

Drafting Clear And Enforceable Contracts

March 9, 2006

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DRAFTING CLEAR AND ENFORCEABLE CONTRACTS

I. DRAFTING CLEAR AND ENFORCEABLE CONTRACTS2

DRAFTING CLEAR AND ENFORCEABLE CONTRACTS

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USE OF TERMS SHEETS AND LETTERS OF INTENT

- **Detailed term sheets establish business points and identify issues prior to drafting**
- **Generally shortens drafting time of documents**
- **Most LOIs and term sheets are non-binding**
- **Binding elements often include confidentiality and expenses**



ANATOMY OF A CONTRACT

- **Definitions**
- **Representations and warranties**
- **Promises or covenants**
- **Conditions precedent**
- **Termination and remedy provisions**
- **Boilerplate provisions**



AN OVERVIEW: DEFINITIONS

- **Remember: goal is to describe precisely**
- **Used to isolate a term or concept and ensure that it will be given the same meaning each time**
- **Can be in the text (short agreements) or in a separate section or exhibit**



AN OVERVIEW: REPRESENTATIONS AND WARRANTIES

- **Statements of fact that are the explicit premises underlying the agreement**
- **Snapshot of the facts that are important to the recipient's decision to enter into the agreement**
- **If not true and material, wronged party may void contract or pursue damages for breach of warranty**

Example: “XYZ Co. has all requisite authority to enter into and perform this Agreement.”



AN OVERVIEW: COVENANTS

- **On-going promises**
 - **Commitments to act or not to act**
Create a legal duty
 - **This can be a mandatory duty**
Identifiable by “shall” or “will”
 - **Affirmative**
 - **Negative**
- Example: “XYZ Co. shall purchase the assets of QRS Company at the closing.”**



AN OVERVIEW: COVENANTS

- **Can also be a permissive duty, a “right”**
 - **Identifiable by “may” (other party agreeing to your authority to do something without breaching the contract)**
- Example: “XYZ may market the products itself or through distributors.”**



AN OVERVIEW: CONDITIONS PRECEDENT

- **Something that must happen or must not happen for a duty or right to arise**
- **Not a promise**

Examples: “The Investor’s obligation to purchase the Preferred Stock is subject to the Company’s obligation to deliver a compliance certificate at the closing.”

“XYZ Co. may manufacture the Products itself if ABC Co. fails to supply adequate quantities.”



AN OVERVIEW: REMEDIAL PROVISIONS

- **Some contracts have no remedial provisions**
- **More complex transactions will**
 - **Don’t want to leave the remedies to a judge/jury or arbitrator**
- **Description of events giving rise to the remedy**
 - **Material breach**
 - **Change in credit rating**



AN OVERVIEW: REMEDIAL PROVISIONS

- **Remedies**
 - **Termination**
 - **Acceleration**
 - **Indemnification**
 - **Liquidated damages**



TWO KINDS OF CONTRACTS

- | | |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none">• Relational Contracts – performance over time, often services<ul style="list-style-type: none">– License Agreement– Supply Agreement– R&D Agreement | <ul style="list-style-type: none">• One-Time Transfer – one-time significant transfer of a capital asset<ul style="list-style-type: none">– Asset Purchase Agreement– Stock Purchase Agreement |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|



A SAMPLE OUTLINE OF A SUPPLY AGREEMENT (RELATIONAL)

Intro Para

Recitals

1. Definitions

- **Confidential Information**
- **Products**

2. Purchase and Sale

3. Forecasts and Ordering

4. Pricing and Payment

5. Shipment, Delivery and Acceptance

6. Product Warranty

7. Warranty Disclaimers

8. Term and Termination

9. Indemnification

10. Reps and Warranties



A SAMPLE OUTLINE OF A SUPPLY AGREEMENT (RELATIONAL)

11. Confidentiality

12. Miscellaneous

Signature block

Exhibits



SOME OBSERVATIONS ABOUT RELATIONAL CONTRACTS

- **Start with what is most important and central to the transaction**
- **Then go to the sub-promises**
- **Arrange logically**
- **Lots of mechanics**
- **Promises, reps & warranties and conditions may be woven together**



A SAMPLE OUTLINE OF A STOCK PURCHASE AGREEMENT (ONE-TIME TRANSFER)

Parties

Recitals

- 1. Purchase and Sale of Stock**
- 2. Reps and Warranties of Company**
- 3. Reps and Warranties of Investor**

- 4. Conditions of Investor's Obligations**

- 5. Conditions of Company's Obligations**

- 6. Miscellaneous**

Signatures



SOME OBSERVATIONS ABOUT ONE-TIME CONTRACTS

- **Basic elements (promises, reps, conditions) are always clumped together under separate headings**
- **Basic promises of exchange**
- **Representations and warranties (each party's)**
- **Conditions to closing (each party's)**



SOME OBSERVATIONS ABOUT ONE-TIME CONTRACTS

- **Affirmative and negative covenants (each party's sub-promises)**
- **Remedy-related provisions**
 - **Liquidated damages**
 - **Holdbacks**
 - **Baskets**
- **Miscellaneous**



BOILERPLATE THE STUFF THAT GOES AT THE END

- **Read it/understand it – your client won't**
- **So important it's in every contract!**



BOILERPLATE ENTIRE AGREEMENT



- **Parol evidence rule**
- **Attached agreements and cross-references**
- **Supersedes letters of intent and other prior agreements**



BOILERPLATE GOVERNING LAW

- **Common law choice of law rules**
- **What law to choose?**
- **Enforceability**
- **Need to negate chosen law's choice of law rules**
- **Impact on opinions**



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BOILERPLATE CHOICE OF FORUM

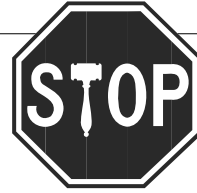


- **Very important strategic, tactical and economic provision**
- **Enforceability**
- **Need to confer with litigator**
- **Allocation of costs and expenses**

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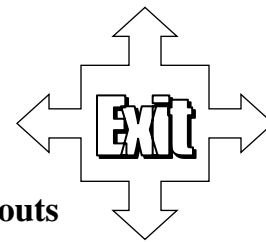
BOILERPLATE ADR



- **Arbitration**
- **Mediation**
- **Rules**
- **Location**
- **Choice of arbitrators**



BOILERPLATE OUTS



- **Acts of God**
- **Common-law doctrines of impossibility, impracticability, and frustration of purpose**
- **Does it supplement or supplant?**
- **Negotiated outs**
 - **Bankruptcy**
 - **Market outs**
 - **MACs**



BOILERPLATE NO ORAL MODIFICATION OR WAIVER



- **Common law of oral modification and waiver**
- **UCC and other statutory overrides**
- **Multiple-party contracts**



BOILERPLATE SEVERABILITY

Law of non-enforceability for public policy reasons

Especially important where contract has provisions of questionable enforceability

- ✓ **Non-competes**
- ✓ **Certain indemnifications**



BOILERPLATE OTHER IMPORTANT PROVISIONS

- **Successors and assigns**
- **Notices**
- **Counterparts**
- **Captions**



REPRESENTATIONS AND WARRANTIES

- **Purpose and Scope of Reps and Warranties**
- **Limitations**
- **The Role of the Bringdown**
- **Disclosure Schedules/Exception Letters**
- **Sandbagging/Anti-Sandbagging**
- **MAC/MAE Clause**
- **Typical Categories and Related Considerations**



PURPOSE OF REPS AND WARRANTIES

Recipient's Reasons for Wanting Reps:

- **Assist recipient in understanding business of other party, and in doing due diligence**
- **Allow recipient to refuse to close transaction if reps not true at closing**
- **Enable recipient to recover damages if rep turns out to have been false when made, whether or not transaction closes**



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PURPOSE OF REPS AND WARRANTIES

Views of Party Required to Deliver Reps:

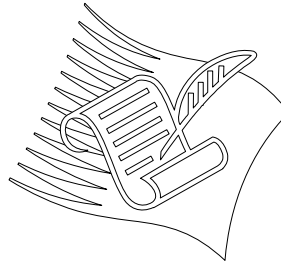
- **Does not want to spend long hours creating detailed disclosure schedule about own business – increases risk of recipient renegotiating business terms**
- **Wants to limit recipient's ability not to close transaction**
- **Wants to limit risk of having to return portion of purchase price following closing because of misrepresentation**

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TYPICAL CATEGORIES

Broad Categories of Seller Representations and Warranties:

- Corporate attributes
- Corporate formalities
- Business condition
- Industry specific
- Transaction related



TYPICAL CATEGORIES

Corporate Attributes – For example....

- Organization
- Good standing
- Subsidiaries
- General corporate power and authority
- Capitalization

TYPICAL CATEGORIES

Corporate Formalities – For example....

- **Specific corporate authority**
- **Duly authorized, executed and delivered**
- **Valid, binding and enforceable**
- **Non-contravention of existing agreements, etc.**



TYPICAL CATEGORIES

Business Condition – For example....

- **Financial statements**
- **Books and records**
- **Title to assets**
- **Inventory**
- **No undisclosed liabilities**
- **Contracts**
- **Compliance with law**
- **Legal proceedings**
- **Insurance**
- **Employees**



TYPICAL CATEGORIES

Business Condition – Some of these require review by subject matter experts for drafting and negotiation, for example....

- **Intellectual property**
- **Employee benefits**
- **Labor relations**
- **Environmental liabilities**
- **Taxes**



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TYPICAL CATEGORIES

Industry Specific – For example....

- **Rates and reimbursement policies**
- **Controlled substances**
- **Clinical trials**
- **Source code escrows**

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TYPICAL CATEGORIES

Transaction Related – For example....

- **Transaction costs**
- **Brokers or finders**



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TYPICAL CATEGORIES

Buyer Representations and Warranties

- **Cash consideration with no financing contingency**
 - **Corporate formalities representations drafted in parallel to Seller representations**
- **Cash consideration with financing contingency**
 - **Add representations on financing and creditworthiness**
- **Non-cash consideration (e.g., shares of stock)**
 - **Probably will require full blown representations and warranties drafted in parallel to Seller representations and warranties**

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SCOPE OF REPS AND WARRANTIES

- **When beginning drafting, understand context for agreement**
- **Scope of reps and warranties should be dictated by type of transaction, type of business and nature of person delivering statements**
- **Don't be slave to the form or the most recent precedent; consider business goals of parties**
- **Purchase price may dictate scope, too**



SCOPE OF REPS AND WARRANTIES

Public/public M&A transactions:

- **Limited categories**
- **Reliance on SEC filings**
- **No post-closing remedy means limited purpose**



SCOPE OF REPS AND WARRANTIES

Private M&A/Equity investment transactions:

- More categories
- More scheduling of factual matters
- Dual purpose – “No closing” triggers and post-closing remedies



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SCOPE OF REPS AND WARRANTIES

Form and amount of consideration:

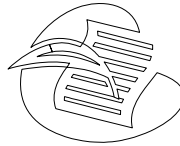
- If stock of buyer is being used, more extensive reps about buyer’s business
- Otherwise, if cash is used, usually limited to authority and ability to pay purchase price
- If relatively low purchase price or distressed seller context, Seller reps may have more limited scope consistent with “as is where is” deal



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LIMITATIONS GENERALLY

- **Each contract is a negotiated document which reflects the parties' relative bargaining power**
- **Careful use of materiality and knowledge limitations on representations can be used to effect compromises between parties**



LIMITATIONS GENERALLY

- **Understand client's relative bargaining power and business goals in order to decide how to properly use qualifiers**

Problem: Seller's primary concern is being sued following closing, while Buyer's principal concern is getting full information and being able to walk in event of misrepresentation

Solution: Include unqualified rep, but limit Buyer's indemnification remedy



LIMITATIONS – MATERIALITY QUALIFIERS

- **“Except for those which do not have a material adverse effect upon the Company, its financial condition or the transaction contemplated hereby”**
- **Shifts risk of non-material items to recipient**
- **Different standards of materiality may appear in different places in agreement (“in all material respects,” “no material violations,” etc.)**
- **Defining materiality may make it easier to determine whether there is a breach, but bright line tests could ultimately harm party delivering materiality-qualified representation (no way to argue non-existence of breach)**



LIMITATIONS – MATERIALITY QUALIFIERS

- **“Double Materiality” (interplay with indemnification and closing provisions)**
- **Understand relationship between indemnification and representations and warranties**
- **Even though representation may not have materiality qualifier, if indemnification remedy does not allow for pay out of damages unless a threshold dollar amount is met, representation may be breached without triggering pay out of damages**
- **Materiality qualifications may still be appropriate to limit disclosure obligation and/or closing condition**
- **For relationship with closing see “The Role of the Bringdown”**



LIMITATIONS – KNOWLEDGE QUALIFIERS

- “To the Seller’s knowledge, . . .”
- **Definition of knowledge is critical to scope of limitation**
- **Can range from actual knowledge of specific persons (narrow) to constructive knowledge standard (*i.e.*, know or should have known after due inquiry) attributed to specific individuals of categories of employees**



LIMITATIONS – KNOWLEDGE QUALIFIERS

When drafting, consider:

- **Is it proper for representation to be qualified by knowledge?**
- **If so, whose knowledge is relevant?**

Example: Agreement includes representation regarding no knowledge of threatened litigation. If Buyer is acquiring subsidiary, and Seller’s in-house counsel performs litigation management function, consider including in-house counsel’s name in knowledge definition.



LIMITATIONS – KNOWLEDGE QUALIFIERS

- **To limit by knowledge can shift allocation of risk to recipient of representation**
- **Recipient now has burden of proving party delivering representation had knowledge in order to obtain recovery for breach**
- **If judge or jury not convinced Seller had knowledge, then no recovery of damages**



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LIMITATIONS – KNOWLEDGE QUALIFIERS

- **Absence of knowledge qualifier may cause Seller to more thoroughly investigate own business, thereby improving due diligence process**
- **Aside from this benefit, if no post-closing indemnification remedy, then including knowledge qualifier makes little difference, unless Seller acquires knowledge between signing and closing, and Buyer discovers that fact before closing (public/public M&A context)**

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THE ROLE OF THE BRINGDOWN

- **Reps and warranties generally speak as of date of agreement**
- **The bringdown causes them to be made again as of closing date, usually without referencing a different date**
- **If untrue as of closing date, recipient not obligated to close, or may have remedy for breach**



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THE ROLE OF THE BRINGDOWN

Standard for Bringdown:

- **If significant time between signing and closing, typically include materiality in bringdown**
- **Consider interplay with reps already qualified by materiality**

Example: “true and correct in all material respects . . . (without taking into account any materiality, material adverse effect or similar qualification contained therein)”

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THE ROLE OF THE BRINGDOWN

- **Timing issues can affect benefit of bringdown**
- **Consider three slightly different reps:**
 - “The Company is in compliance with all laws.”
 - “As of the date of this Agreement, . . .”
 - The Company, as of the date of this Agreement is, and, as of the Closing Date, will be, . . .”
- **If agreement date is January 1 and closing date is March 1, and violation as of March 1, which version would provide greatest protection to recipient? Which would have no benefit?**



DISCLOSURE SCHEDULES/EXCEPTION LETTERS

Purpose:

- **Exceptions to statements as written in agreement**
- **Pure disclosure of facts about business or transaction**



DISCLOSURE SCHEDULES/EXCEPTION LETTERS

Schedule, Schedules or Letter?

- **If single “Disclosure Schedule,” then reps refer to sections of disclosure schedule**
- **If multiple “Disclosure Schedules” then reps may refer to separate disclosure schedules**
- **“Disclosure or Exception Letter” often used to demonstrate document is separate from, and not part of, primary agreement, so as to avoid public disclosure (be sure integration clause drafted accordingly)**



DISCLOSURE SCHEDULES/EXCEPTION LETTERS

- **Language should not have effect of modifying or negating language negotiated in representation**
Example: “Except as disclosed above, Seller is unaware of any potential infringement of third party IP rights.”
- **If representation is not qualified by knowledge, disclosure could be interpreted as exception to representation such that risk now shifts to Buyer to prove knowledge by Seller**



DISCLOSURE SCHEDULES/EXCEPTION LETTERS

Introductory qualifications (favorable to party delivering schedules):

“These Disclosure Schedules are qualified in their entirety by reference to specific provisions of the Agreement and are not intended to constitute, and shall not be construed as constituting, representations or warranties of Seller except as and to the extent provided in the Agreement or expressly provided herein.”



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DISCLOSURE SCHEDULES/EXCEPTION LETTERS

Introductory qualifications (favorable to party delivering schedules):

“The inclusion of any matter in these Disclosure Schedules shall not be construed as an admission by Seller that such matter is, or at any time may be or has been, material to any party to the Agreement or to the transactions contemplated by the Agreement except as and to the extent expressly provided herein.”

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DISCLOSURE SCHEDULES/EXCEPTION LETTERS

Introductory qualifications (favorable to party delivering schedules):

“Matters reflected in these Disclosure Schedules are not necessarily limited to matters required by the Agreement to be reflected in these Disclosure Schedules. Such additional matters are set forth for informational purposes and do not necessarily include other matters of a similar nature.”



DISCLOSURE SCHEDULES/EXCEPTION LETTERS

Introductory qualifications (favorable to party delivering schedules):

“The disclosures in any section of these Disclosure Schedules shall qualify (1) the corresponding section of the Agreement and (2) other sections of the Agreement to the extent that the relevance of such disclosures to such other sections is reasonably apparent (notwithstanding the absence of a specific cross reference) on the face thereof.”



SANDBAGGING/ ANTI-SANDBAGGING

Sandbagging defined:

- **“Notwithstanding any investigation by Buyer of Seller’s business, Buyer is expressly relying on reps and warranties in Agreement.”**
- **Seller’s concern is that Buyer may discover inaccuracy in Seller’s reps during due diligence and then wait until after closing to sue for breach**



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SANDBAGGING/ ANTI-SANDBAGGING

Anti-sandbagging defined:

- **“Seller shall indemnify Buyer for breaches of reps “except to the extent that Buyer had knowledge of such breach prior to closing.”**
- **Buyer’s concern: shifts burden of proof back to Buyer, to prove no knowledge of breach**
- **Buyer’s response: Buyer’s due diligence not intended to serve as insurance policy for Seller**

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MAC/MAE CLAUSE

No Material Adverse Change

“Since the date of the most recent balance sheet, there has not been any material adverse change in the business, operations, properties, prospects, assets, or condition of the company, and no event has occurred or circumstance exists that may result in a material adverse effect.” (a/k/a “MAC” or “MAE” clause)



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MAC/MAE CLAUSE

No Material Adverse Change

- **Sellers often negotiate exceptions from MAC clause, such as events caused by changes in governmental regulation, general economic conditions, industry conditions, changes in GAAP or announcement of transaction**
- **Note: Even when MAC clause is broadly written, see *IBP v. Tyson* (clause may not protect Buyer from event or condition that Buyer knew was threat to business)**

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MAC/MAE CLAUSE

Whether to include prospects in MAC definition:

- **Consider nature of transaction – if acquiring company with new or unproven technologies, may be important**
- **If acquiring public company or long-established private business, may be less important**



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COVENANTS AND CONDITIONS

- **Purpose and Scope of Covenants and Conditions**
- **Examples: Covenants**
- **Examples: Conditions**
- **Limitations**
- **Remedies – A Preview**
- **Drafting Tips**



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PURPOSE OF COVENANTS AND CONDITIONS

- **Covenants**
 - **Ensure that party receives benefits it bargained for in operative provisions of contract**
 - **Set forth additional undertakings as part of the transaction**



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PURPOSE OF COVENANTS AND CONDITIONS

- **Conditions**
 - **Shift risk of nonoccurrence of event**
 - **Act as incentive for party to cause event to occur**
 - **Act as “outs,” permitting party to get out of contract or terminate certain obligations**
 - **Change nonperformance remedy from damages to withholding performance**

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COVENANTS

Ongoing promises by one party to take or not to take certain actions

- **Two categories:**

- **Affirmative – promise to take specified action**

Example: Financial covenants – promise to maintain certain levels of financial performance

- **Negative/restrictive – promise to refrain from taking specified action**

Example: Seller will not operate outside ordinary course of business between signing and closing – preserves status quo



COVENANTS

- **Mandatory**

- **Identifiable by:**

- **Shall**
- **Will**
- **Must not**
- **Agrees to**

Example: “Licensee shall not disassemble, decompile, reverse engineer, translate or otherwise attempt to recreate the source code of the software in any manner.”



COVENANTS

- **Covenants may also be a permissive duty, a “right”**
- **Identifiable by:**
 - **May**
 - **Is entitled to**

Example: “XYZ Co. shall be entitled to market the products itself or through distributors.”



COVENANTS

- **Different from representations**
 - **Representations deal with current or historical facts while covenants address future**
- **Interplay with representations**
 - **May want to preserve a situation that is represented to be true for a period of time after signing or closing**
- **Interplay with conditions**
 - **Covenant may be subject to condition(s)**



AN ILLUSTRATIVE EXAMPLE:

Manufacturing Equipment Lease

- **Lessor's objectives: for Lessee to pay rent and return equipment**
- **Lessor also wants Lessee to maintain equipment and maximize its value upon return**
 - **Keep equipment insured**
 - **Operate equipment in accordance with applicable laws**
 - **Not sell or otherwise transfer**
 - **Not permit the creation of any liens**



CONDITIONS

- **Two categories:**
 - **Conditions precedent**
 - **Conditions subsequent**
- **As a practical matter, conditions subsequent are unusual**
 - **Result in “unwinding” transaction**
 - **Closely related to excuse or termination provisions**



CONDITIONS

- **Conditional event can be under control of either party, of a third party, or beyond anyone's control**
 - **Example: “Lender shall not be required to make Loan if there shall have occurred any change in any applicable law or regulation that would cause making of Loan to violate such law or regulation or subject Lender to any tax, penalty or other liability under any applicable law or regulation other than as in effect on date of this Agreement.”**
 - **Think about who controls condition when negotiating it**



CONDITIONS

- **Express conditions need not be material**
 - **Freedom of contract**
 - **But be sure to coordinate with termination clause (e.g. termination should be for any condition, not just “material items”)**



EXAMPLES: COVENANTS

- **Credit-Related Covenants:**
 - **Restrict party's ability to engage in activities that may result in worsening of its financial condition**
 - **Recall example of manufacturing equipment lease: Lessor will want to ensure that lessee can make rent payments over term of lease**



EXAMPLES: COVENANTS

- **Affirmative credit-related covenants:**
 - **Maintenance of existence**
 - **Reporting (especially with private companies)**
 - **Books and records**
 - **Inspections**
 - **Compliance with law**
 - **Maintenance of insurance**
 - **Payment of taxes**
 - **Payment of claims**
 - **Maintenance of financial ratios/covenants**



EXAMPLES: COVENANTS

- **Other Covenants:**
 - Non-compete
 - Non-solicitation of employees or customers
 - Confidentiality
 - Cooperation with other party (pre- or post-closing)
 - Conduct of business in ordinary course
 - Carrying out transactions as planned (e.g., using proceeds as described in loan agreement)
 - Notifying other party of certain events
 - Payment of other party's fees or expenses



EXAMPLES: COVENANTS

- **Negative credit-related covenants:**
 - Incurrence of debt
 - Creation of liens
 - Asset sales
 - Payment of dividends
 - Making of investments
 - Transactions with affiliates
- **May also use financial covenants as early warning signals**



EXAMPLES: CONDITIONS CONDITIONS PRECEDENT

- “[A]n event, not certain to occur, which must occur, unless its non-occurrence is excused, before performance under a contract becomes due.” Restatement (Second) of Contracts § 224
- Generally not a promise
 - Exception: *Promissory Condition* –party who controls occurrence has duty to make it occur before performance by other party is due
 - Common method used to make conditions promissory – include covenant to use best efforts to satisfy conditions



EXAMPLES: CONDITIONS CONDITIONS PRECEDENT

- Examples:
 - “The Investor’s obligation to purchase the Preferred Stock is subject to the Company’s obligation to deliver a compliance certificate at the closing.”
 - “Buyer shall not be obligated to consummate purchase of Land unless Buyer shall have obtained Loan from [Bank] for an amount of at least \$_____ and with level amortization over not less than X years at an interest rate not greater than Y% per annum.”



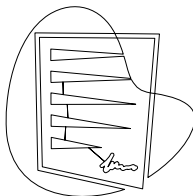
EXAMPLES: CONDITIONS CONDITIONS PRECEDENT – TIMING ISSUES

- ***Simultaneous Closing*** – occurs when agreement is executed and delivered at same time as closing
 - Conditions are all satisfied at time of closing
 - Creates roadmap as to what parties expect at closing
 - Creates permanent record of what occurred at closing
 - Might be described as “closing deliveries” rather than “conditions”



EXAMPLES: CONDITIONS CONDITIONS PRECEDENT – TIMING ISSUES

- ***Delayed Closing*** – occurs when agreement is executed and delivered, but closing occurs later after conditions precedent are satisfied
 - Gives party an “out”



EXAMPLES: CONDITIONS CONDITIONS PRECEDENT – TIMING ISSUES

- ***Drop-Dead Date*** – if all conditions precedent have not been satisfied by specified date, party can terminate contract
 - *Otherwise other party can keep contract alive indefinitely, waiting until most advantageous time to close*



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EXAMPLES: CONDITIONS CONDITIONS PRECEDENT

Conditions as Outs

- Each party wants to minimize number of conditions it must satisfy, and at same time impose conditions on other party to satisfy legal and business concerns
- Failure to satisfy condition does not necessarily have to result in termination of contract – may want to use right to terminate as leverage to extract concessions
- Condition may be waived and agreement re-written to require that it be completed on post-closing basis (“post-closing condition”)

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EXAMPLES: CONDITIONS CONDITIONS SUBSEQUENT

- **Conditions subsequent:**
 - Satisfied after party already has performed its obligations, in whole or in part

Example: “Within 30 days following closing, XYZ Corp. shall have executed agreement with Buyer to continue to receive support services from Buyer regarding the software. If agreement is not executed by such date, then all payment obligations of Buyer (except \$50,000 paid to Seller at closing) shall terminate.”



EXAMPLES: CONDITIONS

- **Other Conditions:**
 - No breach
 - Bringdown of representations (beware double materiality issues)
 - Certified organizational documents
 - Evidence of corporate or other action (e.g. board action authorizing execution, delivery and performance of agreement)



EXAMPLES: CONDITIONS

- **Other Conditions:**
 - Incumbency certificates
 - Governmental approvals
 - Third party consents
 - Legal opinions
 - Completion of related transactions
 - “MAC” or “MAE”



LIMITATIONS

- ***Carveouts*** – removes, or carves out, part of restriction created by covenant
Example: “Borrower shall not sell any of its assets, except for the sale of obsolete equipment in the ordinary course of business.”



LIMITATIONS

- ***Baskets*** – creates right to deviate from covenant’s restrictions by some specified amount

Example: “The Borrower shall not sell any of its assets, except for the sale of obsolete equipment in the ordinary course of business in an aggregate amount not to exceed \$1,000,000.”



LIMITATIONS

Other Limitations:

- **Unconscionability**
- **Substantial performance**
- **Waiver**
- **Estoppel**
- **Discharge**
- **Acceptance of performance**
- **Impossibility**
- **Excuse**
- **Good faith and fair dealing**



REMEDIES – A PREVIEW

Effects Generally:

- **If party doesn't satisfy covenant, it constitutes breach and other party may claim damages, but must still perform as long as breach is not material**
- **If party doesn't satisfy condition, other party may suspend performance or, if too late for condition to occur, terminate performance.**
 - **But other party may not be able to claim damages (unless promissory condition)**



REMEDIES – A PREVIEW

- **Who is supposed to go first?**
 - **In absence of agreement to contrary, performances are generally due simultaneously (Restatement (Second) of Contracts § 234)**
 - **Contractual solutions:**
 - **Express conditions**
 - **Advance payments**
 - **Progress payments**
 - **Security interests**



REMEDIES – A PREVIEW

- **Covenant or condition: If party doesn't perform, must other party perform anyway?**
 - Agreement by parties (express conditions)
 - Statute
 - Court decision
 - Implied conditions
 - Materiality
- **How much or what kind of nonperformance by party excuses performance by other party?**



CONTEXT FOR TERMINATION, INDEMNIFICATION, AND REMEDY PROVISIONS

- **Stock purchase, asset purchase & merger agreements**
- **Venture financing agreements**
- **Credit agreements**
- **Commercial contracts**
- **Licenses**
- **Engagement letters**
- **Other contracts**



TERMINATION PROVISIONS: PURPOSE

- **M&A Context:**
 - Right to terminate and walk away rather than close and seek indemnification
 - Applicable only where the agreement is signed and there is a delay before closing
 - Saves parties the expense of waiting until closing to determine whether a condition is met
- **Non M&A Context:**
 - Termination right may be exercised at any time during the term of the agreement
 - Termination right and length of contract are usually the same

Example: Even though a credit agreement has a funding date, or a “main event,” the termination provisions would extend for the duration of the agreement



TERMINATION PROVISIONS: FUNCTION

- **As a Stand-Alone Section:**
 - Sets forth the set of circumstances giving rise to termination rights
 - Provides for the rights and obligations of the parties depending on different termination scenarios
- **Role in Agreement:**
 - Tied to the conditions, covenants and events of default sections of agreements
 - **M&A context:** triggered by occurrence or non-occurrence of conditions
 - **Credit agreement:** triggered by the occurrence of events of default
 - Termination section serves procedural function of attaching a meaningful right to the substance of agreement



TERMINATION PROVISIONS: WHEN PARTIES HAVE A RIGHT TO TERMINATE

- **Material Breach of any provision of agreement**
 - Basic principle of contract law
 - Prevents parties from having to close the deal and litigate damages later



TERMINATION PROVISIONS: WHEN PARTIES HAVE A RIGHT TO TERMINATE

- **Non-occurrence or impossibility of a condition to a party's obligation to close, provided that party seeking termination did not cause the non-occurrence of the condition**
 - Applies irrespective of fault (e.g. if a significant lawsuit arises)
 - Not tied to materiality or reasonableness
 - Where parties intend to tie termination right to materiality or reasonableness, those concepts are incorporated into the conditions or default provisions



TERMINATION PROVISIONS: WHEN PARTIES HAVE A RIGHT TO TERMINATE

- Sometimes parties negotiate right to cure prior to closing date

Buyers especially beware of blanket cure provisions

- **Mutual consent of the parties**
 - Parties agree ahead of time to walk away from the deal or arrangement if they decide not to follow through with a transaction in the future



TERMINATION PROVISIONS: WHEN PARTIES HAVE A RIGHT TO TERMINATE

- **Drop Dead Date**
 - Date after which either party has the right to terminate
 - Prevents party from keeping contract alive indefinitely and waiting for the most advantageous time to close
 - Parties can build in flexibility based on characteristics of the transaction
 - Can be arbitrary, but parties should think about it prior to signing



TERMINATION PROVISIONS: WHEN PARTIES HAVE A RIGHT TO TERMINATE

- **Parties can insert provisions in termination section that tie a right of termination to key events of particular importance to one party or the other**
 - **For example:**
 - **Employment agreements with essential employees**
 - **Buyer's ability to obtain financing**
 - **May want to consider continuation of other provisions**



TERMINATION PROVISIONS: EFFECT OF TERMINATION

- **No-fault termination: Parties can walk away without any obligations**
 - **Exception: obligations that usually survive termination**
 - **Confidentiality provisions**
 - **Parties' obligation to pay their own expenses**
- **Termination for breach resulting from fault of party:**
 - **Agreement often provides damages remedy**
 - **Liquidated damages**
 - **Option for non-breaching party to pursue specific performance in lieu of damages and election to terminate**
- **Breach does not automatically lead to termination; parties may use breach to extract concessions or re-write agreement to make condition a post-closing matter**



TERMINATION PROVISIONS: COMMONLY NEGOTIATED ELEMENTS

- **Knowledge, materiality or material adverse effects standard**
- **Drop dead date**
 - **Based on what needs to happen between signing and closing**
 - **Government approval**
 - **Third-party consents**
 - **Possible other items in conditions or event of default section of the agreement**



TERMINATION PROVISIONS: COMMONLY NEGOTIATED ELEMENTS

- **Termination Fees**
 - **Breach of no-shop followed by termination by Buyer**
 - **Breach of any other representation, warranty or covenant followed by termination by Buyer and execution by Seller of new agreement within 12 months of termination**
 - **Amount**



TERMINATION PROVISIONS: COMMONLY NEGOTIATED ELEMENTS

- M&A context: generally thought enforceable up to 4% of purchase price
- Recent Delaware Court of Chancery case: Vice Chancellor Strine noted that commentators had suggested termination fees up to 5% of transaction value would be enforceable
- **Liquidated Damages**
 - Apply when contract is terminated after performance has begun



INDEMNIFICATION PROVISIONS: PURPOSE

- To provide one or more parties to a contract with rights to recover damages that are separate from the rights that that party or those parties would otherwise have at law (common law, federal statute or state statutes, including UCC) or in equity
- Parties could rely on breach of contract, fraud and other common law claims, or the UCC, but often prefer to negotiate indemnification provisions, and even rely on them to the exclusion of remedies that would otherwise be available to them at law or equity, to arrive at clearly defined (or at least relatively so) rights to recovery, that may be broader or more narrow than the rights that would exist under statutory or common law, in the event that another party to the agreement breaches it



INDEMNIFICATION PROVISIONS: FUNCTION

Generally:

- **upon the breach of a contract by one party the other party has a right to recover the amount of any losses resulting from that breach from the other party**
- **subject to any limitations on that right agreed upon by the parties**



INDEMNIFICATION PROVISIONS: FUNCTION

- **Rights to Indemnification**
- **Limitations on rights to indemnification**
 - **Substantive**
 - **Procedural**
 - **Quantitative**
- **Limitations on remedies**



RIGHT TO INDEMNIFICATION: M&A CONTEXT

Right to recover from other party for:

- **Losses due to breach of representation, warranty or covenant**
- **Losses suffered as a result of known and agreed-upon issues (*e.g.*, environmental risks or litigation)**
- **Other losses due to the actions of the other party prior to (or after, in the case of buyer) closing**



RIGHT TO INDEMNIFICATION: COMMERCIAL CONTRACT CONTEXT

- **Right to recover from the other party for losses due to:**
 - **Products liability**
 - **Intellectual property infringement**
 - **Breach of contract**
 - **Negligence**



INDEMNIFICATION: SUBSTANTIVE LIMITATIONS ON LIABILITY

- **No right of recovery for**
 - **Matters other than those agreed to**
 - **Losses due to negligence, bad faith or misconduct on the part of the party seeking indemnification (particularly common in commercial context)**
 - **First party claims, unless otherwise agreed (commercial context)**
 - **Fraud (where contract includes merger clause)**



INDEMNIFICATION: PROCEDURAL LIMITATIONS ON LIABILITY

Survival Periods

- **No right to indemnification unless claim made within agreed upon time periods**
- **Time period varies depending on provision breached:**
 - **General representations – 12-24 months (e.g., subsidiaries, absence of undisclosed liabilities, litigation or contracts)**
 - **Fundamental representations - 3 years to indefinite (e.g., capitalization, financial statements or title to assets)**



INDEMNIFICATION: PROCEDURAL LIMITATIONS ON LIABILITY

- **Special Representations - statute of limitations or statute of limitations plus short period (e.g., tax, employee benefits and environmental)**
- **Covenants – indefinite (though sellers will generally try to limit)**
- **Other liabilities - indefinite**



INDEMNIFICATION PROVISIONS: PROCEDURE

- **Third-Party Claims:**
 - **Generally indemnifying party contests and settles**
 - **Carve-outs**
- **Separate, more simple procedure for first-party claims**
- **Subrogation – right to proceed against third parties**



INDEMNIFICATION: QUANTITATIVE LIMITATIONS ON LIABILITY

- **Baskets**
 - **Amount:** generally a percentage of the purchase price
 - **Nature:** tipping (dollar one) vs. deductible
 - **Multiple Baskets**
- **Caps**
 - **Amount:** median amount is 10-15% of the purchase price
- **Scope of Baskets and Caps**



INDEMNIFICATION: EFFECT OF CERTAIN LIMITATIONS ON LIABILITY

- **Materiality qualifiers**
- **Investigation (sandbagging / benefit of the bargain)**
- **Waiver of closing condition that there has been no breach (whether or not subject to materiality or material adverse effect qualifier) of any reps or warranties**
- **Updates to disclosure schedules**
- **Disclaimers of warranties and exclusion of incidental, consequential and/or punitive damages**



INDEMNIFICATION PROVISIONS: LIMITATION ON LIABILITY

- **Several liability vs. joint & several liability**
- **Mitigation**
- **Effect of tax benefits and insurance payments**



INDEMNIFICATION PROVISIONS: REMEDIES

Escrow or Holdback

- **Purpose:**
 - **Indemnification**
 - **Purchase price true up**
- **Term of Escrow: usually parallels survival periods**
- **Amount of Escrow**
- **Ownership for tax purposes**
- **Costs**
- **Security interest**



INDEMNIFICATION PROVISIONS: REMEDIES

Right of Set-Off

- **Common Law right**
- **Express set-off rights**
- **Timing issues (e.g., set-off rights applicable to future payment obligations such as promissory notes or earn-outs)**



INDEMNIFICATION PROVISIONS: REMEDIES

Exclusive Rights and Remedies Provisions

- **One party may want to limit indemnification rights to those set forth in the agreement**
- **Agreement can provide for exclusive source of indemnification**
- **Public Policy: some rights may not be waived (e.g., right to recover for material misstatements or omissions in context of sale of capital stock)**



DRAFTING TIPS

- **Remember – drafter is in position to practice preventative law**
 - **If drafter leaves covenants or conditions vague, court will provide answers**



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DRAFTING TIPS

- **Covenants:**
 - **Structure – if agreement is sufficiently complicated you may want covenants in separately-labeled section**
 - **Determine whether covenant should automatically apply from outset or if its effect should be limited by some condition**
 - **Does covenant comply with applicable laws? Is it enforceable?**

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DRAFTING TIPS

- **Covenants:**

- **Be clear and specific regarding:**

- **Rights and duties**

- What, how, and when of each obligation

Example: In drafting non-compete covenant may want to be more specific. Rather than using terms “operate” or “be involved in,” use “perform services as a salesperson or manager, in either the capacity of an employee or independent contractor for...”

- Or do you want vague terms?

- **Consequences of breaching**



DRAFTING TIPS

- **Conditions:**

- **Drafting clear conditions is necessary since courts often favor interpretation that event is not a condition in order to avoid forfeiture**



DRAFTING TIPS

- **Conditions:**
 - **Be clear by using express language of condition**
 - **If**
 - **On condition that**
 - **In the event that**
 - **Subject to**
 - **Be careful of vague time language (e.g., payment is due “when” a stated event occurs) because court may later interpret as merely a covenant**
 - **Instead, use “contingent upon”**



DRAFTING TIPS

- **Conditions:**
 - **Be clear whether provision is:**
 - **Condition precedent (i.e., parties are not bound until event occurs), or**
 - **Condition subsequent (i.e., parties are bound but may terminate if event does not occur)**



DRAFTING TIPS

- **Conditions:**

- Adequately define event
- Do you want condition objective or subjective?
- Subjective condition may give party an out

Example: “Shareholder shall have completed due diligence review of the business, assets, contracts and financial condition of Company, and shall be satisfied in all respects with the results thereof.”



DRAFTING TIPS

- **Conditions:**

- Express whether satisfaction is to be honest (subjective) or reasonable (objective)
- Where third-party approval is provided, contract should make appropriate provision for possible inability or refusal of third party to make decision



DRAFTING TIPS

- **Conditions:**
 - **Do conditional obligations consistently reference applicable condition(s)?**
 - **Can preface subsequent obligations with “subject to the conditions set forth above...”**
 - **Be selective**
 - **Use Recitals**
 - **Instead of stating that “time is of the essence,” state in recitals *why* time is material**



DRAFTING TIPS

- **Conditions:**
 - **Build remedy into contract**
 - **Is it intended that entire contractual relationship be unwound upon happening of some event?**
 - **“Void ab initio” (void from its inception)**
 - **Is it intended that one or more parties have option of rescinding?**
 - **“Voidable at the option of [either party, seller, etc.]”**
 - **Insert non-waiver clause**
 - **Not always honored by courts**



DRAFTING TIPS

- **Total Integration Clause:**
 - **Covenants and conditions fully stated in agreement**
 - **Agreement contains provision stating that any other agreements, whether oral or in writing, are superceded by the agreement and are thus null and void**
 - **But may not want**
 - **E.g., if parties have separate confidentiality or other agreement they want to continue post-closing**



NOTES



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