United States

Negotiated M&A Guide 2022

Corporate and M&A Law Committee

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1. LEGAL FRAMEWORK

The statutory law and common law (that is, case law) of the individual states of the United States (for example, California, Delaware, Illinois and New York) supply the basic legal framework with respect to M&A activity in the US. However, parties to an acquisition agreement are generally free to negotiate terms and conditions (such as representations and warranties, covenants, closing conditions and indemnification provisions) with very few restrictions under state law. In addition, deal terms can be drafted to avoid or obtain a particular result that would be otherwise be different under statutory or common law.

As a general rule, the statutory law of the state in which the target corporation or other business entity is formed will govern many important aspects of the affairs of such entity, including with respect to acquisition transactions. State statutory laws establish certain requirements that must be satisfied for target corporations to validly enter into and consummate such transactions. For example, state statutory laws generally require that the sale of a target corporation by way of merger, or sale of all or substantially all of its assets, must be approved by both the board of directors and the stockholders of the target corporation. State statutory law also supplies the minimum stockholder vote requirement, which is usually expressed as the holders of a majority (or, in some cases, a supermajority) of the outstanding shares entitled to vote thereon.

State common law supplies many other rules and principles that impact acquisition transactions. These rules and principles are either not expressed in state statutory law or state statutory law can only be fully understood by reference to such common law. For example, courts in Delaware have developed an extensive body of law with respect to the fiduciary duties applicable to boards of directors, including in the acquisition context. As a general matter, the directors of the target corporation must act in good faith, on an informed basis and in the best interests of stockholders and are viewed as having duties of care and loyalty, all of which are understood primarily by reference to state case law. Further, while state statutory law may require stockholder approval upon a sale of all or substantially all of the assets of a corporation, state case law supplies various metrics that must be analysed to determine whether a particular sale of assets amounts to 'all or substantially all' of the assets of a corporation.

Because corporations and other business entities are most commonly formed in the State of Delaware, this discussion will focus on Delaware law. Delaware has developed a robust and well-respected body of corporate common law, and the courts of other states often look to Delaware case law for guidance on corporate law issues. We also assume for purposes of this discussion that the target entity is a corporation, as opposed to a limited liability company or other entity, except as noted.

Though largely beyond the scope of this discussion, US federal securities laws, in particular the Securities Act of 1933 (the Securities Act) and the Securities Exchange Act of 1934 (the Exchange Act), and the rules and regulations of the US Securities and Exchange Commission (the SEC) thereunder, contain requirements that affect the structure and process of many acquisition transactions. For example, when a publicly traded or privately held company proposes to use stock or other securities as acquisition currency, the Securities Act may apply and (among other things) require the company issuing such securities to register such stock or securities with the SEC, unless a private placement exemption or other exemption from registration is available.

Further, if a publicly traded target company is required to obtain stockholder approval in connection with a proposed acquisition transaction, and such company is soliciting proxies in connection with its stockholder meeting to vote upon such transaction, the Exchange Act will apply and generally require that a proxy statement be filed with the SEC that satisfies numerous disclosure rules related to the content of such proxy statement. Again, while beyond the scope of this discussion, companies in the US with 'listed' securities are subject to the rules and regulations of the subject exchange, such as the New York Stock Exchange (NYSE) and Nasdaq. These rules and regulations affect certain aspects of acquisition transactions if the potential buyer or target company is exchange listed.

Finally, the parties should consult with counsel to determine whether a proposed transaction requires compliance with other applicable federal, state, local or foreign laws and regulations, including those related to antitrust. For example, certain regulated industries, such as those involving defence or telecommunications, may present special challenges and approval requirements. Other federal rules must be considered where foreign persons make investments in the US, some of which rules are discussed below.

2. CONFIDENTIALITY AGREEMENTS

At the outset of acquisition negotiations, it is routine for the parties to enter into a confidentiality agreement to protect information exchanged during the course of due diligence and negotiations. Among other things, the confidentiality agreement will typically (1) restrict disclosure of information that a potential buyer receives from the target, (2) restrict use of such information by the potential buyer except in connection with structuring and negotiating the proposed transaction (what falls within the scope of the 'proposed transaction' in this respect should be carefully defined) and (3) impose non-disclosure terms with respect to the existence and status of the negotiations and the potential transaction. Where the target company will perform at least some due diligence on the potential buyer or otherwise receive confidential information of the potential buyer, such as where buyer securities are being used as consideration, the confidentiality agreement should include reciprocal protections. The negotiation of confidentiality agreements tends to centre on a few key issues, and the target company will often have heightened concerns with strategic buyers.

The information protected by a confidentiality agreement is typically very broadly defined, including information not labelled as confidential or delivered prior to execution of the confidentiality agreement. A potential buyer will expect certain exclusions from the definition of confidential information, such as (1) information that is (or becomes) generally available to the public through no fault of the potential buyer, which is a very common exception, and (2) information that the potential buyer has obtained or developed independently, which is a more controversial (but common) exception that the target may try to qualify by imposing a burden of proof requirement on the buyer or by requiring that independent development be demonstrated by written materials. In addition, disclosures required by law (primarily SEC-related) or stock exchange rules (such as NYSE or Nasdaq, if applicable) are generally allowed.

Restrictions on who may receive and use confidential information (particularly on the buyer side) can be a sticking point. For example, the target company may want to protect its confidential information by limiting the number and type of individuals permitted to receive such information, and block certain types of persons from receiving such information or portions of such information (such as sources of debt and equity financing and potential co-buyers). The target company will want to prohibit potential buyers from contacting its employees, suppliers and customers without advance consent. When a strategic buyer is present, the target company may insist that an additional layer of confidentiality be utilised, often referred to as a ‘clean team agreement,’ which may state, for example, that certain highly confidential information may be supplied only late in the process, in redacted form, and special procedures may be imposed on the buyer, such as review by only special counsel to the buyer.

The confidentiality agreement will usually provide that the buyer is responsible for any breach of the confidentiality agreement by its employees and agents, and that such employees and agents must be informed about the confidential nature of the information before being provided any information. Occasionally, the confidentiality agreement will block the sharing of confidential information with third parties unless the third party enters into a confidentiality agreement directly with the target company.

An important issue when negotiating a confidentiality agreement is the duration of its restrictions. Potential buyers often request a duration of between 12 and 24 months. Target companies often request perpetual duration or a duration between two and five years, depending on the sensitivity of the information to be disclosed and whether the potential buyer is a strategic as opposed to financial buyer. A period of 18 to 24 months is common.

Confidentiality agreements usually provide that monetary damages are insufficient if a breach of the confidentiality agreement occurs and will include a provision that allows the target to obtain injunctive relief (specific performance) in addition to any other remedies available at law or equity (monetary damages) in the event of a breach. Some agreements also provide for confidential arbitration to resolve disputes to prevent public disclosure of confidential information in court proceedings.

Finally, given that the potential buyer will become aware of and have access to key employees of the target company, the confidentiality agreement typically will include covenants that prevent the potential buyer from soliciting and/or hiring employees of the target company. As solicitation of employees can be difficult to prove – in part because the employee that may have been solicited is now an employee of the buyer, and in part because there are often solicitation-related exceptions for general advertisements (and sometimes headhunter searches) not directed at employees of the target company – it is fairly common for confidentiality agreements to prohibit hiring of employees and not just solicitation. The scope of protected target employees varies and is often negotiated, and may include among various options (1) only officers or certain key employees of the target, (2) employees that the potential buyer becomes aware of (or is introduced to) as part of the negotiation process, and (3) all employees of the target and its subsidiaries, including recently departed employees. The duration of a non-solicitation provision may be linked to the duration of the confidentiality agreement. At times the non-solicitation provision is mutual and will also protect the potential buyer.

3. LETTERS OF INTENT

During the preliminary negotiating phase of a potential acquisition the parties may enter into a letter of intent in order to memorialise certain fundamental or key terms, such as the basic structure of the transaction and the form and amount of consideration. However, parties may prefer to focus time and resources on preparing the definitive acquisition agreement in lieu of negotiating a non-binding letter of intent. Further, some parties may strategically avoid letters of intent to avoid making concessions on key points too early.

Not surprisingly, letters of intent usually mirror the content and structure of acquisition agreements, but with much less detail, and frequently refer to customary terms and conditions. As such, letters of intent generally state clearly that they are not binding upon the parties, at least insofar as they address the terms of the proposed transaction. The parties should make clear whether and to what extent the provisions of a letter of intent (such as confidentiality or exclusivity terms) are intended to be binding.

Letters of intent are not common in auction transactions. Instead, the investment banker for the seller usually requires the submission of indications of interest, and ultimately a markup of the definitive acquisition agreement.

4. EXCLUSIVITY

Potential buyers often request exclusivity from the target company, either as a binding provision in an otherwise non-binding letter of intent or in the form of a standalone agreement. The typical exclusivity arrangement will block the target company from (1) soliciting offers for the subject business, (2) sharing information and (3) engaging in discussions with other potential buyers. Buyers often attempt to obtain exclusivity to avoid serving as a 'stalking horse' for other bidders, and where the buyer is unwilling to incur the significant time and expense associated with subsequent due diligence and transaction negotiations without exclusivity. However, target companies typically strongly resist granting exclusivity.

The grant of exclusivity by the target company should be extended only with significant caution to avoid claims that the directors of the target company breached their fiduciary duties. Target companies are typically counselled to grant exclusivity only for a limited period, where the offer by the potential buyer is very compelling, and where other potential buyers are not reasonably likely to surface with better terms. That said, it is rare in an auction process for the seller to grant exclusivity.

5. AUCTION PROCESS AND INDICATIONS OF INTEREST

When a target company is to be sold for cash (or for both stock and cash where the cash represents a material part of the consideration) the duty of the target company board is to achieve the highest price reasonably attainable. Delaware courts have expressed the view that, in most cases, the best evidence that a price is the highest reasonably attainable is that such price resulted from a thorough canvass of the available market, such as through an auction process. However, courts have not mandated that an auction be conducted in every case. That said, the sale of target companies in the US pursuant to an auction process is very common.

If an auction process is being conducted for a target company, the investment banker engaged by the target company normally will pursue a structured process to sell the target company. For example:

a) the investment banker and target management will usually prepare an offering memorandum and then make initial contacts with potentially interested parties;
b) preliminary due diligence will be conducted by the potential bidders;
c) potential buyers will submit non-binding indications of interest;
d) approved bidders will be permitted to conduct more extensive due diligence;
e) potential buyers will submit final bids on a specified date, including a markup of the proposed acquisition agreement; and

f) final negotiations will occur with the most attractive bidder or bidders.

In this auction process context, indications of interest and the markup of the definitive acquisition agreement usually takes the place of a letter of intent, and exclusivity may not be granted even in the latter stages of the process, although the highest bidder in an auction process may at times be granted exclusivity for a short period of time.

6. DUE DILIGENCE

Before a buyer commits to acquire a target company, it will routinely perform due diligence on the target business by gathering all relevant and material information available to evaluate (among other things) the business and financial condition of the target company. Due diligence will focus on the material potential risks associated with the target business, including those risks that could prevent the transaction from closing or that could negatively impact the target company following closing. Often the target company will have prepared a 'data room' (a website where due diligence materials can be reviewed and downloaded) and the buyer and its representatives will be given access to such materials only after it has signed a confidentiality agreement.

The type of information shared (for example, strategic plans and price and cost data) can raise serious antitrust issues, especially if the transaction involves two actual or potential rivals. In addition, caution should be exercised about what is reduced to writing (such as studies, analyses and reports) regarding the reasons for the transaction, competition, competitors, markets, market shares and potential for sales growth or expansion into product or geographic markets: if the transaction is reportable to competition authorities, such materials will need to be produced as part of the required filing.

7. POSSIBLE TRANSACTION STRUCTURES

In order to prepare a definitive acquisition agreement, the parties will need to determine the structure of the proposed transaction. There are three basic transaction structures for US acquisitions: asset purchase transactions, stock purchase transactions and merger transactions.

Each of the following factors may be important in the selection of the transaction structure:

- tax considerations;
- capital structure of the target company;
- risk exposure;
- board of directors and stockholder approvals;
- third-party consents and approvals;
- regulatory approvals; and
- dissenters/appraisal rights.

Where a business is acquired by way of an asset purchase transaction, the buyer (or a wholly owned subsidiary of the buyer) takes title to or ownership of specified assets of the target company and may agree to assume specified liabilities, but does not acquire ownership of the target corporation. An asset transaction allows (in general) the buyer to select the assets it desires to acquire and the liabilities it desires to assume. Put another way, all liabilities other than specified liabilities can be left behind with the target company. That said, depending on the circumstances, there can be a risk that certain liabilities retained in the target company can be imposed on the buyer under state law theories.

In a stock purchase transaction, the buyer becomes the owner of the stock of the target company, thereby indirectly acquiring all the assets and liabilities of the target company. A stock transaction is feasible where there are a limited number of stockholders of the target company and all stockholders desire to sell to the buyer on the same terms and conditions. The presence or absence of a drag-along provision in a stockholder agreement (requiring all stockholders to enter into the proposed stock purchase agreement) is a key factor in this regard.

While asset and stock purchase transactions are a matter of contract, a merger is a creature of state statutory law that enables two or more entities to consolidate. Typically, one corporation merges into another, with all its assets and liabilities becoming the assets and liabilities of the surviving corporation by operation of law. A merger is useful where there is a relatively large number of stockholders, not all stockholders desire to sell to the buyer, or it is not feasible to arrange for each stockholder to enter into a stock purchase agreement. Merger statutes generally require that holders of a majority of the outstanding stock entitled to vote thereon approve of the merger transaction. Unanimity is not required.

Because of the limited liability nature of corporations and certain other business organisations, holding an acquired business in a subsidiary can help protect upstream and affiliate assets from third-party claims. To the extent subsidiaries are adequately capitalised and follow required corporate formalities, courts will generally respect the shield on liability that such structures afford. Consequently, a buyer may form a subsidiary entity in connection with the acquisition to obtain the benefit of such limited liability shield. In an asset sale, for example, a corporation may form a new shell subsidiary to acquire the assets and assume any agreed liabilities from the target.

A similar result can be achieved through a 'forward triangular merger,' where the target corporation merges with and into a newly formed subsidiary of the buyer, and as a result the assets and liabilities of the target are transferred to the newly formed subsidiary of the buyer. When an acquiring party forms a subsidiary to merge with the target company, but the target company is the entity that survives such merger, this so-called 'reverse triangular merger' results in an outcome like a stock purchase transaction in that the target company becomes a wholly owned subsidiary of the buyer.

Structuring a transaction to limit liability exposure to the buyer is an important consideration, but tax considerations can dominate the decision. A transaction structured as a stock acquisition or as a reverse triangular merger (both of which are generally treated as a stock acquisition for income tax purposes) normally results in a tax basis in the acquired stock that reflects the acquisition price and leaves the target with its historic 'inside' asset basis. Accordingly, if the target is acquired at a premium to such 'inside' tax basis, the 'outside' stock basis will be high and the 'inside' asset basis of the target will remain at historic levels. In such cases, this acquisition premium cannot be amortised to offset income and will not be realised for tax purposes until a disposition of target stock. Therefore, in situations where the target has appreciated in value, the buyer generally may require either an asset transaction or a transaction that can be 'deemed' an asset acquisition for tax purposes, or, alternatively, one of the tax-free corporate reorganisations where shareholders of the target are generally paid with purchaser stock instead of or in addition to cash.

An asset transaction generally will permit the acquisition premium to be allocated either to existing identifiable assets or to a new 'goodwill' intangible, and depreciated or amortised over time to offset taxable income. An asset acquisition normally is viewed as less desirable from the perspective of the target or seller because it can entail two layers of tax: one at the level of the target-seller and another at the shareholder level when the corporation distributes the proceeds. As a result, there will usually be a negotiation of price that takes into account the structure of the transaction and economics of the different tax treatment to both buyer and seller. In a limited set of situations, a stock sale can be treated as an asset transaction (for tax purposes) without significant negative tax aspects to either party. This is generally limited to transactions involving either a target corporation that meets certain specific requirements under the US tax code, called an 'S corporation', or a target that has net operating losses or is a subsidiary of a domestic 'C corporation', where other requirements are also met.

Transaction structures that do not eliminate minority stockholders of the target are usually avoided, as US state laws protect the rights of minority stockholders in ways that may impose difficult obligations on majority stockholders, increase the cost of operating the target business after the closing, and allow the minority stockholders to obtain the rewards of the capital, efforts and risk incurred by the buying company.

The choice of transaction structure may affect the availability of dissenters/appraisal rights. In most jurisdictions, stockholders of the target corporation who object to the consummation of a merger and who adhere to strict procedural requirements may be able to dissent from the consummation of the merger and exercise appraisal rights, even if the transaction is otherwise approved by the required vote of the target stockholders. In these jurisdictions, dissenting stockholders that adhere to the required procedures will be entitled to commence a proceeding for appraisal of the 'fair value' of their shares in state court (often an expensive and time-consuming process). These stockholders forego the consideration otherwise payable in connection with the merger, and instead receive the fair value of their shares, as determined in the appraisal proceeding. State law varies with respect to whether dissenters/appraisal rights are available in stock and asset purchase transactions.

Each party will need to assess what corporate, third-party and governmental approvals might be required to consummate a transaction, given its proposed structure, and further evaluate whether it is feasible to obtain such consents. For example, under most state statutes, mergers and sales of all or substantially all of the assets of a corporation require the target corporation to obtain the approval of the holders of a majority of its outstanding shares. Furthermore, key contracts may not be assignable to the buyer in an asset purchase transaction absent the consent of the other party to such contract. In general, asset transactions will require more third-party consents and approvals, and could give rise to transfer type taxes not otherwise applicable with other transaction structures. Similarly, the choice of transaction structure may dictate whether certain regulatory or governmental approvals are necessary.

8. THE ACQUISITION AGREEMENT

After the transaction structure has been determined, the other terms and conditions of the transaction will need to be negotiated and documented in a definitive acquisition agreement. Although US acquisition agreements vary in many respects, most will share the same basic components, including the following:

- economic provisions, including cash, certain indebtedness and net working capital adjustment-related provisions;

- representations and warranties;
- pre-closing and post-closing covenants;
- closing conditions;
- termination provisions;
- indemnification provisions; and
- dispute resolution mechanisms.

9. ECONOMIC PROVISIONS

The key economic terms, such as the purchase price, the form of consideration and the mechanics of payment, should be unambiguously reflected in the purchase agreement.

The purchase price may have a variable aspect or formula used to adjust the payment to be made by the buyer. For example, a mechanism is often included to adjust the purchase price for certain changes in the financial condition of the target company, to ensure the buyer takes a balance sheet consistent with its expectations, and to protect against the target company accelerating accounts receivable, delaying the payment of accounts payable and stripping cash from the target company. This is commonly accomplished by use of a net working capital adjustment (such as, current assets less current liabilities) and establishing a target net working capital amount, but other balance sheet measures may be used. Net working capital type adjustments are commonly proposed and accepted. The consideration paid by the buyer at closing is typically adjusted (downward or upward as appropriate) based on a good faith estimate by the target company of net working capital (or other balance sheet measure) as of the closing. A balance sheet is then required to be prepared within a specified number of days after the closing (such as 30 or 60 days) and the adjustment amount is finalised, with a corrective or 'true up' payment being required. While dollar-for-dollar adjustments for these net working capital type provisions (based on the target amount) are most common, the parties at times (albeit infrequently) negotiate an acceptable 'band' of variation (around the target net working capital or other balance sheet number) within which no adjustment is made.

The parties may also provide that the purchase price will be adjusted (dollar for dollar) for other variable components, such as based on cash and cash equivalents of the target, the outstanding amount of certain types of indebtedness of the target, and transaction expenses of the target incurred but not paid before closing.

Net working capital related adjustments commonly involve a purchase price adjustment escrow into which the buyer requires a certain portion of the purchase price to be placed to support any purchase price adjustment in favour of the buyer, which can be the exclusive recourse for the buyer. That said, buyer may also negotiate for the ability to apply funds in an indemnity escrow for any amount of the net working capital adjustment in favour of the buyer that exceeds the amount of the adjustment escrow.

So-called 'locked box' deals are not common in the US.

10. HOLDBACKS, ESCROWS AND EARN-OUTS

The acquisition agreement may include provisions allowing the buyer to withhold a portion of the purchase price from the seller for a negotiated period of time following the closing of the transaction. Such amount is then available for the buyer to satisfy certain obligations of the seller, such as indemnity obligations for breach and post-closing purchase price adjustments as described in the preceding paragraph. The withheld consideration (cash or securities) is usually placed in an escrow account that is managed by a neutral third-party escrow agent, but is sometimes (albeit rarely) retained by the buyer until payable after a specified time.

In order to recover funds from the escrow account, the buyer must assert a claim for indemnification or other recovery under the acquisition agreement, and if undisputed by the seller, the escrow agent will release from escrow the amount of such claim to the buyer. If the seller disputes the claim, the escrow agent will retain the amount of the pending claim in escrow until the resolution of the dispute, by settlement, litigation or arbitration. If no claims are outstanding upon the termination date of an escrow arrangement, the remaining amount in escrow will be distributed to the seller. To the extent there are unresolved claims on such date, it is common for agreements to provide that any amounts in excess of the outstanding claims (valued in the amount demanded by the buyer) will be distributed to the seller. It should also be noted that an interim distribution from escrow is not uncommon.

In transactions in which representations and warranties (R&W) insurance is utilised, the indemnification escrow amount is often linked to the retention amount under the R&W policy, as described in further detail below.

Holdback or escrow arrangements reduce the risk that selling parties will (among other things) transfer sale proceeds to jurisdictions where enforcement of claims for recovery may be impracticable or impossible. They also guard against the transfer of sale proceeds to persons or entities against whom enforcement of claims for recovery may otherwise be difficult. For these reasons, buyers frequently insist on some form of holdback or escrow arrangement, particularly in transactions involving multiple sellers or where the buyer or sellers are located in a foreign jurisdiction. As a result, a vast majority of private company M&A transactions in the US incorporate a holdback or escrow arrangement, although target companies often strongly resist such provisions.

The economics of the transaction can be affected by (when agreed upon by seller and buyer) any earn-out arrangement, where a portion of the purchase price for the acquired business is determined based upon the achievement of financial or other performance measures by the target business following the closing of the transaction. Earn-outs can be used in connection with the acquisition of a target business with a relatively short and/or volatile operating history and significant uncertainty regarding future performance, and are more common in life sciences transactions. The primary appeal of an earn-out is that it can be used to bridge differences of opinion regarding the value of the target business and can help to overcome purchase price-related deadlocks. Earn-outs can provide an incentive for the former owners of the target business to remain employed or otherwise engaged with the business and perform at a high level following the closing of the transaction.

Earn-outs present special drafting concerns and often give rise to disputes. They almost always raise difficult issues of performance measurement and may create conflicting incentives for the recipients of the earn-out payments that remain employed with the business, and for the buying company. The negotiation of earn-outs frequently leads to complicated formulas and arrangements for measuring the success of the target business following the closing, and protection against manipulation by the buying company. Furthermore, in order to accurately gauge performance against earn-out measures, it may be necessary to isolate the target business from the other businesses of the buyer. Sellers often attempt to vest target management with significant control of and discretion over the continued operation of the target business for some period of time after the closing, which can inhibit the integration of the target business into the corporate organisation of the buyer. Buyers typically resist restrictions on their control and operation of the acquired target business.

Typical performance measures for earnouts include target business pre-tax earnings, earnings before interest, taxes, depreciation, and amortisation (EBITDA), and gross revenues. The general view is that earn-outs based on gross revenues are less subject to manipulation by the buyer. Earn-out payments can also be based on the attainment of non-financial milestones, such as the successful development or regulatory approval of new products.

Overall, earnouts are likely to be more successful where (1) the parties agree upon performance measures that will not be negatively affected by post-closing integration of the target business into the other businesses of the buyer, (2) the parties agree upon relatively simple and unambiguous performance measures that are easy to measure and (3) the parties choose realistic performance criteria, agree upon partial payments for partial achievement of these measures and provide a fair mechanism to adjust these measures to adapt to changing business circumstances.

11. REPRESENTATIONS AND WARRANTIES

Representations and warranties require the target to present the state of its business as it exists on the date the acquisition agreement is signed and (in the case of a staggered signing and closing, which is typical) on the closing date. The representations and warranties section is often the lengthiest portion of an acquisition agreement. From the perspective of the buyer, representations and warranties provide several key protections:

- they cause the target to identify specific issues and risks and explain the facts surrounding those issues and risks;
- they enable the buyer to walk away from the transaction (that is, not close the transaction) if facts develop that make the transaction materially less favourable; and
- they apportion liability in the event that the representations and warranties prove inaccurate.

As a general matter and subject to exceptions in certain cases, if an exception or qualification to a representation and warranty is disclosed to the buyer in a disclosure schedule to the acquisition agreement, the buyer will not be able seek indemnification against the seller or sellers based on any resulting losses incurred by the buyer. This is usually so even where the agreement contains a pro-sandbagging clause or is silent in a pro-sandbagging jurisdiction.

While the type and scope of representations and warranties of the target company will vary based upon the circumstances of the particular transaction and the business of the target, typical examples of target company representations and warranties include the following:

11.1 Financial statements

The representations and warranties relating to the financial statements of the target contain important protections for the buyer. Representations are made concerning recent financial statements, usually the most recent audited annual financial statements and unaudited financial statements for the most recently completed quarterly period, including that such financial statements fairly present in all material respects the financial position of the target company and its subsidiaries, and have been prepared in accordance with US generally accepted accounting principles (GAAP) on a consistent basis.

11.2 Undisclosed liabilities

The buyer will frequently request that the target represent that its business is not subject to undisclosed liabilities of any nature (including contingent liabilities) other than those set forth on the financial statements referenced in the definitive acquisition agreement, and certain types of liabilities incurred subsequent to the period covered by such financial statements in the ordinary course of business. The target company may attempt to create further exceptions to such representation, such as limiting such representation to material liabilities or liabilities that would (individually or in the aggregate) have a material adverse effect on the target, limiting such representation to liabilities that would be required to be recorded on a balance sheet in accordance with GAAP or making such representation only to the knowledge of certain officers of the target company.

In addition to those described above, the representations and warranties of the target company likely will include representations with regard to many of the following matters:

- organisation, authorisation and qualifications;
- no violation or conflict;
- capitalisation of the target company and ownership of subsidiaries;
- required third-party consents and approvals;
- financial statements;
- undisclosed liabilities;
- title to and condition of assets, and sufficiency of assets;
- absence of certain changes or events;
- material contracts and commitments;
- compliance with laws and regulations (eg, anti-corruption and export controls);
- environmental matters;
- intellectual property and information technology matters;
- privacy and data security matters;
- material claims and litigation and threats thereof;
- inventory;
- accounts receivable and accounts payable;
- affiliated party transactions;
- insurance policies and claims;
- tax matters;
- significant customers and suppliers;
- books and records;
- labour and employee benefit matters; and
- commitments to pay brokerage or investment banker fees and expenses.

Buyers may seek a ‘full disclosure’ and/or ‘10b-5’ (based on the language of Rule 10b-5 of the Exchange Act) representation from the target company. The 10b-5 version of this representation typically requires the target to represent that none of the representations or warranties made by the target in the acquisition agreement (sometimes, more broadly, any statement made in connection with the transaction) contains any untrue statement or omits to state a material fact necessary to make such representations and warranties, in light of the circumstances in which they were made, not misleading.

Whether a 10b-5 or full disclosure representation is included is usually a contentious negotiating point, with target companies resisting (usually successfully) on the basis that the buyer should negotiate for and rely upon the other more specific representations and warranties. Conversely, a representation and warranty (of the buyer) is often included that the target is not making any representations and warranties beyond those expressly set forth in the definitive acquisition agreement. In an asset transaction, the seller often represents that the assets transferred in the transaction are sufficient to operate the business in all material respects.

The buyer will also make certain representations and warranties, albeit significantly less expansive than those of the target in most cases. Typically, buyers make representations and warranties mirroring those of the target with respect to basic 'corporate' matters and 'no violation of law' matters; it is not uncommon for a buyer to agree to represent that it has (and will have at the time of closing) sufficient funds to consummate the transactions contemplated by the acquisition agreement, or as to its financing commitments. If the transaction involves stock or other securities of the buyer as acquisition currency, in whole or in part, the representations and warranties of the buyer will take on much greater significance.

Negotiating representations and warranties is an exercise in risk allocation. Most buyers seek broad and comprehensive representations that will enable the buyer to allocate as much risk as possible to the seller. Buyers will argue that the target (or seller) is in the best position to know the condition and risks about its own business and, consequently, should assume full risk for any misrepresentations. Conversely, a target or seller will seek to limit and qualify its representations in order to reduce the potential for inaccuracy and claims of breach.

An increasing number of transactions currently involve R&W insurance as a way to minimise risk to the buyer or seller (although R&W insurance is more frequently purchased by the buyer). Use of R&W insurance can ease the process of negotiating representations and warranties. In particular, sellers often are more amenable to relatively broader (or less qualified) representations and warranties if they retain no exposure for general representations and warranties beyond a small escrow, where such insurance coverage is designed to be the sole or primary recourse for buyer in the event of breach of general representations and warranties.

Sellers will seek to limit the scope of individual representations and warranties in a variety of ways. For example, target companies often seek to include materiality qualifiers (or material adverse effect qualifiers) in many representations and warranties. Buyers frequently accept many such materiality qualifiers for purposes of the representations and warranties concerning the target, although this is usually a subject of negotiation.

In addition to materiality qualifiers, the target may seek to limit its duty to disclose by including a knowledge qualifier with respect to certain representations and warranties, thereby forcing the buyer to bear the risk of unknown liabilities or matters. The inclusion of knowledge qualifiers is usually the subject of considerable negotiation, although the use of such a qualifier is fairly typical for certain types of representations, such as with respect to threatened litigation and as to whether parties other than the target company are in breach of agreements with the target company.

If a knowledge qualifier is included, the parties should define (1) whether the term 'knowledge' is actual knowledge or constructive knowledge (that is, in general, the knowledge an individual should have if a reasonable investigation was performed) as well as (2) those employees of the target who will be included within the knowledge group. Occasionally, a target will attempt to qualify all its representations and warranties by knowledge and/or materiality, which is typically rejected. Selling stockholders (and not just the target company) usually make the representations and warranties in respect of the target company, and provide certain ownership and other fundamental type representations.

Because a target company can rarely make the representations and warranties unconditionally, it will create schedules to the acquisition agreement to disclose any known exceptions. The parties will need to negotiate the extent to which a disclosure in one section of the disclosure schedule is deemed to apply for purposes of all the representations and warranties, and whether disclosure of a portion of a matter or document is deemed to include all relevant details of such matter or document whether or not disclosed.

12. PRE-CLOSING COVENANTS

Pre-closing covenants are promises made by the parties that obligate them to take specified actions (or refrain from taking specified actions) during the period between execution of the acquisition agreement and closing of the transaction. The burdens imposed by such covenants fall more heavily on the target company or seller. Examples of pre-closing covenants include the following.

12.1 Access to information and notification

The target typically grants the buyer access to the personnel, properties, financial and operating records of the target, and other pertinent information, to enable the buyer to verify satisfaction of closing conditions, among other things. Each party also typically agrees to notify the other regarding certain events, including the discovery of untrue representations and warranties, breaches of covenants and events that would or could prevent the consummation of the transaction.

12.2 Interim operations

This covenant typically requires the target to operate its business only 'in the ordinary course of business' and obtain the written consent of the buyer for any actions outside the ordinary course of business, except as specified on a schedule, although the parties should consult with counsel to confirm such provisions will not raise antitrust issues in a transaction involving competitors. Allowance is customarily made for target business compliance with applicable law and regulations. The target will also typically be prohibited from taking the following actions without the prior written consent of the buyer, subject to any negotiated exceptions:

- amend its charter, bylaws or other organisational documents;
- invest in or acquire new businesses or form joint ventures;
- declare or pay cash dividends;
- increase employee compensation or increase compensation, beyond specified levels or legally required increases, or enter into employment or severance arrangements;
- expand into new lines of business;
- settle or satisfy liabilities and obligations outside the ordinary course of business;
- make capital expenditures in excess of a specified dollar amount or in excess of amounts set forth in a referenced budget;

- transfer or license certain intellectual property;
- change material accounting practices or policies;
- incur indebtedness or material obligations or grant certain liens; and
- other restrictions and limitations.

12.3 Further assurances and required approvals

The further assurances covenant will require each party to use its reasonable best efforts (or commercially reasonable efforts) to cause its closing conditions to be satisfied. Aspects of the required approvals covenant may be heavily negotiated. The target may insist that the buyer agree to take any actions required by any governmental authority in order to consummate the transaction (such as obtaining antitrust approval, discussed in section 14.4), which may include intensive litigation and/or significant divestitures by (or restrictions on) the buyer pursuant to antitrust laws. At the same time, the buyer may seek to curtail or eliminate its obligations to take such actions.

13. POST-CLOSING COVENANTS

The acquisition agreement will contain various obligations to be performed after closing has occurred. The most significant are those by which the target company (where only a portion of the target is being sold) or the parent or certain stockholders of the target agree not to compete with the buyer in certain businesses and geographic areas following the closing for a specified period of time. The buyer may also negotiate such covenants with key employees in separate agreements. The buyer will likely seek to prevent such parent, stockholders or key employees from competing in the same businesses or industries as the acquired business following the closing of the transaction for a specified period of time. The buyer will likely seek to include additional restrictions, such as on the ability of the parent or sellers to disclose or use confidential information of the target and solicit customers or employees of the target company after closing for a specified period of time.

Historically, non-competition covenants have been viewed as agreements in restraint of trade and, therefore, have been disfavoured by US courts. However, US courts today are likely to enforce non-competition covenants to the extent they are reasonable in scope and duration and appropriate to protect trade secrets, goodwill or other important interests. Many states have adopted statutes (and there is frequently extensive common law) specifically dealing with the permissible scope of non-competition covenants. A non-competition covenant that is provided in connection with the sale of a business (particularly where provided by a significant selling shareholder of such business) is more likely to be enforceable than a similar covenant contained in an employment agreement. Especially when related to non-compete covenants imposed on employees, it is important to consider applicable state law restrictions on such covenants.

In addition to non-competition agreements, covenants with respect to earn-out arrangements and indemnification arrangements, the following post-closing covenants are often included in acquisition agreements:

- covenants not to solicit employees or customers of the acquired business;
- confidentiality and non-disclosure covenants regarding information of the target business and the terms of the acquisition agreement;
- covenants to cooperate with respect to litigation, tax inquiries and similar matters arising out of the transaction;

- covenants by the buyer relating to the compensation of employees of the target business and maintenance of comparable employee benefit plans;
- covenants allocating responsibility for any transfer and other taxes; and
- parent or affiliated entity guarantees of the obligations of the parties.

14. CLOSING CONDITIONS

When there is a lapse of time between the signing of the acquisition agreement and the closing of the transaction (which is common), the obligation of each party to consummate the transaction will be subject to the satisfaction of certain conditions precedent. Failure to satisfy a closing condition may give the other party the right to terminate the acquisition agreement, often after a specified cure period, or the right to terminate may arise if the closing has not occurred by a specified date, where the delay is not caused by the terminating party. There are several key closing conditions.

14.1 Accuracy of representations and warranties

The representations and warranties of the other party must be true and accurate (in all respects, in all material respects or subject to an overall material adverse effect standard) as of closing.

14.2 Compliance with covenants

The other party shall have complied in all material respects with its covenants required to be performed prior to the closing.

14.3 No material adverse change

The buyer often requests and obtains the right not to close if the target has experienced a material adverse change or material adverse effect (often called a MAC or a MAE clause) to its results of operations, financial condition, assets, liabilities, properties, personnel, operations and at times prospects.

The target may limit the effect of this MAC or MAE condition by excluding specific matters that should not give the buyer a right to walk from the transaction or by specifying a more recent measurement date. For example, target companies often seek and obtain exceptions for events and changes caused by general economic or industry conditions that do not disproportionately impact the target business and for changes in law and government regulations.

It can be advantageous for the buyer to include specific financial tests or conditions rather than rely on general MAC language, especially where the buyer is aware of specific problems or risks at the target company, and thus may be deemed to have assumed such problems and risks. As might be expected, target companies heavily resist (and are usually successful in resisting) such objective and specific tests.

14.4 Antitrust approvals

In certain circumstances, the parties may not close the transaction until applicable antitrust approvals have been obtained. The Hart-Scott-Rodino Antitrust Improvements Act (the HSR Act) allows the US federal government to evaluate the antitrust implications of proposed transactions that cross certain size-of-transaction and size-of-person thresholds.

Under the HSR Act, the parties must make 'pre-merger notification' filings and disclose certain information that is reviewed by the government to evaluate whether a transaction may adversely affect competition in violation of the Clayton Act. Such disclosures are required to be made by the target and the buyer to the Federal Trade Commission (FTC) and the Antitrust Division of the Department of Justice (DOJ) prior to closing certain transactions.

Where the information disclosed reveals the possibility that the transaction may have anticompetitive consequences, the FTC or DOJ may open a fuller investigation, and request additional disclosures, and may ultimately seek to enjoin the transaction in federal district court or impose conditions to approval on the buyer and acquired business. Whether a given transaction must be reported under the HSR Act often involves the application of technical rules and evaluation of various exceptions and exemptions. Whether a particular transaction is subject to the HSR Act requirements depends on the value of the transaction and the size of the parties, as measured by their sales and assets. For 2021, an HSR Act filing would be required if, as a result of the transaction, the buyer will hold more than US$368m worth of voting securities or assets of the target. No HSR filing is required for transactions valued at less than US$92m. For transactions valued at greater than US$92m, but less than $368m, a so-called 'size-of-the-person' test also applies. The thresholds are adjusted annually for inflation in late February.

The HSR Act mandates a waiting period of 30 days after both parties complete their filings, during which the parties may not close the transaction. The FTC and DOJ use the waiting period to conduct an initial analysis of the likely effect of the transaction on competition. Upon expiration of the waiting period, the parties may close the transaction. Parties may request early termination of the waiting period upon the filing of their initial disclosures. If early termination is requested and granted, the grant usually comes two to three weeks after all filings required for the transaction are received and reviewed by the FTC and DOJ. If the parties attempt to close the transaction before the waiting period has expired (or if they fail to provide the necessary pre-merger notifications), they can face severe consequences, including substantial monetary penalties or an injunction on consummating the transaction. The DOJ and FTC also may (and do) challenge consummated transactions, regardless of whether they are subject to HSR Act reporting requirements (for example, a transaction that falls below the size of the transaction test), and may seek divestitures or to unwind the entire transaction.

If the FTC or DOJ has concerns about competition during the initial 30-day waiting period, they will issue a Request for Additional Information (colloquially known as a 'Second Request'). A Second Request automatically extends the mandatory waiting period until 30 days after the parties have fully complied with it. Second Requests are burdensome demands for documents and data, and compliance generally takes several months or more. In addition, during this prolonged investigation, the FTC or DOJ may interview or depose certain personnel of the parties. At the end of the second 30-day waiting period (which is often extended to 90 or 120 days through negotiation with the FTC or DOJ) the FTC or DOJ will either close the investigation, negotiate remedies with the parties, or sue to enjoin the transaction from closing.

Parties typically include an antitrust 'cooperation' clause in the acquisition agreement. The cooperation clause is negotiated between the buyer and seller and outlines the obligations of the parties (primarily the buyer) with respect to the efforts required to obtain antirust approval of the transaction. There is a spectrum of possible provisions. The most seller-friendly is the 'hell or high water' clause, which requires the buyer to do whatever it takes to obtain antitrust approval, including any remedy required by the FTC or DOJ, or even litigation. In other cases, the parties may share the risk and put some limits on what the buyer is required to do, such as not litigate, undertake a remedy only up to a certain value, or even not comply with a Second Request.

While government antitrust review of the transaction is pending, there are limits on what the parties can do to integrate their businesses. In general, the parties may plan to integrate certain operations (for example, IT and human resources) but cannot implement such plans. Likewise, only a discrete group of persons from each company (and who do not have pricing authority or responsibility) should participate in such planning.

14.5 CFIUS approvals

Section 721 of the Defense Production Act, known as the Exon-Florio Amendment, as amended by the Foreign Investment and National Security Act of 2007 and the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), and implemented through 31 C.F.R. Parts 800 802, authorises the President and the Committee on Foreign Investment in the United States (CFIUS) to review:

a) mergers, acquisitions and takeovers that could result in the control of a US business by a foreign person;
b) certain non-controlling 'covered investments' that afford a foreign person certain access, rights, or involvement in US businesses that involve critical technology, critical infrastructure, or sensitive personal data of US persons; and
c) certain transactions involving real estate in 'close proximity' to specified sensitive sites.

Pursuant to statute, such reviews are carried out by CFIUS, which is an interagency body chaired by the US Secretary of the Treasury. CFIUS has wide discretion to initiate a review of a proposed or consummated transaction based on national security concerns and may take action in connection with the transaction to protect US national security. There is no statute of limitations to CFIUS reviews. Among the factors considered in these reviews are projected production of domestic national defence needs, the potential national security-related effects on critical infrastructure or technologies, long-term protection of US energy sources, and access to sensitive personal data of US persons.

Typically, where the target business touches on national security concerns, a mandatory or voluntary declaration or notice will be submitted to CFIUS. CFIUS filings are mandatory where a foreign government acquires a 'substantial interest' in certain sensitive US businesses, and for certain transactions that involve critical technologies. CFIUS declarations are short-form filings that CFIUS has 30 calendar days to review upon acceptance. By the end of this 30-day period, CFIUS will determine:

a) the transaction is not within CFIUS jurisdiction;
b) request that the parties to the transaction file a full CFIUS notice;
c) inform the parties that CFIUS is not able to conclude action with respect to the transaction on the basis of the declaration, leaving it to the parties' discretion whether to file a full CFIUS notice to obtain CFIUS 'safe harbour' from future CFIUS review;
d) initiate a unilateral review of the transaction; or

e) provide written notice to the parties that CFIUS has concluded all action with respect to the transaction, thereby providing 'safe harbour' from future CFIUS review.

CFIUS notices are longer filings with filing fees calculated based on the value of the proposed transaction. Upon acceptance of a CFIUS notice, by statute CFIUS conducts a 45-day review to determine whether a full investigation is necessary. At the end of this 45-day period, CFIUS may complete the review or continue to review the transaction for an additional 45-day investigation period. CFIUS can extend this period by 15 additional days under extraordinary circumstances.

After completing the review and possible investigation of a notice, CFIUS may advise the parties in writing that CFIUS has concluded all action with respect to the transaction, thereby providing CFIUS 'safe harbour' with respect to the transaction. Alternatively, CFIUS may determine that a transaction presents national security risks and request that the parties enter into a mitigation agreement. If the mitigation agreement addresses the identified national security risks, CFIUS may then conclude action or, if mitigation is not possible, CFIUS may refer a transaction to the President for decision. The President is required to announce a decision with respect to a transaction within 15 days of the end of the CFIUS investigation period. If a voluntary CFIUS filing is not made with respect to a transaction that is under CFIUS jurisdiction, CFIUS may later decide to review the transaction and impose mitigation measures, up to and including divestment by the buyer of the acquired business. Failure to submit a mandatory CFIUS filing may result in significant civil penalties.

14.6 Stockholder approvals

Corporate law statutes in the US generally require that a merger be approved by the stockholders of the merging companies. Under the applicable Delaware statute, a majority of the outstanding shares of each corporation participating in the transaction must approve a merger. Typically, the ownership of one share entitles the holder to one vote, but companies may create different voting arrangements in their charters. With respect to a target company with multiple stockholders, a stockholder agreement is often utilised, which may contain provisions (such as drag-along rights) with respect to the voting of the stock of the target in connection with a sale transaction.

15. INDEMNIFICATION

Indemnification provisions allow a party, usually the buyer, to recover damages for (1) breaches of the representations, warranties and covenants of the other party and (2) liabilities that the indemnifying party (usually the seller in an asset purchase transaction) has agreed to retain. When a breach of the acquisition agreement occurs, in the absence of an indemnification provision, parties may have several remedies available, including asserting an action for breach of contract or a common law claim of fraud. However, by negotiating specifically tailored indemnification provisions, the parties can limit or expand and clarify the remedies that would otherwise be available. Indemnification pursuant to the terms of the acquisition agreement is typically specified to be the exclusive remedy of the parties, other than for fraud.

Buyers may demand indemnification for specific matters of concern. For example, a buyer may request indemnification for specified litigation or contingent liabilities that the target disclosed in its disclosure schedules. These are often referred to as special indemnity provisions, which sellers usually strongly resist.

It is customary to provide for lawyer fees in the definition of losses that may be recovered under the indemnification provisions, which would not typically be recovered in US courts in the absence of a contractual right. Recoverable losses are often reduced by certain tax benefits realised by the party suffering the loss (the indemnified party) and (to the extent actually received) insurance policy and third-party recoveries. In addition, it is common for acquisition agreements to provide that recoverable losses (and in determining whether a breach has occurred) are measured without regard to any materiality qualification included in the breached contractual provision, as further discussed below.

Targets often seek to incorporate and usually obtain limitations within the indemnification provisions. These limitations often include the following:

15.1 Baskets/deductibles

Baskets/deductibles are minimum thresholds that must be exceeded by the aggregate amount of all losses claimed by an indemnified party before it is entitled to receive an indemnification payment. Baskets/deductibles allow the target to avoid having to indemnify the buyer for relatively minor claims. Such a provision may allow an indemnified party to recover damages only if damages exceed the specified amount, but once aggregate damages meet such threshold amount, recovery for all losses is permitted, even those below the threshold amount (first dollar approach).

Another (more common) approach is a true deductible where the indemnified party is only allowed to recover losses in excess of the agreed upon threshold amount. The majority of transactions include a basket/deductible provision. However, under certain circumstances, such as very significant bidder participation in an auction process, sellers may succeed in achieving a no-survival deal, meaning that the seller has no exposure (and no sale proceeds are escrowed) for breach of general representations and warranties, absent fraud.

15.2 *De minimis* amount

A basket/deductible is often accompanied by provisions that prevent an individual claim from being eligible for indemnification unless it exceeds a specified *de minimis* amount, or a 'mini-basket', which is set at an amount below which the parties consider any claim a nuisance to deal with. Inclusion of such a mini-basket is part of a compromise for certain representations and warranties to contain materiality type qualifiers.

15.3 Caps

A 'cap' or 'ceiling' is the maximum aggregate amount that an indemnified party can recover from the indemnifying party, based on the type of claim advanced by the buyer. Indemnification (for general representations as opposed to fundamental representations) is often limited to an amount in escrow, if an escrow is utilised.

15.4 Exceptions to baskets and caps

Certain matters are often excluded from the limitations of baskets, deductibles or caps. These commonly include fraud (which sellers often seek to define clearly and narrowly to avoid increased liability), breaches of covenants, and a subset of representations and warranties referred to as fundamental representations. These usually include the representations and warranties of the seller relating to (among other things) due authorisation and organisation of the target business, conflicts, capitalisation, ownership of the stock being transferred, broker fees and taxes.

There is typically a time limitation imposed (so-called 'survival periods') on the ability of the buyer to assert a claim to recover for certain types of losses. It is common for survival periods to range from 12 to 18 months with respect to the breach of general representations and warranties, although longer periods are not exceptional.

Despite the inclusion of a survival period, representations involving fundamental representations as well as tax, Employee Retirement Income Security Act (ERISA) and environmental matters often extend until the expiration of the underlying statute of limitations for such claims or perpetually. Claims for breach of covenant often are not subject to survival periods, but sellers at times push for and obtain a limited survival period for covenants. It is typical that claims noticed before the end of the survival period will continue thereafter, which should be made clear in the acquisition agreement.

16. REPRESENTATIONS AND WARRANTIES INSURANCE

Use of R&W policies in connection with US transactions is common and these are usually obtained by the buyer. While beyond the scope of this guide, R&W policies generally protect the buyer (up to the purchased coverage amount, but subject to a retention amount) for a period that significantly exceeds the indemnity survival periods specified in the transaction agreement.

R&W coverage for general representations may extend to three or more years, and coverage for fundamental representations may extend to six or more years. Such policies contain standard exclusions and may also contain transaction-specific exclusions. Use of R&W requires negotiating with (and permitting often substantial due diligence to be performed by) an additional party, as the R&W insurer has a significant interest in the scope of the representations and warranties it will be insuring.

17. MATERIALITY SCRAPE

Buyers may negotiate for a 'materiality scrape' to mitigate limitations on the indemnification obligations of the seller. A 'materiality scrape' is a buyer-friendly provision that excludes materiality, MAC/MAE and other similar materiality qualifiers contained within the representations concerning the target company, or related to the seller for purposes of determining (1) whether a breach of a representation has occurred and (2) the amount of losses that have resulted from such breach, for indemnification purposes. The target and seller generally are more likely to agree to a 'materiality scrape' where a 'mini-basket' and deductible/basket have been agreed upon.

18. SANDBAGGING

Sandbagging refers to the ability of a buyer to seek indemnification from a seller (usually for an inaccuracy or breach of the representations or warranties in an agreement) even when the buyer had knowledge of the issue or breach prior to closing.

An 'anti-sandbagging' provision prohibits indemnification claims with respect to any matter that a buyer had knowledge of prior to signing or closing. While buyers heavily resist their inclusion and are usually successful in this regard, if an anti-sandbagging provision is included, buyers will often attempt to mitigate the effect of the provision by limiting the scope of the definition of 'knowledge' to actual knowledge (as opposed to implied or constructive knowledge), ensuring that the burden to prove such knowledge falls on the target and providing that knowledge is tested as of signing as opposed to closing.

A buyer will commonly request a 'pro-sandbagging' provision (that is, an acknowledgement that the knowledge of the buyer with respect to an inaccuracy or a breach of representation or warranty does not preclude the buyer from bringing an indemnification claim) in the acquisition agreement. Such a pro-sandbagging provision is common. State law varies on whether and to what extent sandbagging is permitted, particularly when the agreement is silent with respect to sandbagging, so the impact of applicable state law should be considered carefully in this regard.

19. INDEMNIFICATION PROCEDURES

The indemnification section will include procedures for bringing indemnification claims and resolving disputes. For disputes involving third parties, the indemnifying party will usually seek to control the defence of the indemnification claim, as the indemnifying party will bear the cost and expense of an adverse ruling or decision, but there are a number of typical or possible exceptions. However, with respect to any settlement that involves non-monetary relief affecting the indemnified party and potentially other matters, the consent of the indemnified party is usually required. This control of litigation provision is frequently negotiated.

20. DISPUTE RESOLUTION

The parties will need to agree whether disputes should be resolved by litigation or an alternative dispute resolution process, in particular arbitration.

Arbitration of disputes has several advantages and is commonly used when the transaction involves parties from different countries. In international transactions, such advantages include greater enforceability of arbitration awards as compared to court judgments, greater confidentiality with respect to the proceeding, a neutral and mutually agreed venue and the appointment of an arbitrator (one or three arbitrators) with particular expertise or experience. Many of these advantages, including the probability of a faster or less costly process, also pertain to domestic transactions. In the US, the use of arbitration clauses in acquisition agreements is common.

Dispute resolution clauses often require mediation and/or negotiation between the parties as a mandatory step prior to litigation or arbitration. If the parties agree to arbitration, they should indicate the geographic location where the arbitration will occur (or be deemed to occur, in the case of remote proceedings). If the parties do not agree upon arbitration, it is typical to include a forum selection clause in the acquisition agreement, whereby the parties agree upon the jurisdiction and court (often referred to as venue) in which disputes can (or must exclusively) be resolved, and often trial by jury is waived if the parties have selected a venue that permits such pre-dispute waivers. The location of dispute resolution can be controversial, particularly in cross-border transactions. Sometimes the city or country of the party not initiating the proceedings is utilised, both as a compromise and as an incentive to resolve disputes amicably. The parties will also normally include a 'governing law' clause specifying the substantive law to be applied by a court or arbitral tribunal.

21. FIDUCIARY DUTIES

No discussion of US M&A activity would be complete without briefly touching on the important subject of fiduciary duties, although a fulsome discussion of this subject is largely beyond the scope of this guide.

Under state statutory law and common law principles, the members of a board of directors of a corporation owe fiduciary duties to the corporation and its stockholders. Fiduciary duties are particularly important in the context of corporate transactions due to the significant impact such transactions may have on the economic interests of stockholders and, consequentially, the importance of the decisions and actions to be taken by the boards of directors of the companies involved in such transactions. These duties primarily consist of the duty of care and the duty of loyalty. A violation of these duties may result in litigation by the stockholders, or a derivative suit brought on behalf of the corporation, against the directors of the corporation.

The duty of care requires directors to act on an informed basis. Under this duty, directors must carry out their functions only after sufficient investigation and inquiry. When contemplating an acquisition transaction, in order to satisfy its duty of care, the board of directors should have a sufficient working knowledge of the business and financial condition of the target company, review significant information and relevant documents related to the transaction and, as necessary, obtain outside expert advice and opinions (for example, a fairness opinion).

The duty of loyalty requires that directors act in accordance with the best interests of the subject corporation instead of the personal interests of such directors. This duty restricts director self-dealing and usurpation of the business opportunities of the corporation and further requires the disclosure of any conflicts of interest. In the event a director is in a relationship or position that might influence the decision regarding a potential transaction, all relevant information should be fully disclosed to the entire board of directors to comply with the requirements of the duty of loyalty. In some instances, it may be desirable to establish a 'special committee' of disinterested and independent directors to negotiate and/or approve the terms of a potential transaction.

The common law principles of most states grant directors significant deference in their decision-making process. Most notably, the so-called 'business judgement rule' is a common law defence to claims against directors for breaches of fiduciary duties. This defence allows a court to presume that directors have complied with their fiduciary duties where their actions were not wasteful, grossly negligent or taken in bad faith. The purpose of the business judgement rule is to allow informed directors to make calculated business judgements without interference or second-guessing from courts that are not well-suited to evaluate such matters.

Special fiduciary duties (called Revlon duties) are generally triggered in a sale of control of a company for cash or stock plus a significant amount of cash. *Revlon* was a landmark decision of the Delaware Supreme Court, in which the Court declared that, in certain limited circumstances indicating that the 'sale' or 'break-up' of the company is inevitable, the fiduciary obligation of the directors of a target company are narrowed significantly. In these situations, the singular responsibility of the board is to maximise immediate stockholder value by securing the highest price available. In general, an auction is the preferred way to determine the best value available.