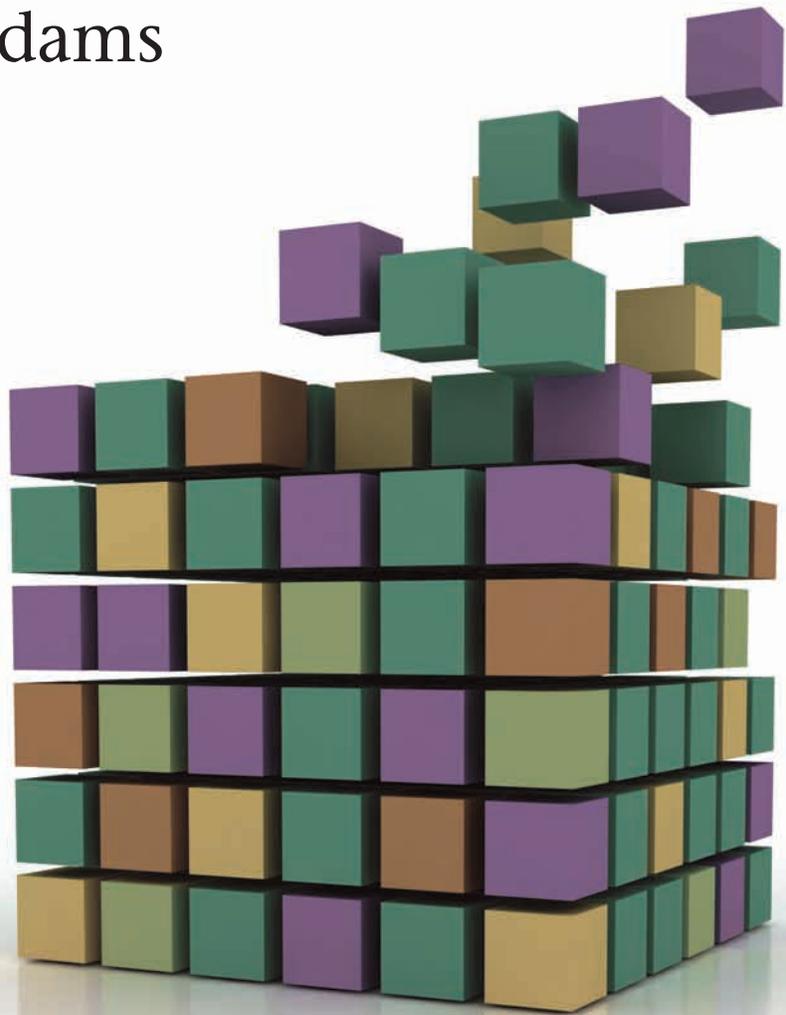


The Structure of M&A Contracts

Kenneth A. Adams



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■ CONTENTS

Click on any entry in the table of contents to go to that part of this book.

List of Figures	viii
List of Tables.....	viii
About the Author.....	ix
Foreword	x
Preface	xii
CHAPTER 1: The Categories of Provisions	1
Where to Address a Given Issue	2
Facts Under the Seller’s Control.....	4
Action Under the Seller’s Control.....	6
Facts or Action Not Under the Seller’s Control	7
CHAPTER 2: Representations.....	9
Function	9
The Representations Lead-in	9
Making Representations on the Date of the Agreement	10
Making Representations Only on the Date of the Agreement	11
Making Representations Also at Closing.....	16
“Represents and Warrants”	18
“Hereby Represents”	21
Using a Verb Instead of a Verb and Abstract Noun	21
Reliance	22
Reference-Point Exception	22
Accuracy	22
Exceptions for Matters Stated in Disclosure Schedules	23

When More Than One Party Makes a Set of Representations	23
The Reference Point	25
Matters Under the Seller’s Control.....	25
Matters Not Under the Seller’s Control.....	28
Exceptions	31
Qualifications Relating to Significance	33
The Problem with “Material”	33
Defining “Material”	35
Using “Material”	37
Using “Material Adverse Change”	38
Defining “Material Adverse Change”	39
“Significant”	40
Using Qualifications Relating to Significance.....	41
Limiting Significance Qualifications	41
Relation to the Bringdown Condition and Indemnification.....	42
Knowledge Qualifications.....	43
Referring to Representation Inaccuracies	47
CHAPTER 3: Preclosing Obligations	49
Function.....	49
The Ensure-the-Conditions-Are-Satisfied Obligation.....	50
Using “Reasonable Efforts”	50
Implications	50
Redundancy	50
Obligation Stating Actions to Take to Satisfy a Condition.....	54
Obligation to Provide Information on Nonsatisfaction of Conditions.....	54

Other Transactional Obligations	56
CHAPTER 4: Conditions	57
Function	57
The Conditions Lead-In	57
“Condition Precedent” and “Condition Subsequent”	58
Categories	58
The Bringdown Condition	62
“Accurate”	63
Relevance of When Representations Are Made	63
Excluding Representations Made on the Date of the Agreement	64
Materiality	65
Stripping Out “Knowledge”	68
Reference-Point Exception	69
The Compliance-with-Obligations Condition	69
CHAPTER 5: Indemnification Provisions	71
What Losses are Indemnified Against	71
Preclosing Knowledge of Inaccurate Representations	72
No-Indemnification-If-You-Know Provisions	72
Indemnification-Even-If-You-Know Provisions	73
Materiality-Scrape Provisions	76
Filling the Basket with Significance-Qualification Losses	78
CHAPTER 6: Termination Provisions	81
Stand-Alone and Condition-Linked Termination Provisions	81
The Link Between Conditions and Termination Provisions	84
Redundancy	88

List of Figures

Figure 1	Links Between the Categories of Provisions.....	3
Figure 2	Where to Address a Given Issue	5
Figure 3	Adding Reference Points and Qualifications Representations	29
Figure 4	Subcategories of Transactional Obligations	51
Figure 5	Categories of Conditions.....	59
Figure 6	Termination Provisions	82
Figure 7	The Link Between Conditions and Termination Provisions	85

List of Tables

Table 1	The Representations Lead-in	9
Table 2	The Reference Point.....	26
Table 3	Exceptions	32
Table 4	Using “Material”	37
Table 5	Knowledge Qualifications	44
Table 6	The Conditions Lead-in.....	57
Table 7	The Bringdown Condition	62
Table 8	The Compliance-with-Obligations Condition.....	70

About the Author

Kenneth A. Adams is a consultant and speaker on contract drafting. He gives seminars in the U.S., Canada, and internationally, acts as a consultant and expert witness, and is a lecturer at the University of Pennsylvania Law School. His book *A Manual of Style for Contract Drafting* (ABA 2d ed. 2008) is widely used throughout the legal profession. As part of its “Legal Rebels” project, in 2009 the ABA Journal, the magazine of the American Bar Association, named Adams one of fifty leading innovators in the legal profession. And the ABA Journal included Adams’s AdamsDrafting Blog in its 2009 and 2010 “Blawg 100”—its list of the hundred best law blogs.

Adams is also founder and president of Koncision Contract Automation, an online service that will make available to lawyers document-assembly templates for business contracts. He maintains at www.koncision.com his new blog, The Koncise Drafter.

After graduating from the University of Pennsylvania Law School in 1989, Adams practiced corporate law in New York and Geneva, Switzerland, with major U.S. law firms.

Foreword

First, do no harm. When drafting M&A contracts, attorneys too often violate this principle. Any given M&A contract is likely to be bloated, impenetrable, and haphazard in how it addresses some key issues. Instead of seeking to articulate the deal succinctly, drafters tack on clauses using *notwithstanding*, *provided however*, *for the avoidance of doubt*, and other warning signs of circumlocution. And drafters routinely seek to address every possible risk, even if doing so distracts attention from those that really matter. This is before negotiations, where the prevailing etiquette seems to require that each party pile on its own language to counter the other guy's.

When this drafting lands in court, it can get messy. The recent litigation between United Rentals and the private equity fund Cerberus provides a good example of that—confusion in the merger agreement resulted in an expensive fight over the remedies available to United Rentals on termination of the agreement.

The M&A world is currently subject to a perfect storm that makes it particularly susceptible to this kind of dispute. Compounding the tendency to dysfunction evident in business contracts generally is the fact that the pressures of M&A transactions favor expediency over meticulousness. On top of that, we have pressures due to the financial crisis—lawyers representing M&A clients can no longer assume that drafting glitches will be rendered irrelevant by the client's zeal to get the deal done.

The renewed focus on drafting is a welcome development. Historically, contract drafting has been treated as a craft that is learned on the job rather than as a discipline acquired through structured training, whether in law school or at a law firm. Corporate associates have learned how to draft by actually preparing and negotiating contracts. At the heart of the traditional system was the understanding that the only way to become truly proficient in M&A contracts is to immerse yourself in them. But due to lack of a truly rigorous framework for contract language and structure, the traditional system has too often become regurgitation of hand-me-down language.

The push for better contract drafting is in its infancy. Law firms are still debating how best to train lawyers. Law schools are, with

varying levels of enthusiasm, taking steps to meet this need by offering courses in contract drafting and clinics in transaction skills. But there has been a dearth of relevant reference materials.

This is where Ken Adams comes in. Ken is a pioneer in this field. In particular, he's author of *A Manual of Style for Contract Drafting*. It's the leading reference work on the subject, and it's in use throughout the legal profession.

Ken has now turned his attention to M&A—hence this book. It's the basis for an eponymous webcast that he and I will be offering through West.

This book brings to bear on the structure of M&A contracts the same rigor, attention to detail, and disregard for sacred cows that informs *A Manual of Style for Contract Drafting*. It describes how to best address in M&A contracts issues related to structure that arise routinely in negotiation. And it does so with a clarity and comprehensiveness that cuts through the murk that surrounds much writing on these issues.

You might disagree with Ken's analysis of a given issue. But I suspect that when Ken encounters resistance, in large measure it's prompted by simple resistance to change. If you really do disagree with Ken, he'd be the first to invite you to do battle in the marketplace of ideas. As the intellectual underpinnings of M&A drafting become more robust, force of habit won't be enough to justify sticking with a given approach.

Ken acknowledges that resistance to a given change might make implementing that change more trouble than it's worth. But as drafting moves from craft to discipline, I expect that invoking that as a justification for the status quo will seem increasingly small beer.

So whether you're a junior lawyer striving for control in a tough field or a more senior practitioner revisiting M&A basics, I think you'll find this book uniquely valuable. It will help you draft contracts that more than satisfy the principle of "do no harm."

Steven M. Davidoff
N.Y. Times "Deal Professor"
Professor of Law, University of Connecticut School of Law

Preface

WHY THIS BOOK?

This book considers the function of the different categories of provisions in a mergers-and-acquisitions (or M&A) contract and the interplay among them. These are topics worthy of study: A slight change of phrasing in one part of a contract can have important implications for other parts of the contract. And issues relating to contract structure arise routinely in M&A negotiations.

This book is intended for anyone who wishes to understand the structure of M&A contracts. That obviously includes junior lawyers—they're the ones who do most of the drafting of M&A contracts. And they could certainly use some help. Many junior lawyers receive little formal training in the structure of M&A contracts, and what instruction they do receive likely features a generous helping of stale conventional wisdom. And the convulsions of the U.S. legal profession in recent years have made it less likely that a junior lawyer will receive meaningful mentoring. This book should help junior lawyers take control of the drafting process, instead of regurgitating precedent contracts of questionable quality and relevance. It should also help them understand what's going on during negotiations.

Senior lawyers who have the time and inclination to revisit how they handle the structure of M&A contracts should also find this book useful. And because other kinds of contracts—such as securities purchase agreements and loan agreements—can exhibit a structure comparable to that of M&A contracts, this book might be of interest to anyone involved in transactions featuring an interval between signing and closing.

The benefits of a clearer understanding of how to structure an M&A contract go beyond making life easier for the drafter. If those doing the drafting and reviewing have a better grasp of the subject, contracts would be clearer and would address the parties' concerns more effectively; negotiations would be more efficient and less contentious; and disputes would arise less frequently.

Others have written about the structure of M&A contracts, but five features serve to distinguish this book. First, its limited scope permits a more cohesive treatment than would be possible in a broader work. Second, rather than simply cataloguing the structures—good, bad, and indifferent—on display in M&A contracts, it identifies those that work best. Third, it specifies what contract language you should use in a given context and what contract language you should avoid; the recommended language complies with the guidelines contained in the author's *A Manual of Style for Contract Drafting*.¹ Fourth, it presents some of its analysis in a series of figures, so as to make it easier to understand. And fifth, it doesn't hesitate to depart from the conventional wisdom.

FEATURES OF THIS BOOK

This book refers to the buyer and seller in a hypothetical M&A contract. Who the seller is would depend on how the transaction is structured.² If it's a stock purchase, the seller is whoever owns the stock of the company being acquired—there might be more than one shareholder. If it's an asset purchase, the seller would be the company that owns the assets being acquired. In the case of a merger, it's inaccurate to refer to a seller, although the one or more shareholders of the company being acquired are analogous to sellers.

And this book focuses on provisions benefiting the buyer. Because to a greater or lesser extent the buyer assumes more risk than the seller, provisions benefitting the buyer necessarily predominate in any given M&A contract. But the categories of provisions can, to a greater or lesser extent, be structured to benefit either the buyer or the seller.

This book includes tables containing enumerated examples of contract language followed by variations. Each example is identified by a number in brackets; each variation is given the same designation but is distinguished by adding a lowercase letter. (For instance, [3b] denotes the second variation on example [3].) A given example or variation might be annotated to show whether it is recommended (✓) or contraindicated (✗). For consistency with the rest of the text, all examples are from a notional asset purchase

agreement and so use the defined terms *the Buyer* and *the Seller*; you'd need to make conforming changes to some of them to use them for a transaction structured other than as an asset purchase.

At various points this book illustrates the frequency of a particular approach by indicating how often it appears in the M&A contracts included in the sample examined for the 2009 Private Target Deal Points Study,³ a study conducted by the Mergers & Acquisitions Market Trends Subcommittee of the Committee on Mergers and Acquisitions of the Section of Business Law of the American Bar Association. Sometimes the 2009 Private Target Deal Points Study itself is cited; elsewhere, it is the author's own review of those contracts that is cited—the contracts are available through the subcommittee's page on the ABA's website.⁴ It makes sense for this book to piggyback off of the Deal Points Study in that manner—those contracts would seem to constitute a representative cross-section, and they are conveniently accessible.

EFFECTING CHANGE

Some recommendations in this book are at odds with current practice. (Wherever that's the case, it's noted in the text.) That shouldn't dissuade you from following those recommendations. For one thing, a given approach may be enshrined in the dysfunction that is mainstream drafting,⁵ but that doesn't mean that it's the most effective approach. In many cases, it clearly isn't.

Furthermore, one of the rewards of contract drafting is that the drafter has the opportunity to control meaning, as opposed to leaving it to the courts to make sense of murky contract language. If novel yet rigorous contract language addresses a flaw in the conventional approach and comes closer to expressing clearly the intent of the parties, you should consider using it. The alternative—sticking with current approaches because they've supposedly been “tested” by the courts—is unpromising. The caselaw is often patchy and even contradictory in its coverage of a given issue, varying from jurisdiction to jurisdiction and even within jurisdictions. And if any contract language came to be so tested, often it's because it failed to state clearly the intent of the parties. Why rely on language that resulted in litigation? Instead,

express any given concept clearly, so you don't have to gamble on courts reading into your contract language the desired meaning.

But change is hampered by inertia. Deviating from standard language, no matter how defective, might spark debate, and debate creates delay and increases transaction costs. But inertia by itself isn't a valid reason to reject change—if it were, the precedent-driven nature of the transactional world would ensure that contract language remains fossilized. Instead, you have to weigh the time and money you might save through don't-rock-the-boat expediency against the increased efficiency and reduced risk offered by rigorous contract language; it shouldn't take much for the latter to outweigh the former. This book aims to help you see what's on each side of the equation.

A note to junior lawyers: before embracing the more novel recommendations made in this book, you should consider getting the approval of someone more senior.

COMMODITIZING

Drafting contracts takes up more lawyer time than it should. Because any transaction typically resembles previous transactions, drafting should be a commodity task, one powered by document-assembly software rather than by junior lawyers retooling word-processing documents. That would allow lawyers to focus on those tasks that add most value—devising strategy and assisting in negotiations.

But to commoditize, first you need broad consensus as to what contracts should look like. The author's goal in writing *A Manual of Style for Contract Drafting* was to propose a set of guidelines for contract usages. For purposes of commoditizing the process of drafting M&A contracts, equally important is a set of guidelines regarding structure. That's what this book provides.

ACKNOWLEDGMENTS

This book benefitted greatly from comments I received from Michael J. Kendall, Vincent R. Martorana, Brian J.M. Quinn, Steven H. Sholk, and Michael A. Woronoff. I offer them my thanks. And thank you to Wilson Chu for helping to make accessible to me the contracts examined for the 2009 Private Target Deal Points Study.

■ CHAPTER 1

The Categories of Provisions

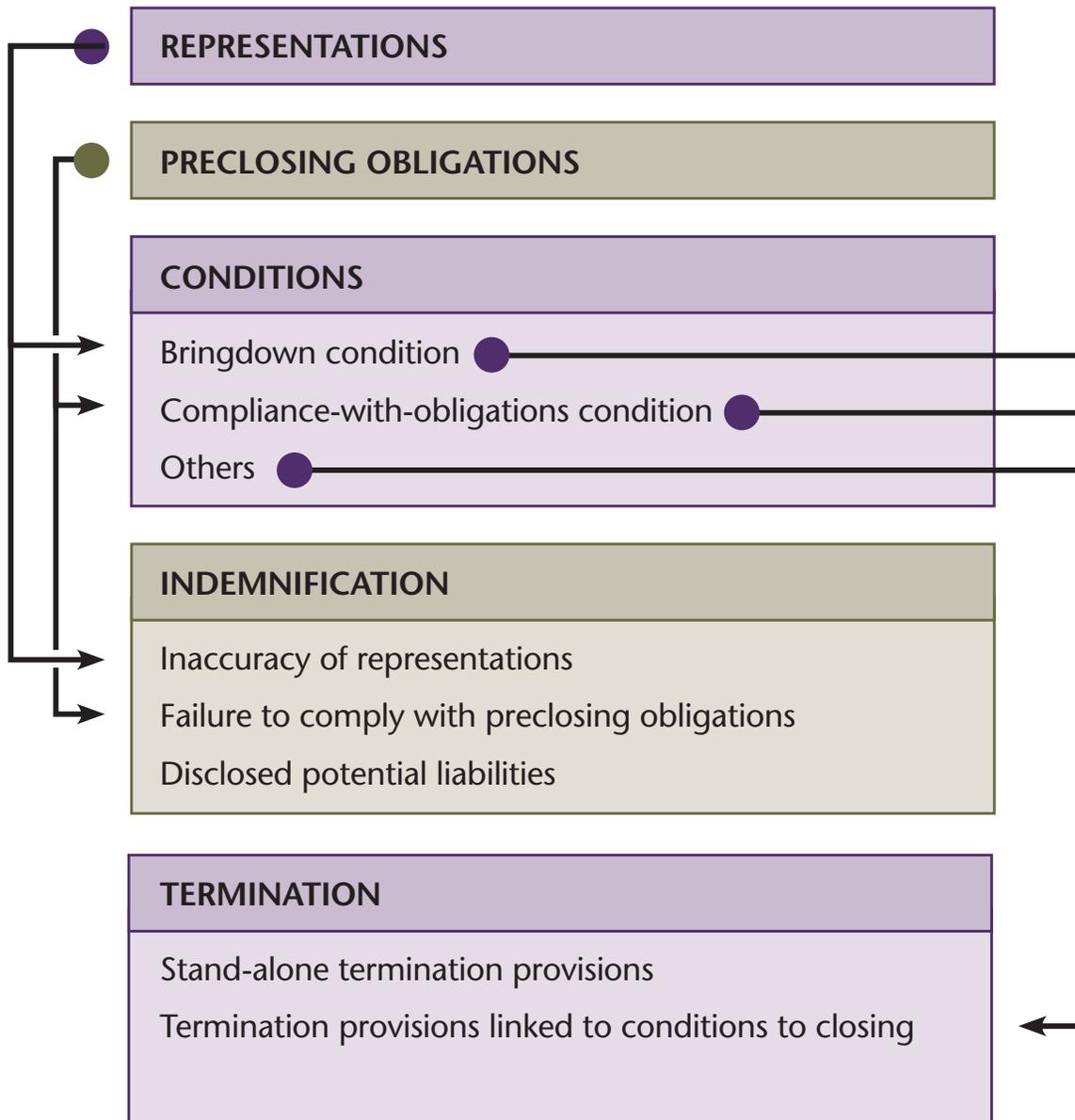
- 1.1 Timing is a key factor in determining what categories of provisions an M&A contract should contain. If the transaction is consummated when the contract is signed—in other words, if the signing and closing are simultaneous—then the contract would usually contain deal provisions, representations, indemnification provisions, and boilerplate, as well as any postclosing obligations.
- 1.2 “Deal provisions” refers to those provisions that describe the core elements of the transaction.⁶ “Boilerplate” refers to provisions that address interpretation of the contract and other matters typically relevant to contracts generally. They’re also referred to as the “miscellaneous” provisions, and usually they’re placed just before the concluding clause and the signatures. Deal provisions have limited bearing, and boilerplate has no bearing, on the interplay of different parts of a contract.
- 1.3 More relevant for purposes of structuring an M&A contract are representations and indemnification provisions. A representation is a statement of fact that one or more parties make so as to induce one or more other parties to enter into a contract.⁷ And indemnification provisions grant a party the right to recover for inaccurate representations, noncompliance with obligations, and any other specified risks.⁸ (Because enforcing indemnification obligations against public-company shareholders is problematic, indemnification is rare in public company transactions, except when a substantial shareholder agrees to indemnify the buyer.⁹ This book assumes a context where indemnification would be appropriate.)

- 1.4** If the closing is scheduled to take place sometime after signing—in other words, if the closing is deferred—the contract would typically also contain obligations to be complied with before closing, conditions that have to be satisfied before the parties will be required to consummate the transaction, and termination provisions, which specify when a party may terminate the agreement. (Termination provisions can also serve the ancillary function of stating the terms of any breakup fee, but that function isn't a focus of this book.) Sometimes a contract contains these provisions even though the signing and closing are simultaneous. Presumably that's because originally it was thought that the closing might be deferred, and thereafter it was decided that stripping out the extra provisions would be more trouble than it was worth.
- 1.5** These additional components complicate matters, so this book focuses on contracts that provide for a deferred closing. More specifically, this book discusses representations, preclosing obligations, conditions, and indemnification provisions—James Freund's "four horsemen"¹⁰—as well as a fifth, termination provisions.
- 1.6** Figure 1 shows the links between these five categories of provisions: An inaccurate representation can result in the bringdown condition not being satisfied. Breach of an obligation can result in the compliance-with-obligations condition not being satisfied. Inaccurate representations and breached obligations can also give rise to a claim for indemnification. And if a condition cannot be satisfied, that could, depending on the condition, give rise to a right to terminate the contract. This book discusses these linkages in detail.

WHERE TO ADDRESS A GIVEN ISSUE

- 1.7** Although each of the five categories of provisions serves a different function, one could conceivably address a given issue in any one of them. But due to the interplay of the different categories, it's most efficient, in terms of structure,

FIGURE 1: LINKS BETWEEN THE CATEGORIES OF PROVISIONS



to address that issue in only one of the categories, except if it would be appropriate to address it in both a condition and the termination provisions. This concept is illustrated in figure 2 and discussed in this chapter.

Facts Under the Seller's Control

- 1.8** If a given issue relates to facts on the date of the agreement and those facts relate to matters that are under the seller's control (see the first main column in figure 2), it makes most sense to address that issue by having the seller make a representation as to those facts.
- 1.9** If that representation were made both on the date of the agreement and at closing (see 2.24–28), the buyer wouldn't also need to impose a preclosing obligation on the seller to undertake to ensure that those facts remain accurate between the date of the agreement and closing. But the subject matter of a given representation may be such that the buyer would be keen to have consistency between the date of the agreement and closing. (One such representation might be a representation that the seller has all permits required by law—it could be problematic if one or more permits were to lapse temporarily between the date of the agreement and closing.) Typically such issues are addressed both in a representation and in an obligation related to operation of the target business between signing and closing. (See 3.2.)
- 1.10** From the buyer's perspective, if a given issue relates to facts at the time the contract is signed and those facts relate to matters that are under the seller's control, addressing that issue only in a condition has the disadvantage of not entitling the buyer to damages if the condition isn't satisfied. And if this issue were addressed in a representation, it would be superfluous also to address it specifically in a condition, as an optimally drafted bringdown condition would serve to make accuracy of that representation a condition to closing. (See 4.17.)

FIGURE 2: WHERE TO ADDRESS A GIVEN ISSUE

In a transaction with a deferred closing, a given issue could be addressed in a representation, a preclosing obligation, a condition, the indemnification provisions, or the termination provisions. Which approach makes most sense depends in part on the nature of the issue. Use of shaded text within thick borders indicates where it would be best to address a given issue.

	<i>Fact Under the Seller's Control</i>	<i>Action Under the Seller's Control</i>	<i>Fact or Action by Person Not Under the Seller's Control</i>	<i>Economic Condition Not Under the Seller's Control</i>
<i>Seller Representations</i>	The Seller is a corporation duly organized, validly existing, and in good standing under the laws of the state of Delaware.	The Seller has granted the Buyer and its representatives access to the Seller's premises between the date of this agreement and the Closing.	Acme has not terminated the Acme Contract.	The price of vanadium is at least \$100 per gram.
<i>Seller Preclosing Obligations</i>	The Seller shall remain a corporation duly organized, validly existing, and in good standing under the laws of the state of Delaware.	The Seller shall grant the Buyer and its representatives access to the Seller's premises between the date of this agreement and the Closing.	The Seller shall cause Acme not to terminate the Acme Contract before the Closing.	The Seller shall cause the price of vanadium to be at least \$100 per gram.
<i>Conditions to the Buyer's Obligations</i>	The Buyer's obligation to consummate the transaction contemplated by this agreement is subject to satisfaction of the following conditions:			
	that the Seller is a corporation duly organized, validly existing, and in good standing under the laws of the state of Delaware;	that the Seller has granted the Buyer and its representatives access to the Seller's premises between the date of this agreement and the Closing;	that Acme has not terminated the Acme Contract;	that the price of vanadium is at least \$100 per gram;
<i>Indemnification</i>	The Seller shall indemnify the Buyer against any Indemnifiable Losses arising from the following:			
	the Seller's not being a corporation duly organized, validly existing, and in good standing under the laws of the state of Delaware;	the Seller's not granting the Buyer and its representatives access to the Seller's premises between the date of this agreement and the Closing;	Acme's terminating the Acme Contract before the Closing;	the price of vanadium being less than \$100 per gram;
<i>Termination</i>	This agreement may be terminated as follows:			
	by the Buyer if the Seller ceases to be a corporation duly organized, validly existing, and in good standing under the laws of the state of Delaware;	by the Buyer if the Seller fails to grant the Buyer and its representatives access to the Seller's premises between the date of this agreement and the Closing;	by the Buyer if Acme terminates the Acme Contract before the Closing;	by the Buyer if the price of vanadium is less than \$100 per gram;
	(For why it would be appropriate to address the issue in the third main column in both a condition and the termination provisions but would be most efficient to address the issue in the fourth main column only in a condition, see 1.16, 6.6, and figure 7.)			

- 1.11** If the issue were addressed in a representation, it would be unnecessary also to address it in a termination provision, as an optimally drafted set of termination provisions would specify that inability to satisfy the bringdown condition constitutes grounds for termination. (See 6.7.)
- 1.12** And the buyer should be indemnified against losses arising from inaccurate representations. (See 5.2.) If that's the case, nothing would be gained by also providing that the seller must indemnify the buyer for inaccuracies in one or more specific representations.

Action Under the Seller's Control

- 1.13** If the issue in question relates to an action to be taken by the seller between the date of the agreement and closing (see the second main column in figure 2), one could address it in a representation with the period between signing and closing as a reference period. (See 2.57.) But it's clumsy to have a seller make representations as to future facts—if you make a representation regarding the future, you're not so much stating facts as gazing into a crystal ball. In this context, it would be more straightforward to impose on the seller a preclosing obligation to accomplish that action.
- 1.14** As with facts under the seller's control, it would be to the buyer's disadvantage to address solely by means of a condition an action under the seller's control, as the buyer wouldn't be entitled to bring a claim for indemnification if the condition weren't satisfied. And it would serve no purpose to address in both an obligation and a condition an action under the seller's control, as the compliance-with-obligations condition would serve to make performance of that action a condition to closing. (See 4.41.) It follows that it would also serve no purpose to address such an action specifically in the termination provisions—a contract should provide that inability to satisfy the compliance-with-obligations condition constitutes grounds for termination. (See 6.7.) And the

buyer should be indemnified if the seller fails to comply with its obligations (see 5.2), so nothing would be gained by also providing that the seller must indemnify the buyer if it fails to comply with a specific obligation.

Facts or Action Not Under the Seller's Control

- 1.15** The issue in question might not be under the seller's control, either because it's entirely or partly under the control of someone else or because it relates to general economic conditions. (See the third and fourth main columns of figure 2.) In either case, it would be illogical for the seller to make a representation regarding that issue: even if the seller could determine that the representation was accurate at signing, it would have no way of controlling changes between the date of the agreement and closing. Similarly, it would be futile to impose on the seller a preclosing obligation to ensure that someone over whom the seller has no control takes a specified action, or that facts over which the seller has no control are accurate at closing.
- 1.16** Instead, it would be more appropriate to address the issue in a condition to closing that requires that the event have occurred before the closing, or that the facts be accurate at closing. And the issue shouldn't also be addressed in the indemnification provisions—if a condition to the buyer's obligation to close isn't satisfied, the buyer wouldn't be entitled to bring a claim for indemnification. Whether you'd also address the issue in a termination provision, and how, would depend on the nature of the condition. (See 6.4–11.) That's why in figure 2 only one of the two issues highlighted as most appropriately addressed in a condition is also addressed in a termination provision.
- 1.17** One could argue that it would nevertheless be preferable to address in a representation or preclosing obligation matters over which a party has no control, because then the buyer could sue for damages if the representation were inaccurate or the obligation had been breached. But that assumes

that rather than recharacterizing it as a condition, a court would take such a representation or preclosing obligation at face value—an uncertain proposition. It would be clearer to address this sort of risk allocation through the indemnification provisions or a negotiated breakup fee.