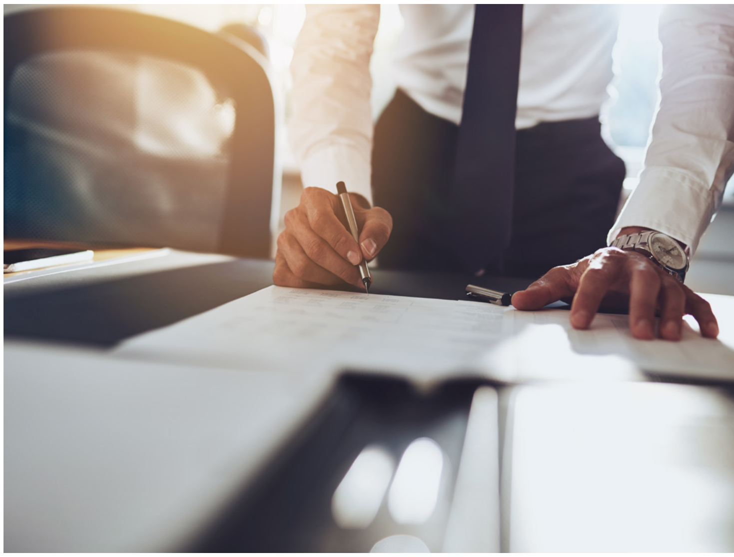
THE IMPORTANCE OF COVENANTS IN A BUSINESS TRANSACTION TO PROTECT YOUR INTERESTS

In a business transaction in which either stock or assets are being transferred, the parties to the transaction rely upon representations, warranties and covenants to protect their interest, whether it is the buyer or seller. Representations and warranties essentially address an information gap between the time the purchase and sale agreement is executed and when a closing takes place. Covenants also assist in addressing the information gap once the transactional documents have been executed to prevent one side or the other from acting in a way that might devalue the assets or stock being purchased. Covenants address this issue by defining the scope of what is actually being agreed upon and defining the conduct expected prior to the closing whether it is affirmatively or negatively. The primary purpose of the covenant is to provide the parameters of conduct that will assure that the parties receive the full benefit of the transaction.



How Covenants Serve to Protect Each Party's Interests

In many business transactions, the purchase agreement should include terms that limit the seller's ability for a reasonable period of time to compete with the business sold, which would be included in a covenant not to compete. This type of covenant provides protection to the buyer to receive the benefit deserved that would be reflected in the purchase price for the business or assets. It essentially serves to limit the activity of the seller such that the buyer is receiving the benefit of the bargain and in the event of a breach, the buyer would have a remedy in damages or through injunctive relief. The scope of the covenant and amount of damages resulting from a breach would be negotiated during the process of finalizing the transactional documents.

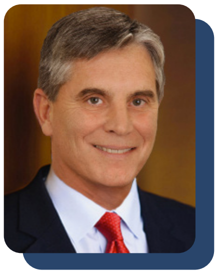
In order for a covenant to be effective, there must be a way for the beneficiary of the covenant to monitor compliance. For example, in the case of an employment agreement, periodic performance reviews would serve this purpose. If a covenant exists not to compete or solicit the seller's customers post-closing, the buyer would have the right to pursue damages and/or obtain an injunction against the seller for breaching the covenant.

Another example of a covenant in the sale of a business relates to the operation of the business by the seller after executing the purchase and sale agreement. This type of covenant stating that the seller should operate the business in the ordinary course and in a manner consistent with industry practice and standards protects the buyer between the time the purchase agreement is executed and when the closing takes place. Basically, the seller is obligated to operate the business in a manner consistent with past practice prior to executing the purchase agreement.

Finally, to protect the buyer in a business transaction, a covenant may provide that the buyer has full access to books and records during the due diligence process, which would include a physical inspection of assets prior to the closing. In the event of a material breach, the buyer would have the right to withdraw from the transaction or negotiate an adjustment to the purchase price.

Covenants exist to provide parameters for each party to protect and ensure that each party receives the full benefit of the transaction. Both the buyers and sellers in a business transaction, along with their attorneys, must exercise caution in finalizing the covenants that will be included in the purchase agreement because the failure to be diligent may result in significant costs and damages to either side of the deal.

If you have questions regarding covenants or any other business matter, please contact PLDO Managing Principal Gary Pannone at 401-824-5100 or email gpannone@pldolaw.com.



Gary R. Pannone
Managing Principal

PANNONE LOPES DEVEREAUX & O'GARA LLC
counselors at law