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Risk Allocation in M&A: Representations, Warranties, Indemnification and Limitations of Liability

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Outline and Topics

- Representations and Warranties
 - Purposes
 - Ways to Limit Representations and Warranties
 - Deal Specific vs. General Representations and Warranties
- Conditions vs. Covenants
 - Purposes and Differences
 - Remedies for Breach/Non-fulfillment
- Indemnification
 - Purposes and Scope
 - Direct Claims vs. Third Party Claims
 - Ways to Limit Indemnification Obligations
 - Funding Indemnification Obligations

Outline and Topics

- Limitations of Liability
 - Exclusive Remedy Clause
 - Effect of Buyer's Knowledge of a Claim
 - Express Waiver of Certain Forms of Damages
- Transactional Insurance
 - What is it?
 - Costs
 - Benefits
 - Limitations

Representations and Warranties

- Purposes:
 - Mechanism for obtaining disclosures from the representing party
 - Aid in the due diligence process by helping to “smoke-out” any problems with the business
 - Mechanism for terminating the agreement
 - Mechanism for allocating risk between parties
 - Give the Buyer the right to sue for damages in the event of a breach
- Representations and Warranties should never be used as a complete substitute for due diligence

Representations and Warranties

- Buyer's Goal
 - Comprehensive unqualified representations and warranties about the Seller and the assets
- Seller's Goal
 - As few qualified representations and warranties as possible with “as-is, where-is” being ideal

Representations and Warranties

- Deal Specific vs. General
 - If possible, your contract should contain both
 - Deal Specific
 - Added specifically with regard to the assets to be acquired or goods or services to be provided
 - Example: Representations with regard to the tenant leases in the acquisition of a commercial building
 - General
 - Will be applicable to various transactions
 - Examples: Corporate organization, authorization, title to the assets, compliance with laws, etc.

Representations and Warranties

- Ways to Qualify Representations and Warranties
 - Knowledge
 - Materiality/Material Adverse Effect
 - Disclosure Schedules
 - Scope
 - Time

Representations and Warranties

- Knowledge Qualifiers
 - Important to Define Knowledge
 - Actual Knowledge vs. Constructive Knowledge
 - Actual – Subjective knowledge with no duty of inquiry
 - Constructive – Seller deemed to know what it would have known after a reasonable investigation
 - Whose Knowledge?
 - Specific Individuals
 - Categories of people
 - Shareholders, Directors, Officers, Managers, Employees

Representations and Warranties

- **Materiality/Material Adverse Effect**

- **Materiality**

- Example: The financial statements fairly present in all material respects the financial condition of the business as of the date prepared
- Parties generally do not define the term “material” in agreements
- Fact-specific case-by-case determination
- Lower threshold than a “Material Adverse Effect”

- **Material Adverse Effect**

- Example: There are no Proceedings listed or required to be listed in the disclosure schedules that could have a material adverse effect on the business, operations, assets, condition or prospects of Seller or upon the Assets
- Unlike materiality, parties sometimes do define “Material Adverse Effect”
- Very high standard to meet
- “Material Adverse Effect” can also be a closing condition or independent representation in purchase agreements

Representations and Warranties

- Disclosure Schedules
 - Serve two purposes
 - Exceptions to the representations and warranties
 - Example: Except as set forth in Schedule X, Seller is not a party to any legal proceedings
 - Additional or supplemental information with regard to the representations and warranties
 - Example: Schedule X contains a complete and correct list of all material contracts to which Seller is a party

Representations and Warranties

- Scope
 - Limited to certain materials – e.g., a data room
- Time
 - Limited to certain period of time – e.g., Seller's ownership

Conditions vs. Covenants

- Condition
 - A future, uncertain event, the occurrence or non-occurrence of which will determine whether or not contractual obligations (i.e. to buy or sell) must be performed
 - Remedy – Excused performance
- Covenant
 - An agreement to do or not to do something
 - Remedy – Action for damages or other remedies

Indemnification

- Seller shall indemnify, defend, and hold Buyer Indemnified Parties harmless from and against Losses arising out of or relating to:
 - Breach of any representation in the agreement
 - Breach of any covenant in the agreement
 - Retained Liabilities
 - *[Other transaction-specific indemnities]*

Indemnification

- Direct Claims vs. Third Party Claims
 - Purchase Agreements
 - Typically cover both
 - Advantageous because legal fees are typically recoverable
 - Commercial Contracts
 - Typically cover only third party claims
 - Direct claims must be brought as breach of contract
 - Example: a manufacturer indemnifies a distributor against product liability claims from retail customers

Indemnification - Limitations

- Baskets
- Thresholds
- Caps
- Survival periods
- Tax benefits
- Insurance proceeds

Indemnification - Limitations

- Baskets
 - Limitations on indemnification that require the Buyer's aggregate Losses to exceed a certain amount before being entitled to indemnification
 - Types of baskets
 - Deductible/Non-Tipping
 - First Dollar/Tipping
 - Combination
 - Amounts
 - Materiality qualifiers in representations

Indemnification - Limitations

- Thresholds

- Limitations on indemnification that require the value of a claim to exceed a certain de minimis amount before it is even considered to be a claim for purposes of indemnification
- Claims under the threshold amount will not count towards the basket
- Once the basket has been exceeded, claims under the threshold amount will still not be recoverable

Indemnification - Limitations

- Caps
 - Seller's maximum exposure under an indemnification
 - Amounts
 - Most deals have caps that are 10% of the purchase price or less
 - Wide range of caps up to 100% of the purchase price
 - Size of cap depends on a number of factors
 - Transaction size
 - Amount of due diligence conducted by buyer
 - Nature of target's business

Indemnification - Limitations

- Survival Periods
 - Limitation based on time rather than dollar amounts
 - Artificial statute of limitations
 - Typically less than 18 months
 - Buyers should focus on how long it will realistically take to discover breaches

Indemnification - Limitations

- Insurance proceeds
 - Seller wants to take into account any insurance proceeds received by Buyer when calculating Losses
- Tax effect
 - Seller wants to take into account any tax benefits received by Buyer when calculating Losses

Indemnification – Limitation Exceptions

- Indemnification claims other than breach of representations
 - Covenants
 - Retained Liabilities
 - Transaction-specific indemnities
- Fraud
- Intentional Misrepresentation
- Fundamental Representations

Indemnification – Limitation Exceptions

- Fundamental Representations
 - Some representations that are frequently considered Fundamental Representations are:
 - Due organization
 - Due authorization
 - Title
 - Tax
 - Employee benefits
 - Environmental
 - Brokers

Funding Indemnification Obligations

- **Shareholder or Affiliate Guaranty**
 - After closing, Seller may have only limited assets, so Buyers may seek a guaranty from certain shareholders (individual or corporate) or affiliates of Seller
- **Holdbacks**
 - Retention by Buyer of a certain portion of the purchase price for a period of time which is designed to cover indemnity obligations
- **Escrow**
 - Similar to a holdback, but the funds are held by a third party escrow agent pursuant to an escrow agreement
- **Right of Set-off**
 - If the Buyer has subsequent payment obligations to the Seller under an installment note or otherwise, it may seek a right of set-off
- **Transactional Insurance**
 - Representations and warranties insurance is becoming much more prevalent

Other Limitations of Liability

- **Exclusive Remedy Clause**
 - Ensures the Buyer is not able to do an “end-run” around the indemnity basket, cap and other limitations by suing the Seller under a general breach of contract theory
- **Effect of Buyer’s Knowledge of a Claim**
 - Anti-Sandbagging Clauses prevent Buyer from bringing indemnification claims if it knew of the breach prior to closing
- **Express Waiver of Certain Forms of Damages**
 - Prevents award of certain expressed forms of damages
 - Lost profits, indirect, incidental, consequential, special and punitive damages

Transactional Insurance

- Representations and Warranties Insurance
 - Insurance policy used in M&A to protect against losses resulting from a breach of a representation or warranty
 - Typically acquired only by the Buyer
 - Shifts liability for breach from Seller to the insurance carrier after deductible is satisfied
 - Coverage is typically 10% of purchase price
 - Typical term is for 3-6 years

Transactional Insurance – Costs

- **Underwriting/Due Diligence Fee**
 - Typically \$15,000-\$50,000 depending on deal size/complexity
 - Typically paid for by Buyer, but can be negotiable
- **Insurance Premium**
 - Typically 2-3% of the coverage limit
 - Typically paid for by Buyer, but can be negotiable
- **Deductible/Retention**
 - Typically 1% of the purchase price
 - Typically split 50/50 between Buyer/Seller, but can be negotiable
- **Insurance Policy Sales Tax**
 - Typically 2.5-6% of insurance premium (PA is 3%)
 - Typically paid for by Buyer, but can be negotiable

Transactional Insurance – Benefits

- **Benefits for Sellers**
 - Reduce/eliminate indemnification for breach of reps & warranties
 - Reduce/eliminate any escrow or holdback
 - Provides more certainty to amount of proceeds Seller will receive
- **Benefits for Buyers**
 - Make Buyer's bid look more attractive
 - Seller likely to give more robust and less qualified reps & warranties, which, in turn, improves Buyer's ability to prevail on a claim
 - Coverage limit may be higher than Seller would be willing to give
 - May extend the duration of the survivability of the reps & warranties
 - Baskets, thresholds and caps likely not necessary
 - Still need to negotiate responsibility for the deductible

Transactional Insurance - Limitations

- Limitations on Coverage
 - Breaches of covenants are not covered
 - Retained liabilities are not covered
 - Purchase price adjustments are not covered
 - Breaches Buyer had knowledge of are not covered
 - Damages in excess of policy amount are not covered
 - Certain tax-related issues may not be covered
 - E.g. Accrued taxes on the balance sheet for pre-closing periods

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