AVOIDING DEAL LITIGATION

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2021 was an unprecedented year for mergers and acquisitions. Both the number of transactions and the dollar value of those deals hit all-time highs. The number of announced transactions exceeded 62,000 globally (up 24% from 2020), while publicly-disclosed deal values reached $5.1 trillion (up 57% from 2020). *See* Global M&A Industry Trends: 2022 Outlook, *available at* https://www.pwc.com/gx/en/services/deals/trends.html.

These highs were matched only by the speed in which transactions often moved to closing. Pressure to close can abbreviate due diligence periods and short circuit negotiation and consideration of deal terms in the sale documents. This presents a recipe for surprised and disgruntled buyers with deal litigation likely to result.

The reasons for the 2021 frenzy are varied, and while the record-breaking numbers are not likely to be beat anytime soon, 2022 already is set to see significant M&A activity. *Id.* So, as businesses, and particularly their in-house counsel, manage the desire to close against the need for due diligence and deal term negotiation, what should they focus on in the transaction documents to best avoid (or better position themselves to avoid) litigation? Here are some of the key contractual provisions that can drive litigation post-closing.

Representations and Warranties: Many deal disputes turn almost entirely on the terms of the representations and warranties in the deal documents. Buyers and sellers sometimes use these provisions as a way to address perceived issues in due diligence. When information or time might be limited, parties may resort to representations and warranties as a fix.

Indeed, a current trend is to eliminate any language stating that a representation and warranty does not apply if the party who is the beneficiary is aware it is inaccurate. This can lead to so-called "sandbagging" claims where the beneficiary knows before closing that a representation is false (or is recklessly indifferent to the truth) but nonetheless enters into the deal and brings a post-closing claim for breach. As counter-intuitive as this might appear, many jurisdictions permit such claims. One Delaware chancellor recently observed, "Delaware is, or should be, a pro-sandbagging jurisdiction" as such is consistent that with the state's "profoundly contractarian predisposition." *Arwood v. AW Site Services, LLC*, No. 2019-0904-JRS, 2022 WL 705841 at *3 (Del. Ch. March 24, 2022).

Parties should consider the potential for sandbagging claims and are best served to expressly state in the sale documents whether such claims are prohibited or allowed. If the deal terms are silent, forum default rules will govern whether the buyer's knowledge of the falsity of a representation can serve as a defense in the event of an alleged breach. As that same Delaware chancellor recently emphasized, although "there is something unsettling about allowing a buyer to lay in wait on the other side of closing with a breach claim he knew before closing he would bring against the seller, the risk of such litigation, like any other risk, can be managed expressly in the bargain the parties strike." *Id.* at *30.

Similarly worthy of consideration is the remedy provided for breach of the representations and warranties. Sellers can limit potential exposure by restricting buyers to suing under an indemnification provision that provides a cap on recovery. Meanwhile, broader representations and warranties might necessitate lower damages caps. In this way, just as due diligence might impact the terms of the representations and warranties (*e.g*., whether the buyer's knowledge is relevant), the strength and breadth of those provisions can be balanced with limits placed on potential damages.

Earn-Out Provisions: While representations and warranties may sometimes have links to due diligence, earn-out requirements might be similarly related to the pricing of a deal. These provisions typically hold back a portion of the sale price at closing and tie future payment of that amount to financial performance post-closing. As a result, they often serve as a vehicle for resolving pricing disputes.

These provisions can be beneficial for both the buyer and seller in deals where the seller (whether through a founder or key stakeholders) will remain involved in the operations of the target company post-closing. In such cases, the incentives of both sides are property aligned. Sellers can receive a higher price for the sale, but they also can be confident in a later payoff because management shares the same goal of positive future performance. Earn-out clauses similarly present less risk where certain factors, like long-term contracts with critical clients or vendors, can provide some assurances of future financial performance.

Conversely, sellers who cede all control over management of a company or otherwise have no confidence in future performance should approach earn-out provisions with great caution. These provisions might create negative incentives for the buyer. Depending upon the earn-out terms and the amount of held-back cash, a buyer might be better off *not* hitting specified financial metrics, trading off profits for a lower purchase price.

Another issue to focus on when crafting earn-out terms are how the post-closing target metrics will be measured. Parties often simply state that they are to be measured consistent with GAAP accounting. This might not be enough. What if a buyer switches the company's accounting methodology (*e.g.* going from cash accounting to accrual accounting) and, as a result, earn-out targets are not reached? The terms of these provisions should either prohibit such changes or provide a way to account for them.

Parties also might consider providing a specific mechanism for resolving disputes regarding whether earn-out targets have been hit. When the sale agreement is silent, such fights often devolve into a battle of accounting experts before a judge or jury. Parties might avoid litigation costs by specifying in the earn-out provisions that disputes be resolved, for example, by a neutral, third party accounting firm.

Material Adverse Effect ("MAE") Clauses: Litigation over MAE (or Material Adverse Change ("MAC")) clauses is nothing new. These provisions allow buyers to opt out of a deal when some significant financial change occurs to the target company prior to closing. As with the other items discussed above, there terms deserve scrutiny.

Some states have developed general rules to help determine when a MAE has occurred. For example, Delaware courts consider "whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." *See Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715, 738 (Del. Ch. 2008). But analysis always begins with the terms agreed to by the parties and there is otherwise "no bright-line test for evaluating whether an event has caused a material adverse effect." *See Level 4 Yoga, LLC v. Corepower Yoga, LLC*, No. 2020-0249-JRS, 2022 WL 601862, at *20 (Del. Ch. March 1, 2022).

When crafting MAC/MAE clauses, particular attention should be paid to what changes are excepted or excluded from the definition of a material event or change. Sellers should identify those anticipated or probable events that could impact their company's earnings, especially if they are industry-specific, and push for their inclusion in the list of exceptions. So, for example, a seller in the hospitality industry might push to include pandemic-related losses in the exceptions list, or a healthcare seller may seek protections surrounding the rate of government procedure reimbursement.

Consideration also should be given to whether the MAE provision is forward-looking. Most definitions cover events that have had or are "reasonably expected to have" a material adverse effect on earnings. *Id.* This allows a buyer to declare a MAE, thereby terminating the deal prior to closing, based on reasonably anticipated earnings losses, even where such losses have not yet occurred. *Id.* Of course, such forward-looking language benefits buyers, while excluding such language to focus solely on events causing current losses favors sellers.

Conclusion

Planning for how a deal might go south often—and justifiably—takes a back seat to getting the transaction closed. Business leaders want the deal done and can be far less interested in what is needed in case it fails. With limited resources and competing demands for time, deal lawyers might focus on the provisions outlined above just in case that rainy day comes.