Negotiating Contractual Indemnity in M&A Deals: Transactional and Litigation Considerations

Structuring Terms to Minimize Financial Risks

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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
- Shifts risk between parties to an agreement as part of an integrated risk allocation system, including reallocation of economic value

Sample Indemnification Provision

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 be 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).

(ABA Model Stock Purchase Agreement, Second Edition)
TYPES OF DAMAGES

Indemnification Coverage

- Representations 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 underlying indemnification obligation
- Includes 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
COMPONENTS OF FINANCIAL STATEMENTS

REPRESENTATIONS AND WARRANTIES

Common Representations
- Organization
- Authorization/Enforceability
- Noncontravention
- Capitalization/Subsidiaries
- Compliance with Laws
- Title to Assets
- Taxes
- Contracts

Specific Accounting Representations
- Accounts Receivable
- Accounts Payable
- Inventory

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

- Labor/Benefits
- Absence of Changes
- Customers/Suppliers
- Affiliate Transactions
- Environmental Matters
- Intellectual Property Matters
- Financial Statements
- Undisclosed Liabilities
# Overview of Limitations

## Survival
- Ability to contractually limit statute of limitations
- Time periods for survival of reps and for ability to make claims

## Caps and Baskets
- Carve-Outs
- Type of Basket
- Uncapped and indefinite obligations unenforceable (DE)
- Amount (relation to amount escrow/deal size)

## Offsets and Mitigation
- Tax Benefits offsets
- Insurance and other proceeds offsets
- Statutory or contractual mitigation requirements

## Materiality Scrapes
- Materiality scrape for determining damages and/or breach

## Sandbagging
- Who knew what when
- Knowledge as first line of defense

## Disclosure Updates
- Effect: do schedule updates affect indemnity?
- Timing: when does breach need to arise?

## Exclusive Remedy
- Four corners of the agreement
LIMITATIONS: SURVIVAL

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 of limitations 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 against selling stockholders

SOL amendments recently applied retroactively.

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


LIMITATIONS: SURVIVAL, cont.

- 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
- Capped escrow or other holdback to satisfy indemnification claims
- Stock purchase agreement or asset purchase agreement

What might work after Cigna?
LIMITATIONS: SURVIVAL, cont.

11.1 SURVIVAL …

All representations, warranties, covenants, and obligations in this Agreement, the Disclosure Letter, the supplements to the Disclosure Letter, and any certificate, document, or other writing delivered pursuant to this Agreement will survive the Closing and the consummation and performance of the Contemplated Transactions.

11.5 TIME LIMITATIONS

If the Closing occurs, Sellers shall have liability under Section 11.2(a) with respect to any Breach of a representation or warranty (other than those in Sections . . ., as to which a claim may be made at any time), only if on or before the date that is ___ years after the Closing Date, Buyer notifies [Target’s representative] of a claim, specifying the factual basis of the claim in reasonable detail to the extent known by Buyer.

(ABA Model Stock Purchase Agreement, Second Edition)

- In most deals, reps survived for 12 to 18 months with carve outs for fundamental representations

![Pie chart showing survival periods]

- 75% in 12-18 mos
- 18% >18 mos
- 7% <12 mos
LIMITATIONS: CAPS

- Caps usually below purchase price
- Fundamental Representations are typically excluded

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<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Median</th>
<th>Minimum</th>
<th>Maximum</th>
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<tbody>
<tr>
<td>Deals in 2014</td>
<td>13.2%</td>
<td>10.0%</td>
<td>0.3%</td>
<td>100%</td>
</tr>
<tr>
<td>Deals in 2012</td>
<td>16.6%</td>
<td>10.0%</td>
<td>2.7%</td>
<td>114.7%</td>
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ABA M&A Deal Points
Study Data on Caps
LIMITATIONS: BASKETS

ABA M&A Deal Points Study Data on Baskets (deals in 2014)

- Most deals with survival provisions had deductibles
- 90% of deals with survival provisions had baskets that were less than 1% of the applicable Transaction Value
- Baskets typically do not apply to Fundamental Representations
- 90% of deals with baskets had baskets that apply to representations and warranties; 9% applied to indemnity generally
- 38% of deals with baskets had Mini-Basket (eligible claim threshold)
LIMITATIONS: OFFSETS AND MITIGATION

ABA M&A Deal Points Study Data on Offsets and Mitigation (deals in 2014)

- Mitigation requirement could exist outside of the contract
- Implementation – what do these offsets mean as a practical matter
- Offsets to the offsets – increase in insurance premiums?
LIMITATIONS: MATERIALITY SCRAPES

MATERIALITY QUALIFICATION IN REPS DISREGARDED FOR ALL INDEMNIFICATION-RELATED PURPOSES

For purposes of this Article VIII (Indemnification), the representations and warranties of Target shall not be deemed qualified by any references to materiality or to Material Adverse Effect.

MATERIALITY QUALIFICATION IN REPS DISREGARDED FOR CALCULATION OF DAMAGES/LOSSES ONLY

For the sole purpose of determining Losses (and not for determining whether or not any breaches of representations or warranties have occurred), the representations and warranties of Target shall not be deemed qualified by any references to materiality or to Material Adverse Effect.

(ABA Private Target Deal Points Study)

ABA M&A Deal Points Study Data on Materiality Scrapes (deals in 2014)

- 70% of deals with baskets had materiality scrape
- More than half of those materiality scrapes were not limited to loss calculations
**LIMITATIONS: SANDBAGGING**

**BENEFIT OF THE BARGAIN/PRO-SANDBAGGING**

*The right to indemnification, payment, reimbursement, or other remedy based upon any such representation, warranty, covenant, or obligation will not be affected by … any investigation conducted or any Knowledge acquired at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of, or compliance with, such representation, warranty, covenant, or obligation.*

*(ABA Model Stock Purchase Agreement, Second Edition)*

**ANTI-SANDBAGGING**

*No party shall be liable under this Article for any Losses resulting from or relating to any inaccuracy in or breach of any representation or warranty in this Agreement if the party seeking indemnification for such Losses had Knowledge of such Breach before Closing.*

*ABA study definition excludes clauses that merely state Target’s reps and warranties “survive Buyer’s investigation” unless include express statement on impact of Buyer’s knowledge on Buyer’s post-closing indemnification rights*
LIMITATIONS: DISCLOSURE UPDATES

- Notice requirement – provisions can expressly require target to notify buyer of breaches
- Effect – Do schedule updates affect indemnity
- Timing – When does breach need to arise

ABA M&A Deal Points Study Data on Exclusive Remedy (deals in 2014)

- Separately, 60% of deals in 2014 deal points study pool required target to notify buyer of breaches
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 this Article. 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.”

ABA M&A Deal Points Study Data on Exclusive Remedy (deals in 2014)

- Sample Exclusive Remedy Provision

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).”

Bar Chart:
- Exclusive Remedy: 90%, 94%, 92%
- Non-Exclusive remedy: 2%, 2%, 2%
- Silent: 8%, 4%, 6%
INDEMNIFICATION 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

- Intentional, willful or negligent misrepresentation
- Define “Intent” as intent to deceive
INDEMNIFICATION CARVE-OUTS, cont.

- Seller may limit liability for fraudulent extra-contractual statements
- Are magic words required?
- May the words be the seller’s or the buyer's?
  - Non-reliance clauses must contain an affirmative promise by the buyer
    - buyer did not rely on any extra-contractual statements
  - buyer relied only on the representations and warranties contained in the agreement
- What is insufficient
  - Standard integration clause
  - Statement by seller formulated solely as a limitation on the seller’s representations and warranties
  - Exclusive remedy clause

- Seller may not limit liability for fraud made within the four corners of the purchase agreement
INDEMNIFICATION CARVE-OUTS, cont.

- “Neither the Seller nor any of its Affiliates or Representatives is making any representation or warranty of any kind or nature whatsoever, oral or written, express or implied (including but not limited to, any relating to financial condition, results of operations, assets of liabilities of the Transferred Group), except as expressly set forth in this Article III, as modified by the Disclosure Schedules, and the Seller hereby disclaims any such other representations and warranties.”

- “The Buyer acknowledges that neither the Seller nor any of its Affiliates or Representatives is making, directly or indirectly, any representation or warranty with respect to any data rooms, management presentations, due diligence discussions, estimates, projections or forecasts involving the Transferred Group, including, without limitation, as contained in the Confidential Information Packet dated August 2013 and any other projections provided to Buyer, unless any such information is expressly included in a representation or warranty contained in Article III.”

- “[N]o claim, action, or remedy shall be brought or maintained subsequent to the Closing Date . . . based upon any alleged misstatement or omission respecting an inaccuracy in or breach of any of the representations, warranties, or covenants of the Company or Parent and Merger Sub, as applicable, set forth or contained in this Agreement; provided, however, that nothing in this Agreement shall be deemed to prevent or restrict the bringing or maintaining of any such claim or action, or the granting of any such remedy, to the extent that the same shall have been the result of fraud by any such Person or by the Company.”

- No party “makes any representation or warranty, express or implied, as to any financial or other matter with respect to the Company, or their respective businesses, operations or assets, except for the representations and warranties of the Company expressly set forth in this Agreement.”

- “This Agreement, the Transaction Documents and the Confidentiality Agreement constitute the sole and entire agreement among the Parties with respect to the subject matter of the Agreement.”
“Flesh and blood humans also can be held accountable for statements that they cause an artificial person, like a corporation, to make.”

Although the company may only make the representations and warranties in the purchase agreement, a selling stockholder may be liable (regardless of whether the seller has consented to the indemnity) if the buyer can show either:

- that the selling stockholder knew that the company’s contractual representations and warranties were false; or
- that the selling stockholders itself lied to the buyer about a contractual representation and warranty

A corporate officer or director can be held personally liable for the torts he commits and cannot shield himself behind a corporation when he is a participant:

- Did the directors and officers know the representations were false?
- Did the officers communicate directly with buyer’s representatives throughout the process?
- Did the directors oversee the sales process?
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
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**

Types of Damages:
- Direct
- Consequential
- Punitive
- Indirect
- Special
- Speculative
- Incidental
- Lost Profits
- Multiples

ABA M&A Deal Points Study Data on Types of Damages:
- Few deals *expressly* limit damages to “out of pocket” (5% of such deals in 2014 in ABA study pool)
- Few deals *expressly* provide for diminution in value, incidental damages, consequential damages, or punitive damages

Considerations:
- “Reassessing the Consequences of Consequential Damage Waivers in Acquisition Agreements,” by Glenn West and Sara G. Duran
- 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
- Against whom can Damages be collected
  - Seller
  - Stockholder who did not participate in the wrongdoing
In Winshall v. Viacom International, Inc., 76 A.3d 808 (Del. 2013), the Delaware Supreme Court held that a buyer was not entitled to reimbursement of its defense costs from selling stockholders in connection with certain post-closing third party claims because the merger agreement required an actual breach of representation or warranty to entitle the buyer to indemnification (and no such breach had occurred) and did not include explicit language requiring the selling stockholders to “defend” the buyer from such claims.

The operative indemnification provision stated: “[E]ach [selling stockholder] agrees . . . to . . . indemnify [buyer], the Surviving Corporation and their respective Affiliates . . . against and hold them harmless from and against any and all Losses, which may be sustained or suffered by any such Parent/MergerCo Indemnified Parties based upon, arising out of or by reason of: (i) the breach of any representation or warranty of the Company contained in this Agreement.”

Takeaways

- Where an agreement expresses only a duty to “indemnify,” as opposed to “indemnify and defend,” there is no separate duty to defend.
  - Buyers should ensure that they use appropriate language (e.g., “indemnify and defend”) to require sellers to reimburse them for defense costs in connection with third party claims that even might constitute a breach of a representation or warranty.
  - “Sellers jointly and severally will defend, indemnify, and hold Parent and Surviving Corporation harmless from and against . . . [_____] claim by parties other than Parent or Surviving Corporation that if true would constitute a breach of any representation or warranty of Company in this Agreement . . . .”
**M&A INSURANCE**

### The Insured
- Buyer or Seller can be insured (90% are Buyer policies)
- Buyer policies do not necessarily mirror the indemnification provisions
- Policy can be in lieu of, or in addition to, Seller indemnification

### Bridging the Gap
- Can provide source of recovery where indemnification 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 relationships with “friendly” indemnitors (e.g., management sellers)
- Smaller escrow required (cover basket 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: 3-5% of coverage
- Retention: The deductible under the policy (1-3% of enterprise value)
- Limits: Amount of coverage under the policy (insurance towers)
- Increased use, more insurers and more claims history has made pricing more competitive and adoption more consistent
## 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)
- Does not cover all types of Losses; does not cover fraud
- No coverage for purchase price adjustments (e.g., working capital, earnout)
- The retention applies to all reps and warranties (including fundamentals)
- No coverage for breaches of covenants

### Other Disadvantages
- Providing legal, accounting and tax due diligence reports to the insurer in connection with the underwriting process almost always waives the privilege
- Smaller transactions may be precluded by use due to cost
- Seller versus Buyer policies

### Limited but Growing Insurers
- Insurers - AIG, AWAC, Ambridge, Beazley, Concord, Hartford, Chubb/ACE, QBE, Maplepoint, Montpelier, Ironshore, Berkshire Hathaway, Great American, XL
- Some industries and topics are more difficult to insure (e.g., healthcare and environmental)
INDEMNIFICATION CONSIDERATIONS

- Which 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
- Is the indemnity consistent with any 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
SPEAKERS

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Frank Koranda assists clients with corporate and financial transactional matters, principally in private mergers and acquisitions. Whether a merger, offering, divestiture or financial reorganization, both domestic and international organizations rely on him for strategic legal counsel. He represents private equity and family office backed and strategic buyers and sellers of businesses and product lines. His practice also includes complex debt financings, including senior syndicated and mezzanine financings. Frank also operates as outside general counsel for a number of private companies, private equity funds and family offices with regard to their merger and acquisition activity and day-to-day management of legal affairs.

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Jessica Pearlman represents emerging and established companies in various corporate, securities, and finance matters, with an emphasis on mergers and acquisitions for both public and private clients, domestic and international. Jessica has particular depth of experience in various technology sectors, including healthcare applications, software, social media, data security, data storage, mobile applications, and search and search engine optimization, as well as in digital and traditional media, biotechnology, and transportation. She is a frequent presenter on mergers and acquisitions topics and was selected for inclusion in The International Who's Who of Merger and Acquisition Lawyers, Who's Who Legal and as a Washington Super Lawyer.

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Lisa Stark has over 15 years of corporate experience in such areas as mergers and acquisitions, strategic investments, initial public offerings, proxy contests, and hostile takeovers. She also has experience advising private and public companies and their boards of directors on corporate governance matters. Lisa also advises private equity and venture capital funds in connection with their investments in Delaware corporations.