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M&A Landmines

A. Successor Liability
B. Commercial
C. Intellectual Property
D. Employment Law

These materials, which provide a general overview of certain legal issues, are not intended to constitute legal advice and should not be relied upon as such. Specific facts and circumstances will directly and significantly affect the legal analysis of any given event or situation.
A. Successor Liability
The Principal Virtues Of An Asset Sale For A Buyer:

• In an asset acquisition, a Buyer can “cherry pick” the assets it wishes to buy.

• More importantly, a Buyer can by express language limit or avoid assuming the target’s liabilities, both known and unknown.

• If only it were so easy. A Buyer should not take complete comfort in the protective contractual language of an asset purchase agreement.
A Buyer Can Still be Saddled with Target Liabilities Notwithstanding Express Limiting Language In The Acquisition Agreement

- Successor Liability Doctrines
- Statutorily Imposed Liabilities

Important: Applicable case law and statutes can vary significantly from state to state.
1. DeFacto Merger


- Facts: The acquisition was structured as an asset purchase. The Buyer contractually disclaimed assumption of all but certain specified liabilities. The business continued. The principal of the Seller bought a 12.5% equity stake in the “new” company. The Seller was paid cash, but failed to pay a trade creditor who sued the buyer.
1. DeFacto Merger (Cont’d)

The SJC noted that courts generally consider four factors in characterizing an asset sale as a defacto merger:

i. There is a continuation of the enterprise of the selling corporation so there is continuity of management, personnel, physical location, assets and general business operations.

ii. There is a continuity of shareholders (here, the principal of Seller acquired a 12.5% equity interest in the Buyer and was given a board seat).

iii. The Seller corporation ceases its ordinary business operations, liquidates and dissolves as soon as legally and practically possible (here, the selling corporation ceased operations, but did not dissolve).

iv. The purchasing corporation assumes those obligations of the Seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller.
1. DeFacto Merger (Cont’d)

The most troubling observation of the SJC in the *Cargill* case:

“No single factor is necessary or sufficient to establish a defacto merger.”

The court also noted:

“Each case must be decided on its specific facts and circumstances.”

Where does that leave a buyer?
1. DeFacto Merger (Cont’d)

Fortunately, a number of subsequent cases have narrowed the open-ended dicta of Cargill:

• In DeJesus v. Bertsch Inc., 898 F. Supp. 2d 353 (D. Mass 2012) the court found: “Under Massachusetts law a defacto merger does not occur absent a showing that there is a continuity of shareholders...” but approvingly cited Cargill for the proposition that: “Continuity of shareholders may occur even if there is no complete shareholder identity...”

• In American Paper Recycling Corp. v. IHC Corp., 707 F. Supp 2d 114 (D. Mass 2010) the court held that “acquisition of less than 3.2 percent of buyer corporation’s stock in consideration for seller corporation’s assets was not sufficient to impose successor liability when seller has no voting rights, cannot transfer its shares, and holds the shares subject to a right of unilateral redemption.”
Other Successor Liability Doctrines

2. Mere Continuation/Continuation of Enterprise

3. Product Line Doctrine

4. Fraudulent Transfer
Tips for Defusing The Successor Liability Landmine

• Require the selling entity to maintain its existence for a period of time post-closing.
• Exercise care in giving stock to the seller.
• Ensure that purchase price proceeds are utilized by Seller to pay its major trade and other creditors.
• Conduct comprehensive due diligence regarding product liability exposure, reserves and insurance.
• Analyze what state’s law will likely apply. In tort suits, it may be the jurisdiction where the injury occurs and so the choice of law is often unpredictable.
**Tips for Defusing the Fraudulent Transfer Landmine**

- Seller solvency representation – somewhat helpful but not definitive
- Seller solvency certificate – again, somewhat helpful
- Solvency opinion – difficult to obtain, expensive
- Fairness opinion – expensive
- Shop the deal – best evidence of reasonably equivalent value
5. Liability Imposed By Statute

Some Federal and State Laws Impose Liabilities that Follow the Acquired Assets:

- Environmental Statutes
- ERISA
- Taxes
- Other
Environmental Liabilities

• Federally Imposed (CERCLA): Successor owners may be liable for the cost of cleanup for previous owners’ contamination.

• Exceptions May Apply (SBLRBRA): Congress created certain Bona Fide Prospective Purchasers exception to liability; also “innocent purchasers” (but with obligations attached).

• States Also Impose Liability: Many state statutes follow the federal model.
ERISA (and federal common law)

• Unfunded Benefit Plans can create successor liability, even if the plan does not fall under ERISA (i.e., common law claims).

• ERISA liability is strict statutory liability; common law liability may exclude innocent purchasers (a trap for the M&A draftsperson).
Taxes (federal and state)

- Successor Liability vs. Liens on Assets: Federal: Liens Only; State: Successors may be liable for state/local taxes.

- Federal tax liability for unpaid taxes allows IRS to place a lien on assets owned at the time of sale.

- Some States impose successor liability on new owner (e.g., Florida sales tax withholding obligation and personal liability).
Other: Choice of Law:

- Choice of Law Provisions: May be especially important in considering successor liability under state laws
B. Commercial Landmines
Anti-Assignment Clauses: Are they Enforceable?
“This agreement is not assignable, by operation of law or otherwise.”
Three questions:

• If the agreement containing this clause is assigned to a buyer, will the assignment be void or voidable?

• If the agreement containing this clause is assigned to the buyer, will the assignor be liable for damages arising from breach of the clause?

• Assuming the buyer does not want to purchase the stock of the target, can the buyer have the benefit of the agreement and, if so, how?
General rules:

• A contractual right can be assigned unless such assignment is expressly forbidden by the contract’s terms.

• Assignments made in contravention of a valid prohibition clause in a contract are void.
Majority Rule: Courts distinguish between the assignor’s “right” to assign an agreement, and the assignor’s “power” to assign.

• A prohibition on the “right” to assign is treated as a covenant not to assign for which the assigning party may be liable for breaching.

• A prohibition on the “power” to assign is treated as a bar to assignment such that any purported assignment is void.
“This agreement is not assignable, by operation of law or otherwise.”
Majority Rule: When agreements limit the “right” but not the “power” to assign, courts:

• Treat the assignment as valid and enforceable against both the assignor and the assignee; and

• Permit the counter-party to sue the assignor for breach of the covenant.
Restatement (Second) of Contracts, § 322(c)(2)

“A contract term prohibiting the assignment of rights under the contract, unless a different intention is manifested . . . (b) gives the obligor a right to damages for breach of the terms forbidding assignment but does not render the assignment ineffective.”
Suggested contractual language that bars assignment absent waiver:

No party to this Agreement shall have the power or the right to assign it, and any purported assignment shall be void such that the assignee shall acquire no rights in the Agreement and the non-assigning party shall not recognize any such assignment.
Other Commercial Landmines

• Deficient Purchase Orders, Contracts, Terms and Conditions
  – Total absence of standard terms of sale or customer-imposed terms
  – Failure to waive consequential damages
  – Lack of clarity on warranties

• Troubled Vendors and Customers
  – Target may be dependent on a single vendor for a mission critical part or service and that vendor may be in financial distress
  – Target may be highly dependent on a single customer – that customer may be in financial distress or about to be acquired by a competitor of the Buyer

• Defusing the landmine: Detailed commercial due diligence
C. Intellectual Property Landmines
Open source software can taint proprietary software

- Open source software types
  - GNU General Public License
  - GNU Lesser General Public License
  - BSD
  - Others
- Impact on proprietary software when combining with open source software
- Obligations of open source software user
- Enforcement considerations
Failure to have employees/IT consultants assign IP

• Employees:
  – Patent law recognizes limited “shop rights”
  – Copyright law recognizes “works made for hire”
  – Trademark rights generally belong to the employer
  – But a written agreement is still necessary for scope & exclusivity

• Consultants/contractors
  – No “shop rights”
  – No work made for hire without a written agreement
  – A written agreement is imperative!

• And don’t forget NDA’s for everyone!
Failure to protect/register Intellectual Property Rights

• Enforcement Issues
  – Without a Patent you cannot exclude others
  – Without a Copyright Registration, you cannot sue
  – Trademark Registration facilitates enforcement/Failure to enforce can result in loss of rights

• Timing Issues
  – Patent bar
  – Copyright remedies
  – Trademark constructive notice

• Cost Issues

• Trade Secrets are enforceable only if subject of reasonable efforts to maintain secrecy.
D. HR-Related Landmines
Independent Contractors vs. Employees

- Has the Seller conducted a proper analysis given the tightening of the definition of independent contractor?

- How well is the Independent Contractor relationship documented?

- What is the risk? Do misclassifications create workers compensation liabilities or threaten the qualified status of benefit plans?
Foreign Nationals in the Workforce

• I-9 Forms – Have they been audited?

• Foreign Nationals – Have they remained in status?

• Does the acquisition trigger a need to file a change of status?
Wage and Hour Exposure

• Does the Seller have in place appropriate policies and well defined job descriptions that support employee classifications as exempt or non-exempt?

• Is the Seller in an industry that has been the target of government investigations or claims by plaintiff attorneys?

• Do you understand the typical compliance issues in the applicable industry?
Accrued Vacation Days, Severance, etc.

- How do you transition employees to less favorable vacation and sick leave policies?

- What protections are you and the Seller going to receive in exchange for providing severance?

- Do you want to have retention agreements in place?
Worker’s Compensation

• Are you accepting responsibility for managing the Seller’s ongoing claims?

• When do you refuse to hire an employee of the Seller who is out on a work related injury and what are the risks of a workers compensation discrimination claim?
Risky Business: Defusing M&A Landmines
Financial & Tax

June 28, 2013
Section I: Financial Considerations
Audit vs. Due Diligence

Audit

- Is at a set point in time.
- Actual results of the company subject to management’s estimates
- Provides reasonable assurance

Due Diligence

- Comprehensive review of a target company’s financial, operational, customers and markets, legal, tax, HR and IT functions prior to the completion of a transaction

Due diligence is different from a financial audit, as most financial audits do not concern themselves with one-time events or sustainable profitability levels. Additionally, audits do not take into consideration special terms of the transaction as specified in the LOI (i.e., carve-out situation, related-party transactions, etc.).
Key Areas of Focus and Concern During Due Diligence

- Historical EBITDA Run-Rate or Quality of Earnings
- Quality of Assets
- Undisclosed Liabilities
- Working Capital and Working Capital Trends
- Future Cash Flows or Pro Forma Effects
- Business Trends
- Impact on Future Projections
- Operational Performance
- Customers, Products and Markets
- Information Systems and Management Information
- Contracts and Commitments
- Tax Compliance and Exposure
Recent Issues We Have Seen

- Deferred spending:
  - Deferred capital expenditures
  - Deferred bonuses
  - Deferred advertising and marketing

- Recent cost savings initiatives are not sustainable

- Receivables:
  - Extended payment terms or other customer concessions

- Lost customers and/or key suppliers (Backlog is key indicator)

- Inventory:
  - Lower of cost of market (LCM) concerns
  - Adequacy of excess & obsolete (E&O) inventory reserve
  - Lack of historical verifiable inventory counts

- Inconsistent application of accounting policies:
  - Revenue recognition
  - Allowance for doubtful accounts
  - Unrecorded liabilities
Quality of Financial Information

- What is the entity we are buying (public/private, stand-alone/carve-out)?

- Sources of numbers and reconciliations:
  - Quantify differences between audited financials and information memorandum, internal financials
  - Sophistication of management

- Generation and quality of management information:
  - Focus on differences between interim and year-end accounting
  - Reliance on outside auditors (to the extent applicable)

- Understanding budget-to-actual:
  - Budget vs. actual results
  - Bridging key components of historical data to forecasts will focus questions

- Key accounting policies

- Audited vs. non-audited financials:
  - Perform a cash to revenue proof
  - Perform a cash to expense proof
  - Gaining comfort with inventory when no prior physical counts exist
Quality of Earnings - EBITDA Analysis Example

- Why – Forms base period earnings for modeling growth
- How – Detailed analysis of results and trends of the business
- The five types of adjustments we generally see:
  - Management proposed adjustments
  - Non-cash items
  - Non-recurring/out of period items
  - Run rate items/cost savings
  - Carve out or stand-alone (if applicable)
- Valuation EBITDA vs. “SX-able” EBITDA

### Quality of Earnings

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<th>FY08</th>
<th>FY09</th>
<th>LTM10</th>
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<tbody>
<tr>
<td>Net revenue</td>
<td>$13,730</td>
<td>$20,282</td>
<td>$24,575</td>
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<tr>
<td>EBITDA, as reported</td>
<td>3,511</td>
<td>5,302</td>
<td>6,511</td>
</tr>
<tr>
<td>EBITDA %, as reported</td>
<td>25.6%</td>
<td>26.1%</td>
<td>26.5%</td>
</tr>
</tbody>
</table>

#### Management’s adjustments

1. Officer compensation
2. Officer bonuses
3. Employee bonuses
4. Enterprise system upgrade
5. Restructuring charges
6. Professional services

<table>
<thead>
<tr>
<th></th>
<th>FY08</th>
<th>FY09</th>
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</thead>
<tbody>
<tr>
<td>Total management</td>
<td>404</td>
<td>540</td>
<td>662</td>
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</table>

#### Management adjusted EBITDA

<table>
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<th>FY08</th>
<th>FY09</th>
<th>LTM10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management adjusted EBITDA</td>
<td>3,915</td>
<td>5,842</td>
<td>7,173</td>
</tr>
<tr>
<td>Management adjusted EBITDA %</td>
<td>28.5%</td>
<td>28.8%</td>
<td>29.2%</td>
</tr>
</tbody>
</table>

#### Due Diligence adjustments

1. Reserve for slow moving/obsolete inventory
2. Accrued vacation
3. Rebate from vendor
4. Accrued commissions
5. Accrued bonus
6. Additional reserve for doubtful accounts
7. Accrued payroll
8. Inventory variance adjustment
9. Warranty reserve
10. Revenue recognition
11. Allowance for credit memos / returns

<table>
<thead>
<tr>
<th></th>
<th>FY08</th>
<th>FY09</th>
<th>LTM10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Due Diligence</td>
<td>(496)</td>
<td>(380)</td>
<td>(1,168)</td>
</tr>
</tbody>
</table>

#### Adjusted EBITDA +/-NQ

<table>
<thead>
<tr>
<th></th>
<th>FY08</th>
<th>FY09</th>
<th>LTM10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusted EBITDA +/-NQ</td>
<td>$3,419</td>
<td>$5,462</td>
<td>$6,005</td>
</tr>
<tr>
<td>Adjusted EBITDA %</td>
<td>24.9%</td>
<td>26.9%</td>
<td>24.4%</td>
</tr>
</tbody>
</table>
Detailed Analysis – Balance Sheet

**Typical Focus Areas – Assets:**

- Accounts receivable:
  - DSO, aging, bad debt
- Inventory:
  - Costing procedures
  - Capitalization policies
  - E&O
  - Turnover
- Prepaid and other assets
- Fixed assets:
  - CAPEX (maintenance versus expansion)
  - CAPEX trends – deferrals

**Typical Focus Areas – Liabilities:**

- Accounts payable:
  - DPO, aging
- Accrued expenses:
  - Judgmental reserves
  - Roll-forwards of significant reserve accounts
  - PTO
- Long-term liabilities:
  - Pension and OPEB
  - Environmental
  - Tax exposures
- Deferred revenue
- Off balance sheet items:
  - Operating leases, contingencies, Fin 46 matters, exit costs
Analyzing Working Capital

Typical Focus Areas – Assets:

- Defined working capital
- Monthly working capital analysis:
  - Adjusted for non-operating items
  - Working capital highs and lows
  - Key metrics – DSO, Inventory turns, DPO
  - Book cash versus bank cash
- Beware of non-operating changes to working capital
- Factors to consider when agreeing on working capital PEG:
  - Seasonality
  - Growth of business
  - Commodity pricing, if applicable
  - Multinational business
- Working capital benchmarking
What Do We Mean By Net Working Capital?

Represents level of investment necessary to allow for normal settlement cycle on trade items and accommodate customer expectations about timing and availability of “inventory” (i.e. fund normal commercial activities) – not defined by GAAP.

<table>
<thead>
<tr>
<th>Include as a Component of Working Capital</th>
<th>Exclude as a Component of Working Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Receivable</td>
<td>Cash (depends on treatment of cash)</td>
</tr>
<tr>
<td>Inventory</td>
<td>Short-term Investments</td>
</tr>
<tr>
<td>Prepaid Insurance</td>
<td>Interest Receivable</td>
</tr>
<tr>
<td>Trade Accounts Payable</td>
<td>Past-due Accounts Payable (if treated as debt)</td>
</tr>
<tr>
<td>Accrued Liabilities (e.g., accrued wages, vacation, rebates, medical insurance, etc.)</td>
<td>Shareholder Receivable</td>
</tr>
<tr>
<td></td>
<td>Accrued Interest</td>
</tr>
<tr>
<td></td>
<td>LIFO Reserve</td>
</tr>
<tr>
<td></td>
<td>Pension Liability</td>
</tr>
<tr>
<td></td>
<td>Fixed Assets</td>
</tr>
<tr>
<td></td>
<td>Line of Credit</td>
</tr>
<tr>
<td></td>
<td>Deposits (asset)</td>
</tr>
<tr>
<td></td>
<td>Current Portion of LTD</td>
</tr>
<tr>
<td></td>
<td>Goodwill</td>
</tr>
<tr>
<td></td>
<td>Long-term Debt</td>
</tr>
<tr>
<td></td>
<td>Investment in Subsidiary</td>
</tr>
<tr>
<td></td>
<td>Interco Accts (in carve out transactions)</td>
</tr>
<tr>
<td></td>
<td>Deferred Income Taxes (asset or liability)</td>
</tr>
<tr>
<td></td>
<td>Restructuring</td>
</tr>
<tr>
<td></td>
<td>Other Items as Agreed</td>
</tr>
</tbody>
</table>
### Debt-Like Items – Some Examples

**Typical Focus Areas – Assets:**
- Stretched payables
- Unpaid bonuses
- Vacation payable over one year
- Capital leases
- Earn-out liabilities and other deferred consideration
- Liabilities related to discontinued operations (e.g., unpaid royalties related to discontinued products)
- Litigation reserves

**Typical Focus Areas – Liabilities:**
- Off balance sheet liabilities
- Deferred Capex
- Pension liabilities (other than 401k)
- Bank overdraft in accounts payable
- Gift card liabilities in excess of one year of operations
- Employee, shareholders’ loan payable
### Debt & Debt-Like Items Analysis – Example

<table>
<thead>
<tr>
<th>Debt and Debt-like Items</th>
<th>US$ in thousands</th>
<th>On B/S</th>
<th>Off B/S</th>
<th>Total</th>
<th>Indemnity</th>
<th>Assumed</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Line of credit</td>
<td>3,000</td>
<td>-</td>
<td>3,000</td>
<td>3,000</td>
<td>-</td>
<td>3,000</td>
<td></td>
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<tr>
<td>Notes payable</td>
<td>12,500</td>
<td>2,000</td>
<td>14,500</td>
<td>14,500</td>
<td>-</td>
<td>14,500</td>
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<tr>
<td>Accrued interest</td>
<td>100</td>
<td>-</td>
<td>100</td>
<td>100</td>
<td>-</td>
<td>100</td>
<td></td>
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<tr>
<td><strong>Total debt</strong></td>
<td><strong>15,600</strong></td>
<td><strong>2,000</strong></td>
<td><strong>17,600</strong></td>
<td><strong>17,600</strong></td>
<td><strong>-</strong></td>
<td><strong>17,600</strong></td>
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<tr>
<td>Leases</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital leases</td>
<td>500</td>
<td>-</td>
<td>500</td>
<td>500</td>
<td>-</td>
<td>500</td>
<td></td>
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<tr>
<td>Operating lease</td>
<td>-</td>
<td>3,500</td>
<td>3,500</td>
<td>-</td>
<td>3,500</td>
<td>3,500</td>
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<tr>
<td><strong>Total leases</strong></td>
<td><strong>500</strong></td>
<td><strong>3,500</strong></td>
<td><strong>4,000</strong></td>
<td><strong>500</strong></td>
<td><strong>-</strong></td>
<td><strong>3,500</strong></td>
<td><strong>4,000</strong></td>
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<tr>
<td>Transaction fees</td>
<td>-</td>
<td>2,000</td>
<td>2,000</td>
<td>2,000</td>
<td>-</td>
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<td>Legal matters</td>
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<td>4,500</td>
<td>5,000</td>
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<td>Environmental liabilities</td>
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<td>Escheatment</td>
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<td>1,000</td>
<td>-</td>
<td>1,000</td>
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<tr>
<td>Purchase commitments</td>
<td>-</td>
<td>11,100</td>
<td>11,100</td>
<td>-</td>
<td>11,100</td>
<td>11,100</td>
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<tr>
<td>Acquisition earn-outs</td>
<td>5,000</td>
<td>10,000</td>
<td>15,000</td>
<td>15,000</td>
<td>-</td>
<td>15,000</td>
<td></td>
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<td>Options</td>
<td>-</td>
<td>750</td>
<td>750</td>
<td>750</td>
<td>-</td>
<td>750</td>
<td></td>
</tr>
<tr>
<td>Change of control</td>
<td>-</td>
<td>5,000</td>
<td>5,000</td>
<td>5,000</td>
<td>-</td>
<td>5,000</td>
<td></td>
</tr>
<tr>
<td>Employee matters</td>
<td>-</td>
<td>320</td>
<td>320</td>
<td>320</td>
<td>-</td>
<td>320</td>
<td></td>
</tr>
<tr>
<td><strong>Total commitments</strong></td>
<td><strong>21,600</strong></td>
<td><strong>40,670</strong></td>
<td><strong>62,270</strong></td>
<td><strong>47,170</strong></td>
<td><strong>15,100</strong></td>
<td><strong>62,270</strong></td>
<td></td>
</tr>
</tbody>
</table>
Carve-Outs

Types of carve-outs:

➢ Stand-alone subsidiary of larger corporation
➢ Noncore business unit/division
➢ Product line within a business unit

Carve-out issues (income statement):

➢ Expenses not included in historical results
➢ Allocations of expense included in historical results
➢ Shared services – transitional services
➢ Stand-alone cost analysis / effort and cost to establish needed functions
➢ Arms length adjustments to related party transactions
➢ One-time costs and timeliness
➢ Revenue and purchasing impacts

Carve-out issues (balance sheet):

➢ Assets/liabilities not included on balance sheet
➢ Common assets/liabilities
➢ Inter-company accounts
Section II:

Tax Considerations
Taxes – Why Should Buyer Care?

- **Past** – due diligence (potentially significant risk item)
- **Present** – transaction structuring (powerful seller motivator and value driver)
- **Future** – modeling cash taxes (one of the largest cash costs of the business)
Due Diligence Considerations

- What are we buying – stock, partnership/LLC interests or assets?
- Who are we buying from – individual, corporation, S corporation or partnership/LLC?
- Where are the business operations and how are they held?
- What is the company’s tax situation (NOLs)?
- What other considerations should we be concerned about?
Are We Buying Stock or Assets?

Stock Deal

- All pre-acquisition liabilities transfer to the Buyer
  - Federal, state and foreign income taxes
  - Property taxes, payroll taxes and sales and use taxes
  - Diligence income and nonincome taxes

Asset Deal

- Step up in tax basis for Buyer
- Pre-acquisition non-income tax liabilities transfer to the Buyer, under successor liability rules
  - Property taxes, payroll taxes and sales and use taxes (successor liability)
  - Diligence generally focuses on nonincome taxes and transfer taxes generated by the asset acquisition
Other Due Diligence Considerations

- Current and recent examinations by taxing authorities
- Recent acquisitions (and whether they were stock or asset acquisitions)
- Tax planning that has been implemented
- Significant deferred taxes and timing of reversal
- International taxes
- State and local taxes
Additional Considerations – International

- Transactions/relationships with foreign affiliates
- Cost sharing agreements/practices
- Foreign currency practices
- Transfer pricing
- Permanent establishment rules
- Forms 5471 and 5472
- Foreign bank accounts
- Other items

**Note:** An international tax (“ITAX”) specialist should be involved in the due diligence process if the Target has international operations/presence.
Additional Considerations – State and Local Tax (SALT)

The main areas of SALT review include:

- Income/franchise Tax
- Gross receipts Tax
- Sales and Use Tax
- Employment Tax
- Property Tax
- Abandoned and Unclaimed Property
- Transactional Tax (sales/use tax and transfer tax)
- Successor liability
Additional Considerations – State and Local Tax (SALT)

Income/franchise tax

- Nexus exposure (income differs from sales tax; factor presence and economic nexus trends)
- Failure to file combined where required
- Incorrect apportionment methodology, e.g.,: Sales throwback, sourcing of service revenue
- Improper use of NOLs due to 382 limitations
- Aggressive intercompany transactions with no business purpose that may be disregarded by separate entity filing states
- Improper push down of debt to subsidiary to create expenses and reduce net worth
- Improper deferral of gain on sale of assets in a consolidated group
- State or local tax audits
Additional Considerations – State and Local Tax (SALT)

Gross Receipts Tax

- Nexus exposure (threshold low, requires only physical presence)
- Based on gross receipts regardless of whether target is in an income or loss position
- Bright line test in certain states, i.e., more than $500K in sales from state triggers filing requirement
Additional Considerations – State and Local Tax (SALT)

Sales/Use Tax

- Nexus exposure (sales tax differs from income tax; new trend towards “click through” nexus for online sellers)
- Failure to determine taxability of goods or services
- Exposure resulting from failing to collect sales tax exemption certificates
- Exposure resulting from collecting but not remitting sales tax to a state or local jurisdiction
- Failure to pay use tax on purchases
- State or local sales/use tax audits
Payroll Tax

- Failure to withhold income tax for proper jurisdiction based on work performed
- Failure of employer to properly report income to employees
- Exposure resulting from misclassification of workers, i.e., independent contractors versus employees (10% federal penalty assuming individual reported and paid tax; up to 47% in federal and state tax if individual did not report income; unemployment insurance tax also applies)
Additional Considerations – State and Local Tax (SALT)

Property Tax
- Failure to file real and personal property tax returns
- Incorrect property values or exclusion of certain property

Abandoned & Unclaimed Property (AUP)
- Investigate policy to track unclaimed property and remit property to state when dormancy period ends
- Special focus on businesses that issue gift cards, gift certificates, or rebates and book as income if not cashed
- No statute of limitations
- States hire bounty hunters on contingency basis
Additional Considerations – State and Local Tax (SALT)

Transactional Tax
- Sales/Use tax imposed on sale of fixed assets assuming no isolated sales or resale exemption, or less than entire assets are sold
- Realty Transfer tax on sale of real property (controlling interest provisions in case of sale of stock)

Successor Liability
- Purchasers of stock succeed to historical income tax and indirect tax exposure
- Purchasers of Assets succeed to indirect tax liability: certain states provide that when a company with unpaid taxes sells the business or stock of goods, the successor must withhold a sufficient amount of the purchase price to satisfy the tax debt unless the seller produces a receipt from the state taxing authority that the tax has been paid, or a certificate that no tax is due.
- Officers and directors may be held personally liable for certain indirect taxes (eg, sales/use tax, withholding)
TRANSACTIONAL RISK INSURANCE

Using Transactional Risk Solutions to Close the Deal

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Agenda

• Transactional Risk Insurance Overview
• Representations & Warranties Insurance
• Tax Indemnity Insurance
• Contingent Liability Insurance
TRANSACTIONAL RISK INSURANCE OVERVIEW
Transactional Risk Insurance Roles

- **Broker**
  - Advises client on feasibility of insurance
  - Facilitates discussions and negotiations between client and insurer
    - Negotiates on behalf of client (broker is **not** an agent)
    - Helps choose best insurer for each transaction
    - Arranges excess insurance, etc.
  - Assists with insurance regulatory filings and handling of claims

- **Insurer**
  - Assumes risk of covered loss by leveraging balance sheet and reserves
  - Underwrites and analyzes risks utilizing specialists and data
  - Pays claims in the event of insured loss
Transactional Risk Insurance Products

• Created to facilitate M&A transactions by addressing indemnification issues that arise during the negotiation of the transaction or during due diligence that may prevent the deal from closing.
  – Representations & Warranties Insurance
  – Tax Indemnity Insurance
  – Contingent Liability Insurance

• Traditional Solutions/Resolutions:
  – Renegotiation of Deal Terms
  – Purchase Price Reduction/Earnout/Holdback, etc.
  – Escrow/Indemnity
  – Buyer or Seller Forced to Take Unwanted Risk
  – Walk Away from Deal

• Our Solution: Transactional Risk Insurance
Transactional Risk Insurance Overview

Insurance is used to protect or mitigate from two types of risk typically arising from M&A transactions:

• Cover for unknown and unforeseen loss (SPA risk)
  – Representations & Warranties (Warranty and Indemnity) Insurance
    - Seller-side
    - Buyer-side

• Cover for identified and known risks
  – Typically Identified Tax Issues
  – Other contingent risks
  – Can be wrapped around indemnities
  – Stand alone policies (possibly attaching to the target)
  – Non-M&A drivers
Transactional Risk Insurance Overview

- The transactional risk insurance market has continued to evolve in recent years and can provide more innovative insurance solutions than ever.

- The Market Now Offers:
  - Broader coverage
  - Streamlined process
  - Increased limits of liability
  - Reduced premium rates and deductible levels

- Marsh has an estimated 35% global market share

- Significant growth in North America during last 3 years:
  - 2012 - $1.4 billion in limits / 51 closed transactions
  - 2011 – $767 million in limits / 45 closed transactions
  - 2010 – $387 million in limits / 25 closed transactions

Global Market Statistics for 2012
(Marsh)

<table>
<thead>
<tr>
<th>US$</th>
<th>AMERICAS</th>
<th>EMEA</th>
<th>ASIA PACIFIC</th>
<th>TOTAL</th>
</tr>
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<tbody>
<tr>
<td>Limits of insurance placed ($)</td>
<td>1,427,300,000</td>
<td>2,133,000,000</td>
<td>463,000,000</td>
<td>4,023,300,000</td>
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<tr>
<td>No. of policies placed</td>
<td>67</td>
<td>105</td>
<td>24</td>
<td>196</td>
</tr>
<tr>
<td>Private equity policies (as % of policies placed)</td>
<td>53%</td>
<td>44%</td>
<td>35%</td>
<td>44%</td>
</tr>
<tr>
<td>Corporate policies (as % of policies placed)</td>
<td>47%</td>
<td>56%</td>
<td>65%</td>
<td>56%</td>
</tr>
<tr>
<td>Seller-side R&amp;W policies (as % of R&amp;W policies placed)</td>
<td>20%</td>
<td>28%</td>
<td>10%</td>
<td>19%</td>
</tr>
<tr>
<td>Buyer-side R&amp;W policies (as % of R&amp;W policies placed)</td>
<td>80%</td>
<td>72%</td>
<td>90%</td>
<td>81%</td>
</tr>
</tbody>
</table>
Transactional Risk Insurance – Dispelling the Myths

• **Myth: prohibitively expensive**
• **Reality**
  – Representations and Warranties 2–3.5%
  – Specific Tax issue 4–8%

• **Myth: High level of retention**
• **Reality**
  – 1%-2% of deal value is standard
  – Less than 1% may be achievable, depending on the deal

• **Myth: Difficult and time-consuming to obtain**
• **Reality**
  – Mirrors transaction timetable / workflow
  – Dedicated broking and underwriting teams, ex-M&A lawyers

• **Myth: Policy riddled with exclusions**
• **Reality**
  – Reduction in generic exclusions i.e. removal of generic exclusions for product liability / environmental
  – Expanded coverage for known issues
  – Exclusion for “actual knowledge of breach” only; no constructive knowledge theory

• **Myth: Claims not paid**
• **Reality**
  – Economic climate precipitated more claims notifications, more payments by insurers
  – Increased insurer competition means greater pressure to pay
  – In any given year, approximately 5 -10% of policies have claims
  – Claims payments have ranged from $500K - $20M
REPRESENTATIONS & WARRANTIES INSURANCE
Reps & Warranties Insurance Overview

Provides coverage for financial losses resulting from breaches of representations and warranties made by target company or sellers contained in purchase agreement

• Protects an insured from unanticipated (unknown) losses that may arise subsequent to the closing
  – Reps & warranties insurance generally covers all reps in the agreement

• Designed to bridge gap between buyer and seller

• Either buyer or seller can be insured under the policy

• No need for other side to know about the insurance at outset – though many deals feature collaboration among parties regarding insurance
Types of R&W Insurance Policies

• Two Kinds of Policies
  
  – **Buyer-Side**
    - Insurance can be structured to replace some/all sellers’ potential indemnification liability under acquisition agreement
    - Can enhance /replace indemnification terms set out in acquisition agreement
      - Extended survival periods
      - Increased cap
    - Typically covers fraud by the sellers
  
  – **Seller-Side**
    - Sellers backstop their potential indemnification liabilities agreed to in acquisition agreement
    - Can be structured to mirror indemnification terms set out in acquisition agreement
    - Typically excludes fraud by the sellers
    - Knowledge between sponsors and management sellers can be severed
<table>
<thead>
<tr>
<th>Buyers</th>
<th>Sellers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Risk Management Uses</strong></td>
<td><strong>Risk Management Uses</strong></td>
</tr>
<tr>
<td>• Increase maximum indemnity / extend survival period for breaches of reps &amp; warranties</td>
<td>• Reduce contingent liabilities</td>
</tr>
<tr>
<td>• Ease collection concerns</td>
<td>• Distribute sale proceeds</td>
</tr>
<tr>
<td>• Provide recourse when no seller indemnity possible (public company sales, bankruptcy)</td>
<td>• Protect passive sellers</td>
</tr>
<tr>
<td><strong>Strategic Uses</strong></td>
<td><strong>Strategic Uses</strong></td>
</tr>
<tr>
<td>• Distinguish bid in auction</td>
<td>• Attract best offers by maximizing indemnification</td>
</tr>
<tr>
<td>• Protect key relationships</td>
<td>• Include R&amp;W Insurance as the sole remedy in draft agreements in auctions</td>
</tr>
</tbody>
</table>
Reps & Warranties Insurance – Key Considerations

• Policies are fully manuscripted
  – Limited policy exclusions
  – “Actual knowledge” exclusion

• Premiums
  – 2% to 3.5% of the policy limit (one-time payment)
  – Rates lower internationally
  – Who pays?

• Deductibles
  – Buyer-insured policies often use the escrow as the deductible
  – Seller-insured policies use a negotiated limit – typically no less than 1% - 2% of the Purchase Price

• Underwriting Process and Claims Handling Capabilities
• Engage broker early in process
Reps & Warranties Insurance – State of the Market

• Increased popularity
  – 500+ deals done annually (split between corporate and PE buyers)

• Insurance market well-developed
  – Insurers / brokers staffed by former attorneys – work on deal timeframes
  – Policies are customized
  – Underwriting process is streamlined

• Target transactions
  – Transactions between $15M - $1.5B
  – Limits available up to $300M+ per deal
  – Generally, no restrictions on industry sector (healthcare may present issues)

• Insurer commitment
  – AIG, Allied World, Ambridge, Beazley, Concord and Hartford
  – International capabilities
Reps & Warranties Insurance – Underwriting Process

• Execute NDA

• Obtain quotes from insurer – 2-3 days
  – Submission includes: recent draft agreement, offering memo, financial statements
  – No cost to obtain quotes

• Select insurer
  – Each insurer has pros-cons (role of broker)
  – Insurer due diligence fee payable before underwriting ($10K-$25K+)

• Insurer underwriting process – 7-10 days
  – High level review of due diligence process (if buyer-side) or disclosure process (if seller-side)
  – Access to legal, financial, tax DD reports
  – Conference call(s) with deal team

• Policy negotiations
  – Concurrent with underwriting process
  – Work closely with outside counsel
R&W Insurance Case Study

- Seller utilizing insurance strategically to limit its indemnification obligations in purchase agreement

  - Seller – portfolio company of US private equity firm
  - Buyer – US private equity firm
  - Target – flexible packaging business of Seller
  - Purchase Price – approx. $100M

- Issue: Seller wanted clean exit / limited indemnification for breaches of reps & warranties

- Solution: Buyer-side R&W policy
  - Limit – $9.8 million (10% of purchase price)
  - Retention – $980,000 (1% of purchase price (in SPA, buyer bears first .5%, seller bears next .5%))
  - Premium - $285,000
  - Policy period – 6 years for all reps
  - Seller initiated the insurance process by obtaining quotes to deliver to buyer
  - Buyer and its counsel had previous experience with R&W insurance
  - Cost of insurance split evenly by Buyer and Seller
R&W Insurance Case Study

• Buyer utilizing insurance in cross-border deal to secure coveted asset
  – Seller – UK private equity firm
  – Buyer – US publicly-traded company
  – Target – European specialty chemicals company
  – Purchase Price – approx. $1.1B

  – Issue: Buyer wanted to expand international presence and acquisition of Target was critical for them; however, Seller was unwilling to provide any indemnification for breaches of warranties (other than for fraud) – insurance would be buyer’s sole recourse in the event of a breach
  – Solution: Buyer-side R&W policy
    - Limit – $100 million (3 insurers participated on program)
    - Retention – $11 million
    - Premium – $2.25 million
    - Policy period – 2 years for general warranties / 6 years for tax and fundamental warranties
    - Buyer had no experience with R&W insurance, but outside counsel had previously utilized it
    - Cost of insurance borne by Buyer
R&W Insurance Case Study

- Sellers utilizing insurance to backstop an indemnity obligation demanded by a buyer
  - Sellers – Venture capital firms and members of management
  - Buyer – US publicly-traded company
  - Target – Software company
  - Purchase Price – approx. $150M

- Issue: Buyer of Target offered a very attractive purchase price to Sellers for Target, but were not flexible on demanding onerous indemnification provisions in the merger agreement
- Solution: Seller-side R&W policy
  - Limit – $50 million (2 insurers participated on program)
  - Retention – $22 million (equal to holdback), dropping to $4 million at 18 month anniversary of closing
  - Premium - $940,000
  - Policy period – 2 years for general reps / 4 years for IP reps / 6 years for tax and fundamental reps (matching survival period in agreement)
  - Insurance policy gave sellers comfort providing such a large indemnity as part of the transaction
TAX INDEMNITY INSURANCE
Tax Indemnity Insurance Overview

Coverage

• Protects against a transaction failing to qualify for the intended tax treatment
• Helps reduce or eliminate a contingent liability arising from a successful challenge to a specific tax liability encountered in a transaction

Issues

• Feasibility and/or economic benefit of transaction dependent on favorable tax treatment
• While likelihood of potential tax liability/IRS denial may be low, $ amount of potential liability very high—most sellers will not put up an escrow equal to potential $ amount; thus, insurance can give buyer this protection

Typical Uses

• 355 Spin-offs
• 338(h)(10) elections/S-Corp
• Cancellation of Indebtedness
• Net Operating Loss Protection
• Successor liability
• Tax-free reorganizations
• Liquidating Trust status
• Capital Gain v. Ordinary Income Treatment
Tax Indemnity Insurance - Overview

Covered Items

• Tax Liability – To Statute Limits
• Fines & Penalties
• Interest
• Legal Cost
• Tax Gross Up

Key Coverage Issues

• Cost – typically, 4% - 8% of policy limit
• Deductible – varies by deal (often no deductible required)
• Underwriting – varies by insurer (similar to R&W underwriting process)
Tax Insurance Case Study

• Buyer utilizing tax insurance to cover a potential tax liability
  
  – Buyer – Portfolio company of US private equity firm
  – Seller – Individual shareholders of Target
  – Target – Retail clothing company

  – Issue: Buyer wanted to make a 338(h)(10) election to take advantage of certain tax deductions it could take going forward after the deal closed, but was concerned about difficulty collecting on an indemnity claim in the event the IRS challenged that “S-status” and subsequently invalidated the 338(h)(10) election

  – Solution: Tax indemnity insurance policy
    - Limit – $17.5 million
    - Retention – $250,000 (Defense costs only)
    - Premium - $750,000
    - Policy period – 6 years from Closing
    - Insurance would respond in the event the IRS challenged the Target’s “S-status” which would invalidate the Buyer’s 338(h)(10) election
    - Policy covered the future tax savings that the Buyer would lose as a result of the election invalidation
    - Insurance allowed parties to focus on other deal issues rather than worry about the indemnity collection issues or require the seller to escrow a significant amount of proceeds to cover this issue
CONTINGENT LIABILITY INSURANCE
Contingent Liability Insurance

Representations & Warranties (Warranty & Indemnity) Insurance Generally Does Not Address Known Exposures.

• Three things necessary to insure a risk:
  – Quantifiable Risk
  – Probability Analysis
  – No Moral Hazard

• Recent Examples
  – Successor Liability
  – Specific Indemnities
  – Fraudulent Conveyance
  – Litigation

• Cost, Limits and Deductibles vary based on particular risk
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