

Justin S. Daniels

Wagner, Johnston & Rosenthal, P.C.

5855 Sandy Springs Circle, Suite 300

Atlanta, Georgia 30328

Email: jsd@wjrlaw.com phone: 404-261-0500

I. REPRESENTATIONS AND WARRANTIES, CONDITIONS AND COVENANTS AND INDEMNIFICATION

A. Representations and Warranties

1. **Concept.** Representations and warranties along with the disclosure schedules are the seller's statement of the condition of the target company that the Buyer is relying upon in paying the purchase price. The representations and warranties are the first hurdle the buyer must surmount to obtain indemnification if a problem arises with respect to the assets or stock the buyer purchased in exchange for the purchase price.

2. **Representations.** These are factual statements about the seller's past or present. For example, the seller represents that the assets are free and clear of all liens claims and encumbrances. This would indicate that the assets have been and currently are free and clear of liens and encumbrances.

3. **Warranties.** Warranties are guarantees that existing and future facts are correct. The seller warrants that the assets are free and clear of all liens claims and encumbrances. This indicates that the assets will continue into the future to be free and clear of liens and encumbrances.

4. **Knowledge and Materiality Seller's best friends** Knowledge and materiality have great impact on representations and warranties.

- a) **Knowledge:** a definition the seller usually wants to insert so that representations and warranties are restricted to seller's knowledge an obvious benefit to seller. The definition is usually along the lines of information that the individual has actually knows about or should have known about or be expected to know in the course of conducting a

reasonable investigation of the business or the particular representation and warranty (seller may try here to omit the reasonable investigation language and leave it at what seller should be reasonably known without an investigation). The parties will also squabble over the group of people who are included or excluded from the knowledge group. Buyer will want more people included the seller less.

- b) **Material:** a qualification seller wishes to add to many representations and warranties so that only material things are considered a breach and not insignificant items. The question becomes what is material and in many agreements this is left vague as it can be very hard to determine on a case by case basis for a particular deal as to what material precisely means. This concept is alternatively dealt with in the deductible or dollar amount of claims for a breach of the representations and warranties for which seller is not responsible.

B. All Representations and Warranties are not Equally Important

1. **Generally.** The breadth and complexity of the representations and warranties are different in each deal. They are also dependent on the relative negotiating power of the buyer and seller. Certain deals are “as is where is” with few if any representations and warranties and the buyer relies on the due diligence conducted prior to consummating the transaction. At the other end of the spectrum, the representations and warranties can continue for over 30 pages in a purchase agreement. Each deal has unique issues and the personalities of the people involved can dramatically impact the representations and warranties.

2. **Financial Statements and Absence of Undisclosed Liabilities.**

a) One of the most important representations and warranties in the agreement. A good financial statement and undisclosed liability representation and warranty along with a good indemnity provision will address about 80% of a buyer’s concerns in a purchase agreement. Most issues are problems that would have shown up somewhere on a financial statement or are otherwise covered by the undisclosed liability representation and warranty.

b) Financial statements should be incorporated by reference into the schedules and be true and complete copies of the balance sheet, income statement and cash flows. Such financial statements should accurately and fairly present the target company's financial performance. Seller will want to amend this to say that the target company's financials are presently fairly and accurately in all material respects.

c) Audited financials are preferred but if not they should have been prepared and reviewed by a licensed and competent CPA.

d) If there is a significant period of time between the execution of the contract and the closing, interim financial statements may be necessary that reflect the most recent financial performance.

e) Except for (i) liabilities disclosed on the financial statements, (ii) liabilities incurred in the ordinary course of business or (iii) specifically disclosed on a disclosure schedule, seller has no undisclosed liabilities, taxes or other obligations.

f) Remember the undisclosed liability representation and warranty will not cover liabilities that may arise in the future for past events (i.e. a future lawsuit for a slip and fall that occurred a year ago).

3. Litigation.

a) This representation and warranty should address that there is no decree judgment, order, litigation, etc before any court, tribunal, arbitration panel or regulatory body against the target company.

b) The representation and warranty should also address that none of the above is threatened or to seller's knowledge threatened against the target company.

c) When appropriate, this representation and warranty should also state that no officer, director, employee, agent or contractor of the target company is not subject to any type of litigation or other proceeding.

d) Seller will want to ask for knowledge qualifiers for litigation and wish to only disclose material litigation.

4. Title to Assets.

a) The main purpose of this representation and warranty is to confirm the purchased assets are not subject to a lien, claim or encumbrance.

b) This representation and warranty should also state that all the assets being sold will allow the buyer to run the business as it has been and is now currently conducted by the seller.

c) This particular representation and warranty should survive closing for the applicable statute of limitations as opposed to other representations and warranties that may expire after 6 months or a year.

5. Taxes.

a) This representation and warranty seeks to ascertain if there are any past due taxes that remain outstanding.

b) This scope of this representation and warranty should cover all applicable federal, state and local taxes, such were filed timely and the amounts shown on such returns are accurate and have been paid.

c) This representation and warranty is critical since Georgia imposes liability on the buyer for unpaid sales tax. Therefore, in retail business asset acquisitions Buyer should insist that Seller provide a tax clearance letter that all such taxes have been paid.

6. Intellectual Property (IP)

a) This representation and warranty confirms what IP the target company owns. All patents, copyrights and trademarks the target company owns should be listed on a disclosure schedule.

b) In a retail business such as a car wash, the IP may be negligible or there may be a proprietary software product or the trademark for the name.

c) In the sale of a technology company or publishing company it is the most important representation and warranty besides the financial statements.

d) The IP does not infringe on the IP rights of third parties and none of the target company's IP is being infringed upon by a third party.

e) No third party consent is needed so assign the IP rights.

f) In certain deals, there is a representation and warranty that all target company employees have signed agreements assigning all inventions or discoveries they made to target company.

7. Real Property

a) This representation and warranty appears in a purchase agreement where real property is being sold to buyer.

b) The seller represents and warrants that it has good and marketable title to the real property free and clear of all encumbrances except the permitted exceptions (i.e. easements of records).

c) A listing of any tenants who lease a portion of the real estate or a representation and warranty that there are none.

d) A representation and warranty that the real property does not violate any applicable federal or state environmental laws. There are no storage tanks or other hazardous materials present on the real property.

8. No Material Adverse Change.

a) This representation and warranty appears in agreements where there is a time lag between the contract execution and closing. This provision states that there has not been any material adverse change in the business, operation, or condition of seller since the date of the most recent balance sheet.

b) The definition of material adverse change may be heavily negotiated. Buyer may wish to include specific items that are MAC's such as (i) revenue of the seller declines by 20% or (ii) a lawsuit against the company for over 5 million dollars. Seller will want carve outs for things such as (i) conditions affecting its whole industry; or (ii) any change resulting from the announcement of this agreement.

9. Disclosures.

a) This representation and warranty states that all disclosures seller makes on its disclosure schedule are true, correct and complete.

b) The provision also states that the disclosure schedules will not contain any misstatements or omissions.

c) Seller's will sometimes request a statement that a disclosure on one schedule is deemed a disclosure on all schedules. The reason is that certain matters may be disclosed on multiple schedules and seller does not want a technical breach of the representations and warranties if an item is not properly disclosed on multiple schedules.

10. Other Common Representations and Warranties.

- a) Organization and Good Standing of Seller.
- b) Enforceability; Authority; No Conflict.
- c) Capitalization of Seller.
- d) Books and Records.
- e) Conditions of Leased Premises.
- f) Accounts Receivable.
- g) Inventory.
- h) Employee Benefits.
- i) Compliance with Government Laws and Authorizations.
- j) Contracts.
- i) Employees and Labor Disputes.
- k) Insurance.
- l) Relationships with Related Parties.
- m) Brokers.

11. Bring Down and Survival of Representations and Warranties.

a) In any purchase agreement where the closing occurs sometime after the execution of the purchase agreement, the buyer should always insist that the representations and warranties are reaffirmed as of the closing date. The reason for this is events can happen between signing and closing that can breach of the representations and warranties at closing. For example, a lien that arose after signing but before closing will breach the representation and warranty relating to the assets being free and clear of all liens claims and encumbrances.

b) The survival of representations and warranties is always subject to negotiation. There is no real standard for expiration, seller wants them to expire as quickly as possible while buyer wants them to last as long as possible. Typically most initial drafts go out without an expiration or at two to three years and the negotiation begins.

c) Certain representations such as corporate authority, title to assets, litigation, taxes, ERISA, environmental laws survive for the applicable statute of limitations. Taxes, in particular, carries successor liability in Georgia for sales tax so a buyer should not easily limit the representation and warranty with respect to taxes.

12. **Joint and Several.** In an asset purchase transaction where there is a major shareholder, the buyer will want to have the shareholder as well as the company make the representations and warranties (i.e. joint and several). The seller will of course want this limited to several on per claim basis with pro-rate percentages allocated to the company and the shareholder(s). This means if a breach occurs the buyer can seek remedies for such breach against the company or the shareholder.

C. Covenants

1. **Concept** A covenant is a promise to do or refrain from doing something. In an acquisition a covenant serves several purposes:

a) require that the seller obtain certain consents to the transfer of a contract or other asset;

b) obtain the seller's assurance that they will continue operating the business as they have in the past in situations where the contract is executed but the closing will take place at a later time.

c) permit the buyer to have involvement in the target company's decision making in situations where the contract is executed but the closing will take place at a later time.

2. **Specific Covenants** An acquisition document will typically contain these covenants that must be complied with through the consummation of the transaction:

a) operating the business in the ordinary course;

b) maintain the assets in a good operating condition ordinary wear and tear excepted;

c) no pledging of assets without buyer's consent unless in the ordinary course of business;

d) all insurance on the business and its assets will remain in place;

e) promptly notify buyer of any previously undisclosed, outstanding or threatened claims, lawsuits, etc. that will adversely affect the business or its assets;

- f) not negotiate with any person or entity or solicit offers for the sale of the business or its assets;
- g) notify buyer of any condemnation, damage destruction to the real property or a previously undisclosed violation of the environmental laws;
- h) notify buyer of any material breach of any contract or lease;
- i) not increase or change the rate of nature of compensation to any employee or adopt any new employee benefit or compensation program;
- j) not issue any capital stock or other ownership interest in the business;
- k) provide financial statements of the most recent quarter ended at least 30 days prior to the closing (or within 30 days after closing);
- l) obtain a release of all disclosed liens on the assets on or prior to the closing date;
- m) obtain or use best efforts to obtain all consents and approvals from third parties under contract and leases (note this would not generally apply in a stock purchase agreement).
- n) give out free or substantially discounted products or services except in the ordinary course of business; and
- o) undertake good faith efforts to perform the covenants and not take actions that breach the representations and warranties.

D. Conditions

1. **Concept:** A condition is the occurrence or non occurrence of an event which triggers the obligation of the buyer or seller to consummate the transaction or terminate the agreement. Closing conditions occur only in the context where the contract is executed and the consummation of the transaction occurs later.

2. **Specific Conditions** An acquisition document will typically contain these conditions that must be complied with through the consummation of the transaction:

a) Conditions that benefit the Buyer:

i) seller complies with all its obligations under the agreement;

ii) the representations and warranties are true and correct as of the closing date;

iii) no material adverse change to the business or assets;

iv) no event of loss exceeding _____ dollars;

v) all ancillary documents such as bill of sale, non compete, closing certificates, opinion letters, etc have been executed and delivered;

vi) seller has obtained all third party approvals and consents required to assign the assets;

v) no liens on the assets;

vi) buyer has obtained financing for the transaction on or prior to the closing of the transaction. This provision is almost always subject to negotiation since it can be a total out for the buyer.

vi) buyer is satisfied, in its sole discretion, with condition of seller and the assets. (This is an easy way for buyer to walk from the deal at the last minute and seller should demand this language be removed as that is the purpose of due diligence); and

vii) where real estate is involved, execution of the limited warranty deed, seller's affidavit, foreign person affidavit, broker lien waivers, closing settlement statement and any of the other customary real estate transfer documents.

b) Conditions that benefit the Seller:

- i) buyer complies with all its obligations under the agreement particularly payment of the purchase price;
- ii) buyer's representations and warranties are true and correct as of the closing date;
- iii) all ancillary documents such as bill of sale, non compete, closing certificates, opinion letters, etc have been executed and delivered; and
- vi) seller has obtained all third party approvals and consents required to assign the assets.

D. Indemnification.

1. Concept: Indemnification is the buyer's remedy for the seller's breach of representations and warranties, covenants or other obligation or agreements in the purchase agreement. Indemnification makes it easier for buyer to recover legal fees and expenses as the indemnity can expressly provide recovery of these items. Even without indemnification, buyer can sue for breach of contract as well as under other tort theories. Many times the parties make it clear indemnification is the sole remedy for breach excluding all other types of remedies.

2. Commonly Addressed Indemnification Issues.

- i) Broad definition of what losses are indemnifiable: this will include any and all losses, damages, costs, expenses, liabilities, obligations, (including without limitation (reasonable attorneys fees and expenses).
- ii) What does the indemnity cover:
 - breach of representations and warranties;
 - failure of seller to perform any of its covenants, agreements, obligations under the agreement; and
 - any suit, action, proceeding or other litigation arising as a result of seller's failure under the first two bullet points.

PLEASE NOTE: that some indemnity provisions additionally contain indemnity for the buyer for losses arising from "the ownership or operation of the company prior to closing including, the retained liabilities and all taxes attributable to periods prior to the closing. Read this

carefully, the buyer gets far greater indemnity coverage here as indemnification from the seller is required from any problem that arose from the time period when seller owned the business regardless of whether a breach of any representation, warranty, covenant or agreement occurred.

iii) Net of Insurance Proceeds: There should be language that makes the indemnity net of insurance proceeds that may apply to the loss subject to indemnification.

iv) Baskets: Think of this provision like the deductible on your insurance policy. This provision provides for what dollar amount of claims that are subject to indemnification will not be seller's responsibility. After the deductible is reached Seller may either be responsible for all amounts that exceed the deductible or be responsible for entire loss not just the portion that exceeds the deductible (this is commonly referred to as a first dollar basket).

v) Caps: This provision limits the seller's liability to a certain amount. Typically buyer initial drafts omit addressing this issue so the amount is theoretically unlimited. Seller's counsel wants to limit this amount to no more than the purchase price and in some transactions the cap might be no more than 10 to 20 percent of the purchase price. Again this is a highly negotiated provision between the buyer and seller.

vi) Indemnification Mechanism: This provision addresses the mechanism by which the buyer notifies seller that it is entitled to indemnification, employment of counsel, under what conditions seller can settle the indemnifiable claim and buyer's participation in any defense

3. Special Indemnification Issues. Due diligence may reveal specific issues that the buyer insists be handled with a special indemnity. Examples may include a 5 million dollar lawsuit seller claims is meritless or an environmental problem with real estate the seller will have cleaned up prior to closing. When these issues arise there may be indemnification that applies specifically to these issues and there may be no deductible or a higher indemnity cap with respect to this specific issue.

4. Indemnification Utility = Seller's Ability to Pay. Ultimately the indemnification remedy is only as good as Seller's ability to pay the indemnity claim. Especially in assets sales where the company is selling substantially all its assets the buyer should seek assurance that seller has the ability to pay any indemnification claims. This can be accomplished using the following methods:

i) Holdback a portion of the purchase price in an escrow account for the purpose of paying indemnification claims. It can last until the

representations and warranties run out or other mutually agreed upon period of time;

ii) Make the majority shareholder or all the shareholders party to the agreement and include a provisions that they are personally responsible for indemnification; and

iii) In more sophisticated transactions, there is actually representations and warranties insurance where an insurer is paid a premium and will pay indemnity claims that arise from a breach of the representations and warranties.

D. How Representations and Warranties, Conditions, Covenants and Indemnification Work Together

Example 1

Facts:

- (1) Buyer revises the purchase agreement removing many of Seller's knowledge and materiality qualifiers.
- (2) Buyer also lowers the deductible for indemnity claims and raises the cap.

Analysis: As seller's counsel, think of representations and warranties and indemnification as separate walls that must be breached in order for buyer to obtain indemnification. When seller negotiates these changes with buyer, he or she should discuss up front that if buyer wants certain knowledge and materiality qualifiers removed it cannot also have the deductible lowered and the cap raised. In other words, these two seemingly separate negotiations are really interrelated and should be handled together not separately.

Example 2

- (1) Seller negotiates to limit litigation representation and warranty to litigation that it currently has knowledge of as of the closing.
- (2) Seller is required to indemnify Buyer for any claims that arise from the ownership or operation of the company prior to closing (see Please Note in D(2) of this outline.

- (3) Litigation claim arises after closing that relates to when seller owned the business that it had no knowledge of as of the closing.

Result: The broad indemnity makes buyer's concession on litigation worthless since the indemnity is available for any claims arising from ownership or operation of the business prior to closing. In other words, the indemnity in favor of buyer is so broad it supercedes any limitations seller negotiates in the representations and warranties section.

Example 3

Facts:

- 1) Seller covenants that it will execute a new employment extending its CEO's employment term an additional 2 years at or prior to closing.
- 2) There is no closing condition in favor of buyer requiring that all agreements and covenants be complied with.

Result: Buyer is required to close but likely has a claim for indemnification. If the deal, however, is predicated on having the CEO locked up for another two years the litigation is cold comfort. Buyer wants this contract extension to be a closing condition AND a covenant. If that happened here buyer would have the choice to not close and still maintain that a breach of the agreement occurred since the covenant had not been completed. This also gives the buyer flexibility to decide if it wants to waive the closing condition, close and then deal with the extension or seek indemnification.

Example 4

Facts:

- 1) Seller makes representation and warranty that no litigation exists at signing and again at closing.
- 2) Litigation arises after signing but before the closing.
- 3) There is a condition that the representations and warranty's be true at closing.

Result: Seller has breached the litigation representation and warranty and buyer can choose to close or not and in either case seek indemnification

from the seller since the representations and warranty's are not true at closing.

Example 5

Facts:

- 1) Indemnification in favor of buyer specifically covers free car washes that seller promised prior to closing that buyer must honor.
- 2) After closing buyer finds out seller handed out free car washes to many more people that buyer anticipated in the amount of \$5,000.
- 3) Seller sold substantially all its assets in sale but there is a holdback escrow in the amount of \$25,000.

Result: Buyer included specific indemnification for the sale of free car washes and required that at least \$25,000 be held back in a general escrow account. As a result the buyer was reimbursed for the cost of honoring all the free car washes. Note that this could have been drafted so that there is a separate holdback for the free car washes and one for other general indemnification claims.

Example 6

Facts:

- 1) Seller makes representations and warranties as of signing date.
- 2) Undisclosed lien arises between the signing and closing date.

Result: Buyer is required to close as the representations and warranties need only be true at signing not closing. This example illustrates the importance of the reaffirmation of the truth of the representations and warranties at closing.