

# Private Company M&A: A Potpourri of Practical Pointers

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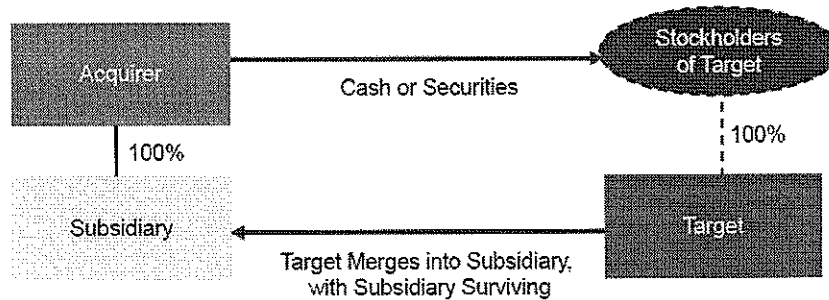
## Practice Points To Be Covered

- Forward/Reverse Subsidiary Mergers
- "Indemnify" and "Survive" May Not Mean What You Think
- Knowledge? Whose Knowledge?
- Fraud Exception to Indemnification Limitations
- The "Fair Presentation" Representation
- Non-Reliance Clauses
- Does the Confidentiality Agreement Survive Execution of a Definitive Acquisition Agreement?
- Indemnification for Non-Meritorious Third Party Claims
- Legal Opinions in M&A Transactions
- MAC ("Material Adverse Change")-Related Issues
- Updating Disclosure Schedules

# Forward/Reverse Subsidiary Mergers

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## Forward Subsidiary Merger

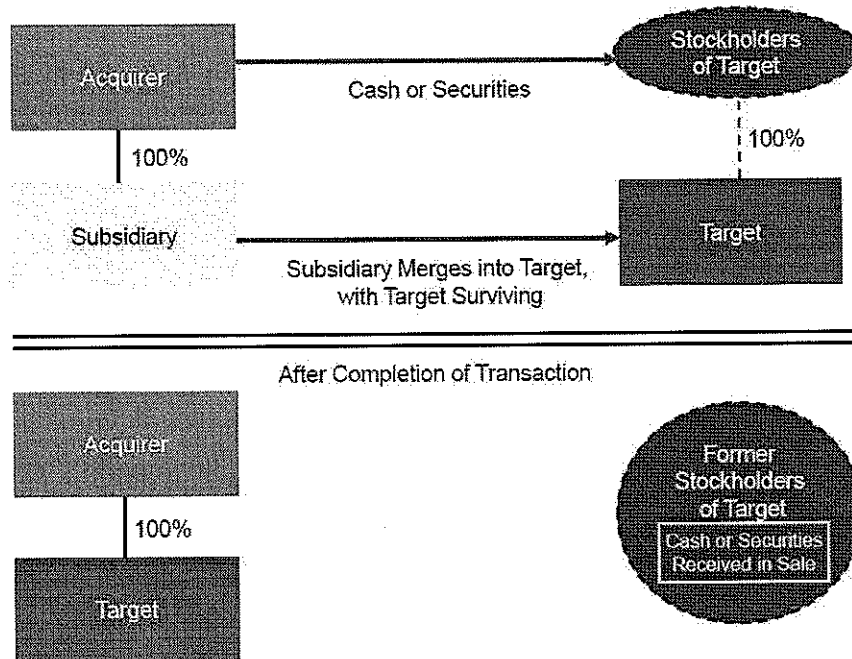


After Completion of Transaction



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## Reverse Subsidiary Merger



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## Forward/Reverse Subsidiary Mergers – Assignment Issues

- Forward subsidiary merger — generally viewed as involving an assignment of target's contracts because they move from target to the surviving subsidiary
- Reverse subsidiary merger — generally viewed as not involving an assignment of target's contracts because they do not move; they remain with target, which survives. However
  - *SQL Sol'ns Inc. v. Oracle Corp.*, 1991 WL 626458 (N.D. Cal. Dec. 18, 1991)
  - *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*, C.A. No. 5589-VCP (Del. Ch. April 8, 2011) (motion to dismiss)
  - *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*, C.A. No. 5589-VCP (Del. Ch. February 22, 2013, revised March 8, 2013) (motion for summary judgment)

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## **Forward/Reverse Subsidiary Mergers – Federal Income Tax**

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- Reverse subsidiary merger – generally treated as an acquisition of target stock
  - Single level of tax
- Forward subsidiary merger – generally treated as an acquisition of target assets and a liquidation of target
  - Two levels of tax – but the asset sale tax is borne by the buyer, since target’s liability for the tax is assumed by subsidiary in the merger
- However, in tax free reorganizations, forward subsidiary merger is more flexible than reverse subsidiary merger (more boot permitted – compare IRC § 368(a)(2)(D) with IRC § 368(a)(2)(E))

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**“Indemnify”  
and “Survive” May Not Mean What  
You Think**

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## The term “indemnify” may be ambiguous

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- What does it mean for a seller to “**indemnify**” a buyer against damages? Does the term “indemnify” always encompass direct, “first-party” damages incurred by the buyer (as distinct from damages arising from third party claims)?
- *Zalkind v. Ceradyne, Inc.*  
(Cal. Ct. of Appeals 2011)

*“Indemnity generally refers to third party claims.”*

*“Although indemnity generally relates to third party claims, ‘this general rule does not apply if the parties to a contract use the term “indemnity” to include direct liability as well as third party liability.’”*

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## The term “indemnify” may be ambiguous (cont’d)

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- Sample indemnification provisions prepared by buyer’s counsel:

- Potentially ambiguous:

*“Sellers will hold harmless and indemnify Buyer from and against any Damages incurred by Buyer that arise from any breach of any representation, warranty or covenant of Sellers.”*

*“‘Damages’ means any loss, damage, liability, claim, demand, assessment, settlement, judgment, award, fine, penalty, tax, charge or expense.”*

- Clearer:

*“Sellers will hold harmless and indemnify Buyer from and against, **and will compensate and reimburse Buyer for**, any Damages incurred by Buyer (**regardless of whether or not such Damages relate to any third party claim**) that arise from any breach of any representation, warranty or covenant of Sellers.”*

*“‘Damages’ includes any loss, damage, **decline in value, lost opportunity**, liability, claim, demand, assessment, settlement, judgment, award, fine, penalty, tax, charge or expense.”*

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## The term “survive” may be ambiguous

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- What does it mean for a representation to “**survive**”? Will a provision stating that the sellers’ representations “survive the closing for one year” operate as an effective contractual statute of limitations?

- *Western Filter Corp. v. Argan, Inc.*  
(9<sup>th</sup> Cir. 2008)

*“...California law does not favor contractual stipulations to limit a statute of limitations. Such a stipulation must be clear and explicit....”*

*“...[T]he Survival Clause was ambiguous....”*

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## The term “survive” may be ambiguous (cont’d)

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- Sample provisions prepared by sellers’ counsel to contractually shorten the applicable statute of limitations to one year:

- Potentially ambiguous:

*“Sellers’ representations will survive the closing for one year.”*

- Clearer:

***“The parties, intending to contractually shorten the applicable statute of limitations, agree that Sellers’ representations will **expire** on the first anniversary of the closing date, and all liabilities of Sellers, and all remedies exercisable by Buyer, with respect to those representations will **terminate** on such first anniversary.”***

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# Knowledge? Whose Knowledge?

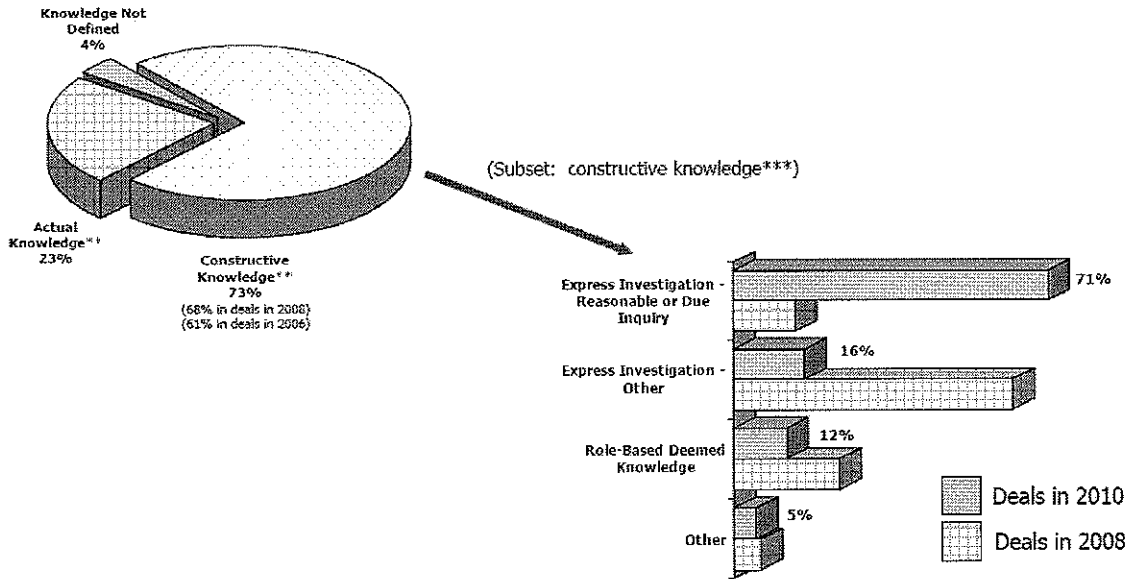
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## Knowledge – Standards

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- Actual Knowledge:
  - "Knowledge" means ***the actual knowledge of the directors and officers of Target.***
  
- Constructive Knowledge (Role-Based Deemed Knowledge):
  - "Knowledge of the Target" means the actual knowledge of the Chief Executive Officer, the President and the Chief Financial Officer of Target ***and the knowledge that each such person would reasonably be expected to obtain in the course of diligently performing his or her duties for the Target.***

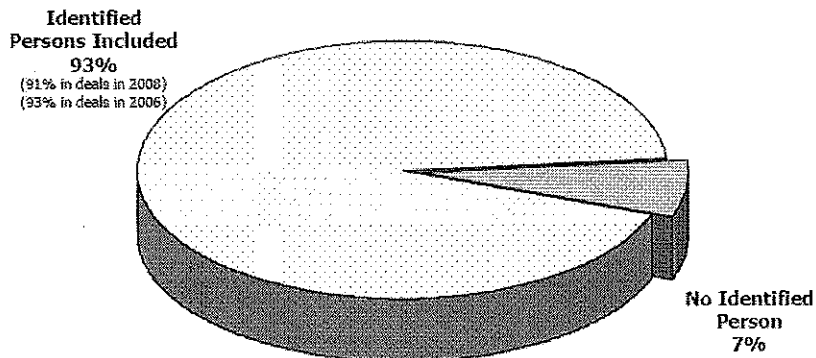
# Knowledge – Standards\*



\* Excludes one agreement for which the applicable provisions were included on an unfiled schedule.  
 \*\* Includes one agreement with both actual knowledge and constructive knowledge provisions.  
 \*\*\* 4% include more than one constructive knowledge element, e.g., role-based deemed knowledge and an express investigation requirement.

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# Knowledge – Whose Knowledge is Imputed to Target?\*



\* Excludes one agreement for which the applicable provisions were included on an unfiled schedule.

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## Knowledge – Whose Knowledge? (cont'd)

"Knowledge" means the actual knowledge of the directors and officers of Target

and the knowledge that each such person would reasonably be expected to obtain in the course of diligently performing his or her duties for Target

or after due inquiry

and of the individuals listed on Schedule X, subject to the limitations set forth on such Schedule

Schedule X  
Knowledge Persons

<b>Name</b>	<b>Knowledge limited to</b>
Person A	Sections 4.17 (Compliance with Laws) and 4.18 (Litigation and Investigations)
Person B	Sections 4.15 (Labor and Employment) and 4.16 (Benefits)
Person C	Section 4.20 (Proprietary Rights)

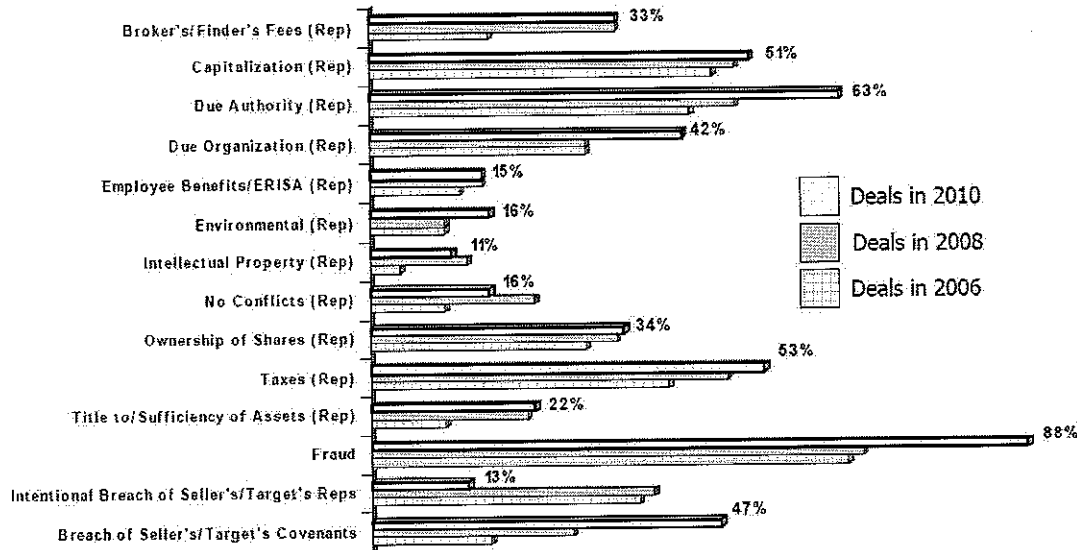
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## Fraud Exception to Indemnification Limitations

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# Cap Carve Outs\*

(Subset: deals with caps)



\* Only those categories appearing 10% of the time or more for deals in 2010 are shown.

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## Fraud Exception to Indemnification Limitations

- Sample exception proposed by counsel to Buyer:
  - *None of the limitations set forth in Sections \_\_\_\_\_ of this Agreement [cap, basket, survival limitation] will apply in the event of any fraud, intentional misrepresentation or other misconduct.*
  
- Sample exception proposed by counsel to Sellers:
  - *Nothing in Sections \_\_\_\_\_ [cap, basket, survival limitation] of this Agreement will operate to limit the common law liability of any Seller to Buyer for fraud in the event such Seller is finally determined by a court of competent jurisdiction to have willfully and knowingly committed a fraud against Buyer, with specific intent to deceive and mislead Buyer, regarding the representations and warranties expressly set forth in Section 3 of this Agreement.*

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## “Fair Presentation” Representation

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## “Fair Presentation” Representation – Two Versions

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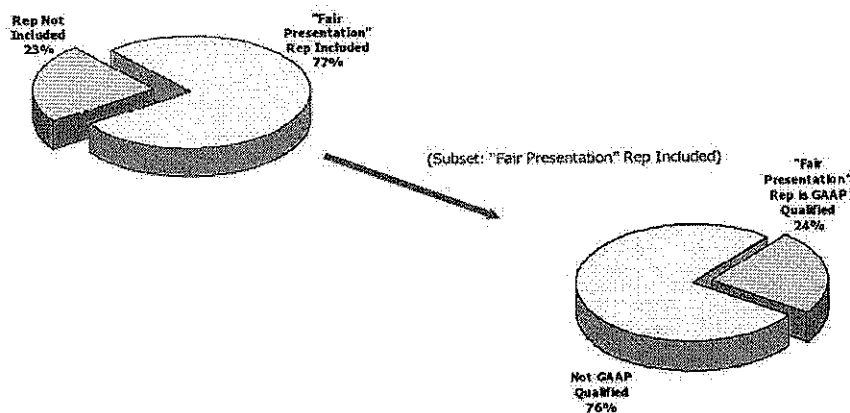
- *“Fairly presents” is GAAP qualified*
  - *The Financial Statements fairly present the financial condition and the results of operations, changes in shareholders’ equity and cash flows of [Target] as at the respective dates of, and for the periods referred to, in the Financial Statements, **all in accordance with GAAP.** (ABA Model Asset Purchase Agreement)*
  
- *“Fairly presents” is not GAAP qualified*
  - *The Financial Statements (i) fairly present the financial condition and the results of operations, changes in shareholders’ equity, and cash flows of [Target] as at the respective dates of, and for the periods referred to in, the Financial Statements, **and** (ii) were prepared in accordance with GAAP, subject, in the case of the Unaudited Financial Statements, to normal recurring year-end adjustments. (ABA Model Stock Purchase Agreement, Second Edition)*

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## “Fair Presentation” Representation – In Practice

### Financial Statements – “Fair Presentation” Representation



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## “Fair Presentation” Representation – Where does it come from?

*The Commission shall, by rule, require, for each company filing periodic reports under section 78m(a) or 78o(d) of this title, that the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted under either such section of this title that...*

*(3) based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report. . . (Section 302 of the Sarbanes-Oxley Act of 2002)*

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## **“Fair Presentation” Representation – What does it mean?**

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- The certification statement regarding fair presentation of financial statements and other financial information is not limited to a representation that the financial statements and other financial information have been presented in accordance with "generally accepted accounting principles" and is not otherwise limited by reference to generally accepted accounting principles. We believe that Congress intended this statement to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under generally accepted accounting principles. In our view, a "fair presentation" of an issuer's financial condition, results of operations and cash flows encompasses the selection of appropriate accounting policies, proper application of appropriate accounting policies, disclosure of financial information that is informative and reasonably reflects the underlying transactions and events and the inclusion of any additional disclosure necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations and cash flows. (SEC Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports, Release Nos. 33-8124, 34-46427, IC-25722; , August 28, 2002)
- *United States v. Simon, 425 F.2d 796 (2d Cir. 1969)*

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## **Non-Reliance Clauses**

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## Non-Reliance Clauses

### "No Other Representations and Warranties"/Non-Reliance

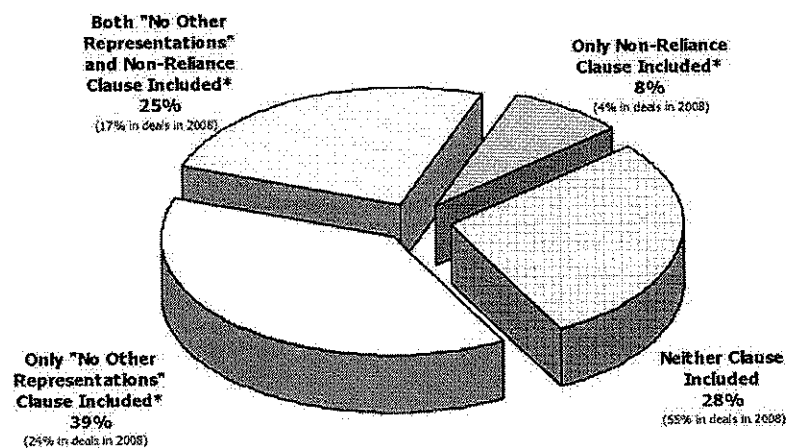
Buyer acknowledges that Target has not made and is not making any representations or warranties whatsoever regarding the subject matter of this Agreement, express or implied, except as provided in Section 3, and that it is not relying and has not relied on any representations or warranties whatsoever regarding the subject matter of this Agreement, express or implied, except for the representations and warranties in Section 3.

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## Non-Reliance Clauses (cont'd)

### "No Other Representations and Warranties"/Non-Reliance



\* Includes 5 deals with fraud carve outs to "no other representations" clause and 2 deals with fraud carve outs to express non-reliance clause.

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## Non-Reliance Clauses (cont'd)

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- Excerpt from Non-Reliance Clause in Alcoa/TransDigm Purchase Agreement
  - *Buyer agrees to accept the Shares without reliance upon any express or implied representations or warranties of any nature, whether in writing, orally or otherwise, made by or on behalf of or imputed to TransDigm or any of its Affiliates, except as expressly set forth in this Agreement.*
- *TransDigm Inc. v. Alcoa Global Fasteners, Inc.*  
(Del. Ch. May 2013)

*"[T]hese anti-reliance provisions do not bar the buyer's claim for fraudulent concealment of material information."*

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## Non-Reliance Clauses (cont'd)

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- Broader Non-Reliance Clause
  - *Buyer agrees to accept the Shares without reliance upon **the accuracy or completeness of** any express or implied representations or warranties of any nature, whether in writing, orally or otherwise, **or any omission,** made by or on behalf of or imputed to TransDigm or any of its Affiliates, except as expressly set forth in this Agreement.*

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## **Does the Confidentiality Agreement Survive Execution of a Definitive Acquisition Agreement?**

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### **Survival of Confidentiality Agreement – Entire Agreement Provision in Definitive Agreement**

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- *This Agreement supersedes all prior agreements, whether written or oral, between the parties with respect to its subject matter (other than the Confidentiality Agreement) and constitutes (along with the Confidentiality Agreement, the Disclosure Schedule, the exhibits, and the other documents to be delivered pursuant to this Agreement) a complete and exclusive statement of the terms of the agreement between the parties with respect to the subject matter of this Agreement.*
- This formulation is intended to preserve target protections included in Confidentiality Agreement if deal fails – confidentiality, no-hire or no-solicit, etc.
- It also preserves non-reliance provision if contained in Confidentiality Agreement, whether or not deal fails. (see *RAA Mgmt., LLC v. Savage Sports Holdings, Inc.*, 45 A.3d 107 (Del. 2012), for the effect of such a provision.)

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# Indemnification for Non-Meritorious Third Party Claims

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## Indemnification for Non-Meritorious Third Party Claims

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- Sample ("traditional") indemnification language that does **not** extend to non-meritorious third party claims:

*"After the closing, Sellers shall indemnify Buyer and Buyer's subsidiaries against any loss arising from any breach of any of Sellers' representations and warranties."*

- Sample indemnification language that **does** extend to non-meritorious third party claims:

*"After the closing, Sellers shall indemnify Buyer and Buyer's subsidiaries against any loss arising from (1) any breach of any of Sellers' representations and warranties or (2) **any claim asserted against Buyer or any subsidiary of Buyer that, if meritorious, would constitute or give rise to a breach of any of Sellers' representations and warranties.**"*

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## **Indemnification for Non-Meritorious Third Party Claims (cont'd)**

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- *Winshall v. Viacom Int'l Inc.*  
(Del. Ch. Dec. 2012)

*"If the Sellers were really to be responsible for paying for the defense of Viacom against any claim that involved an arguable breach of representations and warranties, regardless of whether a breach of representations and warranties was ultimately proven, we should expect to find the relevant contractual provision stating this in as many words....Viacom has not cited in support of its position any merger cases where a party has had a duty to defend another party from claims without there being a breach of representations and warranties."*

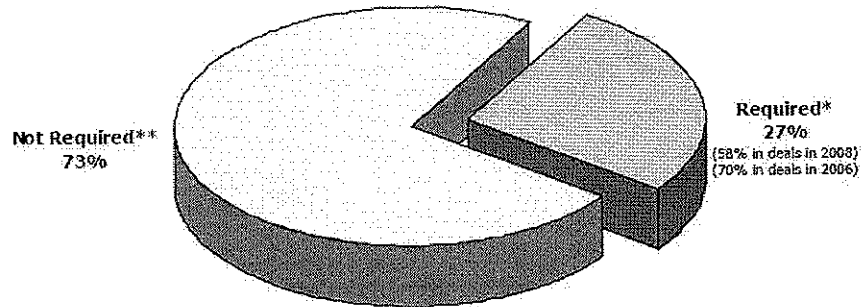
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## **Legal Opinions in M&A Transactions**

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## Legal Opinions (Non-Tax) of Target's Counsel

(All deals: includes simultaneous sign-and-close deals)



\* Typically as a condition to closing, but includes opinions required in a "closing deliveries" covenant.

\*\* Does not account for opinions that may have been required or delivered outside of the express terms of the agreement.

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## MAC ("Material Adverse Change") -Related Practice Points

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## Differences Between Express MAC Condition and “Back-Door MAC ” Condition

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- Express MAC Condition
  - *Buyer’s obligation to close the acquisition is conditioned on ... there not having been a material adverse change in Target’s business between the date of this agreement [Jun. 15] and the scheduled closing date [Aug. 15].*

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## Differences Between Express MAC Condition and “Back-Door MAC ” Condition (cont’d)

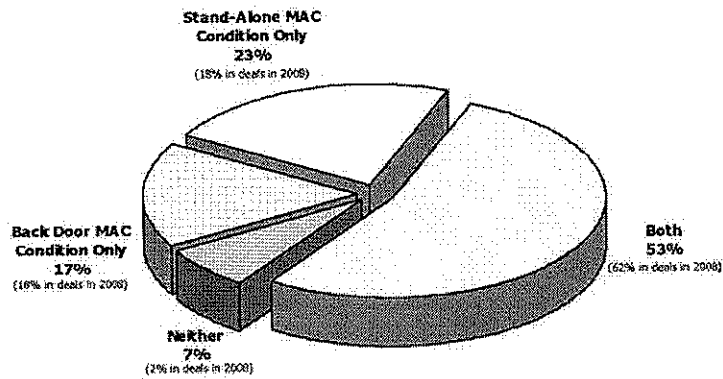
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- “Back-Door MAC” Condition  
(MAC Representation + Bring-Down Condition)
    - MAC Representation. *Sellers represent that, except as set forth in the disclosure schedule, ... since the date of this agreement [Jun. 15], there has not been a material adverse change in Target’s business.*
- +
- Bring-Down Condition. *Buyer’s obligation to close the acquisition is conditioned on ... Sellers’ representations being accurate in all material respects as of the scheduled closing date as if made on the scheduled closing date.*

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## Differences Between Express MAC Condition and “Back-Door MAC ” Condition (cont’d)

### Buyer’s MAC Condition



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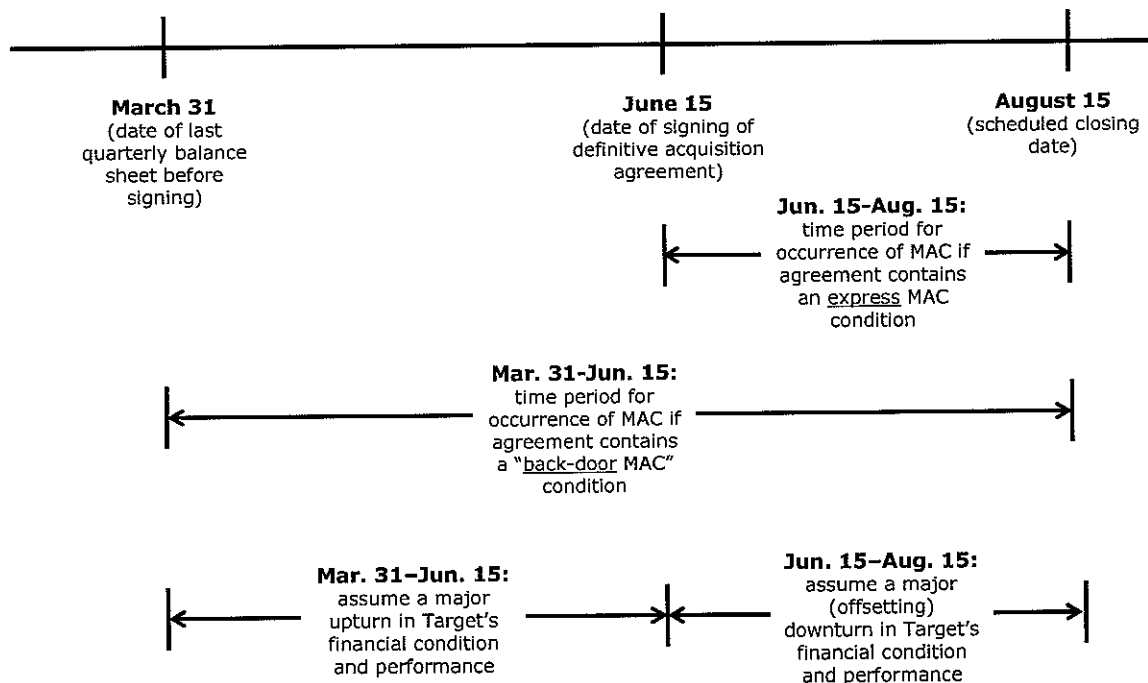
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## Differences Between Express MAC Condition and “Back-Door MAC ” Condition (cont’d)

- Differences between express MAC condition and “back-door MAC” condition:
  - *Applicable time period for occurrence of MAC*
  - *Applicability of disclosures in target company’s disclosure schedule*
  - *Buyer’s ability to terminate acquisition agreement before “drop dead” date*

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## Differences Between Express MAC Condition and “Back-Door MAC” Condition (cont’d)



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## Differences Between a MAC condition and a MAC Termination Right

- Express MAC Condition
  - *Buyer's obligation to close the acquisition is conditioned on ... there not having been a material adverse change in Target's business between the date of this agreement [Jun. 15] and the scheduled closing date [Aug. 15].*
  
- Express MAC Termination Right
  - *Buyer shall have the right to terminate this agreement ... upon the occurrence of a material adverse change in Target's business since the date of this agreement [Jun. 15].*

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## Differences Between a MAC condition and a MAC Termination Right (cont'd)

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- Indirect MAC Termination Right  
(MAC Rep + Termination Right for Inaccurate Rep)
    - MAC Representation. *Sellers represent that, except as set forth in the disclosure schedule, ... since the date of this agreement [Jun. 15], there has not been a material adverse change in Target's business.*
- +
- Termination Right for Inaccurate Representations. *Buyer shall have the right to terminate this agreement ... if (1) any representation made by Sellers is materially inaccurate as if made on any date following the date of this agreement, and (2) the inaccuracy in such representation shall not have been cured within ten days after Buyer notifies Sellers of such inaccuracy.*

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## A Potentially Overbroad Carve-Out From the Definition of MAC

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- Excerpt from sample MAC definition:
  - "Material Adverse Change" means any change or effect that is materially adverse to the business, financial condition or results of operations of Target; provided, however, that none of the following shall be deemed to constitute a Material Adverse Change:
    - ...
    - (e) any adverse change arising from any action required to be taken by Target under the specific terms of this agreement.

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# **Antitrust Risk Allocation**

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## **Antitrust Risk Allocation – Covenants**

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- Buyer's obligation to resolve antitrust challenges to transaction by litigating and offering to resolve challenges by agreeing to divestitures or other corrective action –
  - without limit ("hell or high water" approach)
  - except as would not have a material adverse effect (measured by combined companies or by target alone)
  - subject to specified limitations (revenue or EBITDA contribution, number of customers, spectrum or specified facilities)
  - not at all (expressly negated)

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## **Antitrust Risk Allocation – Financial Remedies**

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- Reverse termination fee payable by buyer to seller or target if transaction fails as a result of an antitrust challenge
  - AT&T's proposed acquisition of T-Mobile – AT&T paid \$3 billion and transferred wireless spectrum to Deutsche Telecom upon termination of the purchase agreement as a result of an antitrust challenge.
- Ticking fee payable by buyer if the closing is delayed
  - Dow Chemical's acquisition of Rohm and Haas Company – the purchase price increased at the rate of 8% per annum, commencing six months after entry into the merger agreement. The merger agreement also provided for a reverse termination fee in the event of a deal failure as a result of an antitrust challenge.

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## **Updating Disclosure Schedules**

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## Disclosure Schedule Updates

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*"Notice of Developments. Between the date of this Agreement and the Closing, Sellers shall promptly notify Buyer in writing of (i) any fact or condition that causes or constitutes a breach of any of Sellers' representations and warranties, or (ii) the occurrence after the date of this Agreement of any fact or condition that would or be reasonably likely to cause or constitute a breach of any such representation or warranty had that representation or warranty been made as of the time of the occurrence of such fact or condition. **Should any such fact or condition require any change to the Disclosure Schedule, Sellers shall promptly deliver to Buyer a supplement to the Disclosure Schedule.**"*

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## Disclosure Schedule Updates (cont'd)

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### Clarify impact on indemnity rights of Buyer:

*"Such delivery shall not affect any rights of Buyer under Section \_\_\_ (Effect of Termination) or Article \_\_\_ (Indemnification) of this Agreement."*

*"Sellers, jointly and severally, will indemnify and hold harmless Buyer. . . . arising from or in connection with . . . any breach of any representation or warranty made by Sellers in this Agreement (**without giving effect to any supplement to the Disclosure Schedule**). . . ."*

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## Caveats

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This presentation is intended merely to provide a general introductory overview of certain matters relating to M&A transactions. This presentation is not intended to provide a complete analysis of the matters covered, but rather is intended to be used and referred to in conjunction with a more comprehensive oral presentation regarding those matters. Accordingly, there are potentially important exceptions and qualifications that are not reflected in this presentation.

The sample provisions included in these materials are intended only to serve as examples of hypothetical provisions. All provisions must be carefully tailored to reflect the specific terms of the transactions to which they relate; accordingly, it may be necessary to make substantial modifications to these provisions before they can be used in the context of any proposed transactions.

This presentation is not intended to provide legal advice or to establish an attorney-client relationship.

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