Disclosure Schedules in Acquisition Transactions

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Disclosure schedules play an important role in all acquisition agreements (whether it is an asset purchase agreement, stock purchase agreement or merger agreement). Schedules are generally related to the representations and warranties ("reps and warranties") made by the seller in the acquisition agreement. Reps and warranties are assertions of fact that the seller, and to a lesser extent, the buyer make about themselves and their businesses. Schedules are an extension of the agreement and add caveats and exceptions to the reps and warranties or disclose instances in which the reps and warranties are not true. Compiling the necessary information and preparing the schedules is one of the most time consuming aspects of an acquisition transaction. It is essential that the schedules are carefully prepared and reviewed because any inaccuracies or incomplete information could leave the seller potentially liable for breaches of the acquisition agreement.

This article sets forth general information about disclosure schedules, why these schedules are necessary and how they are prepared, as well as the importance of the schedules to the seller. It is hoped this article can serve as a guide for any individual, including the seller business person or a junior attorney, managing the disclosure schedule process.

1. Why Are Disclosure Schedules Necessary?

The reps and warranties in the acquisition agreement govern how detailed the disclosure schedules need to be. The seller's reps and warranties in the acquisition agreement are almost always significantly more extensive than the buyer's, and, accordingly, the seller almost always has to prepare more schedules than the buyer. This disclosure schedule process allows the buyer to better understand the target company being acquired.

The main reasons disclosure schedules are necessary are that they further the due diligence process and disclose information about the business in all aspects. The buyer is relying on the statements in the schedules to determine the target's condition, including its financial and legal condition. The reps and warranties, and the related schedules, help the buyer identify possible risks affecting the target company. If the disclosures are incomplete, inaccurate or reveal unfavorable information, the buyer may kill the deal or adjust the purchase price accordingly.

Schedules contain disclosures that are fact specific and either list information in accordance with ("as set forth in the schedules") or as an exception to ("except as set forth in the schedules") the reps and warranties in the acquisition agreement. A list schedule gives the buyer the full picture. These schedules may provide details relating to material contracts, intellectual property, leased or owned real property, assets owned, ownership of the company, key customers, legal proceedings and many other categories of company information. An exception schedule limits the scope of the seller's reps and warranties, and, as a result, may limit the seller's potential liability. For example, the agreement may state that "the seller requires no consents, permits or approvals in connection with the execution of this agreement, *except as set forth on Schedule ___*." A schedule would then be prepared detailing all of the consents, permits or approvals needed in order to consummate the acquisition agreement (and if the answer is none, the appropriate schedule should simply state "None").

The lawyer representing the seller may want to negotiate with the buyer's counsel to add qualifiers to the reps and warranties in the acquisition agreement. Qualifiers such as "to the best of seller's knowledge" or "except those that would not have a material adverse effect" narrow the reps and warranties. As discussed below, the more a seller promises is true in the reps and warranties, the more opportunities the buyer has to claim a breach of the agreement and seek damages. Narrowing the reps and warranties limits the seller's potential liability.

2. Process for Preparing Disclosure Schedules

a. Drafting and Negotiation

The reps and warranties section of the acquisition agreement is often the longest. This section also requires the most time-consuming and laborious action since the disclosure schedules need to be prepared in accordance with the reps and warranties. Preparation of the schedules typically occurs concurrently with the negotiation of the acquisition agreement.

The first draft of the schedules will generally be based on the first draft of the acquisition agreement. Typically, the buyer's attorneys will prepare the first draft of the acquisition agreement. Once the agreement has been reviewed by the seller's counsel, the seller's counsel will typically start to prepare the initial schedules—a separate page or pages for each schedule mentioned in the agreement—in correlation with the reps and warranties and the list of required schedules set forth in the agreement, and include instructions to the seller in brackets "[ ]." The instructions will be either a copy-and-paste or reworded description of the related disclosure requirement in the agreement. To make it easier for the seller's review, the instructions are often highlighted.

Once the initial set of schedules with instructions has been prepared and sent to the seller, the seller must

gather the information related to each schedule. This information-gathering process may include discussions with the seller's accountant, CFO, or employees in different departments of the company to identify the items that need to be included in the disclosure schedules or excluded from the reps and warranties. Either the seller, the seller's counsel or the seller's accountant compiles the information and places it into the appropriate schedule. Once the schedule has been answered, the highlighted instructions should be removed, leaving only the disclosures. Regardless of who prepares the initial draft of the disclosure schedules, it is essential that the seller review the schedules with care. The seller's business people have a much deeper understanding of the facts and conditions of their company. Prior to sending the schedules to the buyer, the seller's counsel must also review the schedules to ensure that the information appropriately and completely answers the disclosure requirements in the agreement and is displayed professionally. As the seller's counsel sends each draft of the schedules to the buyer's side, the seller's counsel should reserve the right for the seller to update the schedules prior to closing.

As part of the buyer's review of the schedules, the buyer will add comments or questions to the disclosures, asking the seller to add, elaborate or explain certain items. Sometimes the buyer will include a comment to the seller related to information that the buyer learned during the due diligence process. The schedules will then be sent back to the seller for another round of adjusting and eventually for completion.

As the seller and the buyer continue to negotiate the acquisition agreement, the schedules will be adjusted accordingly, going through the back-and-forth review process of the seller's side, then the buyer's side, and then back to the seller for revisions. During the negotiation process, some schedules may be added or removed; some schedules may be expanded or qualified in the agreement; and some schedules may be turned into separate agreements entirely. The disclosure schedules must be adjusted to reflect the changes to the agreement as the agreement progresses to completion.

It is important for the seller and the seller's counsel to constantly review the reps and warranties. Together, they must identify the reps and warranties that are untrue, misleading or inaccurate. If the acquisition agreement includes a rep and warranty with no reference to a schedule, but the seller has something to disclose related to that rep, a new schedule should be added and the appropriate words must be included in the agreement. The misleading reps and warranties must be corrected or qualified with a schedule.

The acquisition agreement may be negotiated to include some qualifiers (i.e., to the best of the seller's knowledge). If the agreement includes these qualifiers, it is important that the disclosure schedules do not contain additional qualifiers. To have the agreement limit disclosure with a qualifier, and then have the seller prepare the disclosure schedules with additional qualifiers would be "double dipping," which likely will be offensive to the buyer and its counsel.

b. Who Prepares the Schedules

The schedules may be prepared by the seller, the seller's counsel or the seller's accountant. There are several things to consider when deciding who will prepare the disclosure schedules.

The seller is the likely choice to prepare the disclosure schedules for several reasons. Nobody knows the business like the owner of the business. The seller is in the best position to know specific facts about its business, and to know the right person who would have the relevant information. If the seller takes the responsibility of preparing the schedules, the lawyer's role is to make sure that his or her client understands all of the representations that they are making. The lawyer should also review the schedules and ensure that all necessary information that the lawyer is aware of is included in the disclosures. It is likely, however, that the seller has never been involved in an acquisition transaction before. As a result, the seller may be unfamiliar with the disclosure schedule process, which may result in unprofessional or incomplete schedules, and may delay the preparation of the schedules and the closing of the deal.

The seller's counsel typically takes the role of overseeing and coordinating the preparation process and reviewing the schedules, but counsel may sometimes be in the best position to prepare the schedules, as well. Junior attorneys typically take the lead in the schedule preparation, and the senior attorney or partner will review the junior attorney's work. The attorneys know what information or documents to look for in the data room; what the agreement is asking for; and the meaning of terms used in the agreement that a business person may not completely understand.

Finally, the seller's accountant is another option to prepare the disclosure schedules. The accountant is an educated member of the seller's team who knows the financial and tax specifics of the company. The accountant may have a long-standing relationship with the seller, and may be in a good position to confirm company information. Accountants, like attorneys, are also skilled at the careful and detail-oriented (and often tedious) work required to move through the schedule process. During certain times of year, such as the accountant's "busy tax season," the accountant may ask that the attorney take the lead role in schedule preparation, if the client cannot.

3. Importance of Disclosure Schedules to the Seller

Since the disclosure schedules directly relate to the reps and warranties in the acquisition agreement, should the buyer incur any losses post-closing due to information

the seller failed to disclose or inaccurately disclosed, the buyer may have legal recourse against the seller. For this reason, it is extremely important for the seller to prepare the schedules with precision.

Sellers typically approach schedule preparation in one of two ways: (1) wanting to overdisclose to protect themselves or (2) wanting to keep bad news hidden from the buyer by not including information on the schedules. Overdisclosing in the schedules may alarm the buyer because the sheer volume of information disclosed may lead the buyer to think the target company has a lot of issues. Overdisclosing is helpful to the seller, however, as overdisclosing reduces the seller's risk of liability for breaching its reps and warranties.

It is not encouraged for a seller to keep information hidden from the buyer by excluding it from the disclosure schedules or burying it in tremendous lists. By not disclosing information on the schedules, the seller is leaving itself open to potential liability. Just telling the buyer information, either during due diligence or in passing, does not relieve the seller from the obligation to include such information on the disclosure schedule. The same is true for giving the buyer access to the data room—it is not enough; the information must also be included on the schedules. Further, including bad or surprising information on disclosure schedules without any verbal or prior notice to the buyer may result in a breakdown of trust, and may kill the deal. A good practice is for the seller to have a conversation with the buyer about sensitive matters early on in the transaction process.

Intentional failure to disclose material information can raise fraud concerns and subject the seller's senior executives and, in extreme instances, its counsel to liability and even criminal exposure. Serious ethical issues may result as well. Counsel should encourage clients that this type of conduct must be avoided without exception.

a. Qualifiers

Instead of excluding information from the disclosure schedules, the seller's attorney may negotiate to include qualifiers to the reps and warranties in the acquisition agreement. As mentioned above, narrowing the reps and warranties limits the seller's potential liability. Qualifiers may also reduce the laborious preparation process. Qualifiers change the information that is required to be included in the disclosure schedule. For example, instead of a rep and warranty asking to list all of the contracts entered into by the target company, the lawyers could negotiate to add a qualifier, such as "all contracts that exceed $10,000," in order to make the disclosures list shorter. This is helpful to both the seller and the buyer. Adding qualifiers minimizes the amount of time spent preparing schedules because the preparer no longer has to produce every single applicable thing, and it also makes it easier for the buyer to identify the material items.

b. Indemnification

As mentioned throughout this article, the disclosure schedules play an important role in the seller's potential liability post-closing. A seller's breach of the reps and warranties that creates liability or loss for the buyer post-closing will likely result in the seller's obligation to indemnify the buyer (subject to the terms of the acquisition agreement). If the agreement contains provisions for a holdback amount or earnouts, the seller should be even more aware of the impact of improperly prepared disclosure schedules. If these provisions are included in the acquisition agreement and there are issues related to the seller's reps and warranties, the buyer may be able to exercise "self help" and keep some of the purchase price that was originally due to the seller.

4. Conclusion

The reps and warranties are usually the most voluminous portion of the acquisition agreement. Accordingly, the related disclosure schedules are an integral part of any acquisition. The seller's team must carefully manage the process of preparing and reviewing the schedules due to the high level of specificity and precision needed to complete the disclosures. The schedules may play an important role in the seller's potential liability post-closing.

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