

Avoiding Death by a Thousand Cuts: How to Negotiate M&A Indemnification Without Fatal Injury

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1. PowerPoint Presentation
2. *The Impact of Transaction Size on Highly Negotiated M&A Deal Points*, by Eric Rauch and Brian Burke, *The Business Lawyer*; Vol. 71, Summer 2016
Contact the authors or a member of the M&A Group for a copy.
3. Dorsey eUpdate: *Delaware Chancery Court Provides Further Insights into the Validity of Anti-Reliance Clauses*, John Marsalek (December 19, 2016)
<https://www.dorsey.com/newsresources/publications/client-alerts/2016/12/delaware-chancery-court-provides-further-insights>

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Agenda

1. Indemnification
2. Overview of Limitations
3. Baskets and Caps
4. Materiality Scrape/Readout
5. Anti-Sandbagging
6. Rep & Warranty Insurance
7. Q&A



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INDEMNIFICATION

- **What is it?**
 - Contractual obligation by one party to compensate for the losses incurred by another party
- **Sample Provision:**
 - Seller shall defend, indemnify and hold harmless Buyer from any losses, which Buyer may suffer, incur or sustain as a result of any of the following:
 - a) any breach of the representations and warranties of Seller in this Agreement;
 - b) any breach of any covenant of Seller contained in this Agreement; or
 - c) any matter disclosed in Schedule 9.2(c).

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INDEMNIFICATION COVERAGE

- **Examples of subject matter covered by indemnification:**
 - Representations and Warranties
 - Covenants and Agreements
 - Intellectual Property
 - Special Indemnities
 - Taxes
 - Retained Liabilities



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OVERVIEW OF INDEMNIFICATION LIMITS

- Subject Matter limits
- Time limits: Survival
- Dollar limits:
 - Basket/Deductible
 - Cap
- Limits on types of losses
- Limits on types of remedies: Exclusive Remedies clause
- Other Limits:
 - No Materiality Readout/Scrape clause
 - Anti-sandbagging (Benefit of the Bargain) clause



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LIMITATION: BASKETS

Deductible Basket: Sellers are only responsible for losses in excess of a certain dollar amount.

Tipping/First Dollar Basket: Sellers are responsible for all losses once a certain dollar threshold has been exceeded.

Combination Basket: Once a certain dollar threshold has been exceeded, Seller is responsible for losses in excess of a smaller dollar threshold.

Mini-basket: An individual loss must exceed a certain dollar threshold to be applied to the basket itself.

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TYPES OF BASKETS

Basket Type	2014 Deals
Deductible	65%
Tipping/1 st Dollar	26%
Combination	7%
None	2%
Mini-basket	38%

Data Source: ABA Private Target Mergers & Acquisitions Deal Point Study, December 31, 2015 (2014 Deals)

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BASKET AS % OF DEAL VALUE

% of Transaction Value	2014 Deals
$\leq 0.5\%$	52%
> 0.5% to 1%	38%
> 1% to 2%	9%
> 2%	1%

Data Source: ABA Private Target Mergers & Acquisitions Deal Point Study, December 31, 2015 (2014 Deals)

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BASKET MEAN AS % OF DEAL VALUE

Basket Type	2014 Deals
Deductible	0.69%
Tipping/1 st Dollar	0.47%
Both	0.65%

Data Source: ABA Private Target Mergers & Acquisitions Deal Point Study, December 31, 2015 (2014 Deals)

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LIMITATION: CAPS

% of Transaction Value	2014 Deals
<= 10%	59%
> 10% to 15%	22%
> 15% to 25%	22%
> 25% to 50%	5%
> 50% to < PP	0%
Purchase Price	3%

Data Source: ABA Private Target Mergers & Acquisitions Deal Point Study, December 31, 2015 (2014 Deals)

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CAP AS % OF DEAL VALUE

Cap	2014 Deals
Mean	13.2%
Median	10.0%
Minimum	0.3%
Maximum	100%

Data Source: ABA Private Target Mergers & Acquisitions Deal Point Study, December 31, 2015 (2014 Deals)

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LIMITATION: MATERIALITY SCRAPES

- **What is it?**
 - A provision that reads out all materiality and MAE qualifiers in the representations for purpose of determining whether a breach of representation has occurred and/or for determining the losses resulting from such breach
- **Example Provision:**
 - Seller shall indemnify Buyer against any losses that Buyer may suffer as a result of any breach of the representations and warranties of Seller **without giving effect to any qualifications as to materiality, Material Adverse Effect or similar qualifications contained in such representations and warranties**

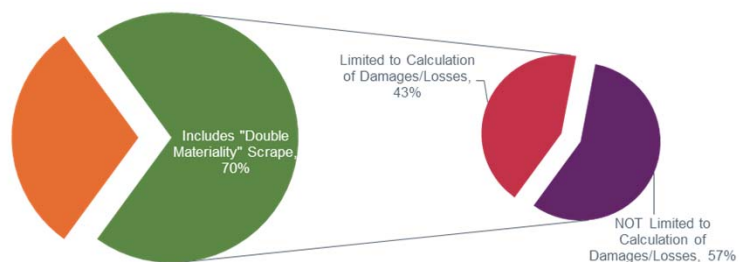
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MATERIALITY SCRAPES

- **Seller's Point of View**
 - Obtain the benefit of negotiated materiality qualifiers in the reps
 - Make recovery of Buyer losses for breaches of Seller reps difficult
- **Buyer's Point of View**
 - Buyer must clear two hurdles:
 - Buyer must first prove that the breach was 'material'
 - Then the loss/damage(s) must exceed the basket

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MATERIALITY SCRAPES



- **70% of deals with baskets had a materiality scrape**
- **More than half of those materiality scrapes were not limited to just the calculation of damages/losses**

Source: ABA Private Target Mergers & Acquisitions Deal Point Study, December 31, 2015 (2014 Deals)

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LIMITATION: ANTI-SANDBAGGING

- **What is it?**
 - Buyer knows that a Seller representation is not true, signs and closes the deal, and then holds Seller responsible for breach of that representation.
- **Example Anti-Sandbag Provision:**
 - Buyer shall not be entitled to indemnification under this Agreement with respect to breach of any representation, warranty or covenant if Buyer had knowledge, at any time prior to the Closing, of such breach or of the events, circumstances or conditions constituting or resulting in such breach.

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BENEFIT OF THE BARGAIN

- **Example Benefit of Bargain (pro-sandbagging) Provision:**
 - The right of a Party to indemnification or to assert or recover on any claim shall not be affected by any investigation conducted with respect to, or any knowledge acquired at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy of or compliance with any of the representations, warranties, covenants, or agreements set forth in this Agreement.

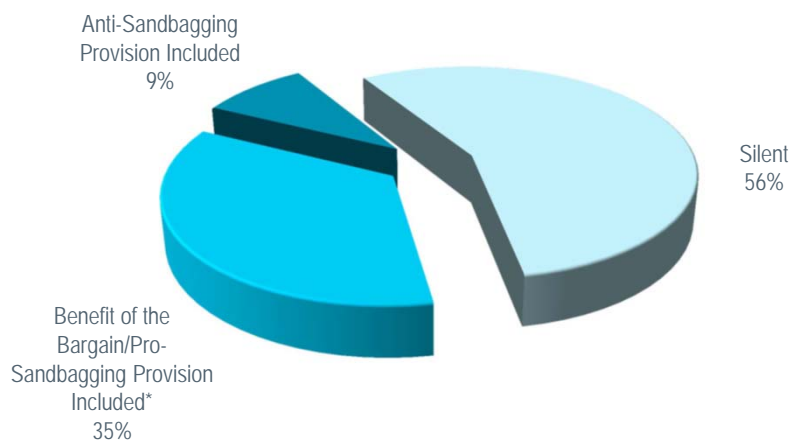
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ANTI-SANDBAGGING

- **Seller's Point of View**
 - Unfair if Buyer does not disclose to Seller that Seller's rep is not true, closes the deal, and then holds Seller liable for such breach
- **Buyer's Point of View**
 - Anti-sandbag clause gives the seller the benefit of the buyer's due diligence
 - Buyer may "know" of breach, but not be "sandbagging"

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ANTI-SANDBAGGING



Source: ABA Private Target Mergers & Acquisitions Deal Point Study, December 31, 2015 (2014 Deals)

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REP & WARRANTY INSURANCE

Insured

- Buyer or Seller can be insured (90% are Buyer policies)
- Buyer policies do not necessarily mirror the indemnification provisions
- Policy can be in lieu of, or in addition to, Seller indemnification
- Seller versus Buyer policies

Economics

- **Premium:** 2-3% of coverage
- **Retention:** Deductible under the policy (1-2% of enterprise value)
- **Limits:** Amount of coverage under the policy (insurance towers)

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R&W INSURANCE

Bridging the Gap between Buyer and Seller

- May be necessary to compete in an auction
- Allows institutional investors to distribute transaction proceeds earlier
- Source of recovery where indemnification otherwise unavailable
- Protection beyond cap and survival limitations
- Insurers generally amenable to a “full” materiality readout/scrape
- May reduce post-closing adversarial proceedings/litigation with Seller
- Smaller escrow required

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R&W INSURANCE LIMITATIONS

Coverage Limitations

- Collectability may drop
- Potential for significant exclusions (may go to core representations)
- Express Sandbagging (i.e. actual and potentially constructive knowledge of breach will be excluded)
- Coverage limited in many instances by carve-outs in Agreement
- No coverage for purchase price adjustments or covenants
- Retention applies to all reps and warranties (including fundamentals)

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R&W INSURANCE LIMITATIONS

Other Disadvantages

- Providing legal due diligence reports to the insurer in connection with the underwriting process almost always waives the privilege
- Smaller transactions may be precluded by use due to cost
- Some industries and topics are more difficult to insure (e.g., health care and environmental)
- Can slow a high paced transaction

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Questions

