Purchase and Sale Agreements

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1. **Introduction**

Purchase and sale agreements are fundamental negotiating and drafting exercises in a corporate/commercial lawyer's practice. These agreements (i) document the legal rights of buyers and sellers; (ii) capture the intentions of the parties as to the business and properties acquired and sold; and (iii) address the risk allocation between the parties with respect to a host of issues related to that business. Purchase and sale agreements are also, unless undertaken for companies or other entities active in acquisitions or in the business of acquisition activity, such as private equity funds, unusual events for the parties to the transaction.

Most legal counsel know what the general acquisition structure options are as well as the steps that are required to progress a transaction from start to finish. Most also understand the general outline of a definitive purchase and sale agreement. We know what we will end up extensively negotiating and which areas of the agreement are more likely to be 'a given'. We also have an idea of the parameters of the negotiations, and what arguments we have made, both as purchasers' and sellers' counsel that will likely be deployed, more or less, in the next set of negotiations. How often have we both used and been on the receiving end of the phrase "that is market" or, perhaps more commonly to emphasize what counsel wants to articulate is an unreasonable position " that is clearly not market". But while there are commonly accepted parameters for the structure of transactions, and the language of such things as indemnification provisions and representations and warranties, it is important to ensure that all of the language is measured against the objectives of your client.

A good place to start before embarking on any of the tasks associated with an acquisition, whether it is due diligence, or drafting and negotiating definitive documentation, is to ask "why". What is the driver behind the transaction itself. From a seller's point of view the reasons for selling the business may be that it is 'time to cash out', for others, it may be a matter of ability to scale the business. Family run companies may be faced with a lack of successorship. For other companies, it may be that parts of the organization are no longer determined to be 'core' and divisions are placed on the sale block. We have also seen of late, various companies that are dealing with challenging economic circumstances and a need to sell assets in what might otherwise not be the optimum seller's market, in order to service their debt loads. From a

purchaser's point of view, there may be any number of reasons for acquiring a business, including vertical integration, technology innovation, key customers or line of business or simply rate of return opportunities. Understanding the drivers behind the acquisition or sale will impact the transaction including with respect to structure and negotiated agreement provisions dealing with risk allocation and risk tolerance in key ones.

The second initial point of analysis is what business the target is in. Understanding the business, and what value derives from that business will also dictate the focus of various provisions in the transaction documentation. While agreements, and acquisition structures follow the same patterns, specific representations and warranties, covenants or ancillary documentation may be required that are tailored to the specific industry. A resource company target has very different concerns than a technology company with its value vested in its intellectual property assets.

2. Structure of Transaction

There are any number of ways that a business can be acquired. Both sellers and purchasers will have a preference in terms of deal structure. Generally, the options are purchase of shares in the business, purchase of assets or combinations pursuant to statutory provisions such as an amalgamation or plan of arrangement[1]. Although a fundamental determination from the outset, the discussions around the structure of the transaction in most instances tend to be accommodated expeditiously. Much of the emphasis in structure determination is on the tax implications of one structure versus an alternative. In very high level terms, sellers typically prefer to sell shares, and purchasers typically prefer to purchase assets. Either one of those options is possible, but each will have, in some cases, not insignificant due diligence and legal issue ramifications quite apart from the tax concerns of the parties. In addition to the structure of the transaction as a whole, I have found that in a large number of private company transactions, personal tax planning considerations are often thought of later in the transaction negotiations, which causes no end of time and cost increases. Purchasers will often be quite willing to envelope the seller's personal tax planning objectives into the transaction structure, but should do

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[1] For example pursuant to the *Business Corporations Act* (BC) sections 269 (amalgamation) and 288 (plan of arrangement).

so cautiously. Such tax planning has resulted in many cases in my experience, in significantly higher transaction costs and potential delays.

An asset sale may be the logical option for situations where a parent corporation is selling an unincorporated division or business unit. It may also be demanded by a purchaser where issues of historical corporate liability are extensive or concerning. In that case, a purchaser will only assume those liabilities that are agreed to and those which are imposed by law on successors. A purchase of assets, in the context of negotiating and documenting the transaction will result in additional considerations and costs. For example, transfer taxes, bulk sales taxes and other taxes associated with the sale of assets would not be applicable in most cases in the context of a share sale. As well, third party consents to agreements are far more typical and extensive in an asset sale as opposed to a share sale or statutory combination. Even relatively 'minor' contracts, such as office equipment leases may have prohibitions on assignment without consent. Permits and licenses may also have to be, either assigned or applied for anew by the acquirer. As a general comment, there are additional steps that make an asset transaction a little more difficult than a share purchase and require counsel to consider the timing of obtaining third party consents, for example, in the overall expectations of the parties. Purchasing the assets, however, does not avoid the requirement of shareholder input. In most cases, while it is the board of directors of the target that will engage in the negotiations and approve the sale of the target by way of asset sale, if the sale of the assets is 'substantially all of the assets' of the target, a shareholders' resolution approving that sale will be necessary.[2]

A share sale typically does not have the same level of third party consent requirements unless either the legislation or regulations governing the issuance of a permit or the language of a contract requires consent on a change of control. However, acquiring the shares of the target obviously means that all liabilities of the target entity will become the responsibility of the buyer, either contained within what will become a subsidiary of the buyer, or, possibly, if done by way of statutory combination without the benefit of a newly formed affiliate of the purchaser, contained within the buyer itself.

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[2] *Business Corporations Act* (BC) section 301

Aside from tax driven aspects, or even liability issues that are considered in the determination of transaction structure, the structure of the shareholdings of the target may also be a consideration. For example, the number of shareholders may make a purchase of the shares of the company prohibitive, or at least risky. If the purchaser does not have sign-off of all the shareholders from the outset, e.g. to a letter of intent (see below), then there is certainly a possibility that a relatively minor shareholder will hold a transaction up. While there are statutory 'squeeze-out' provisions[3] available to a purchaser, there are transaction structure and timing issues associated with making use of such provisions. These considerations may, among other concerns outlined above, lead parties to a transaction to consider alternate methods of combination afforded by statutory mechanisms. For example, an amalgamation will require shareholder approval, but does not require all shareholders to sign onto an agreement in order to effect an acquisition of all of the shares. If the parties wish to effect a reorganization in addition to a purchase, or otherwise address by way of the process of the combination other rights of security or debt holders, then a plan of arrangement may be an appropriate mechanism. As with an amalgamation (which might be included as a step in a plan of arrangement), a plan of arrangement requires shareholder approval, but not the unanimity of shareholder approval by way of contractual signature that is inherent in a purchase of shares. In the public company context, there are mechanisms to effect a purchase by way of take-over bid. This paper will not address either the take-over bid rules or the specific provisions of statutory combinations such as amalgamation or plans of arrangement. In many cases, the definitive agreement language that we will further explore in this paper will be contained in a contractual instrument entered into to effect the statutory combination (for example representations and warranties used to confirm certain matters as a condition precedent to closing of the statutory combination).

3. Establishing the Terms of a Transaction

In many cases, parties will enter into some form of preliminary agreement to document the general proposal for a transaction. The costs of engaging in the process of a transaction, both in terms of external costs as well as internal resources, is extensive and embarking on such a task without the benefit of a documented understanding would be too uncertain. In situations where a

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[3] *Business Corporations Act* (BC) section 300

seller is attempting to create an auction for the sold business, a letter of intent may be a requirement as a first step to selecting a successful proponent for the purchase.

Typically, the document will be set up as a letter of intent (and often in 'correspondence format') or may be set up as a 'term sheet' with specific heads of agreement set out and basic, albeit not detailed, understandings of the parties in respect of each of the topical areas covered. Those heads of agreement will be, in many cases, the same heads of agreement that appear in the definitive purchase agreement.

To capture the key points of agreement, the letter of intent will set out the 'what' – what is being purchased and how; the 'how much' – the purchase price for the 'what' and the 'when' – when the transaction is intending to close, and what pre-conditions there may be to completion. The letter of intent may also deal with additional matters, such as (i) confidentiality; (ii) obligations of each of the parties to do certain things in order to facilitate the transaction such as committing the target to provide access to the purchaser and its representatives for due diligence purposes; and (iii) confirming how costs of the transaction are to be dealt with.

Parties will usually stipulate that the letter of intent is non-binding and that, among other things, the parties intend to enter into a definitive agreement. At the definitive agreement stage, the boilerplate will contain an 'entire agreement' clause, and if it is the intent to have the letter of intent replaced by a signed definitive agreement, then it is best to explicitly say so. At the early stages of a transaction though, there are provisions which the parties may want to be binding. A purchaser will hope to avoid embarking on a transaction negotiation with the risk that the seller will continue to shop the company. If the purchaser intends to avoid this, then it should try to negotiate a provision in the letter of intent that prevents the target and its shareholders (or at least its principal shareholders, if only the latter is feasible) from "shopping the company" for a stipulated period of time to enable the purchaser to complete the steps in the transaction and for all the conditions of a transaction to be reasonably met. It is not uncommon for sellers to demand some earnest money for such a no-shop provision and as with the duration and extent of the lock-up is a matter for negotiation. Make sure, however, that the letter of intent clearly sets out what is binding on the parties and what is not. Do not sweep everything in the letter of intent into the 'non-binding' basket if there are provisions, such as a no-shop, confidentiality (which will typically be more of a seller's concern), access for due diligence purposes and the

responsibility for expenses in the transaction, which should be binding upon the parties regardless of whether terms of a definitive agreement are reached.

While the parties typically want to retain their negotiating flexibility on key terms of a definitive agreement, and even though provisions are expressly stated to be non-binding and subject to a definitive agreement, the terms of a letter of intent are often adhered to in negotiations. Parties can too quickly enter into a letter of intent without thinking of the box that it may put them in at a later stage in negotiations. It is not uncommon for sellers to refer back to the tenor of a letter of intent to constrain the exuberance of extensive definitive agreement terms. Similarly, purchasers can point to the early-stage commitments of a vendor to insist on certain responsibilities of the vendor or conditions to closing. The parties need to strike a balance, though, between extensive negotiations of a transaction, which in part will defeat one of the primary purposes of a letter of intent, and unintentionally ‘committing’ to an ill-advised position that hampers their negotiating abilities at a later, and more informed, stage of the transaction. If the parties find it difficult to negotiate the terms of a letter of intent, even one that confines itself to high level articulation of the business points of the deal, then it is certainly an indication of whether or not terms of the transaction can be reached and are worth the effort or the risk of non-completion.

One other aspect of the letter of intent, is that it also may serve to assist with obtaining or at least commence the process of obtaining, various regulatory approvals that may be required to complete a transaction. It may also serve to assist (i) the board of a target or a purchaser in seeking other approvals internally or amongst passive shareholders not otherwise involved in the transaction and (ii) the purchaser in setting out the basis for financing the transaction with lenders.

4. Definitive Purchase and Sale Agreement

The definitive purchase and sale agreement, however the transaction is structured, is and should be the final agreement of the parties on all elements of the transaction. No matter the structure of the transaction, however, generally the format will include the following:

(a) Description of the transaction – what is being purchased and how (share vs. assets);

(b) Purchase price and when and how the purchase price is paid;

(c) Representations and warranties of both seller and purchaser;

(d) Covenants and agreements of the seller and purchaser, both pre-closing and post-closing;

(e) Survival of representations, warranties and covenants;

(f) Closing mechanics, including deliverables of seller and purchaser;

(g) Conditions precedent to closing of both the seller and the purchaser;

(h) Indemnification provisions in favour of both the purchaser and seller including what is covered by such indemnification, and the mechanics of such indemnification;

(i) Limitations of liability;

(j) Termination of Agreement provisions – what triggers termination and consequences; and

(k) Boilerplate.

While it may be enough, legally, to have a purchase agreement that is as simple as "ABC Corp. hereby purchases all of the shares of XYZ Corp. from the sellers at an aggregate purchase price of $X million", the extensive provisions in a definitive agreement that often runs to 100 pages is the expression of the certainty that the purchaser is seeking in what it is actually acquiring. Representations and warranties of the seller, which will be further described below, will address the matters that the purchaser needs to know about, not only the confirmation of unencumbered ownership of what is being purchased (e.g. title to shares or assets), but also matters related to the operation of the business that have formed the basic understanding of the value of the business.

Although the seller will demand fewer terms in the agreement than a purchaser, the seller will certainly want to know that the agreed-upon purchase price will be paid, and, if it is paid over time, the certainty of that payment and any other issues that are unique to the proposed consideration. For example, the seller may demand a host of representations and warranties from the purchaser in addition to standard authorization and enforceability provisions where part of the purchaser's consideration is shares in its own capital. Most agreement drafters hope that upon closing of the transaction neither will ever have a need to review the document again. However, the purpose of the definitive agreement is to ensure that it contains a detailed reflection

of the parties intentions both with respect to what is being acquired and sold, but also what the parties believed they had bargained for, and who is responsible if they it is subsequently determined that they did not.

While many transactions will, by design[4] or simply by the dynamics of the deal negotiations or timing or both, end up having a definitive agreement signed and delivered at the closing of the transaction, the basic premise of most purchase agreements is that the definitive agreement will be signed at some time prior to the actual closing of the transaction. All of the pre-closing covenants that are imposed on the seller, such as continuing to operate the business in the ordinary course, and, conversely for example, agreeing to not make major capital commitments, are designed to ensure that the business the purchaser expects to acquire will be in the same condition on closing as it is on the date of signing of the definitive agreement. Delays between the execution of the purchase agreement and the closing may be to facilitate obtaining regulatory approval, consent to assignment, financing requirements, shareholder meeting requirements and/or restructuring pre-condition requirements.

Who takes the pen in definitive agreement drafting can be a point of negotiation between the parties. Typically, purchaser's counsel will draft the definitive purchase and sale agreement, as well as various other agreements that may be required as part of the transaction (e.g. escrow agreements, non-competition agreements or employment agreements). The vast majority of provisions in a purchase agreement are there to provide certainty to the purchaser, and so it certainly is compelling to have the purchaser define what is important to it in terms of its bargain and understanding by drafting the agreement to elicit that information. If sellers' counsel drafts the purchase and sale agreement, it inevitably leads to the purchaser's counsel requiring the addition of sometimes extensive proposed 'riders' of representations, warranties and covenants. As a result, if the motivating factor in the 'who takes the pen' question is a cost apportionment one, it rarely succeeds at fundamentally reducing the purchaser's costs by having the vendor draft. It is not uncommon that, in starting from an encompassing set of representations and warranties, the purchaser will ferret out additional matters of risk assessment and follow-up by the way that a seller attempts to qualify or limit specific representations and warranties.

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[4] Parties, particularly purchasers, may prefer the flexibility that comes with signing and closing on the same date – so that they are not bound only to those conditions precedent negotiated in their favour.

Where the above practice is often turned around is in an auction situation. The seller will want to dictate the terms of sale, and, by its drafting of the purchase agreement in a particular manner, limit the types of representations, warranties, covenants and indemnities that it gives (and expanding the limitations of liability) and will evaluate proposed purchasers not only on business terms such as price and certainty of closing, but also on proposed changes to the documentation made by a proponent. A purchaser is put in the position of trying to limit its amendment to the proposed agreement in order to ensure that for evaluation purposes, the transaction documentation is not held out as a negative, while at the same time ensuring that the agreement addresses the acquiror's major concerns.

A word about disclosure schedules. Most definitive purchase agreements will include appended schedules[5] that set out certain matters of clarity of the business acquired, and serve to extract certain factual matters from encompassing representations. For example, a representation as to litigation might read: "Schedule XX contains a complete and accurate listing and description of all current, pending or in progress and threatened, actions, claims, demands, lawsuits, assessments, arbitrations, judgments, awards, decrees, orders, injunctions, prosecutions and investigations, or other proceedings, of, by, against, or relating to the [Company][6] or, any of its [Assets] or the [Business] and other than as set out in Schedule XX, there are no current, pending or in progress and threatened, actions, claims, demands, lawsuits, assessments, arbitrations, judgments, awards, decrees, orders, injunctions, prosecutions and investigations, or other proceedings, of, by, against, or relating to the [Company][7] or, any of its [Assets] or the [Business]. There are no current, pending or in progress, nor any threatened, actions, claims, demands, lawsuits, assessments, arbitrations, judgments, awards, decrees, orders, injunctions, prosecutions and investigations, or other proceedings, in law or in equity, regarding the transactions contemplated hereby." The original drafting of the representation may not have

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[5] Schedules are also often set out in a "Disclosure Schedule" which accompanies the definitive agreement.

[6] The term "Company" is in the context of the target, and will be expanded to include all subsidiaries or other investments of the target as appropriate.

[7] The term "Company" is in the context of the target, and will be expanded to include all subsidiaries or other investments of the target as appropriate.

provided for, or contemplated a disclosure schedule, if no litigation matters had been discovered in the course of the purchaser's due diligence.

If the seller has inserted the concept of a disclosure schedule, then it is important to ensure that: (i) the disclosure schedule is not so broadly worded as to effectively limit, or eliminate, the effectiveness of the representation and warranty; and (ii) does not omit to include matters that the purchaser may have discovered in the course of its due diligence. The latter may simply arise as a result of oversight. While purchasers may feel that non-disclosure of a relevant matter may be dealt with after the fact through indemnification clauses, this tactic may not be either efficient or, in some cases, successful. Sellers will often insist on the inclusion of 'anti-ambush' clauses to the definitive agreement which are designed to prevent exactly that kind of approach. But even in the absence of such a provision, if the matter is significant enough to cause a renegotiation of price, it is better done up front than in argument after the fact, and the outcome of a dispute resolution mechanism is not a certainty. If the matter is not significant, then neither party should object to its inclusion, properly described and with whatever certainty around the magnitude or potential impact of such disclosure as is appropriate. All too often, though, disclosure schedules are prepared and delivered at the last moment and do not provide for adequate review and comment. They are not simply factual documents to be stapled to the definitive agreement – they do form part of the overall negotiation process of the agreement and, as such, purchasers will want to see disclosure documents as early in the process of agreement negotiation as is feasible.

5. **Key Agreement Terms**

As outlined above, the key terms of a definitive purchase and sale agreement seldom vary in headings. They do vary, obviously, in content. The balance of this paper will review the key terms of a definitive agreement.

(a) ***Purchase Price***

How much a purchaser will pay for the acquired business can be a simple statement of an absolute amount, but very often, is more complicated than that. There are various factors that influence how a purchase price is structured: the form of consideration to be delivered; the risk tolerance of the parties; tax or accounting treatment of the transaction and the timing of the completion of the transaction, particularly as compared to the date of execution of an agreement

or other point of determination of the purchase price amount. Determining what the base is for the purchase price is also a matter of consideration. Was the original determination of price based on the latest audited financial statements, and if so, is it appropriate to provide for a mechanism to update that based on a closing valuation or audit? How much time elapses between the date of the definitive agreement and the closing date may be necessary to protect the parties from material changes, both positive and negative, to the value of the business.

To deal with fluctuating factors, it is not uncommon to provide for a combined component of purchase price elements. For example, a fixed portion of the purchase price, coupled with an amount that is determined based on the amount of working capital at closing. To diminish the issue of an indeterminate purchase price, the parties will often provide for an estimate to be delivered prior to closing, and final adjustments to be made after closing following the completion of a closing date balance sheet. The balance sheet will typically be completed in a 60-90 day period immediately following closing, and presented to the seller. There is often a dispute resolution mechanism associated with this type of adjustment. Working capital adjustments look deceptively simple on their face, but whether something is ‘in’ or ‘out’ of the adjustment can be a matter of extensive negotiation prior to closing, and hopefully not a matter for dispute after the closing.

Parties can adjust the purchase price based on pre-determined thresholds. For example, if a purchase price was determined based on last year’s financial statements, and, but for a change in, for example net income or revenues, the purchaser would have paid the same amount, the parties could agree to a post-closing adjustment if the final audited figures differ from the threshold. The post closing adjustment payment, then, would be either by the purchaser to the seller if the final audited statements disclose an amount in excess of the threshold, or a payment back from the seller to the purchaser if the final audited statements disclose an amendment that is less than the threshold. That adjustment could be made on a dollar for dollar basis – e.g. “the Purchase Price will be increased, on a dollar for dollar basis, equal to the amount by which Net Income exceeds [Threshold Amount]. If the purchase price consideration consists only of cash, as opposed to, for example, cash and the issuance of promissory notes, it is always a little more difficult to go after the sellers to return funds, an estimate of what the outside threshold adjustment might be, can be held in escrow pending the final determination of the amount, and,

if the purchaser ends up paying, that amount will be released from escrow with interest and payable together with the additional amount payable by the purchaser.

An alternative method, albeit one that sellers often tend to be averse to, is an earn-out formula. An earn-out formula might be based on something like the following: "an amount equal to 25% of the net revenue of the business in the 12 months following Closing". To compensate for what is, after the closing, a matter solely in the control of the purchaser, an earn-out clause might result in greater aggregate proceeds to the sellers than would otherwise be the case. But the lack of control is often the determining factor in whether or not to accept such an approach. While the lack of control is mitigated in circumstances where management of the target is retained to run the acquired business, it is never eliminated as the resources necessary to meet targets, however they may be determined (e.g. revenue, net income) are still in the purchaser's control. This lack of certainty and control, makes earn-out provisions sometimes very difficult to negotiate and settle. To provide the sellers with some level of certainty in connection with an earn-out provisions, positive and negative covenants are typically required to ensure that there is a reasonable chance that the business will be run in a manner so as to facilitate the meeting of the earn-out threshold numbers. At the same time, the purchaser will not want to be overly constrained in conducting the business it has just acquired, which may be necessary in order to achieve value by rationalization of resources, for example.

Aside from delaying the payment of a portion of the purchase price, a purchaser will argue that it provides incentive to management sellers to drive the business and protects the purchaser from an overvalued offer. That may be important particularly to a buyer that intends to operate the business for return, rather than, for example, a strategic buyer who intends to integrate the business quickly into its own. But the opportunities for, at the least, suspicion in the decisions that are made during the ensuing earn-out period, such as whether resources in promoting the business on the part of the purchaser are being withheld or curtailed, might serve to outweigh the otherwise positive elements of incenting the management/seller team. So in addition to having to negotiate provisions that may serve to constrain the flexibility of the purchaser in dealing with the acquired business, the purchaser should be well aware of any potential fallout arising from these types of provisions. One additional point worth noting, although this paper will not delve into its implications, is fully appreciating the tax implications for devising a purchase price

payable in this manner, and tax advice should be sought by both parties to this structure before agreeing to it.

As mentioned above, the final determination of the purchase price may depend upon the character of the purchase price consideration. To the extent, for example, that a portion of the purchase price is paid by way of issuance of the purchaser's own shares, this will necessitate a determination of the value of those shares at closing. The inclusion or method of payment of, the purchase price consideration by way of issuance of the purchaser's shares is not an uncommon (or at least until recently was not an uncommon) method for public companies to acquire other companies. In some cases, it may be a maximum amount of the purchase price consideration paid by way of issuance of shares. For example, the purchase price will be paid as to that number of purchaser shares calculated by dividing $10,000,000 by the purchaser per price share amount. The purchaser per price share amount might be determined based on a volume weighted average trading price for a certain number of trading days prior to closing.

A stock for stock acquisition might use a formulation of a certain number of the seller's shares in exchange for a certain number of the purchaser's shares, e.g. 1.5 sellers shares for every 1 purchaser share. It could also leave the number of shares to be issued as an indeterminate one until closing, based either on a fixed dollar amount, e.g. dividing $X by the [closing price] of the purchaser's shares. There is an element of uncertainty in such calculations and to contain that uncertainty, parties can also negotiate "collars" around the formulations which allow a party to terminate the transaction if the price fluctuates to a point where the transaction is no longer attractive. For example, where there is a negotiated exchange ratio, the parties can walk if the share price moves beyond specified levels. At the upper end, the purchaser is protected from paying too much. At the lower end, the seller shareholders are protected from the impact in a decline. If the negotiated transaction is a floating exchange ratio, then the collar provides that the ratio can vary within a range, but the price will remain the same. The purchaser is protected from shareholder dilution if its shares drop below the upper end of the exchange ratio, and the seller shareholders are protected from a lower ownership percentage of the combined entity if the shares rise in price above the lower end of the exchange ratio. While deal terms surrounding the appropriate exchange ratios and protective collars can become complicated and protracted, in a volatile market, they may be the only way to provide sufficient protection in share for share transactions.

Finally, the assumption of liabilities, either generally stated or one or more specific liabilities may be part of the purchase price. In an asset transaction, where a purchaser might only assume certain liabilities and not others, the assumption of specific liabilities has value.

The other key determinant, aside from how much the purchase price is, is how the consideration is paid. We have covered some of the elements of payment where part of the purchase price is purchaser stock, but there are other payment schemes that are considered. For example, part of the purchase price may be funded by vendor take-back financing. It may also be the seller's tax considerations that argue for payment over time, to minimize income in any particular year. The payment over time also provides a potential form of security for the purchaser by way of holdback or set off.

If payment is made over time, the seller of course has to bear the risk that payment might not be made. The purchaser may become insolvent after the closing but before payment is made in full, for example. To mitigate that risk, the seller will typically require that security for payment is given. That security may be by way of a security interest over the assets of the business acquired and/or from the purchaser by way of guarantee and security on the purchaser's assets. It might also include a pledge or escrow of the purchased shares. The latter form of security is rarely used on its own, or at least should be carefully considered. It will be cold comfort to a seller to take back the control of a struggling business where the seller was otherwise expecting a cash payment over time.

Each of these forms of security are subject to negotiation in the context of the definitive purchase agreement, but will be drafted into stand-alone agreements deliverable on closing. It is beyond the scope of this paper to outline all of the steps and mechanics of various forms of security, and to a certain extent, this will be covered by other papers in this course. Suffice it to say, that if payment is structured over time, other than in an earn-out context, and other than with respect to holdbacks or escrows that are for the purchaser's protection, then if you are acting for a seller, security must be part of that discussion.

As mentioned above, if a purchase price is not fully determinate at closing, and could result in 'repayment' of an estimated amount payable on closing, the purchaser will want to ensure that the funds are easily accessible. This is certainly all the more so if there are a number of sellers and the consideration will be, from a practical perspective, impossible to chase. In addition to

dealing with post-closing price adjustments, the principal reason for escrows or holdbacks is to provide a source of funds available to satisfy indemnification claims. Typically, the funds are set aside with a third party escrow agent. There are costs associated with establishing an escrow, but they are relatively minor and a worthwhile trade-off to the security to the purchaser that an escrow provides. How long that escrow is, and how much, are intricately wound up in the negotiations that the parties will have on the indemnification provisions in the definitive agreement. For example, it is not uncommon for sellers to request in the course of such negotiations that the escrow funds be the sole source of funds available for indemnification. If there are very specific concerns that have been identified, then the escrow may be for a longer period of time. The escrow funds might also be released in stages. Once, for example, the acquired company has gone through an audit period, various issues would have been most likely brought to the fore and, in the absence of the discovery of such issues, a certain portion of the funds might be released. For other types of claims, such as product liability or product warranty claims, a certain amount might be kept for a longer period of time.

(b) ***Representations and Warranties***

As mentioned at the outset of this paper, there are certain provisions of an agreement that counsel always know will be extensively negotiated. Representations and warranties are one of those sections of the agreement that will be subject to significant review, comment and negotiation by the parties. It is also one of the most significant parts of an agreement – at least if one is measuring by the word.

The reason for the intense scrutiny is that by setting out the representations and warranties, the purchaser is essentially establishing its understanding of the basis of its agreement to acquire the business. Conversely, the seller will want to limit the elements of post-closing exposure to claims. The first method of limiting representations and warranties is simply by reducing their sheer number in the agreement. It becomes a bit of an art to determine the balance between the right breadth and scope of representations and warranties and the relative size and complexity of the transaction. In addition to the need for very specific representations and warranties tailored to the relevant business of the target, you will also find that different industries have different tolerance levels for extensive agreements.

A representation is a statement of fact, which is as at the relevant date of giving such statement of fact. A warranty is a promise that an existing fact or a future fact is or will be true. If untrue, incomplete or inaccurate, the statement will give the purchaser a right to sue or, if discovered prior to closing and the agreement expressly provides for this[8], a failure of a condition in favour of the purchaser entitling the purchaser not to close the transaction. Both those rights need to be maintained for the benefit of the purchaser – both the right to sue on the misrepresentation and the right prior to closing not to close on the failure of the condition precedent. The other practice point, which you should ensure is present, is a positive statement to the effect that the purchaser is relying upon, and the seller acknowledges such reliance, the representations and warranties being true.

The overriding tension in negotiations around the scope of representations and warranties is between the lack of information of the purchaser and the corresponding assumption by the purchaser that the seller must know everything that is being asked of it, versus the fact that the "purchaser has done extensive due diligence on the business, assets and undertaking of the target and knows as much as the seller does". That latter phrase is so common, that for no good reason at all, I now keep tabs on how often and how early it is spoken by sellers' counsel in the course of negotiations. The fact of the matter is, that no amount of due diligence can act as a replacement for the knowledge that comes from running a business. However, in the end, the whole issue of not only the breadth and scope of the negotiated representations but the qualifications to such representations and warranties (described below) is a matter of risk allocation between the parties. A purchaser will have valued the business and therefore agreed to a particular purchase price on the strength of certain assumptions of risk in the business. The more a seller is prepared to provide representations and warranties and therefore comfort on the understanding of the business, typically the higher the price the seller will obtain. By comparison, for example, a purchaser acquiring assets out of a statutory bankruptcy or creditor protection process will have to accept that the trustee in bankruptcy will not give representations and warranties as to the business or assets. Some of the concerns are dealt with by court order,

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[8] Without an express statement that representations and warranties must be true at closing, a misrepresentation does not in an of itself give the purchaser a right not to complete. *Hong Kong Fir Shipping Company Ltd. v. Kawasaki Kisen Kaisha Ltd.* [1962] 1 All E.R. 474 (C.A.)

but any thing else will become a purchaser liability which effectively results in a lower price than might otherwise have been the case.

Other factors are clearly at play in determining risk allocation. The bargaining strength of the parties to the transaction, the prospective purchaser options available to a seller (i.e. is there an auction or possibility of one) and certain other specific transaction factors, such as the availability or access to meaningful indemnification coverage after closing all influence the extent of the representations and warranties and corresponding qualifications agreed to by the parties.

From a practical perspective, a purchaser will have a list of those matters which are critical to its valuation of the business and its willingness to acquire the business on the negotiated terms (or at all) and certain other matters which, while relevant to understanding the business being acquired, do not have the same level of importance. On the latter basket of representations and warranties, a purchaser will be more willing to accept, if not deletion of the representation and warranty altogether, at least qualification of the representation and warranty by way of materiality thresholds and/or knowledge qualifiers outlined below.

Qualifiers

A principal method of qualifying representations and warranties is the use of a 'materiality' threshold qualifier. The seller will attempt to introduce a softening of what otherwise is an absolute statement. The effect of the qualifier is to ensure that potential changes that result in a statement not being completely accurate, but which do not have a significant effect to the business, assets or prospects of the company, are not sufficient to either cause a purchaser to walk away from closing the transaction (because the condition precedent that representations and warranties are not true and accurate at closing) or to take cause a claim for damages following closing.

There are various methods of stating the materiality qualifier. For example, representations related to disclosure, such as a statement that all 'material' contracts are listed in a particular

schedule[9], or have otherwise been provided to the purchaser for review during due diligence, will avoid the task of inclusion of even insignificant contracts that have no bearing on value. Of more importance are the qualifiers that introduce a different level of subjectivity, such as a statement that a fact is true "in all material respects". The challenge with these types of statements, from a purchaser's point of view in particular, is that it introduces a level of speculation into the otherwise bald statement of fact. What constitutes materiality may be very different from a seller's and a buyer's point of view and will be, if it is ever a matter before the courts, measured in part against the nature of the transaction, the nature of the business, the nature of the parties to the transaction.

An attempt to provide some certainty around what the parties each conclude is material is often made by way of dollar threshold definition. A materiality threshold is then defined to be anything more than $X or may be more comprehensively defined to be a qualifier that a particular circumstance will not cause a 'material adverse effect – e.g. "there are no consents or third party approvals required to complete the transactions other than any which would not have a Material Adverse Effect[10]". Much like limitation of liability clauses, a focus by the parties negotiating the contract on what might constitute a material departure from the economics of a transaction would be appropriate. However in drafting dollar figure thresholds, consider whether there are other representations and warranties that, if not true, would not end up in a direct correlation to the loss. A loss of goodwill or an inability to carry on the business after closing might not easily equate to the dollar figure threshold concept. As a result, the language may be supplemented with the additional phrase "or which might otherwise be material to the operation [or prospects] of the Business". I have put the word "prospects" in quotations. For some businesses with steady customers and cash flow, that might not be a particularly problematic phrase. In a fast-changing technology environment, that phrase may be difficult to include.

Finally, there are defined statements of materiality, known as 'material adverse change' clauses or "MAC's". MAC's will appear in various representations and warranties The drafting of

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[9] Although note that there are ways to limit such disclosure statements with more specificity – ie all contracts that have a value of more than $X and/or are not terminable by the target on 30 days notice or less.

[10] Note that Material Adverse Effect is often defined to be in singular events, or in the aggregate, but if they do not, then consider adding such language to the specific representation and warranty.

MAC clauses is important, and all the more so as the economy tightens, and the use of these clauses is heavily scrutinized, put into effect, and potentially litigated. A ‘change’ implies a starting point for comparative purposes. You will find ‘change’ types of representations in many agreements, particularly in connection with a fixed point for valuation, such as financial statements for the last fiscal period. For example, there has been no change in the nature or condition of the assets, business etc. since the Financial Statement Date. Because these clauses may be the sole reason for repudiating a contract, the choice of words are critical. Small differences can have a large effect. For example, the words “could result” or “might result” in an adverse change are different from the words “will result” or “would result”, the former of which have a stronger element of speculation. General wording may be insufficient to rely upon.

The other principal method of qualifying representations and warranties in agreements is the use of knowledge qualifiers. It is an unfortunate first instinct of the seller to blanket qualify everything that is set out in the representations and warranties. This approach, in some cases rather boldly set out in the lead-in language to the representations and warranties section (i.e. “the sellers represent and warrant to the best of the sellers’ knowledge that….”), serves to significantly weaken the value of the representations and warranties. This approach should be avoided, as it rarely if ever succeeds, and, coupled with the “you have done your due diligence” statement, often serves to aggravate the negotiations from the outset.

Knowledge qualifiers do, however, often find their way into final negotiated agreements and are quite typical for certain types of statements. For example, ‘threatened’ or other similar types of prospective ‘and there is no reason for’ types of statements are often qualified by knowledge. Depending upon how they are worded, sellers will often wish to qualify intellectual property representations and warranties with knowledge qualifiers.

If there are knowledge qualifiers, and it is now rare in a more extensive agreement full of representations and warranties not to have such qualifiers, then the parties need to determine what that means. Exactly whose knowledge are we referring to; and what does it mean for that person or persons to be vested with appropriate knowledge. Buyers will want the group of named individuals (or those named by title) to be as large and comprehensive a group as possible. Sellers will want the reverse, and often they will argue, in part, that in some merger situations not everyone within even the senior management ranks is aware of the proposed

transaction and has not yet been 'brought into the tent'. In a recent transaction that I was engaged in, the common refrain in negotiations was that the President knew everything about what was a complicated business and corporate structure and was the only person who was really appropriate to be named as the individual with knowledge. Oddly, however, in due diligence sessions the President would commonly respond that "well, that's not something that I know, but Mr. ABC is likely to be the best person to answer that….." If at all possible from a buyer's perspective, you will want those who have the greatest direct involvement with the factual matter of concern. If there are financial matters, then it is the CFO, if it is related to claims, and litigation, the general counsel, if land or property related, then the senior executive charged with that responsibility etc.

The best language from a purchaser's standpoint is a 'best of the knowledge after due inquiry' type of statement. Sellers will often want to limit the qualifier to 'actual knowledge'. In an attempt to draw a bridge between what is already in someone's head on a casual basis, and what is prudent to confirm prior to giving or asserting a factual statement, knowledge definitions can get quite long, imposing upon the named persons an obligation to inform or confirm facts if such person does not have personal knowledge. That attempt at defining what constitutes appropriate 'knowledge infusion' may at least give the purchaser some comfort that prudent action has been taken to ensure that steps are taken to elicit the correct information to support the statement.

One final word on sellers' representations. Where there are multiple sellers, the purchaser's best position is to ensure that the representations and warranties are given on a 'joint and several' basis. The buyer has the ability then, to look to the best place for recovery in the most expeditious manner. For the same reasons, sellers resist that if at possible. Allocation of that responsibility is, all the more so a motivator for sellers who essentially have had a passive investment, and particularly small investment, in the ownership of the target business. If the negotiations on joint and several liability or other apportionment of liability amongst sellers is too difficult, *vis a vis* the buyer, the sellers can enter into a form of contribution agreement that is amongst themselves to deal with claims that are made pursuant to the underlying agreement. As well, sellers with deeper pockets who wish to avoid being the primary target in a claim, will tend to opt for an escrow arrangement to cover the costs and ensure that a pool of indemnity funds are proportionately accounted for without resort to contribution requirements.

Finally, while the focus of representations and warranties in a definitive agreement is on the statements made by the sellers, purchasers will typically also give limited representations and warranties. Unless the purchaser is issuing shares in its own capital or other similar consideration, as part of, or all of, the purchase price consideration, the purchaser typically gives a relatively small number of representations and warranties that speak to the purchaser's authority to enter into the agreement and close the transactions, including that other than identified pre-conditions to closing, no third party requirements of the purchaser are necessary to close. If the purchaser is a public company, the first, and most comprehensive representation and warranty in relation to its own affairs, is that it has complied with all disclosure requirements under applicable securities laws and exchange requirements including that its filings do not contain any untrue statement of a material fact or omit to state a material fact required to be stated.

(c) ***Covenants***

Covenants are agreements of the parties to do, or refrain from doing, certain things. Most of the covenants in an agreement relate to ensuring that certain things are done, or not done, by the seller in an effort to preserve what it is that the buyer is acquiring, and to ensure that steps are taken by the buyer as necessary to complete the transactions. A purchaser may also have covenants including, for example, that it will maintain the confidentiality of information provided to it during the due diligence phase or otherwise in the context of negotiating the deal or that it will not approach employees, customers or suppliers of the seller until a particular point in the negotiations or after a certain date.

A buyer will want to ensure certain typical things are *not* done by a seller, even if those things might not be uncommon in the normal course of business of the seller. Depending upon the expected time lag between the date of signing a purchase agreement and the closing, those restrictions can be cumbersome to a seller, so sellers will often seek to either eliminate certain restrictions or make thresholds as high as possible. For example, a buyer may want to ensure that the seller does not spend a significant amount on capital expenditures when the buyer is not yet in control of the operation of the business. Certainly, the seller should have no trouble in refraining from issuing new shares (other than pursuant to stock option plans in place already) or transferring material assets or terminating material contracts.

The flip side of the 'don't do this' category of covenants are covenants to ensure that the seller continues to operate the business in a manner that ensures that what is at the closing date handed over to the buyer is still what the buyer expected and paid for. There is a tendency, for example, for sellers to cut back on such things as maintenance of assets during these interim periods particularly where there is a purchase price formula that will reward a preservation of cash, so the buyer will want to ensure that adequate provisions are made for maintenance in the ordinary course (essentially, as if the sale were not proceeding). The buyer will also want the seller to commit to 'maintaining good relations' with customers and suppliers; and to ensure that it performs its contractual obligations to third parties so as not to be in default. A general basket covenant is to provide that the seller will take all such necessary steps to ensure that all representations and warranties are true at closing.

There are also covenants that deal with matters necessary to complete the transaction. For example, where pre-merger review of a transaction under the *Competition Act* (Canada) and/or equivalent legislation in other jurisdictions is required in order to close, the efforts are often jointly undertaken (either by legislation or by agreement). How that is accomplished, and who takes the lead (typically the purchaser) can be set out in a covenant in the agreement. Joint efforts might also be in the context of disclosure, both in obtaining for example, shareholder approval, but also in press releases, which in both cases would be a covenant by each party effectively not to act solo without the input or approval of the other.

Buyers and sellers will sometimes negotiate covenants with respect to information. In particular, if there is an event that would be a MAC, then the party discovering such fact is required to notify the other. They may also negotiate covenants that can be quite specific on the efforts required in due diligence. At the very least, the seller will be required to cooperate and provide access to books and records and facilities. But covenants with respect to how additional due diligence is conducted, or for whose benefit (e.g. in addition to the purchaser, the purchaser's lenders) can also be added.

As mentioned above, there are certain covenants that a purchaser may be asked to give. With rare exceptions (where the seller realizes that a sale price could be considerably higher than what has been negotiated) what a seller will want to ensure is that there is as much certainty as possible that a transaction will close. Where a purchaser has included as a condition precedent

that financing for the transaction will have been obtained, a seller will ask to have included as a covenant that the seller will use all [reasonable commercial] or [best][11] efforts to obtain such financing. Such a statement is, right now, far more difficult to fulfill.

Most covenants expire on closing, the efforts to satisfy them having been completed on or before the closing date. There are however, some covenants that do survive. For example, an asset transaction may include as part of the transferred assets, the name the business is operating under, and so the purchaser will want the seller to take steps to amend its Notice of Articles (or equivalent) to change its corporate name and its collateral containing that name (e.g. stationary, signage, marketing materials etc.). Sellers who hand over the books and records of the business in connection with the transaction will require access for a period of time following closing, and will need the purchaser to commit to providing such access. And, in some cases, particularly where, for example, a division is sold that had shared administrative functions, a seller may covenant to provide certain transitioning services. While these are often complicated enough circumstances to require separate agreements with provisions including, where applicable, terms of payment or service, they can be referenced on a stand-alone basis in agreements for less complicated or shorter term transitioning efforts. It goes without saying that the language of the agreement must expressly state that such covenants survive closing, which can be stated in the relevant covenant clause itself or can be included in a general survival clause in the agreement.

(d) ***Survival***

As mentioned above, most of the covenants in an agreement are likely to have been fulfilled by the closing date. But there are additional covenants, both in the covenant section specifically if the agreement is set out that way, and in other areas of the agreement, that are intended to survive closing. To ensure that they survive closing, the agreement needs to say so.

The principal negotiation on survival beyond the closing date, however, will be concentrated on how long representations and warranties of particularly the seller last after the closing. From a seller's point of view, it will want to know that exposures to claims will, at some point, extinguish. From a purchaser's point of view, the certainty of the continuation of allocation of

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[11] There is a considerable difference in the phrases "best efforts" and "reasonable commercial" effort in law.

pre and post closing risk will argue for longer rather than shorter survival periods, particularly for those matters that cannot be quickly discovered or would not, in the normal course of carrying on the business after closing, be discovered (such as environmental issues).

The nature of the transaction structure may dictate whether representations and warranties can survive. For example, a plan of arrangement with a public company where the surviving entity is the purchaser or purchaser subsidiary and the ownership of the target was publicly held, will mean that the representations and warranties serve only to act as conditions precedent to closing. In private company transactions, the survival of representations and warranties is as actively negotiated as the representations themselves and the indemnification clauses that work in conjunction with them. To survive closing and the transfer of shares or assets, the agreement must expressly provide for this, otherwise the representations and warranties will 'merge' upon closing and thereafter not be actionable. As with any item of negotiation in the agreement, how long representations and warranties survive is part of all of the other elements of the transaction dynamics including the bargaining power of the parties, the extent to which the purchaser is comfortable with the nature of the industry and the business itself and the extent of its due diligence.

Typically, although most operational types of representations and warranties will survive for a limited negotiated period of time, certain matters are excluded from time limitations. These would include, for example, in a share transaction, a representation and warranty as to the title to the shares, or in the case of all agreements, that the agreement was duly authorized and is enforceable. As well, there is also rarely any time limitations to actions grounded in fraud or intentional misrepresentation.

The most difficult clauses to negotiate the survival period on are environmental, pensions and to a lesser degree tax. With respect to the latter, statutory limitations applicable to audit review leads most agreement drafters to assert survival on pre-closing tax matters to the expiry of the relevant limitation period set out in the applicable statute pursuant to which taxes (including interest and penalties) may be imposed. Environmental matters are perhaps the most difficult to deal with. These are claims that may not be determinable for some considerable period following closing, and the quantum of loss is difficult to ascertain. What is appropriate will be a matter of risk allocation between the parties, and is dependant upon the general nature of the

business and the assessment by either party, but certainly the purchaser, as to the potential risk associated with the area.

(e) ***Conditions Precedent***

Conditions precedent are the 'out' or 'ability to walk' clauses of the agreement. We have already covered the requirement that representations and warranties need to continue to be true and accurate at the closing date[12], but there are a host of other conditions that the parties, particularly the purchaser, may require. Again, the seller will be looking to a degree of certainty in the transaction, and on that basis will resist things that are either wholly within the purchaser's control or subject to the purchaser's own 'opinion'. At the same time, a purchaser wants a sufficient level of comfort that what it believes it is buying and the basis (including valuation) on which it is prepared to buy the business at the time of closing, remains accurate and consistent. If the purchaser was otherwise 'ready to close' at the time of signing, but for the requirement of e.g. third party or shareholder approval, then circumstances should not have changed in a fashion that would alter the purchaser's view of the acquisition. The purchaser will want to include as conditions precedent, in addition to all representations and warranties continuing to be true, that all covenants to be performed by the seller have been performed, together with specific conditions such as there being no third party impediment to the closing of the transaction, and that all consents and approvals have been obtained and regulatory requirements complied with.

Third party approval requirements can also be conditions precedent to the benefit of the seller. However, a word of caution in drafting what constitutes meeting the condition precedent in certain cases. By way of example, how 'competition act approval' is defined in the agreement can have a fundamental impact on the purchaser, if it is not carefully enough crafted to ensure that the purchaser is not obligated in the course of obtaining that approval to subject itself to the possibility of divestiture of other assets in order to achieve the defined approval for condition precedent purposes.

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[12] The typical deliverable at closing to ensure or evidence that representations and warranties are brought forward is a certificate of an officer, commonly referred to as a "bring-down" certificate which effectively certifies that the representations and warranties in the agreement continue to be true. There is a tendency of sellers to add in "in all material respects", but purchasers should resist this, particularly because there will likely be materiality qualifiers already in the representations and warranties themselves.

Conditions favourable to a purchaser, if the purchaser wants as much flexibility as possible, would include such things as 'completion of due diligence to the satisfaction of the Purchaser [in its sole discretion]. The latter part of the phrase leaves the determination entirely in the purchaser's hands and should cause the seller some concern. Either a seller will resist the inclusion of due diligence as an 'out' (and the strength of that argument will be inextricably tied to the timing of the execution of the purchase agreement and the access granted to the purchaser and its representatives prior to signing) or will want to limit it including by softening the complete discretion to the purchaser (e.g. by inserting instead, the words "acting reasonably"), by limiting the types of due diligence and by requiring a waiver of such condition prior to certain additional steps being taken prior to closing (for example, expensive steps such as competition filings or approaching regulatory authorities for approval of permit transfers, which could initiate Crown obligations such as aboriginal consultation).

Conditions are to the benefit of the person to whom they are granted, and only that person can waive the requirement of satisfaction of the condition in order to complete the transaction. As a result, conditions are set out in an agreement separately and the language includes the right of the party to whose benefit the condition is granted, to waive that condition. Waivers may be appropriate, for example, when circumstances have intervened to make a seller's specific representation and warranty not true, but the purchaser is prepared to accept that fact and the attendant risk or following additional negotiations that may result in a negotiated reduction in purchase price, for example, to deal with the change in circumstances.

As mentioned above, MAC clauses may be included as a condition precedent, but again, extraordinary care should be given to drafting these provisions as they may prove to be the source of extensive litigation, all the more so in current economic times.

Whether a condition means that a party can close but sue for damages, or only determine not to close or the consequences and payment out of a deposit on termination are matters that can be the source of considerable negotiation as well.

(f) ***Closing Mechanics***

There is not a lot to say about closing mechanics, other than certain basic information about when and where the closing is held is set out in the document. The most significant part of the

closing mechanics section is the requirement of the parties to deliver certain documentation. This is rarely an exhaustive list of all documentation that would appear on a closing agenda, and as a result a ‘catch-all’ phrase is included that all documentation has been delivered as contemplated or reasonably required by the other party. In addition, where there are ancillary documents, such as escrow agreements, non-competition agreements or other types of agreements that are settled and delivered in the form of settled agreement (which may have been scheduled to the definitive agreement), these are listed as closing deliverables together with other deliverables such as bring-down certificates and opinions of counsel. Of course, the other fundamental deliverables are, in the case of a share transaction the shares on the one hand and the purchase consideration on the other.

The deliverables section can also include a requirement for evidence of certain conditions having been met. For example, where it is a requirement that certain consents or approvals have been obtained, the documentary evidence of that approval (which may in itself have been required to have been given in a particular form, or without conditions of issuance) may be listed as a deliverable. Sellers should be cautious about committing to the delivery too strictly of forms of consents. As these by definition involve third parties, it is not entirely within the control of the seller, and so caution should be exercised in agreeing to third party consent delivery terms.

(g) ***Indemnification***

Next to representations and warranties, the indemnification provisions of an agreement are the most strenuously negotiated. They are, in part, bound up in the negotiations on representations and warranties, but there are various elements of the indemnification provisions including the mechanics of claim and obligations of the parties in respect of an indemnifiable claim, let alone the limitations of liability, which are covered below, that can be drafted in any number of ways. However, there are certain goals that indemnity clauses are attempting to address that are common.

First, indemnity provisions need to support the essential risk allocation purpose of the representations and warranties in the agreement. Second, the parties will have to address those matters for which indemnification obligations arise, but which do not require a first assessment of whether or not a breach of representation and warranty has occurred. Third, the indemnity provisions will allocate the method of claim, such as notice and possible time-frames for notice,

who takes conduct of third party claims or has an influence upon the settlement or resolution of such claims, and where the indemnification comes from (e.g. first from escrow funds or holdbacks; set off against outstanding purchase consideration yet to be fulfilled (e.g. vendor take-back notes); indemnification from all sellers or only from certain sellers and not others). These are in addition to the survival of indemnity obligations (see the commentary under the heading "Survival" above) and limitations of liability discussed below.

It is my sense that a great deal of time is spent by the parties on discussing limitations of liabilities in the context of indemnifications far more so than some of the provisions that are drafted that may have a fundamental impact on the parties. For example, whether or not a purchaser is required to mitigate its loss may have consequences to a claim for indemnification when the time comes to make one. Similarly, who takes conduct of a proceeding has potentially far-reaching consequences to the purchaser. I have seen a number of agreements where the purchaser simply agrees to hand over the conduct of a third party claim to a vendor, where the purchaser opts to make a claim under the indemnity provisions. Given that the purchaser is carrying on the target business and the manner in which the third party litigation is carried out may have a long-lasting reflection on the business, I would resist that request from a seller. The seller, on the other hand, will not want to have an 'unmotivated' defendant, which the theory goes, would be the tendency of a purchaser in full control of a settlement of a third party claim when the full coverage for the claim will come from the seller's pockets. To mitigate against this, the indemnity mechanics can provide for participation in the proceedings by the indemnifying party, and an ability to assume conduct if the purchaser fails to pursue the matter. It can also provide for a form of consent of the indemnifying party (or if the indemnifying party has assumed the conduct of the defense, then the consent of the indemnitee). If the parties negotiate this allocation of responsibility, then the additional point to consider is the cost of the indemnitor's participation or assumption of the action.

When an indemnity claim must be paid is also a matter for discussion. Does the matter have to be fully and finally resolved, or is there an allowance for payment of immediate cost requirements arising from the claim? What is timely notice to an indemnitor, and what are the consequences for a 'failure' to meet that timely notice requirement? Certainly, acting expeditiously in a matter can reduce the ultimate liability of that matter, but is there some

uncertainty in what might constitute 'timely' and what might otherwise constitute 'prejudice' to the party failing to receive such notice.

All of the above is relevant to the negotiations and drafting of the agreement and should be carefully drafted or reviewed.

(h) ***Limitations of Liability***

As mentioned above, the focus on indemnity claim language in an agreement very quickly moves, at the sellers' initiation, to what limits the sellers' exposure. Sellers will look to two principal dollar figure limitations on liability. The first is the maximum exposure that the sellers will face on an indemnity claim. The second is how small a claim can be before it is made. The third is 'what's in and what's out' of the limitations of liability including the types of losses that may be claimed, or matters that may be covered.

Starting with the maximum amount – or 'cap' – on liability, the purpose is to establish a ceiling for payment obligations by the sellers. If there is a loss, even one that clearly arises from an indemnifiable event, the purchaser will assume the responsibility for the excess amount of the loss over the cap. Purchasers, of course, wish to leave the maximum liability limitless. Conversely, the starting point for sellers is a reasonable, and as small as possible, percentage of the purchase price. As a result, the 'purchase price' is not an uncommon final negotiated cap, which is justified by those arguing it that it leaves both parties somewhat even in terms of risk. For the purchaser, who has inevitably incurred significant costs associated with the purchase in excess of the purchase price, that amount would not be covered. For the seller, the full benefit of the purchase proceeds would be at risk, and again, the seller would have incurred significant costs in excess of that amount. In larger transactions, however, the parties do tend to settle on a percentage of purchase price amount as the cap on liability. The purchaser should, in determining what it is prepared to accept, consider the amount that this percentage represents as against the potential maximum liability for various types of claims. For that reason, there may be some claims that cannot be included in the cap. For example, title to the shares that are purchased cannot be compensated by a percentage of the purchase price amount, if it turns out not as is expected. Environmental and tax are also matters that are negotiated by the parties in terms of whether or not they are subject to a cap.

Secondly, the sellers will want to ensure that they are not ‘nickled and dimed’ by various claims that may arise after closing. This is the *de minimus* or threshold amounts that must be ‘achieved’ prior to a claim being made. This limitation serves to limit the purchaser from making a claim until the negotiated threshold is reached. This may be in two parts – e.g. no single claim less than $X and aggregate claims less than $Y. Tied to this concept, however, is what happens when the threshold is reached. There are two ways of dealing with this. The first is to treat the threshold as a deductible, meaning that the purchaser may only claim the amount of its loss in excess of the *de minimus* amount. The second is to treat the threshold as only a threshold, and once reached, the purchaser may claim the full amount of the loss back to ‘dollar zero’. It is important to consider these two options before the threshold is negotiated because the method of dealing with that threshold will influence a party’s thinking on the quantum.

One other common limitation of liability is the nature of the loss that may be claimed. It is not uncommon, although purchasers will want to be careful about excluding what otherwise might be the principal loss suffered in any given claim, that indemnifiable loss will not include loss for consequential damages.

Escrow of Funds

As part of the effort to provide some security to a purchaser that, should a loss occur as a result of an indemnifiable claim following closing, sufficient funds will be easily accessible, parties to a transaction will negotiate a holdback or escrow of a certain portion of the purchase price consideration. If a seller agrees to a concept of a ‘set-aside’ of purchase consideration, it is generally rare that the amount is simply treated as a holdback, and instead, the seller will want a third party escrow arrangement to be put in place. These types of escrow are typically with a trust company or bank. While a third party escrow results in an additional cost payable to the escrow agent, it does provide some rules that the escrow agent must follow in order to release the funds. That means that the purchaser cannot simply make an unchallenged claim on the funds or refrain from paying itself from the purchase price proceeds until resolution of any dispute in connection with the indemnity claim.

An escrow agreement will have provisions that make clear when the escrow agent can release funds, including upon expiry of the escrow term, and what documentation must be presented in order to do so. Escrow agents are conservative, and if there is any notice received by them, even

one that ultimately is arguably deficient, the escrow agent is unlikely to release any funds until it is either ordered to do so pursuant to a court order or it receives a joint written direction from the parties in interest. To protect the escrow agent from any liability, the escrow agreement will provide for a release of escrow agent liability if the escrow agent takes steps in good faith together with indemnification of the escrow (often by both parties in interest to the agreement), as well as rights to pay the escrow monies into court and resign from the escrow agent responsibility.

The amount and length of time that the monies will be set aside in escrow is certainly a matter of negotiation, and is part and parcel of the overall discussions regarding indemnities and limitations of liability. As mentioned above, sellers will often want to limit losses payable on an indemnity claim to just those funds held in escrow, and only for the length of time of the negotiated escrow term.

Escrow funds or holdbacks can be staggered so that funds are released in certain amounts based on certain events. For example, a holdback might be in place to provide for purchase price adjustments that will be finalized, e.g. 90 days following closing (assuming no disputes between the parties on the determination). Escrows might be released in tranches depending upon the indemnity loss that it is intended to protect. A portion of the funds might be released after 12 months, with a further amount after another 12 months, or longer. The theory behind staged releases is that the risk of indemnity claims should diminish over time.

Exclusive Remedy

Sellers should always ensure that the language of the agreement provides that the only remedies available to the buyer are those set out in the agreement, other than those that are based on fraud, for example, or injunctive relief in the case of such things as non-competition provisions that are built into the agreement and confidentiality. Without that language, a purchaser may have available to it other causes of action that lie outside the terms of the contract which makes the various negotiations that have occurred with respect to limitations of liability and management of indemnification claims certainly more limited in their benefit. You will see, however, purchaser-drafted agreements that expressly state the opposite – namely that the remedies in the agreement are in addition to all other remedies available to the purchaser.

(i) ***Termination of Agreement***

Parties to an executed agreement can always, by agreement between them, terminate an agreement. The challenge, however, may be in getting both sides to agree. As a result, certain other methods of termination are included in an agreement.

As discussed above, if conditions precedent to the benefit of a particular party are not met by a defined Closing Date, or Closing Time (which is usually a time on the defined closing date sufficiently early in a business day to accommodate the transfer of purchase price consideration among other steps that may be required to close, including filings with corporate registries), then that party may terminate the Agreement. Again, that may not be the optimal choice, so the provision should cover options available to the party benefiting from the condition, namely the right to terminate or to waive the condition. In a similar vein, a mutual right to terminate could be included in a circumstance where there is an order, judgment or ruling that prohibits the completion of the transaction.

In addition, though, agreements might have other provisions that provide for termination rights. For example, if certain third party approvals are not bet by a particular date, an outside date (otherwise known as a 'drop dead' date or sunset date), might trigger termination rights. In that case, it may be, as with the above, a condition in favour of one party, but it may be a right that is triggered by either. Be wary of a blanket statement in that regard, however, because the failure may be wrapped up in the actions or omissions of another party who had covenanted to do certain things. Those obligations should not be wiped out by the right of termination.

Boards of directors of target companies may also require a right to entertain an alternative, often defined as a 'superior' offer to meet the board's fiduciary obligations. The nature of this type of clause and its operation is, or certainly could be, the subject of another paper, but suffice it to say that there are things that a purchaser can do to try to protect itself if such a clause is put into effect.

What will take some time to negotiate is the consequence of termination. Is there liability on termination, or do both parties walk away from the transaction without continuing liability, and if there is liability, does it only apply to certain matters giving rise to termination and not others (e.g. a governmental order prohibiting the completion of the transaction might not give rise to

liability). If a deposit has been made by the purchaser, what happens to that deposit on termination and does that differ depending upon the type and cause of termination? This paper does not cover the topic of break fees and reverse termination fees, both of which became particularly topical following the demise of the BCE deal in December, 2008, of which there has been much written.

(j) ***Boilerplate***

The often neglected, poor cousins of the agreement are the boilerplate clauses tucked away in the back. As I believe one other paper will address, boilerplate is neglected at the drafter's peril. I will not address the law on the efficacy of entire agreement clauses for example, for that reason, but will mention that the boilerplate will have to be addressed in every transaction agreement.

The one clause that is, in multi-jurisdictional transactions, going to have to be faced up front is the governing law section of the agreement. This can cause you more grief than you realize, particularly when opinions of counsel are required at closing. A related matter is where and how disputes will be handled. As purchase agreements are finite in time – there is a buildup to a closing, a closing and then the primary surviving provisions are indemnification, it is not common to resolve disputes by way of escalation clauses, mediation or even arbitration. Certain matters within the agreement might be handled that way. For example a dispute arising from a working capital adjustment might be referred to effectively binding arbitration with a mutually agreed upon, and neutral, accounting firm. Otherwise, the parties will generally resort to the courts of the jurisdiction of the contract.

Dealing with each party's expenses of negotiating and completing the transaction is another matter that should be set out in the agreement. For the most part, expenses of each of the parties for their own advisors and otherwise in the negotiation and settlement of the transaction documents are borne by each such party. In some transactions, it is, or at least was, common to have the expenses of the seller, on successful completion of the transaction, folded into the working capital of the target (although consider the implications of that type of arrangement when there are working capital adjustments).

Finally, and as mentioned above, to avoid the common law rule that representations, warranties and covenants cease to exist upon completion of the transaction, a 'non-merger' clause is included in the agreement.

6. **Conclusion**

While it is tempting to say that 'once you have done one acquisition, then you have done them all' in terms of drafting, that is rarely the case. The last agreement you might have used can certainly form a basis for the next, but it seldom remains after the first draft entirely consistent with the previous deal. This paper has been an attempt to highlight the principal provisions of an acquisition agreement and the meanings and negotiating benefits of certain clauses.

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