# AN ATTORNEY'S PERSPECTIVE IN NEGOTIATING THE BUSINESS ACQUISITION

## I. General Considerations

A. **Buyer's Market**. Due to long-standing market conditions and increased availability of sophisticated purchase documents crafted on behalf of well-positioned buyers by large law firm representation over a many year period, the business acquisition arena continues to generally favor the buyer's circumstances. Accordingly, generally speaking, the buyer with financial resources enjoys substantially increased leverage in structuring the acquisition and the contents of the legal instruments documenting the transaction. In that type of market, the buyer is often able to successfully negotiate one or more basic business points such as a relatively favorable purchase price, low down payment, substantial deferred payments of the purchase price which are seller financed, and no personal guarantee of the deferred payments of the purchase price. Oftentimes, deferred payments of the purchase price are based on contingencies, the most common of which are based on future productivity of the purchased business, sometimes referred to as an "earnout" contingency. In addition, payments that would otherwise be upfront payments of the purchase price are also deferred, in the form of withheld reserves or escrows, to secure various seller representations or to ensure that certain transferred net working capital thresholds are met. The content and wording of seller warranties and representations, and the related seller indemnification provisions, have particularly been molded through decades of sophisticated crafting by large law firm representation of deal-advantaged buyers, providing increased buyer protection and the potential for purchase price clawback.

B. **Negotiation Process**. In a typical acquisition involving an attorney, the buyer will generally perform an extensive due diligence review of the company to be purchased and have prepared significant legal documents, usually in the form of an asset purchase agreement, stock purchase agreement or a merger or conversion agreement, along with numerous exhibits and related agreements, such as covenants not to compete, promissory notes, security agreements, consulting or employment agreements, and various due diligence and closing certificates of representatives of both buyer and seller. Of particular significance is also the inclusion, as exhibits, of often voluminous disclosure schedules to support copious seller warranties and representations contained in the agreement.

The due diligence and document preparation process not only entails a significant expenditure of both the buyer's and seller's time, emotion, and energy, but also, the incurrence of significant expenses in the form of professional fees and related expenses. It is, therefore, imperative that both parties ascertain that there is a "real deal" at the earliest stage possible, so that a party to the transaction is not placed in the position of making unnecessary concessions in order to avoid losing its considerable investment in terms of time and money, which is growing more and more significant as the acquisition process continues.

Worst yet is the exposure of losing the entire deal at the tail end of the due diligence process, due to the inability of the parties to reach agreement on some material point,


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

which disagreement could have been discovered, and possibly resolved, prior to the expenditure of substantial time and money in the acquisition process.

## II. Certain U.S. Income Tax Considerations

A. **From the Seller's Perspective**. It is generally advantageous for the seller to obtain two U.S. income tax objectives when selling his business: (i) incur a single level of tax at (ii) individual capital gain rates.

One way to achieve these two objectives is for the seller to sell his equity interests in the entity conducting the business rather than the assets of the business themselves. However, in most scenarios, a buyer will not be willing to accept the risk of unknown or undisclosed liabilities that would carry over to the buyer in an equity interest purchase, in addition to a buyer's unwillingness to purchase equity interests due to the different tax objectives of buyer discussed below. Therefore, a seller is often not able to successfully negotiate an equity interest sale.

Other than depreciation recapture (including amounts previously expensed under IRC §179) taxed at ordinary income rates, a seller can generally achieve these two objectives even when selling the business assets, rather than the equity interests, for businesses conducted by "pass-through" entities, such as partnerships, limited liabilities companies, and S corporations. In such cases, the U.S. income tax objectives of both seller and buyer can generally be accomplished through an asset sale and purchase.

When selling a business conducted by a C corporation, with its inherent double U.S. income tax structure, consideration of the concept of "personal goodwill" discussed below may ameliorate the harsh U.S. income tax consequences to seller under the right circumstances.

B. **From the Buyer's Perspective**. It is generally advantageous for the buyer to purchase assets rather than equity interests in order to allocate the purchase price to depreciable or amortizable assets for subsequent U.S. income tax benefits.

This generally works out fine for both buyer and seller when the selling entity is a "pass-through" entity, such as partnerships, limited liability companies, and S corporations, where the assets of the entity can be purchased without creating a double tax situation for the seller and, at the same time, allowing for allocation of the purchase price among depreciable or amortizable assets for future cost recovery deductions which will benefit the buyer.

When purchasing a business conducted through a C corporation, with its inherent double U.S. income tax structure, consideration of the concept of "personal goodwill" discussed below may ameliorate the harsh U.S. income tax consequences to seller and still allow future tax benefits to the buyer through future amortization deductions of goodwill intangibles.

C. **Personal Goodwill**. As many purchasers of corporate businesses are insistent on purchasing the assets of the business rather than the stock in the corporation, a double taxation situation occurs for the shareholders of a selling C corporation, a tax at the corporate level and another tax at the shareholder level.


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

A concept designed to, among other things, eliminate a substantial portion of the double taxation under the right circumstances is to recognize that a large portion of the "goodwill" value of a C corporation is not really goodwill of the corporation, but rather goodwill of the key employee/owner ("personal goodwill"). Accordingly, in the right situation, a large part of the purchase price could be allocated and paid directly to the key employee/owner and treated as the sale of a capital asset, resulting in one level of tax at individual capital gain tax rates. There are two seminal key cases in this area: (i) *Martin Ice Cream Company v. Commissioner of Internal Revenue*, 110 T.C. 189 (1998) ("*Martin Ice Cream*") and (ii) *William Norwalk, Transferee, et al v. Commissioner of Internal Revenue*, T.C. Memo 1998-279 ("*Norwalk*").

In *Martin Ice Cream*, the Tax Court held that there is no saleable goodwill in a corporation where the business of the corporation depends on its key employees, unless the key employees had entered into a covenant not to compete with the corporation or another agreement whereby their personal relationships with clients become the property of the corporation. In *Norwalk*, the court held that the shareholder accountants in a liquidating accounting firm realized no taxable income for receipt of corporate goodwill, the goodwill already residing in the individual shareholder accountants absent any covenant not to compete or similar agreement with the accounting firm. Other, more recent cases supporting the personal goodwill position include *Bross Trucking, Inc.*, T.C. Memo 2014-107 and *Estate of Adell*, T.C. Memo 2014-155. But also see two contra cases: *Larry E. Howard v. U.S.*, Doc 2010-17126 (E.D. Wash. 2010), personal goodwill not allowed where dentist was subject to a pre-existing covenant not to compete agreement with his wholly owned practice, and *James P. Kennedy v. Commissioner*, T.C. Memo 2010-206, personal goodwill payments treated as payments for services where seller worked for buyer for several years after sale of company.

Also to be considered is the principle that the presence of personal goodwill is presumably determined in a competitive context, not in a retirement context. That is, it appears that the issue is not whether the corporation could continue if the shareholder were to retire and not be active in the same line of business, but rather, it appears that the question is whether the corporation's business would follow the shareholder if the shareholder engaged in a competitive business.

The estimated percentage of potential U.S. income tax saved from re-allocating each dollar away from corporate goodwill to personal goodwill is 19.8%, assuming a corporate tax rate of 21% (replacing the previous highest corporate tax rate of 35%), an individual capital gain and dividend tax rate of 20%, and non-application of the 3.8% Medicare surtax on the sale of personal goodwill (gain on sale of trade or business property exception), computed as follows:

## Scenario One: Sale of Assets, No Personal Goodwill

| | |
|---|---|
| Sales Proceeds | $1.00 |
| Corporate Tax (21%) | (0.21) |
| | |
| Remaining Funds Distributed to Shareholder | 0.79 |
| Individual Dividend Tax (20%) | (0.158) |


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

| | |
|---|---|
| Individual 3.8% Tax on Net Investment Income | (0.03) |
| Remaining Funds for Shareholder After U.S. Income Taxes | $0.602 |

## Scenario Two: Sale of Assets, With Personal Goodwill

| | |
|---|---|
| Sales Proceeds (Paid to Shareholder for Personal Goodwill) | $1.00 |
| Individual Capital Gain Tax (20%) | (0.20) |
| Remaining Funds for Shareholder After U.S. Income Taxes | $0.80 |

## Difference: $0.80 - $0.602 = $0.198 or 19.8%

D. **IRC §1060**. IRC §1060 was enacted primarily to address certain problems encountered by the IRS with respect to the prevalent practice of inconsistent tax reporting by buyers and sellers of the tax consequences relating to their business sales and purchases. For example, sellers would tend to allocate the purchase price toward goodwill to obtain favorable capital gain rates and buyers would allocate the same amounts to depreciable tangible personal property to obtain depreciation deductions. IRC §1060 requires the buyer and the seller to allocate the purchase price amongst the purchased assets pursuant to the residual method of accounting. To help inform the IRS of such allocation, both buyer and seller are required to file IRS Form 8594 with their respective U.S. income tax returns in the year of sale in order to report such allocation. If the buyer and seller agree to a purchase price allocation in the acquisition documents, then the parties are required to report the U.S. income tax consequences of such sale consistent with such agreement.

III. **Letter of Intent**

A. **In General.** Although negotiation of some points in the later stage of the transaction is almost always unavoidable, the preparation of the definitive agreements should be made as anti-climatic, as possible. Perhaps, the most significant negotiation stage of the business acquisition should be consummated at the beginning of the negotiation process and is best documented through a preliminary document often referred to as a letter of intent. Oftentimes, not enough attention is placed on this important document, so that some potentially contentious issues are left for resolution later on in the process; or, at times, a letter of intent is not entered into prior to the preparation and execution of the definitive agreements.

On the other hand, many times, the letter of intent is left intentionally vague by well-positioned parties, usually, the buyer. In such case, the buyer might use the letter of intent merely to tie up the seller for an extended period through an exclusivity provision (since the other substantive provisions contained in the letter of intent are generally stated not to be enforceable). Additionally, in such case, postponement of potentially contentious issues (such as content of seller's representations and indemnification provisions) could be viewed as a strategy by the buyer to obtain important concessions down the road, at a time when seller's walk-away power may have been significantly diluted due to the time, energy, and cost incurred by the seller as the pre-closing activities progress.

B. **From Buyer's Perspective**. The letter of intent should clearly outline all major business points, which could be "deal breakers", including, aside from the obvious amount and payment terms of the purchase price, (i) whether any personal guarantees are to be required of the buyer for any deferred payments of the purchase price; (ii) whether any assets of the purchased business or other assets of the buyer are to be used as collateral by the seller for any deferred payments of the purchase price; (iii) the contents of warranties and representations and the consequences of any violation of any warranties and representations, including whether a right of offset will be granted; (iv) a long survival period for the seller's warranties and representations after closing; (v) a high "ceiling" for which the indemnification obligation for breach of seller's warranties and representations cannot exceed; (vi) whether legal opinions will be required; (vii) the establishment of contingencies on deferred payments, including the parameters of any "earnout" provision; and (viii) restrictions on seller conduct pending the closing process.

C. **From Seller's Perspective**. Aside from the obvious amount and payment terms of the purchase price, the seller will want (i) personal guarantees of solvent individuals or entities associated with the buyer for any deferred payments; (ii) a security interest in some or all of the purchased assets of the business or in other collateral of the buyer to secure payment of any deferred payments; (iii) specific and short term dates for each step of the closing process, with required earnest money deposits at each stage; (iv) confidentiality provisions; (v) provision for a "deal-breakup" fee; (vi) specific delineation of employment or consulting agreement terms; (vii) provision for "reduced" warranties and representations of seller; (viii) a high "basket" amount before indemnification for breach of seller's warranties and representations would apply; (ix) a low "ceiling" for which the indemnification obligation for breach of seller's warranties and representations cannot exceed; (x) a short survival period for the seller's warranties and representations after closing; and (xi) removal or restriction of contingencies on deferred payments.

## IV. The Due Diligence Process

A. **Seller's Provision of Information**. As a buyer often has the ability to choose among alternative businesses to purchase, for a seller to achieve the highest sales price, most favorable terms and a quick closing, the seller must be prepared to provide pertinent information regarding the business in a highly organized and expedient fashion. In the case of financial information about the business, the seller should be aware that information reported to various taxing authorities, such as federal income tax returns, federal payroll tax returns and state sales tax returns generally will be more credible than internally generated financial statements and reports. Other third party information, such as bank statements, will also be considered highly credible as evidencing actual income and expenses. Therefore, inconsistencies among such data should be reviewed and handled prior to dissemination of information to the buyer. As entries in the financials involving activities between the seller and it owners (such as advances to and from the owners) can lead to various issues in the sales process, related party entries should be "cleaned up" and/or removed from the books in connection with the initial analysis of the seller's financial information. Audited or compiled financial statements by a reputable CPA firm should provide additional credibility, as well.


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

B. **Early Initiation of Third Party Actions and Consents**. Oftentimes, actions or consents of third parties may be required to properly accomplish the transfer of the business from the seller to the buyer. Early initiation of obtaining such third party actions or consents is imperative with respect to a timely closing. Third party action and/or consent is often involved where there are third party liens that need to be released, real estate leases to be assumed and customer/vendor/franchisor/licensor agreements to be assigned. Curing title to assets may be involved, as well, particularly for real estate, personalty subject to a security interest and intellectual property rights. Be sure to order early a title policy commitment for all real estate to be purchased and a UCC search on each selling party. All environmental studies, structural inspections and heavy equipment testing should be accomplished early, as well.

C. **Quick Closing Desired by Seller**. Particularly, the seller should desire as short a due diligence and document preparation period, as possible. As the time period before closing lingers on, there is more opportunity for a buyer to find a better deal. Furthermore, because knowledge of an impending sale generally spreads quickly to employees, suppliers and customers (often with detrimental effect), a long pre-closing period may have a chilling effect, not only with respect to the current buyer, but with future buyers, as well, in the event the current purchase falls through. Substantial earnest money, with specific time commitments for future actions, should be sought by seller, particularly in view of the fact that a newly formed corporate shell will often be the party executing any binding agreement involving the acquisition as buyer.

## V. Definitive Agreements

A. **Warranties and Representations/In General**. The seller naturally desires to receive the purchase price from the sale of the business with very limited rights of the buyer to obtain a refund back of all or a portion of the purchase price (called a "clawback") or to reduce or eliminate deferred payments. In addition to certain contingencies which may be placed on deferred payments, a buyer usually obtains warranties and representations from the seller, which if breached and causing damage to buyer, give the buyer certain rights against the seller.

Attorneys for sellers typically attempt to restrict the warranties and representations to the basic ones regarding organization and existence, ownership of stock or assets, authority, no violation and no default.

Buyer's counsel usually requires a myriad of additional warranties and representations, including accuracy of financial statements, absence of certain changes, tax matters, contracts and agreements, absence of liens, fringe benefits, pension and other retirement plans (ERISA matters), real estate, leases, insurance, intellectual property, permits, personnel data, labor relations, compliance with laws, inventory, transactions with related parties, environmental compliance, permits, accounts receivable, accounts payable, customers and suppliers, improper payments, warranty claims, interests in customers and vendors, litigation, and full disclosure. Particularly for larger transactions, the seller's attorney may be required to render a legal opinion as to the validity of certain warranties and representations.

As a seller will often be a shell entity after the sale of the business and distribution of the sales proceeds to its owners, it is important from the buyer's perspective to have the ultimate recipients of the sales proceeds, usually the owners or shareholders, join in on the


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

warranties and representations and assume joint and several liability with respect to breaches thereof.

B. **Some Specific Purchase Agreement Provisions.** Most modern purchase agreements will contain substantial and sophisticated seller warranties and representations provisions, related seller indemnification provisions and other terms and conditions that may need special consideration. This is true, more and more, even for relatively small deals due to the easy accessibility of modern day mergers and acquisitions form agreements. Various alternatives to some of these provisions are discussed below.

(a) **Material Adverse Effect.** The definition of "Material Adverse Effect", a key term in many of the warranties and representations provisions, can be defined to, among other things, (i) include, exclude or be silent on adverse effects relating to seller's prospects and (ii) include, exclude or be silent with respect to forward-looking language (such as, "or could reasonably be expected to have a materially adverse effect"). Below is an example of a basic, pro-buyer "Material Adverse Effect" provision:

> **Material Adverse Effect**" means any result, occurrence, fact, change, event or effect *(whether or not constituting a breach of a representation, warranty or covenant set forth in this Agreement)* that, individually or in the aggregate with any such other results, occurrences, facts, changes, events or effects, (i) would have *or could reasonably be expected to have* a material adverse effect on Seller's or the Business's historical, *or near-term or long-term projected*, business, operations, *prospects*, assets, liabilities, condition (financial or otherwise) or results of operations (including EBITDA or cash flow), (ii) would or could reasonably be expected to prevent or materially impair or delay the ability of any of the Selling Parties to consummate the transactions contemplated by this Agreement or perform their duties under this Agreement or the Seller Documents or the Shareholder Documents, or (iii) would or could reasonably be expected to be materially adverse to the ability of Purchaser to operate the Business immediately after the Closing substantially *in the manner as the Business was operated by Seller immediately prior to the Closing*. [Emphasis added.]

(b) **Material Adverse Effect Carveouts.** In view of the comprehensive and generally all-inclusive definition of "Material Adverse Effect" promoted by buyers, sellers may attempt to ameliorate the circumstances giving rise to a "Material Adverse Effect" through various carveouts. Below is an example of a "carveout" provision:

> Notwithstanding the foregoing, "Material Adverse Effect" does not include a circumstance, that would otherwise constitute a Material Adverse Effect, to the extent such circumstance results from (i) changes in general local, domestic, foreign, or international economic conditions, (ii) changes affecting generally the industries or markets in which Seller operates, (iii) acts of war, sabotage, or terrorism, (iv) military actions or escalations thereof, (v) changes in applicable laws or accounting rules or principles, including changes in GAAP, (vi) actions required by this Agreement, or (vii) the announcement of the Transaction.

Even where a buyer is willing to accept the carveout concept, such buyer may then counter with a provision that would make the carveouts inapplicable if the seller is impacted more than other parties by such change in circumstances. See, for example, the following modification to the provision above:

> Notwithstanding the foregoing, "Material Adverse Effect" does not include a circumstance, that would otherwise constitute a Material Adverse Effect, to the extent such circumstance results from (i) changes in general local, domestic, foreign, or international economic conditions, (ii) changes affecting generally the industries or markets in which Seller operates, (iii) acts of war, sabotage, or terrorism, (iv) military actions or escalations thereof, (v) changes in applicable laws or accounting rules or principles, including changes in GAAP, (vi) actions required by this Agreement, or (vii) the announcement of the Transaction *(provided that any such aforementioned circumstance, event, change, or action does not affect Seller in a substantially disproportionate manner than other comparable parties)*. [Emphasis added.]

(c) **Materiality Scrape.** Sophisticated buyers often include a "materiality scrape" in the indemnification provisions of the modern purchase agreement. Although the specific warranty or representation contains a materiality qualification, the materiality qualification is disregarded (it is "scraped") when calculating damages for an indemnification claim against seller. Usually, the materiality scrape provision is a "double scrape"; that is, the "scrape" applies to determine both (i) whether or not a breach has occurred and (ii) the amount of indemnified damages that result from such breach. Sometimes, the provision is only a "single scrape", applying the scrape only to the determination of losses resulting from a breach, but not as to whether or not the breach occurred.

Example language: *For purposes of determining the failure of any representations or warranties to be true and correct, the breach of any covenants or agreements, and calculating Losses hereunder, any materiality or Material Adverse Effect qualifications in the representations, warranties, covenants and agreements shall be disregarded.*

One might ask why materiality qualifiers would be included in various of the representations and warranties only to have them negated by a materiality scrape (other than to "trick" a seller). Buyers argue that the materiality qualifiers have relevance for other purposes under the purchase agreement, including (i) determining whether closing conditions have been met (seller's warranties must be true and correct as of the day of closing) and (ii) determining the extent of seller's disclosures (for example, disclosure of all "material" litigation). Thus, the argument continues, the materiality scrape only applies to the indemnification provisions and not to the other areas of relevancy, which remain unchanged.

(d) **Knowledge of Seller.** The definition of "knowledge", another key term in many of the warranties and representations provisions, can be defined to, among other things, (i) include only actual knowledge, (ii) include also constructive knowledge (knowledge that could have been obtained after reasonable or due inquiry), (iii) include the knowledge of some or all owner/members only, and/or (iv) include the knowledge of non-owner/member officers, key managers and department heads, or all employee personnel and agents.


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

(e) **Knowledge Scrape.** Sophisticated buyers often include a "knowledge scrape" in the indemnification provisions of the modern purchase agreement. Similar to the "materiality scrape" discussed above, and although the specific warranty or representation contains a knowledge qualification, the knowledge qualification is disregarded (it is "scraped") when calculating damages for an indemnification claim against seller.

(f) **Financial Statement Representation/Accounting Standard.** The accounting standard for the warranties and representations regarding fair presentation of seller's financials, whether GAAP, modified GAAP, the accounting principles consistently applied by seller on a historical basis, or some other appropriate standard approved by the parties, should be carefully considered. One aspect of the financial statement representation that should be recognized is that it is usually a dual representation. First, the financials are typically represented as making a fair presentation of the seller's financial condition (or that they are complete, accurate and correct), and, then, as an additional and independent representation, the financials are represented as complying with some accounting standard such as GAAP. For example:

> **<u>Financial Statements</u>.** Each of the Financial Statements [*fairly represent*] [*is a complete, accurate and correct representation* of] the financial condition of Seller as of the respective dates thereof and the operating results of Seller for the periods covered thereby *and* has been prepared *in accordance with GAAP* consistently applied throughout the periods covered thereby. [Emphasis added.]

For sellers who have not had their financial statements audited and whose financial statements, thus, are likely to depart from GAAP in important respects, something like the following alternate standard might be used instead of GAAP: *The Financial Statements have been prepared in accordance with sound financial principles consistently applied and generally accepted at the date of this Agreement.*

However, since the GAAP standard has built-in flexibility (such as a materiality component), even in those cases where GAAP has not been used by the seller, strong consideration by the seller might be given to adopting a GAAP standard (or a modified GAAP standard as described in a disclosure schedule). An accounting standard based on some undefined accounting principles could lead to easier breach of warranty claims, particularly if the financials are also warranted to be fairly presented and/or correct and accurate, independent of the accounting standard warranty. Sellers could consider making the warranty a single representation by conditioning the accuracy component of the provision on the accounting standard provision. For example:

> **<u>Financial Statements</u>.** Each of the Financial Statements [fairly represent] [is a complete, accurate and correct representation of] the financial condition of Seller as of the respective dates thereof and the operating results of Seller for the periods covered thereby, *all in accordance with* GAAP consistently applied throughout the periods covered thereby. [Emphasis added.]

(g) **Undisclosed Liabilities.** Seller will generally indemnify buyer for undisclosed liabilities. However, consider whether it is appropriate to word the warranty to favor


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

the buyer, by defining an undisclosed liability in terms of liabilities not reflected or reserved against on the applicable balance sheet. For example, a typical pro-buyer provision is as follows:

> **Undisclosed Liabilities.** Seller has no Indebtedness or Liabilities (whether or not required under any applicable accounting principles to be reflected on a balance sheet or the notes thereto) other than those specifically reflected in, fully reserved against, or otherwise described in the Current Year Financial Statements.

A seller might consider adding various qualifiers to this representation, such as those included in the following sample provision:

> **Undisclosed Liabilities.** Seller has no Indebtedness or Liabilities *of a nature required to be disclosed in a balance sheet prepared in accordance with GAAP* other than those (i) *incurred in connection with the transactions contemplated by this Agreement*, (ii) specifically reflected in, fully reserved against or otherwise described in the Current Year Financial Statements, (iii) *incurred in the Ordinary Course of Business since ___________________*, (v) *that have been disclosed on any other Schedules or which are not required to be disclosed under any representation or warranty in Article V because of materiality, dollar, or knowledge threshold or qualifier*, or (v) *that are immaterial to Seller or the Business*. [Emphasis added.]

With respect to the qualifier excluding liabilities of a nature not required to be disclosed under GAAP, these might include, for example, contingent liabilities, normal contract obligations (like leases) and unknown liabilities.

(h) **Qualified to Do Business in Other Jurisdictions.** Buyer will usually include a representation that seller has complied with all qualification laws in all jurisdictions seller does business in. Becoming compliant in such jurisdictions, where seller was not previously compliant, often requires several years of back taxes to be paid, in addition to the relatively modest registration fees. This is often an area of non-compliance by small sellers that should be thought about carefully by seller before agreeing to such a representation, particularly if registration by buyer in jurisdictions in which seller has been non-compliant might involve disclosure of seller's prior noncompliance.

(i) **Compliance with Laws.** A standard representation of the seller will be that seller has operated the business in compliance with all laws. While it is usually intended that the seller will indemnify the buyer for all liabilities that relate to the seller's conduct of the business before the date of closing, it should be considered whether this warranty extends seller's indemnification for liabilities related to the buyer's conduct of the business after the date of closing, if the buyer were to continue operations the same way that the seller did if such operations were in violation of applicable law (such as, for example, a continuation of business operations that are not in compliance with OSHA requirements).

(j) **Full Disclosure Representation.** Buyers will often include a "global" representation that seller has provided all information that might have a materially adverse impact on seller's business that has not been disclosed in the agreement. Sellers will usually want a provision that the buyer may only rely on the specific information warranted. A typical pro-buyer provision is as follows:

> <u>**Full Disclosure**</u>**.** No representation or warranty of the Selling Parties contained in this Agreement or in any of the Seller Documents or Shareholder Documents, and no written statement made by or on behalf of the Selling Parties to Purchaser or any of its Affiliates pursuant to this Agreement or any of the Seller Documents or Shareholder Documents contains an untrue statement of a material fact or omits to state a material fact necessary to make the statements contained herein or therein not misleading. The Selling Parties have provided complete and correct responses to all requests for documents and information made by Purchasers or their representatives in connection with this Agreement and the transactions contemplated hereby. There are no facts which the Selling Parties have not disclosed to Purchaser in writing which could, individually or in the aggregate, reasonably be expected to have a Material Adverse Effect.

Sellers will usually prefer a provision that states that only the delineated representations are warranted, such as:

> <u>**No Other Representations**</u>**.** Purchaser acknowledges that Seller has not made and is not making any representations or warranties whatsoever regarding the subject matter of this Agreement, express or implied, except as provided in this Article V.

(k) **Due Diligence Materials Warranted.** Buyers will often include that the accuracy of all materials and information submitted to the buyer at any time are warranted. This would include the vast due diligence materials (often including forward-looking projections or assumptions) submitted to buyer prior to execution of the final agreement and which often are not included in the disclosure schedules attached to the agreement. Sellers will generally want only the specific information disclosed in, and attached to, the final agreement to comprise seller's warranted disclosures and seek to have such a provision excluded from the final agreement. Typically, the pro-buyer provision is "buried" in the full disclosure representation, like the following:

> <u>**Full Disclosure**</u>**.** No representation or warranty of the Selling Parties contained in this Agreement or in any of the Seller Documents or Shareholder Documents, and no written statement made by or on behalf of the Selling Parties to Purchaser or any of its Affiliates pursuant to this Agreement or any of the Seller Documents or Shareholder Documents contains an untrue statement of a material fact or omits to state a material fact necessary to make the statements contained herein or therein not misleading. The Selling Parties have provided complete and correct responses to all requests for documents and information made by Purchasers or their representatives in connection with this Agreement *and the transactions contemplated hereby*. There are no facts which the Selling Parties have not disclosed to Purchaser in writing which could, individually or in the aggregate, reasonably be expected to have a Material Adverse Effect. [Emphasis added.]


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

(l) **Non-Reliance Provision.** Buyer will usually not include any warranty disclaimer language in the agreement. Seller should consider including a provision that seller is making no other representations or warranties, express or implied, not specifically made in the agreement and that buyer agrees that it is not relying on any warranties or representations in consummating the acquisition, except for the warranties and representations specifically made in the agreement. A typical pro-seller "non-reliance" provision is as follows:

> **Non-Reliance.** Purchaser is not relying and has not relied on any representations or warranties whatsoever regarding the subject matter of this Agreement, express or implied, except for the representations and warranties provided for in this Article V.

(m) **Sandbagging Provision.** Buyer may include a provision that buyer's prior knowledge of a breach of a representation or warranty does not affect seller's indemnity obligation with respect to such representation or warranty. In other words, there is no relevance as to whether buyer was relying on such representation or warranty in consummating the transaction. Sellers would generally prefer an anti-sandbagging provision (buyer's pre-closing knowledge of the breach eliminates liability for the breach). A typical pro-buyer provision, usually found in the indemnification provisions (as opposed to the warranties and representations provisions), is as follows:

> The right to indemnification or any other remedy based on representations, warranties, covenants and agreements in this Agreement, or in any Seller Document, Shareholder Document or Purchaser Document shall not be affected by any investigation conducted at any time, or any knowledge acquired (or capable of being acquired) at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of, or compliance with, any such representation, warranty, covenant or agreement. The waiver of any condition based on the accuracy of any representation or warranty, or on the performance of or compliance with any covenant or agreement, will not affect the right to indemnification or any other remedy based on such representations, warranties, covenants, and agreements.

A typical pro-seller "anti-sandbagging" provisions is as follows:

> No party shall be liable under this Agreement for any Losses resulting from or relating to any inaccuracy in, or breach of, any representation or warranty in this Agreement, if the party seeking indemnification for such Losses had Knowledge of such breach before Closing.

(n) **Diminutions in Value as Measure of Damages.** In its laundry list of types of damages that are recoverable against seller in seller's indemnification provisions, buyers often include "diminutions in value". Particularly where the purchase price has been determined as a multiple of earnings or where the post-sale value of a company is determined as a multiple of earnings ("EBITDA"), this type of language could lead to damages amounting to multiples of the actual dollar amount involved. Sellers would generally prefer to omit such a measure of damages or expressly exclude it. A typical pro-buyer provision is as follows:


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

**Indemnification by Seller.** From and after the Closing, the Selling Parties hereby agree to jointly and severally indemnify and hold Purchaser, its Affiliates and the respective directors, managers, officers, employees, shareholders, members, partners, other equity holders, agents, attorneys, representatives, successors and assigns of all of Purchaser and its Affiliates (collectively, the "Purchaser Indemnified Parties") harmless from and against, and pay to the applicable Purchaser Indemnified Parties the amount of, any and all losses, liabilities, claims, obligations, deficiencies, demands, judgments, damages (including all indirect, incidental and consequential damages), *diminutions in value*, interest, fines, penalties, claims, suits, actions, causes of action, assessments, awards, costs and expenses (including costs of investigation and defense and attorneys' and other professionals' fees and including those arising under Environmental Law), whether or not involving a third party claim (individually, a "Loss" and, collectively, "Losses") based upon, attributable to or resulting from any of the following: [Emphasis added.]

(o) **Consequential, Indirect and Special Damages as Measure of Damages.** In its laundry list of types of damages that are recoverable against seller in seller's indemnification provisions, buyers often include "consequential", "indirect" and/or "special" damages (see provision above), which substantiality increases the seller's potential indemnification liability. Sellers would generally prefer to omit such terms in the definition of included damages or expressly exclude them from recoverable damages. A typical pro-seller exclusion provision is as follows:

No party shall ever be liable or responsible to the other party or to any third party for any indirect, incidental or consequential damages whatsoever.

(p) **Survival Periods.** In the normal setting involving sophisticated parties, it is difficult for a seller to avoid extensive warranties and representations, often involving a "right of offset". However, important limitations on such warranties and representations sometimes are achievable. Since the extensive warranties and representations (and right of offset) usually result from the buyer's fears that its due diligence efforts cannot pick up every material defect, and that only a period of operation can make such defects discernible, the seller can sometimes obtain a removal or lapse of all or most warranties and representations after a reasonable period of time of buyer's operation of the purchased business (for example, twelve to eighteen months from closing). Longer or indefinite periods will still be pursued by knowledgeable buyers for fundamental representations and/or fraud.

(q) **Tiered Survival Periods/Carveouts.** In exchange for a relatively short survival period, buyers will often seek to create tiers of survival periods. The short survival period would apply generally to all warranties and representations, but certain specified carveouts, sometimes call "fundamental representations", will be assigned an extended or indefinite survival period. Sellers will generally attempt to restrict or limit the number and applicability of such warranties and representations, as well as the length of the survival period(s).


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

(r) **Survival Period Carveouts/Fraud.** Buyers will often have a carveout relating to fraud which would have a long or indefinite survival period. However, the fraud carveout is usually worded to include similar, but importantly distinctive, concepts such as "intentional misrepresentation". Sellers will generally seek to eliminate any concepts not specifically worded as fraud, in order to preserve all of the "badges of fraud" as necessary elements of proof, including the element of detrimental reliance.

(s) **Ceilings.** Usually the aggregate amount of damages that can be recoverable against the seller can be limited to a specified dollar amount, referred to as the "ceiling". Buyers will usually include a provision setting a high ceiling such as the total purchase price amount. Sellers will seek a much lower ceiling such as 10% to 25% of the total purchase price. Buyers agreeing to a lower ceiling amount may then seek tiered ceilings, providing, for example, a higher ceiling or no ceiling for damages caused by fraud or breach of a fundamental representation.

(t) **Baskets.** In order to avoid a "nickel and dime" approach to seller indemnification claims, a base amount, called a "basket", is usually established, so that no damages may be awarded to buyer until the basket amount has been achieved. Baskets are often either "deductible baskets" (seller is not responsible for the basket amount, only the excess) or "tipping baskets" (once the basket amount is achieved, seller is also responsible for the basket amount). Buyers will generally seek low tipping basket amounts (for example, a dollar amount with no relationship to the size of the deal), while sellers will generally seek a high deductible basket amount (for example, an amount approximating 0.5% to 1% of the total purchase price). Buyers also often seek a provision that eliminates baskets if the claims relate to fraud or breach of a fundamental representation.

(u) **Responsibility for Sales Tax on Sale of the Business.** Buyers generally include a provision that the seller is responsible for any sales or other transfer tax due on the sale of the business or its related assets. Sellers in Texas often rely on the occasional sale exemption (TAC §3.316) that no sales tax is due in Texas; however, careful consideration of such exemption should be made as the exemption is not automatic and has some qualifications.

(v) **Seller's Cost of Representation as Leakage.** Particularly in the case of a small closely held company, the owners of which having relatively little liquid financial resources outside of the company, the owners of seller may be placed in a position where they must make concessions because they cannot afford the costs of representation. This is because buyers often require that the costs of representation be funded by the owners directly and not from funds of the selling entity. If funded by the selling entity, then often the modern purchase agreement provides that (i) buyer has the right to terminate the agreement prior to closing, as such use of funds would be in violation of the restrictions on the use of the selling entity's assets pending closing, (ii) such use of the selling entity's funds constitutes "leakage", which reduces the purchase price dollar for dollar and/or (iii) such use of funds impacts the net working capital reserve, if the deal has one, which potentially reduces the purchase price dollar for dollar. Sellers, recognizing that transaction costs might be significant and may need to be paid pre-closing, may wish to provide that costs of representation and other transaction costs may be paid directly by the selling entity. Sellers may also provide that the purchase price and/or net working


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

capital thresholds be adjusted to recognize that there will be transaction costs that, in seller's mind, should not reduce the purchase price.

(w) **Confidentiality Provisions.** Prior to the preparation and execution of the definitive purchase agreement, the parties have usually entered into a comprehensive confidentiality and nondisclosure agreement that primarily protects the seller's information in the event the sale is not consummated. The modern purchase agreement also usually contains a confidentiality provision, but it is primarily worded to protect the buyer after the sale is consummated. It often also provides that the confidentiality provisions are terminated if no closing takes place. It would also be standard for the purchase agreement to contain an "entire agreement" provision. It might be prudent for a seller to make sure the "entire agreement" provision references the earlier confidentiality and nondisclosure agreement as an agreement that remains binding between the parties and does not terminate if the deal is not closed.

C. **Escrows and Reserves.** To further protect buyers and entice buyers to proceed with a business acquisition, certain purchase price payments that would otherwise constitute upfront cash down payments for the business will be carved out as an escrowed fund, or otherwise reserved as a holdback or deferred payment. Common escrows and reserves include: (i) cash escrows or reserves, (ii) working capital escrows or reserves, (iii) debt escrows and reserves, and (iv) indemnity escrows and reserves. Buyers will generally attempt to establish sizeable, long-lasting escrows and reserves and sellers will generally resist and attempt to limit or eliminate such reserves.

D. **Other Closing Documents**. Aside from the definitive basic agreement, usually in the form of an asset purchase agreement, a stock purchase agreement or a merger or conversion agreement, there are other numerous important legal documents associated with the business acquisition. There will be various documents relating to title of the purchased assets and the release or assumption of prior liens, such as bills of sale, warranty deeds, releases of liens and UCC-3 termination statements. In the case of a seller financed or leveraged buyout transaction, there will be various documents evidencing seller's right to deferred payments, such as promissory notes, security agreements, deeds of trust, UCC-1 financing statements and/or guaranty agreements. In connection with leased assets, there may be lease agreements, estoppel certificates from existing landlords and assignments of leases, including landlord consents. For intellectual property rights, there may be patent assignments and license agreements to be obtained. Oftentimes, there are restrictive covenant agreements, providing for covenants not to compete and nonsolicitation prohibitions, as well as employment agreements and/or consulting agreements, whereby the seller, or individuals affiliated with the seller, continue to work for, and receive payments from, the buyer in the future.

VI. **Continuing Relationship**. Due to the continuing existence of seller financing in many business acquisitions and the often continuing relationship between seller and buyer through employment and consulting agreements, it is important to recognize that often the relationship between buyer and seller does not end at closing, but rather, in a real sense, only begins. The structuring and documentation of all of the important aspects of this ongoing relationship is of vital importance. Throughout the negotiation process and the document preparation stage, the parties must always be cognizant and deal effectively with the


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law

ramifications that there will be, in most likelihood, a continuing relationship between the parties, oftentimes for an extended period of time after the transfer of the business from seller to buyer.


ROBERT M. MENDELL, ATTORNEY AT LAW, P.C., 800 TOWN & COUNTRY BLVD., SUITE 300, HOUSTON, TEXAS 77024
PHONE: 713-888-0700. EMAIL: rmendell@mendellgroup.com WEB SITE: www.mendell.law