabilities for taxes in any states or localities in which it is subject to Tax.

(v) ***Substantial Understatement Penalty.*** **Seller has disclosed on its federal income Tax Returns all positions taken therein that could give rise to a substantial understatement of federal income Tax within the meaning of Code Section 6662.**

COMMENT

Section 3.14 seeks disclosure of tax matters that may be significant to Buyer. Although the buyer does not assume the seller's tax liabilities, the buyer would be interested in both ensuring that those liabilities are paid and understanding any possible tax issues that may arise in the buyer's post-acquisition operation of the business. By obtaining assurances that the seller has paid all of its taxes, the buyer reduces the likelihood of successor liability claims against it for the seller's unpaid taxes. Although such a claim is unlikely for the federal income tax liability of the seller, such a claim could be made for state or local taxes.

Some state laws specifically provide that a buyer in an asset acquisition may be liable for the selling corporation's state tax liability. For example, Section 212.10 of the Florida Statutes (a) requires a seller to pay any sales tax within fifteen days of the closing, (b) requires a buyer to withhold a sufficient portion of the purchase price to cover the amount of such taxes and (c) provides that if the buyer:

> shall fail to withhold a sufficient amount of the purchase money as above provided, he or she shall be personally liable for the payment of the taxes, interest, and penalties accruing and unpaid on account of the operation of the business by any former owner, owners or assigns.

In addition to statutory successor liability, a buyer could be subject to liability for a seller's taxes under a common law successor liability theory. *See, e.g.,* Faber, *State and Local Income and Franchise Tax Aspects of Corporate Acquisitions*, NEGOTIATING BUSINESS ACQUISITIONS, J-14–J-15 (ABA-CLE, 1998).

If the buyer were acquiring subsidiaries of the seller, the buyer would want to verify that all taxes of the subsidiaries have been paid because any acquired subsidiary remains responsible for any such liability after the acquisition. In order to avoid taking over all of a subsidiary's liabilities, the buyer could either (a) purchase the assets of the subsidiary, thereby making a multiple asset acquisition, or (b) have the seller liquidate the subsidiary, which can be accomplished tax free under Code Section 332, and then acquire the assets of the former subsidiary directly from the seller. See Appendix B, Section G.

Section 3.14(a) focuses on the tax returns and reports that are required to be filed by a seller, the accuracy thereof and the payment of the taxes shown thereon. Thus, it is designed to ensure that the seller has complied with the basic tax requirements. This representation can stay the same even if the seller is an S corporation because an S corporation may be subject to state, local and foreign taxes and may be subject to federal income tax with respect to built-in gains under Code Section 1374 and to passive income under Code Section 1375. Even though an S corporation generally is not subject to federal income taxation, it still must file a return.

Section 3.14(b) deals with the background information relating to the seller's tax liability. Here the seller must turn over all tax returns and information relating to the audit of those returns. The seller may insist upon a carve-back on the returns and audit information it must provide, such as limiting the returns to the federal income tax returns and material state, local and foreign returns. This subsection also seeks information regarding tax issues that could be raised in the future with respect to returns that have not yet been audited or even filed. Thus, it might be seen as a provision designed to ferret out all issues with respect to the potential underpayment of taxes previously paid or currently due.

Section 3.14(c) is designed to ensure that any outstanding tax liabilities are properly reflected in the books of the seller.

Section 3.14(d) deals with specific potential Tax Liabilities or situations that may or may not be present depending upon the circumstances. Most of the items are addressed in a more general manner in preceding subsections, but it may be helpful in focusing the attention of the parties to address certain specific items in subsection (d). The first item, withholding obligations, is particularly important. Tax-sharing agreements, covered in clause (ii), are common for consolidated groups where there is a minority interest. Clause (iii) is designed to ensure that there is no potential tax liability with respect to other consolidated groups of which the seller may have been a member.

Certain provisions of Section 3.14 are qualified by "Knowledge." The seller may argue that tax matters are the responsibility of a particular officer of the seller and only that officer's knowledge should be considered. The definition of "Knowledge," however, states that the seller will be deemed to have knowledge of a fact or matter if any of its directors or officers has knowledge of it. Therefore, the responsible officer's knowledge is imputed to the seller, and it is not necessary to change the language in Section 3.14 or to foreclose the possibility that another director or officer of the seller may have knowledge of relevant tax matters.

Section 3.14(d)(iv) addresses the basic situations that can arise with respect to S corporation status:

(a) Seller is not an S corporation;
(b) Seller is an S corporation and neither the built-in gains tax nor the tax on passive income applies; or
(c) Seller is an S corporation and the tax on passive income does not apply, but the tax on built-in gains does apply.

For a discussion of the built-in-gains tax under Code Section 1374, see Appendix B, Section E.

If the seller is an S corporation, the buyer will want to know the states and localities in which the seller is subject to tax as an entity and that the seller has, in fact, discharged its obligations to those states. The last two sentences of clause (iv) address these issues.

The substantial understatement representation in clause (v) could help identify any aggressive practices in which the seller has engaged.

If the seller were publicly held, the buyer would want representations that address, respectively, excessive employee compensation under Code Section 162(m) and golden parachute payments under Code Section 280G. These representations could be worded as follows:

> **(vi)** ***Excessive Employee Remuneration.*** **The disallowance of a deduction under Code Section 162(m) for employee remuneration will not apply to any amount paid or payable by Seller under any contractual arrangement currently in effect.**

(vii) ***Golden Parachute Payments.*** **Seller has not made any payments, is not obligated to make any payments and is not a party to any agreement that, under certain circumstances, could obligate it to make any payments that will not be deductible under Code Section 280G.**

Such representations should be included for publicly held sellers only because these Code sections specifically do not apply to certain defined closely held corporations.

Finally, although the buyer in a taxable acquisition will not succeed to the seller's basis for its assets and other attributes, the buyer will, in essence, be taking over the basis and other tax attributes of any acquired subsidiaries. This information would permit the buyer to make the decision on whether to make a Section 338 election with respect to any acquired subsidiary for which a Section 338(h)(10) election is not filed. A representation soliciting this information would read as follows:

(viii) ***Basis and Other Information.*** **Part 3.14(d)(viii) sets forth the following information with respect to Seller and its Subsidiaries (or in the case of clause (B) below, with respect to each of the Subsidiaries) as of the most recent practicable date [(as well as on an estimated pro forma basis as of the Closing giving effect to the consummation of the transactions contemplated hereby)]: (A) the basis of Seller or Subsidiary in its assets; (B) the basis of the shareholder(s) of each Subsidiary in such Subsidiary's stock (or the amount of any Excess Loss Account); (C) the amount of any net operating loss, net capital loss, unused investment or other credit, unused foreign tax or excess charitable contribution allocable to Seller or any of its Subsidiaries; and (D) the amount of any deferred gain or loss allocable to Seller or any of its Subsidiaries arising out of any deferred intercompany transaction under the regulations under Code Section 1502.**

See Chapter 6, "Tax Matters," of the *Manual on Acquisition Review* and Appendix B, Section G.

3.15 NO MATERIAL ADVERSE CHANGE

Since the date of the Balance Sheet, there has not been any material adverse change in the business, operations, prospects, assets, results of operations or condition (financial or other) of Seller, and no event has occurred or circumstance exists that may result in such a material adverse change.

COMMENT

A seller may have several comments to this representation. First, the seller may resist the representation in its entirety on the basis that the buyer is buying assets rather than stock. Second, if the seller is unsuccessful in eliminating the representation in its entirety, the seller might try to limit the representation by, for example, deleting the reference to "prospects" on the basis that "prospects" is too vague. Third, the seller might try to specify a number of items that will not be deemed to constitute a material

adverse change in the business, etc. of the seller even if they were to occur. In that regard, the seller might suggest the following "carve outs" be added to the end of Section 3.15.

> **; provided, however, that in no event shall any of the following constitute a material adverse change in the business, operations, prospects, assets, results of operations or condition of Seller: (i) any change resulting from conditions affecting the industry in which Seller operates or from changes in general business or economic conditions; (ii) any change resulting from the announcement or pendency of any of the transactions contemplated by this Agreement; or (iii) any change resulting from compliance by Seller with the terms of, or the taking of any action contemplated or permitted by, this Agreement.**

The buyer, however, will resist the changes suggested by the seller on the basis that the buyer needs assurances that the business it is buying through its asset purchase has not suffered a material adverse change since the date of the most recent audited balance sheet of the seller. If the buyer agrees to one or more "carve outs" to the material adverse change provision, the buyer might want to specify a standard of proof with respect to the "carve outs" (e.g., that (a) the only changes that will be excluded are those that are "proximately," "demonstrably" or "directly" caused by the particular circumstances described above, and (b) with respect to any dispute regarding whether a change was proximately caused by one of the circumstances described above, the seller shall have the burden of proof by a preponderance of the evidence).

Whether or not the general material adverse change provision remains in the agreement, counsel to the buyer may wish to specifically identify those changes in the business or assets that the buyer would regard as important enough to warrant not going ahead with the transaction. *See* Esplanade Oil & Gas, Inc. v. Templeton Energy Income Corp., 889 F.2d 621 (5th Cir. 1989) ("adverse material change to the Properties" held to refer to the seller's right, title and interest to oil properties and not to a decline in the value of those properties resulting from a precipitous drop in the price of oil). *See also* John Borders v. KRLB, Inc., 727 S.W.2d 357 (Tex. App. 1987) (material adverse change in the target's "business, operations, properties and other assets which would impair the operation of the radio station" held not to include a significant decline in "Arbitron ratings" of the target radio station, indicating that the target had lost one-half of its listening audience because (a) the material adverse change provision did not specifically refer to a ratings decline, and (b) a ratings decline was not within the scope of the material adverse change provision at issue).

For a discussion of the advisability of including a separate "no material adverse change" condition in the acquisition agreement, see the Comment to Section 7.1 under the caption "Desirability of Separate 'No Material Adverse Change' Condition." For a discussion of the implications of various methods of drafting a phrase such as "that may result in such a material adverse change" (which appears at the end of Section 3.15), see the introductory Comment to Section 3 under the caption "Considerations When Drafting 'Adverse Effect' Language in Representations."

In addition to Section 3.15, which deals generally with material adverse changes affecting Seller, Section 3.19 covers several specific matters that are considered significant (though not necessarily adverse) events for Seller and may, individually or in the aggregate, constitute material adverse changes. Section 3.19 requires disclosure of such events that occurred after the date of the Balance Sheet but before the signing of the acquisition agreement, and Section 5.3 requires Seller to prevent such events from

occurring (to the extent it is within its power to do so) after the signing date but before the Closing (for further discussion, see the Comment to Section 3.19). Together, Sections 3.15 and 3.19 require Seller to disclose to Buyer updated information concerning important developments in the business of Seller after the date of the Balance Sheet.

3.16 EMPLOYEE BENEFITS

(a) Set forth in Part 3.16(a) is a complete and correct list of all "employee benefit plans" as defined by Section 3(3) of ERISA, all specified fringe benefit plans as defined in Section 6039D of the Code, and all other bonus, incentive-compensation, deferred-compensation, profit-sharing, stock-option, stock-appreciation-right, stock-bonus, stock-purchase, employee-stock-ownership, savings, severance, change-in-control, supplemental-unemployment, layoff, salary-continuation, retirement, pension, health, life-insurance, disability, accident, group-insurance, vacation, holiday, sick-leave, fringe-benefit or welfare plan, and any other employee compensation or benefit plan, agreement, policy, practice, commitment, contract or understanding (whether qualified or nonqualified, currently effective or terminated, written or unwritten) and any trust, escrow or other agreement related thereto that (i) is maintained or contributed to by Seller or any other corporation or trade or business controlled by, controlling or under common control with Seller (within the meaning of Section 414 of the Code or Section 4001(a)(14) or 4001(b) of ERISA) ("ERISA Affiliate") or has been maintained or contributed to in the last six (6) years by Seller or any ERISA Affiliate, or with respect to which Seller or any ERISA Affiliate has or may have any liability, and (ii) provides benefits, or describes policies or procedures applicable to any current or former director, officer, employee or service provider of Seller or any ERISA Affiliate, or the dependents of any thereof, regardless of how (or whether) liabilities for the provision of benefits are accrued or assets are acquired or dedicated with respect to the funding thereof (collectively the "Employee Plans"). Part 3.16(a) identifies as such any Employee Plan that is (w) a "Defined Benefit Plan" (as defined in Section 414(l) of the Code); (x) a plan intended to meet the requirements of Section 401(a) of the Code; (y) a "Multiemployer Plan" (as defined in Section 3(37) of ERISA); or (z) a plan subject to Title IV of ERISA, other than a Multiemployer Plan. Also set forth on Part 3.16(a) is a complete and correct list of all ERISA Affiliates of Seller during the last six (6) years.

(b) Seller has delivered to Buyer true, accurate and complete copies of (i) the documents comprising each Employee Plan (or, with respect to any Employee Plan which is unwritten, a detailed written description of eligibility, participation, benefits, funding arrangements, assets and any other matters which relate to the obligations of Seller or any ERISA Affiliate); (ii) all trust agreements, insurance contracts or any other funding instruments related to the Employee Plans; (iii) all rulings, determination letters, no-action letters or advisory opinions from the IRS, the U.S. Department of Labor, the Pension Benefit Guaranty Corporation ("PBGC") or any other Governmental Body that pertain to each Employee Plan and any open requests therefor; (iv) the most recent actuarial and financial reports (audited and/or unaudited) and the annual reports filed with any Gov-

ernment Body with respect to the Employee Plans during the current year and each of the three preceding years; (v) all collective bargaining agreements pursuant to which contributions to any Employee Plan(s) have been made or obligations incurred (including both pension and welfare benefits) by Seller or any ERISA Affiliate, and all collective bargaining agreements pursuant to which contributions are being made or obligations are owed by such entities; (vi) all securities registration statements filed with respect to any Employee Plan; (vii) all contracts with third-party administrators, actuaries, investment managers, consultants and other independent contractors that relate to any Employee Plan, (viii) with respect to Employee Plans that are subject to Title IV of ERISA, the Form PBGC-1 filed for each of the three most recent plan years; and (ix) all summary plan descriptions, summaries of material modifications and memoranda, employee handbooks and other written communications regarding the Employee Plans.

(c) **Except as disclosed in Part 3.16(c), full payment has been made of all amounts that are required under the terms of each Employee Plan to be paid as contributions with respect to all periods prior to and including the last day of the most recent fiscal year of such Employee Plan ended on or before the date of this Agreement and all periods thereafter prior to the Closing Date, and no accumulated funding deficiency or liquidity shortfall (as those terms are defined in Section 302 of ERISA and Section 412 of the Code) has been incurred with respect to any such Employee Plan, whether or not waived. The value of the assets of each Employee Plan exceeds the amount of all benefit liabilities (determined on a plan termination basis using the actuarial assumptions established by the PBGC as of the Closing Date) of such Employee Plan. Seller is not required to provide security to an Employee Plan under Section 401(a)(29) of the Code. The funded status of each Employee Plan that is a Defined Benefit Plan is disclosed on Part 3.16(c) in a manner consistent with the Statement of Financial Accounting Standards No. 87. Seller has paid in full all required insurance premiums, subject only to normal retrospective adjustments in the ordinary course, with regard to the Employee Plans for all policy years or other applicable policy periods ending on or before the Closing Date.**

(d) **Except as disclosed in Part 3.16(d), no Employee Plan, if subject to Title IV of ERISA, has been completely or partially terminated, nor has any event occurred nor does any circumstance exist that could result in the partial termination of such Employee Plan. The PBGC has not instituted or threatened a Proceeding to terminate or to appoint a trustee to administer any of the Employee Plans pursuant to Subtitle 1 of Title IV of ERISA, and no condition or set of circumstances exists that presents a material risk of termination or partial termination of any of the Employee Plans by the PBGC. None of the Employee Plans has been the subject of, and no event has occurred or condition exists that could be deemed, a reportable event (as defined in Section 4043 of ERISA) as to which a notice would be required (without regard to regulatory monetary thresholds) to be filed with the PBGC. Seller has paid in full all insurance premiums due to the PBGC with regard to the Employee Plans for all applicable periods ending on or before the Closing Date.**

(e) **Neither Seller nor any ERISA Affiliate has any liability or has Knowledge of any facts or circumstances that might give rise to any liability, and the Contemplated**

Transactions will not result in any liability, (i) for the termination of or withdrawal from any Employee Plan under Sections 4062, 4063 or 4064 of ERISA, (ii) for any lien imposed under Section 302(f) of ERISA or Section 412(n) of the Code, (iii) for any interest payments required under Section 302(e) of ERISA or Section 412(m) of the Code, (iv) for any excise tax imposed by Section 4971 of the Code, (v) for any minimum funding contributions under Section 302(c)(11) of ERISA or Section 412(c)(11) of the Code or (vi) for withdrawal from any Multiemployer Plan under Section 4201 of ERISA.

(f) Seller has, at all times, complied, and currently complies, in all material respects with the applicable continuation requirements for its welfare benefit plans, including (1) Section 4980B of the Code (as well as its predecessor provision, Section 162(k) of the Code) and Sections 601 through 608, inclusive, of ERISA, which provisions are hereinafter referred to collectively as "COBRA" and (2) any applicable state statutes mandating health insurance continuation coverage for employees.

(g) The form of all Employee Plans is in compliance with the applicable terms of ERISA, the Code, and any other applicable laws, including the Americans with Disabilities Act of 1990, the Family Medical Leave Act of 1993 and the Health Insurance Portability and Accountability Act of 1996, and such plans have been operated in compliance with such laws and the written Employee Plan documents. Neither Seller nor any fiduciary of an Employee Plan has violated the requirements of Section 404 of ERISA. All required reports and descriptions of the Employee Plans (including Internal Revenue Service Form 5500 Annual Reports, Summary Annual Reports and Summary Plan Descriptions and Summaries of Material Modifications) have been (when required) timely filed with the IRS, the U.S. Department of Labor or other Governmental Body and distributed as required, and all notices required by ERISA or the Code or any other Legal Requirement with respect to the Employee Plans have been appropriately given.

(h) Each Employee Plan that is intended to be qualified under Section 401(a) of the Code has received a favorable determination letter from the IRS, and Seller has no Knowledge of any circumstances that will or could result in revocation of any such favorable determination letter. Each trust created under any Employee Plan has been determined to be exempt from taxation under Section 501(a) of the Code, and Seller is not aware of any circumstance that will or could result in a revocation of such exemption. Each Employee Welfare Benefit Plan (as defined in Section 3(1) of ERISA) that utilizes a funding vehicle described in Section 501(c)(9) of the Code or is subject to the provisions of Section 505 of the Code has been the subject of a notification by the IRS that such funding vehicle qualifies for tax-exempt status under Section 501(c)(9) of the Code or that the plan complies with Section 505 of the Code, unless the IRS does not, as a matter of policy, issue such notification with respect to the particular type of plan. With respect to each Employee Plan, no event has occurred or condition exists that will or could give rise to a loss of any intended tax consequence or to any Tax under Section 511 of the Code.

(i) There is no material pending or threatened Proceeding relating to any Employee Plan, nor is there any basis for any such Proceeding. Neither Seller nor any fiduciary of an Employee Plan has engaged in a transaction with respect to any

Employee Plan that, assuming the taxable period of such transaction expired as of the date hereof, could subject Seller or Buyer to a Tax or penalty imposed by either Section 4975 of the Code or Section 502(l) of ERISA or a violation of Section 406 of ERISA. The Contemplated Transactions will not result in the potential assessment of a Tax or penalty under Section 4975 of the Code or Section 502(l) of ERISA nor result in a violation of Section 406 of ERISA.

(j) Seller has maintained workers' compensation coverage as required by applicable state law through purchase of insurance and not by self-insurance or otherwise except as disclosed to Buyer on Part 3.16(j).

(k) Except as required by Legal Requirements and as provided in Section 10.1(d), the consummation of the Contemplated Transactions will not accelerate the time of vesting or the time of payment, or increase the amount, of compensation due to any director, employee, officer, former employee or former officer of Seller. There are no contracts or arrangements providing for payments that could subject any person to liability for tax under Section 4999 of the Code.

(l) Except for the continuation coverage requirements of COBRA, Seller has no obligations or potential liability for benefits to employees, former employees or their respective dependents following termination of employment or retirement under any of the Employee Plans that are Employee Welfare Benefit Plans.

(m) Except as provided in Section 10.1(d), none of the Contemplated Transactions will result in an amendment, modification or termination of any of the Employee Plans. No written or oral representations have been made to any employee or former employee of Seller promising or guaranteeing any employer payment or funding for the continuation of medical, dental, life or disability coverage for any period of time beyond the end of the current plan year (except to the extent of coverage required under COBRA). No written or oral representations have been made to any employee or former employee of Seller concerning the employee benefits of Buyer.

(n) With respect to any Employee Plan that is a "multiemployer plan" within the meaning of Section 4001(a)(3) of ERISA ("Multiemployer Plan"), and any other Multiemployer Plan to which Seller has at any time had an obligation to contribute:

- **(i) all contributions required by the terms of such Multiemployer Plan and any collective bargaining agreement have been made when due; and**
- **(ii) Seller would not be subject to any withdrawal liability under Part 1 of Subtitle E of Title IV of ERISA if, as of the date hereof, Seller were to engage in a "complete withdrawal" (as defined in ERISA Section 4203) or a "partial withdrawal" (as defined in ERISA Section 4205) from such Multiemployer Plan.**

COMMENT

The employee benefit representations requested in Section 3.16 may, at first glance, appear overly burdensome. When a buyer is not expressly assuming any of the employee benefit plans of the seller, why should the buyer be concerned about the existence or nature of employee benefit plans or programs maintained by the seller or an affiliate of the seller?

First, the buyer may use this information to determine what, if any, obligation it may undertake in the acquisition documents to provide certain levels of benefits to transferred employees. In some cases, the buyer's obligations to transferred employees may be met in full or in part through plans maintained by the seller or by reference to levels of benefits paid (or payable) by plans maintained by the seller (or out of the assets to be acquired from those plans); in that event, the buyer will be relying on the financial integrity of those plans, and these representations are not only relevant to the unencumbered nature of the acquired assets but also to the magnitude of future benefit obligations undertaken by buyer in the acquisition documents. The buyer should be concerned with the future administration of those plans if the buyer has estimated its future benefit liabilities in reliance on the seller's plans, providing some part of benefits the buyer will be obligated to provide.

The second reason the buyer would be interested in information about the employee benefit plans offered by the seller and its affiliates is the potential for imposition on the buyer of certain liabilities relating to the seller's plans, even though the buyer has attempted expressly to disavow any such liabilities. Although the general rule in an asset acquisition is that the buyer can control which debts and liabilities of the seller it assumes, in the context of employee benefit plans, this general rule does not always hold true. In certain situations, the assets purchased by the buyer can be reached by the IRS or the PBGC to satisfy certain current, or even future, liabilities of the seller with respect to its employee benefit plans or plans maintained by affiliates of the seller. These risks are usually limited to defined benefit plans and multiemployer plans. See discussions below entitled "Minimum Funding; Benefit Liabilities," "Title IV Plans" and "Multiemployer Plans." Thus, the degree of employee benefit representations a buyer may require will be proportionate to the amount of risk the buyer is willing to assume of a lien attaching to the acquired assets which is superior to the buyer's rights to the assets.

If the seller is a subsidiary or division of a large company with many subsidiaries or divisions, the seller may (rightfully) object to such extensive disclosure requirements. In that case, the buyer could (a) limit the definition of "Employee Plans" to (1) the plans in which employees of the acquired business participate and (2) other plans which are sponsored by or contributed to or in which the employees of the acquired business have participated and (b) include a separate definition of "ERISA Affiliate Plans," which would include any other defined benefit, money purchase and multiemployer plans maintained or contributed to by any ERISA Affiliates of the Seller. A new term, "Acquired Business Plans," could be defined as all "Employee Plans" and all "ERISA Affiliate Plans." The representations in Section 3.16(c), (d) and (e) would then reference "Acquired Business Plans" instead of only "Employee Plans."

The risk of a lien attaching to the acquired assets is greater in the following factual situation: (1) the assets are being purchased from a corporation, which will distribute the proceeds to individual shareholders who may not otherwise have the funds to satisfy any liability imposed by the IRS or the PBGC, and (2) the seller maintains an underfunded pension plan. The buyer may be comfortable accepting fewer representations by the seller with respect to its employee benefit arrangements (and especially with respect to those of the seller's affiliates) where (a) the assets purchased are those of a subsidiary or division of a large and financially healthy parent corporation, (b) the seller's plans (and those of its affiliates) are sufficiently funded, or (c) neither the seller nor any of its ERISA Affiliates maintains or has maintained a defined-benefit plan or a multiemployer plan.

There are several ways a buyer can try to minimize its exposure to a lien on the acquired assets. For example, it can require the seller to fully fund all employee benefit plans on a termination basis. This is the approach taken in the Model Agreement.

Section 3.16(c) contains a representation that the assets of each employee benefit plan are sufficient on a termination basis to satisfy the Liabilities of that plan. Based upon the Fact Pattern, this representation is false. Section 7.12 states, however, that as a condition precedent to Buyer's obligation to close, Seller will provide all requisite funding to any underfunded benefit plans.

Funding plans on a termination basis is almost always more expensive than funding them merely on an ongoing basis. Where the seller will not or cannot agree to fully fund its benefit plans on a termination basis, the buyer might instead require a representation from the seller that the amount of the underfunding is no greater than a certain specified dollar amount. Another approach is to include the risk of a lien attaching to the assets as part of a general indemnity or provide separate indemnification without regard to any basket (i.e., with "first-dollar" liability) and protected by the funds retained in escrow.

The law and the accounting standards governing employee benefits continue to evolve. Many rules appear in both ERISA and the Code; for example, the vesting, benefit accrual and minimum funding rules are set forth in ERISA Sections 203, 204 and 302 and Code Sections 411(a), 411(b) and 412, and the COBRA continuation of coverage provisions appear in both ERISA Section 601 *et seq*. and Code Section 4980B. The two statutes sometimes use different words to label the same or similar concepts, such as "party in interest" (ERISA Section 3(14)) and "disqualified person" (Code Section 4975(e)(2)). Conversely, the two statutes sometimes assign different meanings to a particular word; for example, the definition of "plan" in ERISA Section 3(3) differs from the definition in Code Section 4975(e)(1). Some rules are found only in one statute or the other.

The main potential employee benefit liabilities include:

(a) minimum funding liability,
(b) termination liability for single employer pension plans,
(c) withdrawal liability for multiemployer pension plans,
(d) PBGC insurance premium liability,
(e) disqualification of a qualified plan,
(f) liability for failure to file, disclose, or notify,
(g) excise taxes and
(h) liability for violations of fiduciary duties.

The first four categories arise from defined benefit pension plans (and minimum-funding liability can also arise from a money purchase pension plan).

Defined Benefit Plans. Defined benefit pension plans promise the employee periodic payments beginning at some date in accordance with a formula; for example, the annual payment will equal the product of x percent multiplied by the number of years of covered employment, multiplied by the average annual earnings in the employee's three, highest-paid years. Current contributions are based upon estimates of items such as the amount and duration of the periodic payments that will be owed, the rate of return that will be earned on the assets of the plan and the rate of employee turnover.

ERISA Affiliate. Generally, related entities, including noncorporate entities, are jointly and severally liable for pension obligations. *See* ERISA §§ 302(c)(11), 4001(b), 4007, 4041(c)(2)(B), 4062(a), 4068(a) and 4001(a)(14); Code §§ 412(c)(11)(B), 4971(e). The buyer should determine whether the seller may have liability with respect to a plan established or maintained by a related entity that is not being acquired.

Minimum Funding; Benefit Liabilities. The sponsor of a single-employer defined benefit plan must make a minimum contribution every calendar quarter unless the plan is fully funded. *See* ERISA § 302; Code § 412. All assets of the employer and affiliated entities are subject to a lien in certain circumstances if the employer fails to

meet the minimum funding requirements. *See* ERISA §§ 302(a), 302(c)(6)–(7), 4041(b)(1)(D) and 4241; Code §§ 412(a) and (c)(6)–(7). The present value of benefit liabilities, as determined under ERISA, may differ substantially from the liabilities determined in accordance with GAAP. The buyer and its actuary should analyze the assumptions upon which the funding of the seller's plans is based; the assumptions applied in estimating a plan's liabilities can have a material impact on those liabilities. If representations regarding the adequacy of funding depend upon actuarial assumptions (other than PBGC-specified assumptions for plan termination purposes), a representation as to the reasonableness and general acceptability of those assumptions might be added.

Multiemployer Plans. Nearly identical definitions of this term are found in ERISA § 4001(3) and Code § 414(f). An employer may promise in a collective bargaining agreement to contribute an agreed amount to an industry pension plan per hour of covered employment. Even if the employer makes all agreed contributions, the plan may be underfunded. An employer that withdraws from or ceases to contribute to a multiemployer plan, either completely or partially, is liable to the plan for its share of unfunded vested benefits. *See* ERISA § 4201 et seq.; 29 U.S.C. § 1381 et seq.; 56 C.F.R. § 12,228. Where the assets of a company are sold and employees of the seller participating in a multiemployer plan become employees of the buyer, the seller may incur a liability due to a complete or partial withdrawal from the multiemployer plan unless the requirements of ERISA § 4204 are met. This, in general, requires the buyer (a) to agree to continue to contribute to the plan on substantially the same basis as the seller and (b) to provide to the plan, for a period of five years, a bond or an escrow arrangement in an amount equal to the greater of the seller's three year average annual contribution to the plan or the seller's annual contribution for the last plan year. An additional requirement is that the acquisition agreement must provide that, if the buyer withdraws from the plan in a complete or partial withdrawal during the first five plan years after the sale, the seller will remain secondarily liable for any withdrawal liability that it would have had to the plan.

A suggested form of ERISA § 4204 covenant follows:

Multiemployer Plan.

(a) The parties intend to comply with the requirements of Section 4204 of ERISA in order that the transactions contemplated by this Agreement shall not be deemed a complete or partial withdrawal from the _____ Pension Fund (the "Multiemployer Plan"). Accordingly, Seller and Buyer agree:

(i) After the Closing Date, Buyer shall contribute to the Multiemployer Plan with respect to the operations of the _____ facility for substantially the same number of "contribution base units" for which Seller had an "obligation to contribute" to the Multiemployer Plan (as those terms are defined in Sections 4001(a)(11) and 4212 of ERISA, respectively) pursuant to the Collective Bargaining Agreement.

(ii) Buyer shall provide to the Multiemployer Plan, for a period of five consecutive plan years commencing with the first plan year beginning after the Closing Date, either a bond issued by a surety company that is an acceptable surety for purposes of Section 412 of ERISA or an amount held in escrow by a bank or similar financial institution satisfactory to the Multiemployer Plan. The

amount of such bond or escrow deposit shall be equal to the greater of (A) the average annual contribution that Seller was required to make under the Multiemployer Plan with respect to the operations of the _____ facility for the three plan years immediately preceding the plan year in which the Closing Date occurs, or (B) the annual contribution that Seller was required to make under the Multiemployer Plan with respect to the operations of the _____ facility for the last plan year immediately preceding the plan year in which the Closing Date occurs.

(iii) If Buyer completely or partially withdraws from the Multiemployer Plan prior to the end of the fifth plan year beginning after the Closing Date, and the resulting liability of Buyer with respect to the Multiemployer Plan is not paid, then Seller shall be secondarily liable in an amount not to exceed the amount of withdrawal liability Seller would have had to pay to the Multiemployer Plan as a result of the transactions contemplated by this Agreement but for Section 4204 of ERISA. Buyer shall indemnify Seller against any liability incurred by Seller pursuant to this clause (iii).

(b) Seller shall cooperate with Buyer if Buyer wishes to prepare and submit to the Multiemployer Plan or the Pension Benefit Guaranty Corporation (PBGC) a request for a variance of exemption from the bond/escrow requirement of Section 4204(a)(1)(B) of ERISA (as described in clause (ii) of this subsection). Unless and until such a variance or exemption is granted, Buyer shall comply with the bond/escrow requirement, except to the extent provided in PBGC Regulation Section 2643.11(d).

An employer may obtain from the plan the information necessary to compute its withdrawal liability. *See* ERISA § 4221(e). An employer (and its ERISA Affiliates) will have statutory, as well as perhaps contractual, liability if a multiemployer plan terminates or goes into reorganization. *See* ERISA §§ 4041A and 4243.

Title IV Plans. Title IV establishes a limited form of pension insurance covering both single-employer plans and multiemployer plans. *See* ERISA §§ 4022 and 4022A. The employer (and its affiliates) are liable to the PBGC for plan termination insurance premiums. *See* ERISA § 4006. An employer (and its affiliates) are also liable to the PBGC for unfunded benefit liabilities assumed by the PBGC upon plan termination. *See* ERISA § 4062 et seq. All of the assets of the employer and its ERISA affiliates are subject to a lien in favor of the PBGC to secure such amounts. *See* ERISA § 4068.

Qualified Plans. A deferred-compensation or retirement-income plan that satisfies the requirements of Code § 401(a) receives favorable tax treatment in several respects:

(a) contributions to the plan are deductible when made;
(b) the employee for whose benefit the contribution is made does not recognize income until the employee receives a distribution from the plan; and
(c) the trust that holds plan assets generally does not pay tax on investment income attributable to those assets.

These rules defer the income tax that the employee would otherwise owe on sums contributed and on the investment earnings from those contributions. At the same time,

the employer is permitted an immediate deduction. A plan will ordinarily obtain a determination letter from the IRS that the terms of the plan qualify under § 401(a). Plans are tested periodically for compliance with various Code provisions. *See, e.g.,* Code §§ 401(a)(4) and (26), 401(k) and (m), 410(b), 415 and 416.

Requirements to Report, Disclose, and Notify. Both ERISA and the Code impose requirements that various parties file and distribute reports and give various notices, and both impose sanctions for failure to meet these requirements. *See, e.g.,* ERISA §§ 101 et seq., 502(c)(2) and 4071; Code §§ 6058(a), 6652 and 6692.

Excise Taxes. The Code imposes excise taxes for (a) failure to meet funding standards (*see* Code § 4971), (b) engaging in prohibited transactions (*see* Code § 4975), (c) making nondeductible contributions to a plan (*see* Code § 4972), (d) failing to distribute excess contributions in a timely manner (*see* Code § 4979) and (e) receiving reversions of excess assets on plan termination (*see* Code § 4980). The Code also imposes an excise tax on certain parachute payments. *See* Code §§ 280G and 4999.

The Secretary of Labor may assess a civil penalty against a person or entity that is a party in interest in a prohibited transaction. *See* ERISA § 502(i). There are also penalties for failing to comply with the rules regarding continuation of health care coverage in accordance with ERISA § 601 et seq. and Code § 4980B.

Other Benefit Obligations. This term covers arrangements with persons who are not employees (such as directors) that are not legally binding, but the buyer may feel compelled to continue, or that are not plans, such as a practice of entering into consulting agreements with retired directors. *See* 29 C.F.R. § 2510.3-1. The seller's arrangements with present and former executives may not have been handled by the same people who deal with other employee relationships and may therefore require special effort for the buyer to discover.

COBRA. The Consolidated Omnibus Reconciliation Act of 1985 (COBRA) amended the Internal Revenue Code, the Employee Retirement Income Security Act (ERISA) and the Public Health Services Act (PHSA) to require continuation of group health insurance to individuals who, under certain circumstances, lose insurance coverage under an employer group health plan. *See* 26 U.S.C. § 4980B; 29 U.S.C. § 1161 et seq.; and 42 U.S.C. § 300 bb et seq. Under COBRA, each qualified beneficiary who will lose coverage under a group health plan as a result of a "qualifying event" is entitled to elect, within a designated period, continuation of coverage under the plan. ERISA § 601(a). Qualified beneficiaries include a covered employee under a group health plan, and the spouse and dependants of the covered employee. ERISA § 607(3). COBRA requires that notice of a qualifying event be given to qualified beneficiaries and provides penalties for failure to provide the proper notice. ERISA § 606. Qualifying events under COBRA include, among other things, the voluntary or involuntary termination of employment of the covered employee (other than for gross misconduct), death or disability of the covered employee and divorce. ERISA § 603. Qualified beneficiaries are entitled to elect from eighteen to thirty-six months of coverage depending upon the nature of a qualifying event. ERISA § 602(2).

Proposed Treasury Department regulations provide that, in corporate transactions involving the sale of substantial assets (e.g., sale of a division or plant or substantially all of the assets of a trade or business), the seller generally has the obligation to make COBRA continuation coverage available to qualified beneficiaries, which include all individuals who are already receiving COBRA benefits prior to the transaction and those individuals who lose coverage as a result of the transaction. 64 Fed. Reg. § 5237 and Prop. Treas. Reg. 54.4980B-9Q/A 6; Q/A 8. In addition, covered employees who become employed by the buyer are deemed to experience a termination of employment with the seller as a result of the asset sale, entitling such employees and their qualified dependents to COBRA continuation coverage. Fed. Reg. § 5237 and Prop. Treas. Reg. 54.4980B-9Q/A 6(b).

The proposed regulations make an exception, however, where the seller ceases to provide any group health plan to any employee in connection with the sale (or any health plan within the seller's control group) and where the buyer continues to operate the business without interruption or substantial change (i.e., where the buyer is deemed a successor employer). In that situation, no COBRA-qualifying event is deemed to have occurred with respect to those employees who continue employment with the buyer, and the buyer will be responsible for providing COBRA continuation coverage to the qualified beneficiaries who are already receiving COBRA benefits or who lose coverage as a result of the transaction. In addition, if the buyer is deemed a successor employer, the buyer will be liable for the seller's failure to comply with COBRA. 64 Fed. Reg. § 5237 and Prop. Treas. Reg. 54-4980B-9 Q/A 6; Q/A 8. As a result, the buyer will want appropriate representations, warranties and covenants from the seller as to its compliance with all COBRA requirements, including the applicable notice requirements.

Even though the proposed regulations allocate COBRA responsibility in acquisition transactions, they permit a seller and buyer to allocate COBRA responsibility in the acquisition agreement as they may agree. Nevertheless, in the event that the party who is assigned COBRA responsibility under an acquisition agreement fails to perform its COBRA obligations as set forth in the agreement, the party having the obligation under the proposed regulations to make COBRA available to designated qualified beneficiaries will continue to have that obligation. 64 Fed. Reg. § 5237 and Prop. Treas. Reg. § 54.4980 B-9 Q/A 7.

If the seller retains the obligation under the acquisition agreement to provide COBRA coverage, the buyer may wish to insist that the acquisition agreement include indemnification provisions in the event that the seller fails to provide COBRA coverage to the qualified beneficiaries pursuant to the agreement. To the extent that the buyer assumes liability for COBRA under the acquisition agreement or otherwise has such liability under the proposed regulations, the buyer may wish to consider requesting copies of the records of persons covered under the seller's group health plans within thirty-six months prior to the closing of the asset sale.

Although COBRA does not apply to small employer plans (fewer than twenty employees on a typical business day during the preceding calendar year), many states have also enacted their own "mini" or "state" COBRA continuation provisions to cover small employers whose employees are not covered by COBRA. Therefore, buyers will want appropriate representations concerning applicable state law requirements as well.

See Chapter 11, "Labor and Employment Matters," of the *Manual on Acquisition Review*.

3.17 COMPLIANCE WITH LEGAL REQUIREMENTS; GOVERNMENTAL AUTHORIZATIONS

(a) Except as set forth in Part 3.17(a):

(i) Seller is, and at all times since _____, 19/20___, has been, in full compliance with each Legal Requirement that is or was applicable to it or to the conduct or operation of its business or the ownership or use of any of its assets;

(ii) no event has occurred or circumstance exists that (with or without notice or lapse of time) (A) may constitute or result in a violation by Seller of, or a failure on the part of Seller to comply with, any Legal Requirement or

(B) may give rise to any obligation on the part of Seller to undertake, or to bear all or any portion of the cost of, any remedial action of any nature; and

(iii) Seller has not received, at any time since _____, 19/20___, any notice or other communication (whether oral or written) from any Governmental Body or any other Person regarding (A) any actual, alleged, possible or potential violation of, or failure to comply with, any Legal Requirement or (B) any actual, alleged, possible or potential obligation on the part of Seller to undertake, or to bear all or any portion of the cost of, any remedial action of any nature.

(b) Part 3.17(b) contains a complete and accurate list of each Governmental Authorization that is held by Seller or that otherwise relates to Seller's business or the Assets. Each Governmental Authorization listed or required to be listed in Part 3.17(b) is valid and in full force and effect. Except as set forth in Part 3.17(b):

(i) Seller is, and at all times since _____, 19/20___, has been, in full compliance with all of the terms and requirements of each Governmental Authorization identified or required to be identified in Part 3.17(b);

(ii) no event has occurred or circumstance exists that may (with or without notice or lapse of time) (A) constitute or result directly or indirectly in a violation of or a failure to comply with any term or requirement of any Governmental Authorization listed or required to be listed in Part 3.17(b) or (B) result directly or indirectly in the revocation, withdrawal, suspension, cancellation or termination of, or any modification to, any Governmental Authorization listed or required to be listed in Part 3.17(b);

(iii) Seller has not received, at any time since _____, 19/20___, any notice or other communication (whether oral or written) from any Governmental Body or any other Person regarding (A) any actual, alleged, possible or potential violation of or failure to comply with any term or requirement of any Governmental Authorization or (B) any actual, proposed, possible or potential revocation, withdrawal, suspension, cancellation, termination of or modification to any Governmental Authorization; and

(iv) all applications required to have been filed for the renewal of the Governmental Authorizations listed or required to be listed in Part 3.17(b) have been duly filed on a timely basis with the appropriate Governmental Bodies, and all other filings required to have been made with respect to such Governmental Authorizations have been duly made on a timely basis with the appropriate Governmental Bodies.

The Governmental Authorizations listed in Part 3.17(b) collectively constitute all of the Governmental Authorizations necessary to permit Seller to lawfully conduct and operate its business in the manner in which it currently conducts and operates such business and to permit Seller to own and use its assets in the manner in which it currently owns and uses such assets.

COMMENT

Section 3.17(a) contains Seller's "compliance-with-laws" representation. This representation requires disclosure of past, current and potential violations of laws and governmental regulations by Seller.

The representation in Section 3.17(b) relating to governmental licenses and permits of Seller is crucial in highly regulated industries. In these industries, availability and transferability of licenses and permits often dramatically affect the viability of the acquisition. A critical portion of the representation is Seller's affirmation that it has all of the licenses and permits necessary for the conduct of its business. Together with the representation concerning the sufficiency of Seller's assets (see Section 3.6) and the effect of the Contemplated Transactions on the status of Governmental Authorizations (see Section 3.2(b)(iii)), this representation gives Buyer some comfort that all of the essential elements of the business will be both present and operable after the Closing.

See Chapters 9, "Environmental Laws," 12, "Securities Laws," 13, "Antitrust Laws," and 14, "Foreign Operations and Investments," of the *Manual on Acquisition Review*.

3.18 LEGAL PROCEEDINGS; ORDERS

(a) Except as set forth in Part 3.18(a), there is no pending or, to Seller's Knowledge, threatened Proceeding:

(i) by or against Seller or that otherwise relates to or may affect the business of, or any of the assets owned or used by, Seller; or

(ii) that challenges, or that may have the effect of preventing, delaying, making illegal or otherwise interfering with, any of the Contemplated Transactions.

To the Knowledge of Seller, no event has occurred or circumstance exists that is reasonably likely to give rise to or serve as a basis for the commencement of any such Proceeding. Seller has delivered to Buyer copies of all pleadings, correspondence and other documents relating to each Proceeding listed in Part 3.18(a). There are no Proceedings listed or required to be listed in Part 3.18(a) that could have a material adverse effect on the business, operations, assets, condition or prospects of Seller or upon the Assets.

(b) Except as set forth in Part 3.18(b):

(i) there is no Order to which Seller, its business or any of the Assets is subject; and

(ii) to the Knowledge of Seller, no officer, director, agent or employee of Seller is subject to any Order that prohibits such officer, director, agent or employee from engaging in or continuing any conduct, activity or practice relating to the business of Seller.

(c) Except as set forth in Part 3.18(c):

(i) Seller is, and, at all times since _____, 19/20___, has been in compliance with all of the terms and requirements of each Order to which it or any of the Assets is or has been subject;

(ii) no event has occurred or circumstance exists that is reasonably likely to constitute or result in (with or without notice or lapse of time) a violation of or failure to comply with any term or requirement of any Order to which Seller or any of the Assets is subject; and

(iii) Seller has not received, at any time since _____, 19/20___, any notice or other communication (whether oral or written) from any Governmental Body or any other Person regarding any actual, alleged, possible or poten-

tial violation of, or failure to comply with, any term or requirement of any Order to which Seller or any of the Assets is or has been subject.

COMMENT

A buyer would typically evaluate each disclosed proceeding to determine the probability of an adverse determination and the magnitude of the potential damages. The information provided in the disclosure letter and the seller's financial statements and accompanying notes, as well as attorneys' responses to auditors' requests for information, would typically be reviewed. If the buyer reviews privileged materials relating to legal proceedings in which the seller is involved, however, there may be a waiver of the attorney-client privilege (see the Comment to Section 5.1). For each proceeding, the buyer should determine whether the potential liability justifies a larger holdback of a portion of the purchase price or whether indemnification is sufficient. Finally, the buyer and the seller must agree on the manner in which all such proceedings will be conducted up to and after the closing (issues such as who will designate lead counsel and who is empowered to effect a settlement must be resolved).

The disclosures required by Section 3.18 will allow the buyer to determine whether the seller is subject to and in compliance with any judicial or other orders or is involved in any proceedings that could affect the acquisition or the operation of the business. This representation does not address:

- violations of laws or other legal requirements of general application (see Section 3.17(a)),
- violations of the terms of governmental licenses or permits (see Section 3.17(b)),
- contractual compliance (see Section 3.20(d)) or
- violations of laws and other requirements that would be triggered by the acquisition (see Section 3.2(b)).

The representations in Section 3.18(c) focus on four overlapping categories of violations of judicial and other orders:

- past violations (clause (i)),
- pending violations (clause (i)),
- potential or "unmatured" violations (clause (ii)) and
- violations asserted by governmental authorities and other parties (clause (iii)).

A seller may object to the provision in clause (i) of Section 3.18(c) that requires disclosure of past violations, arguing that the buyer should not be concerned about historical violations that have been cured and are no longer pending. The buyer may respond by pointing out that, without this provision, the buyer may not be able to learn what type of litigation the seller's operations historically have attracted. The parties may compromise on this point by selecting a relatively recent date to mark the beginning of the period with respect to which disclosure of past violations is required.

In some acquisition agreements, the phrase "since _____, 19/20____" (which appears in both clause (i) and clause (iii) of Section 3.18(c)) is replaced with the phrase "during the _____-year period prior to the date of this Agreement" (or a similar phrase). For an explanation of why the use of this alternative language may be disadvantageous to the buyer, see the introductory Comment to Article 3 (under the caption "Considerations When Drafting Representations Incorporating Specific Time Periods").

For a discussion of the significance of the phrase "with or without notice or lapse of time" (which appears in clause (ii) of Section 3.18(c)), see the Comment to Section 3.2.

Although clause (iii) of Section 3.18(c) (which requires disclosure of notices received from governmental authorities and third parties concerning actual and potential violations) overlaps to some extent with clauses (i) and (ii), clause (iii) is not redundant. Clause (iii) requires disclosure of violations that have been asserted by other parties. The seller is required to disclose such asserted violations pursuant to clause (iii) even if there is some uncertainty or dispute over whether the asserted violations have actually been committed.

The parties should recognize that, if information regarding an actual or potential violation of a court order is included in the seller's disclosure letter, this information may be discoverable by adverse parties in the course of litigation involving the seller. Accordingly, it is important to use extreme care in preparing the descriptions included in part 3.18 of the disclosure letter (see the Comment to Section 3.2).

Certain of the provisions in Section 3.18 are sometimes the source of heated negotiation. For example, (a) the language in Section 3.18(a) with respect to knowledge of the basis for the commencement of any proceeding is usually requested but often successfully resisted by a seller; (b) Section 3.18(b)(i), a materiality carve-out for the effect on the operation of the Seller's business, is often negotiated; (c) clause (ii) of Section 3.18(b) is generally only requested by a buyer when the services of an individual are critical to the transaction; (d) the representation in clause (ii) of Section 3.18(c) with respect to the occurrence of events which might constitute violations is often successfully resisted by a seller; and (e) the representation in clause (iii) of Section 3.18(c) with respect to the absence of any oral notices from or communications with nongovernmental persons is often successfully resisted by a seller.

A typical representation concerning litigation will require the seller to represent that "To the knowledge of Seller, no proceeding involving Seller has been threatened." The word "threatened" connotes action that a prudent person would expect to be taken based either upon (a) receipt of a written demand, letter threatening litigation or notice of an impending investigation or audit or (b) facts that a prudent person would believe indicate that action likely will be taken by another person (e.g., a recent, well-publicized industrial accident likely to give rise to claims even though no claims have yet been filed). When the term "threatened" is used in conjunction with a knowledge qualification, the buyer will normally insist that the seller's knowledge be based upon some inquiry or process of investigation, whereas the seller may attempt to limit its knowledge of threatened action to the actual knowledge of the seller and perhaps the seller's senior management (or a limited number of designated officers) without any independent investigation. (See the definition of Knowledge in Section 1.1.)

By comparison, the ABA Statement of Policy Regarding Lawyers' Responses to Auditors' Requests for Information (December 1975) (the "Policy Statement") also contains standards for determining when threatened litigation must be disclosed. The Policy Statement examines the appropriateness of responses by lawyers to auditors' requests for information concerning loss contingencies of their clients. The Policy Statement is the result of a carefully negotiated compromise between the ABA and the American Institute of Certified Public Accountants. The compromise involved the balancing of the public interest in protecting the confidentiality of lawyer-client communications, as well as the attorney-client privilege, with the need for public confidence in published financial statements. Under the terms of the Policy Statement, only "overtly threatened" litigation need be disclosed. The customary threshold for disclosure in a business acquisition is lower, and the Policy Statement is not considered an appropriate benchmark for the allocation of risk between sellers and buyers in business acquisitions.

In addition to the representations concerning pending or threatened litigation, other provisions of the acquisition agreement may require disclosure of items that the seller

is aware of and may affect the seller. For example, the expected effect of a possible catastrophe may be covered by representations concerning the financial statements (see Section 3.4) or the absence of certain changes and events (see Section 3.19) or provisions regarding disclosure (see Section 3.33). Even if such a matter does not warrant disclosure by means of a reserve, a provision or a footnote in the seller's financial statements, and even if its significance cannot yet be fully assessed, the seller's failure to disclose it in the disclosure letter may give the buyer the right to elect not to close or, if the matter is discovered after the closing, to seek indemnification.

See Chapter 7, "Litigation," of the *Manual on Acquisition Review*.

3.19 ABSENCE OF CERTAIN CHANGES AND EVENTS

Except as set forth in Part 3.19, since the date of the Balance Sheet, Seller has conducted its business only in the Ordinary Course of Business and there has not been any:

(a) change in Seller's authorized or issued capital stock, grant of any stock option or right to purchase shares of capital stock of Seller or issuance of any security convertible into such capital stock;

(b) amendment to the Governing Documents of Seller;

(c) payment (except in the Ordinary Course of Business) or increase by Seller of any bonuses, salaries or other compensation to any shareholder, director, officer or employee or entry into any employment, severance or similar Contract with any director, officer or employee;

(d) adoption of, amendment to or increase in the payments to or benefits under, any Employee Plan;

(e) damage to or destruction or loss of any Asset, whether or not covered by insurance;

(f) entry into, termination of or receipt of notice of termination of (i) any license, distributorship, dealer, sales representative, joint venture, credit or similar Contract to which Seller is a party, or (ii) any Contract or transaction involving a total remaining commitment by Seller of at least $_____;

(g) sale (other than sales of Inventories in the Ordinary Course of Business), lease or other disposition of any Asset or property of Seller (including the Intellectual Property Assets) or the creation of any Encumbrance on any Asset;

(h) cancellation or waiver of any claims or rights with a value to Seller in excess of $_____;

(i) indication by any customer or supplier of an intention to discontinue or change the terms of its relationship with Seller;

(j) material change in the accounting methods used by Seller; or

(k) Contract by Seller to do any of the foregoing.

COMMENT

This representation seeks information about actions taken by Seller or other events affecting Seller since the date of the Balance Sheet which may be relevant to Buyer's plans and projections of income and expenses. In addition, this provision requires disclosure of actions taken by Seller in anticipation of the acquisition.

Most of the subjects dealt with in this representation are also covered by other representations. For example, although Section 3.16 contains detailed representations concerning employee benefit plans, Section 3.19(d) focuses on recent changes to such plans. For a discussion of the relationship between the representations in Sections 3.16 and 3.19, see the Comment to Section 3.16.

In addition to the disclosure function described above, this representation, along with Sections 5.2 and 5.3, serves another purpose. Section 5.3 provides that Seller will not, without the prior Consent of Buyer, take any action of the nature described in Section 3.19 during the period between the date of signing the acquisition agreement and the Closing. Section 5.2 is a general covenant by Seller to operate its business between those dates only in the ordinary course; Section 5.3 specifically commits Seller not to make changes as to the specific matters covered by Section 3.19.

Finally, there may be other specific matters that pose special risks to a buyer and should be included in this representation.

3.20 CONTRACTS; NO DEFAULTS

(a) Part 3.20(a) contains an accurate and complete list, and Seller has delivered to Buyer accurate and complete copies, of:

- **(i) each Seller Contract that involves performance of services or delivery of goods or materials by Seller of an amount or value in excess of _____ dollars ($_____);**
- **(ii) each Seller Contract that involves performance of services or delivery of goods or materials to Seller of an amount or value in excess of _____ dollars ($_____);**
- **(iii) each Seller Contract that was not entered into in the Ordinary Course of Business and that involves expenditures or receipts of Seller in excess of _____ dollars ($_____);**
- **(iv) each Seller Contract affecting the ownership of, leasing of, title to, use of or any leasehold or other interest in any real or personal property (except personal property leases and installment and conditional sales agreements having a value per item or aggregate payments of less than _____ dollars ($_____) and with a term of less than one year);**
- **(v) each Seller Contract with any labor union or other employee representative of a group of employees relating to wages, hours and other conditions of employment;**
- **(vi) each Seller Contract (however named) involving a sharing of profits, losses, costs or liabilities by Seller with any other Person;**
- **(vii) each Seller Contract containing covenants that in any way purport to restrict Seller's business activity or limit the freedom of Seller to engage in any line of business or to compete with any Person;**
- **(viii) each Seller Contract providing for payments to or by any Person based on sales, purchases or profits, other than direct payments for goods;**
- **(ix) each power of attorney of Seller that is currently effective and outstanding;**
- **(x) each Seller Contract entered into other than in the Ordinary Course of Business that contains or provides for an express undertaking by Seller to be responsible for consequential damages;**

(xi) each Seller Contract for capital expenditures in excess of _____ dollars ($_____);

(xii) each Seller Contract not denominated in U.S. dollars;

(xiii) each written warranty, guaranty and/or other similar undertaking with respect to contractual performance extended by Seller other than in the Ordinary Course of Business; and

(xiv) each amendment, supplement and modification (whether oral or written) in respect of any of the foregoing.

Part 3.20(a) sets forth reasonably complete details concerning such Contracts, including the parties to the Contracts, the amount of the remaining commitment of Seller under the Contracts and the location of Seller's office where details relating to the Contracts are located.

(b) Except as set forth in Part 3.20(b), neither Shareholder has or may acquire any rights under, and neither Shareholder has or may become subject to any obligation or liability under, any Contract that relates to the business of Seller or any of the Assets.

(c) Except as set forth in Part 3.20(c):

(i) each Contract identified or required to be identified in Part 3.20(a) and which is to be assigned to or assumed by Buyer under this Agreement is in full force and effect and is valid and enforceable in accordance with its terms;

(ii) each Contract identified or required to be identified in Part 3.20(a) and which is being assigned to or assumed by Buyer is assignable by Seller to Buyer without the consent of any other Person; and

(iii) to the Knowledge of Seller, no Contract identified or required to be identified in Part 3.20(a) and which is to be assigned to or assumed by Buyer under this Agreement will upon completion or performance thereof have a material adverse affect on the business, assets or condition of Seller or the business to be conducted by Buyer with the Assets.

(d) Except as set forth in Part 3.20(d):

(i) Seller is, and at all times since _____, 19/20___, has been, in compliance with all applicable terms and requirements of each Seller Contract which is being assumed by Buyer;

(ii) each other Person that has or had any obligation or liability under any Seller Contract which is being assigned to Buyer is, and at all times since _____, 19/20___, has been, in full compliance with all applicable terms and requirements of such Contract;

(iii) no event has occurred or circumstance exists that (with or without notice or lapse of time) may contravene, conflict with or result in a Breach of, or give Seller or other Person the right to declare a default or exercise any remedy under, or to accelerate the maturity or performance of, or payment under, or to cancel, terminate or modify, any Seller Contract that is being assigned to or assumed by Buyer;

(iv) no event has occurred or circumstance exists under or by virtue of any Contract that (with or without notice or lapse of time) would cause the creation of any Encumbrance affecting any of the Assets; and

(v) Seller has not given to or received from any other Person, at any time since

_____, 19/20___, any notice or other communication (whether oral or written) regarding any actual, alleged, possible or potential violation or Breach of, or default under, any Contract which is being assigned to or assumed by Buyer.

(e) There are no renegotiations of, attempts to renegotiate or outstanding rights to renegotiate any material amounts paid or payable to Seller under current or completed Contracts with any Person having the contractual or statutory right to demand or require such renegotiation and no such Person has made written demand for such renegotiation.

(f) Each Contract relating to the sale, design, manufacture or provision of products or services by Seller has been entered into in the Ordinary Course of Business of Seller and has been entered into without the commission of any act alone or in concert with any other Person, or any consideration having been paid or promised, that is or would be in violation of any Legal Requirement.

COMMENT

Section 3.20 requires Seller to provide a complete list of its Contracts that meet specified criteria. Representations concerning such contracts are especially important when they are a major asset of the seller. For examples of the types of contracts that may fall within the broad scope of the definition of "Seller Contract," see the Comment to Section 3.2.

A buyer may choose to require the seller to list only contracts that are "material" to its business or that were incurred other than in the ordinary course of the business. If the buyer uses this alternative, it is important to provide, within the text of the representation itself, a definition of "material." A definition of materiality typically is keyed to a threshold dollar amount relating to the seller's remaining commitment or liability under each contract.

Buyer succeeds to the rights of Seller under Contracts assigned to it under Section 2.1 and assumes the obligations of Seller under its Contracts to the extent set forth in Section 2.4. If not all of a seller's contracts are being assigned to or assumed by the buyer, the seller might be required to list only those contracts that are being assigned or assumed. Unless the listing becomes burdensome, however, it might be worthwhile to have listed all contracts that meet the specified criteria.

The portion of this representation that relates to such matters as validity, performance and absence of default is limited to those contracts that are being assigned to or assumed by the buyer. The seller may object to making a representation with respect to the performance of the other parties to its contracts or may request that this representation be qualified by knowledge.

This representation addresses the assignability of listed Contracts without Consent but not whether any listed Contract is subject to cancellation or termination at the option of a Third Party upon execution of the Model Agreement or consummation of the acquisition—that issue is covered by Section 3.2(b) and Section 7.1. This representation requires disclosure of existing or pending defaults resulting from the conduct of Seller's business rather than those caused by consummation of the acquisition.

For a discussion of the significance of the phrase "with or without notice or lapse of time" (which appears in clause (iii) of Section 3.20(d)), see the Comment to Section 3.2.

See Chapter 3, "Contracts," of the *Manual on Acquisition Review*.

3.21 INSURANCE

(a) Seller has delivered to Buyer:

(i) accurate and complete copies of all policies of insurance (and correspondence relating to coverage thereunder) to which Seller is a party or under which Seller is or has been covered at any time since _____, 19/20___, a list of which is included in Part 3.21(a);

(ii) accurate and complete copies of all pending applications by Seller for policies of insurance; and

(iii) any statement by the auditor of Seller's financial statements or any consultant or risk management advisor with regard to the adequacy of Seller's coverage or of the reserves for claims.

(b) Part 3.21(b) describes:

(i) any self-insurance arrangement by or affecting Seller, including any reserves established thereunder;

(ii) any Contract or arrangement, other than a policy of insurance, for the transfer or sharing of any risk to which Seller is a party or which involves the business of Seller; and

(iii) all obligations of Seller to provide insurance coverage to Third Parties (for example, under Leases or service agreements) and identifies the policy under which such coverage is provided.

(c) Part 3.21(c) sets forth, by year, for the current policy year and each of the ____ (____) preceding policy years:

(i) a summary of the loss experience under each policy of insurance;

(ii) a statement describing each claim under a policy of insurance for an amount in excess of _____ dollars ($_____), which sets forth:

(A) the name of the claimant;

(B) a description of the policy by insurer, type of insurance and period of coverage; and

(C) the amount and a brief description of the claim; and

(iii) a statement describing the loss experience for all claims that were self-insured, including the number and aggregate cost of such claims.

(d) Except as set forth in Part 3.21(d):

(i) all policies of insurance to which Seller is a party or that provide coverage to Seller:

(A) are valid, outstanding and enforceable;

(B) are issued by an insurer that is financially sound and reputable;

(C) taken together, provide adequate insurance coverage for the Assets and the operations of Seller [for all risks normally insured against by a Person carrying on the same business or businesses as Seller in the same location] [for all risks to which Seller is normally exposed]; and

(D) are sufficient for compliance with all Legal Requirements and Seller Contracts;

(ii) Seller has not received (A) any refusal of coverage or any notice that a defense will be afforded with reservation of rights or (B) any notice of cancellation or any other indication that any policy of insurance is no

longer in full force or effect or that the issuer of any policy of insurance is not willing or able to perform its obligations thereunder;

(iii) Seller has paid all premiums due, and has otherwise performed all of its obligations, under each policy of insurance to which it is a party or that provides coverage to Seller; and

(iv) Seller has given notice to the insurer of all claims that may be insured thereby.

COMMENT

This representation seeks information and assurances regarding the seller's insurance coverage. In addition to traditional property and casualty insurance policies, many corporations have large self-insured retentions and complicated retrospective premium programs and may participate in captive insurance company programs. A buyer needs to understand these alternative risk transfer mechanisms in evaluating the insurance program of a seller.

Because it is purchasing assets, questions can arise regarding a buyer's rights under insurance policies issued to the seller or under the buyer's own policies for claims arising from preacquisition operations of the seller. This can be particularly significant if the buyer may be subject to liability imposed by the various environmental laws or for products liability. It will therefore be important for the buyer to obtain adequate records of the seller's historic insurance coverage as well as information necessary to assess the adequacy of the coverage and the seller's quality control and safety programs.

The description in Section 2.1 of the assets to be sold specifically includes insurance benefits, including proceeds, arising from or relating to the Assets or the Assumed Liabilities prior to the Closing Date. Although standard form policies preclude assignment without the insurer's consent, there is authority to the effect that an assignment is nevertheless effective when the injury or damage takes place during the policy period. The buyer might explore seeking a partial assignment of the seller's policies or inclusion as an additional insured to these policies to eliminate any question of coverage. In order to functionally provide the buyer with access to the seller's coverage, the buyer might also require that the seller seek coverage under its policies on behalf of the buyer if it incurs defense costs and damages under the seller's indemnity obligation.

See Chapter 8, "Liability and Property Insurance," of the *Manual on Acquisition Review*.

3.22 ENVIRONMENTAL MATTERS

Except as disclosed in Part 3.22:

(a) Seller is, and at all times has been, in full compliance with, and has not been and is not in violation of or liable under, any Environmental Law. Neither Seller nor either Shareholder has any basis to expect, nor has any of them or any other Person for whose conduct they are or may be held to be responsible received, any actual or threatened order, notice or other communication from (i) any Governmental Body or private citizen acting in the public interest or (ii) the current or prior owner or operator of any Facilities, of any actual or potential violation or failure to comply with any Environmental Law, or of any actual or threatened obligation to undertake or bear the cost of any Environmental, Health and Safety Liabilities with respect to any Facility or other property or asset (whether real, personal or mixed) in which Seller has or had an interest,

or with respect to any property or Facility at or to which Hazardous Materials were generated, manufactured, refined, transferred, imported, used or processed by Seller or any other Person for whose conduct it is or may be held responsible, or from which Hazardous Materials have been transported, treated, stored, handled, transferred, disposed, recycled or received.

(b) **There are no pending or, to the Knowledge of Seller, threatened claims, Encumbrances, or other restrictions of any nature resulting from any Environmental, Health and Safety Liabilities or arising under or pursuant to any Environmental Law with respect to or affecting any Facility or any other property or asset (whether real, personal or mixed) in which Seller has or had an interest.**

(c) **Neither Seller nor either Shareholder has any Knowledge of or any basis to expect, nor has any of them, or any other Person for whose conduct they are or may be held responsible, received, any citation, directive, inquiry, notice, Order, summons, warning or other communication that relates to Hazardous Activity, Hazardous Materials, or any alleged, actual, or potential violation or failure to comply with any Environmental Law, or of any alleged, actual, or potential obligation to undertake or bear the cost of any Environmental, Health and Safety Liabilities with respect to any Facility or property or asset (whether real, personal or mixed) in which Seller has or had an interest, or with respect to any property or facility to which Hazardous Materials generated, manufactured, refined, transferred, imported, used or processed by Seller or any other Person for whose conduct it is or may be held responsible, have been transported, treated, stored, handled, transferred, disposed, recycled or received.**

(d) **Neither Seller nor any other Person for whose conduct it is or may be held responsible has any Environmental, Health and Safety Liabilities with respect to any Facility or, to the Knowledge of Seller, with respect to any other property or asset (whether real, personal or mixed) in which Seller (or any predecessor) has or had an interest or at any property geologically or hydrologically adjoining any Facility or any such other property or asset.**

(e) **There are no Hazardous Materials present on or in the Environment at any Facility or at any geologically or hydrologically adjoining property, including any Hazardous Materials contained in barrels, aboveground or underground storage tanks, landfills, land deposits, dumps, equipment (whether movable or fixed) or other containers, either temporary or permanent, and deposited or located in land, water, sumps, or any other part of the Facility or such adjoining property, or incorporated into any structure therein or thereon. Neither Seller nor any Person for whose conduct it is or may be held responsible, or to the Knowledge of Seller, any other Person, has permitted or conducted, or is aware of, any Hazardous Activity conducted with respect to any Facility or any other property or assets (whether real, personal or mixed) in which Seller has or had an interest except in full compliance with all applicable Environmental Laws.**

(f) **There has been no Release or, to the Knowledge of Seller, Threat of Release, of any Hazardous Materials at or from any Facility or at any other location where any Hazardous Materials were generated, manufactured, refined, transferred, produced, imported, used, or processed from or by any Facility, or from any other property or asset (whether real, personal or mixed) in which Seller has or had an interest, or to the Knowledge of Seller any geologically or hydrologically adjoining property, whether by Seller or any other Person.**

(g) Seller has delivered to Buyer true and complete copies and results of any reports, studies, analyses, tests, or monitoring possessed or initiated by Seller pertaining to Hazardous Materials or Hazardous Activities in, on, or under the Facilities, or concerning compliance, by Seller or any other Person for whose conduct it is or may be held responsible, with Environmental Laws.

COMMENT

The seller generally will want knowledge and materiality qualifications to environmental representations. In addition, the seller and the shareholders will often try to limit their liability to that resulting from active violations of law, as opposed to strict liability and liability for actions by predecessors and other third parties, by limiting the definitions of terms such as "Environmental Laws" and "Hazardous Materials" to a specific list of existing federal and state laws.

The "innocent-purchaser defense" is available in certain asset acquisitions. The innocent-purchaser defense is embodied in CERCLA § 107(b) (42 U.S.C. § 9607(b)) and applies where the release was caused "solely by . . . an act or omission of a third party . . . other than . . . one whose act or omission occurs in connection with a contractual relationship . . . with the defendant . . . if the defendant establishes . . . that (a) he exercised due care with respect to the hazardous substance . . . and (b) he took precautions against foreseeable acts or omissions of any such third party and the consequences" thereof.

Representations from the seller will assist the buyer in establishing one of the requirements of the defense: that he [it] did not know hazardous substances had been disposed of on, in, or at the facility. 42 U.S.C. § 9601(35)(A)(i).

The buyer may also wish to obtain an environmental site assessment pursuant to the standards promulgated by the American Society for Testing and Materials, ASTM Standards E1527 and E1528. These standards were developed for the express purpose of satisfying one of the requirements of the "innocent-landowner defense," which requires "all appropriate inquiry into the previous ownership and uses of the property consistent with good commercial or customary practice" as defined in 42 U.S.C. § 9601(35)(B).

Although the general representations in Sections 3.17 and 3.18 can incorporate environmental issues, representations concerning compliance with environmental laws are often drafted as a separate section because environmental representations are negotiated separately, and the risks and costs of failing to comply with environmental laws can be tremendous. Specific representations concerning environmental issues help the buyer define or confirm the value of the property being acquired and, together with indemnification and other provisions, offer some protection against the potentially open-ended nature of these liabilities, some of which may not be manifest upon inspection of the property. When the buyer is financing the acquisition with borrowed funds, lenders to the buyer will have their own concerns.

In addition, the buyer likely will have to make important determinations of nonapplicability of certain environmental laws. For example, the buyer may want to confirm that federal or state laws do not require environmental impact assessments of new projects (or that such assessments have been completed) or that state and federal laws relating to wetlands do not apply to the seller. An example of a representation that addresses the latter issue is as follows:

> **The Facilities do not contain any wetlands, as defined in the Clean Water Act and regulations promulgated thereunder, or similar Legal Require-**

ments, or other especially sensitive or protected areas or species of flora or fauna.

The seller may want to add a materiality qualification to the representation in Section 3.22(b). The buyer generally will want these provisions to require disclosure of all matters, without such a qualification. Among other reasons, the buyer may be or become a public company with a responsibility to make environmental disclosures that will require its understanding of all pending and threatened matters. For example, SEC Regulation S-K, Item 103 requires disclosure of a pending administrative or judicial proceeding, or one contemplated by the government, arising under environmental laws and to which the registrant or its subsidiary is a party, or to which any of their property is subject, if "such proceeding involves potential monetary sanctions, unless the registrant reasonably believes that such proceeding will result in no monetary sanctions, or in monetary sanctions, exclusive of interest and costs, of less than $100,000." Regulation S-K, Item 103, Instruction 5, at C, 17 C.F.R. § 229.103. Obviously, the registrant must have the information necessary to make such an assessment, and the buyer will want to be aware of these issues prior to the closing.

Statutes such as CERCLA and similar state statutes, which are the primary basis for environmental liability, impose strict and retroactive liability. Consequently, the buyer will not want to limit the representations in Section 3.22(c) to violations of the environmental laws but will want to have the seller represent that there are no past or present actions or conditions that could form the basis of an environmental claim. This representation is included in the first sentence of subsection (c).

The representations in Section 3.22(c) also cover persons and entities for whose conduct Seller is or may be liable. An important issue for a buyer, especially in the acquisition of an entire business, is potential liability relating to the seller's predecessors and subsidiaries, if any, to properties it no longer owns or businesses it no longer operates (such as divisions that have been spun off) and to prior agreements to indemnify and assume environmental liabilities. Consequently, the representations include any person or entity whose liability for any environmental claim the seller has retained or assumed, either contractually or by law.

The seller may want to limit the broad scope of the potential sources of communications of possible liability to governmental agencies or property owners by inserting the following phrase after the word "communication": "from (x) any Governmental Body, including those administering or enforcing any Environmental Law, or (y) the owner of any real property or other facility."

The final portion of the representation in Section 3.22(c) addresses off-site locations to account for liabilities that arise under CERCLA and analogous state statutes even if the seller has taken all actions in a lawful manner. The seller likely will attempt to exclude this language or include a knowledge qualification because it is difficult for the seller to know about such situations even if it has undertaken extensive investigation. Thus, this representation is in part a risk allocation mechanism.

The seller will likely object to the representations in Section 3.22(e) because of the broad definitions of Hazardous Materials and an unwillingness to make representations concerning prior owners or adjoining property.

The buyer should be aware of any relevant information already in possession of the seller. Such information enables the buyer, if a public company, to anticipate environmental disclosure issues, including cost estimates.

Although there is much debate as to the existence of a privilege for information obtained during self-assessments of environmental, health, and safety policies, procedures and compliance issues, such a privilege does not protect information, the disclosure of which is necessary for the seller to avoid making false representations to a buyer.

Many states, however, have provisions that protect memoranda and documents that discuss an environmental self-assessment. Arguably, in a jurisdiction that extends the privilege as such, a party could assert that disclosure to a potential buyer should be covered by the privilege as a part of the critical self-assessment.

Another means of protection of the information is to consider the assessment as property of the business. The transfer of the assets of the business itself may allow transfer of the protection of the information to the buyer. On the other hand, many jurisdictions have attempted to limit the use of the privilege for policy reasons and may not embrace the concept of transferring the privilege.

To the extent a privilege otherwise exists, the buyer and the seller may wish to enter into a separate confidentiality agreement to attempt to protect the information disclosed to the buyer by the seller from necessary further disclosure to third parties. The effect of such an agreement may vary by jurisdiction.

Overall, when considering disclosure of information from a critical self-assessment, or a part thereof, it is vital to evaluate the law of the state where the transaction may take place. Understanding the overall policy factors considered most important in the state is essential to providing adequate advice on the business transaction in which a critical self-assessment may be at risk of disclosure.

See Chapter 9, "Environmental Laws, " of the *Manual on Acquisition Review*.

3.23 EMPLOYEES

(a) Part 3.23(a) contains a complete and accurate list of the following information for each employee, director, independent contractor, consultant and agent of Seller, including each employee on leave of absence or layoff status: employer; name; job title; date of hiring or engagement; date of commencement of employment or engagement; current compensation paid or payable and any change in compensation since _____, 19/20___; sick and vacation leave that is accrued but unused; and service credited for purposes of vesting and eligibility to participate under any Employee Plan, or any other employee or director benefit plan.

(b) Part 3.23(b) contains a complete and accurate list of the following information for each retired employee or director of Seller, or their dependents, receiving benefits or scheduled to receive benefits in the future: name; pension benefits; pension option election; retiree medical insurance coverage; retiree life insurance coverage; and other benefits.

(c) Part 3.23(c) states the number of employees terminated by Seller since _____, 19/20___, and contains a complete and accurate list of the following information for each employee of Seller who has been terminated or laid off, or whose hours of work have been reduced by more than fifty percent (50%) by Seller, in the six (6) months prior to the date of this Agreement: (i) the date of such termination, layoff or reduction in hours; (ii) the reason for such termination, layoff or reduction in hours; and (iii) the location to which the employee was assigned.

(d) Seller has not violated the Worker Adjustment and Retraining Notification Act (the "WARN Act") or any similar state or local Legal Requirement. During the ninety (90) day period prior to the date of this Agreement, Seller has terminated _____ (_____) employees.

(e) To the Knowledge of Seller, no officer, director, agent, employee, consultant, or contractor of Seller is bound by any Contract that purports to limit the ability of such officer, director, agent, employee, consultant, or contractor (i) to engage

in or continue or perform any conduct, activity, duties or practice relating to the business of Seller or (ii) to assign to Seller or to any other Person any rights to any invention, improvement, or discovery. No former or current employee of Seller is a party to, or is otherwise bound by, any Contract that in any way adversely affected, affects, or will affect the ability of Seller or Buyer to conduct the business as heretofore carried on by Seller.

COMMENT

The employment relationship between an employee and employer generally is on an "at-will" basis, that is, it can be terminated at any time without notice by either party for any reason or for no reason. The nature and obligation of that relationship can change, however, if the parties have entered into an employment contract for a fixed period of time or if the employee is covered by a collective bargaining agreement with a union. Furthermore, in some states, an employment contract can be implied from personnel policies or employee handbooks. In addition, most states have carved out statutory and judicial exceptions to the employment-at-will doctrine, including public policy exceptions. The buyer may therefore wish to review applicable state law to determine its effect on the employment-at-will relationship.

The buyer should also learn about the seller's employment agreements, benefit arrangements, and pension and insurance obligations. For example, an existing severance pay plan or practice may be construed to entitle employees who become employees of the buyer to vacation and severance pay due to the termination of their employment with the seller upon the closing of the acquisition. In addition, the seller may have extensive retiree medical insurance liability or unsatisfied obligations to pay pension or welfare plan payments, which may become the obligation of the buyer by operation of law. The buyer may wish to consider whether state statutes accelerate employees' entitlement to vacation pay or other benefits.

The Fact Pattern indicates that the number of Seller's employees who will not be hired may be sufficient to trigger the WARN Act. The WARN Act generally requires that a "covered employer" provide sixty days advance notice of a "plant closing" or "mass layoff" to affected employees, bargaining representatives, and local government officials. A "covered employer" under the WARN Act is an employer with (a) 100 or more employees (excluding part-time employees) or (b) 100 or more employees (whether or not part-time) who, in the aggregate, work at least 4,000 hours per week (excluding overtime hours). 29 U.S.C. § 2101(a)(1). The WARN Act defines part-time employees as those employees who are employed for an average of fewer than twenty hours per week or who have been employed fewer than six of the twelve months preceding the date on which notice is required. 29 U.S.C. § 2101(a)(8).

The WARN Act requires that a covered employer provide this advance notice of a "plant closing" in which fifty or more full-time employees experience an "employment loss" during any thirty-day period. A "plant closing" is a temporary or permanent shutdown of a single site of employment or one or more facilities or operating units within a single site of employment. An "employment loss" includes: (a) a termination of employment other than a discharge for cause or a voluntary departure or retirement, (b) a layoff exceeding six months, and (c) reductions of more than fifty percent of an employee's working hours during each month of a six-month period. The WARN Act also requires that a covered employer provide this advance notice of a "mass layoff." A mass layoff includes situations in which: (1) at least one-third of the full time employees at a single site during any thirty-day period experience an employment loss where at least fifty full time employees are laid off; and (2) at least 500 employees at a single site during any thirty-day period experience an employment loss. 29 U.S.C. §§ 2101(a)(2)-(3).

The WARN Act contains a somewhat vague provision relating to the sale of a business, providing, generally, that a seller is responsible for providing notices up to and including the effective date of the sale and that the buyer is responsible for giving notices thereafter. 29 U.S.C. § 2101(b)(1). (See the Comment to Section 7.11). Despite that provision, however, potential problems for a buyer may arise when the seller, prior to the effective date of the sale, has laid off a number of employees insufficient to trigger the WARN Act but that, when combined with the number of employees laid off by the buyer, results in a sufficient number to trigger WARN Act obligations with respect to employees laid off by the seller (as well as the buyer). For this reason, the buyer should be aware of all employees of seller who have suffered an employment loss within ninety days prior to the closing date and should seek indemnification for actions of the seller that may trigger (or contribute to the triggering of) WARN Act liability. The buyer should recognize, of course, that a request for indemnification from the seller may result in a request by the seller to the buyer for reciprocal indemnification.

Many states, and some local governments, have enacted similar statutes relating to plant closings and mass layoffs, and buyers should be aware of potentially applicable statutes. Such states include: Connecticut, Hawaii, Kansas, Maine, Maryland, Massachusetts, Michigan, Minnesota, Montana, Oregon, South Carolina, Tennessee, and Wisconsin.

See Chapter 11, "Labor and Employment Matters," of the *Manual on Acquisition Review*.

3.24 LABOR DISPUTES; COMPLIANCE

(a) Seller has complied in all respects with all Legal Requirements relating to employment practices, terms and conditions of employment, equal employment opportunity, nondiscrimination, immigration, wages, hours, benefits, collective bargaining and other requirements under [name of statute], the payment of social security and similar Taxes and occupational safety and health. Seller is not liable for the payment of any Taxes, fines, penalties, or other amounts, however designated, for failure to comply with any of the foregoing Legal Requirements.

(b) Except as disclosed in Part 3.24(b), (i) Seller has not been, and is not now, a party to any collective bargaining agreement or other labor contract; (ii) since _____, 19/20__, there has not been, there is not presently pending or existing, and to Seller's Knowledge there is not threatened, any strike, slowdown, picketing, work stoppage or employee grievance process involving Seller; (iii) to Seller's Knowledge no event has occurred or circumstance exists that could provide the basis for any work stoppage or other labor dispute; (iv) there is not pending or, to Seller's Knowledge, threatened against or affecting Seller any Proceeding relating to the alleged violation of any Legal Requirement pertaining to labor relations or employment matters, including any charge or complaint filed with the National Labor Relations Board or any comparable Governmental Body, and there is no organizational activity or other labor dispute against or affecting Seller or the Facilities; (v) no application or petition for an election of or for certification of a collective bargaining agent is pending; (vi) no grievance or arbitration Proceeding exists that might have an adverse effect upon Seller or the conduct of its business; (vii) there is no lockout of any employees

by Seller, and no such action is contemplated by Seller; and (viii) to Seller's Knowledge there has been no charge of discrimination filed against or threatened against Seller with the Equal Employment Opportunity Commission or similar Governmental Body.

COMMENT

The degree of detail of the representations concerning labor relations and compliance with labor and employment laws will vary depending upon the nature and extent of the seller's business. If the seller operates in a foreign nation, the buyer should include specific representations concerning compliance with the labor and employment laws and practices of the applicable foreign jurisdictions.

The courts and the National Labor Relations Board (NLRB) have defined the duties of employers who acquire businesses that are organized by labor unions. The form of the transaction is not alone determinative of the buyer's labor obligations. Even in an asset purchase, the new employer may be a "successor" under labor law principles.

When a buyer uses substantially the same facilities and work force to produce the same basic products (or to provide the same basic services) for essentially the same customers in the same geographic area, the buyer may be regarded as a "successor." A successor must recognize the union that represented the predecessor's employees as its employees' bargaining representative and, upon demand, negotiate in good faith as to the terms and conditions of employment of its employees.

The key factor in determining whether a buyer has a duty to bargain is whether a majority of the employees hired by the buyer were previously represented by the union. This rule applies as to each group of employees (bargaining unit) that was represented. Thus, when a seller's employees are represented by more than one union, the buyer must recognize and bargain with the unions to the extent that a majority of the buyer's employees in each bargaining unit was previously represented by a union.

A buyer is free to select its own work force. A buyer may not, however, discriminatorily refuse to hire the employees of the seller, either because of their union membership or because of the buyer's desire to avoid having to recognize the union.

A buyer that is not a "successor" is ordinarily free to set initial terms on which it will hire the employees of the seller. When it is perfectly clear that the buyer plans to retain all of the employees in a bargaining unit, however, the buyer may be required to bargain in good faith with the union before terms are set. In other situations, it may not be clear until the buyer has hired a full complement of employees that the buyer has a duty to bargain because it will not be clear until then that the bargaining representative represents a majority of the employees in the union.

A buyer is not required to adopt the terms of the collective bargaining agreement between the seller and the union, unless the transaction is deemed a sham transfer, designed to avoid contractual obligations. The buyer's bargaining obligation is limited to negotiating with the union in good faith to impasse or until agreement is reached as to all terms and conditions of employment.

The buyer's counsel should, however, obtain copies of any collective bargaining agreement at an early stage in the negotiations to ascertain its expiration date and whether it contains a successors and assigns clause. If there is such a clause, the union (if it learns of the transaction in time) may be able to get the acquisition enjoined unless the buyer satisfies the collective bargaining agreement. Local Lodge No. 1266, IAM v. Panoramic Corp., 668 F. 2d 276 (7th Cir. 1981).

Some states have special labor relations agencies. For example, in California, the Agricultural Labor Relations Board acts pursuant to the Agricultural Labor Relations Act. This Act was patterned after the National Labor Relations Act (NLRA) but, in prior

years, was enforced in a manner much more favorable to unions than is enforcement of the NLRA. If the seller's business falls within the jurisdictional reach of such a statute, the buyer should obtain a complete understanding of the statutory scheme not only to frame appropriate representations but also to understand how the statutory framework will affect its conduct of the business following the acquisition.

Section 3.24 states, in effect, that there have been no proceedings instituted in respect of an employee grievance. Virtually all collective bargaining agreements, as well as the nonunion employment policies and practices of many companies, provide procedures for handling employee grievances. The information is often almost meaningless to the buyer. The buyer should obtain an understanding of the seller's grievance procedures and collective bargaining agreements in order to define the level of significance to which grievances must rise before disclosure is required. The buyer should be aware, however, that a large number of pending grievance proceedings, immaterial in the single case, could be symptomatic of deeper problems with the employment relations of the seller.

The buyer should also consider any potential liability for the seller's failure to comply with state, federal and local employment discrimination laws. In particular, the buyer should require disclosure of any pending or potential discrimination charges or complaints that might arise from the seller's actions. Most federal employment discrimination laws prohibit employers with fifteen or more employees from discriminating against employees in protected categories, including, race, sex, age, disability, religion and national origin. Many states have enacted similar employment discrimination laws.

It is important for the buyer to determine whether there are any wrongful discharge or other pending claims under the NLRA or employment discrimination statutes and evaluate those claims as part of due diligence. In *Golden State Bottling Co. v. NLRB,* 414 U.S. 168 (1973), the Supreme Court held that an employer who acquires substantial assets of a predecessor and who continues, without interruption or substantial change, the predecessor's business operations, and who has notice of an unfair labor practice charge at the time of acquisition, can be required to remedy the predecessor's unfair labor practice. Similar successorship concepts have also been applied in some employment discrimination cases, especially where the successor employer has notice of the pending discrimination claim, the predecessor is insolvent, and the business continues in operation despite a change in ownership.

See Chapter 11, "Labor and Employment Matters," of the *Manual on Acquisition Review*.

3.25 INTELLECTUAL PROPERTY ASSETS

(a) The term "Intellectual Property Assets" means all intellectual property owned or licensed (as licensor or licensee) by Seller in which Seller has a proprietary interest, including:

- **(i) Seller's name, all assumed fictional business names, trade names, registered and unregistered trademarks, service marks and applications (collectively, "Marks");**
- **(ii) all patents, patent applications and inventions and discoveries that may be patentable (collectively, "Patents");**
- **(iii) all registered and unregistered copyrights in both published works and unpublished works (collectively, "Copyrights");**
- **(iv) all rights in mask works;**
- **(v) all know-how, trade secrets, confidential or proprietary information, customer lists, Software, technical information, data, process technology,**

plans, drawings and blue prints (collectively, "Trade Secrets"); and

(vi) all rights in internet web sites and internet domain names presently used by Seller (collectively "Net Names").

(b) Part 3.25(b) contains a complete and accurate list and summary description, including any royalties paid or received by Seller, and Seller has delivered to Buyer accurate and complete copies, of all Seller Contracts relating to the Intellectual Property Assets, except for any license implied by the sale of a product and perpetual, paid-up licenses for commonly available Software programs with a value of less than $_____ under which Seller is the licensee. There are no outstanding and, to Seller's Knowledge, no threatened disputes or disagreements with respect to any such Contract.

(c) (i) Except as set forth in Part 3.25(c), the Intellectual Property Assets are all those necessary for the operation of Seller's business as it is currently conducted. Seller is the owner or licensee of all right, title and interest in and to each of the Intellectual Property Assets, free and clear of all Encumbrances, and has the right to use without payment to a Third Party all of the Intellectual Property Assets, other than in respect of licenses listed in Part 3.25(c).

(ii) Except as set forth in Part 3.25(c), all former and current employees of Seller have executed written Contracts with Seller that assign to Seller all rights to any inventions, improvements, discoveries or information relating to the business of Seller.

(d) (i) Part 3.25(d) contains a complete and accurate list and summary description of all Patents.

(ii) All of the issued Patents are currently in compliance with formal legal requirements (including payment of filing, examination and maintenance fees and proofs of working or use), are valid and enforceable, and are not subject to any maintenance fees or taxes or actions falling due within ninety (90) days after the Closing Date.

(iii) No Patent has been or is now involved in any interference, reissue, reexamination, or opposition Proceeding. To Seller's Knowledge, there is no potentially interfering patent or patent application of any Third Party.

(iv) Except as set forth in Part 3.25 (d), (A) no Patent is infringed or, to Seller's Knowledge, has been challenged or threatened in any way and (B) none of the products manufactured or sold, nor any process or know-how used, by Seller infringes or is alleged to infringe any patent or other proprietary right of any other Person.

(v) All products made, used or sold under the Patents have been marked with the proper patent notice.

(e) (i) Part 3.25(e) contains a complete and accurate list and summary description of all Marks.

(ii) All Marks have been registered with the United States Patent and Trademark Office, are currently in compliance with all formal Legal Requirements (including the timely post-registration filing of affidavits of use and incontestability and renewal applications), are valid and enforceable and are not subject to any maintenance fees or taxes or actions falling due within ninety (90) days after the Closing Date.

(iii) No Mark has been or is now involved in any opposition, invalidation or cancellation Proceeding and, to Seller's Knowledge, no such action is threatened with respect to any of the Marks.

(iv) To Seller's Knowledge, there is no potentially interfering trademark or trademark application of any other Person.

(v) No Mark is infringed or, to Seller's Knowledge, has been challenged or threatened in any way. None of the Marks used by Seller infringes or is alleged to infringe any trade name, trademark or service mark of any other Person.

(vi) All products and materials containing a Mark bear the proper federal registration notice where permitted by law.

(f) (i) Part 3.25(f) contains a complete and accurate list and summary description of all Copyrights.

(ii) All of the registered Copyrights are currently in compliance with formal Legal Requirements, are valid and enforceable, and are not subject to any maintenance fees or taxes or actions falling due within ninety (90) days after the date of Closing.

(iii) No Copyright is infringed or, to Seller's Knowledge, has been challenged or threatened in any way. None of the subject matter of any of the Copyrights infringes or is alleged to infringe any copyright of any Third Party or is a derivative work based upon the work of any other Person.

(iv) All works encompassed by the Copyrights have been marked with the proper copyright notice.

(g) (i) With respect to each Trade Secret, the documentation relating to such Trade Secret is current, accurate and sufficient in detail and content to identify and explain it and to allow its full and proper use without reliance on the knowledge or memory of any individual.

(ii) Seller has taken all reasonable precautions to protect the secrecy, confidentiality and value of all Trade Secrets (including the enforcement by Seller of a policy requiring each employee or contractor to execute proprietary information and confidentiality agreements substantially in Seller's standard form, and all current and former employees and contractors of Seller have executed such an agreement).

(iii) Seller has good title to and an absolute right to use the Trade Secrets. The Trade Secrets are not part of the public knowledge or literature and, to Seller's Knowledge, have not been used, divulged or appropriated either for the benefit of any Person (other than Seller) or to the detriment of Seller. No Trade Secret is subject to any adverse claim or has been challenged or threatened in any way or infringes any intellectual property right of any other Person.

(h) (i) Part 3.25(h) contains a complete and accurate list and summary description of all Net Names.

(ii) All Net Names have been registered in the name of Seller and are in compliance with all formal Legal Requirements.

(iii) No Net Name has been or is now involved in any dispute, opposition, invalidation or cancellation Proceeding and, to Seller's Knowledge, no such action is threatened with respect to any Net Name.

(iv) To Seller's Knowledge, there is no domain name application pending of any other person which would or would potentially interfere with or infringe any Net Name.

(v) No Net Name is infringed or, to Seller's Knowledge, has been challenged, interfered with or threatened in any way. No Net Name infringes, interferes with or is alleged to interfere with or infringe the trademark, copyright or domain name of any other Person.

COMMENT

The definition of "Intellectual Property Assets" encompasses all forms of intellectual property, including the forms expressly identified.

The representation in Section 3.25(b) requires Seller to list license agreements and other agreements that relate to the Intellectual Property Assets, such as a covenant not to sue in connection with a Patent, a noncompetition agreement, a confidentiality agreement, a maintenance and support agreement for any Software Seller is licensed to use or an agreement to sell or license a particular asset. Disclosure of such agreements enables a buyer to identify which of the Intellectual Property Assets are subject to a license or other restriction and to determine whether the seller has the exclusive right to practice certain technology.

If there is a general representation that all of the seller's contracts are valid and binding and in full force and effect and that neither party is in default (see Section 3.20), a separate representation is not needed in this section. If there is not a general representation on contracts, or if it is limited in some way, the buyer should consider including such a representation in this section, especially if the seller licenses intellectual property that is important to its business.

A seller may object to the representation called for in clause (i) of Section 3.25(c) as too subjective and try to force the buyer to draw its own conclusion as to whether the seller's intellectual property assets are sufficient to operate its business.

Whether a buyer will want to include the representations in Sections 3.25(d)–(h) depends upon the existence and importance of the various types of intellectual property assets in a particular transaction. For example, patents and trade secrets can be the key asset of a technology-driven manufacturing company, whereas trademarks and copyrights could be the principal asset of a service company. Below are descriptions of the main categories of intellectual property and how they are treated in the Model Agreement.

Patents. There are three types of United States patents. A "utility patent" may be granted under 35 U.S.C. § 101 for "any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof." Patents also may be granted under Chapter 15, 35 U.S.C. §§ 161–164 (a "plant patent") for new varieties of plants (other than tuber or plants found in an uncultivated state). Finally, a patent may be granted under Chapter 16, 35 U.S.C. §§ 171–173 (a "design patent") for a new, original and ornamental design for an article of manufacture.

In the United States, the patenting process begins with the filing of a patent application in the Patent and Trademark Office (PTO). Except under certain limited conditions, the inventor (or the inventor's patent attorney) must file the application. A patent application or a patent may be assigned by the owner, whether the owner is the inventor or a subsequent assignee.

The term "patent" as used in the definition of "Intellectual Property Assets" includes utility, plant and design patents as well as pending patent applications and patents granted by the United States and foreign jurisdictions and also includes inventions and discoveries that may be patentable.

Section 3.25(d) requires disclosure of information that will enable the buyer to determine whether the seller has patents for the technology used in its businesses and how long any such patents will remain in force; it will also enable the buyer to do its own validity and infringement searches, which the buyer should do if the seller's representations are subject to a knowledge qualification or if the patents are essential to the buyer.

The buyer should seek assurances that the seller's patents are valid. For a patent to be valid, the invention or discovery must be "useful " and "novel" and must not be "obvious." Very few inventions are not "useful;" well-known examples of inventions that are not "useful" are perpetual motion machines and illegal devices (such as drug paraphernalia). In order to qualify as "novel," the invention must be new; a patent cannot be granted for an invention already made by another person, even if the person seeking the patent made the invention independently. An invention is "obvious" if the differences between the invention sought to be patented and the prior art are such that the subject matter of the invention as a whole would have been obvious at the time the invention was made to a person having ordinary skill in the art to which the subject matter pertains.

To determine conclusively that an invention is not "obvious" requires knowledge of all prior art. It is difficult even to identify all prior art relevant to the invention, much less to make judgments about what would have been obvious to a person having reasonable skill in such art. Thus, although the seller may, in good faith, believe that its patents are valid, those patents are subject to challenge at any time. If someone can establish that the invention covered by a patent does not meet these three criteria, the patent will be invalid. Because of the difficulty in conclusively determining the validity of a patent, the seller will want to add a knowledge qualification to the representation concerning validity. Whether the buyer agrees to such a qualification is a question of risk allocation.

If the buyer agrees to a knowledge qualification, it may want to conduct a patent search in the PTO (and, if appropriate, the European Patent Office and other foreign patent offices) to identify all prior art and obtain a validity opinion. However, such searches and analysis of their results can be costly and take time.

The buyer should ensure that the terms of the seller's patents have not expired and that all necessary maintenance fees have been paid. In general, the term of a utility or plant patent is twenty years from the date of application. Special rules apply to patents in force on or applications filed before June 8, 1995. Patents that were in force on June 8, 1995, and patents issued on applications filed before that date have a term equal to the longer of seventeen years from the date of grant or twenty years from the date of application. The term of a design patent is fourteen years from the date of grant. Maintenance fees on utility patents must be paid during the six-month period beginning on the third, seventh and eleventh anniversary of the date of grant. Maintenance fees need not be paid on plant patents or design patents.

In many states, an invention made by an employee is not necessarily the property of the employer. The buyer should verify, therefore, that the seller has perfected title to all patents or patent applications for inventions made by its employees. In addition, the seller should have written agreements with its employees providing that all inventions, patent applications and patents awarded to employees will be transferred to the seller to the full extent permissible under state law.

A United States patent has no extraterritorial effect, that is, a United States patent provides the patent owner the right to exclude others from making, using or selling the invention only in the United States. Thus, the owner of a United States patent can prevent others from making the patented invention outside the United States and shipping it to a customer in the United States and from making the invention in the United

States and shipping it to a customer outside the United States. The patent owner cannot, however, prevent another from making the invention outside the United States and shipping it to a customer also outside the United Sates. If the seller has extensive foreign business, the buyer should seek assurances that important foreign markets are protected to the greatest extent possible under the intellectual property laws of the applicable foreign jurisdictions. Special rules apply in the case of foreign patents. If there are extensive foreign patents and patent applications pending, the buyer's due diligence may become quite involved and time consuming. If foreign patents represent significant assets, reliance on the representations of the seller (in lieu of extensive buyer due diligence) alone may be seriously misplaced.

The buyer should seek assurances that the seller's patents are enforceable. Failure to disclose to the PTO relevant information material to the examination of a patent application can result in the patent being unenforceable. In addition, misuse of a patent (for example, use that results in an antitrust violation) can result in the patent being unenforceable. Finally, because patent rights vary in each jurisdiction, representations concerning enforceability require the seller to confirm the enforceability of foreign patents separately in each jurisdiction.

The grant of a patent does not provide any assurance that using the invention will not infringe another person's patent. A patent could be granted, for example, for an improvement to a previously patented device, but the practice of the improvement might infringe the claims of the earlier patent on the device. A patent confers no rights of any kind to make, use or sell the invention; it grants the inventor only the right to exclude others. Therefore, the buyer should seek assurances that it can use the inventions covered by the seller's patents. The buyer may conduct a patent search in the PTO and obtain an infringement opinion as a step in the process of determining whether certain technology owned (or licensed) by the seller infringes any United States patents. In addition, the buyer may conduct a "right to practice examination" for expired patents covering inventions that have passed into the public domain.

The seller may want to add a knowledge qualification to the entire representation in clause (iv) of Section 3.25(d) because it cannot verify that no one else in the world is practicing the technology covered by the seller's patent. Whether the buyer accepts such a qualification is a question of risk allocation.

Without proper marking of the patented product or the product made using a patented process, damages cannot be collected for infringement of the patent.

Trademarks. A trademark is a word, name, symbol or slogan used in association with the sale of goods or the provision of services. Generally, all trademarks are created under the common law through use of the mark in offering and selling goods or services. A trademark that is not registered is commonly referred to as an "unregistered mark" or a "common law mark." The term "trademark" as used in the definition of "Intellectual Property Assets" includes both registered and unregistered marks. If the seller has many unregistered trademarks, it may want to limit the definition to registered trademarks. The buyer should insist that the definition include any unregistered trademarks that the buyer identifies as important and that all goodwill associated with these trademarks is transferred to the buyer.

The owner of a trademark can prevent others from using infringing marks and, in some instances, can recover damages for such infringement.

Although trademark registration systems are maintained at both the state and federal levels, trademarks need not be registered at either level. State registrations are of little value to businesses that operate in more than one state or whose market is defined by customers from more than one state.

Two of the major benefits of registration at the federal level are "constructive use" and "constructive notice." The owner of a federal registration is deemed to have used

the mark in connection with the goods or services recited in the registration on a nationwide basis as of the filing date of the application. Therefore, any other person who first began using the mark after the trademark owner filed the application is an infringer regardless of the geographic areas in which the trademark owner and the infringer use their marks. Federal registration also provides constructive notice to the public of the registration of the mark as of the date of issuance of the registration. Because of the importance of federal registration, the representations in Section 3.25(e)(ii) require Seller to ensure that it has obtained federal registration of its trademarks.

An application for federal registration of a trademark is filed in the PTO. The PTO maintains two trademark registers: the Principal Register and the Supplemental Register. The Supplemental Register is generally for marks that cannot be registered on the Principal Register. The Supplemental Register does not provide the trademark owner the same rights as those provided by the Principal Register, and it provides no rights in addition to those provided by the Principal Register. The buyer should determine whether the seller's trademarks are on the Principal Register or the Supplemental Register. If the buyer learns that an important mark is on the Supplemental Register, the buyer should find out why it was not registered on the Principal Register. If the mark cannot be registered on the Principal Register, the buyer should consult trademark counsel to determine the scope of protection for the mark.

After a trademark has been registered with the PTO, the owner should file two affidavits to protect its rights. An affidavit of "incontestability" may be filed within the sixth year of registration of a mark to strengthen the registration by marking it "incontestable." An affidavit of "continuing use" must be filed with the PTO during the sixth year of registration; otherwise, the PTO will automatically cancel the registration at the end of the sixth year. Cancellation of a registration (or abandonment of an application) does not necessarily mean that the trademark owner has abandoned the mark and no longer has rights in the mark; proving abandonment of a mark requires more than merely showing that an application has been abandoned or that a registration has been canceled. Nevertheless, because of the benefits of federal registration, the representations in Section 3.25(e)(ii) require the seller to have timely filed continuing-use affidavits (as well as incontestability affidavits, which are often combined with continuing-use affidavits) for all of the seller's trademarks.

The buyer should verify that the terms of the seller's federal registrations have not expired. Federal registrations issued on or after November 16, 1989, have a term of ten years; registrations issued prior to that date have a term of twenty years. All federal registrations may be renewed if the mark is still in use when the renewal application is filed. Registrations expiring on or after November 16, 1989, may be renewed for a term of ten years. A registration that was renewed before November 16, 1989, has a renewal term of twenty years. Registrations may be renewed repeatedly. An application for renewal must be filed within the six-month period immediately preceding the expiration of the current term (whether an original or renewal term).

A trademark that is not registered is commonly referred to as an "unregistered mark" or a "common law mark." Generally, the owner of a common law mark can prevent others from using a confusingly similar mark only in the trademark owner's "trading area." Thus, the owner of a common law mark may find, upon expanding use of the mark outside that area, that another has established superior rights there and can stop the trademark owner's expansion. If the buyer plans to expand the seller's business into new geographic markets, it should verify that all of the seller's important trademarks have been registered at the federal level.

Rights in a trademark can be lost through nonuse or through nonauthorized use by others. In an extreme example of the latter, long use of a mark by the public to refer

to the type of goods marketed by the trademark owner and its competitors can inject the trademark into the public domain. Therefore, the buyer should determine whether the seller is using the marks that are of primary interest to the buyer and whether any others using those marks for similar goods or services are doing so under a formal license agreement.

The trademark owner must ensure a certain level of quality of the goods or services sold with the mark. A license agreement, thus, must provide the licensor with the right to "police" the quality of the goods or services sold with the mark. The licensor must actually exercise this right because failure to do so works an abandonment of the mark by the licensor. Similarly, an assignment of a mark without an assignment of the assignor's "goodwill" associated with the mark constitutes an abandonment of the mark.

Because the representation in Section 3.25 (e)(iv) is qualified by the seller's knowledge, the buyer may want to conduct a trademark search to ensure that there are no potentially interfering trademarks or trademark applications. Several search firms can do a trademark search; limited searching can also be done through databases. A trademark search and analysis of the results should be much less costly than a patent search and analysis.

A mark need not be identical to another mark or be used with the same goods or services of the other mark to constitute an infringement. Rather, a mark infringes another mark if it is confusingly similar to it. Several factors are examined to determine whether two marks are confusingly similar, including the visual and phonetic similarities between the marks, the similarities between the goods or services with which the marks are used, the nature of the markets for the goods or services, the trade channels through which the goods or services flow to reach the markets and the media in which the goods or services are advertised. As with patents, the seller may want to add a knowledge qualification to all of the representations in Section 3.25(e)(v) because of the difficulty in conclusively determining that no other person is infringing the seller's trademarks and that the seller's marks do not infringe other trademarks.

Copyrights. 17 U.S.C. § 102(a) provides that "[C]opyright protection subsists . . . in original works of authorship fixed in any tangible medium of expression . . . from which they can be perceived, reproduced, or otherwise communicated." Works of authorship that can be protected by copyright include literary works, musical works, dramatic works, pantomimes and choreographic works, pictorial, graphic and sculptural works, motion pictures and other audiovisual works, architectural works and sound recordings. *See* 17 U.S.C. § 102(a)(1)–(8). Computer software is considered a "literary work" and can be protected by copyright. Ideas, procedures, processes, systems, methods of operation, concepts, principles and discoveries cannot be copyrighted. *See* 17 U.S.C. § 102(b). The copyright in a work subsists at the moment of creation by the author—registration of the copyright with the U.S. Copyright Office is not necessary. The term "copyright" as used in the definition of "Intellectual Property Assets" includes all copyrights, whether or not registered.

Section 3.25(c) provides assurances to Buyer that Seller actually has title to the Copyrights for works used in Seller's business. Such assurances are important because the copyright in a work vests originally in the "author," who is the person who created the work unless the work is a "work made for hire." *See* 17 U.S.C. § 201(a)–(b). A work can be a "work made for hire" in two circumstances: (a) when it is created by an employee in the course of employment or (b) when it is created pursuant to a written agreement that states that the work will be a work made for hire, and the work is of a type listed in 17 U.S.C. § 101 under the definition of "work made for hire."

Although rights in a copyright may be assigned or licensed in writing, the transfer of copyrights in a work (other than a "work made for hire") may be terminated under the conditions described in 17 U.S.C. § 203. If a seller owns copyrights by assignment

or license, the buyer should ensure that the copyrights cannot be terminated or at least that such termination would not be damaging to the buyer.

The buyer should verify that the terms of the seller's copyrights have not expired. The term of a copyright is as follows:

(a) For works created on or after January 1, 1978, the life of the author plus seventy years after the author's death.
(b) For joint works created by two or more authors "who did not work for hire," the life of the last surviving author plus seventy years after the death of the last surviving author.
(c) For anonymous works, pseudonymous works and works made for hire, ninety-five years from the date of first publication or 120 years from the year of creation of the work, whichever expires first.

Although it is not necessary to register a copyright with the U.S. Copyright Office for the copyright to be valid, benefits (such as the right to obtain statutory damages, attorneys' fees and costs) may be obtained in a successful copyright infringement action if the copyright in the work has been registered and a notice of copyright has been placed on the work. Indeed, registration is a prerequisite to bringing an infringement suit with respect to U.S. works and foreign works not covered by the Berne Convention.

Due to the broad range of items that could be subject to copyrights, depending upon the nature of the seller's business, it may be appropriate to limit the representations in Section 3.25(f) to copyrighted works that are "material" to the seller's business.

As with patents and trademarks, the seller may want to add a knowledge qualification to all of the representations in Section 3.25(f)(iii) because of the difficulty in conclusively determining that no other person is infringing the sellers' copyrights and that the seller does not infringe other copyrights (such determinations would require, among other things, judgments regarding whether another person and the seller or its employees independently created the same work and whether the allegedly infringing party is making "fair use" of the copyrighted material). Again, whether the buyer accepts such a qualification is a question of risk allocation.

Trade Secrets. Trade secret protection traditionally arose under common law, which remains an important source of that protection. Now, however, a majority of the states have adopted some version of the Uniform Trade Secrets Act, which defines and protects trade secrets. Moreover, the misappropriation of trademarks is punishable as a federal crime under the Economic Espionage Act of 1996, PUB. L. 104-294, Oct. 11, 1996, 110 Stat. 3488. (18 U.S.C. §§ 1831–39). Trade secrets need not be technical information—they can include customer lists, recipes or anything of value to a company, provided that it is secret, substantial and valuable. One common type of trade secret is "know-how": a body of information that is valuable to a business and is not generally known outside the business. The term "trade secret" as used in the definition of "Intellectual Property Assets" includes both common law and statutory trade secrets of all types, including know-how.

As part of the disclosure required by Section 3.25(g)(i), the buyer may want a list of all of the seller's trade secrets and the location of each document that contains a description of the trade secret. Although a trade secret inventory would assist the parties in identifying the trade secrets that are part of the acquisition, it may be difficult or impossible to create a trade secret inventory, especially if the seller is retaining certain parts of its business. The buyer could ask the seller to identify key trade secrets, which would enable the buyer to determine whether information regarded by the buyer as important is treated by the seller as proprietary. The seller, however, may be reluctant to disclose trade secrets to the buyer prior to either the closing or a firm

commitment by the buyer to proceed with the acquisition. Moreover, the buyer's receipt of this information can place the buyer in a difficult position if the acquisition fails to close and the buyer subsequently wants to enter the same field or develop a similar product or process. In these circumstances, the buyer risks suit by the seller for theft of trade secrets, and the buyer may have the burden of proving that it developed the product or process independently of the information it received from the seller, which may be very difficult.

Because the validity of trade secrets depends in part upon the efforts made to keep them secret, the representation in Section 3.25(g)(ii) provides assurances to the buyer that the seller treated its trade secrets as confidential. Important methods of maintaining the confidentiality of trade secrets include limiting access to them, marking them as confidential, and requiring everyone to whom they are disclosed to agree, in writing, to keep them confidential. In particular, the buyer should verify that the seller has treated valuable know-how in a manner that gives rise to trade secret protection, such as through the use of confidentiality agreements. In the case of software, the buyer should determine whether the software is licensed to customers under a license agreement that defines the manner in which the customer may use the software or instead is sold on an unrestricted basis. The buyer should also investigate any other procedures used by the seller to maintain the secrecy of its trade secrets, and the buyer should determine whether agreements exist that govern the disclosure and use of trade secrets by employees and consultants of the seller and others who need to learn of them. The seller may seek a knowledge qualification to the last sentence of clause (iii) of Section 3.25(g) because of the difficulty in determining that trade secrets do not infringe any third party's intellectual property. As previously stated, whether the buyer accepts this is a matter of risk allocation.

Mask Works. Mask works are related to semiconductor products and are protected under 17 U.S.C. § 901 et seq. Because this technology is unique to a particular industry (the microchip industry), the Model Agreement does not contain a separate representation concerning mask works.

Domain Names. Internet domain names may be obtained through a registration process. Internet domain name registration is a process separate and independent of trademark registration, but registering another's trademark as a domain name for the purpose of selling it to the trademark owner ("cybersquatting") or diverting its customers ("cyberpiracy") may be actionable as unfair competition, trademark infringement, or dilution or under Section 43(d) of the Lanham Act (the "Anticybersquatting Consumer Protection Act"). Domain name disputes may also be resolved under the ICANN Rules for Uniform Domain Name Dispute Resolution.

See Chapter 10, "Intellectual Property," of the *Manual on Acquisition Review*.

3.26 NO DATE LIMITED SOFTWARE, ETC.

(a) All Software, firmware, computers, equipment and other devices (collectively, "Devices") owned, used, reduced, sold, leased, licensed or distributed by Seller that store or utilize dates or date-related data (in any form) will receive input of, recognize, store, retrieve, process and generate output of dates and date-related data without error, ambiguity, interruption, malfunction or the need for any change in the manner of its use and in accordance with current calendar conventions with respect to all dates from and including (i) the earliest of (A) the earliest date stored on such Device; (B) the earliest date that could reasonably be expected to be input into, stored, retrieved, processed, generated or output

by such Device during its operation throughout the Testing Period; and (C) the beginning of the Testing Period, through and including (ii) the latest of (A) the latest date stored on such Device; (B) the latest date that could reasonably be expected to be input into, stored, retrieved, processed, generated or output by such Device during its operation throughout the Testing Period; and (C) the end of the Testing Period.

(b) Seller has no reason to believe, after reasonable inquiry, that any Device owned or used by suppliers or customers of, or other Persons doing business with, Seller that stores or utilizes dates or date-related data (in any form) will fail to receive input of, recognize, store, retrieve, process and generate output of dates and date-related data without error, ambiguity, interruption, malfunction or the need for any change in the manner of its use and in accordance with current calendar conventions with respect to all dates from and including (i) the earliest of (A) the earliest date stored on such Device; (B) the earliest date that could reasonably be expected to be input into, stored, retrieved, processed, generated or output by such Device during its operation throughout the Testing Period; and (C) the beginning of the Testing Period, through and including (ii) the latest of (A) the latest date stored on such Device; (B) the latest date that could reasonably be expected to be input into, stored, retrieved, processed, generated or output by such Device during its operation throughout the Testing Period; and (C) the end of the Testing Period, except for failures that could not, individually or in the aggregate, reasonably be expected to have a material adverse effect on Seller's business and results of operations or its dealings with such Person.

(c) Part 3.26 lists, and Seller has provided Buyer with complete and accurate copies of, all guarantees, warranties or other assurances provided by Seller to any Third Party with respect to any matter of the type covered by this Section 3.26.

(d) As used in this Section 3.26, "dates" includes times, combinations of dates and times (whether absolute or relative) and data relating to the period or interval between any dates or times, "input" and "output" include transmission or representation of data through any interface with another Device or to or from one or more individuals, and the "Testing Period" is the period beginning [date] and ending [date].

COMMENT

Dates and date-related data are stored and processed by many types of software and hardware, including devices not commonly regarded as computers. During the last few years of the twentieth century, it became apparent that many businesses were still using software and hardware that stored and processed date-related data using only two digits to represent the year, a technique that could result in ambiguity or the failure to function after December 31, 1999. As a result, it became common practice to include representations concerning "Year 2000" or "Y2K" compliance in acquisition agreements.

The potential problems associated with date-limited software and hardware did not end with the start of the new millennium. Some Year 2000 fixes used a process called "windowing" in which a cutoff year is chosen (e.g., twenty-five), and year entries below twenty-five are recognized as being in the twenty-first century, whereas year entries after twenty-five are recognized as being in the twentieth century. Moreover, software and hardware that avoided the entire Y2K issue by not representing years with two digits will still contain date limitations. In some cases, the date limitation will

extend so far into the future that the limitation is of no practical significance (e.g., a representation of years with four digits, which will function through December 31, 9999, or a representation of dates as the number of days from December 31, 1899, which with thirty-two-bit integers will function for more than 5,000,000 years). In other cases, the date limitation may be of more than theoretical interest. For example, a common representation of dates and times is as the number of seconds since the start of January 1, 1970. With thirty-two-bit integers, that representation will not be able to handle dates later than early in the year 2038 and could fail earlier if used in software that needs to deal with dates in the future (e.g., software that generates a thirty-year mortgage amortization table).

It can be very difficult to perform comprehensive diligence with respect to these issues, particularly if properly documented source code is not available (which will often be the case). A strong representation may be the buyer's only source of protection against date-limitation issues.

Section 3.26 recognizes that it is unreasonable to request assurances that Software and hardware will be able to process dates in perpetuity and requests assurances that they will be able to do so through a defined "Testing Period" instead. Because software and hardware will often need to process dates on a prospective basis (e.g., budgeting software that looks forward five years), however, the representation expands the Testing Period to include dates that could reasonably be expected to be encountered during the Testing Period.

Apart from the limitation relating to the Testing Period, the representation is broad and with respect to the Software and hardware produced or used by Seller, absolute. Subsection (a) provides assurances concerning all Software and hardware. A seller may wish to limit the scope of subsection (a) to identified software and hardware that is critical to the operation of the seller's business, exclude off-the-shelf software and hardware provided by third parties or otherwise insert a materiality qualification. A seller may also seek a knowledge qualification.

In the context of evaluating their Y2K compliance, it became common practice for companies to request assurances from third parties with whom they did business that the third parties dealings with them would not be disrupted by Y2K issues, and it also became common practice for representations in acquisition agreements to request assurances as to the results of those requests. Subsection (b) continues that practice beyond the Year 2000. The draftsperson should consider, however, whether anything beyond a naked "cold-comfort" representation (i.e., a representation excluding the words "after reasonable inquiry" in the first line of subsection (b)) is appropriate for an issue that is continuing and is not focused on a particular date or year.

3.27 COMPLIANCE WITH THE FOREIGN CORRUPT PRACTICES ACT AND EXPORT CONTROL AND ANTIBOYCOTT LAWS

(a) Seller and its Representatives have not, to obtain or retain business, directly or indirectly offered, paid or promised to pay, or authorized the payment of, any money or other thing of value (including any fee, gift, sample, travel expense or entertainment with a value in excess of one hundred dollars ($100.00) in the aggregate to any one individual in any year) or any commission payment in excess of _____ percent (_____%) of any amount payable, to:

(i) any person who is an official, officer, agent, employee or representative of any Governmental Body or of any existing or prospective customer (whether government owned or nongovernment owned);

(ii) any political party or official thereof;
(iii) any candidate for political or political party office; or
(iv) any other individual or entity;

while knowing or having reason to believe that all or any portion of such money or thing of value would be offered, given, or promised, directly or indirectly, to any such official, officer, agent, employee, representative, political party, political party official, candidate, individual, or any entity affiliated with such customer, political party or official or political office.

(b) Except as set forth in Part 3.27(b), Seller has made all payments to Third Parties by check mailed to such Third Parties' principal place of business or by wire transfer to a bank located in the same jurisdiction as such party's principal place of business.

(c) Each transaction is properly and accurately recorded on the books and Records of Seller, and each document upon which entries in Seller's books and Records are based is complete and accurate in all respects. Seller maintains a system of internal accounting controls adequate to insure that Seller maintains no off-the-books accounts and that Seller's assets are used only in accordance with Seller's management directives.

COMMENT

The purpose of the representations in subsections (a), (b), and (c) of Section 3.27 is to determine whether a seller may be in violation of the Foreign Corrupt Practices Act (FCPA) 15 U.S.C. §§ 78dd-1, -2 and -3. The buyer may wish to include this representation in the agreement if the seller conducts extensive offshore business, especially with foreign governments.

Subsection (a) sets forth all of the elements of an antibribery offense under the FCPA. If a buyer insists that the seller make the representation in subsection (a), it will want details about any disclosed payments. The buyer normally will want indemnification rights against the seller, however, whether or not such payments are disclosed. The seller may argue that the representation should not cover the acts of employees because the seller cannot know, for example, what a low-level employee may have done to curry favor with an inspector.

The FCPA's antibribery provisions prohibit bribery of any foreign official by any "domestic concern," including any individual, corporation, partnership, association, joint-stock company, business trust, unincorporated organization or sole proprietorship. The legislative history of the FCPA confirms the intent of Congress to exempt foreign subsidiaries of U.S. parent companies from the antibribery provisions so long as the foreign subsidiary does not fall within the FCPA's statutory definition of "domestic concern" or "issuer." ("Issuer" means an issuer of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 or an issuer required to file reports pursuant to Section 15(d) of that Act. 15 U.S.C. § 78m(b)(2).) The antibribery provisions do not, however, prohibit "grease payments" made to expedite or secure the performance of "routine government action" such as obtaining permits, licenses, or documents or facilitating shipments through customs. 15 U.S.C. §§ 78dd-1(b) and 78dd-2(b). Penalties for violating the antibribery provisions of the FCPA include fines of up to $2,000,000 for corporations and fines of $100,000 and/or imprisonment for up to five years for individuals. 15 U.S.C. § 78dd-2(g). Fines imposed against individuals may not be paid directly or indirectly by their companies. Therefore, companies are prevented from indemnifying their officers and employees against liability under the FCPA. 15 U.S.C. §§ 78ff(c)(3) and 78dd-2(g)(3). Section 3.27(a) should be drafted

so that de minimis payments and expenses under a certain dollar amount, e.g., $100, do not fall under the scope of the representation.

Subsection (b) recognizes that the majority of bribes and improper payments take the form of third-party payments delivered to remote locations rather than payments sent directly to the parties at their principal places of business. Although the antibribery provisions of the FCPA do not cover foreign subsidiaries of U.S. entities that have their principal place of business outside the U.S., parent companies may be liable for such subsidiaries' behavior if the parent directly or indirectly made illegal payments through such subsidiaries. 123 CONG. REC. S. 38600 (Dec. 6, 1977) (statement of Senator Proxmire). In any case, if the seller has foreign subsidiaries, the buyer will want to know whether they are making payments which, although not illegal in the foreign jurisdiction, constitute a violation of the FCPA for the seller; cessation of such activities after the closing could materially alter the business condition of the seller.

Subsection (c) addresses the recordkeeping and accounting provisions of the FCPA. These provisions require public U.S. companies and their subsidiaries to maintain "reasonably detailed books and records," as well as a system of internal accounting controls, to accurately reflect all transactions and dispositions of assets. "Reasonable detail" is defined by the FCPA to mean "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs." 15 U.S.C. § 78m(b)(7). The intent of the statutory requirement is to prevent the use of unrecorded "slush funds" for corrupt payments to foreign officials. In contrast to the bribery provisions, arguably, the recordkeeping and accounting provisions apply to both domestic and foreign subsidiaries of public U.S. companies. Penalties for violating the recordkeeping provisions of the FCPA include fines of up to $2,500,000 for corporations and fines of up to $1,000,000 and imprisonment of up to ten years for individuals. 15 U.S.C. § 78ff(a).

If this representation is used, the buyer should require the seller to deliver, both through the Disclosure Letter and to the buyer's representatives prior to the closing, copies of any "business-practices," "ethics" or "conflicts-of-interest" policies of the seller, the reports and questionnaires that may have been periodically submitted by employees pursuant to these policies and details relating to breaches of these policies and actions taken in response to any such breaches. In addition to requiring disclosure of the seller's policies, the buyer may want to include representations that the policies have been in place for a given period of time and that there have been no breaches of the policies (other than as described in the Disclosure Letter).

If the buyer is engaged in the same business as the seller, the buyer may have its own views on the conduct of the business and may be prepared, subject to whatever level of due diligence inquiry it decides to make, to proceed with the acquisition without much concern about the seller's prior and existing practices. On the other hand, a careful buyer may conclude, following its due diligence investigation, that there has been a course of conduct of such a questionable nature that the buyer should elect to walk away from the acquisition.

Subsections (a) and (b) cover not only payments prohibited by the FCPA but some legal payments as well because buyers in certain industries may be concerned with certain types of legal payments, such as political contributions, which violate industry-wide standards or accepted practices.

(d) Seller has at all times been in compliance with all Legal Requirements relating to export control and trade embargoes. No product sold or service provided by Seller during the last five (5) years has been, directly or indirectly, sold to or performed on behalf of Cuba, Iraq, Iran, Libya or North Korea.

COMMENT

If the seller exports any of its products or conducts significant foreign operations, then the buyer should seek assurances, such as in subsection (d), that the seller complies with U.S. export control laws (including those at 50 U.S.C. § 2401 et seq.). The U.S. government restricts exports of tangible and intangible goods and technical data by regulating (a) direct exports of goods and technology from the U.S., (b) re-exports of U.S.-origin commodities and technical data from one foreign country to another, (c) exports and re-exports from a foreign country of foreign products containing U.S.-origin parts and components and (d) exports and re-exports from a foreign country of foreign products that utilize U.S.-origin technical data, regardless of the products' actual origin. The export control laws apply to American-made products for their entire life, no matter how many times they are resold, and their violation carries potentially serious criminal penalties for manufacturers.

(e) Except as set forth in Part 3.27(e), Seller has not violated the antiboycott prohibitions contained in 50 U.S.C. § 2401 et seq. or taken any action that can be penalized under Section 999 of the Code. Except as set forth in Part 3.27(e), during the last five (5) years, Seller has not been a party to, is not a beneficiary under and has not performed any service or sold any product under any Seller Contract under which a product has been sold to customers in Bahrain, Iraq, Jordan, Kuwait, Lebanon, Libya, Oman, Quatar, Saudi Arabia, Sudan, Syria, United Arab Emirates or the Republic of Yemen.

COMMENT

Subsection (e) addresses statutes and regulations that prohibit and penalize U.S. companies and taxpayers for taking actions in support of foreign economic boycotts. In particular, the representation addresses the antiboycott prohibitions of the Export Administration Act (EAA) and related penalties imposed under the Code. 50 U.S.C. §§ 2401–20; 15 C.F.R. § 760 (1999). The EAA expired on August 20, 1994. Exec. Order No. 12924, 3 C.F.R., 1994 Comp. 917 (1995), extended by Presidential Notices of August 15, 1995, 3 C.F.R., 1995 Comp. 501 (1996), August 14, 1996, 61 Fed. Reg. 42,527 (1996), August 13, 1997, 62 Fed. Reg. 43,629 (1997), August 13, 1998, 63 Fed. Reg. 44,121 (1998), and August 10, 1999, 64 Fed. Reg. 44,101 (1999), continued the Export Administration Regulations in effect under the International Emergency Economic Powers Act, 50 U.S.C. §§ 1701–1706. Although this representation should be of particular concern if the seller conducts substantial business in the Middle East where the Arab League nations listed in the second sentence of Section 3.27(e) have historically prohibited trade between its members and Israel, it also may be useful with regard to companies that do business in India, Pakistan, China and Taiwan, where boycott issues arise as well.

The intention of the representation is to force the seller to reveal any relationships that the seller may have with parties that engage in prohibited boycotts and any seller contracts that contain boycott provisions. If, as part of the transactions contemplated by an asset purchase, the buyer assumes a seller contract that contains boycott provisions, then, under Section 999 of the Code, as soon as the buyer becomes a party to such an agreement, the buyer may lose certain tax benefits related to any foreign operations it may have, including certain foreign tax credits and tax benefits associated with foreign sales corporations and domestic international sales corporations. In addition, if the buyer performs the contract in violation of the EAA, it may be subject to civil penalties (fines and the denial of export privileges) and criminal fines and im-

prisonment. Under the Code, if one member of a seller's "controlled group" participates in or cooperates with a foreign boycott, all operations of the controlled group in all boycotting countries will be presumed tainted by boycott participation unless it can be established that the operation in which the boycott participation was found is "separate and identifiable" from other operations.

The antiboycott laws prohibit "knowingly" acting or agreeing to act in furtherance of a boycott imposed by a foreign government, including (a) refusing or requiring any other person to refuse to do business with or in a boycotted country; (b) refusing to employ, or discriminating against or requiring any other person to refuse to employ or discriminate against, any U.S. person on the basis of race, religion, sex or national origin; (c) furnishing information with respect to race, religion, sex or national origin of any U.S. person; (d) furnishing information about whether any person has or proposes to have any business relationship with, or is affiliated with an organization which supports, a boycotted country; (e) furnishing information about whether any person is a member of, has made contributions to, or is otherwise associated with or involved in the activities of any charitable or fraternal organization that supports the boycotted country; or (f) paying, honoring, confirming or otherwise implementing a letter of credit containing any condition or compliance that is prohibited by rules and regulations issued under the antiboycott laws. 50 U.S.C. § 2407(a)(1); 15 C.F.R. § 760.2(a)(2), (a)(4), (c), (d), (e)(1)-(2) and (f) (1999).

The following is a list of boycott "red flags" to which buyers should be alert: (a) requests not to do business with a boycotted country, with nationals of such a country or with "blacklisted" companies or persons; (b) requests to do business only with approved firms or persons; (c) requests to do business with designated firms or persons such as potential contractors or subcontractors, which one has reason to believe have been selected for boycotting reasons; (d) requests to discriminate against a U.S. person on the basis of race, religion, gender or national origin; (e) requests in which the words "Israel," "Hebrew," "Jewish" or other words indicative of ancestry, nationality, religion or national origin are used, including requests about parentage; (f) requests to furnish information regarding race, religion, nationality, gender or national origin; (g) requests to furnish information about a person's or company's business relationships with a boycotted country; (h) contract clauses making applicable or requiring compliance with boycott laws; and (i) requests to supply a negative certificate of origin of goods (e.g., "not produced in Israel").

For business review purposes, agreements should be screened for boycott provisions. Such provisions may not always be explicitly boycott related on their face; agreements to comply with the laws and regulations of a boycotting country, without specific reference to its boycott laws, are penalized under the Treasury guidelines issued under the Code. If the seller has extensive foreign operations or sells goods or services in countries likely to have boycott laws, then, during its business review, the buyer should request a copy of the seller's antiboycott compliance policies and a description of any related training and enforcement programs.

The EAA applies to "U.S. persons," including U.S. corporations, partnerships, legal entities and citizens, and foreign subsidiaries, affiliates and branch offices of U.S. persons that are controlled by a U.S. parent. The law applies only if (a) a transaction involves a person or entity considered to be a U.S. person; (b) the transaction involves goods or services from the U.S.; and (c) the transaction involves goods or services that are acquired for or ultimately used to fill an order or complete a transaction outside the U.S. The laws do not apply, however, if a transaction involves goods or services from the U.S., but the goods and services (a) are not acquired to fill an order or complete a transaction outside the U.S., *and* (b) (1) in the case of goods, are further manufactured into, refined into or reprocessed into another product or (2) in the case of services, are ancillary to the transaction with a person outside the U.S.

3.28 EURO-AFFECTED PRODUCTS AND SERVICES

To the extent that Seller's Software, hardware, systems, products and services receive, recognize, use or process financial information from any European Union member that has changed its currency to the Euro (collectively, the "Euro-Affected Products and Services"), all of Seller's Euro-Affected Products and Services will (a) operate without errors, problems, delays or the need for any further modifications as a result of the introduction of the Euro in whole or in part as a European currency or currency unit and (b) continue to receive, recognize, use and process both national currency units and Euro units (and permit conversions from national currency units to Euro units and vice-versa) without errors, problems, delays or the need for any further modifications before, during and after the period from January 1, 1999, through December 31, 2001.

COMMENT

The Euro is the European single currency, which was adopted by eleven nations on January 1, 1999. Securities are denominated in Euros, and the currency is used for electronic commerce. Currency conversion between member states' national currency units and between national currency units and the Euro must be made with specific conversion method and to an accuracy of three decimal points. The Euro itself has a value based upon the value of the dollar and the participating nations' currencies. These factors are expected to cause difficulties in computer processing of financial information involving the Euro. The buyer will want assurances that the seller's information systems are capable of handling the changes resulting from adoption of the Euro.

3.29 RELATIONSHIPS WITH RELATED PERSONS

Except as disclosed in Part 3.29, neither Seller nor either Shareholder nor any Related Person of any of them has, or since _____, 19/20___, [the first day of the next to last completed fiscal year of Seller] has had, any interest in any property (whether real, personal or mixed and whether tangible or intangible) used in or pertaining to Seller's business. Neither Seller nor either Shareholder nor any Related Person of any of them owns, or since _____, 19/20___, [the first day of the next to last completed fiscal year of Seller] has owned, of record or as a beneficial owner, an equity interest or any other financial or profit interest in any Person that has (a) had business dealings or a material financial interest in any transaction with Seller other than business dealings or transactions disclosed in Part 3.29, each of which has been conducted in the Ordinary Course of Business with Seller at substantially prevailing market prices and on substantially prevailing market terms or (b) engaged in competition with Seller with respect to any line of the products or services of Seller (a "Competing Business") in any market presently served by Seller, except for ownership of less than one percent (1%) of the outstanding capital stock of any Competing Business that is publicly traded on any recognized exchange or in the over-the-counter market. Except as set forth in Part 3.29, neither Seller nor either Shareholder nor any Related Person of any of them is a party to any Contract with, or has any claim or right against, Seller.

COMMENT

The first sentence of this representation provides assurances that Seller, Shareholders and Related Persons do not have any interest in any property used in the business. The broad definition of "Related Person" covers indirect relationships, which may be very important to a buyer. If there are many interrelationships among individuals who are related persons of the seller or of any shareholders, as well as of other entities that are affiliated with the seller, a significant amount of disclosure may be required, and a rather detailed and elaborate series of representations may be needed to cover various relationships.

In acquisitions involving large corporations, a seller may be unable to make this representation without a list of exceptions so long that the representation becomes meaningless. Moreover, depending upon the size of the corporations and the relationship of the parties, the representation may not be necessary or relevant. A more appropriate alternative may be to require, solely for the purpose of disclosure, that the disclosure letter describe such relationships.

Many corporations have "conflict-of-interest" policies that require periodic questionnaires to be completed and signed by certain levels of management and employees. The buyer should demand disclosure of any such policies and that true and complete copies of all policies that have been in effect either currently or during the past five years be attached to the disclosure letter. The buyer should also request detailed descriptions of any breaches or remedial or disciplinary action taken. The buyer may want to require as a condition to the closing that all employees who are subject to the policy complete and sign current questionnaires.

The final sentence in the representation can be revised to exclude Seller's rights to the Purchase Price and the Shareholders' rights to distributions of the Purchase Price and to the pre-Closing compensation and other distributions they currently receive from Seller.

If a seller's disclosures reveal that officers, directors or major shareholders of the seller or related persons hold beneficial interests in competing businesses, the buyer should determine whether the interest in question constituted a corporate opportunity for the seller and why the opportunity was not taken by the seller.

3.30 BROKERS OR FINDERS

Neither Seller nor any of its Representatives have incurred any obligation or liability, contingent or otherwise, for brokerage or finders' fees or agents' commissions or other similar payments in connection with the sale of Seller's business or the Assets or the Contemplated Transactions.

COMMENT

There are many types of intermediaries who may facilitate an acquisition through a variety of services ranging from introducing the parties (a finder) to assisting in every stage of the transaction (a broker). The Model Agreement representation expresses the usual format for finders' or brokers' fees when no finder or broker is involved. If obligations for brokers' or finders' fees or agents' commissions have been incurred, the acquisition agreement should specify whether the shareholders, the buyer or the seller will bear the financial liability for these payments.

3.31 SECURITIES LAW MATTERS

(a) Seller is acquiring the Promissory Note for its own account and not with a view to its distribution within the meaning of Section 2(11) of the Securities Act.

(b) Seller confirms that Buyer has made available to Seller and its Representatives the opportunity to ask questions of the officers and management employees of Buyer and to acquire such additional information about the business and financial condition of Buyer as Seller has requested, and all such information has been received.

COMMENT

The definition of "security" under the Securities Act includes "any note." Thus, the United States Supreme Court has held that a promissory note is presumed to be a "security." This presumption can be rebutted, however, by a showing that the note bears a strong "family resemblance" to one of the instruments that the courts have found not to be securities. Reves v. Ernst & Young, 492 U.S. 56 (1990). The motivation of the parties to the transaction, the plan of distribution and the reasonable expectations of the investing public are examined to determine if the presumption has been rebutted. *Id.* at 66–67. If the maker's motivation in issuing the note is to raise money, and the holder's motivation is profit, the note is likely a security. A note exchanged to "facilitate the purchase or sale of a minor asset," to correct the maker's cash flow difficulties or for "some other commercial purpose" is less likely to be deemed a security. *Id.*

Thus, a question exists as to whether a note representing seller financing constitutes a "security" for purposes of the Securities Act. Nonetheless, the Model Agreement treats the Promissory Note as a "security" that has not been registered under the Securities Act. This representation is intended to support a claim that the issuance of the Promissory Note is exempt from the registration requirements of the Securities Act.

Assuming that the Promissory Note is a security, Buyer must either register the Promissory Note under the Securities Act and applicable state securities laws or structure the transaction to comply with the requirements for an exemption from the registration requirements. Rule 145 under the Securities Act, 17 C.F.R. § 230.145, for the purpose of providing protection to persons offered securities in certain business transactions, provides that an "offer," "offer to sell," "offer for sale" or "sale" shall be deemed to be involved, so far as the security holders of the selling corporation are concerned, where, pursuant to state statute or the corporation's governing documents, there is submitted for the vote or consent of its security holders a plan or agreement for transfer of assets of the corporation for consideration of securities of the another party in the following circumstances: (a) where the plan or agreement calls for dissolution of the corporation, (b) where the plan or agreement provides for a pro rata or similar distribution of such securities to the security holders voting or consenting, (c) where the board of directors of the corporation adopts resolutions relative to (a) or (b) above within one year after the taking of such vote or consent or (d) where the transfer of assets is a part of a pre-existing plan for distribution of such securities. Thus, where shareholder approval is needed for an asset transaction, and the agreement calls for a security (e.g., a note or other evidence of indebtedness that is a security) to be given as consideration under circumstances where dissolution of the corporation or distribution of the securities received to shareholders is contemplated, the security issued must be registered under the Securities Act prior to the vote or consent or the transaction must qualify for the private offering or another exemption from the registration requirements.

Section 4(2) of the Securities Act exempts from the registration requirements "transactions by an issuer not involving any public offering"—generally referred to as "private placements." The U.S. Supreme Court has held that the Section 4(2) exemption must be interpreted in light of the statutory purpose of the Securities Act to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions" and that its applicability "should turn on whether the particular class affected need the protection of the Act." SEC v. Ralston Purina Co., 346 U.S. 119, 124–25 (1953). Subsequent court opinions have enumerated a number of more specific factors to be considered in determining whether a transaction involves a "public offering," including the following:

(a) the number of offerees (there is no number of offerees that always makes an offering either private or public; twenty-five to thirty-five is generally considered consistent with a private offering, but the sophistication of the offerees is more important; an offer to a single unqualified investor can defeat the exemption, and an offering to a few hundred institutional investors can be exempt; note that the judicial focus is upon the number of persons to whom the securities are offered, not the number of actual purchasers);
(b) offeree qualification (each offeree should be sophisticated and able to bear the economic risk of the investment; a close personal, family or employment relationship should also qualify an offeree);
(c) manner of offering (the offer should be communicated directly to the prospective investors without the use of public advertising or solicitation);
(d) availability of information (each investor should be provided or otherwise have access to information comparable to that contained in a registration statement filed under the Securities Act; commonly investors are furnished a "private offering memorandum" describing the issuer and the proposed transaction); and
(e) absence of redistribution (the securities must come to rest in the hands of qualified purchasers and not be redistributed to the public; securities sold in a private placement generally may be replaced privately, sold pursuant to SEC Rule 144 under the Securities Act, 17 C.F.R. § 230.144 ("Rule 144"), or sold to the public pursuant to a registration statement filed and effective under the Securities Act; the documentation of a private placement normally includes contractual restrictions on subsequent transfers of the securities purchased).

See generally Schneider, *The Statutory Law of Private Placements*, 14 REV. SEC. REG. 869 (1981); ABA Committee on Federal Regulation of Securities, *Integration of Securities Offerings: Report of the Task Force on Integration*, 41 BUS. LAW. 595 (1986); Fletcher, *Sophisticated Investors Under the Federal Securities Laws*, 1988 DUKE L. J. 1081 (1988).

SEC Regulation D ("Reg D") under the Securities Act, 17 C.F.R. § 230.501–508 (1999), became effective April 15, 1982, and is now the controlling SEC regulation for determining whether an offering of securities is exempt from registration under Section 4(2) of the Securities Act. Under Rule 506 of Reg D, there is no limitation on the dollar amount of securities that may be offered and sold, and the offering can be sold to an unlimited number of "accredited investors" (generally institutions, individuals with a net worth of over $1 million and officers, directors and general partners of the issuer) and to a maximum of thirty-five nonaccredited investors (there is no limit on the number of offerees so long as there is no general advertising or solicitation). Each of the purchasers, if not an accredited investor, must (either alone or through a representative) have such knowledge and experience in financial matters as to be capable of evaluating the risks and merits of the proposed investment. Unless the offering is made solely to accredited investors, purchasers must generally be furnished with the same level of

information that would be contained in a registration statement under the Securities Act. Resale of the securities must be restricted and a Form D notice of sale must be filed with the SEC. An offering which strictly conforms to the Reg D requirements will be exempt even if it does not satisfy all of the judicial criteria discussed in the preceding paragraph; however, because Reg D does not purport to be the exclusive means of compliance with Section 4(2), a placement that conforms to those judicial criteria also may be exempt from registration under Section 4(2) of the Securities Act, even if it does not strictly conform to Reg D.

Section 3(a)(11) of the Securities Act exempts from the registration requirements of the Securities Act "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or if a corporation, incorporated by and doing business within, such State or Territory." Consequently, there are two principal conditions to the intrastate offering exemption: (a) that the entire issue of securities be offered and sold exclusively to, and come to rest in the hands of, residents of the state in question (an offer or sale to a single nonresident will render the exemption unavailable to the entire issue) and (b) that the issuer be organized under the laws of and doing substantial business in the state. Rule 147 promulgated under the Securities Act, 17 C.F.R. § 230.147 (1999), articulates specific standards for determining whether an offering is intrastate within the meaning of Section 3(a)(11).

Rule 144 under the Securities Act provides generally that a security issued in a private transaction will be freely transferrable, after a two-year holding period, by a holder who is not an affiliate of the issuer at the time of the sale and has not been an affiliate during the preceding three months. If the securities were publicly traded, Rule 144 would permit limited sales under specified conditions after a one-year holding period.

If a seller plans to distribute a buyer's promissory note to its shareholders prior to its maturity (see Section 10.4), the buyer will need to consider, in addition to Rule 145, whether that transfer will be integrated with the original issuance and, if so, whether the subsequent distribution could result in a distribution in violation of Section 5 of the Securities Act. Depending upon the circumstances, violation of Section 5 could allow the seller to rescind the transaction under Section 12(a)(l) of the Securities Act. See Section 10.4 and related Comment.

In addition to the above exemptions, Section 3(a)(3) of the Securities Act provides an exemption from the registration requirements of the Securities Act for promissory notes with a maturity date not exceeding nine months from the date of issuance.

Where stock or warrants (instruments that are clearly "securities" under the Securities Act) are to be received by the seller, the buyer may request more extensive investor representations and covenants (restrictions on transfer, legending, etc.)

3.32 SOLVENCY

(a) Seller is not now insolvent and will not be rendered insolvent by any of the Contemplated Transactions. As used in this section, "insolvent" means that the sum of the debts and other probable Liabilities of Seller exceeds the present fair saleable value of Seller's assets.

(b) Immediately after giving effect to the consummation of the Contemplated Transactions: (i) Seller will be able to pay its Liabilities as they become due in the usual course of its business; (ii) Seller will not have unreasonably small capital with which to conduct its present or proposed business; (iii) Seller will have assets (calculated at fair market value) that exceed its Liabilities; and (iv) taking into account all pending and threatened litigation, final judgments against Seller

in actions for money damages are not reasonably anticipated to be rendered at a time when, or in amounts such that, Seller will be unable to satisfy any such judgments promptly in accordance with their terms (taking into account the maximum probable amount of such judgments in any such actions and the earliest reasonable time at which such judgments might be rendered) as well as all other obligations of Seller. The cash available to Seller, after taking into account all other anticipated uses of the cash, will be sufficient to pay all such debts and judgments promptly in accordance with their terms.

COMMENT

Most jurisdictions have statutory provisions relating to fraudulent conveyances or transfers. The Uniform Fraudulent Transfer Act (UFTA) and Section 548 of the United States Bankruptcy Code (the "Bankruptcy Code") generally provide that a "transfer" is voidable by a creditor if the transfer (a) is made with actual intent to hinder, delay or defraud a creditor or (b) leaves the debtor insolvent, undercapitalized or unable to pay its debts as they mature, and is not made in exchange for reasonably equivalent value. If a transfer is found to be fraudulent, courts have wide discretion in fashioning an appropriate remedy and could enter judgment against the transferee for the value of the property, require the transferee to return the property to the transferor or a creditor of the transferor or exercise any other equitable relief as the circumstances may require. If a good-faith transferee gave some value to the transferor in exchange for the property, the transferee may be entitled to a corresponding reduction of the judgment on the fraudulent transfer or a lien on the property if the court requires its return to the transferor. If the transferor liquidates or distributes assets to its shareholders after the transaction, a court could collapse the transaction and hold that the transferor did not receive any consideration for the assets and that the transferor did not receive reasonably equivalent value for the transfer. *See* Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488 (N.D. Ill. 1988). The statute of limitations on a fraudulent transfer action can be as long as six years under some states' versions of the UFTA.

This solvency representation is included to address the risk of acquiring assets of the seller in a transaction that could be characterized as a fraudulent transfer or conveyance by the seller and may be required by the lender financing the acquisition. It is intended to provide evidence of the seller's sound financial condition and the buyer's good faith, which may affect the defenses available to the buyer in a fraudulent transfer action. Conclusionary statements in an asset purchase agreement would be of limited value if not supported by the facts. Because financial statements referenced in Section 3.4 as delivered by the seller are based upon GAAP rather than the fair valuation principles applicable under fraudulent transfer laws, a buyer may seek further assurance as to fraudulent transfer risks in the form of (a) a solvency opinion to the effect that the seller is solvent under a fair valuation, although it may not be solvent under GAAP (which focuses on cost) and has sufficient assets for the conduct of its business and will be able to pay its debts as they become due or (b) a third-party appraisal of the assets to be transferred which confirms that reasonably equivalent value was to be given for the assets transferred. *Cf.* Brown v. Third Nat'l Bank (*In re* Sherman), 67 F.3d 1348 (8th Cir. 1995). The need for this representation will depend, in part, upon a number of factors, including the financial condition of the seller and the representations which the buyer must make to its lenders.

Statutory Scheme. UFTA is structured to provide remedies for creditors in specified situations when a debtor "transfers" assets in violation of UFTA. A "creditor" entitled to bring a fraudulent transfer action is broadly defined as a person who has "a right to payment or property, whether or not the right is reduced to judgment, liquidated,

unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." Persons who could be included as creditors under the statute include: noteholders, lessees on capital leases or operating leases, litigants with claims against the seller that have not proceeded to judgment, employees with underfunded pension plans and persons holding claims which have not yet been asserted. There is a presumption of insolvency when the debtor generally is not paying its debts as they become due.

A debtor is insolvent if the sum of the debtor's debts is greater than all of the debtor's assets at a fair valuation. A significant body of law under the Bankruptcy Code interprets the phrase "at a fair valuation" to mean the amount that could be obtained for the property within a reasonable time by a capable and diligent business person from an interested buyer who is willing to purchase the assets under ordinary selling conditions. A "fair valuation" is not the amount that would be realized by the debtor if it was instantly forced to dispose of the assets or the amount that could be realized from a protracted search for a buyer under special circumstances or having a particular ability to use the assets. For a business that is a going concern, it is proper to make a valuation of the assets as a going concern and not on an item-by-item basis.

The UFTA-avoidance provisions are divided between those avoidable to creditors holding claims at the time of the transfer in issue and those whose claims arose after the transfer. The statute is less protective of a creditor who began doing business with a debtor after the debtor made the transfer rendering it insolvent. Most fraudulent transfer actions, however, are brought by a bankruptcy trustee, who, under Section 544(b) of the Bankruptcy Code, 11 U.S.C. § 544(b), can use the avoiding powers of any actual creditor holding an unsecured claim who could avoid the transfer under applicable nonbankruptcy law.

Intent to Hinder, Delay, or Defraud Creditors. An asset transfer would be in violation of UFTA § 4(a)(1) and would be fraudulent if the transfer was made "with actual intent to hinder, delay, or defraud any creditor of the debtor." If "actual intent" is found, it does not matter if value was given in exchange for the assets or if the seller was solvent. A number of factors (commonly referred to as "badges of fraud") that are to be considered in determining actual intent under UFTA § 4(a)(1) are set out in UFTA § 4(b) and include whether:

(1) the transfer or obligation was to an insider;
(2) the debtor retained possession or control of the property transferred after the transfer;
(3) the transfer or obligation was disclosed or concealed;
(4) before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit;
(5) the transfer was of substantially all the debtor's assets; . . . [and]
(10) the transfer occurred shortly before or shortly after a substantial debt was incurred.

Although the existence of one or more badges of fraud may not be sufficient to establish actual fraudulent intent, "the confluence of several can constitute conclusive evidence of an actual intent to defraud, absent 'significantly clear' evidence of a legitimate, supervening purpose." Max Sugarman Funeral Home, Inc. v. A.D.B. Investors, 926 F.2d 1248, 1254–55 (1st Cir. 1991).

Fraudulent Transfer Without Intent to Defraud. An asset purchase may be found to be fraudulent if it was effected by the seller "without receiving a reasonably equivalent value in exchange for the transfer or obligation," and:

(a) the seller's remaining assets, after the transaction, were unreasonably small in relation to the business or transaction that the seller was engaged in or was about to engage in, *or*

(b) the seller intended to incur, or believed (or should have believed) that it would incur, debts beyond its ability to pay as they became due.

The "unreasonably-small-assets" test is a distinct concept from insolvency and is not specifically defined by statute. In applying the unreasonably-small-assets test, a court may inquire whether the seller "has the ability to generate sufficient cash flow on the date of transfer to sustain its operations." *See In re* WCC Holding Corp., 171 B.R. 972, 986 (Bankr. N.D. Tex. 1994). In pursuing such an inquiry, a court will not ask whether the transferor's cash flow projections later proved to be correct but whether they were reasonable and prudent at the time they were made.

Remedies for Fraudulent Transfers. The remedies available to a creditor in a fraudulent transfer action include entry of judgment against the transferee for the value of the property at the time it was transferred, entry of an order requiring return of the property to the transferor for satisfaction of creditors' claims or any other relief the circumstances may require. UFTA §§ 7(a), 8(b). Courts have wide discretion in fashioning appropriate remedies.

Transferee Defenses and Protections. Even if a transfer is voidable under the UFTA, a good-faith transferee is entitled under UFTA § 8, *to the extent of the value given to the transferor,* to (a) a lien on or right to retain an interest in the asset transferred, (b) enforcement of the note or other obligation incurred or (c) reduction in the amount of the liability on the judgment against the transferee in favor of the creditor. UFTA § 8(d)(1)-(3). If the value paid by the transferee was not received by the transferor, the good-faith transferee would not be entitled to the rights specified in the preceding sentence. If the transferor distributed the proceeds of sale, in liquidation or otherwise, to its equityholders, a court could collapse the transaction and find that the proceeds were not received by the transferor, thereby depriving the good-faith transferee of the rights to offset the value it paid against a fraudulent transfer recovery. With this in mind, a buyer may seek to require that the seller pay all of its retained liabilities prior to making any distribution, in liquidation or otherwise, to its equityholders. See Sections 10.3 and 10.4.

3.33 DISCLOSURE

(a) No representation or warranty or other statement made by Seller or either Shareholder in this Agreement, the Disclosure Letter, any supplement to the Disclosure Letter, the certificates delivered pursuant to Section 2.7(a) or otherwise in connection with the Contemplated Transactions contains any untrue statement or omits to state a material fact necessary to make any of them, in light of the circumstances in which it was made, not misleading.

(b) Seller does not have Knowledge of any fact that has specific application to Seller (other than general economic or industry conditions) and that may materially adversely affect the assets, business, prospects, financial condition or results of operations of Seller that has not been set forth in this Agreement or the Disclosure Letter.

COMMENT

The representation in subsection (a) assures Buyer that the specific disclosures made in Seller's representations and in the Disclosure Letter do not, and neither any supple-

ment to the Disclosure Letter (see Section 5.5) nor the specified certificates will, contain any misstatements or omissions. By including in subsection (a) the clause "otherwise in connection with the Contemplated Transactions," every statement (whether written or oral) made by Seller or Shareholders in the course of the transaction may be transformed into a representation. This might even apply to seemingly extraneous materials furnished to a buyer, such as product and promotional brochures. Thus, a seller may ask that this language be deleted from subsection (a).

There is no materiality qualification (except for omissions) in subsection (a) because the representations elsewhere in Article 3 contain any applicable materiality standard; including an additional materiality standard here would be redundant. For example, Section 3.1 represents that Seller is qualified to do business in all jurisdictions in which the failure to be so qualified would have a material adverse effect. If subsection (a) provided that there is no untrue statement of a "material" fact, one would have to determine first whether the consequences of a failure to qualify were "material" under Section 3.1 and then whether the untrue statement itself was "material" under subsection (a). Subsection (a) contains no requirement of Knowledge or scienter by Seller (any such requirements would be in the representations elsewhere in Article 3) and no requirement of reliance by Buyer. As a result, subsection (a) imposes a higher standard of accuracy upon Seller than the applicable securities laws.

Subsection (a) contains a materiality standard with respect to information omitted from the representations and from the Disclosure Letter because the representations concerning omitted information are independent from the representations elsewhere in Article 3. Although the omissions language is derived from Section 12(2) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, the representations are contractual in nature, do not require any proof of reliance on the part of Buyer and do not require any proof of negligence or knowledge on the part of Seller or Shareholders. Thus, the Model Agreement imposes a contractual standard of strict liability, in contrast with (a) Rule 10b-5, which predicates liability for misrepresentation or nondisclosure on reliance by the buyer and conduct involving some form of scienter, (b) Section 12(2) of the Securities Act, which provides a defense if one "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission" and (c) common law fraud, which is usually predicated upon actual intent to mislead. *See* B. S. Int'l Ltd. v. Licht, 696 F. Supp. 813, 827 (D.R.I. 1988); BROMBERG & LOWENFELS, 4 SECURITIES FRAUD & COMMODITIES FRAUD § 8.4 (1988).

The buyer should ensure that it receives the disclosure letter (subject to necessary modifications) before signing the acquisition agreement. If the seller insists on signing the acquisition agreement before delivering the disclosure letter, the buyer should demand that the acquisition agreement (a) require delivery of the disclosure letter by a specific date far enough before the closing to permit a thorough review of the disclosure letter and an analysis of the consequences of disclosed items and (b) give the buyer the right to terminate the agreement if there are any disclosures it finds objectionable in its sole discretion. *See* FREUND, ANATOMY OF A MERGER 171–72 (1975).

Subsection (b) is a representation that there is no material information regarding Seller that has not been disclosed to Buyer. This representation is common in a buyer's first draft of an acquisition agreement. A seller may argue that the representation expands, in ways that cannot be foreseen, the detailed representations and warranties in the acquisition agreement and is neither necessary nor appropriate. The buyer can respond that the seller and its shareholders are in a better position to evaluate the significance of all facts relating to the seller.

In contrast to subsection (a), subsection (b) imposes a Knowledge standard on Seller. A buyer could attempt to apply a strict liability standard here as well, as in the following example:

There does not now exist any event, condition or other matter, or any series of events, conditions or other matters, individually or in the aggregate, adversely affecting Seller's assets, business, prospects, financial condition or results of its operations that has not been specifically disclosed to Buyer in writing by Seller on or prior to the date of this Agreement.

A seller may respond that such a standard places upon it an unfair burden.