

Morgan Lewis

M&A ACADEMY REPRESENTATIONS AND WARRANTIES

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November 15, 2016

Topics to Be Covered

1. The Basics – Understanding representations and Warranties
2. Reading the Fine Print
3. Updating Disclosure Schedules
4. Favorite examples and explanations
5. Problems of knowledge – the art of the sandbag

Section One: The Basics

Understanding Representations and Warranties

- What are they?
- What do they do?
- When do they have to be true?

What Are They?

- **Representation:** A statement of fact made to induce another to enter into a contract.
- **Warranty:** An assurance by one party of the existence of a fact upon which the other party may rely.
- Why the difference matters:
 - The maker of the inaccurate statement has made a misrepresentation, and the recipient is entitled to remedies for misrepresentation.
 - If a warranty is untrue, it is breached and the recipient of the warranty is entitled to damages for breach of contract.
 - Some commentators distinguish between representations and warranties stating that representations support potential tort claims and warranties support potential contract claims *OR* that representations are tied to past statements and warranties are tied to future-looking statements.
 - Other commentators reject any functional difference between the two because courts do not distinguish between them and contracts typically outline indemnifications to cover misrepresentations or breaches of warranty.
 - Most acquisition agreements do not draw any meaningful distinction between representations and warranties.
- Seller's representations and warranties section tends to be one of the most negotiated sections of the acquisition agreement.

What Do They Do?

- Make promises
 - “The following is true”
 - “The following is true, except”
 - “Except as set forth on the schedule, the following is true”
- Disclose information
 - “The Schedule lists all of our”
- The point of them?
 - Confirmation of due diligence process
 - Making diligence process more efficient
 - Allocation of risk between parties
 - Closing condition
 - Termination
 - Indemnification

When Do They Have to Be True?

- At the signing of the Agreement
- At the consummation (closing) of the transaction
 - “The representations and warranties in this Agreement were true and correct as of the date of this Agreement and are true and correct today.”
- At each subsequent closing of the transaction
 - Multiple borrowings under a loan facility
 - Multiple closings under a preferred equity investment
- Why do they have to be true at signing and closing?
 - Investors, lenders, and buyers base their investment decisions on the representations and warranties so they must be true at signing and at closing.
 - Requiring the representations to be remade at closing protects the buyer against changes in the seller’s business occurring between signing and closing.

Section Two: Reading the Fine Print

- Determining scope of disclosure
- Qualifiers to disclosure
- What does “disclosure” actually mean?

General Considerations in Determining Scope of Representations & 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
- Consider who/what is making the representation
- Are there any issues arising from due diligence that need to be included or excluded in the representations and warranties?

Qualifiers to Disclosure

- Materiality, material adverse effect, and similar qualifiers
- Knowledge
- Specific time periods
- Others: Likelihood of effect & reasonableness

Materiality

What does “material” mean?

- “Material” to whom and when?
- “Set forth on the Schedule are all of our . . . in excess of [\$_____].”
- “The following is true except as would not reasonably be expected to cause a problem that would cost us more than [\$_____].”
- “Set forth on the Schedule are all of our material . . . ”
- “The following is true in all material respects . . . ”

Material Adverse Effect (MAE)/Material Adverse Change (MAC)

- What does that mean?
- ‘Material Adverse Effect’ means any fact or circumstance that is materially adverse to the assets, liabilities, financial condition [or prospects] of the Company or that prevents or materially delays our deal.”
- Standard 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.
- “Since [date of financial statements], there has been no MAE.”
- “Except as would not reasonably be expected to have an MAE, there has been no”

Material Adverse Change – Helpful Case Law

- **2001 – *In Re: IBP Shareholders Litigation*.** The Delaware Chancery Court held that the material event must “substantially threaten the overall earnings potential of the target.” When it is a close call, the burden is on the buyer to make a strong showing to invoke a MAC exception to its obligation to close.
- **2005 – *Frontier Oil Corp. v. Holly Corp.*** The Delaware Chancery Court followed IPB in finding that the burden of proof falls on the party asserting that the MAC has occurred or would reasonably be expected to occur. Stated that the MAC provision “is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner.”
- **2007 – *Genesco, Inc. v. Finish Line, Inc.*** The Tennessee Chancery Court found that Genesco’s financial performance had declined, but the decline was due to general economic conditions and thus carved-out from the MAC definition under the agreement. The court cited IPB and Frontier and listed other “common-sense considerations” in determining whether a change was significant within the context and circumstances of the merger.
- **2008 – *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*** The Delaware Chancery Court continued its pro-seller streak and noted that it was “not a coincidence” that the Delaware courts have never found a MAC to have occurred in the context of an acquisition agreement. The court also articulated that the duration of the MAC’s effect must be assessed over “a commercially reasonable period, which one would expect to be measured in years rather than months.” Benchmark for Measurement should be EBITDA and not EPS for a cash buyer, especially one who intends to replace the capital structure of the target business.

Knowledge

“To the Company’s knowledge . . . ”

- Knowledge issues
 - Whose knowledge? Who is “the Company”?
 - Actual knowledge, or implied?
- Examples (Tab 1)
 - Deemed knowledge
 - Reasonable inquiry
 - Actual knowledge

Specific Time Periods

- Designating a specific time period to limit the scope of a statement
- Examples:
 - “No third-party claims have been asserted in the last five (5) years.”
 - “As of [date of Agreement], there is no litigation.”
 - “The Company has not engaged in X over the last [two (2) years].”
 - “The financial statements are true and correct as of [insert date].”

What Does “Disclosure” Actually Mean?

- The meaning of “disclosed”
- Cross-referencing
- “Reasonably apparent on its face”
- “Disclosed somewhere = disclosed everywhere”
- Public companies often provide information by reference to documents publicly filed with the SEC
- In cross border deals consider differences in approach to disclosure

- Examples (Tab 2)
 - Seller first draft
 - Buyer first draft

Public Company Representations and Warranties Disclosures

- Disclosure schedules are typically shorter and do not typically contain as much information in a public acquisition for several reasons:
 - Value of target business is reflected by the market, and material information is available in public filings
 - Seller often qualifies representations and warranties by materiality qualifiers. If exceptions to representations and warranties are listed on the disclosure schedules, that could be interpreted as an admission that material information had previously not been publicly disclosed
 - No provision for postclosing indemnification so buyer must evaluate accuracy of the representations and warranties before closing
 - Seller typically does not make detailed representations and warranties and cross-references to publicly available SEC filings

Public Company Representations and Warranties – Titan Report

- Titan entered into a Merger Agreement to be acquired by Lockheed Martin
- Titan represented that, to its knowledge, neither it nor anyone acting on its behalf had taken any action that would cause Titan to be in violation of the FCPA (FCPA Representation)
- Then, FCPA claims were brought against Titan for funneling money toward the reelection of the president in Benin in West Africa
- The Merger Agreement was attached to Titan's proxy statement, and the SEC took the position that the continuing inclusion of the FCPA Representation in the appendix to the proxy statement (and the unchanged description of the representation in the text of the proxy statement) might constitute a "materially misleading disclosure to Titan's stockholders," because a reasonable investor could conclude that the statements made in the representation describe the actual state of affairs

What Are Issuers Doing in the Wake of the Titan Report?

- Some issuers are not making acquisition agreements available in SEC filings and when the agreements are filed, issuers omit disclosure schedules from the filings
- ***The better approach*** is to publicly file, but first scrutinize disclosure of each material provision in the acquisition agreement for accuracy, completeness, and materiality in light of nonpublic information known by issuer
 - NOTE: Some issuers also include a paragraph in the SEC filing stating that representations and warranties in the acquisition agreement should not be viewed as characterizations of the actual state of facts and circumstances, since they were only made as of the date of the acquisition, they are modified in important part by the disclosure schedule, and they could have changed since the acquisition date. However, the SEC has advised that general disclaimers will not protect against a failure to disclose specific facts known to the Issuer. The SEC will object to language that seeks to undercut the Issuer's disclosure obligations as set forth in the Titan Report.
- Issuers should also carefully consider whether, with respect to each material provision of the contract, disclosure of additional information is necessary to prevent investors from being misled as to the actual state of affairs
- If representation is no longer accurate and the change would be deemed material to a reasonable investor, issuers should consider qualifying the representation appropriately with an amendment to disclosure or a separate filing with the SEC incorporated by reference

Limiting Effect and Adding Reasonableness

- Limiting effect to actual or likelihood of effect, instead of possibility
 - Use “would” instead of “could” if seller to limit effect.
 - “Company is qualified to do business in every jurisdiction in which the conduct of its business requires qualification, except where the failure to so qualify [would not have (if seller)/is not likely to have (if buyer)] a material adverse effect on its business.”
- Adding reasonableness
 - “Company has made all government filings except those in which the failure to make such filings is not individually or in the aggregate reasonably likely to result in a material adverse effect.”

Survival Periods

- Survival periods:
 - Representations and warranties can “survive” their making
 - Variety of periods: single period for all, different survival periods for different categories, expressly expire
 - Fundamental representations vs. others
- Indemnification tied to survival periods
 - Note: Indemnification issues covered in greater depth in a separate client training presentation

Waiver of Implied Warranties under Article 2 of the UCC

- Parties typically agree to waive implied warranties under Article 2 of the Uniform Commercial Code (UCC) in asset deals. These warranties include:
 - Implied Warranty of Merchantability (§ 2-314)
 - Implied Warranty arising from Course of Dealing (§ 2-314)
 - Implied Warranty arising from Usage of Trade (§ 2-314)
 - Implied Warranty of Fitness for a Particular Purpose (§ 2-315)
 - Implied Warranty of Title (§ 2-312)
 - Implied Warranty against Infringement (for leases, § 2A-211)
 - Implied Warranty against Interference (for leases, § 2A-211)

(Example: THE BUYER UNDERSTANDS, AND HEREBY ACKNOWLEDGES AND AGREES, THAT ALL OTHER REPRESENTATIONS AND WARRANTIES OF ANY KIND OR NATURE EXPRESSED OR IMPLIED (INCLUDING ANY RELATING TO THE FUTURE OR HISTORICAL FINANCIAL CONDITION, RESULTS OF OPERATIONS, PROJECTIONS OR FORECASTS WITH RESPECT TO THE REVENUES, ASSETS OR LIABILITIES OF THE SELLER PARTIES OR ANY OF THEIR AFFILIATES, OR THE QUALITY, QUANTITY OR CONDITION OF THE SELLER PARTIES OR THEIR AFFILIATES' ASSETS INCLUDING ANY REPRESENTATION OR WARRANTY AS TO THE MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OF ALL OR ANY PART OF SUCH ASSETS) ARE SPECIFICALLY DISCLAIMED BY THE SELLER PARTIES.)

Section Three: Updating Disclosure Schedules

- Transaction may allow or obligate the seller or issuer to update disclosure schedules based on new facts and circumstances
- Seller – disclose changes between signing and closing
- Issuer – disclose changes between multiple rounds of financing

Ability and Obligation to Update Schedules

- Depending on the transaction, the seller may have the ability to update the disclosure schedules based on changes between signing and closing or new knowledge learned
- For multiple closings in an equity financing, the issuer may have the ability and obligation to update the disclosure schedules to reflect any changes between signing and closing
- Effect on buyer: If there are changes to certain disclosure schedules, the Buyer could still be required to close even if the buyer would not have entered into the agreement had it known the new information at the time of signing and may lose the ability to be indemnified for postsigning matters
- Examples (Tab 3)
 - Seller First Draft
 - Buyer First Draft

Section Four: Favorite Examples and Explanations

- Buyer and Seller Approaches to:
 - Organization and Authority
 - Capitalization
 - No Conflicts/Consents
 - Financial Statements
 - Undisclosed Liabilities
 - Absence of Changes
 - Material Contracts
 - Intellectual Property
 - Litigation
 - Compliance with Laws
 - Taxes
 - Title to Assets
 - Employees and Benefit Plans
 - Full Disclosure – 10b-5

Corporate Organization

- What does buyer want to know?
- Why does buyer care?
- What can seller tell buyer?
- What concerns might seller have?
- Example (Tab 4)

Capitalization

- What is the purpose?
- Example (Tab 5)
 - Negotiated Agreement

No Conflicts/Consents

- Conflict with what?
- Consent from whom?
- Why do we care?
- Examples (Tab 6)

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
- Example (Tab 7)

Undisclosed Liabilities

- What are these?
- Buyer perspective
- Seller perspective
- Knowledge qualifier
- Qualified based on GAAP standards
- Unqualified representation in effect is a blanket indemnity on unknown liabilities
- Example (Tab 8)
 - Seller first draft
 - Buyer first draft

Absence of Changes

- Why is this relevant?
- Importance of balance sheet date
- Importance of bring down
- Example (Tab 9)
 - Seller first draft
 - Buyer first draft

Material Contracts

- What are they?
- Have copy of contracts been provided?
- Is anyone in default?
- Will this deal affect any of them?
- Example (Tab 10)
 - Seller first draft
 - Buyer first draft

Intellectual Property

- What is it?
- Who owns it?
- Are there any problems?
- Example (Tab 11)
 - Seller first draft
 - Buyer first draft

Litigation

- What is out there or threatened?
- How bad is it?
- What is the likely outcome?
- Example (Tab 12)
 - Seller first draft
 - Buyer first draft

Compliance with Laws

- All laws?
- Laws specific to industry?
- Reasonable for industry?
- Example (Tab 13)
 - Seller first draft
 - Buyer first draft

Taxes

- Consider tax profiles of parties involved
- Consider tax structure of the transaction (e.g., taxable stock or asset sale or tax-deferred stock or asset sale)
- Stand-alone tax indemnity (bright line indemnity) elsewhere in the agreement?
- If there is a bright line indemnity (typically there is), then the tax representations will serve only a diligence function rather than a tax risk allocation function
- Example (Tab 14)
 - Seller first draft
 - Buyer first draft

Title to Assets

- What is the difference between good and valid title?
- Sufficiency and condition of assets for business use
- Free and clear of liens
- Examples (Tab 15)
 - Seller first draft
 - Buyer first draft

Employees and Benefit Plans

- Treatment of options and other equity awards — is the treatment contemplated in the transaction document consistent with the equity plans?
- Code Section 280G issues – shareholder vote required
- Consideration of 409A issues
- Example (Tab 16)
 - Seller first draft
 - Buyer first draft

Full Disclosure – 10b-5

- Full Disclosure – 10b-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.”
- Examples (Tab 17)
 - Seller first draft
 - Buyer first draft
 - Negotiated draft

Section Five: Problems of Knowledge

- The Art of the Sandbag
- Disclosure and qualifiers must be understood in light of a sandbagging clause

The Art of the Sandbag

- Seller says: Anti-sandbagging clause needed
 - “You knew all along ...”
- Buyer says: Pro-sandbagging clause needed
 - “You can’t hold my knowledge against me.”
- *Note that for contracts governed by New York law, if the agreement is silent as to sandbagging, there is a risk that a buyer could not be able to invoke a closing condition or claim indemnification for anything it knew about. Buyer in NY will want a pro-sandbagging clause.*
- Examples (Tab 18)
 - Seller first draft
 - Buyer first draft

Biography



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