Private Equity M&A Key Deal Terms: Reverse Break Fees, Seller Remedies and Post-Closing Indemnity
Negotiating and Structuring Closing Conditions and Termination Rights in a Changing Market

THURSDAY, JANUARY 9, 2014
1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today’s faculty features:

Adam R. Schaeffer, Partner, Jones Day, Chicago
Andrew J. Sherman, Partner, Jones Day, Washington, D.C.
Robert Profusek, Partner, Jones Day, New York

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Negotiating and Structuring Key Deal Terms in a Changing Market

Robert Profusek, Andrew Sherman, and Adam Schaeffer
Robert A. Profusek
Partner

Experience Highlights
- Potash Corporation of Saskatchewan successfully defends historic $43.1 billion hostile takeover bid
- Continental Airlines and United merge in $8.5 billion all-stock merger of equals
- Procter & Gamble sells its Folgers coffee business for $3.3 billion

Areas of Focus
- M&A
- Private Equity
- Corporate Governance
- Capital Markets
- Joint Ventures & Strategic Alliances

Honors & Distinctions
- Named "Dealmaker of the Year" by The American Lawyer in 2005
- BTI Consulting Group "Client Service All-Star" (2013)

Education
- New York University (J.D. summa cum laude 1975; Order of the Coif; Note and Comment Editor, Law Review); Cornell University (B.A. magna cum laude 1972)

Bar Admissions
- New York

Bob Profusek is an advisor to substantial businesses, focusing on M&A, including takeovers and buyouts; restructurings; and corporate governance matters, including executive compensation. He chairs the Firm’s global M&A Practice.

Recent representative M&A transactions include Potash's successful defense against BHP's unsolicited tender offer ($43.1 billion), the Continental-United Airlines merger of equals ($8.5 billion), Total's tender offer for SunPower ($1.4 billion), Cliffs National Resources' acquisition of Thompson Mining ($4.9 billion), and Procter & Gamble's sale of its Pringles business ($2.7 billion) and joint venture with Teva Pharmaceuticals for its global OTC medicine business. Prior transactions include Nextel's merger of equals with Sprint ($46.5 billion); Ernst & Young's divestiture of its consulting business through merger with Cap Gemini ($11.7 billion); and numerous transactions for WL Ross & Co., including the acquisition, IPO, and sale of International Coal Group ($3.4 billion); the merger of International Steel Group and Mittal Steel ($4.1 billion); and its build-ups in automotive components, textiles, and mortgage servicing.

Other companies with which Bob has worked on substantial matters include Abbott Laboratories, Disney, Macy's, RadioShack, and Wasserstein & Co.

Bob is a member of the boards of directors of two NYSE-listed companies. He also is a frequent speaker regarding corporate takeovers and corporate governance, has authored numerous articles, has testified before Congress and the SEC about takeover and compensation-related matters, and is a regular guest commentator on CNBC, CNN, Fox, and Bloomberg TV.
Andrew J. Sherman focuses his practice on issues affecting business growth for companies at all stages, including developing strategies to leverage intellectual property and technology assets, as well as international corporate transactional and franchising matters.

He has served as a legal and strategic advisor to dozens of Fortune 500 companies and hundreds of emerging growth companies. He has represented U.S. and international clients from early stage, rapidly growing start-ups, to closely held franchisors and middle market companies, to multibillion dollar international conglomerates. He also counsels on issues such as franchising, licensing, joint ventures, strategic alliances, capital formation, distribution channels, technology development, and mergers and acquisitions.

Andrew has written 24 books on the legal and strategic aspects of business growth, franchising, capital formation, and the leveraging of intellectual property. He also has published many articles on similar topics and is a frequent keynote speaker at business conferences, seminars, and webinars. He has appeared as a guest commentator on CNN, NPR, and CBS News Radio, among others, and has been interviewed on legal topics by The Wall Street Journal, USA Today, Forbes, U.S. News & World Report, and other publications.

Andrew serves as an adjunct professor in the M.B.A. programs at the University of Maryland and as well as the law school at Georgetown University and is a multiple recipient of the University of Maryland at College Park's Krowe Excellence in Teaching Award.
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Partner

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Experience Highlights
Saputo acquires dairy and non-dairy extended shelf-life producer Morningstar Foods from Dean Foods Company for $1.45 billion
Empeiria Acquisition completes $56 million tender offer
Veolia Environnement sells U.S. solid waste business to Highstar Capital’s portfolio company Star Atlantic Waste for $1.9 billion

Areas of Focus
Mergers & Acquisitions
Private Equity

Education
The University of Chicago (J.D. 2003); State University of New York at Geneseo (B.A. 2000)

Bar Admissions
Illinois

Adam Schaeffer concentrates his practice in the areas of mergers and acquisitions, leasing transactions, and general corporate matters. He represents buyers, sellers, and management teams in public and private acquisitions and divestitures, restructurings, joint ventures, and other strategic alliances, including those in distressed and non-distressed settings. He regularly advises clients regarding general corporate matters, including corporate governance, fiduciary issues, and strategic planning, and in connection with the negotiation of commercial contracts.

Adam has represented clients in a wide range of industries, including manufacturing, mining, aerospace, agriculture, health care, pharmaceuticals, logistics, and software.
Agenda

- State of the Market
- Deal Certainty
- Post-Closing Indemnity
- Other PE-Specific Considerations
State of the Market
Worldwide M&A Deal Volume

Source: Bloomberg Global Legal Advisory Mergers & Acquisitions Rankings 4Q 2013
Worldwide M&A Deal Numbers

Source: Bloomberg Global Legal Advisory Mergers & Acquisitions Rankings 4Q 2013
LBOs as a Percentage of US Targeted Announced M&A

Source: Thomson Global Mergers & Acquisitions Review 4Q 2013
Add-On Trend*

Percentage of Add-Ons has steadily increased

Source: Pitchbook 4Q 2013 Private Equity Breakdown
## Characteristics of 2013 M&A Market

<table>
<thead>
<tr>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Oceans of capital available; <em>torrid</em> equity markets</td>
<td>• Capital investment spending generally tepid</td>
</tr>
<tr>
<td>• Benign antitrust Environment</td>
<td>• Unpredictability in consumer-facing horizontal transactions (American Airlines)</td>
</tr>
<tr>
<td>• Globalization</td>
<td>• Nationalism still a factor (Yahoo!) but waning in U.S. (Smithfield)?</td>
</tr>
<tr>
<td>• Low GDP growth in West</td>
<td>• Slowdown in China?</td>
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Deal Certainty
Deal Certainty

- Most transactions today are a result of auctions or at least market checks
  - Deal certainty benefits sellers ("best and final") and, obviously, buyers (who want to keep their deals after the effort invested)

- Maximizing deal certainty
  - Limit conditions
  - Creative alternatives to closing if conditions are not satisfied
Sell-Side Certainty

● Sellers need certainty
  – In auction process, value maximized if seller can say make “best and final” proposal; if buyers think they have another bite at the apple, they may hold back
  – The target business comes under internal and external pressures once deal announced (risk of damaged goods)

● Keys are:
  – Tightness of closing conditions (the “MAE” standard)
  – Certainty in financing after 2007-2008 debacles where buyer is not just writing a check
  – Measure of closing commitment (regulatory requirements and third-party consents)
Buy-Side Protection: Deal Protection Devices

● Exclusivity
  – No shop / no talk
  – Subject to fiduciary outs
● Break up fees
  – Generally intended to be used to protect buyer in the event target’s board exercises fiduciary out, but may be used in other scenarios
● Proxies or votes from majority stockholders
  – Consider Omnicare and Openlane cases
  – Requirement to deliver vote
● Stockholder joinders to purchase agreement
● Right to match competing offers (“last look”)
● Purchase options for blocks of shares
● Board obligation to recommend transaction
● Force-the-vote provisions
● Generally, devices must be “reasonable” and aimed at protecting the interests of the target
Deal Protection Devices: Breakup Fees

- Traditional Breakup Fee
  - Target pays buyer if target doesn’t close
  - Generally around 3-4%
  - But recent Delaware case law recognizes that there is no formula, and Delaware cases have upheld termination fees as high as slightly more than 6%

- All fact-specific
  - Concerns re enforceability: question is whether, together with other deal protection devices, breakup fees are preclusive or coercive
  - 2008-2013: no clear trend. Values are presented as a percentage of enterprise value:

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<tr>
<th>Year</th>
<th>Median</th>
<th>Mean</th>
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<td>3.1%</td>
<td>3.4%</td>
</tr>
<tr>
<td>2011</td>
<td>3.1%</td>
<td>3.2%</td>
</tr>
<tr>
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<td>3.4%</td>
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<tr>
<td>2009</td>
<td>3.2%</td>
<td>3.6%</td>
</tr>
<tr>
<td>2008</td>
<td>3.3%</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

*Source: Houlihan Lokey 2012 Transaction Termination Fee Study Summary*
Deal Protection Devices: No Shop

- No-shop provisions prohibit the target from soliciting or entertaining third party bids

“The Company shall not, during the Exclusivity Period, cause or permit any Person to (i) enter into any agreement . . . relating to any Competing Transaction, (ii) solicit or encourage the submission of any proposal relating to any Competing Transaction, or (iii) participate in any discussions or negotiations regarding, or furnish to any other Person any information with respect to, . . . any Competing Transaction.”

- Common even in private company sales and divestitures
  - Don’t fall asleep just because the target is private
Deal Protection Devices: Fiduciary Outs

- When so-called *Revlon* duties are implicated, Target’s board must entertain the best available offer.
- Fiduciary outs permit the Target’s board to seek the best offer.
- Three main types of outs:
  - Right to consider competing proposals.
  - Right to change recommendation and terminate based on a new fact or event unknown at signing.
  - Right to change recommendation and terminate if not doing so would violate the board’s duties.

*Source: ABA’s 2011 Strategic Buyer/Public Target Mergers & Acquisitions Deal Points Study*
Deal Protection Devices: Fiduciary Outs *con’t.*

- Key is defining the scope, both generally and through applicable definitions (i.e., “competing proposal”)
  - Superior proposal or intervening event: “At any time before the approval of this Agreement by the [Target’s Stockholders], the Board Recommendation may be withdrawn or modified in a manner adverse to Buyer if: (A)(i) an unsolicited, bona fide written offer is made to Target and is not withdrawn and the Board determines in good faith (based upon a written opinion of an independent financial advisor of nationally recognized reputation) that such offer constitutes a Superior Offer; or (ii) a material development or change in circumstances occurs or arises after the date of this Agreement [that was not known by the Target Board as of the date of this Agreement] (an “Intervening Event”), and (B) the Target Board determines in good faith that, in light of such Superior Offer or Intervening Event, the withdrawal or modification of the Board Recommendation is required in order for the Board to comply with its fiduciary obligations to Target’s stockholders under applicable law.”*

*Source: ABA’s 2011 Strategic Buyer/Public Target Mergers & Acquisitions Deal Points Study*
Deal Protection Devices: Delivery of Required Vote

- Delivery of required vote (where applicable: PE/private deals)
  - Buyer may terminate if Target does not deliver written consents approving the transaction within a short period following closing

  “[The Agreement may be terminated] by Parent if the Shareholder Approval is not delivered to Parent within 2 business days of the execution of this Agreement”

  - Response to *Omnicare*
  - Recently supported in *Openlane* decision

- PE seller may deliver the vote immediately after signing
Closing Conditions

- Typical conditions
  - Bring down of representations
  - Compliance with covenants
  - Stand-alone MAC / MAE
  - Legal proceedings
- Consider condition for buyer vs. seller
- Limited to government litigation?
- Shareholder contests
  - Appraisal rights
  - Financing
- As seller:
  - Limit third parties’ ability to derail the transaction
  - Avoid pure financing outs (more on this later)
  - Limit third-party consents (material permits and contracts at most)
- As buyer:
  - Clearly define MAE events
  - Avoid “hell or high water” standard on HSR filings
Material Adverse Effect

- **Purpose**
  - Condition to Buyer’s obligation to close – stand alone and bring down
  - May be used to qualify representations and warranties

- **Typical definition, simplified**
  - A fact, change or event that has a “materially adverse effect on the business, assets, liabilities, capitalization, condition or results of operations” of the target

- **Considerations**
  - Forward looking
  - Prospects
  - Near-term vs. long-term effect
  - Carveouts

- **Remember disproportionate effect qualifier**
  - Targets individually or taken together

- **No published decision has ever let a buyer off the hook where target is public**
Material Adverse Effect

- Case study
  - Post-signing, target’s earnings dip to the lowest point in 10 years
  - MAE?
- Not a hypothetical: Genesco v. Finish Line
  - While the earnings slide was a “material adverse effect,” it was not an “MAE” because it was caused by a change in general economic conditions
- Takeaways
  - Determine physical events (i.e., plant inoperable) that constitute an MAE
  - Be specific
  - Not much bang for the buck: a lot of negotiation and hand-wringing for little result
Bring Down

● Each party’s obligation to close is contingent on the other party’s performance

● No Qualifier
  – “The representations and warranties of the Company . . . will be true and correct in all respects as of the Closing Date, as if made on the date hereof and the Closing Date . . . ;”

● Materiality Standard
  – “The representations and warranties of the Company . . . will be true and correct in all material respects as of the Closing Date, as if made on the date hereof and the Closing Date . . . ;”

● MAE Standard
  – “The representations and warranties of the Company . . . will be true and correct in all respects as of Closing Date, as if made on the date hereof and the Closing Date, except (i) to the extent the failure of such representations and warranties to be true and correct would not reasonably be expected to cause a Material Adverse Effect . . . ;”

● Statistically:
  – Almost evenly split between MAE and materiality, with just a few unqualified*
  – Most deals today that variable approach – some “fundamental” representations are absolute, others MAE-qualified

*Source: ABA’s 2011 Private Target Mergers & Acquisitions Deal Points Study
Bring Down

● Carveouts
  – Fundamental representations

● Double materiality scrape
  – “the representations and warranties of the Company . . . will be true and correct in all material respects as of the Closing Date, as if made on the date hereof and the Closing Date (it being understood that, for purposes of determining whether such representations and warranties are true and correct, all Material Adverse Effect, materiality and similar qualifications will be disregarded). . . ;”
  – Most common (about 75%); remainder are silent*

● Other negotiated point is the timing of the bring down: at signing, closing or both
  – Most deals (about 60%) include both; remainder are as of closing only*

*Source: ABA’s 2011 Private Target Mergers & Acquisitions Deal Points Study.*
Financing Conditions

- Prevalence of stand-alone financing out has declined significantly after Financial Crisis
  - Stand-alone financing condition: condition without accompanying break fee
  - Example: “Buyer shall be permitted to terminate this Agreement if the Financing has not been consummated on or prior to [a date certain]”

- In the PE world, nearly every big deal is financed with debt

- PE buyers might prefer a financing contingency (and they sometimes, but rarely, are successful in getting it), but auction dynamics make that not practical in most circumstances
  - Current approach is to require equity commitment, fully committed debt financing and a reverse break fee
Anatomy of the Modern Financing Condition

- Termination right by the seller if the proposed financing is terminated or other events occur that make the financing unlikely:
  - “Agreement may be terminated . . . if (i) the Commitment Letter is terminated without a closing . . . , (ii) the Lenders have given notice (A) of breach thereunder by Parent or Merger Sub or (B) of their intent to terminate the Commitment Letter or not consummate the transactions . . . , (iii) the conditions to the Lenders’ obligations . . . have been satisfied, but the Lenders do not consummate such transactions . . . or (iv) Parent or Merger Sub breach any of their obligations [with respect to the financing covenant] . . .”

- Payment of termination fee (or “reverse break fee”) by buyer if buyer doesn’t close:
  - “If (i) the conditions to Purchaser’s obligations . . . have been satisfied or duly waived and (ii) this Agreement is validly terminated by the Seller pursuant to [financing termination provision or drop dead], then Purchaser will pay to Seller . . . the Termination Fee. Company may not obtain both the specific performance . . . and receive the Termination Fee.”
Anatomy of the Modern Financing Condition *con’t.*

- Termination Fee as liquidated damages
  - “Payment of the Termination Fee is deemed to be liquidated damages for any and all losses suffered . . . and shall be the sole and exclusive remedy . . . against Purchaser, its Affiliates and the Lenders for any loss suffered as a result of . . . the failure of the transactions contemplated hereby to be consummated. . . . In light of the difficulty of accurately determining actual damages with respect to the foregoing upon any termination of this Agreement under circumstances in which the Termination Fee is payable, the right to such payment (i) constitutes a reasonable estimate of the damages that will be suffered by reason of any such termination, and (ii) shall be in full and complete satisfaction of all damages arising as a result of any such termination.”
Financing Condition: Reverse Breakup Fee

- Because reverse termination fees do not have the effect of chilling bidding (i.e., no negative effect to the target’s stockholders), they are not held to the same scrutiny, and may be enforceable at levels in excess of traditional breakup fees.
- In 2012, the median reverse breakup fee of deals within the study was approximately 5% of transaction value, and 4.7% of enterprise value.*
- Reverse breakup fees have generally increased.*

*Source: Houlihan Lokey 2012 Transaction Termination Fee Study
Because PE firms use “Newcos” as buyers, reverse break fees are much more prevalent in PE deals

- In 2012, 31 of 37 PE deals (84%) within the study included termination fees, while 38 of 121 (31%) strategic deals included termination fees*

*Source: Houlihan Lokey 2012 Transaction Termination Fee Study
Anatomy of the Modern Financing Condition: Covenants

- Heavily negotiated covenants of buyer and target; lender will be involved
- Best efforts vs. commercially reasonable efforts
  - In Delaware, these are essentially the same thing, unless the document uses both constructions
  - Court will assume that the drafters intended to mean a higher standard
- The buyer is typically obligated to pursue consummation of financing on the terms and conditions in the buyer-procured commitment letter (with respect to which the buyer typically provides certain reps, or that may be an exhibit to the purchase agreement), including:
  - maintenance in effect of the commitment letter;
  - negotiation and execution of definitive agreements for the financing;
  - timely satisfaction by the buyer of the conditions in the commitment letter;
  - enforcement of buyer’s rights under the commitment letter in the event of its breach by the financing sources;
  - causing lenders to fund on the closing date; and
  - obtaining alternative financing in the event the committed financing becomes unavailable.
Anatomy of the Modern Financing Condition: Buyer’s Pre-Closing Covenant

- “Purchaser shall use its [reasonable best efforts] to (a) arrange and maintain the Financing on the terms and conditions described in the Commitment Letter (provided, that Purchaser may amend . . . the Commitment Letter so long as the amended terms would not . . . materially and adversely impact . . . the Purchaser’s ability to timely consummate the Transactions) and (b) consummate the Financing or, at the option of Purchaser . . ., such other financing such that the Purchaser will have proceeds sufficient to consummate the Transaction at or prior to the Closing. No Party (other than the Purchaser Related Parties) shall have any right to join in the enforcement of the rights of the Purchaser under the Commitment Letter, and notwithstanding anything to the contrary herein or in the Commitment Letter, none of the Company, Seller or the Seller Representative is a third party beneficiary under the Commitment Letter. In no event shall Purchaser be obligated to initiate any lawsuit, action, claim or proceeding against the Lenders to consummate the Financing. Purchaser shall keep the Seller Representative informed on a reasonably current basis and in reasonable detail of the status of its efforts to arrange such financing. Purchaser shall give the Seller Representative prompt notice of any material breach by any party to the Debt Commitment Letter.”
Anatomy of the Modern Financing Condition: Target’s Pre-Closing Covenant

- Target is typically required to cooperate with the financing efforts, including:
  - participating in meetings with prospective investors and warehouse lenders;
  - participating in “road shows” and meetings with rating agencies;
  - participating in drafting sessions related to any offering materials prepared by the buyer in connection with its financing efforts;
  - certifying financial statements;
  - procuring opinions; and
  - directing the target’s accountants to participate in the drafting process as applicable.

- Be cognizant of representations provided with respect to information provided in connection with the financing (specifically, 10b-5 standards on financial statements)

- Consider chicken and egg financing issue
  - Target is the borrower, but can’t borrow until buyer completes deal; buyer can’t complete deal until financing closes
Anatomy of the Modern Financing Condition: Target’s Pre-Closing Covenant

- “The Company will use commercially reasonable efforts to . . . provide such cooperation as is reasonably requested . . . , which such cooperation shall only include the following: (i) participating in bank marketing meetings, investor presentations and no more than two meetings with credit rating agencies; (ii) providing such financial information as is expressly required by the Commitment Letter, and using commercially reasonable efforts to provide financial projections and . . . balance sheets [and related financial statements] as necessary in order to assist in receiving customary ‘comfort’ from independent accountants in connection with the bank debt financing . . . and using commercially reasonable efforts to cause its independent accountants to provide customary comfort letters, [all of which such information shall not contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading]; (iii) executing and delivering customary certificates and other documentation [including legal opinions] . . . ; (iv) delivering notices of prepayment for borrowed money that will be repaid at Closing; and (v) taking other actions reasonably requested by Purchaser in connection with the Financing; provided that (a) no such documents shall be executed or effective earlier than the Closing, (b) [no personal liability shall be imposed on the directors, officers or employees in connection with the foregoing] and (c) the Company shall not be required to take any action that would unreasonably interfere with its ongoing operations. The Purchaser shall reimburse the Company for all reasonable costs incurred in connection with such cooperation.”
Anatomy of the Modern Financing Condition: Lenders’ Rights and Releases

- Lenders will participate in negotiating financing covenants, which will generally match conditions and covenants in the commitment papers.
- Lenders want assurances that they will not be sued by the Seller if the financing does not occur.
- “Each of the parties: (a) agrees that it will not bring or support any person in any Action against any Lender in any way relating to this Agreement or any of the transactions contemplated hereby or the Financing, in any forum other than the federal and New York state courts located in the Borough of Manhattan; (b) agrees that, except as specifically set forth in the Commitment Letter, all Claims against any of the Lenders in any way relating to the Commitment Letter shall be governed by . . . the laws of the State of New York . . . ; and (c) hereby irrevocably and unconditionally waives any right such party may have to a trial by jury in respect of any Action arising out of or relating to the Commitment Letter. Subject to the rights of the parties to the Commitment Letter, (i) neither any party hereto nor any of their respective Affiliates shall have any Claims against any Lender in any way relating to this Agreement or in respect of any oral representations made or alleged to have been made in connection herewith and (ii) no Lender shall have any Liability to any Party or any of their Affiliates for any obligations or liabilities of any Party under this Agreement or for any claim based on, in respect of, or by reason of, the transactions contemplated hereby or in respect of any oral representations made or alleged to have been made in connection herewith. The Lenders are intended third party beneficiaries of this Section.”
Anatomy of the Modern Financing Condition: Parent Guarantees

- A solvent entity must stand behind buyer’s obligations
- Generally, the guarantee is limited to the obligation to pay the termination fee or in an amount up to a defined equity commitment, though guarantee could also cover all pre-closing obligations
- Can be in the form of an equity commitment or as a guarantee:
  - Equity commitment tied to financing: “if (a) the Lenders are prepared to fund the Financing on the terms set forth in the Commitment Letter and (b) the conditions set forth in Section 2.01 of the Purchase Agreement have been satisfied or duly waived, to the extent Parent does not have sufficient funds available to pay the Purchase Price at the time it is required to do so, Guarantor shall contribute to Parent at the Closing an amount up to the Commitment Amount to enable Parent to consummate the transactions contemplated by the Purchase Agreement.”
Anatomy of the Modern Financing Condition: Parent Guarantees con’t.

- Can be in the form of an equity commitment or as a guarantee:
  - Limited to payment of breakup fee: “Guarantor hereby guarantees to the Company, the indefeasible payment by Parent of any and all amounts owed by Parent under the Purchase Agreement, including any damages for any breach of the Purchase Agreement; provided that in no event shall Guarantor’s aggregate liability exceed the Commitment Amount. . . . In the event that the Lenders are not prepared to fund the Financing on the terms set forth in the Commitment Letter or Parent is otherwise obligated to pay the Termination Fee, then the maximum liability of Guarantor shall be $25,000,000.”

- Guarantee of all pre-closing obligations: “Parent Guarantor unconditionally and irrevocably guarantees, as a principal and not as a surety, to Sellers the prompt and full performance and payment of Parent’s obligations hereunder . . . This guarantee terminates . . . upon the earliest to occur of (i) the Closing, (ii) termination of this Agreement [(other than for buyer’s breach)] and (iii) 30 days after this Agreement is terminated [for buyer’s breach].”
Post-Closing Indemnification Issues
Post-Closing Indemnity

- Sample menu of indemnity:
  - Breaches of representations
  - Breaches of covenants
  - Transaction expenses
  - Indebtedness
  - Pre-closing taxes
  - In an asset deal, retained liabilities
  - Specifically identified issues

- Environmental claims

- Litigation

- Typically negotiated items
  - $$ values: caps, baskets / deductibles, de minimis claims
  - What is subject to the cap?
  - Time limitations
Post-Closing Indemnity

- Dollar value limitations
  - Caps*

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<td>9.9%</td>
<td>9.6%</td>
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<tr>
<td>2008</td>
<td>0.6%</td>
<td>100%</td>
<td>16.9%</td>
<td>10.0%</td>
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</table>

- When does the cap apply?
  - Representations and warranties
    - Specific carveouts (fundamentals, tax)
  - Covenants?
  - Specific indemnities?

*Source: Houlihan Lokey Purchase Agreement Study for Transactions Completed in 2012 and Prior Years.
Post-Closing Indemnity

- **Deductibles / Tipping Baskets**
  - True deductible is more common (88% in 2012; higher than 10-year trend (78%))

<table>
<thead>
<tr>
<th></th>
<th>Deductible</th>
<th>Tipping Basket</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Median</td>
</tr>
<tr>
<td>2012</td>
<td>0.8%</td>
<td>0.7%</td>
</tr>
<tr>
<td>2011</td>
<td>0.7%</td>
<td>0.7%</td>
</tr>
<tr>
<td>2010</td>
<td>0.8%</td>
<td>0.6%</td>
</tr>
<tr>
<td>2009</td>
<td>0.7%</td>
<td>0.7%</td>
</tr>
<tr>
<td>2008</td>
<td>0.9%</td>
<td>0.6%</td>
</tr>
</tbody>
</table>

- **De Minimis Claims Thresholds**
  - Consider in connection with materiality scrapes

*Source: Houlihan Lokey Purchase Agreement Study for Transactions Completed in 2012 and Prior Years.*
Post-Closing Indemnity

- Survival Periods (breaches of representations and warranties)
  - Generally see 12-18 months

- Consider applicable carve outs
  - May be different in stock and asset deals

*Source: Houlihan Lokey Purchase Agreement Study for Transactions Completed in 2012 and Prior Years.*
Types of Damages Covered

● Beware of the “boiler plate” consequential damages waiver
  – “Notwithstanding anything to the contrary contained herein, no Indemnifying Party shall be liable for special, consequential, punitive, exemplary, incidental, or indirect damages, lost profits or losses calculated by reference to any multiple of earnings or earnings before interest, tax, depreciation or amortization (or any other valuation methodology), in each case, except to the extent an Indemnified Person is required to pay such damages to a third party.”
  – What are “consequential damages”?
  – Consider what other recoveries one would have in connection with the acquisition of a business.

*Source: ABA’s 2011 Private Target Mergers & Acquisitions Deal Points Study*
Types of Damages Covered *con’t.*

- Beware of the “boiler plate” consequential damages waiver
  - Multiples of damages are a hallmark PE valuation method. An alternative construction could include:
  
- “In no event shall a Party be liable under this Article 6 for Losses based upon a multiple of earnings or a multiple of a similar financial measure (other than as actually paid to a Third Party); provided that an Indemnified Party shall not be prohibited from introducing enterprise valuation methods based on a multiple of earnings or a multiple of similar financial measure.”

- Increasing trend to exclude consequential damages: Deals excluding consequentials rose from 31% to 55% from 2006 – 2010.*

- Confirm state law

*Source: ABA’s 2011 Private Target Mergers & Acquisitions Deal Points Study*
Other Indemnification Considerations

- **Anti-sandbagging**
  - Anti-sandbagging: “No Seller shall have any liability for any breach . . . if Buyer or any of its Affiliates had actual knowledge of such breach or inaccuracy prior to the Closing. For purposes of demonstrating ‘actual knowledge,’ Buyer is deemed to have ‘actual knowledge’ of a breach if such breach is reasonably apparent from information provided to Buyer or any of its Representatives by the Sellers or any of their Affiliates prior to the date hereof, including in the materials made available in the electronic data room.”

  - Pro-sandbagging: “The right to indemnification . . . shall not be affected by any investigation conducted at any time, or any knowledge acquired (or capable of being acquired) at any time, with respect to the breach . . .”

  - Statistically, these appear in about 5% of transactions. Most of the time (about 50%), the agreement is silent. In the rest, the buyer has negotiated a pro-sandbagging provision.*

  - Confirm the default position under state law

*Source: ABA’s 2011 Private Target Mergers & Acquisitions Deal Points Study.*
Other Indemnification Considerations con’t.

● Exclusive remedies
  – Be sure to carve out injunctive relief provisions
  – Negotiations typically center on willful misconduct
  – Generally, fraud cannot be subject to the exclusivity provision, but be sure to confirm

● Mitigation clauses
  – “Each Indemnified Person must use its commercially reasonable efforts to mitigate any Indemnifiable Losses hereunder . . .”
  – Every indemnification claim can become a factual question
  – State law varies
  – About ¼ of transactions include express mitigation clauses; remainder are silent*

*Source: ABA’s 2011 Private Target Mergers & Acquisitions Deal Points Study.
Other Indemnification Considerations con’t.

- Reductions of claims for tax benefits
  - If agreed, consider limited time period and pre-agreed tax rate
  - Included about half the time, but an increasing trend*
- Reductions of claims for third party and insurance claims
  - Makes sense if based on actual recoveries (net of the cost of recovery, including increased insurance premiums)
  - From buy side, be wary of subrogation rights
- Potential claims against customers or suppliers

*Source: ABA’s 2011 Private Target Mergers & Acquisitions Deal Points Study
Other Indemnification Considerations *con’t.*

- **No-dig provisions**
  - Limit seller’s indemnification obligations for environmental matters by restricting what buyer can do on the property

- **Generally prohibit remediation other than as required by law and excavation or construction, other than as required to maintain existing buildings**
  - Limited no-dig: “Neither Purchaser nor Company shall undertake any investigation that would involve subsurface sampling or excavation unless such investigation is (i) the result of a demand (including the assertion of legal right to perform such investigation) or claim by a governmental authority or other third party other than an Affiliate of Purchaser or Company, or (ii) necessary to comply with the requirements of applicable Environmental and Safety Requirements for industrial real property. Notwithstanding the foregoing, Purchaser or Company may conduct subsurface sampling or excavation (i) necessary for normal maintenance of structures and improvements at the Real Property or for the expansion of structures or construction of new structures on the Real Property; or (ii) required by a Subsequent Purchaser of the Real Property or by a third party in contemplation of providing financing secured by the Real Property.”
Post-Closing Indemnity: PE Specifics

- Remember PE goals when negotiating indemnity: distributing proceeds to investors and limit post-closing exposure
- Who is indemnifying?
  - Are there other assets at the seller level?
  - Is an escrow an option?
- Survival period
- Specific sources of recovery
- Several, and not joint, indemnification
  - Caps vs. pro rata apportionment
  - Management sellers - look for indemnity through letters of transmittal
  - Fund vehicles - different equity holders
- Materiality scrape
  - Representation qualifications as limiting disclosure or indemnification (or both)
  - “For purposes of determining the failure of any representations or warranties to be true and correct, the breach of any covenants or agreements, and calculating Losses hereunder any materiality or Material Adverse Effect qualifications in the representations, warranties, covenants and agreements shall be disregarded.”
Other PE-Specific Considerations
Transaction Mechanics

- Multiple selling entities
  - PE structure may include a holding company with several sellers, including management holders
  - Buyer would look for management holders’ consent to transaction through letters of transmittal
  - Buyer would need both fund investment vehicles to sign on
  - Look for proper organizational authorization to do the deal

- Buyer may need to untangle existing tax structure
Representations and Warranties

- PE seller more likely to incorporate more materiality and MAE qualifiers in operational representations and warranties
  - Not on the ground day to day to observe operations
  - Frequently coupled with materiality “scrape” for indemnity purposes
  - Included in 49% of reported transactions in 2010*
- Increasing trend (22% in 2006)*
- Make sure knowledge parties include operations people

*Source: ABA’s 2011 Private Target Mergers & Acquisitions Deal Points Study
Management Sellers

- Management internal tug of war
- May affect structure of the transaction (merger vs. stock purchase)
- Pay attention to letter of transmittal
  - Representations
- Ownership of shares
- No encumbrances
- Authority
  - Indemnity
- For breaches of representations in the letter of transmittal
- Generally capped at holder’s proceeds
  - Release
- General release vs. claims related to stock ownership
- Tax implications
  - Rollover
  - 338(g) Election
- Independent counsel when representing sellers
Post-Closing Transition

- Especially with a new platform, it may take a PE buyer more time to learn the ropes

- More likely to rely on existing senior management. Issues to consider:
  - Transaction bonuses
  - Employment agreements
  - Equity

- Transition services
  - Crucial to be able to take time to replace supporting or shared services