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TOP 10 PRACTICE TIPS: NEGOTIATING AN UNDERWRITING AGREEMENT

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In connection with a registered securities offering, the underwriters of the offering typically enter into an underwriting agreement with the issuer of the securities and any selling stockholders. The underwriting agreement sets forth the terms and conditions pursuant to which the underwriters will purchase the offered securities and distribute them to the public. Both the issuer's and underwriters' legal counsel play critical roles in negotiating key provisions of the underwriting agreement that have significant effects on the offering. Below are 10 practice tips to consider in drafting and negotiating an underwriting agreement.

1. FORM OF UNDERWRITING AGREEMENT

The lead underwriter's counsel is expected to provide the initial draft of the underwriting agreement. A good starting point would be the form of underwriting agreement of the lead underwriter, which will contain the representations, warranties, and covenants generally sought by the underwriter. The form can then be tailored to address the specific facts and circumstances, and can be negotiated with the issuer's counsel, which may request carve-outs, changes to the language of specific representations or warranties or changes to key definitions, many of which we discuss below. In adapting a lead underwriter's form underwriting agreement, consideration should be given to whether the offering relates to securities of a domestic or a foreign issuer, whether the offering will involve selling stockholders and whether the offering is the issuer's initial public offering or a follow-on offering. In the latter case, for a follow-on offering, it is often instructive to review the underwriting agreements entered into by the issuer for the prior offerings. The issuer's counsel ought to review current precedent by taking a look at underwriting agreements entered into in other recent offerings in the same industry led by the same underwriter in order to gauge the willingness of the lead underwriter and its counsel to accede to requests for changes to the underwriting agreement.

2. TAILORED REPRESENTATIONS AND WARRANTIES

During the drafting process, both the underwriters' and issuer's counsel should focus on tailoring the representations and warranties to the current market precedent based on recent offerings in the issuer's industry. The representations and warranties provide both parties an opportunity to focus on and resolve any open diligence issues, and industry-tailoring can help both parties identify the protections or issues that are most important to them given the issuer's line of business, regulatory considerations, and market precedents. Both parties also should consider the type of offering, which may range from a new issuer's initial public offering of common stock to a seasoned issuer's follow-on offering of debt, equity or equity-linked securities, when tailoring representations and warranties in order to ensure that they address issues that relate to the particular offering.

3. DEFINITION OF MATERIAL ADVERSE CHANGE

An underwriting agreement should define an event that triggers a material adverse change (MAC) or material adverse effect (MAE). Depending on how these terms are defined, a breach in a representation or warranty may result in a MAC or MAE in the issuer's business and results of operations.

and therefore allow the underwriters the opportunity to exit the transaction, because the occurrence of the MAC or MAE resulted in it being impracticable or inadvisable to pursue the offering (commonly referred to as a market-out). The underwriter will want to draft the MAC or MAE provision as broadly as possible in order to allow the most flexibility to exit the deal if a representation or warranty is breached. Form underwriting agreements may also include forward-looking language that defines a MAC or MAE as a material change in the issuer's prospects, granting the underwriters additional flexibility if a breach occurs that may not be material at present but could potentially lead to material adverse effects in the future. The issuer may insist on narrowing the definitions of MAC and MAE so as to not give the underwriters the freedom to walk away from the transaction and they may seek to minimize or remove any language that provides the underwriters full discretion to determine on their own whether or not a particular event has risen to the level of a MAC or MAE. The issuer also may seek to strike any forward-looking language to prevent the underwriters from exiting a transaction upon the occurrence of a nonmaterial breach.

4. KNOWLEDGE QUALIFIERS

When drafting an underwriting agreement, underwriters will require the issuer to make representations about the state of its business and the marketability of its securities. In respect of certain issuer representations and warranties that relate to assets or disputes as to which diligence may be costly or where there may be some difficulty associated with accessing information related to third parties, there is often negotiation as to whether these representations will be given without qualification or whether a particular representation should be given subject to a knowledge qualifier. An issuer will want to limit any representations about itself and its business to what it knows or reasonably should know in order to avoid an unanticipated breach. The underwriter, however, will seek to limit the knowledge qualifiers included in the underwriting agreement as much as possible, because the issuer is in the best position to provide accurate information about its business. If a knowledge qualifier is included, legal counsel for the underwriters should consider adding a due inquiry provision to provide support.

5. FCPA, OFAC AND ANTI-MONEY LAUNDERING REPRESENTATIONS

In the underwriting agreement, the issuer is often expected to make representations relating to its compliance with the Foreign Corrupt Practices Act of 1977 (FCPA), the sanctions administered by the Office of Foreign Assets Control (OFAC) of the US Department of the Treasury, and anti-money laundering (AML) laws. Underwriters have typically placed increased importance on these compliance representations because of recent increases in enforcement activity by federal authorities and severe civil and criminal penalties that result from violations. The underwriters therefore should focus on maintaining the standard FCPA, OFAC and AML representations in the form underwriting agreement

designated by the lead investment bank. Nonetheless, the issuer may want to tailor these representations and warranties to its specific circumstances. A common negotiation point is the scope of the parties subject to the representation. Most form underwriting agreements certify compliance by the issuer, its subsidiaries and their respective directors, officers, employees and agents. The issuer may be able to agree on a narrower selection of parties, identifying those parties that the issuer has more direct control over, or oversight of, as it may be costly or impractical to locate every one of its agents. Additionally, the issuer may be able to add a knowledge qualifier to a representation or warranty that certifies compliance of one or more parties over which it does not have direct control.

6. UNDERWRITER INFORMATION CARVE-OUT

When drafting the underwriting agreement, the underwriters will typically provide a short list of information that it is providing to the issuer that will be included in the prospectus. This information is typically limited to the underwriters' contact details and intended distribution and stabilization methods. The underwriters often agree to indemnify the issuer for any claims arising from the use of some or all of the information on the list. The underwriters will want to identify a very limited list of the information it provides the issuer, either prepared by the underwriters or third parties selected by them, in order to define clearly the scope of the indemnity. Because this information will be used for the prospectus and any road show presentations, the issuer will want to draft the information carve-out as broadly as possible in order to protect itself from claims caused by misinformation or misstatements made by the underwriter.

7. INDEMNIFICATION AND TERMINATION

Underwriters' counsel typically insists on little to no changes being made to the indemnification and termination sections from the language included in the representative underwriter's form underwriting agreement. Underwriters want as much flexibility as possible in order to exit the transaction in the event of a termination and as much protection as possible in the event of litigation. Beyond negotiating the definitions of MAE or MAC as described above, which would by consequence limit the scope of the termination provision in the underwriting agreement and what situations indemnification would trigger, the issuer and their counsel are unlikely to convince the underwriters to make any substantive changes to these sections and thereby create a narrower public market precedent. Notwithstanding the issuer's inability to materially amend the form indemnity section, the issuer and their counsel should insist that the indemnity provided by the underwriters to the issuer, as described above, uses the same protective language as the indemnity provided by the issuer to the underwriters.

8. ISSUER LOCK-UP

During and following the transaction, the underwriters will want to prevent the issuer from issuing, and its directors and senior executives from selling any securities that could negatively affect the pricing of the securities in the offering. A large issuance of the issuer's shares could dramatically decrease the demand, and thus the price, of the securities to be offered in the transaction or cause investors to become more skeptical about the potential risk of investing in the securities to be offered by the underwriter. The underwriters will seek to obtain lock-up agreements from all or substantially all existing security holders for a period of 180 days. The issuer should seek carve-outs that will prevent the lock-up from interfering with existing agreements. These include, but are not limited to, carve-outs for already planned issuances or transfers of securities, ordinary course lending or capital markets activities, and issuances for employees under existing agreements or to attract or retain key talent. For more practice tips on lock-up agreements, see Top 10 Practice Tips: Lock-Up Agreements.

9. OFFERING EXPENSES

The issuer is expected to pay for or reimburse the underwriters for any offering-related expenses. The issuer is also expected to reimburse the underwriters for counsel expenses relating to the Financial Industry Regulatory Authority (FINRA) review. The issuer typically includes a limitation on the amount reimbursable for underwriter counsel fees in connection with the FINRA review. The underwriting agreement may also include a provision requiring the underwriters to reimburse the issuer for certain offering expenses in the event that the underwriters breach the underwriting agreement. For example, an issuer may request reimbursement if the underwriters fail to market

the securities in a manner consistent with the underwriting agreement. Notwithstanding the limited reimbursement obligation, the underwriters are expected to pay for their own counsel.

10. DELIVERABLES

The underwriting agreement will specify the documents that are required to be delivered to the underwriters as a condition to completing the offering. Deliverables include legal opinions to be delivered by each party's counsel, officers' and secretary's certificates, good standing certificates and a comfort letter from the issuer's independent auditor. Both counsels should also deliver negative assurance letters to the underwriters that confirm that no material misstatements or omissions were included in the prospectus. This letter allows either party to establish a due diligence defense against claims that missing or misstated material information has misled investors. The comfort letter delivered by the issuer's auditor provides certain assurances regarding the independence of the auditors, their completion of an audit for the annual financial statements, their completion of a review for interim financial statements, the conformity of the issuer's financial statements to US GAAP or IFRS as adopted by the IFRS, as well as certain agreed upon procedures in relation to other financial information contained in the offering documents and derived from the financial statements. Depending on the nature of the issuer's business and the laws and regulations applicable to their business, underwriters' counsel should also seek additional specialist opinions from counsel to the issuer, such as tax matters, regulatory matters or intellectual property matters. Due to the short period between signing and closing (typically two business days), the underwriters' and issuer's counsel should negotiate as far in advance as possible the scope of all legal opinions.

