SHARE AND ASSET ACQUISITION AGREEMENTS

R. Paul Edmonds
Partner
Miller Thomson LLP
Toronto

This paper examines acquisitions from a structural perspective, and is divided into two parts. Part A considers the structure of the acquisition *transaction*, and Part B addresses the structure of the acquisition *agreement*.

A. STRUCTURE OF THE ACQUISITION TRANSACTION

To begin at the beginning, business acquisitions in Canada are structured as share or asset transactions, and mergers (amalgamations) are a variant of the share transaction.

In my paper, I've capitalized but not defined many terms found in Share and Asset Acquisition Agreements, such as Purchaser, Vendor, Purchase Price and Closing. I use **"Target"** to mean both a share purchase and an asset purchase, if it is necessary to refer specifically to the Target's business or assets, I will so state. I use **"Acquisition Agreement"** to mean both a share purchase agreement and an asset purchase agreement, and **"Transaction"** to mean the transaction of purchase and sale contemplated by an Acquisition Agreement.

I've also found it convenient on occasion to distinguish between two kinds of Purchaser – the Finance Professional and the Business Owner. **"Finance Professional"** means an investment banker, venture capitalist, pension plan or other institutional purchaser or investor, and **"Business Owner"** means an entrepreneur or a hands-on owner of a business.

As a general rule, a Vendor prefers to sell shares, and a Purchaser prefers to buy assets, for several reasons. This creates an interesting tension between the Purchaser and Vendor in the initial stages of a transaction, as each manoeuvres to impose its favoured structure on the other.

1.1 <u>The Vendor's Perspective</u>

A Vendor prefers to sell shares because it transfers to the Purchaser all of the risks associated with the Target, such as employee and contractual liabilities and obligations, and allows the Vendor, subject to specific legislation and the provisions of the Acquisition Agreement, to end its responsibility for the Target.

A share Transaction is most likely to result in capital gains treatment for the Vendor, and some Vendors may also qualify for the $500,000 capital gains exemption. In an asset Transaction, the Vendor may be saddled with, for example, recapture (which is an income inclusion).

Furthermore, the share Transaction also provides some opportunities for the Vendor to do some Tax planning before closing. For example, the Vendor could be in a position to:

(a) dividend out "safe income", which is a Tax-free dividend equal to the amount of Tax-paid retained earnings; and

(b) declare capital dividends, which are a Tax-free dividend equal to the amount of Tax-paid capitals gains arising on past dispositions of assets, such as a sale of land.

1.2 The Purchaser's Perspective

A Purchaser prefers to buy assets because, putting aside the availability of the section 167 GST election, the Purchaser can buy the assets it wants and assume the liabilities associated with those assets.

The Purchaser may also be in a better post-closing Tax position if it buys assets instead of shares. The Purchaser will have some flexibility to allocate the Purchase Price among the purchased assets, so the Purchaser may be able to attribute significant value to assets with higher depreciation or capital cost allowance rates. In the years after closing, this would result in larger capital cost allowance deductions in computing income for Tax purposes, which would reduce the Purchaser's income for Tax purposes and its income Taxes. If the Purchaser purchased shares, the Purchaser would have no opportunity to "write up" the cost base of the underlying assets, and consequently would have lower capital cost allowances and, everything else being equal, higher income and income Taxes.

By way of a caution to the Purchaser in structuring a Transaction, the Purchaser should take note of the following:

(a) If the Target receives investment Tax credits or some other form of government benefit, those credits or benefits may not follow the assets, in which case the Purchaser should be alert to the costs of losing those credits or benefits. It may be that the cost of losing those credits or benefits is large enough to cause the Purchaser to favour a share Transaction instead of an asset Transaction.

(b) In an asset Transaction, if acquisition of the Target's business is merely "accretive" to the Purchaser's existing business, the section 167(1) GST election may not be available to the parties to exempt the transaction from Goods & Services Tax.

The issue in (b) above can be best explained by was of example. Consider a trucking company with 20 trucks which proposes to purchase the assets of another trucking company with 12 trucks. The Purchaser is prepared to buy all 12 trucks, all accounts receivable and the customer list. The Purchaser is willing to assume all liabilities relating to the trucks and, of course, all of the Vendor's employees with become employees of the Purchaser upon closing.

Aside from the 12 trucks, the Target business doesn't have many assets. Since the Purchaser has all the transportation authorities it needs, it doesn't want the target's transportation authorities. The Purchaser also doesn't want the Target business's name, which suits the Vendor, because the name includes the Vendor's name, and the Vendor doesn't want trucks on the road featuring its name unless the Vendor is in control. The Vendor feels that it won't have any assets to speak of left after Closing and, so far as the Vendor is concerned, the section 167(1) GST election is available.

In substance, the Purchaser plans to simply add these assets to its existing business, and to carry on as before, only with more trucks, customers and employees, and so we can say that the assets purchased, and the liabilities assumed, by the Purchaser are accretive to, or added on to, the Purchaser's existing business.

The issue, then, is whether the Purchaser is acquiring all or substantially all of the assets of a *business*. It's very likely that the assets to be acquired account for virtually the entire value of the Target business, and those assets not purchased certainly don't amount to a viable business. However, in light of the Purchaser's existing business, the assets to be acquired simply supplement what the Purchaser already has.

The prudent course for the Purchaser's lawyer to adopt is to advise the client that the section 167 GST election may not be available and, naturally, to confirm your advice in writing. The client may want to proceed with the election in any event and, if Canada Revenue Agency should challenge the election, one would hope that, aside from any penalties and interest, the GST itself would be only a cash flow timing issue.

B. STRUCTURE OF THE ACQUISITION AGREEMENT

The typical Acquisition Agreement is divided into a number of articles, like this:

Article 1 Definitions

Article 2 Purchase Price

Article 3 Representations and Warranties

Article 4 Pre-Closing Covenants

Article 5 Closing Conditions

Article 6 Post-Closing Covenants

Article 7 Survival and Indemnities

Article 8 General Contract Provisions

You will have seen many variations on this form, which is fine; there is no right or wrong form for the Acquisition Agreement. The form set out above, however, provides a useful framework in which to examine and comment on the structural elements of the Acquisition Agreement.

ARTICLE 1 - DEFINITIONS

Why do some Acquisition Agreements begin with the Purchase Price, and relegate definitions to a schedule at the back? Is it merely the drafter's preference, or is there a reason to do it one way or the other?

I've found over the years that the Finance Professional likes to see definitions right up front in the Acquisition Agreement, where they're easy to find. These types of clients aren't put off by pages of defined terms, and know that you can't read the Acquisition Agreement properly

without continually turning to the definitions part. The Finance Professional, or at least a junior member of the team, will pore over the Acquisition Agreement and take the time to fully understand it.

I've also found that the Business Owner wants to get to the Purchase Price immediately, and the Business Owner's appetite for the rest of the Acquisition Agreement will vary directly with your persuasive abilities in convincing them that other parts of the Acquisition Agreement can and do affect the Purchase Price and the Business Owner's liability. The Business Owner can get annoyed with ten pages of definitions before getting to what is, to them, the important part of the Acquisition Agreement: the money.

There are exceptions to these guidelines, of course, but my point is that if you give some thought about how your client would like the Acquisition Agreement to look, you can set yourself apart from the other lawyers your client has had to deal with over the years.

ARTICLE 2 - PURCHASE PRICE

I'd like to focus on three aspects of the Purchase Price: escrows, adjustments and earn -outs.

2.1 Escrows

Escrows appear in acquisition Transactions in several ways:

(a) The Vendor may want a deposit against the Purchase Price held in escrow pending Closing.

(b) The Purchaser may want a portion of the Purchase Price held in escrow after Closing for, say, 60 days, to pay for any adjustments to the Purchase Price.

(c) The Purchaser may want a portion of the Purchase Price held in escrow after Closing for the survival period to pay damages resulting from any breaches of representations and warranties and covenants.

You may be asked to act as escrow agent in any of these situations. If you agree to act as escrow agent, it is critically important that you appreciate that you will, as of that moment, be in a legal conflict position, because you now have two clients, and you owe fiduciary duties to both of them with respect to the escrow. If there are multiple Vendors or Purchasers, you will have multiple clients and you will owe multiple duties as escrow agent.

The key point here is that you cannot and must not favour your original client over your new, additional clients in relation to the escrow. A client who says that it will feel better if you are the escrow agent, instead of the lawyer on the other side, can be forgiven if all the client is worried about is someone running off with the money. But a client who feels that it will be better off in some way if you act as escrow agent just doesn't get it, and you will have to be clear and blunt with the client until it does.

It was fairly common for lawyers to sign on to Acquisition Agreements as escrow agent, and usually those agreements would feature a line or two, or maybe a page, outlining what you were supposed to do. It's not a good idea to be a party to the Acquisition Agreement because it

emphasizes the dual role you must play, as both counsel to a Party and escrow agent for all Parties, which could be interpreted against you if a dispute should arise with respect to the escrow funds. Furthermore, the contents of the Acquisition Agreement are irrelevant to you in your role as escrow agent.

If follows that there should be a separate escrow agreement among the Purchaser, the Vendor and you as escrow agent. From your perspective, you want to be, and frankly are entitled to be, fully indemnified by all the Parties, which is to say your "own" client and any "new" clients, so long as you've acted in good faith and haven't been grossly negligent in your capacity as escrow agent. But equally important from your respective is for the escrow agreement to spell out in the clearest possible terms what you are supposed to do with the money, and in what circumstances you are to release it. Your aim in drafting the escrow agreement is to eliminate all discretion on your part, because with discretion comes pressure to exercise it in some way not set out in the escrow agreement. If you should find yourself uncertain about what to do, you can interplead the money, which is to pay it in court, and let the court direct you.

Time doesn't allow me to say much more about your role as escrow agent, but I would like to say that there are firms in Toronto which will not, as a matter of policy, act as escrow agent for the firm's clients. The concern is that they will upset, and possibly lose, clients if they find themselves obligated as escrow agent to do something which the clients won't like. Certainly my firm takes great care about the contents of the escrow agreement should a firm member feels that he or she must agree to a request to act as escrow agent.

2.2 Adjustments to the Purchase Price

When a Purchaser and a Vendor sit down to talk about a potential Transaction, they usually have to settle the Purchase Price by looking at the financial information available to them at the time they make their deal. This information usually consists of last year's financial statements, updated by management's internally prepared financial statements, and forecasts of the Target's future profitability.

The difficulty confronting the Parties is that none of these sets of numbers is necessarily based on the same principles. Last year's financial statements for the Target likely will be based on GAAP, but it is also likely that the Target's internally prepared financial statements will not be GAAP compliant. The forecasts, by their very nature, will not be prepared in accordance with GAAP, as they are based on future assumptions about the future and are concerned with the cash flow potential of the Target. The forecasts will also use estimated market values instead of depreciated cost for assets, such as land, which may have increased in value over the years, and the forecasts will often assume that redundant assets or lines of business have been sold for cash. On top of this, the Parties may also refer to the Target's income Tax Returns, in which income is calculated based on the *Income Tax Act* and not GAAP.

Given the bewildering array of financial information the Parties must work with, Acquisition Agreements generally provide for financial statements to be prepared after Closing, as at the Closing Date, and for a mechanism for the Purchaser and the Vendor to pay or receive, as the case may be, an amount to adjust the Purchase Price, as paid on Closing, to what it should have been, based on the financial statements prepared as at the actual Closing Date.

Two frequently encountered adjustment mechanisms are the tangible net worth (**"TNW"**) adjustment and the working capital (**"WC"**) adjustment. The TNW adjustment is the more complicated of the two, since it deals with the Target's entire balance sheet, and a change to any of the financial situation of the Target will work its way through the income statement and onto the balance sheet.

The WC adjustment involves only those changes which impact working capital, which is, essentially, the Target's short term assets minus its short term liabilities.

The TNW or WC adjustment is normally calculated by the auditors for the Target who, in most cases, are also the Vendor's auditors. The Target/Vendor auditors are familiar with the Target's accounting systems and are generally in the best position to prepare the adjustments quickly, which is in the interest of both the Purchaser and the Vendor.

As lawyers, our concern is with the adjustment process. From the Purchaser's perspective, the Acquisition Agreement should give the Purchaser some oversight rights while the Target/Vendor auditors are preparing the Purchase Price adjustment. Once the Target/Vendor auditors have finalized the adjustment calculation, the Vendor will have a fixed, and usually fairly short, period within which to review the calculation and to decide whether to challenge it, and the Purchase Price adjustment clause should also contain dispute resolution provisions. Given the tight time lines, it is in the Purchaser's interest to be involved in the process so it can understand what was done before the adjustment is finalized and the review period starts to run. From the Vendor's perspective, it doesn't want the Purchaser and its auditors bothering the Target/Vendor's auditors, which will increase its costs. Accordingly, commitments are made that there will be full cooperation, but no interference, with the Target/Vendor auditors while they are preparing the Purchase Price adjustment.

On the subject of costs, it is quite usual for the Vendor to bear the cost of *preparing* the Purchase Price Adjustment. The Vendor knows its business and should know whether its forecasts are realistic, and so it is not unreasonable for the Vendor to bear this cost. From the Purchaser's perspective, it will say that it agreed to the Purchase Price on the basis that the forecasts were an accurate prediction of what the Target would be worth on Closing, and that it is not prepared to pay to have that price adjusted to reality. If there should be a dispute over the Purchase Price adjustment, it is not unusual for the costs of the challenge to be determined by the adjudicator, having regard to the relative success of the Parties.

2.3 <u>The Earn-Out</u>

An Earn-out is a fixed, or capped, component of the Purchase Price which is based on the post-Closing financial performance of the Target. The mechanics of the Earn-out will usually set a minimum amount of profits the Target must earn achieve each year during the Earn-out period before any amount can be paid to the Vendor on account of the Earn-Out, and the amount paid on account of the Earn-out is capped. The yearly minimum of profits usually increases over the life of the Earn-out. From the Vendor's perspective, the Earn-out cap should allow for carryforwards, so that if, for example, the minimum profit amount is $1.0 million a particular year, with a yearly cap of $1.5 million, so that up to $500,000 of Earn-out is available to be paid to the Vendor. If the Target earns profits of only $900,000 that year, then next year up to $600,000 should be available to be paid to the Vendor.

I was surprised with the number of Earn-out Transactions I encountered last year. I saw more last year than in the previous five years combined. I'm not sure why, unless Purchasers have suddenly woken up to the advantages of the Earn-out. For my part, when representing Vendors, I don't like Earn-outs, which I will explain later in this section of the paper.

It is important for Tax reasons to structure the Earn-out so that it is clearly part of the Purchase Price, and not an amount in addition to the Purchase Price. Assume a Transaction where the cash on Closing for the sale of the Target is $10,000,000, with a $2,500,000 Earn-out:

(a) If the Purchase Price is defined to be $12,500,000, being the sum of the cash on Closing plus the amount of the Earn-out, the Earn-out is part of the Purchase Price, and the Vendor should receive capital gains treatment on the Earn-out, and reserves are available.

(b) If the Purchase Price is defined to be $10,000,000 cash on Closing plus an Earn-out of $2,500,000, it is likely that the Earn-out will be Taxed as income as it is received.

Earn-outs are often negotiated where the Purchaser is concerned that the Vendor's asking price may be too high while the Vendor isn't prepared to accept a lower price. The solution, which is quite logical, is for the Purchaser to say, "I'm prepared to pay you cash on Closing of $X, which is what I happen to think your business is worth, and if this business is as good as you say it is, it should easily generate profits equal to or greater than $Y each year for a given number of years after Closing (usually 2 to 3 years, sometimes 5, depending on the economics of the deal), and I, the Purchaser, will be more than happy to pay you the amount in excess of $X each year of that given number of years so that you, the Vendor, will have been paid the Purchase Price you say the business is worth". The Vendor, of course, replies "Done", and then it's over to the lawyers.

My concerns about Earn-outs stem from the Vendor's loss of control over the Target. My concerns remain even where the Vendor stays on with the Target in some capacity after Closing, which the Vendor is definitely well advised to do. The harsh reality, however, is that after Closing, the Vendor will be simply one more employee or consultant on the Purchaser's payroll.

When representing the Vendor in an Earn-out, try to imagine what the Target will look like at the moment of Closing, and then draft language in the Acquisition Agreement to try to preserve that moment. Consider, for example, the following:

> "During the Earn Out Period:
>
> (a) The Target shall remain under the management control of the Vendor.
>
> (b) Subject to any agreement between the Purchaser and the Vendor, the Purchaser shall not materially alter the day-to-day management, growth initiatives, recruiting, or strategic direction of the Target.
>
> (c) The Purchaser shall maintain the Target as a separate accounting entity.

(d) The Purchaser shall not sell or dispose of the Target unless the buyer of the Target agrees to assume the obligations of the Purchaser with respect to the Earn Out Amount.

(e) Without ●'s consent, the Purchaser shall not redirect a material portion of ●'s staff, or ●'s staff's time and/or responsibilities, from the management of the Target.

(f) the Purchaser and the Vendor shall act in good faith to adjust the Threshold if the Target loses a material customer or project as a direct result of the Transactions, or the public announcement or disclosure of the Transactions.

(g) The Target and the Purchaser shall cooperate to achieve the strategic and growth plans of the Target as set out on Schedule ● (the "Business Plan"). Without limiting the generality of the foregoing, the Purchaser shall provide the necessary management, financial and operational resources and support to allow the Target to achieve the goals and growth plans set out in the Business Plan, provided that the nature and amount of such resources to be provided by the Purchaser shall be:

(i) commensurate with the performance of the Target; and

(ii) subject to the reasonable performance standards and investment criteria consistently utilized by the Purchaser in making such internal investment decisions.

(h) The Purchaser shall not develop a *de novo* business which would be competitive with the Target."

The "Threshold" in the referred to in the above is the minimum amount of profits the Target business must achieve before amounts can be paid to the Vendor on account of the Earn-out.

A further reason for concern for the Vendor is that the Earn-out is based on profits, and the Purchaser can easily load up the Target with inter-company charges to reduce profits. Therefore, the Vendor will want to exclude from the Earn-out the following charges when the calculation of the minimum profit amount is made:

(a) any pass-through revenue, such as remuneration for travel-related expenses or other reimbursable expenses that can be invoiced directly to the client at the cost to the Target;

(b) the results of any company or business acquired by the Target or the Purchaser after the date of this Agreement, provided, however, that the Parties shall discuss in good faith the impact of any acquisition of a [similar] business and negotiate

such changes to the methodology used to calculate EBITDA or the applicable Earn Out Amounts as may be consistent with the spirit and intent of this Agreement so that the Sellers will not be negatively impacted by such acquisition;

(c) any indirect expenses allocated to the Target, including non-payroll expense, out-of-pocket supplies expense, sales and marketing expense, administrative expenses and depreciation and amortization expense;

(d) the cost of new employees hired into the Target in excess of the Business Plan, unless approved by ● or his/her designated successor; or

(e) any increase in employee benefit costs resulting from changes, if any, made by the Purchaser to any of the Target's employee benefit plans in effect as of the Closing, which increase shall be calculated as the amount, if any, by which employee benefit costs incurred by the Target during the Earn Out Period exceeds employee benefit costs incurred by the Target during the 12-month period immediately preceding Closing.

ARTICLE 2 - REPRESENTATIONS AND WARRANTIES

Representations and warranties are used synonymously in Acquisition Agreements. While there are, strictly speaking, differences between them, that is a matter of concern, if not interest, to our litigation colleagues when picking at the desiccated remains of a good deal gone bad. For our purposes, it is sufficient to say the representations and warranties are statements of fact that are said to be true at the time they are made.

It seems plain to me that the number and exhaustiveness of representations and warranties in Acquisition Agreements has grown over the years. Perhaps a factor in this trend is a result of the technology we are both blessed and cursed with, as it is now a simple matter to pull together clauses from many sources. The ease with which we can assemble a comprehensive list of representations and warranties may have allowed us to think less about what we're actually asking for. In any event, we find ourselves dealing with pages of representations and warranties to deal with in even the smallest and most straightforward Transactions. I believe this tendency to pile on representations and warranties will only grow, because while we may be critical of overkill when acting for Vendors, we're all quite happy to load up the representations and warranties when we wear our Purchaser's hat.

I'd like to address some ways to manage this lush undergrowth of verbiage.

I start from the proposition that a Purchaser and its counsel are entitled to ask just about whatever they want. Today's hourly rates preclude us from undertaking a ditch by ditch negotiation of representations and warranties, and so our focus should be less on whether the representation and warranty is "fair", and more on whether it is true. Note that I say "less" emphasis on fair, not "no" emphasis. The obviously inappropriate has to be objected to and either deleted or qualified in some manner**.** I recently was involved in a transaction in which our client, the Vendor, was asked to represent and warrant that he had never paid a bribe to a government official anywhere in the world. Now, even if the Vendor dealt with government (it did not) and had global operations (it did not), it would be a triumph of faith over reality to expect someone who had actually bribed a government official to suddenly come clean and say

that he or she did. I pointed out to the Purchaser's counsel that there were any number of other representations and warranties in the agreement which would be breached by such behaviour, and that to ask for such a representation and warranty in the circumstances of that particular Transaction was inappropriate, and the representation and warranty was deleted.

It is always a challenge for a Vendor to say with confidence that the representations and warranties in an Acquisition Agreement are true. Even the most conscientious of Vendors, who has carefully read the representations and warranties, is in touch with the day to day operations of the Target, and has discussed the representations and warranties with the Target's senior management, is still going to have concerns about whether certain representations and warranties are true. There are two qualifications commonly used to limit or qualify such representations and warranties: knowledge and materiality. Unfortunately, these are two of the slipperiest concepts in the law. Nevertheless, I have set out at the end of this section of the paper some sample definitions of knowledge and materiality for your consideration.

2.1 Knowledge

For our purposes, knowledge can be either actual or objective. Actual knowledge is simply that: it's what you actually know. Objective knowledge is what you know and *should have known*.

2.1.1 Actual Knowledge

From a Purchaser's perspective, allowing a Vendor to qualify its representations and warranties with actual knowledge is risky. If an issue should arise after Closing about whether a particular representation and warranty was true as of Closing, the Vendor will simply say, "I didn't know about that", and the Purchaser will be faced with the daunting task of proving the Vendor did in fact know. Unless the Purchaser is lucky enough to uncover something in writing that shows that the Vendor knew before Closing that the particular representation and warranty was not true, the Purchaser will likely have no practical recourse against the Vendor. In short, "actual knowledge" is the knowledge of a moron in a hurry, and a Purchaser should strongly resist being saddled with an actual knowledge standard for representations and warranties.

Sample definitions of actual knowledge:

> **"Knowledge"** means the actual knowledge of the Vendor.
>
> **"Knowledge"** means the actual knowledge of ●, the President of the Vendor.

2.1.2 Objective Knowledge

The Purchaser is in the best position if the representations and warranties are qualified by objective knowledge. If a question should arise after Closing about whether a particular representation and warranty was true as of Closing, the Vendor can't simply say, "I didn't know about that" and leave the Purchaser hanging. The question will be: *should* the Vendor have known? In drafting a definition of objective knowledge in the Acquisition Agreement, the lawyers will go back and forth in trying to express the concept of "objective". The Purchaser will want to force the Vendor to actually do things, such as review files and speak with management, to show that the Vendor has made genuine efforts to fully inform itself as to the facts as they pertain to any particular representation and warranty. The Vendor will want to keep

the definition as loose as possible, and to leave open what the Vendor should have done, so that at least there's something to argue about.

Sample definitions of objective knowledge:

> **"Knowledge"** means the actual knowledge of the Vendor and the knowledge it would have had if it had conducted a diligent inquiry into the relevant subject matter.
>
> **"Knowledge"** means the knowledge which a prudent individual could be expected to discover or otherwise become aware in the course of conducting a reasonably comprehensive investigation regarding the accuracy of any representation or warranty contained in this Agreement.

2.2 <u>Materiality</u>

We often see Acquisition Agreements with representations and warranties liberally sprinkled with the word "material": "the Company has all *material* licenses…"; "there is no *material* litigation…"; the Company is not in *material* default…" Used in this way, the best that can be said about what "material" means is that it is, well, material; it's as if, like good art, the Parties will know it when they see it.

Simply using the word "material" on its own isn't of much use to a Purchaser, and frequently sows the seeds of future discord between the Parties. Problems always come up after Closing; the real world works that way, and so both the Purchaser and the Vendor really need a definition of "material" with some substance to it.

To me, the materiality concept is best defined in terms of the monetary cost or value of the result or outcome of any particular event.

Sample definition of material/materiality:

> **"Material"** means, when used as an adjective, that any breach, default or deficiency in the satisfaction of any covenant, representation or warranty so described might reasonably:
>
> (a) give rise to an aggregate remedial cost (including consequential loss and loss of profit) of more than $●, in any individual instance, or more than $● collectively in any greater number of instances, where all such instances arise pursuant to multiple breaches of the same covenant, representation or warranty; or
>
> (b) where no adequate remedy is reasonably available, result in disturbance in the ordinary conduct of the Business of an aggregate cost properly attributable to such disturbance (including consequential loss and loss of profit) of more than $ ●,
>
> and "**Materially**" shall have the corresponding meaning.

ARTICLE 3 - PRE-CLOSING COVENANTS

As with representations and warranties, covenants have a specific, technical meaning. For our purposes, covenants are promises that particular actions will be taken.

The pre-Closing covenants in an Acquisition Agreement deal with actions to be taken by the Parties between the date the Acquisition Agreement is signed and the Closing Date. For example, a familiar Purchaser's pre-closing covenant is that it will use its best efforts to obtain any required governmental approval on or before Closing, and a Vendor must invariably agree to operate the target business in the ordinary course of the business until Closing.

I've chosen as examples these two pre-closing covenants because each contains a troublesome phrase: "best efforts" and "ordinary course". As with knowledge and materiality, the meaning of these terms is difficult to express. I've also noticed that variations of these terms, such as "very best efforts" and "commercially reasonable best efforts", and "ordinary course of business" and "ordinary course of the business" tend to be used in the same Acquisition Agreement, which should be avoided.

3.1 Best Efforts

At the outset, it is important to note that the expressions "best efforts" and "commercially reasonable best efforts" don't mean the same thing. Used alone, and without any further explanation, "best efforts" may not require a Purchaser or Vendor to spend money, while "commercially reasonable best efforts" does.

The expression "best efforts" does convey an admirable sense of purpose; like clergy before the baptismal font, one could feel secure in the belief that the matter in hand, so to speak, will be just that much better for the sentiments expressed. As commercial lawyers, however, we need to define best efforts in an Acquisition Agreement if the term is to be of any use to the Parties. There is also not much point in defining best efforts unless it is linked to the expenditure of money. Therefore, the frequently used expressions "best efforts" and "commercially reasonable best efforts" should be folded into one defined term.

Sample definition of Best Efforts:

> **"Best Efforts"** means the efforts that a prudent person desirous of achieving a result would use in similar circumstances to achieve that result as expeditiously as possible; provided, however, that a person required to use Best Efforts under this Agreement will not be thereby required to take actions that would result in a Material adverse change in the benefits to such person of this Agreement and the transactions contemplated by this Agreement or to dispose of or make any change to its business, expend any Material funds or incur any other Material burden or obligation unless specifically set forth in this Agreement.

3.2 Ordinary Course

The expressions "ordinary course", "ordinary course of business" and "ordinary course of the business" can have quite difficult meanings, depending on the circumstances.

People use the expression "ordinary course" in day to day conversation in the sense of there being "no surprises", so simply using the unadorned expression "ordinary course" in an Acquisition Agreement leaves open the question of whether the "surprise" is meant to refer to the results of a Parties' action or something which occurs for no discernible reason. As lawyers, we should try to confine the concept of "ordinary course" to the results of a Parties' actions. The

consequences of random acts can be addressed with the concepts of material adverse change and force majeure, which are subjects for another day.

In the absence of definitions, the expression "ordinary course of business" is a more of an objective standard that "ordinary course of the business", which relates to the Target. As was the case with "knowledge", a Purchaser will want the more objective version. The Vendor will want to use "ordinary course of the business", so that it is the history of the Target which is the standard, and not other businesses generally.

The sample definition below seeks to steer a middle ground. Instead of simply looking at the action itself to determine whether it in the ordinary course, the definition also looks at how the action was taken. In other words, the definition considers process as well as results.

Sample definition of ordinary course of business:

> **"Ordinary Course of Business"** means, in relation to an action taken by a person, an action which:
>
> (a) is consistent in nature, scope and magnitude with the past practices of such person and is taken in the ordinary course of the normal, day-to-day operations of such person;
>
> (b) does not require authorization by the board of directors or shareholders of such person (or by any person or group of persons exercising similar authority) and does not require any other separate or special authorization of any nature; and
>
> (c) is similar in nature, scope and magnitude to actions customarily taken, without any separate or special authorization, in the ordinary course of the normal, day-to-day operations of other persons that are in the same line of business as such person.

ARTICLE 4 - CLOSING CONDITIONS

For our purposes, Closing conditions are things which must be done or satisfied before the Parties will close the Transaction. Note that I refer to Closing conditions in a positive manner. Our litigation colleagues, however, might view Closing conditions in a negative light, as things which a Party has failed to do and which would entitle the other Party to refuse to close the Transaction or commence legal action.

Some Closing conditions may be said to be in both Parties favour, such as receipt of government approvals, and these are often referred to as true conditions precedent, but most Closing conditions are expressed to be in favour of one Party or the other, and are often called conditions precedent. Together, are often simply called Closing conditions.

Some of the typical Closing conditions in favour of the Purchaser will be the same as those in favour of the Vendor, since each is looking to the other for some of the same things. For example, the Purchaser may require a legal opinion from the Vendor's counsel, and vice versa.

Broadly speaking, Acquisition Agreements fall into two types where Closing conditions are concerned: the "sign and close" Acquisition Agreement, and the executory Acquisition Agreement.

4.1 The "Sign and Close" Agreement

A "sign and close" Transaction is a two-step process: the Parties move from a letter of intent or meeting of the minds regarding a potential Transaction, directly to Closing. The Acquisition Agreement is signed at the time of Closing, and Closing occurs essentially if, as and when the Parties are ready to close.

The "sign and close" Acquisition Agreement is very similar to the executory Acquisition Agreement; the only significant difference between them concerns the handling of the subject matter of the Closing conditions. The "sign and close" Acquisition Agreement will contain a list of closing actions and deliveries which will look very much like the list of Closing conditions in the executory Acquisition Agreement. The difference, however, is that failure by a Party to a "sign and close" Acquisition Agreement to satisfy or deliver any of the listed items on Closing won't result in any legal consequences, since neither Party is under a binding obligation to buy or sell, as the case may be, much less to comply with any particular Closing condition. Instead, the Parties will agree either to delay Closing until that which should have been done, is done, or walk away. In either case, there are no law suits between the Parties.

In my experience, "sign and close" Acquisition Agreements appear in two quite difference kinds of Transactions. The first is in "friendly" or non arm's length deals, such as inter-family Transactions. The second is where one of the Parties, usually the Purchaser, has superior bargaining power.

The second type of Transaction creates a great deal of risk for the Vendor:

(a) The Vendor will incur legal and other professional fees, devote a great deal of management time and resources to the sale process, and advise customers, suppliers, banks, landlords and employees of the pending sale, all with no assurance that the Transaction will actually be completed.

(b) The Purchaser will be sorely tempted to assure the Vendor that the Target is a great little business, but not quite as great as the Purchaser first thought, and to suggest, with crocodile tears, that it has no alternative but to offer the Vendor a significant haircut on the Purchase Price.

In the end, the Vendor is quite likely to feel that it has no choice but to close the deal, because its disappointment in the Purchase Price will be as nothing compared to the damage done to the Target if the deal doesn't close, since the Vendor:

(i) could be embarrassed in front of its competitors and customers;

(ii) might lose credibility with banks, landlords and suppliers; and

(iii) will almost certainly be loathed by its employees for, in their minds, trying to sell out their jobs from under them.

Not surprisingly, I try to avoid "sign and close" Transactions when acting for Vendors. It could be said that the Purchaser is just as exposed as the Vendor; certainly the Purchaser will experience some embarrassment if the Transaction doesn't close. In my view, however, the damage to the Vendor's business, and its relations with its key stakeholders – the customers, suppliers, employees and financiers, from failing to close will greatly exceed any damages the Purchaser might suffer.

4.2 The Executory Agreement

An executory Transaction is a three-step process. As with the "sign and close" Transaction, the Parties begin with the letter of intent or other understanding, but then proceed to negotiate and sign an Acquisition Agreement which provides for a future Closing Date. The Parties use this interim period between signing and the Closing Date to work towards satisfying the Closing conditions in time for Closing. It is in the executory Transaction where Closing conditions become critical. The key point about a Party's failure to comply with a Closing condition in an executory acquisition transaction is that the failure triggers rights and remedies which can have very serious consequences for the non-compliant Party.

The well drafted executory Acquisition Agreement will provide that representations, warranties and covenants of the Parties become Closing conditions, so that the failure of a Party's representation and warranty to be true and correct as at Closing, or the failure of a Party to comply with or perform a covenant by the time of Closing, is a failure to comply with a Closing condition, triggering the rights and remedies of the other Party.

The legal positions of the Parties where a Party fails to comply with any of its conditions can be complex, but at the risk of oversimplifying matters, I'll lay out some basic concepts. Please note, however, that sections (a) to (e) below assume that the Parties are Business Owners. Finance Professionals are dealt with in (e) below.

4.2.1 The Ideal.

(a) The Purchaser would like the Acquisition Agreement structured so that, if the Purchaser comes to Closing having complied with all of its conditions, and the Vendor has not, the Purchaser would have the right to either:

(i) treat the Transaction as at an end, demand the return of any deposit paid by the Purchaser, and sue the Vendor for the amount by which the Purchaser's damages exceeds the amount of the deposit, or

(ii) treat the Transaction as remaining in effect, and sue the Vendor for specific performance.

(b) The Vendor would like the Acquisition Agreement structured so that, if it the Vendor comes to Closing having complied with all of its conditions, and the Purchaser has not, the Vendor would have the right to either:

(i) treat the Transaction as at an end, retain the Purchaser's deposit as part payment of the Vendor's damages, and sue the Purchaser for the amount by which the Vendor's damages exceeds the amount of the deposit, or

(i) treat the Transaction as remaining in effect, and sue the Purchaser for specific performance.

4.2.2 The Deposit.

Each Party may feel that, in light of the other Party's ideal position, it is exposed to too much risk if it can't comply with a Closing condition.

(a) The Purchaser might be prepared to forfeit the deposit, provided that the Vendor agrees to abandon any right to sue the Purchaser for any shortfall in the Vendor's damages.

(b) The Vendor might be prepared to accept the deposit and abandon any right to for a shortfall, provided that Purchaser agrees that no part of the deposit, if retained, would constitute a penalty.

4.2.3 Satisfaction.

Each Party will be concerned that the other Party will hold it to an unreasonably high standard in determining whether it has satisfied all of its Closing conditions. It is therefore common for the Parties to agree to act reasonably in this regard.

4.2.4 Control.

Each Party may feel that it's not fair to be exposed to liability if it the fails to satisfy a condition for reasons which were beyond its control. This is a reasonable enough concern, and the Parties will likely be able to agree to language to the following effect: "….unless the reason for the Party's failure to comply is beyond the Party's control …". Each Party, however, may be concerned that this language gives the other Party an easy out, since if the other Party has a change of heart, and doesn't want to complete the transaction, it might not take any steps to satisfy the condition, and thereby abort the transaction. A common reaction by the concerned Party is to insert "reasonable" to the foregoing language, so that it reads, "….unless the reason for the Party's failure to comply is beyond the Party's reasonable control …".

The practical effect of the word "reasonable" in this situation is, I believe, to undermine a Party's right to take any legal action based on the other Party's failure to comply with a particular condition. To be effective, conditions must be clear-cut. I've notice a tendency for Agreements between Business Owner to provide for this "reasonableness" qualification. This may be simply an acknowledgment by Business Owner that they don't want to get into a major battle about a failed condition, and would rather reach a compromise solution.

Instead of resorting to the "reasonableness" language provided above, a preferred solution, I submit, would be to make use of the definition of Best Efforts, set out earlier in this paper, to the following effect: "….unless, notwithstanding the Party's Best Efforts, the reason for the Party's failure to comply is beyond the Party's control …".

4.2.5 Waiver.

Each Party may feel that some of the Closing conditions it must satisfy are minor, and that it shouldn't be exposed to liability if it hasn't complied with a minor Closing condition at the time of Closing. Provided that both Parties feel the same way, they should be able to agree to language to the following effect: "….unless, notwithstanding the other Party's Best Efforts, the reason for the other Party's failure to comply is beyond the other Party's control, or unless the Party has waived in writing compliance by the other Party with any such condition,…".

Some may say that the underlined qualification is meaningless, and provides no comfort to the Parties, since the decision to waive is entirely in the other Party's discretion. This is, of course, true, but the mere fact that the language is included in the Acquisition Agreement shows that the Parties have at least contemplated the possibility that one of them might fail to comply with a condition, so that if I'm acting for one of the Parties, my client can say, with a reasonably straight face, "look, this failure to comply is with respect to a minor matter, and since you turned your mind to the possibility that I might not be in absolute compliance with every condition, why don't you simply waive the failure in writing, and let's get on with it." The other Party, of course, might demand something in return for waiving the Vendor's failure, but my sense of it is that the other Party would demand more from my client in the absence of this qualification.

4.2.6 The Finance Professional.

Finance Professionals will want to resist the compromises suggested in (c), (d) and (e) above. The Finance Professional doesn't ever want to find itself in a position where it can be compelled to purchase or invest, and the Finance Professional won't purchase or invest unless and until every condition has been satisfied.

In practice, the Finance Professional is very solution oriented, which is not surprising, since the Finance Professional didn't get to be a professional by walking away from deals, and will work with the other Party to get the deal done in an acceptable manner, but the Finance Professional won't agree in advance to any language which could compromise its legal rights.

The Business Owner must recognize and accept that, if it is dealing with a Finance Professional and it looks like a Closing condition can't be complied with, the solution proposed by the Finance Professional will always come with a price. The Business Owner can expect to see the price go down, or the closing fee charged by the Finance Professional go up, or the Finance Professional's minimum rate of return over the course of the Transaction go up, or a combination of some or all of those things.

ARTICLE 5 - POST-CLOSING COVENANTS

Post-Closing covenants are things the Parties promise to do after Closing. There are two post-Closing covenants which will be found in virtually every share and acquisition transaction. The covenants deal with access and Taxes.

5.1 Post-Closing Access.

After Closing, the Vendor will still need access to the Target's business premises, the Target's employees and the books and records of the Target (collectively, "Premises, Personnel and Information") for a number of reasons, including the following:

(a) Post-Closing Adjustments.

If the Transaction provides for financial statements to be prepared after Closing, but as at the Closing Date, and for the Parties to pay or receive, as the case may be, the amount necessary to bring the pre-Closing or estimated financial statements into line with these actual Closing Date financial statements, the Vendor will want access to verify any amount which it is required to pay, or is entitled to receive.

(b) Audits.

It is likely that the Vendor and/or the Target will be audited by the federal or provincial government at some point after Closing with respect to Tax years or Tax matters which arose at some time before Closing, when the Target was under the Vendor's control.

(c) Claims.

The Vendor will have indemnified the Purchaser for third party claims and, in a well drafted indemnity, will have negotiated the right to take over the defence of any third party claims in order to control the defence, and the legal costs associated with the defence of the third party claims. In order to effectively defend third party claims, the Vendor will need access to premises, employees and documents.

In the situations noted above, the Vendor wants unlimited access to Premises, Personnel and Information. The Vendor wants to be able to come into the Target's office, talk to whoever the Vendor thinks can help and look at and take copies of whatever the Vendor thinks might be useful.

The Purchaser, however, has a business to run, and is not that interested in the Vendor's problems. The Purchaser wants to minimize interruptions to what is now its bu siness.

The Parties should be able to agree on the following parameters to govern access to Premises, Personnel and Information:

5.1.1 Notice.

The Purchaser is entitled to some advance notice that the Vendor wants access to the Target's Premises, Personnel and Information. Twenty-four hours notice is reasonable in most cases. It is not unreasonable for the Purchaser to require written notice, and, as will be seen under (d), there may be good reason for the Purchaser to require notice in writing.

5.1.2 Business Hours.

Access should be restricted to normal business hours on normal business days. It is not unreasonable to specify those hours, such as from 9:00 a.m. to 5:00 p.m., Monday to Friday, if those are the Target's normal business hours, and provided those days are Business Days. You will have probably defined "Business Days" elsewhere in the Acquisition Agreement.

5.1.3 Cost.

If the Vendor wants copies of documents, the Vendor should pay for them. It is not unreasonable to specify a price, or guideline, for copies; consider what the Law Society allows us to charge our clients for photocopies. A more delicate issue is the cost of management/administrative time. I've not seen many deals where the Vendor is charged for the time a Target employee spends meeting with to the Vendor, or standing at the photocopier. As a practical matter, make sure the Further Assurances clause conforms to the costs arrangements for access.

5.1.4 Scope of Information.

From the Purchaser's perspective, by requiring notice to be in writing is, the Purchaser can require the purpose of the access to be clearly stated in the notice. The Purchaser should be advised to restrict access to this purpose, and not to give the Vendor free reign once it's on the premises. As a practical matter, the Purchaser would want to ensure that the Vendor's confidentiality obligation extends to information received from the Vendor after Closing.

5.1.5 Cooperation.

From the Vendor's perspective, if it is required to give a precise explanation of the nature of the problem which brings it to the Purchaser's door, the Vendor would want the Purchaser to provide, and to cause its Personnel to provide, full cooperation to the Vendor while the Vendor is exercising its access rights.

5.2 Taxes and Tax Returns.

Taxes and Tax Returns will always need to be addressed in Acquisition Agreements. Payment of Taxes for any period before Closing is for the Vendor's account, which should be taken into account in pricing the Transaction. Payment of Taxes for any period after Closing is for the Purchaser's account.

5.2.1 Deemed Year End.

If the Transaction results in a change of control of the Target for purposes of the *Income Tax Act*, it will trigger a year end on the Closing Date for income Tax purposes.

(a) Who Prepares the Tax Returns?

The Vendor's accountants will normally prepare the Tax Returns. This is efficient and cost-effective, since the Vendor's accountants are familiar with the Target's books and records, and it also shields the Purchaser's accountants from finding itself in a conflict position with their client, the Purchaser, by reason of preparing Tax Returns on behalf of the Vendor, should Tax problems arise after Closing.

(b) Right to Review.

It is also normal for the Purchaser and its accountants to be given a reasonable amount of time to review the Tax Returns before they are filed; however, the Vendor should reserve the right to file the Tax Returns without having received comments from the Purchaser or its accountants if to delay the filing would expose the Vendor or the Target to late filing penalties.

(c) Covenant to Pay.

The Vendor must covenant to pay all Taxes applicable to any period of time before the Closing Date. Similarly, the Purchaser must covenant to pay all Taxes applicable to any period of time on or after the Closing Date. The Purchaser should consider holding back, or escrowing, a portion of the Purchase Price to cover an estimate of the Vendor's Tax liability.

5.2.2 Straddle Taxes

Straddle Taxes is a term of art which refers to tax periods which straddle the Closing Date. The legislation governing these types of Taxes does not provide for a deemed year end because of the change of control, and these Taxes will become due and payable without regard to the completion of a Transaction. Each of the Purchaser and the Vendor must agree to pay its share of the Straddle Tax liability, as set out in (c) below.

(a) Who Prepares the Tax Returns?

If a Straddle Tax is due and payable within a relatively short period of time after Closing, it makes sense for the Vendor's accountants to prepare the Straddle Tax Return for the reasons discussed above. This is particularly so if the Transaction provides for an adjustment of the Purchase Price after Closing. As we saw above, the Vendor's accountants will likely be preparing the financial statements for the Target for adjustment purposes, and so should also prepare any Straddle Tax Returns required within that short period of time.

If a Straddle Tax is due and payable two months or more after Closing, there is less reason to have the Vendor's accountants prepare the Straddle Tax Returns. The new accountants should be in a position to efficiently prepare these returns, and by this point, the Purchaser would be happier if its own accountants did so. Furthermore, the Vendor's accountants will have moved on, and won't be able to bring any particular benefit to the exercise.

(b) Right to Review.

The Vendor will now be the one that wants the right to review the Straddle Tax Returns before they are filed, and the Purchaser will want to ensure that it has the right to file the returns in sufficient time to avoid any late filing penalties and interest, regardless of whether the Vendor has provided any comments.

(d) Covenant to Pay.

The Vendor must covenant to pay all Taxes applicable to any period of time before the Closing Date. Similarly, the Purchaser must covenant to pay all Taxes applicable to any period of time on or after the Closing Date. The Purchaser should consider holding back, or escrowing, a portion of the Purchase Price to cover an estimate of the Vendor's Tax liability.

ARTICLE 6 - SURVIVAL AND INDEMNITIES

6.1 Survival

Survival periods have been a vexed issue since the *Limitations Act, 2002* (Ontario) (the **"Act"**) came into force on January 1, 2004. The Act reduced the limitation period for contracts from six years to two years for things which a Party should have discovered, and provided for an ultimate limitation period of 15 years for things you reasonably couldn't have discovered within the 2-year period. Furthermore, the Act forbade the Parties from altering the two-year period.

The Act caused great consternation amongst commercial lawyers, since a two-year survival period for representations, warranties and covenants which were capable of being discovered was considered wholly inadequate for commercial transactions.

The Act was amended effective October 19, 2006 (the **"2006 Amendments"**). The 2006 Amendments kept the basic 2-year limitation period and the ultimate 15-year limitation period, and it allowed the Parties to a "business agreement" to exclude, suspend, shorten or lengthen the basic 2-year limitation period, but not the ultimate 15-year limitation period.

6.1.1 "Freedom" to Extend Survival Period.

As a result of the 2006 Amendments, the Parties are now "free" to negotiate the length of the survival period for representations, warranties and covenants under an Acquisition Agreement, although since the world did not come to end for Purchasers during the period from January 1, 2004 to October 19, 2006, one wonders why a Vendor would now agree to a longer survival period. If representations and warranties are supposed to be the Purchaser's "insurance policy", the "policy premium" could perhaps be pushed up, by way of a higher price, if the Purchaser wants more than two years of "policy coverage".

6.1.2 Post-Closing Covenants.

One consequence of the mandatory two-year survival period was that drafters of Acquisition Agreements took care to distinguish between pre-Closing and post-Closing covenants. Pre-Closing covenants merge into the Closing, subject to the survival period, but post-Closing covenants do not, and are subject only to the 15-year ultimate limitation period under the Act. The Purchaser would want to preserve that structure, and arguably

should be entitled to insist on that, as there is no reason why a Vendor should be able to refuse or fail to do something it promised to do after Closing. Vendors will, of course, try to limit the length of time it is under that obligation.

6.2 Indemnification

The Acquisition Agreement frequently provides for indemnity rights which, in the circumstances provided in the Acquisition Agreement, will enable a Party to launch a claim for indemnity against the other Party at any time during the survival period.

6.2.1 Indemnity vs. General Contract Remedies.

(a) Broader Range of Damages.

Indemnities are used in Acquisition Agreements because a Party who is entitled to claim indemnity can recover a broad range of damages. In the absence of a right to claim indemnity, the aggrieved Party would have to claim damages under general contract principles, meaning that the damages must have been reasonably foreseeable, as originally set out in *Hadley v. Baxendale*. Under an indemnity, foreseeability, reasonable or otherwise, is not the issue; the issue is, "what damages did the Party suffer". This enables the indemnified Party to claim economic losses (such as lost profits), punitive and special damages, all legal and other costs and disbursements, and the value of management time lost as a result of event giving rise to the claim.

(e) Easier Proof of Damage.

Because foreseeability is not relevant, it is generally easier for the indemnified Party to prove damages.

6.3 A Negotiating Suggestion

6.3.1 The Purchaser's Need

While indemnities under Acquisition Agreements are often mutual, the Party bringing an indemnity claim is usually the Purchaser. All the Vendor wants is to get paid on Closing, but the Purchaser has to earn back what it paid through profits generated by the Target over a reasonable period of time, and so the Purchaser relies heavily on the Vendor's representations and warranties and covenants. A Purchaser of the Target is therefore entitled to ask for and receive robust representations and warranties, and it is clearly in the Purchaser's interest to have an unlimited right of indemnity which it can exercise for as long as legally possible.

6.3.2 The Vendor's Need

The Vendor also has a legitimate interest to consider. The Vendor wants to bring closure to its exposure from the Target, and is concerned that the Purchaser will nibble away at the Vendor's proceeds of sale with a number of small issues which, in the Vendor's mind, any reasonable Business Owner would regard as part and parcel of business life, and not vendettas to be

pursued. The Vendor's need is to move on after Closing with a sense of security and finality regarding the business sold.

6.3.3 A Realistic Package Deal

If we return for a moment to the comments made under Article 3 of this paper, I think we would all agree that, no matter how carefully we draft definitions of knowledge and materiality, these concepts always involve an element of uncertainty. One of the most important roles lawyers play in acquisition transactions is to reduce risk for our clients, and where there is uncertainty, there is risk. This is not to suggest that we should dispense with the concepts of knowledge and materiality: representations and warranties must be true, and these concepts help honest, conscientious people to make statements which are true.

If, however, the Vendor and the Purchaser understand the each other's needs, that it may be possible to structure a package along the following lines:

(a) Acceptance of Representations and Warranties.

The Vendor basically accepts the Purchaser's proposed representations and warranties (except for those which are clearly inappropriate).

(b) Objective Knowledge.

The Vendor accepts an objective definition of knowledge.

(c) Materiality Quantified.

The Vendor accepts a numbers-based definition of materiality.

(d) "True Deductible".

The Purchaser accepts an indemnity with a "true" deductible. A "true" deductible provides that the Purchaser has no right to recover any money from the Vendor under the indemnity for breaches of representations and warranties unless and until the Purchaser's damages from the breaches exceed, for example, $100,000. One damages exceed $100,000, the Purchaser can begin to recover its damages, but only that portion of the damages which exceeds $100,000.

The Purchaser's need is addressed because the knowledge definition has forced the Vendor to look hard to see if the representations and warranties are true before the Vendor can avoid liability, and the numbers-based definition of materiality brings certainty to the representations and warranties.

The Vendor's need to be free from quibbling claims is addressed because it has no liability for breaches until the value of the breaches reaches $100,000, and then only for the excess.

6.3.4 Indemnity Caps

If acting for the Vendor, it may also be possible to negotiate a cap on the Vendor's liability under the indemnity. Depending on the type of business the Target carries on, and the results of the

Purchaser's due diligence, the Purchaser might agree to cap the amount it can recover under the indemnity to a percentage of the purchase price. This will enable the Vendor to sleep a little better at night, knowing that even in a worst-case scenario, the Vendor will be able to retain a portion of the proceeds of sale.

On the face of it, there is logic to capping the indemnity at the amount the Vendor receives for the Target. After all, the Vendor didn't sell the business in order to wind up in a negative position. From the Purchaser's perspective, however, damages resulting from environmental or products liability claims arising after Closing bear no relationship to the Purchase Price of the Target, and could leave the Purchaser responsible for damages from these types of claims vastly in excess of the Purchase Price. Accordingly, if the Target is in a business with environmental hazards, or that manufactures consumer products, the Purchaser may not be prepared to accept a cap on the indemnity.

ARTICLE 7 - GENERAL CONTRACT PROVISIONS

These sections of the Acquisition Agreement are usually lumped together at the end of the agreement, under the anodyne name of "Miscellaneous", and are often referred to by lawyers and clients alike as "boilerplate" or "legalese". When reviewing Acquisition Agreements, it is sometimes hard to resist the feeling that, just like this presentation, we're on the home stretch, so let's just eyeball the provisions and get back to the meat of the Acquisition Agreement.

While it is true that General Contract Provisions are not the most hotly negotiated parts of an Acquisition Agreement, they can contain traps or surprises for the unwary. I'd like to finish my paper with comments on two frequently encountered General Contract Provisions: the Notice clause and the Entire Agreement clause.

7.1 Notice

No one cares about the notice provision until one Party faxes an indemnity claim at 8:00 p.m. on the Friday of a long weekend to someone at the other Party who left at noon that day for two weeks vacation. By the time the dust settles, and the right people are alerted to the claim, you're probably looking at the following Wednesday at the earliest before much can be done about answering the claim

When drafting or reviewing notice clauses, consider or be alert to the following:

7.1.1 Defining Notices.

The typical notice provision begins with language to the following effect "any notice, demand or other communication…". Acquisition Agreements usually contain several defined notices, such as Notice of Claim in the indemnity section. Consider defining Notice to mean "any notice, including a Notice of Claim, demand or other written communication …". This brings clarity to the Acquisition Agreement and, since we assuredly intend to be dealing with written notices, we should say so.

7.1.2 Means of Delivery.

Notice provisions refer to all or some combination of:

(a) Personal delivery.

(b) Delivery by courier.

(c) Delivery by registered mail.

(d) Delivery by facsimile or other means of electronic communication.

(e) Delivery by regular mail.

7.1.3 When Deemed Given or Received.

(a) For personal delivery, the "person" should be specified by title, such as an officer of the Party, or its President, or the General Counsel. If a Notice is important, you want to be sure that it is received by someone in authority.

(b) For delivery by courier, the Notice provision should be deemed to have been given when consigned to the courier, which is when the courier representative signs for the envelope at the Party's office or mail room.

(c) For delivery by registered mail:

(i) The Notice provision should be deemed to have been given when postmarked, and the Notice should provide for confirmation of delivery by the post office. The post office's confirmation date should be deemed to be the delivery date of the Notice.

(ii) Ensure that any registered mail charges are to be prepaid.

(d) For delivery by facsimile or other means of electronic communication:

(i) The Notice provision should provide for testing of the fax machine before the Notice is sent, and the date of the transmission confirmation produced by the sender's machine should be deemed to be the date and time the Notice was given.

(ii) The Notice provision should provide that the Notice, if transmitted before 4:00 p.m. on a Business Day, is deemed to have been received on that day (the 4:00 p.m. deadline should give enough time for the Notice to actually be delivered to the addressee before the end of the working day), otherwise the Notice should be deemed to have been received on the next Business Day.

(iii) My preference would be to delete "or other means of electronic communication", which means e-mail. If your client's e-mail is not read by someone else in the client's absence, the client may not see the Notice until after the Notice has been deemed to have been received.

(e) For delivery by regular mail, provide that the Notice is deemed to have been received when actually received. This is not a recommended way to deliver a Notice.

7.2 Entire Agreement

The purpose of the Entire Agreement clause is to prevent the use of oral or other extrinsic evidence to alter the written terms of the Acquisition Agreement. There are cases which allow extrinsic evidence to be admissible in the teeth of an Entire Agreement clause, but that is for the litigators to worry about. As a commercial drafter, my advice to clients is that the Entire Agreement clause will render "side letters" unenforceable, so that if the clients want something to be enforceable, it has to be in the Acquisition Agreement.

It is a good idea to define precisely what we mean by the term "agreement", so that when "agreement" is used in the Entire Agreement, it really is the entire agreement. This can be done in the following way:

(a) Define "Acquisition Agreement".

The Acquisition Agreement should be defined to mean the Disclosure Schedules and the Exhibits, as they may be amended in writing by the Parties from time to time.

(b) Disclosure Schedules.

Disclosure schedules are used to qualify or supplement the representations and warranties set out in the Acquisition Agreement. Each disclosure schedule is numbered to correspond to a specific section of the Acquisition Agreement. The disclosure schedules should be listed in a section of the Acquisition Agreement and they should be stated to be the disclosure schedules attached to the Acquisition Agreement and that they form an integral part of the Agreement. Lastly, the term "Disclosure Schedules" should be defined to mean the disclosure schedules set out in the particular section of the Agreement.

(c) Exhibits.

The same procedures should be followed for exhibits, culminating in a defined term "Exhibits". The exhibits to an Acquisition Agreement are usually the forms of other agreements or instruments which are important to the transaction, such as employment agreements, consulting agreements, releases and restrictive covenants. The forms of these agreements may not actually be settled until Closing, so it is customary to describe them as being substantially in the form of the agreements attached to the Acquisition Agreement as exhibits.

(d) Letter of Intent.

It is wise to exclude from the Acquisition Agreement any letter of intent signed by the Parties, as the business terms of the of the Acquisition Agreement will have superseded them. As you are aware, there are always some portions of a non-

binding letter of intent which the Parties express to be binding, such as confidentiality provisions. Those provisions should be carried forward into the Acquisition Agreement.

(e) Confidentiality Letter.

Further to (d) above, if the Parties signed a confidentiality agreement in connection with the Transaction which is separate from the letter of intent, and the language of the confidentiality agreement has not been carried forward into the Acquisition Agreement, then the confidentiality agreement should be attached to the Acquisition Agreement as an exhibit, and the Acquisition Agreement should specifically incorporate the confidentiality agreement into the terms of the Acquisition Agreement by reference.