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MORGAN LEWIS
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ISSUES TO CONSIDER IN CHOOSING AN
ACQUISITION STRUCTURE AND STRUCTURING A
DEAL [OCTOBER 13, 2015]

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Representation and Warranty Insurance

Q: What is representation and warranty insurance?

A: Representation and Warranty insurance is a recent development in the M&A market. It has been around for about 10 years, but it has seen rapid acceptance in the M&A market in the last few years and is now widely used. Insurers who specialize in this area will write insurance policies that insure the accuracy of the representations and warranties in an acquisition agreement. These can be seller-side polices, that provide coverage to the seller in case the seller is required to indemnify the buyer for breaches of the seller’s representations and warranties in the acquisition agreement. However, more often in recent years they have been obtained in the form of a buyer side policy, which insures the buyer against losses arising from the seller’s breaches of representations and warranties. This buyer side policy is often in lieu of most of the seller’s traditional indemnification obligation for representations and warranties, and can significantly reduce the requirements for an escrow in many instances. The policy is typically subject to a deductible, a cap on liability, and a fixed time period for claims.

This transfer of liability from sellers to a third party insurer in exchange for a premium (typically 3-4% of the limit of liability of the policy) makes this a very attractive option for sellers, and any buyer in the M&A market must be familiar with these policies and how to structure bids using these policies, in order to be competitive with other buyers who will be offering attractive indemnity structures to sellers using insurance as part of the overall proposal.

In light of the strong interest in representation and warranty insurance, we have scheduled an M&A Academy session on March 22, 2016 focusing on this topic. It will be hosted by one of our M&A partners experienced in the use of these policies, and we expect it will include one or more brokers or insurers who specialize in these policies.

Q: Would you please discuss your experience, if any, with rep and warranty insurance in the context of a public company deal (e.g., how common is it to procure this type of insurance, as well as its cost, availability, and effectiveness).

A: As noted on the call on Tuesday, we haven’t seen representation and warranty insurance used in a lot of public deals. After the call we checked with a broker that specializes in these policies, and he confirmed that these policies have not been widely used to date for deals involving public targets for a few reasons. One of the big reasons is the way the representations and warranties are structured in those deals. Often the representations and warranties are subject to materiality qualifiers with very high thresholds (for example, “material to the Company and its subsidiaries as a whole”), and an insurance policy that is subject to these same high materiality thresholds is not very useful to a buyer. I expect over time buyers, sellers and insurers will develop insurance policies and related due diligence procedures that facilitate the use of these policies in more public deals. In addition, note that for very large public M&A deals, it may be difficult to obtain policies with liability limits that big. If you would like more information on these policies we can put you in touch with one of our broker contacts.

I expect this is one of the topics we will touch on in our March 22 M&A Academy session.
Payments to Employees

**Q:** Do you have any experience with acquisition of personal goodwill as a way to funnel proceeds to a key employee who is not a shareholder?

**A:** I don’t have experience with deals involving personal goodwill as a basis for payments to employees. I note that any payments to seller employees in connection with an M&A deal should be reviewed and approved by the seller’s Board of Directors as part of the discharge of their fiduciary duties.

I have seen lots of deals where it is very important that certain non-stockholder employees receive some form of monetary incentives either to help get a deal done, or to agree to move over to the buyer and work with the buyer for some period of time. Sometimes these are set up in the form of retention or “stayput” bonuses payable in order to keep the employee at the seller through closing and to assist with the sale, and to agree to stay with the buyer after closing for some period. One general practice point on this is that the seller should plan these arrangements early in the sale process, in order to create the maximum retention and motivation effect for employees, who may be nervous about a pending sale.

Private Auction Process

**Q:** If a seller is conducting a private auction, what is best practice as to how much information the seller should convey to the pool of buyers? Is such information a condition of the auction? e.g. number of bidders.

**A:** As a general rule, the seller should disclose enough information such that the buyers can fully assess and value the business, and prepare meaningful bids. Sellers also typically provide information on the sale process itself – the date initial bids are due, time periods for management presentations and detailed due diligence, and the deadline when best and final offers are due, including detailed comments on the seller’s proposed transaction documents, However, I rarely see sellers disclose specific information on how many buyers are in the process, although investment bankers acting for the seller will occasionally provide indirect guidance, as a negotiating tool, that there are other competitive buyers, one or more buyers have stronger offers etc.

Exclusivity in Term Sheets

**Q:** What are typical remedies available to a potential buyer if the seller inadvertently or intentionally informs other potential buyers in presumed violation of an exclusivity clause in the term sheet?

**A:** If there is a signed letter of intent or term sheet, it is important to provide in that document that any exclusivity obligation is intended to be a binding obligation, even if the rest of the letter of intent or term sheet is not binding. In addition, the letter of intent or term sheet should provide that equitable relief is available for breaches. That said, it could be difficult to get meaningful relief for a breach of exclusivity in the context of a letter of intent or term sheet with a short life span. Our M&A Academy presentation next Tuesday (October 20) focuses on non-disclosure agreements and letters of intent, and we will address this question in more detail on that call.

We hope that you find the foregoing Q&A to be helpful. If you have any other questions on choosing an acquisition structure please contact:

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