Negotiating Contractual Indemnity in M&A Deals:
Transactional and Litigation Considerations
Structuring Terms to Minimize Financial Risks, Measuring Damages in the Event of Breach

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Today’s faculty features:
Frank C. Koranda, Jr., Partner, Polsinelli, Kansas City, Mo.
Lisa R. Stark, Partner, K&L Gates, Wilmington, Del.
Brandon Vongsawad, Kirkland & Ellis, Los Angeles
Frank Dery, Director, PricewaterhouseCoopers, Chicago

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INDEMNIFICATION

- A contractual obligation by one party to pay or compensate for the Losses, Damages or other liabilities incurred by another party
- Indemnity shifts risk between parties to an agreement as part of an integrated risk allocation system, including reallocation of economic value

Sample Indemnification Provision

ABA Publishing, Model Stock Purchase Agreement, 2nd Edition

Sellers, jointly and severally, shall indemnify and hold harmless Buyer, the Acquired Companies, and their respective Representatives, shareholders, Subsidiaries, and Related Persons (collectively, the “Buyer Indemnified Persons”) from, and shall pay to Buyer Indemnified Persons the amount of, or reimburse Buyer Indemnified Persons for any Loss that Buyer Indemnified Persons or any of them may suffer, sustain, or become subject to, as result of, in connection with, or relating to:

(a) any Breach of any representation or warranty made by Sellers in (i) this Agreement or the Disclosure Letter (without giving effect to any supplement to the Disclosure Letter), (ii) any supplement to the Disclosure Letter, (iii) the certificate delivered pursuant to Section 8.3 (without giving effect to the words “in all material respects” in Section 8.1(a)), or (iv) any other certificate, document, or other writing delivered by Sellers pursuant to this Agreement;

(b) any Breach of any covenant or obligation of any Seller in this Agreement or in any certificate, document, or other writing delivered by any Seller pursuant to this Agreement;

(c) any claim by any Person for brokerage or finder's fees or commissions or similar payments based upon any agreement or understanding made, or alleged to have been made, by any such Person with any Seller or an Acquired Company (or any Person acting on their behalf) in connection with any Contemplated Transaction;

(d) (i) any Taxes of any Acquired Company not reflected on the Closing Date Balance Sheet relating to periods on or prior to the Closing Date, and (ii) any liability of any Acquired Company for Taxes of any other Person, as transferee or successor by Contract or otherwise;

(e) any product shipped or manufactured by, or any services provided by, any Acquired Company, in whole or in part, prior to the Closing Date; or

(f) any matter disclosed in Part 11.2(f).
Types of Damages

- Reps and warranties
- Covenants and agreements
- Indebtedness
- Taxes
- Retained liabilities
- Special indemnities

Definition of “Losses” or “Damages”

- Pro-Buyer
  - Expansive litany of types of Losses
  - Arising under, in connection with or related to the underlying indemnification obligation
  - Include expenses for investigation and defense of any claim and pursuit of claim against Seller
- Pro-Seller
  - Limited to out-of-pocket, actual and reasonable fees and expenses
  - Must directly result from the underlying indemnification obligation
REPRESENTATIONS AND WARRANTIES

Common Representations
- Organization
- Noncontravention
- Compliance with Laws
- Taxes
- Labor/Benefits
- Customers/Suppliers
- Environmental Matters
- Authorization/Enforceability
- Capitalization/Subsidiaries
- Title to Assets
- Contracts
- Absence of Changes
- Affiliate Transactions
- Intellectual Property Matters

Specific Accounting Representations
- Financial Statements
- Accounts Receivable
- Accounts Payable
- Inventory
- Undisclosed Liabilities

Financial Statements
- Types of Financial Statements
- Books and Records
- GAAP versus Historical Company Policies and Principles
- “Fairly Presents”
- Interim Statements – year-end adjustments and footnotes
LIMITATIONS

- Carve-Outs for fundamentals, special circumstances, specified liabilities
- Tipping Basket versus Deductible
- Uncapped and indefinite obligations unenforceable (Cigna Health and Life Insurance Co. v. Audax Health Solutions, Inc., 107 A.3d 1082 (Del. Ch. 2014))
- Basic Cap often limited to escrow
- Dependent upon the size of the Deductible, presence of a Mini-Basket and size of the deal

- Materiality scrape for determining breach
- Materiality scrape for measuring damages
- Exceptions to materiality scrapes
- MAE qualifiers – when do they belong in reps/warranties at all

- Tax Benefits offsets
- Insurance and other proceeds offsets
- Mitigation requirements
LIMITATIONS

- **Exclusive Remedy**
  - “The sole and exclusive remedy for any breach or failure to be true and correct of any representation or warranty shall be indemnification made in accordance with Article X. In furtherance of the foregoing, the parties hereby waive, to the fullest extent permitted by law, any and all other rights, claims, and courses of action under any federal, state or local law.”

- **Sandbagging**
  - The moral highground and middle of the road position
  - Knowledge as a first line of defense

- **Purchase Price Adjustment and Double-Dipping**
  - “No Purchaser Indemnified Party shall make any claim for indemnification under this Article X in respect of any matter that is taken into account in Section 2.4 (working capital adjustment).”

- **Disclosure During Executory Period**
  - Effect – Do schedule updates effect indemnity
  - Timing – When does breach need to arise
LIMITATIONS

- Unlike some other states, Delaware allows parties to contractually shorten the statute of limitations (which is 3 years for breach of contract and fraud in DE) so long as reasonable.

- Parties may contractually extend the statute of limitations (without signing “under seal”) for up to 20 years for contracts involving more than $100,000. The statute may be extended for:
  - a specific period of time
  - a period of time defined by reference to some other event, action, document or statute
  - an indefinite period, which will be construed as 20 years
  - After *Cigna*, indefinite (i.e., 20 year survival) may not be enforceable
  - SOL amendments recently applied retroactively

- Similar to a statute of limitations, litigation must be commenced prior to the end of the survival period (notice is not in and of itself sufficient) unless the agreement specifically provides otherwise.
LIMITATIONS

- Indemnifications obligations that are temporally limited and/or do not put all of the merger consideration at risk of clawback
- Side letters or joinders (individual agreements by stockholders to assume indemnities)
- Contingent payment provisions – The merger agreement might specify that the target’s stockholders have a right to receive some specified amount of merger consideration if, and only if, the stockholders sign letters of transmittal containing an agreement to be bound by the indemnification obligations. The LoT should be attached to the merger agreement.
- Closing condition that gives the Buyer the right to walk if a specified percentage of target stockholders don’t agree to the LoT – Language in LoT should be clear that stockholders can’t be forced to sign but that the deal will not close unless enough sign
- Escrow or other holdback to satisfy indemnification claims
- Stock purchase agreement or asset purchase agreement

What might work after Cigna?
INDEMNIFICATION CARVE-OUTS

Fraud Carve-Outs

- Actual fraud:
  - Making a (material) rep that is false;
  - Knowing (in some jurisdictions, a reckless disregard for the accuracy or inaccuracy of a statement will suffice) that the rep is false;
  - Making it with the intent to deceive the other party;
  - Justifiable reliance on the rep by the other party; and
  - The other party was injured as a result of the false rep

- Constructive or Equitable Fraud
  - Generally same elements as ‘actual fraud’ or ‘fraud’ but ‘constructive fraud’ “may result from reckless and heedless rep not made with a deliberate intent to deceive”
  - Much lower standard and scienter is not required, but in Delaware a special relationship of trust or fiduciary relationship must exist between parties
  - Jurisdictional analysis is necessary to determine whether constructive fraud is a recognized cause of action and whether actual fraud includes reckless misrepresentations – other options include negligent misrepresentation

Other Carve-Outs

- Intentional, willful or negligent misrepresentation
- Define “Intent” as intent to deceive
What should non-reliance cover to minimize Seller’s liability for fraud based on extra-contractual statements:

- Seller is making no express or implied representations or warranties
- Seller is making no representations or warranties as to the accuracy or completeness of information provided by Seller to Buyer
- Buyer is not relying on any representations, warranties or omissions of the Sellers

What is insufficient

- Standard integration clause
- Statement that Seller is making no express or implied representations or warranties

ESCROWS AND CLAIM PROCESS

Key Considerations

- Escrow – First source? Sole source?
- Carve-Outs – fundamental reps, taxes, special indemnities, covenants
- Spillover claims – recourse for claims outside of escrow
- Escrow versus Holdback versus Seller Note
- Earnout – Does the acquirer have a responsibility to maximize value of the earnout post-closing
- Rollover Equity
- ‘Naked’ indemnification obligations

Third Party Claims Process

- Who controls defense
  - Who has more at risk
  - Reservation of rights/acknowledgment of responsibility
  - Exclusions: injunctive relief, government claims, criminal/quasi-criminal, failure to prosecute, other (adverse to business or reputation, adverse precedent)
  - Requirement of posting a bond or other security upon assumption of defense
- Wrapping up third-party claims – consent and exceptions
  - Final Adjudication
  - Settlement
2013 PRIVATE TARGET M&A DEAL POINTS STUDY

Sandbagging

- Pro-Sandbagging – 41% included Pro-Sandbagging (right to indemnification not affected by investigation or knowledge)
- Anti-Sandbagging – 10% included Anti-Sandbagging (no indemnification if party seeking indemnification had knowledge of such breach)
- 49% silent

Survival Periods

- Majority survival periods between 12-18 months with fundamental Carve-Outs

Baskets

- Most Baskets range from .5%-1% of Transaction Value
- 59% Deductible/Threshold
- 32% Dollar 1/Tipping
- 5% Hybrid
- 4% No Basket
- Fundamental Representations are typically excluded
- Most Baskets apply to reps and warranties; some apply to indemnity generally
- 30% have Mini-Basket
2013 PRIVATE TARGET M&A DEAL POINTS STUDY

- 28% have Scrapes
- 41% of Scrapes limited to calculation of Losses; 59% of Scrapes apply to Losses and truth of the rep

- 89% had Caps less than purchase price
- Mean – 16.6% of Transaction Value
- Median – 10.0% of Transaction Value
- Minimum – 2.7% of Transaction Value
- Maximum – 115% of Transaction Value
- Fundamental Representations are typically excluded
CREDITWORTHINESS OF INDEMNITORS

Key Considerations

- Who is the Seller/Indemnitor
  - Number of Sellers
  - Domestic or Foreign Sellers
  - Individuals
  - Entities
    - reps and warranties
    - actual entity with assets to backstop/be put at risk
    - currently solvent/able to make cash indemnification payments (debt restrictions on payments)
    - future prospects of indemnitor
    - guarantor

Buyer Perspective

- Company versus individual Seller reps and warranties
- Several versus Joint and Several
- Carve-Outs for specific items (Environmental, Taxes, Employee Benefits, Specific Indemnities)

Seller Perspective

- Several versus Joint and Several
- Seller will typically want to limit any obligations to the legal owner of the target company—especially if Seller is solvent and is an operating entity with real assets
- If there is an escrow, Seller will want to limit its exposure to the amount of the escrow in all cases
TYPES OF DAMAGES RECOVERABLE

- Direct
- Consequential
- Punitive
- Indirect
- Special
- Speculative
- Incidental
- Lost Profits
- Multiples

Weil Gotshal & Manges LLP article “Reassessing the Consequences of Consequential Damage Waivers in Acquisition Agreements”

- Loss of Value Concepts (“as is,” “where is” or “as warranted”)
  - Asset value – how to calculate fair market value
  - Earnings value (LTM EBITDA, Projected EBITDA, Other)
  - When to use transaction methodology versus a new valuation methodology
    - Net Assets, Multiple of Sales, Discounted Cash Flow, Comparables
- Breach of a specific or general warranty, and connection to Basket/Cap
  - Agree in advance to preferred approach and document the decision
- Prevailing Party Provision – In a dispute the loser pays
- Who can the Damages be collected against
  - Seller
  - Stockholder who did not participate in the wrongdoing
M&A INSURANCE

The Insured

- Buyer or Seller can be insured
- Policy can be in lieu of, or in addition to, Seller indemnification

Bridging the Gap

- Can provide a source of recovery where indemnification is otherwise unavailable
- Additional protection beyond indemnity Cap and survival limitations
- Insurer generally amenable to a “full” Materiality Scrape
- Improving collectability (compare to joint and several liability)
- Protect key relationships with “friendly” indemnitees (e.g., management sellers)
- Smaller escrow required (cover Deductible and special indemnities)
- “Clean Exit” - Allows institutional investors to distribute transaction proceeds earlier, with limited potential for clawback
- Avoid post-closing adversarial proceedings/litigation with Seller
- Ability to assign policy to affiliates, collaterally to lenders and to future Buyer
- Improved Buyer position in an auction

Economics

- Premium: 1-6% of coverage
- Retention: The Deductible under the policy (1-3% of enterprise value); exclusive of any Indemnification Basket/Deductible; Step-Downs
- Limits: Amount of coverage under the policy (insurance towers)
M&A INSURANCE LIMITATIONS

Coverage Limitations

- Pre-existing conditions (e.g. known environmental contamination)
- Express Sandbagging (i.e. actual and potentially constructive knowledge of breach will be excluded)
- Coverage for punitive damages, governmental penalties (e.g. reportable transactions), fraud
- The retention applies to all reps and warranties (including fundamentals)
- Covenant breaches will not be covered

Other Disadvantages

- Providing the legal, accounting and tax due diligence reports to the insurer in connection with the underwriting process almost always waives the privilege
- Seller versus Buyer policies
INDEMNIFICATION CONSIDERATIONS

- What parties are being indemnified
- What is the scope of covered losses
- Are legal fees and costs included within the scope of indemnity
- Does the indemnity extend to liabilities in addition to losses or damages
- Are there baskets and caps
- Is the indemnity consistent with any insurance products and other contractual provisions
- Is the indemnification the exclusive source of rights and remedies
- What is the survival period and when does that commence
- What carve-outs and exclusions to the obligations exist
- Does the indemnity cover direct and third party claims
- What is the indemnity procedure and who controls the defense
- Is the indemnifying party creditworthy; any guarantees or other parties needed