

Morgan Lewis

M&A ACADEMY

**Be Prepared—Why Representations &
Warranties, Due Diligence and Disclosure
Schedules Matter**

Eric Tajcher and Allison Gargano

November 19, 2019

© 2019 Morgan, Lewis & Bockius LLP

What We Plan to Cover Today

- Purpose of Due Diligence
- Due Diligence Process
- Data Room Preparation and Process
- Purpose of Representations and Warranties
- Representation and Warranty Qualifiers
- Disclosure Schedules Basics
- Preparing Disclosure Schedules
- Buyer's Comment Process
- Key Takeaways

Due Diligence Purpose

- Buyer gets educated about business
- Evaluation of commercial and legal relationships
- Evaluation of third party or governmental/regulatory consents
- Identification of material issues (i.e. litigation, employee classification, financial statement issues)
- Provide support and knowledge about business to lenders and R&W insurers

Due Diligence Process

Be Prepared

- Keep accurate and up to date records
- Maintain central repository for all company documents
 - Organize, collect, and maintain all contracts and subsidiary information
 - Clean up and verify capitalization (particularly options, warrants, and any other securities)
 - Gather all board of director and shareholder minutes, including all board packet and shareholder communications
 - Organize financial statements and supporting files
- Be internally prepared with messaging on any problematic items before they are presented to the other side; no surprises—**find them yourself first**

Data Room Set-up

1. Pick a vendor that is appropriate for the size of the deal
 - Work with investment bankers and legal counsel to choose provider
 - Security
 - Product functionality
2. Product functionality
 - Ensure that searching is enabled and efficient
 - Consider printing enablement and/or downloading enablement
 - Alerts
 - Tracking

Data Room Preparation and Process

How to Best Organize/Share Contracts

1. Group contracts in logical sets based on type using a form diligence request
2. Work with business team to discuss any commercially sensitive or employee privacy information that will not be provided up front or will be provided pursuant to special procedures
 - E.g., sensitive commercial agreements or those with strict restrictions on confidential information; SSNs of employees
3. Address any antitrust issues raised by sharing contracts with competitors
4. Coordinate with legal counsel to review for organization and substance
 - *Note for transactions with international components: consider whether foreign contracts need to be translated or if local counsel needs to review

Data Room Preparation and Process

1. Buyer typically offers up a relatively standard list of requests
2. Appoint one or two people to manage incoming requests, communicate with appropriate internal teams, and coordinate external responses

Representations and Warranties – What Are They?

- A statement of fact upon which the other party may rely
- Seller's representations and warranties section tends to be one of the most negotiated sections of the acquisition agreement, unless the parties will obtain R&W insurance, which is the subject of another presentation in the M&A Academy on December 10, 2019
- Types
 - Affirmative v. Negative
 - “The following is true . . . ”
 - “Except as set forth on the disclosure schedule, the following is true . . . ”
 - Lists
 - “The Schedule lists all of our . . . ”

Representations and Warranties - What Do They Do?

- “Trust but verify” — Due diligence
- Allocation of risk between the parties
 - Closing condition (only applicable in a deferred closing)
 - Indemnification (responsibility for breaches)

Scope of Representations and Warranties

- Consider whether there are other potential buyers — relative leverage makes a big difference on form and scope of representations
- Consider whether each representation is appropriate for the target's business
 - E.g., environmental, owned real property, manufacturing, healthcare, franchises
- Consider who/what is making the representation
 - E.g., who stands behind the indemnity and who has access to the information

Typical Fundamental Representations

Typical Fundamental Representations (percentages based on the 2017 Deal Points Study – Carve Outs to Survival Limitations)

- Organization (76%)
- Authority (84%)
- Capitalization (71%)
- Taxes (75%)
- Broker's/Finder's Fees (68%)

General Representations and Warranties

- No Conflicts/Consents
 - Conflict with what?
 - Consent from whom?
 - Why do we care?
- Financial Statements
 - What is the basis for the investment decision?
 - Audited statements
 - Unaudited statements
 - Compliance with GAAP
 - Importance of a balance sheet date
 - Financial controls
- Material Contracts
 - What are they?
 - Have copies of contracts been provided?
 - Is anyone in default?
 - Will this deal affect any of them?
- Full Disclosure – 10-b-5
 - “Nothing you have told me is untrue or misleading and you haven’t failed to tell me anything that would make what you told me untrue or misleading.”

Representations and Warranties- When Do They Have to Be True and How True are They?

- At signing of the agreement (unless as of a specific date)
 - Only applicable in a deferred closing
- At closing of the transaction
 - Requiring the representations to be re-made at closing protects the buyer against changes in the seller's business occurring between signing and closing
 - Transaction may allow or obligate the seller or issuer to update disclosure schedules based on new facts and circumstances
- Standards of truthfulness
 - Fundamental Representations (in all respects; in all respects, other than *de minimis* inaccuracies; in all material respects)
 - General Representations (in all material respects; in all respects, except as would not be expected to result in a Material Adverse Effect)

Representation and Warranty Qualifiers: Materiality

Different Standards

- Material
- Materially adverse to the company (undefined)
- “Material Adverse Effect”

Representation and Warranty Qualifiers: MAE/MAC

- Case law

- Extremely high standard under Delaware law
 - Should be material when viewed from the longer-term perspective of a reasonable acquirer, measured in years rather than months (*Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*)
 - Threatens the overall earnings potential of the target in a durationally significant manner (*Frontier Oil Corp. v. Holly Corp.*)
- Only one MAE has been found in Delaware, which was facts-specific (*Akorn v. Fresenius*)

- Definition

- “Material Adverse Effect” means any change, effect, event, occurrence, circumstance, condition, state of facts or development that is **or [would/could] reasonably be expected to be, individually or in the aggregate**, materially adverse to the Business or the assets, liabilities, properties or condition of the Company Entities
- Typical exceptions to MAE: changes in general financial or capital market, economic or political conditions (including any changes arising out of acts of terrorism or war) or general conditions in the industry in which the Company and the Subsidiaries primarily operate or changes after the agreement date in GAAP or law, **provided that the changes do not have a disproportionate impact on the Company and the Subsidiaries taken as a whole relative to other companies operating in the industry in which the Company and the Subsidiaries primarily operate**

Representation and Warranty Qualifiers: Materiality Scrape

- What is a materiality scrape
 - Ignores (reads out) materiality qualifiers
- Closing Conditions (87%)
 - All representations and warranties of the Sellers and the Company set forth in this Agreement shall be true and correct in all material respects **(without giving effect to any limitation as to “materiality” or “Material Adverse Effect” or any similar limitation contained in this Agreement)** as of the Closing as though made as of the Closing (except to the extent that any such representation and warranty expressly speaks as of an earlier date, in which case such representation and warranty shall be true and correct as of such earlier date)
- Indemnity Provision (85%)
 - If any representation or warranty contained herein is limited or qualified based on materiality, including **the terms “material,” “Material Adverse Effect,” or similar qualifications such limitation or qualification shall in all respects be ignored and given no effect** both for purposes of (i) determining whether there has been an inaccuracy in or breach of any representation or warranty and (ii) determining the amount of Losses resulting from such breach

Representation and Warranty Qualifiers: Specific Time Periods

- Designating a specific time period to limit the scope of a representation
- Examples:
 - “No third-party claims have been asserted in the last five years.”
 - “As of [date of Agreement], there is no litigation.”
 - “The Company has not engaged in X over the last [two years].”
 - “The financial statements are true and correct as of [insert date].”

Representation and Warranty Qualifiers: Knowledge

- “To the Company’s knowledge,...”
 - Representation qualifier
 - Less common than materiality qualifier and typically not scraped
- Issues
 - Whose knowledge? Specific list of individuals?
 - Actual knowledge, reasonable due inquiry or constructive knowledge?
 - Actual knowledge – “Knowledge” means, with respect to a party, the **actual knowledge (without any requirement of investigation other than reviewing this Agreement and the Company Disclosure Schedule)** of the directors, officers, legal or financial personnel of such party
 - Reasonable due inquiry – “Knowledge” means, with respect to a party, the **actual knowledge** of the directors, officers, legal or financial personnel of such party **after reasonable due inquiry**
 - Constructive knowledge – “Knowledge” means, with respect to a party, **the actual knowledge** of the directors, officers, legal or financial personnel of such party **and such knowledge as would reasonably be expected to be known by such individuals after exercising reasonable due diligence in the conduct of his or her duties and responsibilities with respect to such party**

Disclosure Schedules - Why Do They Matter?

1. Relationship to representations and warranties
2. Closing requirements and certainty of closure
3. Risk-shifting and post-closing indemnification

Disclosure Schedules- Key Considerations

1. Key to signing—all too often ignored until later in process

- Aim to prevent any surprises for buyer
- Socialize sensitive issues

2. Qualifications

- Incorporation by reference: “reasonably/readily apparent on its face”
- Does not expand scope of representation or warranty
- Does not constitute admission or materiality

***Note for international transactions:** In US-style transactions, reference to a data room is not customary; detailed disclosure schedules are generally expected. In some instances, copies of documents will need to be specifically attached.

Preparing Disclosure Schedules

1. At a minimum, all business people within “knowledge” definition need to review the current representations, warranties, and schedules (schedule must not simply be left to the lawyers)
2. Ask lawyers to prepare an annotated list based on current representations and warranties (those will be a moving target)
3. Information must be responsive to representations and warranties in the acquisition agreement

Disclosure Schedules: Buyer Comments

1. Buyer will request documentation for each item disclosed
2. Calls to discuss comments can be more efficient
3. Changes based on representation and warranty negotiations

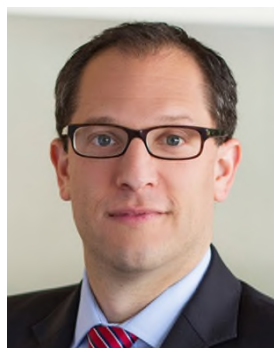
Key Takeaways from This Session

1. Designate clear leads on the internal and external teams, and set up systems to organize production and tracking of diligence materials
2. Consider whether there are any issues arising from due diligence that need to be included or excluded in the representations and warranties
3. Representations and warranties – Consideration of the allocation of risk; know your qualifiers
4. Robust, thoughtful disclosure schedules, and getting prepared early are key

QUESTIONS?



Biography



Eric Tajcher

New York, NY

+1.212.309.6803

eric.tajcher@morganlewis.com

Eric Tajcher counsels businesses on US and cross-border mergers and acquisitions (M&A). His clients include both financial and strategic acquirers, as well as companies that are acquisition targets or for sale. He also advises organizations on joint ventures, strategic alliances, private placements, and general corporate and compliance matters. Eric advises companies in a host of industries, including energy, natural resources, fintech, media, education, manufacturing, and retail and franchise. Eric also serves on the pro bono advisory council of the New York Lawyers for the Public Interest.

Biography



Allison Gargano

New York

+1.212.309.6948

allison.gargano@morganlewis.com

Allison D. Gargano focuses her practice on advising Fortune 500 companies, private equity sponsors, investment banks, and emerging market companies on a broad range of corporate matters, including mergers, acquisitions, dispositions and private equity investments, in both domestic and cross-border transactions. She also advises clients on general corporate and compliance matters. Allison has experience in a broad range of industries, including media, technology, retail and financial services.

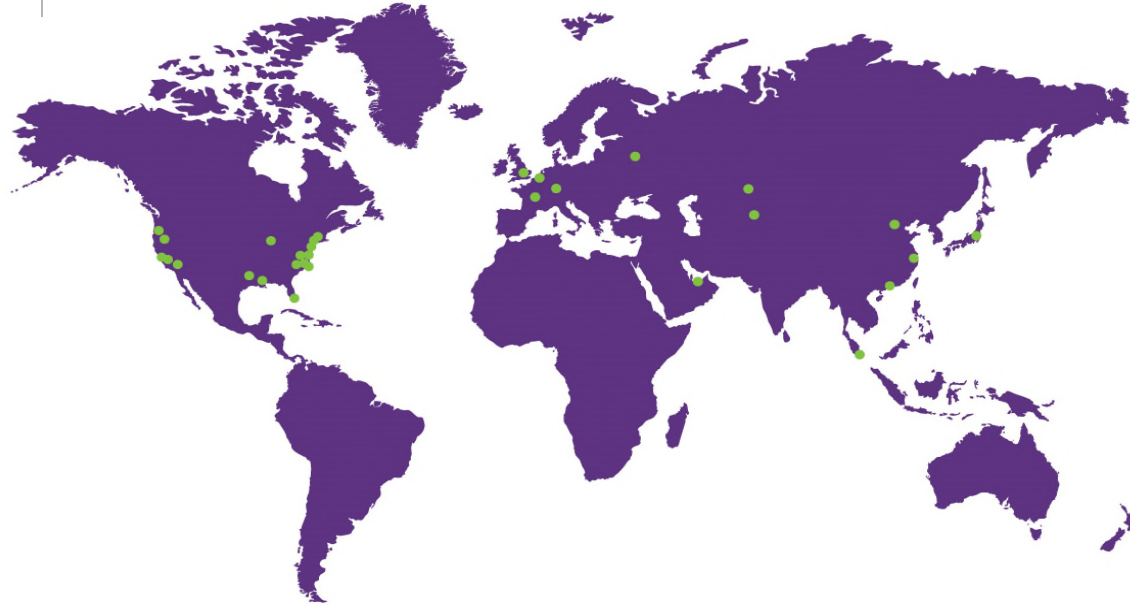
Morgan Lewis

Our Global Reach

Africa
Asia Pacific
Europe
Latin America
Middle East
North America

Our Locations

Almaty	Chicago	Houston	Orange County	Shanghai*
Astana	Dallas	London	Paris	Silicon Valley
Beijing*	Dubai	Los Angeles	Philadelphia	Singapore
Boston	Frankfurt	Miami	Pittsburgh	Tokyo
Brussels	Hartford	Moscow	Princeton	Washington, DC
Century City	Hong Kong*	New York	San Francisco	Wilmington



Morgan Lewis

*Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners.

THANK YOU

© 2019 Morgan, Lewis & Bockius LLP
© 2019 Morgan Lewis Stamford LLC
© 2019 Morgan, Lewis & Bockius UK LLP

Morgan, Lewis & Bockius UK LLP is a limited liability partnership registered in England and Wales under number OC378797 and is a law firm authorised and regulated by the Solicitors Regulation Authority. The SRA authorisation number is 615176.

Our Beijing and Shanghai offices operate as representative offices of Morgan, Lewis & Bockius LLP. In Hong Kong, Morgan Lewis operates through Morgan, Lewis & Bockius, which is a separate Hong Kong general partnership registered with The Law Society of Hong Kong as a registered foreign law firm operating in Association with Luk & Partners.

This material is provided for your convenience and does not constitute legal advice or create an attorney-client relationship. Prior results do not guarantee similar outcomes. Attorney Advertising.

Morgan Lewis