M&A ACADEMY: REPRESENTATIONS AND WARRANTIES – WHY DO THEY MATTER?

Presenters: Eric Tajcher and Adam Benbassat
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Topics to Be Covered

1. The Basics
2. The Fine Print
3. Disclosure Schedule Updates
5. Sandbagging
Section One: The Basics

Understanding Representations and Warranties

• What are they?
• What do they do?
• When do they have to be true?
• How true do they have to be?
• Typical fundamental representations
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 11, 2018
- Examples
  - 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 . . .”
What Do They Do?

- Due diligence process
- Allocation of risk between the parties
  - Closing condition (only applicable in a deferred closing)
  - Indemnification (responsibility for breaches)
When Do They Have to Be True?

- At signing of the agreement (unless as of a specific date)
  - Only applicable in a deferred closing

- At 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.”
  - Requiring the representations to be re-made at closing protects the buyer against changes in the seller’s business occurring between signing and closing
  - The ability to update disclosure schedules is discussed in Section Three

- At each subsequent closing
  - Multiple borrowings under a loan facility
  - Multiple closings under a preferred equity investment
How True do They Have to Be at Closing?

- **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

- **Example**
  - All representations and warranties of the Sellers and the Company set forth in this Agreement shall be true and correct *in all material respects* 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)
Typical Fundamental Representations

- Typical Fundamental Representations (percentages based on the 2017 Deal Points Study – Carve Outs to Survival Limitations)
  - Organization (76%)
  - Authority (84%)
  - No Conflicts (27%)
  - Capitalization (71%)
  - Ownership of Shares (35%)
  - Subsidiaries (40%)
  - Title to/Sufficiency of Assets (19%)
  - Employee Benefits/ERISA (28%)
  - Environmental (24%)
  - IP (16%)
  - Taxes (75%)
  - Broker’s/Finder’s Fees (68%)
Section Two: The Fine Print

- Scope
- Qualifiers
- Disclosure Mechanics
- Public Company Issues
- Survival Periods

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Scope

- 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

- Are there any issues arising from due diligence that need to be included or excluded in the representations and warranties?
Qualifiers

- Materiality
- Knowledge
- Specific time periods
- Reasonableness

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Qualifiers: Materiality

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

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Qualifiers: MAE/MAC

- **Caselaw**
  - 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.
Qualifiers: MAE/MAC (cont’d)

- Uses
  - Representation/Condition
    - “Since [date of financial statements/signing], there has been no MAE.”
  - Representation Qualifier
    - “Except as would not reasonably be expected to have an MAE, there has been no...”
  - Representation bring-down standard (see Section One)
• Limiting effect to actual or likelihood of effect, instead of possibility
  – Sellers prefer to use “would” instead of “could” 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)/could not 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”
Qualifiers: Materiality Scrape

- What is a materiality scrape
  - Ignores (reads out) materiality qualifiers
- Materiality would only have practical significance at signing
- Closing Conditions
  - Deal Points Study – included 87% of the time
  - 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
  - Deal Points Study – included 85% of the time
  - 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.
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?
    - Buyer wants more individuals, seller wants less
    - Typically don’t include third-parties
  - Actual knowledge, reasonable due inquiry or constructive knowledge?
    - Examples (Tab 1)
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 (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].”
Disclosure Mechanics

- Issues
  - The meaning of “disclosed” and “made available”
  - Cross-referencing
  - “Disclosed somewhere = disclosed everywhere”
  - “Reasonably apparent on its face”
  - 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
  - **Note:** a seller-friendly draft may only include a single reference to the disclosure schedule in the introduction to the article in the purchase agreement, which bolsters the argument for cross-application of the disclosures
Public Company Issues

- Disclosure schedules are typically shorter and do not typically contain as much information in a public acquisition for several reasons:
  - Seller typically does not make detailed representations and warranties
  - Cross-references to publicly available SEC filings
  - 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 post-closing indemnification, so buyer must evaluate accuracy of the representations and warranties before closing
Survival Periods

• Survival periods:
  – Default statute of limitations for breach of contract
    – DE – 3 years
    – NY – 6 years
  – Modification of SOL
    – NY – requires clear and explicit language to limit the SOL (*Hurlbut v. Christiano*)
    – NY and DE – “indefinite” survival is unenforceable
    – 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 presentation on December 4, 2018

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Section Three: Disclosure Schedule Updates

- 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.
- Typically exclude disclosure schedule updates if the parties will obtain R&W insurance.
Effect of Disclosure Schedule Updates

- Seller-friendly
  - Schedule updates cure inaccuracies in representations made at signing
  - Buyer can’t terminate the agreement or seek indemnity for cured inaccuracies
- Buyer-friendly
  - Schedule updates don’t cure inaccuracies
  - Buyer can terminate the agreement or close and seek indemnity for inaccuracies
- Middle Ground
  - Buyer can only terminate or close and seek indemnity for inaccuracies that would cause a closing condition failure

- Examples (Tab 3)
  - Seller First Draft
  - Buyer First Draft

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Section Four: Sample Provisions

Buyer and Seller Approaches to:

- Corporate Organization Tab 4
- Capitalization Tab 5
- No Conflicts/Consents Tab 6
- Financial Statements Tab 7
- Undisclosed Liabilities Tab 8
- Absence of Changes Tab 9
- Material Contracts Tab 10
- Litigation Tab 11
- Compliance with Laws Tab 12
- Title to Assets Tab 13
- Full Disclosure – 10b-5 Tab 14
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?
- What does it cover?
- Why is it important?
- 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 copies 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?
Litigation

- What is out there or threatened?
- How bad is it?
- What is the likely outcome?
- Example (Tab 11)
  - Seller first draft
  - Buyer first draft
Compliance with Laws

- All laws?
- Laws specific to industry?
- Reasonable for industry?
- Example (Tab 12)
  - 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
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 13)
  - 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
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 14)
  - Seller first draft
  - Buyer first draft
  - Negotiated draft
Section Five: Sandbagging

- Seller says: Anti-sandbagging clause needed
  - “You knew all along ...”
  - Deal Points Study – 6%
- Buyer says: Pro-sandbagging clause needed
  - “You can’t hold my knowledge against me.”
  - “I can’t be held responsible for every page of every document in the data room
  - Deal Points Study – 42%
- Middle Ground: Silent as to sandbagging
  - Deal Points Study – 51%
- New York
  - 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 (generally where the fact was disclosed by the seller). Buyer in NY will want a pro-sandbagging clause.
- Delaware
  - Knowledge acquired by the buyer through its own due diligence typically has no bearing on its right to rely on the seller’s warranties.
- Examples (Tab 15)
  - Seller first draft
  - Buyer first draft
Biography

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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, payment processing solutions, 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.

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Adam Benbassat focuses his practice on advising private equity and strategic clients in their domestic and cross-border mergers and acquisitions, carve-out, joint venture, equity financing, restructuring, fund formation, and general corporate transactions. Adam has experience in a broad cross-section of industries, including energy and infrastructure, media, real estate, food and beverage, financial services, and automotive.
**Our Global Reach**
- Africa
- Asia Pacific
- Europe
- Latin America
- Middle East
- North America

**Our Locations**

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