How is the Acquisition Purchase Agreement Structured?

In order to close an acquisition, it often seems to require a mind-boggling array of piles of documents to be signed. The Acquisition Purchase Agreement is made up of two major components that work together hand in glove to correctly get the deal done. The first is the Purchase Agreement that defines the agreement between the parties. The second component is the set of support documents that are often referred to as the Ancillary Documents that support and effectuate the Purchase Agreement.

The Acquisition Purchase Agreement has common but different characteristics or components dependent on whether the acquisition is a stock transaction or an asset purchase. The function of the Acquisition Purchase Agreement is to describe the business to be purchased, describe representations, describe the transaction or deal between the parties, provide a timetable and path to closing, define closing conditions and assign or allocate risks in the deal between the seller and acquirer.

Both major components are described below.

A. The Purchase Agreement

Most purchase agreements normally are structured in sections or articles according to the following chronological order:

1. Preamble or Introduction
2. Terminology Definitions
3. Description of the Transaction
4. Representations and Warranties
5. Closing Deliveries and Conditions to Closing
6. Post Closing Covenants and Indemnifications
7. Miscellaneous and Signatures
8. Exhibits and Schedules

The type of business together with the scope, size and complexity of the transaction dictate the use of a particular section and its associated content. For example, an agreement for the sale of a manufacturer will contain representations and warranties that may be quite different than those of a seller of a software company. Though technology
has made it easy for law firms of all sizes to produce incredibly lengthy and sophisticated agreements, acquirers expect that the acquisition agreement fit the particular transaction at hand and exclude unnecessary verbiage.

1. Preamble or Introduction

This introduction section including its length of any preamble tends to reflect the personal style of the drafting attorney or standard practice/protocol in a particular state. The preamble will simply recite the core transaction in a few brief sentences or sections. It is common to see the preamble structured with a series of sentences beginning with the word “Whereas”. If the transaction is small, the preamble may describe and define many if not all of the transaction terms. The preamble normally does not carry legal effect. If the parties intend for the preamble to have legal effect, the agreement should clearly state this, although any significant legal or business terms should be in the body of the agreement. In a larger transaction, the preamble may be brief, because significant terms are defined in a separate section.

2. Terminology Definitions

The definitions section performs several essential functions in the agreement. Definitions will usually appear after the introduction terms; although, some attorneys prefer to place terminology definitions at the end of the agreement, or less often, appended to the agreement as a stand-alone document. Definitions permit the drafting attorney to achieve consistency in the agreement so that if the parties change a definition, the changes apply consistently throughout the agreement.

The acquirer’s and seller’s respective attorneys may negotiate extensively over definitions such as "working capital" "purchased assets" "excluded assets" “purchase price" "assumed liabilities" "knowledge" and "materiality." The drafting attorney should be careful to avoid defining terms that are not relevant to the transaction. The agreement negotiation will start off poorly if the seller’s attorney receives a six-page definition section from the acquirer’s attorney that contains numerous superfluous defined terms from a boilerplate or template agreement not relevant to the transaction at hand.

3. Transaction Structure

The transaction structure section describes the basic business transaction to which the parties have agreed. This section details the purchase price for the stock or the purchased assets, pro-rations and other adjustments to the purchase price, escrowed amounts, assumed liabilities, and allocation of purchase price. Often the acquirer and seller believe they are fully aware of the economics of their transaction until they see it memorialized in this section of the agreement.

If the transaction involves the purchase of an operating business, the parties may often agree upon a working capital adjustment that occurs after the closing date. If the transaction closes on December 31, but the parties used the balance sheet of seller from
October 31 for their closing date figures, the working capital adjustment can increase or decrease the purchase price. If there is a purchase price adjustment in the agreement whether based upon working capital or some other benchmark, the parties should specify who is responsible for preparing the closing date balance sheet. The agreement should also include the mechanism for resolving any disputes over any purchase price adjustment. The parties may include the name of an independent accounting firm that will resolve all disputes.

In a similar vein, the allocation of the purchase price among the purchased assets will affect the net purchase price the seller and ultimately the seller’s owner receive after taxes. The allocation negotiations reflect the differences between the desire of the seller and its owner to maximize after tax proceeds and the acquirer’s desire to amortize the purchase price as quickly as possible and use pre-tax dollars as part of the consideration if possible.

The tax status of the seller affects this analysis. Flow through entities such as Limited Liability Companies and Subchapter S corporations offer the parties greater tax flexibility in structuring the deal than "regular" or Subchapter "C" corporations. However, all tax structures present purchase price allocation issues.

Example A: The Limited Liability Company or Subchapter S Corporation

- A seller that is taxed as a LLC or Subchapter S corporation may own assets that include machinery and equipment with significant economic value that the seller has fully depreciated for tax purposes.

- The acquirer may want to allocate a substantial part of the purchase price to these purchased assets because it can depreciate that part of the purchase price quickly.

- The seller however, realizes that every dollar of purchase price allocated to machinery and equipment triggers depreciation recapture and ordinary income rather than the preferred treatment as long-term capital gain.

Therefore the parties need to negotiate the amount of purchase price to allocate to equipment relative to other assets of the seller.

Example B: The C Corporation

The purchase price allocation for a Subchapter "C" corporation or “C-corp” also presents issues that can change the effective after-tax proceeds. The preferential capital gains rate is not available to the C-corp seller. This often prompts the parties to allocate part of the purchase price to assets or services outside of the seller corporation. For example, the seller’s owner may advocate allocating some of the purchase price to a consulting agreement, covenant not to compete, or goodwill that the owner asserts is not owned by the C-corp seller, but rather
personally by the seller’s owner. This type of allocation in turn competes with the acquirer’s desire to quickly amortize the purchase price.

The agreement should typically specify:

• The agreed allocation of purchase price, which is in the body of the transaction structure or more often appended to the agreement as a schedule.
• The method of determining the allocation.
• The requirement that the parties report the allocation consistently between them for Federal income tax purposes.

4. Representations and Warranties

The representations and warranties, particularly those of the seller, are often a substantial section of the agreement. Although the terms are lumped together, the more accurate term is "seller representations." The representations are "statements of past or existing facts."

These representations usually address the seller’s

• Legal status,
• Authority to transact business,
• Representations about the quality of the purchased assets,
• Operations,
• Financial statements,
• Taxes,
• Litigation,
• Environmental issues,
• Retirement plans,
• Employees and
• Labor matters.
• Acquirer representations, particularly if the purchase price is all cash, are often limited to the status of the acquirer,
• Its organization and
• Its authority to enter into the agreement.
• If the buyer is a newly created entity or thinly capitalized, the seller will also sometimes seek a solvency representation.

The representations and warranties section can also suffer from overuse of a template form agreement. For example, if a seller maintains a simple prototype 401(k) plan, the agreement may not need several pages of representations about the seller’s qualified plans. If the seller is a service business, the agreement may not need extensive environmental representations.

The representations and warranties section may also reflect the due diligence efforts of the seller and acquirer. During the due diligence process, the seller usually provides extensive information about its operations to buyer, including financial statements, information about its assets, significant obligations, environmental reports, personnel
information, and the status of any litigation or claims. This information will usually be condensed and presented on disclosure schedules that are linked to specific representations in the agreement.

Generally the seller will seek to absolve itself of responsibility for items that it has scheduled and disclosed to the acquirer. The acquirer on the other hand desires to avoid responsibility for anything that occurred prior to the closing and may require specific language in the agreement that disclaims such liability. If a disclosed item is significant, the parties will need to specifically negotiate who is responsible after the closing for the disclosure item.

Acquirer and seller negotiations over representations and warranties often revolve around use of the term "knowledge" to qualify a representation. The seller will seek to confine representations to the actual knowledge of the owner, while the acquirer desires that the knowledge of all employees of the company should be imputed to the company. Often, an agreement will merely use the term "knowledge" without defining it. This can create disputes after the closing date that the parties could avoid with a better definition. For example, "knowledge" might be defined as "the knowledge of seller’s owner, chief executive officer, and chief financial officer after due inquiry into the matter." The number of individuals included in the knowledge definition will ultimately reflect the compromise between the acquirer’s desire to include the knowledge of all employees of seller and the seller’s desire to limit knowledge to one person or a select number of key executives or employees.

Representations in the agreement may also be qualified by the term "material," or "material adverse affect." These qualifications often appear in the representations associated with the seller’s financial statements. Many agreements do not define "material" or "material adverse affect." Even an authoritative definition of materiality in a financial statement context is murky.

The parties may resort to specifying a certain dollar threshold as being "material." Based upon the size of the transaction, the parties should consider the degree to which they need to define the terms "material" or "material adverse affect."

5. Closing Deliveries and Conditions to Closing

The closing conditions are specific conditions imposed upon the seller and acquirer as a condition to closing the transaction. These usually include:

- "Date down" representations from the seller that there has not been any material change in the business of the seller, or the condition of the purchased assets from the date of the agreement or a prior date to the closing date.

- Restriction on the seller's ability to make decisions about its operations. For example, the closing conditions may prohibit the seller from paying bonuses to its employees or increasing compensation.
As a practical matter, the acquirer and the seller are often negotiating the agreement up to the closing date. If so, the conditions to closing are less relevant, because the acquirer and seller technically do not have a binding agreement.

Following the closing conditions, the agreement will specify closing deliveries (what each party is required to produce at the closing). Some attorneys prefer to place the closing deliveries at the front of the agreement. It is more common for the deliveries to follow the conditions to closing.

The closing deliverables generally list the manner of delivering the purchase price and the various documents executed on the closing date, including:

- the bill of sale,
- assignment and assumption agreement,
- directors and shareholders resolutions,
- director and officer resignations and
- any leases or other agreements specific to the transaction and
- items needed to consummate the closing of the transaction.

6. Post Closing Covenants and Indemnification

The post closing covenants section of the agreement contains the various promises of the parties that survive the closing date. The most prominent covenant is often the covenant not to compete, which details the scope and duration of non-competition and related restrictions on the activities of seller and its owner after the closing date. Also see "B. Common Ancillary Documents…Number 2”

The indemnification section, although technically a post closing covenant, is usually in a separate section of the agreement after the post closing covenants. The indemnification provisions describe how the seller and acquirer will indemnify each other for the items in the agreement that trigger any indemnification obligation.

Generally, the agreement will require each party to indemnify the other for liability arising out of claims that occur before or after the closing date, as applicable. Each party will also indemnify the other for a breach of their respective representations and warranties.

The parties often negotiate the indemnification provision’s duration, deductibility on indemnifiable claims, and the ceiling or cap on damages recoverable from the indemnifying party.

In order to avoid the ten-year statute of limitations on a written contract, the seller, and seller’s owner who is often required to personally indemnify the acquirer, will seek to limit the indemnification period to a relatively short term of twelve months or less. The acquirer, knowing the seller will not agree to a ten-year indemnification provision,
typically seeks an indemnification period such as three years. Generally, the indemnification for environmental matters and fraud will not contain any limitation period and indemnification for tax matters typically will not expire until the relevant statute of limitations underlying the tax matter has expired.

The indemnification deductible is premised upon the desire of the parties to avoid disputes over minor items. For example, if the purchase price is $10 million, the parties may agree that the acquirer cannot recover the first $100,000 of items that would otherwise be indemnifiable by the seller.

The deductible may take the form of a true deductible so that the acquirer recovers the first dollar for any claim or claims in excess of the deductible (e.g. only $1 is indemnified for $100,001 in damages in the above example), or a reset or disappearing deductible which requires the seller to indemnify the acquirer from the first dollar if claims exceed the deductible. Like the varying limitations periods on certain representations, the parties may agree that a deductible does not apply to particular claims such as tax or fraud claims.

Whether there is a cap or ceiling on the amount indemnified and the dollar amount of such cap is the final major prong the parties typically negotiate involving indemnification. The seller and its owner seek to limit indemnification obligations as much as possible, while the acquirer seeks to avoid any cap or ceiling. Often, the negotiated result is a cap on indemnification limited to the purchase price for the purchased assets. In certain circumstances, the seller may be able to reduce the indemnification ceiling based upon the nature of the industry and the knowledge that the acquirer possesses about the seller.

Importantly, the agreement will define the indemnification procedure to be followed by the parties. This section should describe the method in which the indemnified party must notify the indemnitor about an indemnifiable claim, the ability of the indemnitor to use its own counsel, and the consequences of the indemnitor’s failure to fulfill its indemnification obligations under the agreement.

7. Miscellaneous and Signatures

The miscellaneous section of the agreement normally contains other miscellaneous terms. The miscellaneous section typically specifies governing law, the venue for disputes and the method of resolving disputes. This section may also specify that the prevailing party be entitled to its legal fees and costs if it prevails in any dispute.

Often included are arbitration clauses, an increasingly popular approach to resolving disputes. If the parties agree that arbitration will resolve disputes, they should specify in detail the protocol for conducting the arbitration and its legal effect.

And lastly, the signature pages should include correct spelling of each individual with their respective correct title.
8. Exhibits and Schedules

It is common practice for drafting attorneys to use exhibits and schedules to list exactly what is being conveyed by the parties in the agreement. For example the parties may have the document call for schedules of:

- Cash and Cash Equivalents,
- Accounts Receivable,
- Inventory,
- Equipment,
- Customer Contracts,
- Other Assumed Contracts,
- Intellectual Property,
- Software Licenses,
- Permits and Authorities
- Environmental Permits,
- Financial Statements,
- Collective Bargaining Agreements,
- Leases,
- Account Payables Assumed and the like.

In some cases, the schedule will be for something that is nil, in such case the parties put none or N/A and initial the entry. Certain documents may be treated in a similar manner as schedules such as:

- Bill of Sale,
- Sellers Closing Certificate or
- Sale of Trade Name.

The overall effect is for the transaction to be very specific as to what assets are being sold and what liabilities are assumed and what items are conveyed as part of the ongoing business. Consent documents may be handled in a similar way such as:

- Consents by the Board of Directors,
- Consents of the Shareholders, and
- Consents of the Limited Liability Company Members or Managers.

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B. Common Ancillary Documents That Further Comprise The Acquisition Agreement

Introduction

Whether the transaction calls for an asset purchase agreement or a stock purchase agreement, negotiating and drafting the purchase agreement, itself, is only part of the final set of documents. The attorneys must also prepare the ancillary documents to support and effect the purchase agreement. A correct understanding of the function of each of the documents and attention to detail in negotiating the same are critical to the transaction’s success. They typically are as follows:

1. Title Documents
2. Non-Compete Agreement
3. Employment Agreement and Consulting Agreement
4. Escrow Agreement
5. Promissory Note
6. Security Documents
7. Legal Opinion
8. Real Estate Documents

The following is a brief overview of the ancillary documents to a purchase agreement.

1. Title Documents

Purchase agreements are agreements to do something, i.e., to sell and buy assets or stock or to merge two companies. However, they are not the documents by which such acts are achieved. To actually effect the transaction purchase agreements will be accompanied by title documents. These are the documents by which title to the property is transferred from the seller to the acquirer and by which the acquirer becomes the actual owner of such property.

In an asset sale, the assets are transferred from the seller to the acquirer by a bill of sale. The bill of sale incorporates the representations of seller about the assets set forth in the purchase agreement. If the company is selling registered trademarks and/or patents, separate assignment agreements are used that will be filed with the United States Patent and Trademark Office.

In addition, in most asset purchase agreements, the acquirer will assume the trade payables and the business contracts of the seller at closing. The parties accomplish this by entering into an assignment and assumption agreement whereby the seller assigns and the acquirer assumes such payables and contracts. This agreement should specifically state
when the acquirer is assuming the obligations and liabilities such as those that accrue on or after the closing date.

The parties should be aware that many contracts require the consent of the other party to the contract before it can be assigned. Failure to obtain such consent would be a default under such contract, possibly resulting in termination. The acquirer’s counsel would normally advocate that the seller obtain consents where required to all material contracts. In any asset sale, the parties must comply with bulk sales statutes of say inventory, and ensure that all accounts payable are paid.

In addition, the board of directors of the seller must approve a sale of all or substantially all of the assets of a corporation other than in the usual and regular course of business and two-thirds of the outstanding shares entitled to vote. Shareholders must be given notice of their right to dissent. Shareholders who make a demand for payment before the vote is taken and who do not vote for the sale may dissent thereto by following the statutorily ascribed procedure to dissent.

In a stock purchase agreement, the stockholders assign their stock to the acquirer. This is often achieved by use of an assignment separate from the certificate, also known as a stock power. In a merger agreement, certain states require that filing articles of merger with the secretary of state effects the merger.

Merger agreements need to be approved by the seller’s board of directors and most merger agreements need to be approved by two-thirds of the outstanding shares entitled to vote in the non-surviving corporation. Shareholders who make a demand for payment before the vote is taken and who do not vote for the merger may dissent thereto and receive fair value for their shares. The non-surviving corporation must give notice to the shareholders of their right to dissent and any shareholder who desires to avail himself of such right must follow the statutorily ascribed procedure to dissent.

Acquirer’s counsel usually drafts the acquisition agreement and the title documents.

2. Non-Compete Agreement

From the acquirer’s perspective, the non-competition agreement is especially important.

When buying the business, the acquirer has the rightful expectation that the seller will not move across the street or around the corner and set up a competing business; otherwise, the acquirer would not have paid a premium over book value for the company as an ongoing business. The agreement that protects this expectation is the non-competition agreement.

The non-competition agreement generally includes four covenants:
First, the seller agrees not to compete with the acquirer. This prohibits a seller from engaging in any activity that is competitive with the business sold to the acquirer in a particular, well-defined territory for a particular period of time.

Second, the seller agrees not to solicit any of the customers of the business. This prohibits the seller from doing business with the company’s prior customers for a particular period of time, no matter where such customer is located. Often, the seller will also be prohibited from inducing any supplier, licensee, licensor or other business relation from discontinuing or reducing its relationship with the buyer, as it pertains to the purchased business.

Third, the seller agrees not to entice away the employees of the sold enterprise for a particular period of time.

Finally, the seller agrees to hold as confidential all confidential information pertaining to the sold business for a particular period of time.

Covenants not to compete are easier to enforce in the sale of business context than in the employer/employee context. One court has held,

"If the covenant [not to compete] is ancillary to the sale of a business by the covenantor to the covenantee, then all the covenantee must show is that the restriction is reasonable as to time, geographical area and scope of prohibited business activity. If, however, the covenant is ancillary only to an employment agreement, the covenantee must show additional special circumstances, such as a near-permanent relationship with his employer’s customers and that but for his association with the employer, the former employee would not have had contact with the customers."

Most attorneys for the acquirer will agree that it is good practice to have the seller acknowledge in the non-competition agreement that the agreements and covenants contained therein are central to the goodwill of the sold business; that the acquirer would not have entered into the business purchase but for the covenants and agreements; and that such agreements and covenants are reasonable in geographical and territorial scope and in all other respects.

In addition, drafting attorneys normally require the seller to acknowledge that a court of law may reduce the scope, duration or area of any term or provision or replace or delete certain words in order to prevent such agreement from being invalid or unenforceable.

Finally, this agreement should provide that the acquirer, among its other remedies, may seek injunctive relief against the seller for the breach thereof without the requirements of posting a bond. The acquirer’s counsel usually drafts this agreement.

3. Employee Agreements and Consulting Agreements

Although not always the case, at the closing of a purchase agreement, the key stockholders and managers of the seller will often enter into an employment agreement or a consulting agreement with the acquirer. This is done for two reasons:
• The acquirer often wants to keep such people around to continue to run the business or to train the acquirer to manage the business. If the acquirer is a financial buyer i.e. a private equity firm, it will almost certainly require employment agreements for such people because, as a general rule, although the private equity firm will provide management oversight for the re-capitalized company, it will not run its day-to-day operations.

• The acquirer will often try to transfer some of the purchase price to the employment agreement. By doing so, the employer/acquirer is able to expense the cost of such employment for tax purposes, which permits it to deduct such costs from income during the year that expense is incurred.

The same principles apply to a consulting agreement. Typically, a consulting agreement has a shorter duration than an employment agreement (e.g., one to six months). Also, because the consultant is an independent contractor, the employer generally does not provide benefits to the consultant or have to withhold taxes. Acquirer’s counsel generates these agreements.

4. Escrow Agreement

Escrow agreements are commonly used in purchase agreements. An escrow agreement is an agreement whereby the acquirer and the seller establish an escrow fund with a third party, typically a bank. A portion of the purchase price is placed in the escrow fund to protect the acquirer.

Escrow agreements are used for a variety of purposes. The two chief functions of an escrow agreement and the escrow fund is to provide a readily-available fund to pay any of seller’s indemnification obligations or to pay for any purchase price adjustment that may be necessary.

As noted earlier in this white paper, the purchase agreement contains a section wherein the seller is making certain representations and warranties about the business being sold. Another section of the purchase agreement covers indemnification. Among other things, this section requires the seller to indemnify the acquirer from any damages the acquirer might experience as a result of a breach by the seller of the representations and warranties.

Generally, the duration of the indemnification obligation depends upon both the representations and warranties being breached and the negotiating leverage of both parties. Typically, breaches of representation about authority to do the transaction, validity of the transaction, enforceability of the transaction, title to the assets and third party fees can last forever. Breaches of representations about taxes, environmental and employee benefits will last for the relevant statute of limitations. All other breaches of representations (e.g., regarding litigation, condition of the assets or the financial statements) last for an abbreviated period (e.g., 18 months or two years).
However long such representations may be valid, the seller’s promise to indemnify is only as good as its ability to pay. When the sellers receive payment at closing, it is not unusual for them to re-deploy the funds immediately or to use such monies to fund trusts for the benefit of others, including children and grandchildren. As a consequence, an acquirer is often left with the possibility of suing someone who no longer has enough assets to make good on a claim.

To avoid this problem, the acquirer generally insists that a portion of the purchase price, typically 10 to 15 percent, be placed in an escrow fund as a source of compensation for such eventualities. The escrow agreement provides the mechanism for releasing such funds to the acquirer upon a successful claim for damages against seller.

The escrow agreement also provides a mechanism whereby the seller can dispute such a claim, preventing the release of funds. In the event of a dispute, the escrow agent will not release the funds until it has received a signed agreement from both the acquirer and the seller or a final non-appealable judgment of a court or arbiter. At the end of a negotiated period, the funds remaining in the escrow fund, reduced by any amounts needed to cover any disputed claims, are released to the seller.

Escrow agreements also provide a source of funds to the seller to pay any purchase price adjustment. The purchase price in many purchase agreements is based upon the financial statements of the purchased company at a particular point in time. Or, the purchase price can be based on the assumption that the purchased company will have net assets or working capital at the time of the closing equal to a certain amount.

In the earlier discussion regarding the purchase agreement example where the purchase price was based on the balance sheet as of October 31 and the closing was December 31, there could be a working capital adjustment. Within a certain amount of time after the closing, the parties calculate the balance sheet as of the December 31 closing date of the purchased company and the price adjustment is then made from the escrow.

There is usually a procedure specified in the escrow agreement to resolve any differences. If the target amount of net assets or working capital is not met, then the purchase price is adjusted upward or downward, as the case may be. If the purchase price is adjusted upward, the acquirer pays the difference to the seller. If the purchase price is adjusted downward, the seller must pay back the difference.

Since the acquirer is not always confident that the seller will not have disbursed the purchase price by the time of the downward adjustment, the acquirer requires the seller to put a certain amount of the purchase price into the escrow fund at the closing. The acquirer, the seller and the escrow agent sign an escrow agreement.

The escrow agent will be concerned about three things:

- The agent will want to see that its responsibilities are set forth clearly in the escrow agreement.
The agent will want the escrow agreement to be a stand-alone document *i.e.*, it does not want to have to refer to any other document (*e.g.*, the purchase agreement).

The agent will be particularly concerned about the provisions detailing its liabilities. Most escrow agreements provide that the escrow agent will only be liable for its gross negligence or intentional malfeasance.

In addition, the escrow agreement permits the escrow agent to submit any dispute between the other parties to a court for resolution. It also details the procedure allowing the escrow agent to resign. Accordingly, it is advisable to get the escrow agent involved in the preparation of the escrow agreement well before its execution. The acquirer’s counsel usually prepares the escrow agreement.

5. **Promissory Note**

Many acquirers and/or the lenders providing the acquisition financing will require that a portion of the purchase price be paid in the form of a promissory note to the seller often called a seller note or seller financing. Many times this can represent a portion of the purchase price that may vary greatly depending on numerous issues among the parties such as risk, urgency to close, strength of the company, strength of the acquirer and many more.

The promissory note also provides the acquirer with some comfort in the event of a breach by the seller of some part of the purchase agreement. The acquirer will provide in the purchase agreement that it can offset any payment due under the promissory note against any claim for indemnification it has made. The seller will often require that such offset be put in an escrow fund until the dispute is resolved. Acquirer’s counsel usually prepares the first draft of the promissory note.

6. **Security Documents**

If the seller accepts a promissory note in a transaction, it will be entitled to security for such payment. In many instances, the seller will receive a subordinated security interest in the assets being purchased pursuant to a security agreement by and between the acquirer and the seller that will be accompanied by a UCC-1 filing.

The seller sometimes requests a pledge of the stock of the acquirer, or some portion thereof, from the principals under a pledge agreement. In the alternative, the seller may request that the principals of the acquirer execute a guaranty of the promissory note.

The acquirer will usually resist giving a guaranty from the principals, since it encumbers their credit and future ability to obtain financing. The acquirer will also usually resist any request to secure the promissory note with a letter of credit because a letter of credit will reduce the acquirer’s amount of available credit on a dollar-to-dollar basis equal to the value of the letter of credit.
Banks will always require that the seller sign a subordination agreement whereby the seller’s security interest in the assets will be subordinate to the bank’s security interest. The subordination agreement will also contain a standstill provision, which prohibits the seller from exercising any remedy pertaining to the promissory note and security agreement for a particular period of time after a default by the acquirer.

Banks will also often require a standstill agreement with respect to a pledge agreement or a guaranty. The reason for this is simple. If an acquirer defaults under the promissory note and the security documents, it may be or may become in default under the bank’s loan documents as well. For its part, the bank wants to maintain the status quo for as long as possible after any default by the acquirer to give the buyer room to remedy the situation and to position itself to recapture the greatest portion of its loan. And, more importantly, the bank is not going to permit some other party to foreclose on its first lien position

The seller’s counsel typically drafts the first drafts of security documents. The bank’s counsel typically generates the first drafts of subordination agreements and standstill agreements between the seller and the bank.

7. Legal Opinions

While this author believes them to be bogus exercises, some purchase agreements require that the seller’s counsel provide a legal opinion to the acquirer at closing. If that is the case, and the seller’s counsel is willing to provide the opinion (rarely), the seller’s counsel will usually request that the acquirer’s counsel provide a reciprocal opinion. For the most part, legal opinions do not provide much substance to the transaction and only add legal fees to the total transaction.

Many articles have been written on legal opinions and the conventions regarding the same. If there is a legal opinion, at a minimum, the parties will request that counsel opine that:

- The client is organized in its state of organization.
- The client has the power to enter into the purchase agreement and the documents ancillary thereto and that all necessary actions have been taken by the client to authorize the execution, delivery and performance of the purchase agreement and the documents ancillary thereto.
- Any such documents do not violate the client’s organizational documents or any statute or regulation.
- Any such documents have been duly executed and delivered.
- Any such documents constitute the legal, valid and binding obligations of the client and are enforceable against it in accordance with its respective terms.
- The right of the client to enter into the transaction does not require the consent of any court or governmental agency.
Opinions often are accompanied by certain assumptions and exceptions that can be heavily negotiated by the respective counsel of buyers and sellers. Unlike the other ancillary documents, the clients do not have any input into the opinions.

Legal practitioners normally avoid giving opinions related to factual matters, as opposed to legal matters. A typical example of such an opinion requested from the seller’s counsel is that "counsel has no knowledge of any litigation involving the client, except as disclosed in the schedules to the asset purchase agreement or except for litigation which would not have a material adverse effect on the sold business."

The forgoing is not a legal opinion, because it does not require any legal analysis. In this case, the acquirer’s counsel would be trying to get the seller’s counsel to make a statement of fact (a representation) that is covered by the purchase agreement already. This sort of thing occurs occasionally but no attorney will normally agree to do so, so any discussion serves only to drive up billable hours.

The acquirer and its counsel should rely on the purchase agreement and all due diligence information to verify such a representation. An attempt to get the seller’s counsel to opine as to the statement of facts reflects the acquirer’s lack of confidence in the seller’s candor or its due diligence. It is also an attempt to make the seller’s counsel, and more importantly, its insurance carrier, liable for breaches of the seller’s representations.

8. Real Estate Documents

The acquisition purchase agreement is often accompanied by a real estate transaction. If the seller owns its real estate, it can either sell or lease such real estate to the acquirer. If the seller leases its real estate, the seller and the acquirer will enter into a lease assignment agreement that will almost always require the consent of the landlord. These commercial transactions follow the general conventions of real estate transactions.

Conclusion

This white paper has reviewed the major components of an acquisition purchase agreement. The supporting or ancillary documents to a purchase agreement are critical to the overall business purchase agreement itself as are both to the success of a transaction. The counsel for the respective parties must ensure that these documents properly and accurately reflect the deal between the parties. As such, this writer always encourages principals to engage experienced deal savvy investment bankers and attorneys to represent their interests in this, a significant transaction.

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