EVERSHEDS SUTHERLAND

Risk Allocation in M&A Agreements and Reps & Warranties Insurance

What's on the Horizon?

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ACC Association of Corporate Counsel
SAN FRANCISCO BAY AREA

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Introduction

Building on strong foundations: Our Global M&A Group

74
offices

35
jurisdictions

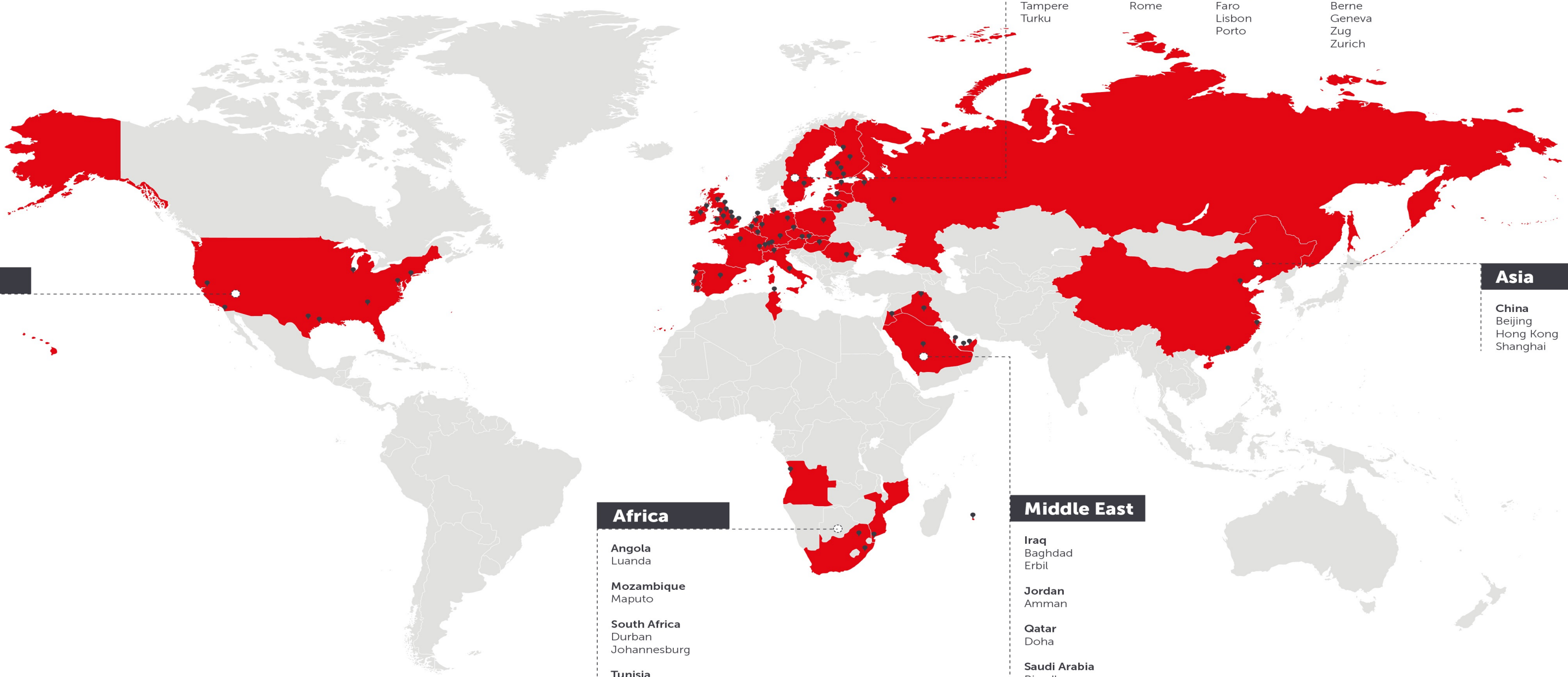
500+
corporate lawyers

Top 30
for global M&A

Top 15
for European M&A

24%
more deals completed YTD in 2021 v. 2020

Our Global Presence



US

Atlanta
Austin
Chicago
Houston
New York
Sacramento
San Diego
Washington DC

Europe

Austria
Vienna

Belgium
Brussels

Czech Republic
Prague

Estonia
Tallinn

Finland
Hämeenlinna
Helsinki
Jyväskylä
Oulu
Tampere
Turku

France
Paris

Germany
Berlin
Düsseldorf
Hamburg
Munich

Hungary
Budapest

Ireland
Dublin

Italy
Milan
Rome

Latvia
Riga

Lithuania
Vilnius

Luxembourg
Luxembourg City

Netherlands
Amsterdam
Rotterdam

Poland
Warsaw

Portugal
Faro
Lisbon
Porto

Romania
Bucharest

Russia
Moscow
St Petersburg

Slovakia
Bratislava

Spain
Madrid

Sweden
Stockholm

Switzerland
Berne
Geneva
Zug
Zurich

United Kingdom
Belfast
Birmingham
Cambridge
Cardiff
Edinburgh
Ipswich
Leeds
London
Manchester
Newcastle
Nottingham

Asia

China
Beijing
Hong Kong
Shanghai

Africa

Angola
Luanda

Mozambique
Maputo

South Africa
Durban
Johannesburg

Tunisia
Tunis

Mauritius
Port Louis

Middle East

Iraq
Baghdad
Erbil

Jordan
Amman

Qatar
Doha

Saudi Arabia
Riyadh

United Arab Emirates
Abu Dhabi
Dubai

Customary Transaction Risks

- Finances
- Operations
- Suppliers
- Customers
- Employees
- Litigation
- Regulatory/Compliance
- Real Estate/Environmental
- Privacy/Data Security
- Tax

Customary Risk Mitigation

- Due Diligence
- Transaction Value/Purchase Price Adjustments
  - Earn-outs
  - Stock consideration
- Representations and Warranties
- Indemnification and RWI

What's Different About 2021?

COVID-19-Specific Concerns

- Transaction process
- Employees and furlough measures
- Business continuity plans
- Supply chain issues
- Level of business activity
- IP developed at home
- Inconsistent financial performance

Transaction Process

- Due Diligence
  - Logistical issues posed by COVID-19 including travel, site visits, personnel interviews
  - Evaluating the target when COVID-19 has affected strategy, budget, contracts, liquidity, customers, suppliers, costs
  - Capacity constraints within DD providers and the need for third-party providers
- Transaction Negotiation
- Post-Closing Integration

Opportunity in a Crisis

- Buyers willing to take more risks (RWI not a panacea)
- Financially strong strategics
- PE deploying large funds
- Insulated industries
- At-risk industries

COVID-19 M&A

Headlines

- Despite predictions of a swing to buyer-friendly terms, it has remained a sellers’ market
- Contingent and deferred consideration mechanisms (including earn-outs and retentions) have been a popular method to mitigate transaction risks
- Deal conditionality is increasing outside of the US due to anti-trust and foreign direct investment regimes and generally increased regulation
- Use of W&I/R&W insurance has increased across the board during the pandemic
- Biden’s election win has led to an uptick in rest-of-world M&A activity, with US corporates not keen to repatriate cash (which was happening under Trump)
- The pandemic has accelerated the importance of environmental, social and governance (ESG) considerations in the US, Europe, the UK and Asia

Post-COVID-19 M&A

Key changes we have seen

Valuations

- Rebalancing toward completion account, but it remains a sellers’ market
- More earn-outs and deferred consideration, including retention/escrows
- Intense competition remains for good assets and multiples remain high, but to protect price, sellers are needing skin in the game (50% roll)
- Though we expected some return to buyer influence in a COVID-19-constrained market, we have not seen that in practice, and it remains a sellers market

Post-COVID-19 M&A

Key changes we have seen

Key structure terms

- Refocusing on representations/warranties packages, disclosure and target indemnities
  - Reps and warranties on COVID-19 – impact on business, planning and response
    - Disclosure against these reps and warranties of particular interest to clients
  - Target’s use of any government bailout funds (in the US, for example, PPP loans)
    - IP developed at home
    - Inconsistent financial performance
- Refocus on conduct of business provisions (whether in a gap or during an earn out period)
- MAC

Bridging the Valuation Gap

Methods to bridge the valuation gap

How does a buyer protect against downside risk?

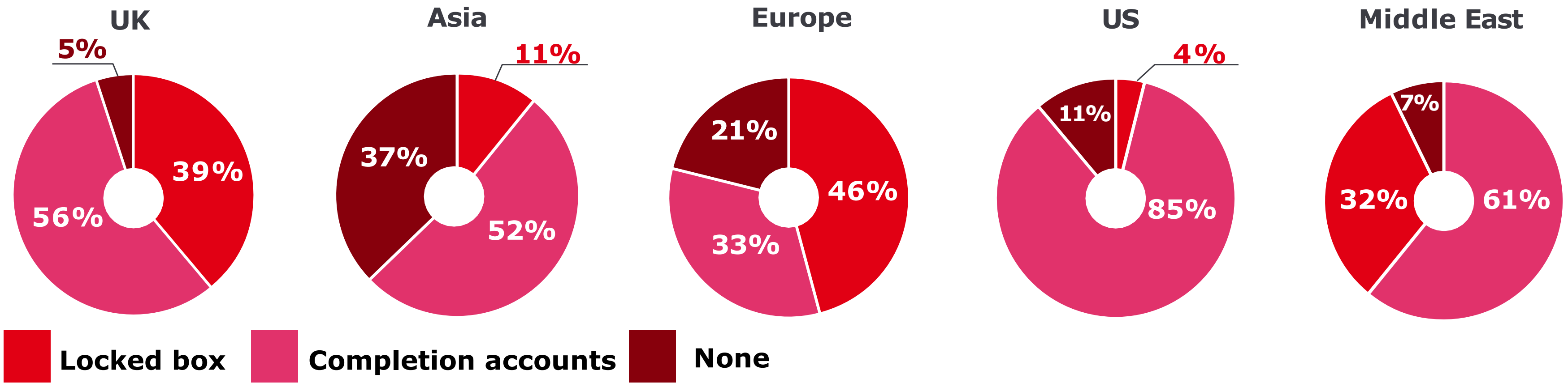
- Rebalancing toward completion accounts – though locked box remains popular with PE sellers/ auction deals where sellers can dictate terms
- Pay the right price – we have seen that deals are more likely to fall over as a result of difference of opinion on price/diligence issues

What other mechanisms exist to ease valuation uncertainty?

- Warrant the accuracy of specific financial information – with like-for-like comparisons more difficult over 2019-2021 in certain sectors, we have seen buyers requesting that sellers warrant the accuracy of, e.g., sales data or customer data
- Seller roll-over or reinvestment – partial cash-out
- Deferred consideration mechanisms – e.g., earn out

Bridging the Valuation Gap

Purchase price adjustments – locked box or completion accounts

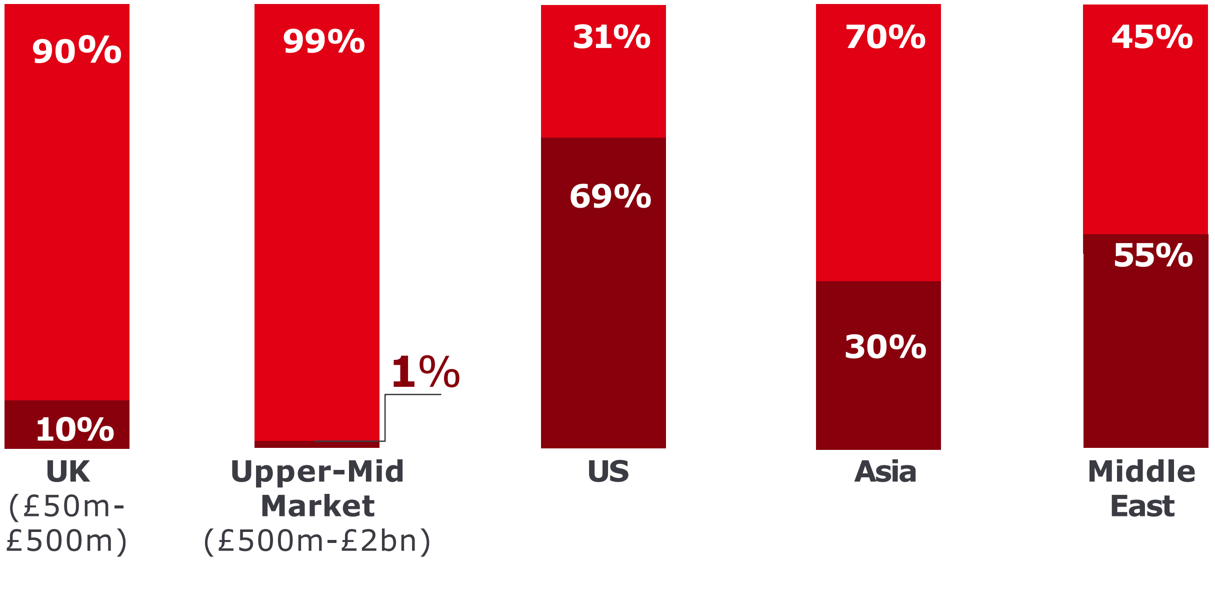


- Completion accounts continue to be much more commonly used in the US than the UK
- Locked box adjustments have grown in usage over the past 10 years and are particularly popular in upper-mid market deals
- In Asia, historically a higher proportion of deals had no purchase price adjustment at all when compared with other regions; in recent years, the overall proportion of deals that included purchase price adjustments, whether completion accounts or locked box, has increased
- However, we have seen a rebalancing toward completion accounts in 2020 and 2021

Bridging the Valuation Gap

Retention provisions

Was there security for warranty claims and/or for completion account adjustments?



- The most common reasons for a retention are for warranty claims and indemnity claims (e.g., litigation) and for completion account adjustments
- Roughly a third of deals in Asia have retention or some form of security for claims
- In the UK, retentions typically take the form of an escrow held with a third-party provider; in the US, buyer retentions are more common

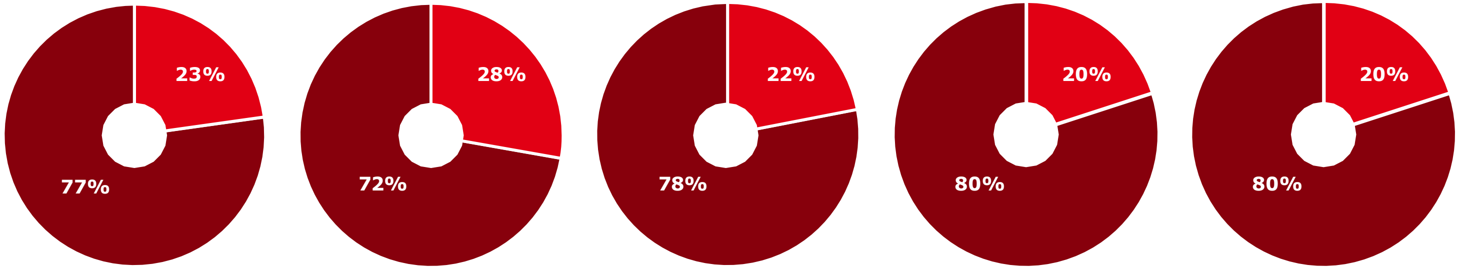
Increased Use of Earn-outs

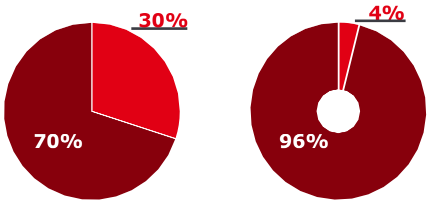
- Up to 20% of surveyed private deals
- Average earn-out amount increased to 40% of purchase price
- Longer earn-out periods

Bridging the Valuation Gap

Earn-outs

UK US Asia Europe Middle East





Lower-Mid Market
(up to £50m)

Upper-Mid Market
(£500m - £2bn)

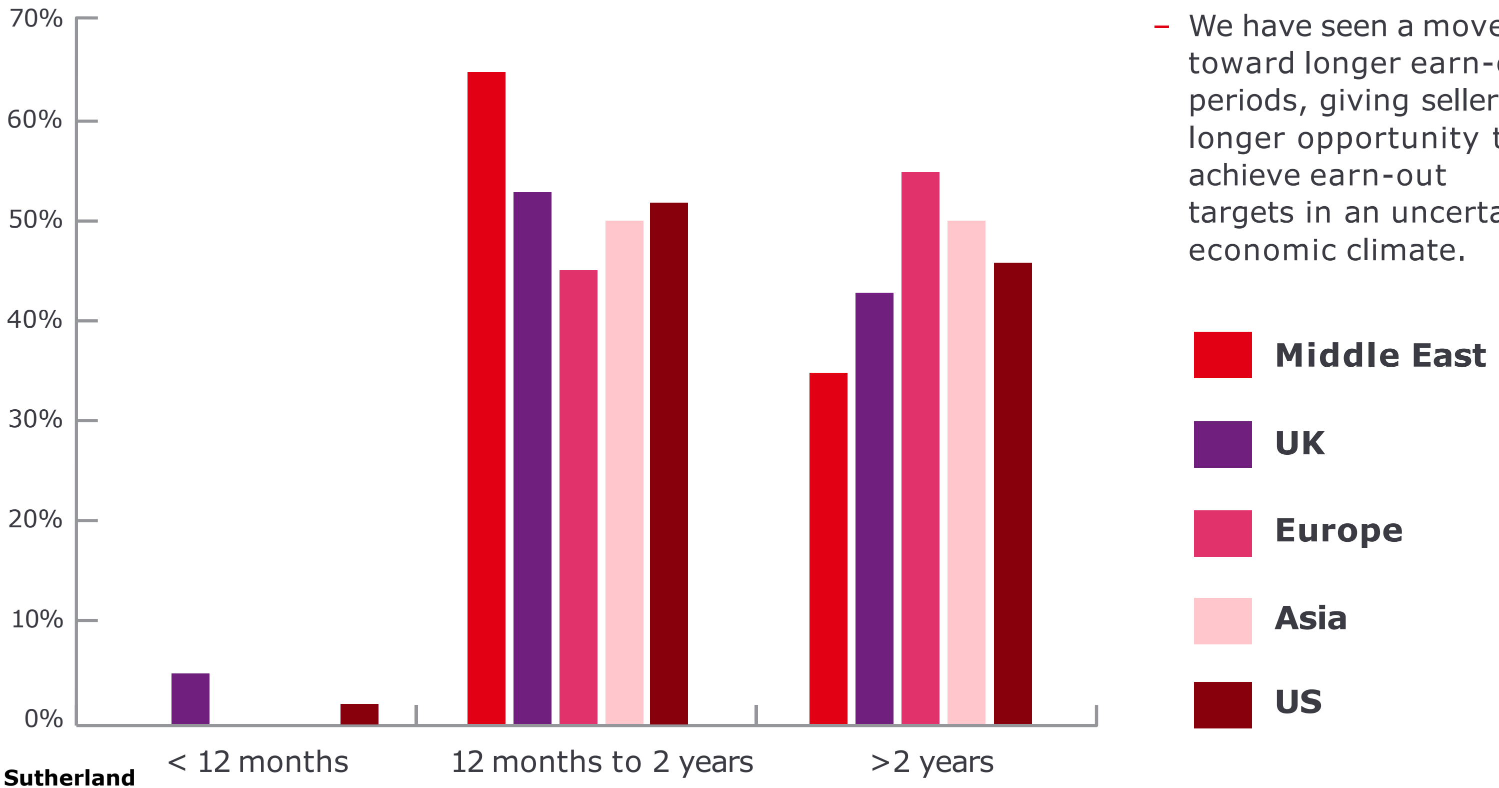
Was there an earn-out?

Yes No

- We've seen more earn-outs in 2020 and the first half of 2021
- Earn-outs are more common in the US across the board
- More common in lower-value deals than in upper- mid market deals in the UK and Europe
- Statistics for Asia fall in between the UK/Europe and the US

Bridging the Valuation Gap

Earn-out period



- We have seen a move toward longer earn-out periods, giving sellers a longer opportunity to achieve earn-out targets in an uncertain economic climate.

Representations and Warranties

- No undisclosed liabilities – see discussion of MAC and consider "ordinary course of business" exception if measuring period is post-pandemic
- Use of 10b-5/full-disclosure representations continues to decline in popularity, perhaps as a result of RWI
- Increased use of "no other representations" and "non-reliance" provisions, often with fraud carve-out

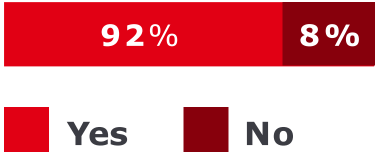
MAC Clauses

Key structure terms

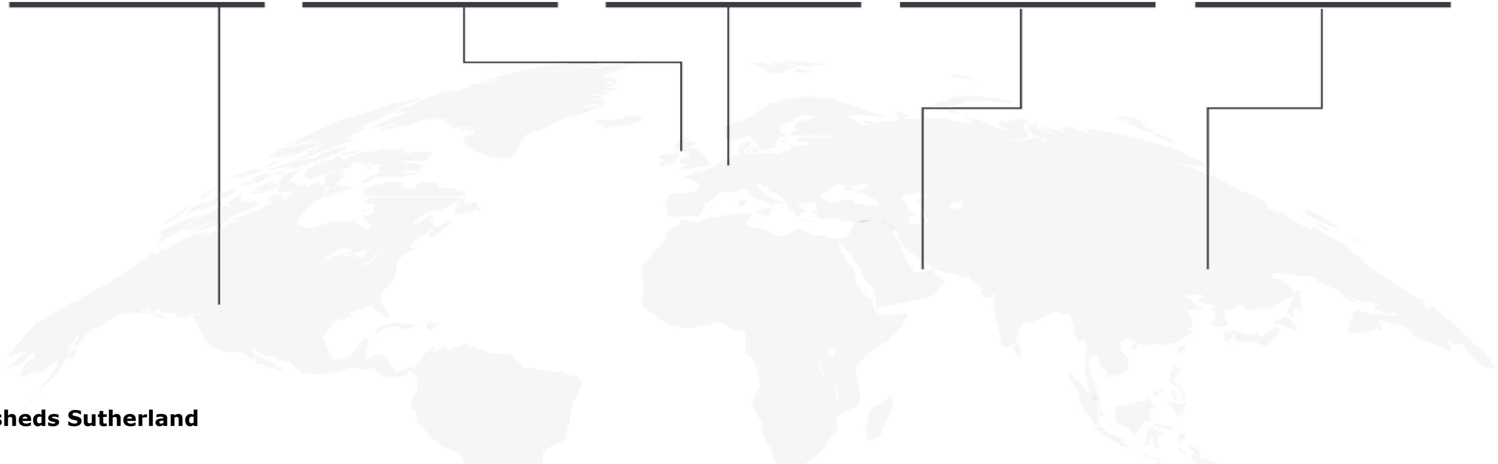
Was there a MAC clause?

Buyer protection between exchange/signing and completion/close

Upper-Mid Market
($500m-2bn)



US		UK		Europe		Middle East		Asia	
93%	7%	25%	75%	20%	80%	55%	45%	58%	42%



MAC Clauses

MAC definition

- Exclusion of "pandemic," usually with a disproportionate qualifier
- Exclusion of "COVID-19"
- Exclusion of COVID-19-related government actions
- Most MACs still don't include "prospects"
- Most MACs have forward-looking language – "could be" or "would be" expected to have…
- Increased use of termination fees

Indemnification

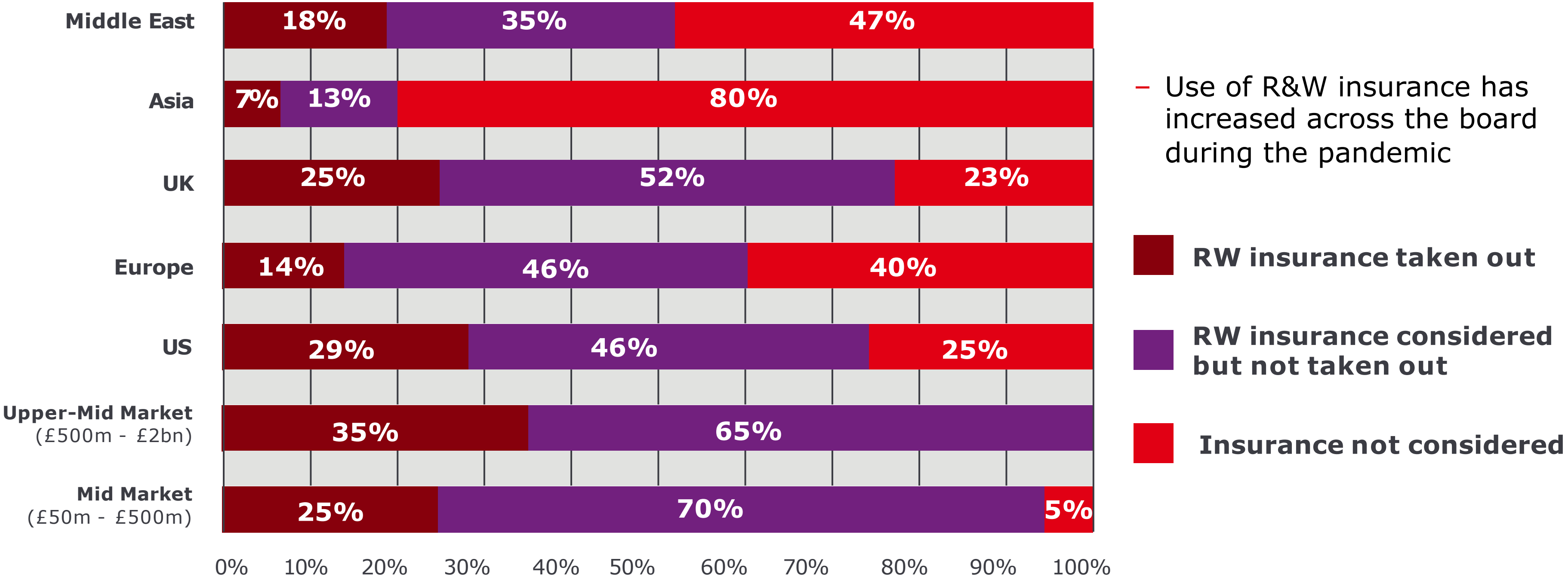
- Indemnity escrow deals – 10% to 15% escrow is common
- RWI deals with indemnity – indemnity value is 0.5% or less
- Decline in deals with an eligible claim threshold to 28%
- Anti-sandbagging provision (buyer’s knowledge of breach invalidates remedy) in less than 5% of deals
- Pro-sandbagging provisions (buyer’s knowledge of breach does not impact remedy) in approximately 50% of deals; doesn’t work with RWI deals because of knowledge exclusions
- Balance of deals silent on impact of buyer’s knowledge on seller’s liability (consider the default rule)

Indemnification

- Close to 60% of deals include exclusion of materiality qualifiers for purposes of determinations of breach and damages
- Approximately 1/3 of deals have 12-month survival for representations and warranties
- Approximately 1/3 of deals have 18-month survival for representations and warranties
- Caps in 50% of non-RWI deals are between 5% and 15% of transaction value
- Caps in 50% of RWI deals are 0.5% or less

RWI

Is RWI considered?



- Use of R&W insurance has increased across the board during the pandemic

RWI

Key factors

01

Zero recourse for the seller (i.e., buy-side policy)

02

$1 liability cap

03

Policy enhancements – the US claim period: 3 years/6 years; the UK claim period: exceeding those in the SPA (offered in 4% of policies); knowledge scrape in 5% of the UK policies; materiality scrape in almost 100% of US policies

04

Underwriting premium – the UK generally 0.65% to 1.65% of the policy limit (which tends to be around 30% of consideration); the US: 3.5% to 5%/5% to 7 %

05

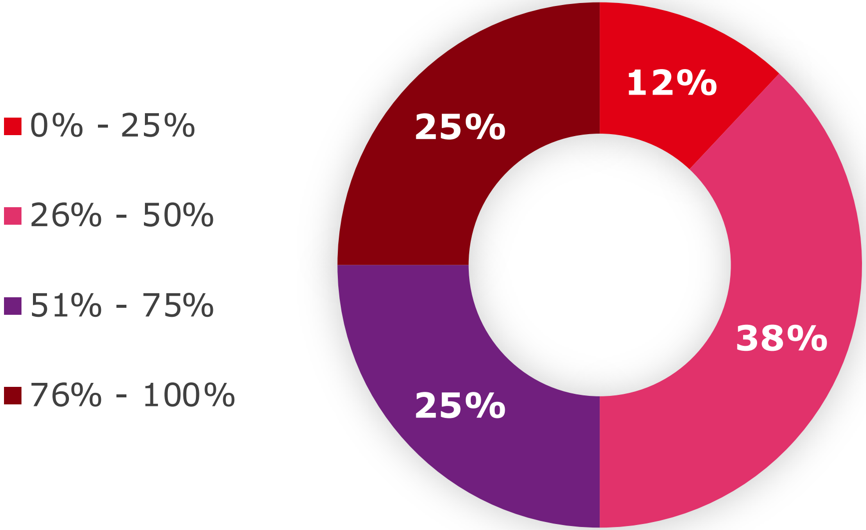
Retention/ deductible – 0.5% to 1% of EV

06

Deductible will generally drive the amount of the basket in a RWI deal

RWI

Policy limits (business warranties) as a % of consideration



Premium rates remain low, but risk aversion and policy limits are rising

Reflects the UK and European market data

RWI

- Overwhelming demand for RWI as a result of both increased M&A activity in 2021 and increased “penetration” within the deal marketplace
- RWI carriers have become increasingly selective
  - Increase in minimum deal size
    - US: $50 million - $100 million
  - Rates have increased, but mostly in Q4 2020
  - Increasing requirement for audited financial statements
  - Refusing to underwrite deals in particular sectors
  - Limited RWI availability for balance of 2021?
  - Timing/process
    - Diligence call only after all due diligence completed

Standard v Bespoke Policy

The standard policy can be negotiated

- Tailor the policy to the deal
  - Knowledge scrape
  - Limitations on general and removal of deal specific exclusions
  - Deal specific variation of Loss
  - Enhanced time periods for claims for breach
  - Extension of time where late awareness to notify post end of policy period
  - Synthetic tax and other warranties
- Important to involve specialist broker at early stage

Claim Trends

- Increase in claims over last few years
  - Increased number of policies written
  - Increasing sophistication of buyers
  - Notifications being made early (6 months to 1 year from placement)
- Claims relating to a breaches of:
  - Financial statements
  - Accounting and tax
  - IT/Data third-party claims
- Hardening claims market
  - Insurers challenging larger claims
  - Settlements to avoid court decisions

Post-COVID-19 M&A

Key changes we have seen

Broader trends in the market

- Divergence of the market along sector lines
- RWI – increased use of policy enhancements (knowledge scrape, disclosure scrape) to enhance coverage
- Divestments – businesses streamlining and focusing on key revenue streams
- Accelerated/distressed M&A brought into sharper focus, though uptick in distressed M&A less than expected
- ESG – the pandemic has accelerated the importance of environmental, social and governance considerations

Post-COVID-19 M&A

Key changes we have seen

Continuing themes

- Continued convergence of European and US practices in relation to certain deal terms
- Increased regulatory scrutiny of foreign investment (e.g., CFIUS in the US)
- Increased prominence of data security and privacy as part of due diligence

Post-COVID-19 M&A

Key changes we have seen

Continuing themes

- Financing for M&A deals remains available and interest rates remain low, though we are beginning to see more concern about inflation and, with it, potentially higher borrowing costs
- Low cost of capital with interest rates remaining low
- Abundance of dry powder in market, particularly in PE and with SPACs in the US
- In the US, the impact of Biden’s policies remains to be seen, including the impact of potential tax increases, infrastructure spending, etc.

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