

CHAPTER 7

Litigation

The purchaser will rely particularly upon its counsel for advice regarding the significance of pending litigation, and litigation risks, of the target company. Litigation is the aspect of an acquisition review that is least likely to be undertaken by the officers or other advisers of the purchaser. In the case of an acquisition of all of the stock of the target company, the consequences of the litigation of the target company will have a direct impact upon the value of the acquired business. An asset acquisition in which the purchaser assumes litigation liabilities is substantially identical in effect, and even if there is no assumption of the seller's liabilities, an analysis of the seller's litigation is relevant both for an understanding of the litigation exposure inherent in the target company's business and for assessing the risk that the purchaser may become liable, under the several, ever-expanding theories of successor liability, for claims arising out of the seller's conduct of the business.

The following outline assumes the acquisition is being carried out pursuant to an acquisition agreement containing representations and warranties adequate to require the seller to disclose, as an exception thereto, all material pending or threatened suits and claims involving the target company and all outstanding judgments to which the target is subject.

Litigation in which the target company is the plaintiff is relevant to the purchaser insofar as it provides evidence of the significance of the issue being raised by the target to the success of the target's business.

Ordinarily purchaser's counsel's review of litigation does not begin until the seller's litigation disclosures are received. The scope of counsel's review of litigation will in each instance be the product of a cost-benefit analysis by the purchaser and its counsel, with the purchaser making the judgment as to what additional investigation will be of value to the purchaser. Frequently, the purchaser's response to the disclosure of significant litigation will be to seek adjustment of the purchase price or a particularized indemnification. In those instances, purchaser's counsel's principal role in reviewing the materials discussed in this chapter will be to ensure that the purchaser accurately understands the legal implications of a judgment against the target company. When the purchaser does not attempt, or is unable, to obtain a specific accommodation from the seller regarding disclosed litigation, greater reliance may rest upon purchaser's counsel's review of available information and analysis of the target company's situation because the seller may escape liability for breach of warranty when facts relating to such proceedings would have been discovered upon "reasonable" inquiry by the purchaser.

A. Disclosed Pending or Threatened Litigation

With respect to pending or threatened litigation disclosed by the seller in the schedules to the acquisition agreement, the scope of the purchaser's counsel's investigation is likely to be limited by the seller's counsel's

concern for protection of confidential communications. Assuming that the amount in controversy or subject matter of the suit is material, purchaser's counsel should request and review the following:

- ___ 1. Pleadings
- ___ 2. Correspondence between seller's counsel and counsel representing adverse parties, including, as to threatened litigation, any notices of claims or demands
- ___ 3. Seller's counsel's response to auditor's requests for information, and auditor's management letters to the target's board of directors
- ___ 4. SEC and other governmental filings
- ___ 5. Information as to any rights of indemnification or contribution available to the target company

In regard to particularly important litigation, counsel for the purchaser could also review deposition transcripts and documents, although litigation sufficiently serious to justify such an extensive review by purchaser's counsel frequently is dealt with by way of indemnification or it results in a business decision not to proceed with the transaction.

If the seller discloses that the target company is the subject of an outstanding judgment, decree, or settlement agreement (decree), purchaser's counsel should obtain and examine the following:

- ___ 1. The decree and any administrative or judicial opinion or finding of facts that may be relevant to the decree
- ___ 2. The case or proceeding docket with respect to the decree
- ___ 3. All post-judgment filings made by the target company with respect to the decree
- ___ 4. References to the decree in the target's SEC or other agency filings and financial statements
- ___ 5. Settlement agreements not resulting in a decree

Counsel's principal focus concerning outstanding judgments or settlement agreements should be, first, to confirm that any such judgment or settlement agreement would not prohibit, or require a consent for, consummation of the acquisition and, second, to provide information for the purchaser about the extent to which the decree limits the target's activities. If the outstanding decree is the result of litigation with a government department or agency, it may be appropriate for counsel to discuss the judgment with the agency's enforcement lawyers; the target company's permission should be obtained before any such discussions are initiated.

From the purchaser's standpoint, it is desirable that the seller's warranties in the acquisition agreement be framed to require disclosure of the target's litigation completed in the past five years involving material amounts or significant issues. Such disclosure is relevant to the purchaser

in understanding the litigation profile of the target company. In reviewing such disclosure, counsel should be particularly concerned with identifying those issues that have been resolved factually or legally against the target company. The fact that the litigation has been concluded should reduce or eliminate the target's concerns regarding confidentiality. The extent of counsel's investigation with regard to completed litigation will be determined by the purchaser's judgment as to the anticipated benefit of any such investigation, but the purchaser and its counsel should have in mind that breach of warranty claims against the seller with respect to disclosed proceedings may be very difficult to maintain.

B. Undisclosed Litigation

In some circumstances, the purchaser may be concerned that the seller's indemnification undertaking will have little value if it becomes necessary to prosecute a breach of warranty claim against the seller. In such situations, there is frequently some distrust of the seller and possibly other factors that lead the purchaser to suspect the seller's disclosures may be incomplete. In those situations, the purchaser's counsel can investigate additional sources of information, including the following:

- ___ 1. Nexis or other similar computer-based publication libraries
- ___ 2. Searches of judgment indexes and plaintiff/defendant indexes
- ___ 3. Searches of agency dockets
- ___ 4. Freedom of Information Act requests

Using most of these additional sources requires a preliminary judgment as to the particular courts or agencies in which an action involving the target may be pending.