Stock Purchase Agreement Commentary

PLC Corporate and Securities

Commentary on key terms and conditions commonly found in a stock purchase agreement.

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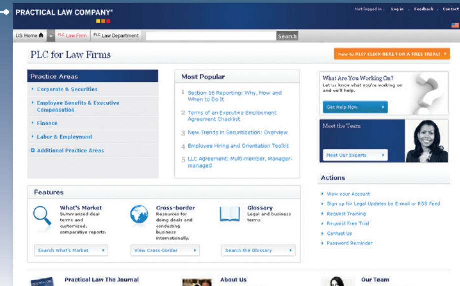

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The stock purchase agreement (sometimes called a share purchase agreement) is the main transaction document for a stock acquisition. It sets out what is being sold, details the sale process, and sets out the liabilities and obligations of the parties. While each deal has its own unique set of issues, almost all stock purchase agreements have the same key provisions and structure. This Note provides an overview of these provisions.

Once you understand the basic structure and main provisions of a stock purchase agreement, you can focus on the deal-specific issues that are important to the parties. For more information see the following:

- *Box, Key Negotiation Issues.*
- *Practice Note, Stock Acquisitions: Overview (http://us.practicallaw.com/4-380-7696).*
- *Practice Note, Stock Acquisitions: Tax Overview. (http://us.practicallaw.com/9-383-6719)*
- *Standard Document, Stock Purchase Agreement (Pro-Buyer Long Form) (http://us.practicallaw.com/4-382-9882).*
- *Standard Document, Stock Purchase Agreement (Auction Form) (http://us.practicallaw.com/3-502-5305).*
- *Stock Acquisition Checklist (http://us.practicallaw.com/0-383-2141).*

This Note assumes that each of the parties and the target company is a corporation. If any of the parties or the target company is a limited liability company (LLC) or partnership instead of a corporation, certain provisions of the stock purchase agreement will need adjusting. For example, if the target company is an LLC, the buyer acquires LLC interests rather than stock.

PREAMBLE

The preamble dates and defines the agreement. This section also identifies and defines the parties. It includes the type of entity and place of formation of any party that is not a natural person. If there are multiple sellers, a schedule to the agreement may list them rather than the preamble. The target company is typically not a party to the agreement, as it would be in a merger or asset acquisition.

RECITALS

The recitals provide the basic background to the deal. The recitals are a good place to explain any related transactions or other relevant information. For example, if there is more than one target company, the recitals clarify which seller owns shares in which target company.

DEFINITIONS

Stock purchase agreements can be long documents, so defined terms are commonly grouped together for structure and clarity. Defined terms are helpful when drafting or reviewing a stock purchase agreement because each term does not need explanation when used. For example, if the target company has subsidiaries, you can define "Company" to mean each of the companies which are part of the target group. Some defined terms are simply abbreviations, such as SEC, which stands for Securities and Exchange Commission. The parties negotiate other defined terms because they impact operative provisions of the agreement. For example, the parties often heavily negotiate the term Material Adverse Change (MAC) because it is critical to the allocation of risk between the parties (see *Practice Note, Material Adverse Change Provisions: Mergers and Acquisitions (http://us.practicallaw.com/9-386-4019)*).

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PURCHASE AND SALE

This is where the parties agree to buy and sell the target company's stock. The agreement requires the seller to deliver good title to the stock and deliver it free of third party claims. This section also generally states:

- The purchase price for the stock (or a mechanism for determining the purchase price).
- How and when the purchase price is paid (the consideration).
- If there are multiple sellers, how the consideration is split among them.

The most common forms of consideration are:

- Cash.
- Stock.
- Promissory note (debt).
- Any combination of the above.

Since the consideration often impacts the parties' tax consequences, the parties should consult a tax specialist when choosing the form of consideration, (see *Practice Note, Stock Acquisitions: Overview (http://us.practicallaw.com/4-380-7696)*).

PURCHASE PRICE ADJUSTMENTS AND EARN-OUTS

Purchase Price Adjustments

The purchase price is either fixed or subject to adjustment. A purchase price adjustment is a mechanism used to confirm the value of the target company as of the closing date. The most common purchase price adjustment is a working capital adjustment (see *Standard Clause, Stock Purchase Agreement: Working Capital Purchase Price Adjustment Provision (http://us.practicallaw.com/6-383-9979)*). The working capital adjustment increases or decreases the purchase price after review of a specially prepared balance sheet of the target company as of the closing date (sometimes called the closing balance sheet). Other common purchase price adjustments are based on:

- Profit and loss statements.
- Valuation of specific assets.
- Level of cash and debt.

Because the financial information is not ready until after the closing (usually 30 to 90 days), the parties agree to adjust the purchase price after it is paid. If the stock purchase agreement includes a purchase price adjustment , this section of the agreement usually contains:

- A mechanism for the preparation and review of the final financial information.
- Procedures for dispute resolutions.
- Allocation of expenses.

Earn-outs

Sometimes, future performance determines a portion of the purchase price of the target company. This is called an "earn-out." An earn-out is commonly used to provide an incentive to a key manager or owner. If there is an earn-out, the buyer pays part of the purchase price at closing and the rest gets paid in one or more stages if the target company achieves certain earnings targets. The parties typically negotiate the earnings targets and how to measure performance.Since the structure of an earn-out often impacts the parties' tax consequences, the parties should consult a tax specialist when drafting an earn-out provision.

ESCROW

The buyers can pay the purchase price in full at closing or have part of it withheld in an escrow account. The escrow secures possible purchase price adjustments or indemnification obligations. The seller often receives the escrow in stages, but can receive a lump sum at the end of an agreed period. The terms of the escrow account are usually in a separate escrow agreement entered into at the closing of the stock purchase agreement (see *Standard Document, Escrow Agreement (http://us.practicallaw.com/1-386-3603)*).

CLOSING MECHANICS

This provision sets out the when, where, what and how of the closing. Here you will find the closing date, where the closing takes place (usually at the offices of the buyer or seller's attorneys) and the method of payment for the purchase price (for example, by wire transfer).

REPRESENTATIONS AND WARRANTIES

Representations and warranties are statements of fact and assurances made by the parties. They are usually the longest part of the stock purchase agreement and take the most time to negotiate. These are statements made by the parties which:

- Disclose material information about the parties, the stock being sold and the target company.
- Allocate risk between the parties.
- Serve as the foundation for an indemnification claim in case of a breach (see below Indemnification).
- Impact a party's obligation to close the transaction or right to terminate the agreement before closing and walk away (see below Termination). The parties often must make representations at signing and again as a condition to closing (see Box, Bring down).

Limitations of Representations and Warranties

The scope of representations and warranties can be limited in the following ways:

- Materiality: you can qualify a representation or warranty by what is material or what might cause a material adverse effect.

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For example, seller might represent and warrant that "the company is not a party to any material legal action."

- Knowledge: you can qualify a representation or warranty by what a party knows or should know. For example, seller might represent and warrant that "to the knowledge of seller, there is no legal action pending against the company." The knowledge definition can be limited to the actual knowledge of certain employees of the seller or can impose a duty of care or inquiry, such as providing that a seller "would have known after a reasonable investigation."
- Range: you can limit a representation or warranty to certain material. For example, the representation or warranty might be limited to the materials identified in the data room.
- Time: you can make a representation or warranty as of a specified date or time. For example, the seller might make a representation or warranty as of the signing date or as of the fiscal year end.
- Scheduled information: you can limit a representation or warranty by reference to the disclosure schedules (see *Practice Note, Disclosure Schedules: Mergers and Acquisitions (http://us.practicallaw.com/6-381-1367)*). For example, buyer may represent and warrant that "there is no broker's fee payable except as set forth on Schedule 3.5."

Seller's Representations and Warranties

The seller's representations and warranties are much more extensive than the buyer's. In this section, the seller gives the buyer important facts about the target company, the stock it is selling and about the seller's right to sell the stock. If these facts are not true, the seller may have to make indemnification payments to the buyer.

Whether the seller's representations and warranties are broad or narrow depends on the allocation of risk between the parties. For example, if the buyer is buying the target company "as is" for a discounted purchase price, the seller will make limited representations and warranties. If there are multiple sellers, some sellers may only make limited representations and warranties about the individual seller's ability to transfer its stock. In that case, the major stockholder or parent company usually makes the representations and warranties about the target company.

Common representations and warranties of seller include:

- The seller has legal authority to consummate the transaction.
- The target company is duly organized under the laws of its jurisdiction.
- Information regarding the capitalization of the target company.
- Whether the target company has subsidiaries.
- The target company is in compliance with laws.
- The target company disclosed all liabilities.
- Tax matters.
- Litigation matters.
- Information regarding the target company's material contracts.
- Employee matters.
- Environmental matters.
- Intellectual property matters.
- Real property matters.
- The target company's assets are sufficient for the operation of its business.
- Neither the seller nor the target company owes any broker fees in connection with the transaction.
- Private placement representations and warranties if the seller receives stock as consideration.

Buyer's Representations and Warranties

Generally, the seller wants assurance that the buyer can complete the transaction, both legally and financially. If the buyer issues stock as all or part of the consideration, then the seller will require more detailed representations and warranties from the buyer. Typically, the buyer only makes the following types of representations and warranties:

- The buyer has legal authority to consummate the transaction.
- The buyer does not owe any broker fees in connection with the transaction.
- The buyer has sufficient knowledge about the target company and that the buyer is acquiring the stock of the target company for its own account with no intent to resell the stock. The seller requires this representation and warranty as part of its compliance with securities laws.
- The buyer has sufficient funds to complete the transaction.

CLOSING CONDITIONS

If there is a gap of time between signing and closing, each party will require the other fulfill certain conditions before the transaction closes. Usually there are conditions that both parties must satisfy and individual conditions that only bind one of the parties. The law may require some conditions, such as obtaining a governmental approval. Other conditions allocate risk between the parties.

If a condition of a party is not satisfied, then that party is not typically required to close the stock purchase until the condition is satisfied. A party can always waive its own closing condition. For example, if seller's receipt of landlord consent is a condition to the buyer's obligation to close and the seller does not get the consent, the buyer can waive the condition and close anyway. Often the parties agree to a remedy, such as indemnification, before waiving a condition. Common closing conditions include:

- Obtaining necessary government approvals (for example, approval under the Hart-Scott-Rodino Antitrust Improvements Act 1976) (see *Hart-Scott-Rodino Act: Overview (http://us.practicallaw.com/9-383-6234)*).
- No injunctions or other legal constraint on the transaction.

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- Bring down of the accuracy of representations and warranties (see *Box, Bring down*).
- All covenants of the parties have been complied with.
- A certificate of an officer of each party certifying the accuracy of representations and warranties and covenant performance.
- Receipt of required documents and instruments.
- No material adverse change in the seller.

Transaction-specific closing conditions could include:

- Stockholder approval.
- Tax opinions.
- Legal opinions.
- Third party consents.

BRING DOWN

When signing and closing are not on the same day, there is a risk that not all representations and warranties will continue to be accurate through closing. The buyer usually requires that representations and warranties be made at signing and again at closing. If the representations and warranties are not true at closing, then the buyer does not have to close. This "bring down" condition of the representations and warranties typically qualifies (at least in part) by materiality or material adverse change. Although the bring down mainly benefits the buyer, usually both parties will have a bring down of the other party's representations and warranties as a condition to closing.

COVENANTS

A covenant is a promise to take an action (an affirmative covenant) or to refrain from taking an action (a negative covenant). Covenants can govern the behavior of the parties from signing through post-closing.

Pre-closing Covenants

These covenants only apply between signing and closing. Often the parties cannot sign and close a stock purchase at the same time because of regulatory, financing or third party consent issues. If there is a gap of time between signing and closing, the seller typically covenants that it will conduct the business of the target company as usual until closing. Known as the interim operating covenant, this covenant is a list of certain things which the seller must do or not do before closing without the buyer's consent. This list depends on the industry of the target company and deal specific factors. Common pre-closing covenants include:

- Preserving the assets of the business.
- Not entering into any long-term or material contracts.
- Not dismissing or engaging any employees.
- Not incurring indebtedness.
- Not issuing shares.
- Not making capital expenditure in excess of a certain amount.

The parties may also make covenants to ensure the completion of the transaction. Other common pre-closing covenants include:

- Using best efforts to consummate the transaction.
- Not soliciting other buyers for the target company (known as a no-shop).
- Allowing the buyer access to its employees and premises.

Post-closing Covenants

These covenants only apply after the closing of the transaction. It is an attempt to manage the behavior of the parties after the deal is done. For example, the parties may include a mutual covenant to keep certain tax and business records of the target company for a period of time.

The buyer normally requires the seller to enter into a number of restrictive covenants relating to its conduct after closing (usually for a defined period of time). These are likely to include covenants not to compete with the target company or to hire employees of the target company (see *Purchase Agreement: Non-compete and Non-solicit Provision (http://us.practicallaw.com/8-383-9978)*).

Depending on the specifics of the transaction, the seller may also require the buyer to make post-closing covenants. For example, the buyer may covenant to provide director and officer insurance to outgoing directors and officers of the target company or to change the name of the target company if it contains a trademark used by the seller. If employees are transferred with the target business, the buyer often covenants to provide similar compensation and employee benefits for a period of time.

TERMINATION

A termination provision allows the parties to terminate the agreement under certain circumstances. If there is a period of time between signing and closing, the stock purchase agreement usually contains a termination provision. Generally, a party cannot terminate the agreement if that party is in breach of its obligations (see *Practice Note, Break-up Fees and Termination Provisions (http://us.practicallaw.com/6-382-5500)*).

Common Reasons for Termination

Common conditions that permit a party to terminate the agreement are:

- If the other party fails to fulfill its closing conditions.
- If the other party is in material breach of the agreement.
- If the seller has a fiduciary obligation to accept a better offer from another buyer.

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- By either party if the transaction has not closed by a specified date (known as the drop dead date).
- If both parties agree to terminate the agreement.

Break-up Fees

In many cases the parties agree to a break-up fee. Break-up fees are used to compensate the party who is not in breach if the deal is terminated. A break-up fee is commonly paid if a party fails to fulfill its conditions, accepts a bid from another buyer or is in material breach of the agreement (see *Practice Note, Break-up Fees and Termination Provisions (http://us.practicallaw.com/6-382-5500)*).

INDEMNIFICATION

Indemnification is a post-closing remedy for losses incurred under the stock purchase agreement. These losses can occur as a result of:

- Failure to perform a covenant.
- Breach of, or inaccuracy in, a representation or warranty.
- Certain liabilities allocated to one party or the other (for example, a particular litigation of the target company).

Procedures

Parties generally agree to specific procedures for indemnification. Examples of the types of issues that are negotiated in this section are:

- How to notify a party of a claim.
- Which party controls third party litigation.
- Ability to participate in third party litigation.
- Ability to settle a third party claim with or without consent.
- Requirement to cooperate or mitigate claims.

Limitations

Although both parties have indemnification obligations, it is more likely that the buyer will seek recovery than the seller. This is because the seller provides more extensive representations and warranties than the buyer. Even though any limitations apply to both parties, the seller will try to limit the recovery under the indemnification and the buyer will try to fight those limitations. Common limitations include:

- Caps. This provision limits a party's maximum total recovery to a stated dollar amount.
- Thresholds, baskets or deductibles. These provisions require a party to reach a total amount of losses before indemnification is available.
- Mini-basket or de minimis claims threshold. This prohibits any claim below a certain amount. Normally, these claims do not count toward thresholds, baskets or deductibles.
- Survival period. This provision provides an expiration time for indemnification claims made under the representations and warranties section. Survival periods usually range from six months to three years (18 months is common). Certain representations and warranties, such as tax, employee benefits and environmental matters, typically have a longer or unlimited survival period.

Certain provisions are often excluded from the limitations stated above, such as:

- Legal authority to complete the transaction.
- Title to shares.
- Capitalization of the target company.
- Certain matters set out on the disclosure schedules.
- Covenants.

MISCELLANEOUS

Every stock purchase agreement contains boilerplate clauses. Although these provisions are standard, they can have a significant impact on the agreement. For example, if the stock purchase agreement is not assignable, the seller may run into administrative problems if it wants to move the target company under control of another subsidiary before the closing. Common miscellaneous provisions are:

- Entire agreement.
- Assignment.
- Choice of law.
- Dispute resolution.
- Third party beneficiaries.
- Allocation of expenses.

DISCLOSURE SCHEDULES

The disclosure schedules list exceptions to the representations and warranties and other information that is too lengthy for the main agreement, (see *Practice Note, Disclosure Schedules: Private Mergers and Acquisitions (http://us.practicallaw.com/6-381-1367)*).

You should read the stock purchase agreement and the disclosure schedules together because the disclosure schedules impact many of the operative provisions in the stock purchase agreement. For example, if the seller represents and warrants that the target company is not party to any litigation except as set out on Schedule 3.7, the representation and warranty is meaningless without review of Schedule 3.7. The buyer verifies the schedules based on its due diligence review. For example, if the seller lists material contracts on a schedule that were not provided to the buyer, the buyer will request those contracts and conduct further due diligence, (see *Practice Note, Due Diligence for Private Mergers and Acquisitions (http://us.practicallaw.com/9-382-1874)*).

EXHIBITS

It is often necessary for parties to enter into ancillary agreements to handle issues that come up in connection with the transaction.

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These agreements are often attached as exhibits to the stock purchase agreement. Common ancillary agreements include:

- Escrow Agreement (see *Standard Document, Escrow Agreement (http://us.practicallaw.com/1-386-3603)*).
- IP Assignment Agreement (see *Standard Document, Intellectual Property Assignment Agreement (http://us.practicallaw.com/1-385-2746)*).
- Transition Services Agreement (see *Standard Document, Transition Services Agreement (http://us.practicallaw.com/7-386-4628)*).

KEY NEGOTIATION ISSUES

While each deal has different issues, there are certain provisions in the stock purchase agreement that the buyer and seller typically negotiate. Key issues that you should focus on when drafting or reviewing a first draft of the stock purchase agreement are:

- Key definitions. Defined terms such as "Material Adverse Change" and "Knowledge" are often heavily negotiated because they can significantly affect the allocation of risk between the parties.
- Escrow provisions. Parties negotiate whether to escrow any portion of the purchase price. If there is an escrow, the parties negotiate how much of the purchase price is escrowed, how long it is escrowed for, mechanics for its release and the identity of the escrow agent.
- Purchase price adjustments. Parties negotiate whether there will be a post-closing adjustment of the purchase price. If there is an adjustment, the parties negotiate the mechanics of the calculation and how disputes are resolved.
- Representations and warranties. Parties negotiate the scope of the representations and warranties. For example, if a buyer is purchasing the target company "as is," the seller will usually limit its representations and warranties to its ability to sell the stock of the target company and avoid giving any representations or warranties as to the business, assets or operations of the target company. Parties also negotiate whether a representation and warranty may be qualified by materiality, material adverse effect, knowledge or the disclosure schedules (see above Limitations of Representations and Warranties).
- Closing conditions. There are usually certain standard conditions to closing (see above Closing Conditions), but deal specific conditions, obtaining buyer financing or certain third party consents are typically topics of negotiation.
- Covenants. Parties negotiate the scope of the restrictive covenants. For example, the buyer tries to limit actions of the seller under the interim operating covenant while the seller tries to expand what actions are permissible. The parties also negotiate the inclusion and scope of other common restrictive covenants such as a no-shop (or exclusivity) and a non-compete. Another key area of negotiation is the allocation responsibility for liabilities in post-closing covenants, such as employee and tax matters.
- Termination. Parties negotiate who has the right to terminate the agreement, under what circumstances and whether break-up fees are payable in connection with a termination. If the agreement provides for the payment of a break-up fee, the parties negotiate the size of the break-up fee.
- Indemnification. Parties negotiate what is indemnified and the procedure for obtaining the indemnification. Limitations on indemnification are also heavily negotiated. For example, the size of any caps, baskets, or deductibles (see above Limitations).
- Dispute resolution. The parties often negotiate whether or not to include any alternative dispute resolution procedures. If the stock purchase agreement provides for alternative dispute resolution, the procedure is also typically negotiated.

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