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Pursuing or Defending Against M&A Post-Closing Indemnification Claims: Guidance for Deal Counsel

Evaluating Claims, Navigating the Process, Leveraging Claim and Damages Limitations, and More

THURSDAY, OCTOBER 27, 2016

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

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***Pursuing or Defending Against M&A
Post-Closing Indemnification Claims:
Guidance for Deal Counsel***

Strafford Webinar: October 27, 2016

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INTRODUCTION

- In a perfect world, **every M&A transaction would be an unqualified success**. However, the **unfortunate reality** is that M&A transactions sometimes **do not work out as hoped or planned**.
- For **Buyers**, the indemnification process can be a **crucial way to recoup losses** resulting from misrepresentations or omissions made by the Sellers in connection with the transaction.
- For **Sellers**, indemnification obligations can result in the **loss of purchase consideration put into escrow** or substantial out-of-pocket payments.
- Indemnification obligations in M&A transactions **generally cover Buyer losses** resulting from:
 - Breaches of the Sellers' **reps and warranties** in the purchase agreement.
 - Breaches of the Sellers' **covenants** in the purchase agreement.
 - **Tax and other special indemnification items** under the purchase agreement.
 - **“Excluded liabilities”** in asset purchase transactions.

SOURCES OF CLAIMS

- **Indemnification claims** in M&A transactions **typically arise from two sources:**
 - **Issues identified by the Buyer** in its **post-closing integration** of the acquired company.
 - The **first audit conducted by the Buyer** that includes the acquired company can reveal issues that become the basis for indemnification claims.
 - Similarly, the **first consolidated income tax returns filed by the Buyer** that include the acquired company can reveal issues that become the basis for indemnification claims.
 - **Claims made by third parties** against the Buyer and/or the acquired company after the closing.
 - **Contract counterparties** claiming breach of their contracts.
 - **Regulatory authorities** claiming violations of law.

OVERVIEW OF THE CLAIM PROCESS

- **First, the Buyer must tie the issue to its indemnification rights in the purchase agreement.**
 - Identify the **applicable reps and warranties** in the purchase agreement
 - **Tax indemnification provision** or **special indemnification rights**
- **Next, the Buyer identifies any limitations on its indemnification rights.**
 - Materiality Adverse Effect (MAE) and knowledge qualifiers in the reps
 - Time limits by which indemnification claims must be made
 - Buyer knowledge (sandbagging), deductibles, baskets and caps
- Then the Buyer prepares and sends the **indemnification claim letter describing the issue** and the **basis for indemnification** to the Sellers.
- The parties then **negotiate resolution** of the claim or, if necessary, the **Buyer brings suit** for indemnification. Upon resolution, the **Buyer is compensated for its losses.**

TYING THE ISSUE TO THE REPS

- To make a successful claim, the Buyer must **tie the issue to the Sellers' indemnification obligations** in the purchase agreement.
- Most commonly, the issue will constitute a **breach of the Sellers' reps and warranties** in the purchase agreement, including:
 - **Improper accounting practices** used by the acquired company (potentially covered by the reps concerning financial statements).
 - Undisclosed or inaccurately described **litigation and other disputes** (potentially covered by the reps concerning litigation).
 - **Breach of contract allegations** made by the acquired company's **customers, suppliers or other contract counterparties** (potentially covered by the reps concerning material contracts, no MAE since the most recent balance sheet date, and the acquired company's relationships with its customers and suppliers).

TYING THE ISSUE TO THE REPS

- Some additional **reps and warranties** that can be the **subject of indemnification claims** include:
 - **Violations of law** by the acquired company (potentially covered by the reps concerning compliance with law (generally) and compliance with specific regulations applicable to the acquired company).
 - **Unpaid taxes** (potentially covered by the reps concerning taxes).
 - **Employee benefit plan liabilities**, including liabilities triggered by the sale of the acquired company to the Buyer (potentially covered by the reps concerning employee benefits matters, taxes and compliance with law).
 - **Labor and employment issues**, including discrimination, harassment and wrongful termination claims and WARN Act violations (potentially covered by the reps concerning labor and employment matters and compliance with law).

TYING THE ISSUE TO THE REPS

- Some **additional reps and warranties** that can be the **subject of indemnification claims** include:
 - **Intellectual property (IP) issues**, including infringement of the acquired company's IP by other companies, the acquired company infringing upon other companies' IP, and the acquired company's registered IP not having been properly maintained (potentially covered by the reps concerning IP matters and the acquired company's intangible assets).
 - **Environmental issues**, including fines and penalties due to acquired company's failure to conduct its business in compliance with environmental laws and its undisclosed remediation obligations (potentially covered by the reps concerning environmental matters and compliance with law).
 - Issues with the acquired company's **tangible assets**, including **undisclosed liens and other encumbrances** on title to its assets (potentially covered by the reps concerning tangible assets).

TYING THE ISSUE TO THE REPS

- Some **additional reps and warranties** that can be the **subject of indemnification claims** include:
 - Issues with the acquired company's **relationships with its key customers and suppliers**, including undisclosed threats by key customers and suppliers to **terminate** or otherwise **adversely change their business relationships** with the acquired company (potentially covered by the reps concerning material contracts, no MAE since the most recent balance sheet date, and relationships with customers and suppliers).
 - Undisclosed **affiliated party contracts and other arrangements** (potentially covered by the reps concerning affiliated party transactions).
- The issues described above **may also constitute breaches** of the “**no undisclosed liabilities**” and “**Rule 10b-5**” reps and warranties in the purchase agreement.

SPECIAL INDEMNIFICATION RIGHTS

- In addition to indemnification claims based on breaches of reps and warranties, the Buyer may have **other indemnification rights**:
 - **Tax Indemnification Provision:**
 - The purchase agreement will typically include a provision requiring the Sellers to indemnify the Buyer for any **pre-closing income tax obligations of the acquired company**.
 - The tax indemnification right is **typically broader** than indemnification for breaches of the Sellers' tax reps and warranties – often **no deductible/basket applies**.
 - **Procedure for handling audits, etc.** under the tax indemnification provision **may be different** than for third-party claims under the indemnification provisions in the purchase agreement.
 - **Special Indemnification Rights:**
 - Buyers sometimes receive special indemnification rights for **issues identified in due diligence or listed in disclosure schedules**.

LIMITS ON INDEMNIFICATION RIGHTS; MATERIALITY

- **Generally:** The next step is to analyze the limitations on indemnification under the purchase agreement, including:
 - **Materiality, Material Adverse Effect** or **knowledge** qualifiers.
 - Expired **survival periods of reps and warranties**.
 - Are the Buyer's damages excluded from **indemnifiable "Losses"**?
 - Has there been **any prior Seller disclosure or Buyer knowledge of the issue** (i.e., sandbagging)?
 - Are indemnification **deductibles, baskets** or **caps** applicable?
- **Materiality Qualifiers in Reps and Warranties:**
 - Rarely defined in purchase agreements with a **specified dollar amount**.
 - Test is whether a **reasonable Buyer would consider the issue to be important** in making its decision to acquire the company.
 - **"Materiality scrape" provisions** may **reduce or eliminate the impact** of materiality qualifiers in the reps and warranties.

MAE AND KNOWLEDGE QUALIFIERS

- **Material Adverse Effect (MAE) Qualifier in Reps and Warranties:**
 - Sets a **very high barrier** for the Buyer to make an indemnification claim, in which only an issue having a **very substantial impact on the acquired company as a whole** gives the Buyer recourse against the Sellers.
 - More common in **acquisitions of publicly-traded companies** (which don't have post-closing indemnification) or private company acquisitions where the **Sellers have substantial negotiating leverage**.
- **Knowledge Qualifiers in Reps and Warranties:**
 - Standard may be **actual knowledge** or “**constructive**” knowledge (i.e., knew or should have known).
 - **Proving actual knowledge** usually requires the “**scarlet letter**” (or e-mail). A constructive knowledge standard **much easier to satisfy**.
 - Sometimes only the knowledge of **specified “knowledge people”** within the **acquired company's management team** counts.

SURVIVAL PERIODS

- **Survival Period of Reps and Warranties:**
 - The trend is towards **shorter survival periods** for reps and warranties in M&A transactions – Sellers want finality, but Buyers want sufficient time for issues to surface.
 - Typically a “**general**” **survival period** of **12 to 24 months** after closing.
 - Reps concerning **environmental, employee benefits, tax** and sometimes other regulatory matters usually survive until expiration of the **statutes of the limitations** of the underlying matters.
 - “**Fundamental**” **reps**, such as authority to enter into the transaction and clear title to stock or assets, often **survive indefinitely** after closing.
 - **Statute of limitations** for a rep and warranty is **usually tolled while the claim relating to that rep and warranty is pending**.
 - If the escrow is the **Buyer's sole remedy**, the **escrow release date effectively acts as the time limit** for indemnification claims.

ARE THE BUYER'S LOSSES INDEMNIFIABLE?

- **Indemnifiable “Losses”:**
 - “Losses” are typically **defined very broadly**, including **attorneys’ fees**. That is important because the general rule is that **attorneys’ fees are not recoverable** unless there is an express attorneys’ fees provision.
 - The **Buyer’s losses are often easy to determine** – for example, the Buyer’s damages from **settlement of an undisclosed litigation** or **payment of a regulatory fine**.
- In other cases, however, the **Buyer’s losses are less readily determinable:**
 - For example, the acquired company’s financial statements were **not prepared in accordance with GAAP**, artificially inflating its EBITDA.
 - Presumably, damages are a **multiple applied to the difference** between the **misstated and correct EBITDA**. If so, **what multiple should be used?** What if it were an auction transaction in which the Buyer increased its bid several times, changing the implied multiple?

LOSSES; CONSEQUENTIAL DAMAGES WAIVERS

- **Less Readily Determinable “Losses” (cont.):**
 - Another example: undisclosed **breach of a material customer contract**. Are the Buyer’s losses just the amount necessary to **settle the resulting breach of contract dispute**?
 - What about **lost profits** from the resulting **termination of the customer relationship**? Should the lost profits under the contract **simply be totaled up** or instead reflect the **time value of money** using a **NPV** calculation? Should they be **subjected to the EBITDA multiple** used by the Buyer in determining the purchase price that it paid for the acquired company?
- **Consequential Damages Waivers:**
 - Can preclude the Buyer from obtaining **lost profits** or damages calculated using a **multiple of EBITDA** or another financial measure.
 - Are sometimes **tucked into “boilerplate” miscellaneous provisions** – along with the punitive damages waiver provision – and **not fully understood** by the parties during negotiations.

THIRD-PARTY RECOVERIES

- **Third-Party Recovery Provisions**
 - The Buyer's indemnifiable losses are often stated as being **net of tax benefits, insurance proceeds and other third-party recoveries** relating to the issue underlying the indemnification claim.
 - However, the Buyer may not **realize the tax benefits for several years into the future**, if at all. Is the Buyer barred from collecting from the Sellers based on a **possible future tax benefit**?
 - What about the **attorneys' fees and other expenses** that the Buyer incurs in **obtaining the insurance payment** or **suing a contract counterparty** to obtain a recovery?
 - Can the Buyer **obtain the funds now** from escrow or the Sellers and **pay any third-party recoveries to the Sellers later**, when received? Or can it **reserve funds in escrow** while its third-party recovery process continues?
 - What about **expenses incurred by the Buyer** from **higher insurance premiums** in the future due to the insurance claim?

BUYER KNOWLEDGE OF THE ISSUE

- **Information Contained in Disclosure Schedules:**
 - Disclosure of an issue in **any section of the disclosure schedules** usually qualifies the other reps as long as it would be **apparent to a reasonable Buyer** that the disclosure also applies to those other reps.
 - Accrual of a **liability relating to an issue** in the financial statements (if specific enough), or disclosure of an issue in the **notes to the financial statements**, could **qualify as disclosure** of the issue to the Buyer.
- **Disclosures Outside the Purchase Agreement:**
 - Information contained in the “**virtual data room**” created by the Sellers.
 - Information provided in response to **Buyer due diligence requests**.
 - Information contained in the **Confidential Information Memorandum** prepared by the Sellers’ investment bankers.
 - Information contained in **management presentations** made by Seller personnel to the Buyer.

BUYER KNOWLEDGE OF THE ISSUE

- **Entire Agreement and Non-Reliance Provisions:**
 - Purchase agreements typically include “entire agreement” provisions, stating that **all of the transaction terms** are memorialized in the purchase agreement, which **supersedes all other agreements, understandings, communications, etc.** among the parties relating to the transaction.
 - Some purchase agreements include “**non-reliance**” language in which the Buyer **expressly disclaims reliance on any information** provided by the Sellers to the Buyer **other than the reps in the purchase agreement.**
- **Sandbagging:**
 - The Buyer makes an indemnification claim against the Seller concerning an **issue that it knew about before closing.**
 - **Court decisions go both ways** about whether Buyers can sandbag.
 - Some parties negotiate “**pro-sandbagging**” or “**anti-sandbagging**” provisions in their purchase agreements, while others choose to be silent on this point.

BUYER KNOWLEDGE OF THE ISSUE

- **“No Dig” Provisions:**
 - Purchase agreements can contain provisions explicitly **prohibiting the Buyer from seeking out problems** (best example is environmental—literally to not dig).
 - Otherwise, post-Closing, the Seller might now own physical locations, information, access to witnesses, etc. that would make the **search for and discovery of potentially indemnifiable issues worthwhile and attractive** (to try and have Seller pay for post-Closing upgrades).
- **Privilege Ownership:**
 - Post-Closing, **the Buyer may now own pre-Closing privilege**, including: (1) day-to-day privilege issues; and (2) deal negotiations. (Varies by state.)
 - Consider contracting for **which party owns pre-Closing privilege** with specificity and considering whether that would work as a practical matter (e.g., no waiver through continued access).

DEDUCTIBLES, BASKETS AND CAPS

- **Applying Indemnification Deductibles, Baskets and Caps:**
 - In preparing its indemnification claim, the Buyer needs to apply any **deductibles, baskets and caps** to the amount claimed, taking into account any **prior Buyer indemnification claims**.
 - Is there a **“true” deductible** or is there instead a **“basket”** in which, once the threshold amount has been reached, the Sellers’ liability goes **back to first dollar**?
 - There are usually **carve-outs from the deductible/basket** for Buyer losses resulting from **breaches of “fundamental” reps, excluded liabilities** (in asset purchase transactions) and **fraud or intentional breach**.
 - There is typically a **higher indemnification cap** (e.g., full purchase price) for losses resulting from **breaches of “fundamental” reps and excluded liabilities** (in asset purchase transactions) and a **carve-out from the cap** for losses resulting from **fraud or intentional breach**.

PREPARING THE CLAIM NOTICE

- **Indemnification Claim Notice:**
 - **Describes in reasonable detail the issue** that is the subject of the claim.
 - Specifies the **reps, excluded liabilities or indemnification rights** upon which the **claim is based**.
 - Usually includes **“reservation of rights” language** reserving the Buyer’s right to **increase the claim amount** or **make additional claims** as it learns more about the issue upon which the claim is based.
 - Is usually **accompanied by supporting documentation** concerning the issue upon which the claim is based.
- **Timing:**
 - For indemnification claims based upon **third-party claims**, the Buyer is typically required to provide the indemnification claim notice to **the Sellers promptly** after its receipt of the third-party claim.
 - In any event, notice of a third-party claim must be provided soon enough to **avoid prejudicing Sellers’ ability to assume and defend** claim.

CHARACTERIZING THE ISSUE

- Buyers typically list in the indemnification claim notice **all of the reps arguably breached by the issue**, even though breach of a single rep would be sufficient.
- Sometimes, there is a **strategic benefit** for the Buyer in **characterizing an issue in a certain way** in the indemnification claim notice.
 - If possible, it is better for the Buyer to characterize an issue as **breach of a “fundamental” rep**, rather than a non-fundamental rep, because the former typically have **no deductible/baskets or caps** and **longer survival periods**.
 - It is often better for the Buyer to characterize an issue as **breach of tax, employee benefits or environmental reps**, rather than “no undisclosed liabilities” rep, because the former typically have **longer survival periods**.
 - In **asset purchase transactions**, it is often better for the Buyer to characterize an issue as an **excluded liability**, rather than as a **breach of the Sellers’ reps**, because the former typically has **no deductible/ basket** and either **no cap** or a **much higher cap**.

CHARACTERIZING THE ISSUE; LOSSES

- It is often better for the Buyer to **use the tax indemnification provision** for tax-related issues, rather than characterizing an issue as a **breach of the tax reps.**
 - Under the tax indemnification provision, the **Buyer may be able to control the IRS audit** or other dispute with the taxing authority (rather than the Sellers being entitled to assume the Buyer's defense).
 - The Sellers' indemnification obligations under the tax indemnification provision **may not be subject to the deductible/basket or cap.**
- **Specifying Losses in the Indemnification Claim Notice:**
 - The Buyer will need to make a **judgment call** regarding including **lost profits, damages calculated using a multiple** and other forms of **indirect damages** in its "losses" amount.
 - It can be to the Buyer's advantage to specify an **estimated losses amount** in order to **reserve that amount in escrow**, which is **subject to revision later** as more information is learned about the issue.

RESOLVING THE CLAIM

- The **process for resolving an indemnification claim** varies depending on whether it is based on an **issue identified by the Buyer** or the **result of a third-party claim** made against the Buyer or the acquired company.
- **Process for Claims Based on Buyer-Identified Issues:**
 - The purchase agreement typically requires the **Sellers to provide a written response to the Buyer's indemnification claim notice**, in which the Sellers respond to the Buyer's allegations and include supporting documentation, within a specified time period.
 - If the Sellers **fail to provide their response** within that time period, they are typically **deemed to have conceded** the claims made in the Buyer's indemnification claim notice.
 - Some purchase agreements provide for a **mandatory period** in which the Buyer and the Sellers must attempt to **negotiate a good faith resolution** of the indemnification claim **before the Buyer is allowed to commence litigation** against the Sellers.

RESOLVING THE CLAIM

- **Process for Indemnification Claims Based on Buyer-Identified Issues (cont.):**
 - Even when negotiation among the parties is not required by the purchase agreement, such **negotiation typically occurs** because the parties want to avoid incurring the **time and expense associated with litigation**.
 - Advisable for the parties to **expressly state** that all information is **being provided in connection with settlement negotiations** and is subject to Federal Rule of Evidence 408 and analogous state **evidentiary privileges**.
- **Process for Indemnification Claims Based on Third-Party Claims:**
 - The Sellers typically have the right to **assume the Buyer's defense in the third-party claim**, subject to certain exceptions.
 - Whichever party is defending the third-party claim is typically required to **keep the other party informed of developments** in the third-party claim, including providing the other party with **copies of any litigation documents**.

RESOLVING THE CLAIM

- **Process for Indemnification Claims Based on Third-Party Claims (cont.):**
 - The defending party typically **cannot settle the third-party claim** without the **other party's consent** (which usually cannot be unreasonably withheld).
 - Sometimes, the Sellers (after assuming the Buyer's defense) **can only settle a third-party claim** if the settlement provides for:
 - Cash payment **paid in full** by the Sellers.
 - **Full release** of the Buyer.
 - **No admission of guilt** by the Buyer.
 - **No restrictions on the Buyer's conduct.**
 - Alternatively, in some cases, the Sellers are **not required to obtain the Buyer's consent** to settle a third-party claim as long as specified requirements, like those above, have been satisfied.

SATISFYING THE CLAIM

- The purchase agreement typically describes **how amounts due to the Buyer upon resolution of an indemnification claim will be satisfied**, including:
 - Satisfaction **out of the escrow**.
 - **Forfeiture of Buyer stock** issued to the Sellers as part of the transaction consideration.
 - **Set-off against** the Buyer's obligations to the Sellers under an **earnout**, "**seller notes**" issued to the Sellers or **other contingent or deferred transaction consideration**.
 - **Cash payment** by the Sellers to the Buyer.
- The purchase agreement will specify the **order in which such methods of satisfaction are used** (Buyers typically prefer cash first; Sellers the opposite).
- If **Buyer stock** is used to satisfy indemnification claims, the purchase agreement will have a **methodology for valuing that Buyer stock** for that purpose, which can be a **fixed price**, the then-current **fair market value of the Buyer stock**, or the **higher or lower** of the two.

SATISFYING THE CLAIM

- **Release from escrow** to satisfy **amounts due to the Buyer** upon resolution of an indemnification claim occurs pursuant to a **joint written instruction** executed by the Buyer and the Sellers and delivered to the escrow agent.
- If there are **multiple Sellers** satisfying indemnification obligations to the Buyer, the purchase agreement typically **specifies whether each Seller is:**
 - **Jointly and severally liable** - each Seller is required to pay the full amount to the Buyer and can then seek contribution from the other Sellers for their allocable portions of the amount paid; or
 - **Severally but not jointly liable** - each Seller is only required to pay its allocable portion of the amount due to the Buyer, usually based on its percentage ownership in the acquired company.
- If the Sellers are **jointly and severally liable**, they will typically sign a separate **contribution agreement** in which they agree to **reimburse each other** for any indemnification amounts paid **in excess of their allocable portions**.

THANK YOU!

Questions or Comments?



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