FROM THE CHAIR

By Nat Doliner

Our stand alone meeting in Montreal is a sellout, with a record breaking attendance, and promises to be one of the best meetings we have ever had. We hope you will be joining us in Montreal. We have acknowledged in our mailing for the stand alone meeting the tremendous effort of our host committee members and their law firms in making this meeting a very memorable one. I would like to thank them once again.

Our Committee’s task forces have some incredibly talented and energetic members. I am always impressed with the level of discussions and quality of written product that has been and is being produced by the task forces.

Our Joint Venture Task Force (chaired by Tom Hyman and Alison Youngman) is well on the way to producing a joint venture agreement with commentary. They have been having very stimulating discussions about a number of complex issues with respect to the structure and life cycle of a joint venture. In addition to the expertise of our M&A attorneys, the task force has recruited some partnership and tax experts such as George Coleman, Allan Donn and Bob Keatinge. There is still plenty of work left to be done as the task force begins writing commentary for the agreement. If you have an interest in joint

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ventures, I am confident that you will enjoy participating on this task force.

The Task Force on Acquisition Practice and Process (chaired by Tom Thompson and Vince Garrity) has gotten off to a great start. The task force will produce a manual on a number of topics concerning the process of doing a merger and acquisition transaction. This manual will supplement and complement our other published materials. The task force had a great meeting at the ABA convention in New York with a lot of interesting discussions.

If you practice in the area of acquisitions of public companies, you will find many of the leading practitioners in the field on the Public Company Task Force (chaired by Steve Knee and Diane Frankle). The task force met in New York at the offices of Wachtell, Lipton, Rosen and Katz with Committee member and Wachtell partner, David Katz, hosting the meeting. The task force is making great progress toward completing a model public company acquisition agreement with commentary. The discussion at the task force meetings is always at a very sophisticated level.

The Stock Purchase Agreement Task Force (chaired by Robert Harper) is revising the Model Stock Purchase Agreement with commentary and preparing a seller’s response document. These two endeavors will provoke a lot of lively debates in the task force meetings as to the various negotiating positions taken by buyers and sellers in these types of deals. If you are interested in getting in on the ground floor of this great project, you should check out this task force.

The International Transactions Task Force (chaired by John Leopold and Guy Weijer), in addition to its terrific written products, continues to present programs of high quality at the ABA annual conventions. At this year’s bifurcated annual convention in New York and London, the task force presented or co-sponsored three programs that were very extremely well done.

Our special thanks to Henry Lesser and Daniel Rosenberg for their efforts in planning and coordinating these programs.

Our Committee continues to be instrumental in presenting programs at meetings of the ABA Business Law Section, satellite broadcasts of CLE programs, and in sponsoring or participating in national and international institutes. Our 5th Annual National Institute on Negotiating Business Acquisitions (co-sponsored with the ABA Tax Section) will take place in Boca Raton, Florida, on November 6 and 7. Members of our Committee are also participating in an ABA National Institute on International Ventures in San Francisco on November 16 and 17.

Finally, several of our members will participate in a mock stock purchase agreement negotiation at the American Corporate Counsel Association annual meeting this Fall.

I know of no other committee in the bar that is as productive. I am also of the belief that no other committee has better dinners or social events, or nicer members. Thank you for your interest in and participation on the Committee.

FEATURE ARTICLES

Negotiating the Public Company Merger: Understanding the Key Issues
Part I -- The “Standstill” Agreement

INTRODUCTION

This article is derived from a program entitled “Negotiating the Public Company Merger: Understanding the Key Issues,” presented at the
Committee on Negotiated Acquisitions
“Committee Forum” on July 9, 2000 at the Annual Meeting of the American Bar Association’s Section of Business Law in New York City. The format of the article is a mock negotiation between counsel for a publicly held acquiring company and counsel for a publicly held target in a typical, stock-for-stock merger. This article contains Part I of the mock negotiation and consists of an edited transcript of the first half of the Committee Forum presentation. The article focuses on the negotiation of a “standstill” provision – a key provision often included in the confidentiality agreement between the parties. We will publish Part II of the program in a subsequent Deal Points issue, which will highlight some of the meatier issues in the negotiation of the definitive merger agreement itself. The participants in both Parts I and II are all partners who have made a career of specializing in this complex practice area and who work for law firms with highly developed public company M&A practice groups. We think you will find their insights and practice pointers interesting and useful.

“STANDSTILL” AGREEMENT MOCK NEGOTIATION

MODERATOR (RICK CLIMAN): My name is Rick Climan. I head the Mergers & Acquisitions Group at Cooley Godward, based in California’s Silicon Valley, and I will serve as the moderator of today’s program. Our additional panelists today are Joel Greenberg from Kaye, Scholer, Fierman, Hays & Handler, LLP here in New York; Keith Flaum from the Palo Alto office of Cooley Godward, LLP; David Katz from Wachtell, Lipton, Rosen & Katz here in New York; and Diane Frankle from the Palo Alto office of Gray, Cary, Ware & Freidenrich.

We’re going to set things up today as a mock negotiation of a hypothetical acquisition, with David Katz and Diane Frankle playing the role of counsel for the publicly held acquiring company, and with Joel Greenberg and Keith Flaum playing the role of counsel for the publicly held target company. Our transaction structure is a classic one-step, stock-for-stock merger, with our acquiring company considerably larger than our target company.

We begin today at the beginning, before a draft of the definitive merger agreement has even been produced. We’re going to assume that the target company’s counsel – Joel Greenberg and Keith Flaum – have proffered their standard form of confidentiality agreement to the acquiror. Only this one contains a provision that you normally don’t see in a privately-held company’s form of confidentiality agreement: a “standstill” provision. Here is what Joel and Keith have offered up on behalf of the target company:

“During the three-year period commencing on the date of this letter agreement (the “Standstill Period”), neither the Prospective Acquiror nor any of the Prospective Acquiror’s Representatives will, in any manner, directly or indirectly:

(a) make, effect, initiate, cause or participate in (i) any acquisition of beneficial ownership of any securities of the Target or any securities of any subsidiary or other affiliate of the Target, (ii) any acquisition of any assets of the Target or any assets of any subsidiary or other affiliate of the Target, (iii) any tender offer, exchange offer, merger, business combination, recapitalization, restructuring, liquidation, dissolution or extraordinary transaction involving the Target or any subsidiary or other affiliate of the Target, or involving any securities or assets of the Target or any securities or assets of any subsidiary or other affiliate of the Target, or (iv) any “solicitation” of “proxies” (as those terms are used in the proxy rules of the Securities and Exchange Commission) or consents with respect to any securities of the Target;
(b) form, join or participate in a “group” (as defined in the Securities Exchange Act of 1934 and the rules promulgated thereunder) with respect to the beneficial ownership of any securities of the Target;

(c) act, alone or in concert with others, to seek to control or influence the management, board of directors or policies of the Target;

(d) take any action that might require the Target to make a public announcement regarding any of the types of matters set forth in clause “(a)” of this sentence;

(e) agree or offer to take, or encourage or propose (publicly or otherwise) the taking of, any action referred to in clause “(a)”, “(b)”, “(c)” or “(d)” of this sentence;

(f) assist, induce or encourage any other Person to take any action of the type referred to in clause “(a)”, “(b)”, “(c)”, “(d)” or “(e)” of this sentence;

(g) enter into any discussions, negotiations, arrangement or agreement with any other Person relating to any of the foregoing; or

(h) request or propose that the Target or any of the Target’s Representatives amend, waive or consider the amendment or waiver of any provision set forth in this section.

The expiration of the Standstill Period will not terminate or otherwise affect any of the other provisions of this letter agreement.”

MODERATOR (RICK CLIMAN): If you take a look at this “standstill” language, you’ll see that it’s very broad. The provision is designed to prevent, for a period of three years after the confidentiality agreement is signed, virtually all forms of coercive and quasi-coercive conduct, from outright hostile tender offers and hostile proxy fights to somewhat less aggressive, but still potentially coercive, types of behavior, including “bear hugs” and simple open-market acquisitions of stock in the target company.

Let me begin by posing a question for Joel, one of the authors of this “standstill” provision. What’s the rationale for including a provision like this in a confidentiality agreement, and why do you need something so broad?

COUNSEL FOR TARGET (JOEL GREENBERG): Well, I think the rationale is very simple. As you said, this occurs at the beginning – at a time when the potential acquiror has made no commitments whatsoever to the target company. There’s no agreement to do an acquisition, and the potential acquiror has asked for access to the target company’s nonpublic information in order to work on a negotiated and consensual proposal to buy the target company. This “standstill” provision is intended to say that, having started down the road of a negotiated and consensual proposal, we – the target company – want it to stay that way. The price of access to this information is participation in a board-managed process without the ability to move to a hostile acquisition. The target company doesn’t want to facilitate an unsolicited offer by providing confidential information that can be used against it.

MODERATOR (RICK CLIMAN): Just to get a sense for why the “standstill” provision needs to be so broad, Keith, I see that the last clause – clause “(h)” – provides that the prospective acquiror can’t even request, on a friendly basis, a waiver of the “standstill” provision. Why do you need to go so far?

COUNSEL FOR TARGET (KEITH FLAUM): A couple of reasons. First of all, the target company doesn’t want the potential acquiror to take any action that might require the target company to make a public announcement, because then the target company could be put in play
before we want it to be. So we want to be careful that the potential acquiror doesn’t make a request or take any other action that would require a public disclosure. Also, as Joel said, we want to be able to control the process and we don’t want to put the target board in the uncomfortable position of having to analyze the request for a waiver. If we want somebody to come in, then we will certainly invite them to come in and participate in negotiations.

MODERATOR (RICK CLIMAN): So, Diane and David, your client, the prospective acquiror, is talking on a very congenial and friendly basis about the possibility of acquiring the target company. I see that you have prepared an outline of your response to the “standstill” provision proffered by the target company’s lawyers. Let’s take a look at it:

RESPONSE BY ACQUIRING COMPANY TO “STANDSTILL” PROVISIONS PROPOSED BY TARGET COMPANY

- Shorten duration of “Standstill Period” to 180 days
- Delete references to “affiliate” of Target
- Replace “Representatives” with “subsidiaries”
- Add the following sentence:

“Notwithstanding anything to the contrary contained in this letter agreement, if, at any time during the Standstill Period,

(i) a third party (A) “commences a tender offer” (within the meaning of Rule 14d-2 under the Securities Exchange Act of 1934) for at least 50% of the outstanding capital stock of the Target or (B) commences a proxy contest with respect to the election of any directors of the Target, or

(ii) a third party enters into an agreement with the Target contemplating the acquisition (by way of merger, tender offer or otherwise) of at least 50% of the outstanding capital stock of the Target or all or substantially all of the Target’s assets,

then (in either of such cases) the restrictions set forth in this section __ shall immediately terminate and cease to be of any further force or effect.”

MODERATOR (RICK CLIMAN): Why don’t you walk us through your response and tell us what you find objectionable about the “standstill” language that’s been proffered by Joel and Keith.

COUNSEL FOR ACQUIROR (DIANE FRANKLE): Sure Rick. First of all, it seems to us that a three-year term for this kind of a “standstill” provision is really beyond what you would normally expect to see, especially given how tightly it’s drafted. At this point, the target company has not been willing to sign a “no-shop” agreement – an exclusivity agreement – and our client, the prospective acquiror, is coming in and spending a considerable amount of time and money on this without the assurances that a “no-shop” would provide. We don’t know whether there is a deal here for our client, and we just don’t think that this “standstill” provision is an appropriate restriction for that length of time. A more reasonable period of time for this type of agreement would be six months.

COUNSEL FOR TARGET (JOEL GREENBERG): We can certainly talk about the
duration, although six months is kind of short. It seems to me that one guidepost for how long the “standstill” period should run is how long the information the target company is giving your client will have significance. At some point I think that we would agree that the confidential information we provided is no longer terribly helpful to making a bid. Six months is too short, though. As another benchmark, we need enough time to let a board-managed process play out. Again, I think six months is a bit short for that. We might be willing to compromise more in the two-year area.

COUNSEL FOR ACQUIROR (DAVID KATZ): Joel, on your first point, the rest of the confidentiality agreement deals with keeping the information confidential, and it’s going to protect the target company for more than six months. If the prospective acquiror misuses or improperly discloses any of your client’s sensitive information, nine or twelve months down the road, then your client will have an action against the prospective acquiror under the confidentiality provisions of the agreement. Therefore, these arguments do not support your position on the duration of the “standstill.”

COUNSEL FOR TARGET (JOEL GREENBERG): I’m glad to hear that you’re comfortable with the confidentiality provisions in the agreement we served up, but we don’t really expect a potential acquiror like your client to be able to compartmentalize its decision-making process that easily. You’re going to make some valuation and synergy judgments based on our confidential information and I don’t think it’s reasonable to assume that you can be a little schizophrenic and put those out of your mind should you decide to go hostile.

COUNSEL FOR TARGET (KEITH FLAUM): We think the use restriction and the fact that it’s tied to a negotiated transaction is very helpful, Rick. But we want to be absolutely sure that there can’t be any hostile or quasi-hostile action. And we don’t want to fight over whether or not the prospective acquiror is misusing the information. We want “standstill” restrictions that are straightforward and unambiguous.

MODERATOR (RICK CLIMAN): Let me ask each of you to step out of character for a moment. Joel, David, Diane, Keith – when you finish negotiating the duration of the “standstill” provision, where do you typically end up?

COUNSEL FOR TARGET (GREENBERG): Most typically I think you would see it somewhere between one and two years. It’s likely to come out at the shorter end when you’re trying to get a deal done quickly and the target has significant leverage. But six months is very short, and three years is unusually long. I think we all agree on that.

COUNSEL FOR ACQUIROR (DAVID KATZ): I think Joel is correct. I think the more normal term is in the eighteen-month to two-year range, but I certainly do see “standstills” outside that timeframe. It also depends on what the context is. If it’s an auction-type process where the target company is trying to hold everybody to the same
limitations and really wants a controlled process, you don’t want anybody stepping outside the process. In this type of controlled auction, the target company probably has a much better argument for whatever period it sets and whatever “standstill” provision it’s going to impose because it can say it’s making all the bidders toe the same line. Bidders who want access to this process often will agree to a longer “standstill”, as long as it’s clearly required for all of the players. Contrast this with the situation where it’s a one-off transaction and the parties are just trying to see if they can put together a deal. Then, absent some type of exclusivity or “no-shop” agreement between the parties (and often there isn’t such an agreement), the potential acquiror is not usually willing to agree to a “standstill” like this if it has any real length of time to it. If somebody comes in on an unsolicited basis or the target company is otherwise put into play, our client is going to have to compete with other bidders. It wants to be sure it won’t be foreclosed or have to rely on the target’s board of directors to decide unilaterally to waive the “standstill”, especially where, as here, the “standstill” would prevent our client from even asking for a waiver.

MODERATOR (RICK CLIMAN): David, you mentioned something that I’d like to explore a little further. In your experience, is the trade-off between a “standstill” provision and a “no-shop” provision a typical one? In other words, do you often see the “standstill” provisions considered in tandem with a request by the prospective acquiror for an exclusivity provision that precludes the target company from talking to anyone else about an acquisition for some period of time?

COUNSEL FOR ACQUIROR (DAVID KATZ): I think you often see the two tied together. A potential acquiror is more willing to entertain a request for a “standstill” if it knows it’s being given a leg-up via exclusivity. However, exclusive “no-shop” agreements are not very common at all for public companies and, if they are given, are usually for a very limited duration (like two weeks).

Let me mention a few other points on the topic of “standstills.” In some situations -- for example, where the target company is in a consolidating industry -- nobody really knows what’s ultimately going to happen. Companies in today’s world often are very unwilling to limit themselves to a “standstill” or a “no shop” for any real length of time because they just don’t know what is going to happen among their competitors and they really have to be free to deal with a variety of situations.

Another thing a prospective acquiror presented with a request for a “standstill” ought to be concerned with is what happens if the target company is acquired by someone else down the road. Are you now going to have a “standstill” that is going to apply perhaps twelve months down the road and is even broader in that it now applies to the merged company?

Something else that comes up in this context is how to advise the client whose attitude is “Let’s not fight it. Let’s go ahead and sign the ‘standstill’ since we can always just breach it.” And frankly there have been some cases where people breach “standstills” and, at the end of the day, the target company doesn’t sue. If the target company is “in play” it is very difficult to actually litigate one of these “standstill” provisions. The forum is very public, and the target company fears it would be seen as keeping its shareholders away from what may be a better offer. But even though the target company may decide not to litigate, as the lawyer for the potential acquiror you should counsel your client that if it proceeds to breach a “standstill,” then the next time around when your client is negotiating one of these provisions with another target, that target may not be willing to give your client any confidential information at all because your client may be seen as untrustworthy based on its past behavior. So it’s too easy an answer for a prospective acquiror to say “we can
decide later on the ‘standstill’ issue because we can always just breach the ‘standstill.’” That approach can have a detrimental business impact on the prospective acquiror.

MODERATOR (RICK CLIMAN): Still, the target company’s counsel should let his or her client know that these “standstill” agreements don’t always stand up in court – that a bidder’s lawyer may successfully defend a suit brought to enforce an executed “standstill” agreement simply by raising the question of what damages are being caused by the bidder’s breach of the agreement.

COUNSEL FOR ACQUIROR (DAVID KATZ): I agree that putting the target in the position of having to argue that a court should enjoin an offer that’s clearly superior to the one on the table is difficult; it’s not a case I would find very attractive to bring on behalf of a target company, even though it may be legally correct.

COUNSEL FOR TARGET (KEITH FLAUM): Incidentally, what we often do if a prospective acquiror refuses to sign a “standstill” is to stage the disclosure of information so that we will give some not-so-sensitive information about the target company early on and, as the prospective acquiror looks to be more interested, provide more sensitive information in progressive steps.

COUNSEL FOR ACQUIROR (DIANE FRANKLE): There are some other problems with this “standstill” provision beyond the unreasonable term. Let’s discuss the issue of whom the “standstill” is meant to apply to. As drafted, it applies not only to the target company, our client, but also to “Representatives” of our client. The definition in the target company’s draft provides:

“For purposes of this letter agreement, a party’s ‘Representatives’ will be deemed to include each Person that is or becomes (i) a subsidiary or other affiliate of such party, or (ii) an officer, director, employee, partner, attorney, advisor, accountant, agent or representative of such party or of any of such party’s subsidiaries or other affiliates.”

If you look at the definition of “Representatives” it appears to us, for example, that if an employee of our client’s subsidiary located in France, knowing nothing about this deal, happens to buy a share of target company stock, then our client will breach the “standstill.” I think that’s really too broad and we really ought to think about a limitation there. It may be appropriate for certain of our client’s officers and directors to be held accountable here, but not too many people beyond that.

COUNSEL FOR TARGET (JOEL GREENBERG): But Diane, shouldn’t the prohibition extend at a minimum to the same class of people that the prospective acquiror is authorized to disclose the target company’s sensitive information to? And I suspect that in your response to our draft of the confidentiality agreement you’re going to ask for permission to disclose the information to your client’s “Representatives.” I can understand trying to exempt insignificant open-market purchases by people who are totally away from the transaction process, and I don’t think that will be a problem to work out. But I do think that anybody who gets into the process has got to be caught up in this...

COUNSEL FOR ACQUIROR (DAVID KATZ): Then Joel, are you saying that this “standstill” restriction should apply to our client’s investment banker, who is clearly a “Representative” of our client and who trades in securities of the target company every day? That’s obviously not going to be acceptable.

COUNSEL FOR TARGET (JOEL GREENBERG): No. I think there you can come up with an appropriate carve-out. The investment bankers are going to need “Chinese wall” provisions anyway if they’re going to continue to
trade in the target company’s stock. I don’t think my client would be terribly offended by normal market-making activities.

MODERATOR (RICK CLIMAN): David and Diane, isn’t there another, related problem with this “standstill” language? The “standstill” provision forbids not only any acquisition of securities of the target company itself, but also any acquisition of securities of the target company’s “affiliates.” It’s one thing if the term “affiliates” is taken to refer only to downstream subsidiaries and other entities controlled by the target company, but we all know that the term “affiliates” can be construed very broadly. It may well be interpreted to cover significant shareholders of the target company, such as venture capital funds and other entities that may hold a 15 or 20% block of the target company’s stock and may have representation on the target company’s board. So a bidder that signs a “standstill” in this form can be deemed to breach it merely by investing in one of these upstream entities. And David, doesn’t this also tie into an issue you raised earlier – the issue of what happens if the target company gets acquired by another public company that thereby becomes an upstream “affiliate”?

COUNSEL FOR ACQUIROR (DAVID KATZ): It does, and you are correct in pointing out that you have to look very carefully at what the “standstill” really applies to – which companies’ securities and exactly what actions it covers. The target company’s initial draft of these types of provisions tends to be overbroad. As counsel for the prospective acquiror, you’ve got to really focus on these provisions and think about them in different contexts. As drafted, the “standstill” restriction likely applies to the stock of these current and future upstream entities. It’s hard for the target company, I would think, to justify why it should be entitled to this type of protection. The rationales that Joel and Keith gave earlier wouldn’t seem to apply to these scenarios.

COUNSEL FOR TARGET (JOEL GREENBERG): I think it depends a lot on the factual context. You can conceive of situations where the upstream affiliate is so closely tied to the target company that it’s not unreasonable to seek a “standstill” that applies to acquisitions of the upstream affiliate’s stock.

COUNSEL FOR ACQUIROR (DIANE FRANKLE): Another issue here is that this “standstill” provision ties our client’s hands in a case where a third party comes along and puts the target company in play. At that point, we’ve spent a lot of time thinking about this acquisition, and our client would want to be able to participate freely in a bidding contest and go forward with an offer. So if the target company is in play, I think you would agree with me that this “standstill” provision should just terminate and fall away, as I’ve provided in the “fall away” provision I’ve provided for your consideration.

COUNSEL FOR TARGET (KEITH FLAUM): Well I don’t think so Diane. If the target company is put into play because some third party takes some hostile action, we can easily fend that hostile third party because that party doesn’t have the same access to our sensitive information that your client does. Now it might be that the target company would want to invite your client in at that point in time because we want to negotiate a deal with your client. But as Joel was saying earlier, the critical thing here is for the target company’s board to be able to control that process.

MODERATOR (RICK CLIMAN): If I may interject here, this is one issue that seems to come up in virtually every “standstill” negotiation. On one side, you have the prospective acquiror – often in a consolidating industry where there may be only two or three other players – saying to the target company, “Look, I don’t want to be the poor fool standing on the sidelines with my hands tied by this overbroad ‘standstill’ agreement while you negotiate a deal with one of my hated
competitors.” On the other side, you have the target company making the arguments that Keith and Joel have been making here today.

As I look at Diane’s “fall away” language, I note that there are really two separate triggers – two separate situations in which the prospective acquiror is seeking to have the “standstill” restrictions terminate. One is the hostile tender offer made by someone else. Here Keith has made the persuasive argument that one of the best defenses a target company has against a hostile tender offer is the fact that the hostile bidder hasn’t had the opportunity to do consensual due diligence on the target company. But letting a third party’s hostile bid give a once-friendly bidder – a bidder that has had the opportunity to do thorough due diligence on the target company – the ability to become a hostile bidder can be very dangerous, so this particular prong of the “fall away” can often be successfully resisted by a well-advised target company.

The second trigger in the “fall away” language proffered by Diane is the target’s execution of a definitive acquisition agreement with another acquiror – a definitive agreement that presumably will be protected through the use of traditional arrangements in the form of a “break up” fee, a “lockup” option and other customary contractual deal protection measures. Joel, what’s wrong with having the “standstill” fall away under these circumstances? Why wouldn’t you allow Diane’s client to lob in a competing bid, subject to the payment of the “break-up” fee provided for in the existing definitive agreement?

COUNSEL FOR TARGET (JOEL GREENBERG): I’d make this observation. If my client – the target company – is conducting an auction, it will want to give Diane’s client every motive to put its best deal on the table during the auction process. As the target’s counsel, I don’t want any prospective acquiror to hold something in reserve thinking it can come back and top its original bid later if it is not the successful bidder. If my client is talking to a bunch of potential acquirors, my client would like to try to squeeze the best price out of each of them during the process.

MODERATOR (RICK CLIMAN): Let me ask just a couple of additional questions before we move off the topic of “standstills.” Suppose the two parties represented here today – the target company and the acquiror – come together and actually negotiate a definitive agreement contemplating the acquisition of the target company by the acquiror in a stock-for-stock merger. There’s traditionally a provision in that definitive acquisition agreement stating that the pre-existing confidentiality agreement between the two parties – which we can assume includes a “standstill” provision – will survive the execution of the definitive acquisition agreement and will remain in effect thereafter. After all, there’s no assurance that the acquisition is ultimately going to be consummated, and the target company has a strong interest in continuing to maintain the confidentiality of its sensitive information. David, as counsel for the acquiring company, would you seek to include an additional clause in the definitive acquisition agreement clarifying that the “standstill” portion of the confidentiality agreement will not survive, but rather will fall away once the definitive agreement has been signed? Obviously, if a third party later comes in with a competing bid, this would allow your client to continue to “play in the game.”

COUNSEL FOR ACQUIROR (DAVID KATZ): It depends. Target companies that insist on having the board control the process often resist this. One other thing I would definitely do as counsel for the acquiring company in this situation – and this is something people often don’t focus on until the last minute – is include, in the “conduct of business” covenant in the definitive acquisition agreement, a provision limiting the target’s ability to release anybody else from any of these confidentiality and “standstill” agreements. Of course, one of the things that target companies...
sometimes do in anticipation of this, right before the definitive agreement is signed, is send a letter to various other prospective acquirors who have previously signed these agreements, stating that they are being released from their “standstill” obligations.

MODERATOR (RICK CLIMAN): Joel and Keith, do you ever object when an acquiring company’s lawyers attempt to include in a definitive acquisition agreement a provision requiring the target company to enforce all of its “standstill” agreements and not waive any rights under them?

COUNSEL FOR TARGET (JOEL GREENBERG): It’s kind of hard to take the position that our client should have complete freedom to waive those protections when we’ve just had this discussion about how our client wants to manage the process and use those “standstills” to ensure that it can do this. So I think that, properly drafted, this type of provision is not unreasonable.

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INDEMNIFICATION PROVISIONS IN PURCHASE AGREEMENTS

By: Elizabeth A. Dellinger
    Baker & Hostetler LLP

Indemnification provisions are included in the majority of acquisition purchase agreements. The indemnification provisions provide a contractual remedy for breaches of representations and warranties and, in certain instances, specifically negotiated matters.

This article is intended to serve both as a primer and a reminder of the purposes of the indemnification provisions, the frequently negotiated details, and the relationship of these provisions to remedies otherwise available under common law.

Indemnification Provisions in Purchase Agreements: Why Bother?

Purchaser’s Counsel: “Here is my draft purchase agreement with a standard indemnification section.”

Seller’s Counsel: “Why do you need that provision? I will give you whatever remedies you have available under law, including breach of contract remedies and fraud, but nothing more. You do not need it as common law protects you.”

Purchaser’s Counsel: “But an indemnification provision is included in every form my firm has for a purchase agreement....”

Let’s think of a better response to this argument of Seller’s counsel.

First, an explicit indemnification provision will likely present a more direct and perhaps more compelling argument before a court or arbitrator in the event of a suit over a breach of representations and warranties. The explicit provision will knock out or at least raise the bar on certain defenses of the Seller. The obvious example: A Seller cannot argue that the parties excluded the indemnification provision because no right to indemnification on the part of the Purchaser was intended.

Second, the indemnification provision may expand the parties who are beneficiaries of the provision. Most purchase agreements provide that “Seller shall indemnify and hold harmless Purchaser and its officers, directors, shareholders, agents and affiliates....” Common law remedies are likely to be limited to the Purchaser only.
Third, the indemnification provision may expand the scope of indemnifiable losses. Often, indemnification provisions will provide that “Seller shall indemnify for... all claims, losses, liabilities and expenses....” Attorney fees and other out-of-pocket expenses can contractually be included in the scope of indemnification. Under common law, such expenses likely would be the subject of argument.

Finally, a “defense of claim” subsection is often included in a purchase agreement as part of the indemnification provisions. The “defense of claim” and other specific terms of the indemnification provisions set forth in detail the process and mechanics of asserting indemnification claims and defending third party claims. Common law has no equivalent outside the general rules of civil procedure.

Indemnification Provisions in Merger Agreements

Senior Attorney: “Nice job on the draft Purchase Agreement. But you have the Seller (which merges into the Purchaser) indemnifying the Purchaser.”

Young Inexperienced Attorney: “Yes, I understand it is customary for Sellers to indemnify Purchasers in acquisition agreements.”

Obviously, the problem here is that the Purchaser assumes all liabilities of the Seller upon consummation of the merger, including the Seller’s indemnity obligation under the purchase agreement. Thus, the Purchaser is indemnifying itself.

Notwithstanding the frequently lodged Seller’s argument that “Seller’s shareholders do not want any exposure to liabilities post closing...”, effective indemnification under a merger agreement will require one of the following: (a) contractual indemnification in favor of the Purchaser executed by the Seller’s shareholders; (b) a purchase price holdback or escrow (which may be used for both cash and stock purchase consideration); or (c) set off rights against deferred purchase price consideration.

The merger context also raises certain issues regarding calculation of the “loss” for indemnification purposes.

Certain losses are easy to calculate. If there is a third party claim for $5,000 against the Seller (and now the surviving entity), the Seller’s shareholders pay $5,000 to the surviving entity.

Others are a bit trickier. Assume the Seller breaches a representation, the effect of which is a somewhat diminished value of the Seller (and thus now the surviving corporation). For example, the Seller represented that it had good relations with its top ten customers, three of which bolted immediately before the merger due to poor service from the Seller. Several options exist. The Seller’s shareholders could pay to the surviving corporation the full value of the loss ascertained through negotiation or some more arduous method (the “loss amount”). This is a “make-well” approach. Or the Seller’s shareholders could pay to the shareholders of the Purchaser an amount equal to the “loss amount” multiplied by the percentage ownership of the surviving corporation held by the Purchaser’s shareholders. This is intellectually satisfying, as the Purchaser effectively overpaid the Seller. If the consideration were stock, the Seller’s shareholders’ equity interest in the surviving corporation may be reduced by the full “loss amount.” This amount may be calculated by dividing the loss amount by the per share value of the stock used for purposes of the transaction and redeeming in satisfaction of the indemnification obligation this number of shares from the Seller’s shareholders.
Specific Indemnification Provisions

Seller’s Counsel: “We cannot give you a litigation representation because of that really big lawsuit we have told you about.”

Purchaser’s Counsel: “But you agreed to indemnify us fully for any losses resulting from the litigation. Why not give a clean rep and we will rely on the standard indemnification provisions?”

This approach by the Purchaser’s counsel is a bad idea. First, disclosure should be encouraged in negotiations, and documents should evidence that disclosure. Second, specific indemnification provisions can be drafted to address any necessary details of the matter and, if well drafted and successfully negotiated, carve out the specific matter from otherwise agreed baskets and caps. In this example, the purchase agreement should include a specific indemnification provision requiring the Seller to indemnify the Purchaser for losses, costs and expenses associated with the defense and resolution of the litigation proceeding, and the same should be outside the scope of baskets, caps and survival periods.

In addition to pending litigation, taxes, environmental claims and ERISA liabilities are frequently the subject of specific indemnification provisions.

Indemnification Provisions and Purchase Price Adjustments

Seller’s Counsel: “It is inappropriate to require indemnification for a breach of our accounts receivable representation (i.e., all accounts receivable are collectible in the ordinary course). The purchase price adjustment already takes non-collection of accounts receivable into account by way of a reduction to the purchase price.”

Purchaser’s Counsel: “Oh, I guess you are right. Good catch.”

Purchase price adjustment provisions are common in acquisition transactions. Often, purchase price adjustments are intended to address working capital (inventory and accounts receivable) fluctuations between the date of the financial information that the Purchaser evaluated in determining the purchase price and the closing date. An inventory or accounts receivable representation and warranty, in this instance, serves a significant role with respect to preserving “walk-away rights” in the event of a pre-closing breach. But the same representations and warranties are not properly the subject of indemnification if the Purchaser is already “made whole” for a decrease in inventory or accounts receivable values through the purchase price adjustment mechanism. The same analysis applies to other matters addressed through the purchase price adjustment.

Assignment of Indemnification Rights: Leveraged Acquisitions

Purchaser’s Counsel: “I know we signed the purchase agreement weeks ago, but our lender is insisting that you permit the assignment of the indemnity rights.”

If the Purchaser is obtaining leveraged acquisition financing, Purchaser’s counsel should require that the purchase agreement expressly permit the assignment of the Purchaser’s indemnification rights under the agreement. The Purchaser should anticipate that the financial institution will require this assignment as additional security and avoid the eleventh hour renegotiation of the “no-assignment” provision with the Seller.

Survival, Baskets and Caps

Purchaser’s Counsel: “3 years, no basket and no cap.”
Provisions governing the survival of representations and warranties and providing for “baskets” and “caps” are all limitations on the indemnification provisions contained in the purchase agreement.

The survival period is most commonly couched in a phrase such as “the representations and warranties will survive the closing of the transactions contemplated by this Agreement for a period of ….” This is the period during which the Purchaser may invoke its indemnification rights for breaches of representations and warranties. The Purchaser’s counsel should consider if there should be any exceptions to this survival period.

The “basket,” if any (and there usually is one), will either serve as a “deductible,” namely, that no payment until a threshold is reached, or as a “threshold,” namely, that all indemnifiable claims are paid from dollar one after the threshold is reached. Although deal specific, “baskets” generally are in the range of 1 to 2% of the purchase price, and less than this in larger deals (it is not unusual for the Seller to ask for a 5 to 10% basket, however). The “cap” is the maximum exposure of the Seller to indemnification claims. Absent special circumstances, it is hard for the Seller’s counsel to negotiate for a low cap with a straight face; it is tantamount to saying that the Seller will freely give representations and warranties if it has no financial responsibility for their inaccuracies. Nonetheless, in the competitive deal environment, and in transactions in which financial investors are the sellers, caps below the purchase price are increasingly common. As mentioned above, the Purchaser’s counsel should be mindful of appropriate exceptions to “baskets” and “caps”, such as the Seller’s tax obligations or non-assumed liabilities intended to be discharged by the Seller at or following closing. Also, Purchaser’s counsel should be prepared to argue that the Seller’s counsel’s request for “materiality” and “knowledge” in the representations is a double-dip with the basket, and that the Seller should not be entitled to both.

**Indemnification “Net of Tax Effects” and “Net of Insurance Proceeds”**

Seller’s Counsel: “OK, I had to listen to your “no double-dip” argument on the representations and basket. Now it’s my turn….”

Seller’s counsel will commonly request that any indemnification payments to be made by the Seller be “net of tax effects” and “net of insurance proceeds.”

The “net of tax effects” concept is premised on the argument that the Purchaser will receive a tax benefit due to the loss. Attempting to accommodate this concern raises two principal challenges. First, is the “loss” for which indemnification is being made an actual “loss” and thus a loss that already takes into account tax effects? Second, tax rate and timing differences may make it very difficult to actually determine the tax effect at the time the indemnification is required to be paid. Also, the Purchaser may be hesitant to open its tax records to the Seller in the event of a dispute as to the amount of the tax effect. A negotiated “tax rate” for this purpose may be a “rough justice” solution.

As above, the “net of insurance proceeds” argument may be asserted as an adjustment to the indemnity otherwise required to be paid by the Seller, or the same may already be included in the calculation of “loss” for purposes of determining the indemnification otherwise due. Overall, this is generally viewed as a fair request by Seller’s counsel. Purchaser’s counsel may seek to emphasize that the proceeds are “actually received”, “net of deductibles” and applicable only to the extent the Purchaser is not self-insured.
Indemnification as the Exclusive Remedy

Seller’s Counsel: “Since you, Purchaser’s counsel, insisted that indemnification be included in the purchase agreement, we now insist that it be the exclusive remedy.”

Seller’s counsel should insist that the carefully negotiated indemnification provision be the exclusive remedy for breaches of representations and warranties. Absent an exclusivity provision, a Purchaser may be able to pursue claims based on common law breach of contract claims and avoid the limitations imposed by short survival periods, baskets and caps.

“Off the contract” claims may also be made by the Purchaser on grounds of fraud or securities law violations, and these often may be asserted notwithstanding an exclusivity provision. Under the common law in most states, fraud claims are not deemed waived by an exclusivity clause. Similarly, under Section 14 of the Securities Act of 1933 and Section 29 of the Securities Exchange Act of 1934, liabilities arising under the federal securities laws cannot be waived by a contractual exclusivity provision.

Next Meetings. We will be meeting in Montreal on Friday, September 22, 2000 from 2:00 – 5:00 p.m. On Saturday January 13, 2001, we will meet at Gray Cary Ware & Freidenrich's offices in downtown San Diego, California.

Voting Agreements. After introductions, we discussed the Task Force's experience with SEC views on voting agreements (particularly when a public company target has delivered voting agreements for more than a majority of shares outstanding, or when persons delivering agreements are not officers or directors). We agreed that the SEC position on these issues is not uniform and that it is hard to predict the SEC position in this area until Rule 159 is reproposed.

Regulation M-A. We also discussed current practice regarding deal-related communication prior to effectiveness of the registration statement. Some SEC staff have taken the position that a Form 8-K with only the definitive deal agreements constitutes gun-jumping! These staff believe the materials should be properly legended and filed under Rule 425 under the 1933 Act. (This filing will not result in incorporation by reference into other previous filed SEC documents, and therefore a duplicative Form 8-K filing may be necessary). If deal publicity has inadvertently not been filed or properly legended, the staff position is to encourage filings as soon as practicable after discovery. [Note that subsequent to the meeting, an extensive Q and A on Regulation MA was made available in the newly released supplement to SEC telephone interpretations, addressing some of these issues.]

We also discussed recent experiences in filing exchange offers on Form S-4 registration
statements which the staff is reviewing on an accelerated basis. Further clarification of the rules is expected later this year. If the SEC continues to provide timely review of exchange offers, and pooling is no longer available after 2000, one can expect that starting in 2001, many acquirors will do exchange offers rather than mergers, due to the speed of the two-step transaction. We discussed the changes required to our model agreement in that event and agreed to revisit this issue at our January 2001 meeting.

Termination and No-Shop Provisions. We finalized the termination and breakup fee provisions as well as the definition of the "company triggering event." We discussed the no shop provisions, finalizing definitions of Acquisition Transaction, Acquisition Proposal and Superior Proposal. In September 2000, we will complete the remainder of the no shop provisions and the meeting covenants.

The covenants, conditions, representations and warranties and exchange working groups are working hard between meetings to produce new drafts of those documents.

Diane Holt Frankle and Stephen H. Knee, Co-Chairs

International Transactions Task Force

We had a very successful meeting in New York with twenty-five people attending, representing nine countries.

It was agreed at our meeting to set up an editorial committee to oversee the production of answers to the model Stock Purchase Agreement questionnaire. The target for all answers to be finalized is the Summer of 2001. We will be looking to form an editorial committee at our stand alone meeting in Montreal that will be responsible for coordinating the responses from our foreign correspondents. We also agreed to use the same foreign correspondents who provided responses on the asset project provided their performance had been satisfactory. It was further suggested that we test the questionnaire in a few countries to allow us to determine if there are any questions that those respondents find unclear before sending the questionnaire to all countries.

As a new project for the Task Force, we discussed producing a public company acquisition questionnaire. This would be similar to but possibly not as detailed as the existing private company stock/asset purchase questionnaire. We reviewed during the course of the meeting a series of different possible questions. Daniel Rosenberg and Henry Lesser will produce a list of these questions and circulate them for comment before the Montreal meeting. It was agreed that we would only seek answers to the questionnaire from those countries which have seen in the last few years a significant number of takeovers by U.S. acquirers. These countries would probably include Canada, Australia, the United Kingdom, Germany, France, Italy and Japan and might also include Mexico, Hong Kong, Holland and some other European countries.

On the program front, the Task Force organized one program for New York and two programs for London in respect of the year 2000 meeting. Both programs had a transatlantic M&A focus.

Finally, with respect to the work product of the Task Force on international asset acquisitions, an update of the responses is in the process of being completed. We anticipate publication in the Spring of 2001.

Guy-Martial A.X. Weijer and John W. Leopold, Co-Chairs
Joint Venture Agreements
Task Force

The Joint Venture Agreement has been revised by the Editorial Committee and recirculated. It was agreed in New York that the main goal now should be to proceed with the commentary and that as a result of discussions surrounding the commentary it may be necessary to make further revisions to the Agreement.

A list of commentary assignments for the Joint Venture Agreement was circulated, in each case with a "leader" assigned to take the lead in the drafting exercise. It is hoped that there will be a significant amount of commentary available for review and discussion at the stand-alone meeting in Montreal and the Task Force meeting on Friday morning will focus on this issue.

It was agreed that where there is an overlap between issues to be considered in the Joint Venture commentary, the commentary drafters would use the latest version of the asset purchase agreement commentary to the extent possible. The Task Force has joined up with the RUPA Committee and Scott Ludwig, Bob Keatings and Allan Donn have agreed to assist with RUPA commentary.

Additional assistance with commentary is welcome if any members of the committee are looking for assignments.

Tom Hyman and Alison Youngman, Co-Chairs

Asset Acquisitions Task Force

The Model Asset Purchase Agreement ("MAPA") has been delivered to the American Bar Association by the Asset Acquisition Agreement Task Force. The ABA editorial process is now under way and various interstices in MAPA are being completed. While the Task Force has likely had its last formal meeting, a number of members of the Task Force continue to be involved in the process of bringing MAPA from a Committee product to an item with a Library of Congress Card Catalog Number. Publication information will be forthcoming in a later report.

Byron F. Egan and H. Lawrence Tafe, III, Co-Chairs

Task Force on Manual of Acquisition Practice and Process

The Task Force on the Manual of Acquisition Practice and Process met in New York on July 9 to continue the early stage planning and work begun at the Columbus meeting. The Task Force agreed generally on the scope of the Manual and its intended audience. It is anticipated that the Manual will be directed to the beginning lawyer embarking upon his or her first role in a corporate acquisition. We see the book also as a valuable tool for the more experienced general practitioner who is beginning his or her first acquisition as well as a tool for the experienced M&A lawyer on specific issues.

The Task Force remains in its infancy and is developing a working table of contents and arriving at the scope and depth of each topic to be addressed. At the July meeting, preliminary topic outlines for four of the chapters of the Manual were presented by Task Force members and discussed by the Task Force, and a number of other topic outlines were assigned in anticipation of the Montreal meeting.

Co-Chairs Tom Thompson and Vince Garrity will be circulating a draft introduction to the Manual to engender Task Force discussion on some of the editorial principles and directions. We will also examine in Montreal the possibility of a
Task Force on Revisions and Seller's Response to the Model Stock Purchase Agreement

This is a relatively new Task Force. Our assignment is to update the Model Stock Purchase Agreement and accompanying Ancillary Documents and prepare a Seller's Response document. The Task Force has had two organizational meetings and has divided itself into three Working Groups: (1) Revisions to the Model Stock Purchase Agreement (Samuel Friedman, Chair); (2) Revisions to the Ancillary Documents (Murray Perelman and Cynthia Coffee, Co-Chairs); and (3) Seller's Response document (David Albin, Chair). In keeping with the spirit of the Model Stock Purchase Agreement, our Task Force will develop an updated and expanded stock acquisition agreement and ancillary documents, together with a counsel's memo analyzing the purchaser's initial draft from the perspective of the Seller. Where appropriate, useful response provisions will be included. It is our hope that the Revised Model Stock Purchase Agreement will serve as a comprehensive teaching and research instrument for lawyers. Anyone interested in joining the Task Force is encouraged to contact:

Robert T. Harper, Chair

Committee Forums
Subcommittee

Our Forum at the Montreal meeting will be: “Current Developments in Delaware Law With Significant Implications for M&A Practitioners.” We will have the benefit of the following speakers:

1. Mark A. Morton (a partner in the Wilmington, Delaware office of Potter Anderson & Corroon LLP)
2. Frederick H. Alexander (a partner in the Wilmington, Delaware office of Morris, Nichols, Arsht & Tunnell)
3. C. Stephen Bigler (a partner in the Wilmington, Delaware office of Richards, Layton & Finger, P.A.)
4. John F. Grossbauer (a partner in the Wilmington, Delaware office of Duane Morris & Heckscher LLP)
5. Michael A. Pittenger (an associate in the Wilmington, Delaware office of Potter Anderson & Corroon LLP)

Description

These leading Delaware lawyers will discuss recent Delaware Chancery Court rulings relating to “fiduciary outs” and other recent developments
in Delaware law with significant implications for M&A practitioners. The discussion will be interactive and will encourage a lively interchange of various points of view from speakers and the members of the Negotiated Acquisitions Committee as a whole.

Keith Flaum, Chair

Membership Subcommittee

The Membership Subcommittee is actively seeking to increase the diversity of the Committee and to encourage younger lawyers to join in its activities. To this end, we will be actively seeking ways of reaching out to other groups within the ABA Business Law Section. A description of the Committee and its activities has been posted on the ABA's web site at www.abanet.org.

Alison Youngman, Chair

Programs Subcommittee

The Committee distinguished itself with the programs it sponsored or co-sponsored at the Annual Meeting in New York and the London Sessions. In New York, despite confusion about time and location, Rick Climan, Keith Flaum and David Gemunder presented an excellent program on “Merger and Acquisition Transactions – A Primer.” The Committee was to the fore on the transatlantic aspects of the 2000 ABA Annual Meeting with the “Hands Across the Sea” trilogy. Each leg was successful standing on its own, and all three programs were informative and well developed as a sequence. Many thanks are due to our Committee members who worked so hard on these programs, including Henry Lesser and Dan Rosenberg (co-chairs on the Committee sponsored programs in New York and London), Nelea Absher, Stephanie Bass, Ian Fagelson, David Katz, Doug Rofe and Guy Weijer.

Looking to the future, we are developing programs for the 2001 Spring Meeting in Philadelphia and the 2001 Annual Meeting in Chicago, as well as the prospects of an being planned for Paris. At the Spring Meeting, we are hoping to co-sponsor a program with the international symposium in conjunction with the Committee’s 2001 stand alone meeting that is being planned for Paris. At the Spring Meeting, we hope to co-sponsor a program with the Federal Regulation of Securities Committee and the Joint Venture Task Force is working on a program on aspects of its project. In Chicago, we intend to present programs on the Model Asset Purchase Agreement as well as an additional program addressing cross-border topics. As always, please contact me at (615) 742-4529 or dmckenzie@sherrardroe.com if you have any ideas for programs or if you would be interested in participating as a speaker.

Donald I.N. McKenzie, Chair
The Negotiated Acquisitions Committee Newsletter is published approximately three times a year by the American Bar Association, Section of Business Law, Negotiated Acquisitions Committee. The views expressed in the Negotiated Acquisitions Committee Newsletter are the authors’ only and not necessarily those of the American Bar Association, the Section of Business Law or the Negotiated Acquisitions Committee. If you wish to comment on the contents, please write to the Negotiated Acquisitions Committee, Section of Business Law, American Bar Association, 750 North Lake Shore Drive, Chicago, Illinois, 60611.