

Preserving Post-Closing Deal Value in Private M&A

Al Hudec and Teresa Tomchak
Farris, Vaughn Wills & Murphy LLP

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Purpose of our Presentation

- Highlight areas where claims arise post-closing (68% of all deals)
 - Indemnity claims
 - Working capital adjustments
 - Earn-outs
- Identify drafting terms that address post-closing issues
 - Drafting tips
 - Flags
 - Best practices

Indemnity Caps

- Have become more seller friendly over time
- Now less than purchase price in 60% of deals
- Exceeds purchase price in 19% of deals
- Under 10% of purchase price in 18% of deals
- Exceptions for fundamental reps, tax, environmental and fraud

Survival Periods

- Have also become more seller friendly
- Average in Canada now 24 months (18 months in the US)
- 24 months or longer – 56% of deals (15% in the US)
- 12 months or less – 21% of deals (24% in the US)
- Exceptions for fundamental reps, tax, environmental and fraud
- Interplay with Limitations Statute – if intent is to abridge, expressly say so

Baskets, Thresholds, Deductibles

- Provide that buyer cannot make claims until actual indemnifiable losses exceed a threshold
 - First dollar – median is 0.64% of transaction value
 - Deductible – median is 0.31% of transaction value
- Also, individual claims under a certain size are usually excluded from the indemnification

Clauses Limiting Fraud Claims

- Entire Agreement Clause – there are no other representations or warranties except as included in the agreement.
- Integration Clause – the agreement supersedes, replaces and nullifies all previous discussions and prior agreements.
- As Is – Where is Clause – Except as represented in the agreement, the purchase is on a ‘as is ‘ where is’ basis
- Accuracy and completeness disclaimers – seller has not represented the accuracy or completeness of information provided
- Non-reliance clause – acknowledge that seller has not made representations outside of the agreement; and that buyer has not relied on representations except those in the agreement
- Exclusive Remedy Clause – Claims under the indemnity for breaches of the representations and warranties in the agreement are the buyers exclusive remedy with respect to the agree

Clauses Limiting Fraud Claims

- Non – Reliance Clause – acknowledges that the seller has not made representations outside of the agreement, and buyer had not relied on representations except those in the agreement.
 - Language must demonstrate intent to eliminate extra-contractual fraud claims
 - More than just a statement seller had not provided any reps outside agreement
 - Non-reliance language must come from perspective of buyer
 - Non-reliance language must extend to omissions and completeness of forecasts.
 - Should extend to waiver of any claim based on fraudulent concealment
- Indemnity should be net of insurance and tax impacts
- Exclude consequential losses, including loss of profit
- Exclude indemnity for ‘diminution of value’ – based on some multiple of income, earnings or other valuation multiple

Clauses Limiting Fraud Claims

- Anti-sandbagging clause – deems recovery if buyer entered contract knowing representation was false – imposes a reliance requirement
- Indemnity usually only relates to direct losses so need to expressly including language relating to third party claims
- Indemnity should be net of insurance and tax impacts
- Exclude consequential losses, including loss of profit
- Exclude laundry list of loss opportunity, punitive damages etc.
- Exclude indemnity for ‘diminution of value’ – based on some multiple of income, earnings or other valuation multiple

Narrowing the Fraud Exception

- Fraud claimed in 1% of deals
- Hard to resist giving a ‘fraud exception’ to liability limitations
- But dangerous to include it – imports concepts of
 - Misrepresentations in course of negotiations
 - Equitable fraud – no intent to deceive
 - Promissory fraud
 - Concepts of fair dealing
- If included – provide limited definition to include only situations where the seller deliberately and knowingly, with an intent to deceive, misleads the buyer with respect to a representation in the agreement

Controlling Privilege After Closing

- Who owns the privilege after closing?
- Will the company's lawyers be available post-closing to represent the sellers?
- Who owns transaction related memos and emails on the target's servers?
- The solicitor-client relationship and attorney client privilege flow to the buyer at closing
- Add clause to agreement agreeing that company lawyer can act for seller post-closing and providing that buyer waives conflict of interest
- Exclude deal-related memos and files and servers from the purchased assets; obtain buyer acknowledgment that such files remain privileged solicitor notwithstanding disclosure

Indemnification Mechanics

- Dangerous to glaze over details of who controls the defence of third party claims – moral hazard problem if person ultimately responsible to pay claim does not control process
- Buyers are reluctant to allow seller to fully control the process where outcome of claim may have reputational impacts or liability in excess of indemnification caps
- Seller protection needs to go beyond right to approve settlement – right to participate in selection of counsel, establishing strategies and budgets
- Often seller has right to a seat at the table but not to determine or conduct the defence
- Seller right to conduct defence if buyer declines
- Seller requires access to books and records; employees as reasonably required to resolve dispute

Escrows

- Escrows in 37% of deals
- Range from 1% to 40% of transaction value
- Means – 11%, Median – 10%
- Shareholder representative
- Expense fund
- Language to ensure a timely release

Avoiding Improper Lock-Up

- Typically at end of escrow period buyer can hold back escrow release for claims reasonably likely to result in loss
- Seller should tighten up the drafting
 - Define claim as filed lawsuit or potential claim arising out of threat letter alleging specific grievance, acted upon within a specified period of time
 - Or require that claim be of sufficient consequence that buyer is required to accrue in its financial statements
 - Include time by which third party claimant must take next step

Complexities Arising With Multiple Sellers

- Mistakes in capitalization tables are frequent – calculating who gets what in a distribution waterfall difficult where there are liquidation preferences, conversion features and option holders – unresolved issues
- Gets even more complicated when there is an escrow –seems unfair that common shareholders bear the full risk of forfeiture; complicated where preferreds can elect to take preference or convert to common
- Binding minority shareholders to indemnities where there is no privity of contract
 - Support Agreements which include joinder provisions
 - Letters of transmittal
 - Draft so that remainder of escrow is additional consideration, rather than escrow claim as clawback
 - Drag-Along Rights
 - Plan of Arrangement

Working Capital Adjustments

- Typically estimated at closing with subsequent true up
- Disputes common – formulas imprecise, disputes over accounting issues
- WC should be determined using the target's policies and procedures (e.g. inventory reserves, bad debt reserves, liability accrual)
- Include schedule referencing line items in company's accounts, specify inclusions and exclusions
- Limit WC concepts to items expected to generate or use cash within 12 months
- Deferred tax assets and liabilities – simply an accounting concept to deal with timing differences in recognition of revenues and expenses for accounting and tax purposes
- Consider time limits – *NOV Enerflow v. Everflow Industries* – 2015 ABQB 759

Earn-Outs

- A portion of purchase price paid post-closing based on post-closing performance of the business – 25% of deals but varies over the business cycle
- Valuation gaps often arise in
 - Development state companies
 - Companies financially dependent on new products or unproven technologies
 - Turnaround acquisitions where seller argues historical information is not accurate measure of value
 - Fast growing market sectors

May be difficult to use where measurement is problematic such as where business will be fully integrated

Earn-Outs

- May be based on financial metric such as EBITDA or non-financial milestone
- Sellers prefer revenue based metric (12%) and buyers prefer earnings (33%)
- Milestones missed in 44% of deals – if milestone defined too precisely, it may be missed even though business objective achieved; disputed (5% of the time)
- Agree on parameters to apply certain estimates and judgements
- Agree if any adjustment to accounting measures appropriate
- Courts are reluctant to read in duties of good faith and fair dealing – require buyer to run business consistent with past practice or to use commercially reasonable efforts to achieve milestones
- Consider whether earn out subject to acceleration for change of control
- Provide for right to offset indemnification against earn-out
- Consider the appropriate time period; 1-3 years is most common.

When a Dispute Arises – Boilerplate Clauses Are Important

- Choice of law
- Forum selection; consent to service
- Limitation periods; notice requirements – can contract extend statutory limitation periods?
- Exclusive remedy clauses

Dispute Resolution Mechanisms

- Litigation
 - Choice of law
 - Jurisdiction
- Arbitration – General ADR provision – in 30% of Canadian deals (15% in US)
 - Faster, confidential process
 - More streamlined procedure and pleading process, limited discovery, shorter hearings, expert adjudicator
 - BC Arbitration Act – provides that *BC Commercial Arbitration Centre* is the default institution
 - Rules of the ADR Institute of Canada
 - International Commercial Arbitration Rules
- Mediation – part of a multi-tier dispute resolution process
- Expert Determination

The Courts or Arbitration?

- Choice requires looking ahead and making a judgment as to whether, given types of disputes that are likely to arise, it will be more advantageous to resolve dispute by litigation or arbitration
- Frequently companies have a bias to one or another, often based on experience
- Arbitration generally preferred in international disputes – avoids uncertainty of foreign courts
- Arbitration often disappoints – in the hands of lawyers becomes a litigation-like process; tendency of arbitration panels to 'split the baby'
- Courts offer greater adherence to legal norms, plenary right of appeal

Potential Advantages of Arbitration

- Important to customize drafting so as to maximize potential benefits
- Choose number and qualifications of arbitrators
- Confidentiality
- Faster and more flexible scheduling of hearing – impose time limits
- Parties not bound by rules of court – limited discovery, no oral evidence, written witness statements
- Award of actual legal fees
- Difficult to appeal
- Agreement that judgment may be filed on the arbitral award



Contact Information:



AL HUDEC, SENIOR PARTNER
Tel: (604) 661-9356
Cell: (778) 886-9356
Email: ahudec@farris.com



TERESA TOMCHAK, PARTNER
Tel: (604) 661-1711
Email: ttomchak@farris.com

FARRIS

FARRIS, VAUGHAN, WILLS & MURPHY LLP

Barristers & Solicitors