MERGERS & ACQUISITIONS VI: ASSET PURCHASE TRANSACTIONS: DEAL POINTS

July 2022

I. Executive Summary

This is the sixth in our series of advisories on Mergers & Acquisitions ("M&A"). Its predecessors in the series, "Mergers & Acquisitions I: Overview and Transaction Types" ("M&A I"), "Mergers & Acquisitions II: Tax Structuring Considerations ("M&A II"), "Mergers & Acquisitions III: Acquisition Consideration ("M&A III"), "Mergers & Acquisitions IV: Preliminary Documentation" ("M&A IV") and "Mergers & Acquisitions V: Stock Purchase Transactions" **(**"M&A V"**)** are available with other M&A resources on our website at Kurtin PLLC Mergers & Acquisitions and on Lexology at the Kurtin PLLC Lexology Hub. Following the discussion are "Deal Points" on important considerations in the purchase or sale of a business: what to do, and *what at all costs not to do*.

This advisory will focus on the second of the three principal types of transaction structures used in M&A, an Asset Purchase. We'll discuss specific issues and attributes of Asset Purchase deals, and in section III, review the common elements of Asset Purchase Agreements, the main transaction document used to put an Asset Purchase deal together. Future editions in the series will focus on Merger transactions, as well as in "specialty" topics such as antitrust (competition), intellectual property, real property, employment and equity-based compensation, financing and others. In this and all future editions of this M&A series, familiarity with the preceding editions linked above will be assumed and previously defined terms will be used without further introduction.

II. Asset Purchase Deals

Asset Purchase transactions are one of the simplest M&A transaction types, as outlined and diagrammed in M&A I, at section III(b). As explained there, in contrast to a classic Stock Purchase, which is fundamentally a transaction between Acquiror and Target's shareholders, a paradigm Asset Purchase is a transaction between Acquiror and Target itself as an independent legal entity, a direct sale of assets by Target to Acquiror for Acquisition Consideration of cash, notes, stock, assumption of debt or liabilities and/or other consideration. Assets to be purchased can be cherry-picked by Acquiror subject to Target's agreement, and those specifically included and excluded in the Asset Purchase can be listed in the Asset

Purchase Agreement. The same is true for liabilities. The ability to include and exclude assets and liabilities to be acquired is the main reason that an Asset Purchase is the structure generally preferred by Acquirors, all other things being equal. An "Asset Purchase" in the context of M&A transactions does imply a transaction involving all or most of Target's assets, not merely a purchase of assets in the ordinary course of Target's business, such as purchasing its inventory or surplus equipment or machinery. If all, or nearly all, of Target's assets are acquired, Target is left a shell company, which is usually (although not necessarily) wound up and dissolved post-transaction, with the Acquisition Consideration and any remaining assets and liabilities finally distributed to Target's shareholders (there are cases in which it makes sense to continue Target's corporate existence post-transaction, such as Target's shareholders wanting to use it for another purpose, perhaps with assets excluded from the M&A deal and left with Target, such as relating to a core business after divesting the other parts of the business). Also, Target shareholders may receive a "stepped-up tax basis" in Target's remaining assets (akin to the stepped-up tax basis described in M&A II section III when making Tax Code sections 338(g) and (h)(10) elections for Stock Purchases to be treated as "deemed asset sales"), meaning that the tax basis of the assets is adjusted to equal their fair value at the time of the adjustment as compared to the transaction purchase price, which may confer a meaningful tax benefit to Target shareholders later on.

If, on the other hand, the Acquisition Consideration paid to Target for its assets is Acquiror stock, in whole or in part, Target and ultimately its shareholders, indirectly or directly, become Acquiror shareholders, as explained in M&A III section II(b). In a properly structured Acquiror-stock-for-Target-assets Asset Purchase transaction, in which "substantially all" of Target's assets are acquired using only Acquiror's or its affiliate's voting stock, the transaction can qualify for "tax-free" treatment under Tax Code section 368(a)(1)(C) or (D), in which Acquiror and Target recognize no tax gain or loss on the transaction, as explained in M&A II section II(c) and (d). Following is a discussion of Asset Purchase Agreement common elements.

III. Asset Purchase Agreement Common Elements

Many of the elements of an Asset Purchase Agreement are similar to those in a Stock Purchase Agreement as described in Stock Purchase Transactions, M&A V, section III. Since readers planning an Asset Purchase will not necessarily have read Stock Purchase Transactions, we will cover them again here, drawing distinctions in those elements' purpose and use in an Asset Purchase where appropriate.

Following are the most significant items treated in most M&A Asset Purchase Agreements, not necessarily in the order in which they would appear in the agreement itself.

a. Definitions: Just as we have defined terms for this M&A Deal Points series, which when introduced eliminate the need to re-explain them each time, Asset Purchase Agreements will invariably have a definitions section, often at the beginning, sometimes at the end, sometimes pitched out to an annex or schedule. Definitions are often inattentively or dismissively treated, but they can influence the whole transaction and lay traps for the unwary or dismissive. See below, ***Deal Point No. 1: Don't sneer at the defined terms, use them and use them consistently.***

b. Transaction Description: A concise statement of what Target assets are to be purchased (generally defined as "Acquired Assets" or something similar) and which excluded ("Excluded Assets" or something similar), and what liabilities and debt are to be assumed. Depending on the Target and the type of transaction, broad categories of assets to be acquired might be set forth (inventory, equipment, real estate, cash and cash equivalents, notes, accounts receivable, intellectual property, etc.), with only specifically listed assets excluded (sometimes "scheduled out"), so that anything not specifically listed as an Excluded Asset is deemed an Acquired Asset and included in the acquisition. On other transactions, the reverse method might be used, with only specifically listed or scheduled assets to be acquired, and everything not specifically listed excluded from the transaction. It is important to remember that an Asset Purchase Agreement is a private contract between Acquiror and Target, and the exclusion of liabilities or obligations does not as a legal matter prevent a third party from suing Target (or Target's shareholders if Target has been liquidated and dissolved). This is a main reason, along with assuring that Target has the right to convey its assets, that it is critically important to obtain third party consents to the transaction, whether by assignment of contract, novation, or otherwise.

c. Purchase Price: The Acquisition Consideration or purchase price, whether in the form of cash, notes, stock, a hybrid or combination, assumption of Target debt and/or other liabilities, or other assets. How and by what method the Acquisition Consideration should be paid should also be set out. In general, payment of Acquisition Consideration in full at closing is the default, but it is possible to structure payment in installments, subject to post-closing adjustments (see below) with a portion of the Acquisition Consideration held back, perhaps in a third party escrow.

d. Purchase Price or Acquisition Consideration Adjustments: Whether any pre-closing or post-closing discoveries or events can cause an adjustment to the Acquisition Consideration; these can be any variety of negotiated things: pre-closing change in Acquired Asset valuation relating to failure to obtain a third party consent or transfer a third party contract or regulatory approval; due diligence revelations; issues relating to accounting, such as changes to expected accounts receivable or cash on hand. Transactions often provide for "contingent earnouts," portions of the Acquisition Consideration held in escrow or deferred from payment unless and until agreed-to post-closing milestones are met, functioning as a hedge for Acquiror against overpaying.

e. Closing: When closing will occur and under what circumstances should be set out.

f. Closing Deliveries: Each party's required deliveries at closing, from certificates to executed documents to certified checks or wire transfer receipts.

g. Representations and Warranties: Each party's undertaking that a state of affairs exists as of the date of the Asset Purchase Agreement and (usually) will continue to exist until the closing. Some are very basic and nearly universal: that each party is properly formed and organized; in good standing in its home jurisdiction of domicile and every jurisdiction in which it does business; has no liens, tax or otherwise, against it, etc.; that Target has title to convey the Acquired Assets being purchased, etc.; that the M&A transaction has been duly authorized by proper corporate action; that the transaction will not contravene any law, regulation or third party right; that except as listed in an annexed schedule, there are no material undisclosed liabilities or contingencies like liabilities, debts, threatened or pending litigations or administrative/regulatory proceedings, etc.

   In contrast to a Stock Purchase Agreement, in which the fundamental reason for these basic representations and warranties is to establish that Target, which is itself what Acquiror is purchasing, is what Acquiror believes it to be (i.e., a company properly formed, in good standing, with no unknown material liabilities, contingent or otherwise; see M&A V), the fundamental reason for these representations and warranties in an Asset Purchase Agreement is to establish that Target has a right to sell its assets to Acquiror, since Target itself is not being acquired. Sometimes that is relatively simple, such as showing bank accounts, bills of sale for office equipment, title deeds to real property, etc. Sometimes it is more complex, such as establishing the right to convey a license to real property or a leasehold interest in real property, in which, depending on the asset, a third party consent may be necessary to obtain (for example, a real property lessor's assignment of the lease, a patent holder's assignment of the patent or patent exploitation rights or a IP licensor's transfer of the license to Acquiror).

In some cases, third party consent may be unobtainable, leading to a carve-out of that asset from the Acquired Assets in the deal and probably, if significant enough, a consequent purchase price adjustment. In some cases, failure to obtain a necessary third part consent might actually tank the deal. After all, the transaction is an Asset Purchase; there is always a potential straw that would break the camel's back, and asset or assets that, if they cannot be included in the deal, make the whole transaction not worthwhile for Acquiror. Obtaining third party consents is normally Target's primary responsibility, since Target has a pre-existing relationship with the third party, although Acquiror will often be expected to reasonably cooperate in the effort. For example, if the third party wants some information on Acquiror before giving its consent (financial means to pay the third party license, lease fees, etc., Acquiror is normally required to reasonably cooperate in giving adequate assurances to the third party. However, that Acquiror obligation has to be included in the Asset Purchase Agreement, often as an Acquiror affirmative covenant (see subsection III(n) below).

Other representations and warranties are more technical, specific to the parties and transaction, and asymmetrical, made by only one party and not the other: that a certain material Target third party contract is in good standing and has not been breached; that the Target has certain government licenses and permits in place and in good standing; that Target owns or has the right to use (by license, assignment or otherwise) certain intellectual property being conveyed as part of the acquired assets and the extent and duration of those rights; that Target and any subsidiaries have not incurred or guaranteed any more than a stated level of indebtedness, such as:

h. Intellectual Property: Ownership and/or the right to use the intellectual property included in the assets being acquired. Whether the M&A transaction may infringe any third party IP rights. Whether Target has or has obtained the right to convey the IP in the Asset Purchase.

i. Real Property: Ownership or leasehold to real property to be included in the Acquired Assets and any to be excluded from it. Whether Target has or has obtained the right to convey the real property in the Asset Purchase.

j. Employment and Employment Benefits: Key personnel employment contracts and equity-based compensation arrangements, like stock option pools, plans and grants; collective bargaining agreements and other agreements affecting Target employer-employee relations. There is never a right to specific performance of an employment contract; indentured servitude is illegal. However, the good standing and lack of breach of employment contracts can be represented and warranted in the Asset Purchase Agreement, and the resignation or failure to agree to a new or continued employment contract of a key employee can be made a trigger of remedies, from purchase price adjustment to termination of the Asset Purchase Agreement.

k. Other Assets: A schedule of other Target assets included and any being excluded from the transaction; examples might include inventory; cash and cash equivalents; accounts receivable; and office equipment.

l. Material Contracts: a schedule of contracts materially affecting Target's business, and third party consents or contract novations confirming that the third party accepts Acquiror being substituted into the contract in each case.

m. Insurance: Insurance policies constituting Target assets; their status and certificates transferring the policy to Acquiror; claims made or threatened against them.

n. Covenants: Sometimes confused with representations and warranties, but different in that they are not representations that a state of affairs exists and will continue to do so until closing, but each party's promises either to do something (or continue doing something) until and sometimes after closing (affirmative covenants) or to refrain from doing something until/until after closing (negative covenants). Examples might include Target covenants to maintain various regulatory approvals or licenses (affirmative), or not to let an approval or license lapse (negative), for Target shareholders not to compete with Acquiror after closing, etc.

o. Conditions to Closing: A list of conditions to each party's obligation to close the transaction, the failure of which to occur will excuse that party's obligation to close, such as that all previously made representations and warranties continue to be true as of closing; that no "Material Adverse Change" or "Material Adverse Event" as defined in the Asset Purchase Agreement affecting Target's business or the Acquired Assets has occurred (often called a MAC clause); that all third party consents have been obtained; that insurance commitments have been obtained, "fairness opinion" letters obtained and others.

p. Tax Treatment: Whether tax-free or tax-advantaged treatment for the Asset Purchase transaction will be sought in the transaction structuring (see M&A II).

q. Indemnification: Indemnification rights, the right of one party to claim against another for indemnification from third party claims. There are also "carve-outs" to indemnification rights, such as when a generally indemnified type of event has a subset that might occur without either party being at fault, or when an indemnified event falls short of an agreed-to threshold in potential damages. There are even sometimes "exceptions to carve-outs."

r. Compliance with Law: The parties will frequently negotiate obligations (whether by covenant or otherwise) to comply with applicable laws, such as those governing foreign corrupt practices or bribery (the Federal Corrupt Practices Act); technology export restrictions (U.S. State Department International Traffic in Arms Regulations, or ITAR; U.S. Commerce Department Export Administration Regulations, or EAR); foreign investment controls (Committee on Foreign Investment in the U.S., or CFIUS); sanctions (U.S. Treasury Department Office of Foreign Assets Control, or OFAC); money laundering and others. Obviously, not all, and sometimes not any, of these laws are relevant to every deal, but when they are, they must be structured for and cleared.

s. Termination and Effects of Termination: If there is a failure of a condition to close, such as a breach of representation, warranty or covenant; another material breach of the Asset Purchase Agreement; a failure to obtain financing or a critical regulatory or third party approval; or there is delay beyond a certain point in doing so, whether the non-breaching party may terminate the Asset Purchase transaction and what effects and remedies such a termination will have. Some breaches may give the non-offending party the right to terminate immediately; some may give the breaching party the chance to cure the breach before closing, or allow for purchase price adjustment to reflect the damage caused by the breach. There are sometimes "break-up fees" provided for to the non-breaching party to compensate it for its transaction time, effort and costs, and the opportunity costs of not have sought or obtained a deal with another party.

t. The "Boilerplate:" Almost invariably, the final article of every Asset Purchase Agreement will have sections derisively known as the "boilerplate" or "general" provisions. Like the definitions, the boilerplate does not always repay the sneers. Some provisions, like choice of governing law, choice of dispute resolution forum, assignment rights, confidentiality, third party beneficiaries, releases, rules of construction and others may provide critical rights; like the definitions, they should not be dismissively treated.

IV. Deal Points

Deal Point No. 1: Don't sneer at the defined terms, use them and use them consistently.

We made this point at the top of section III(a) and for Stock Purchases in M&A V. A lot of lawyers skip glassy-eyed over the definitions section, and let things go into them unremarked that are time bombs for their clients. Worst of the worst are M&A lawyers who go to the trouble of defining terms in the definitions section and then forget to use them in the text, or don't use them consistently. I had this come up a few years ago, when a highly specific and negotiated defined term list of "Indemnifiable Events" was ignored by opposing counsel in the text, allowing a non-listed event to also creep in and be subject to indemnification by his client. And…the unintended indemnifiable event actually happened. It's amateur hour, a low percentage move. Don't sneer at the defined terms.

Deal Point No. 2: Any non-cash-paid-in-full-at-closing Acquisition Consideration is in some measure contingent, and should require a premium over a cash on the barrelhead deal.

Any non-cash-on-the-barrelhead deal is in some measure contingent, and Acquiror should pay more overall than if paying cash in full at closing. Cash on the barrelhead should command a premium over any non-cash-on-the-barrelhead deal. A cash on the barrelhead offer is superior to a non-cash-on-the-barrelhead offer and should cost an Acquiror less for the same acquisition than the non-cash competing deal.

Deal Point No. 3: A cash-for-assets deal is generally assumed to be, for Target and its shareholders, a walk-away; that as long as they get their cash, they're happy. But they still need to be careful not to expose themselves to future claims based on representations, warranties, covenants, etc.; or to third party claims on indemnification or fraud. In a stock-for-assets deal, Target and, indirectly and ultimately, Target shareholders, become Acquiror shareholders, and should be as interested in Acquiror's status as Acquiror is in Target's.

The "cash out and walk away" aspect of a cash-for-assets deal for Target and its shareholders is overstated; Target/Target shareholders may still have potential liabilities from breach of representations, warranties or covenants and, potentially, for indemnification and fraud. All of that means that Target and its shareholders should be paying attention to the negotiation of the deal overall and the Asset Purchase Agreement and ancillary agreements. A stock-for-assets deal makes Target an Acquiror shareholder and Target shareholders indirect and ultimate Acquiror shareholders, and they should be as interested in Acquiror's representations, warranties, covenants, financials and other indicators of Acquiror status and health as Acquiror is interested in Target's status and health.

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