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MERGER AGREEMENTS

Looking Ahead: Expected Hot Buttons for M&A Negotiations in 2015

By Robert B. Little

Conventional wisdom holds that mergers and acquisitions activity will continue to increase in 2015. The heralded return of a seller's market may portend intensified negotiations of provisions in M&A agreements that previously have been viewed as standard and unremarkable but upon closer examination may vitiate a seller's hard fought limitations on a buyer's post-closing recourse for seller breaches. At the same time, recent history suggests that buyers are increasingly focused on their post-closing remedies and ensuring that the words of the contract match their expectations. With this backdrop, below is an examination of areas in M&A practice expected to receive increased attention in 2015.

Fraud Exceptions

M&A practitioners are familiar with the fraud carve-out to the exclusive remedies and indemnification provisions of M&A agreements. In fact, many of us have heard from opposing counsel and maintained on behalf of our clients that such an exception is implied by law, arguing that an express fraud exception in the contract is either an ''easy give'' or superfluous, depending on your side of the argument. An exclusive remedies provision states that the indemnification provisions (including the limitations on recovery in such provisions) of the M&A agreement constitute the sole and exclusive remedy with respect to claims arising under the M&A agreement. The purpose of the exclusive remedies provision is to foreclose a party from bringing claims for breach outside of the carefully crafted contours of the indemnification provisions of the agreement, which generally mandate a time period within which such claims may be brought, include limitations on the amount of damages for which a party may be liable, such as thresholds, baskets and caps, and set forth processes with respect to the defense and settlement of third party claims. When parties agree to any exception to the exclusive remedies provision, they open the door to uncapped liability, limited only by the applicable statute of limitations, notwithstanding specifically negotiated limits on recourse in the indemnification provisions. As a result, any exception to the exclusive remedies provision should be considered with great care.

It is not uncommon for the fraud carve-out to the exclusive remedies provision to take several forms. For example, parties may phrase the exception in terms of not only fraud, but also intentional fraud, willful misconduct, willful misrepresentation or gross negligence. Many times, the parties misunderstand the meaning of these words, which import tort concepts into the contract. In arguing for a fraud exception, a buyer often argues that the indemnification limits should not apply in the event the seller lies, and it can be difficult for a seller to find the moral high ground to argue that any limits should apply in such a circumstance. However, not all of the phrases listed above that often appear as exceptions to the exclusive remedies provision cover only the situation where a party lies.

Parties can generally agree that there is a moral difference between intentionally and unintentionally misrepresenting the facts, and when including some type of fraud exception to the exclusive remedies provision, the parties generally intend to cover the former. In securities and M&A law, however, fraud can be deemed to en-

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compass reckless misconduct, which is a much different mode of behavior (and easier to allege and prove) than a deliberate lie. In addition, the concept of ''equitable fraud'' invoked when there has been an ''unconscionable bargain'' could bypass the requirement of intent altogether.

Sellers are increasingly aware that these types of exceptions to their carefully crafted indemnification provisions intended to limit their post-closing exposure give buyers a valuable toehold to avoid these contractual limitations. In fact, an aggrieved buyer can use the threat of a fraud or other tort-based claim, which have murky meanings in the M&A context and are often difficult to dismiss on a pre-discovery motion, to create leverage for a settlement that goes beyond the contractually agreed indemnification limits. While a seller is necessarily subject to the potential judicial outcome that, even if there is no contractual exception for fraud, a court could find that public policy compels it to disregard the contractual limitations on recourse because of some egregious conduct by the seller, the seller may be best served by not attempting to define the contours of that exception in the M&A agreement because the contractual exception may be broader than what a court would impose. As a result, sellers are more likely to resist these contractual exceptions, or at least to insist that the exception be carefully defined to apply solely to conduct that is akin to a deliberate lie by a principal party actively involved in the negotiations. For example, a seller may agree to an exception so long as it is limited to intentional fraud with actual knowledge rather than an amorphous fraud exception, or resist an exception altogether on the basis that any fraud exception should be applied by a court under appropriate circumstances and should not be addressed contractually.

Damage Waiver Provisions

In recent years, M&A practitioners have paid greater attention to damage waiver provisions in M&A agreements, particularly as commentators have repeatedly sounded the alarm regarding the risks of such provisions. Damage waiver provisions typically provide that the parties to the agreement will have no liability under the agreement for all or a portion of the following categories of damages: consequential, incidental, special, punitive, indirect, lost profits, diminution in value, business interruption or multiples-based damages. The flip side to the dangers described above with respect to the fraud exception to the exclusive remedies provision, which can be used by an aggrieved party to recover damages in excess of indemnification limits, is the damages waiver provision, which can be used to foreclose recovery by an aggrieved party, notwithstanding indemnification provisions that otherwise specifically provide for post-closing recourse.

Parties increasingly understand that these provisions may be interpreted to waive damages that they believe should be recoverable. For example, the term ''consequential damages,'' which many practitioners have understood to mean damages that are not the reasonably foreseeable result of a breach or are unduly speculative and remote, can be interpreted to mean direct damages in certain situations. Similarly, incidental damages, diminution in value damages, business interruption damages, multiples-based damages and lost profits may also constitute direct damages. For example, if a seller's representation in the M&A agreement regarding the validity and enforceability of a material customer contract turns out to be untrue, and the buyer expected to reap a certain profit from such contract, the breach (i.e., the loss of that contract) would result in lost profits to the buyer. If the M&A agreement provides that the parties will not be liable for lost profits, then such recovery – the only real loss suffered as a result of the breach, and certainly a foreseeable loss arising from such a breach – would not be available. While a buyer may be under the impression that it is entitled to damages out of an escrow or up to a certain cap as a result of such breach, if the agreement excludes these damages, the buyer would receive nothing. The problem with most of these damages labels is that they do not have clear meanings, which can result in unintended consequences.

In most situations, a waiver of damages provision is not appropriate (except perhaps with respect to a waiver of punitive damages) because contract law already limits damages to those that are the reasonably foreseeable result of a breach. In other words, a concern about liability for speculative or remote damages is generally groundless. If a party is concerned about the extent of exposure to damages, the more appropriate means to limit such exposure is by setting baskets, caps and thresholds with respect to the amount of damages rather than relying on an exclusion of categories of damages that are not well defined and often misunderstood. Buyers increasingly are not willing to negotiate indemnification baskets, caps and thresholds only to turn around and agree to an additional burden to their ability to recover for losses in the form of a damages waiver provision.

Third Party Claims

Practitioners are paying increasing attention to how M&A agreements treat indemnification obligations triggered by third party claims. First, how the agreement defines what constitutes an indemnifiable third party claim is critical. For example, if the agreement provides that an indemnifiable third party claim arises only when legal action is threatened or commenced by a third party, and a party becomes aware of a possible third party claim prior to the expiration of the applicable survival period, but there is no legal action threatened or commenced prior to expiration of the applicable survival period, the party would be unable to preserve such claim beyond the survival period. The party seeking indemnification would be better served if an indemnifiable third party claim had been defined to include ''potential'' third party claims. However, the counterargument to such a definition would be that it is not appropriate for a party to use a placeholder to preserve a claim beyond the survival period if no legal action has actually been threatened or commenced. In furtherance of this argument, the indemnifying party could contend that, at a minimum, the purported third party claim must be sufficiently advanced to allow the indemnifying party to make an informed decision concerning its rights, if any, with regards to such claim, including whether to exercise any right to assume the defense of the claim. Specifying in an M&A agreement exactly what a notice of a claim for indemnification must contain can help provide certainty as to whether a notice is sufficient to preserve a claim.

Relatedly, parties should carefully consider when it is appropriate to release funds from escrow. Clear stan-

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dards identifying whether a claim is ''pending'' on the escrow release date, and therefore permitting the indemnified party to keep funds in the escrow account, can help minimize disputes when a party is aware of potential third party claims, but such claims have not been threatened or commenced, on the release date.

Representation and Warranty Insurance

The prevalence of representation and warranty insurance in M&A transactions has grown significantly in recent years, and the market for these policies is now well-developed. The advantages of these policies to deal makers are numerous: (a) easing collection concerns arising from the financial distress of the seller, the wide disbursement of sellers or jurisdictional concerns (i.e., cross-border), (b) enhancing a bid in a competitive auction situation by eliminating issues relating to post-closing recourse, (c) attracting the best offer in an auction by maximizing post-closing recourse for the buyer, (d) expediting the distribution of sale proceeds because proceeds do not need to be held in escrow or otherwise retained to satisfy post-closing indemnification claims, and (e) protecting key relationships with management sellers who remain with the target company post-closing by collecting indemnity claims from the insurer rather than the management team.

Representation and warranty insurance will continue to be used as a tool to address road blocks to deal completion. Practitioners who are well versed in the key negotiated policy terms will bring value to their deal making clients. In particular, practitioners should expect to negotiate with insurers regarding the definition of losses in the insurance policy to ensure that it is sufficiently broad to cover the types of losses that would be recoverable under the M&A agreement. In addition, skilled practitioners will negotiate the ''knowledge'' exclusion in the policies such that it covers only the actual knowledge of specified individuals. Also, the subrogation provisions in the policy will receive attention; the focus will be on what actions the insured may be required to take to secure the subrogation rights and remedies of the insurer. Finally, although a traditional indemnification provision will usually cover breaches of post-closing covenants, representation and warranty insurance will not cover such breaches. As a result, if a seller's post-closing covenants are a critical aspect of the deal for the buyer, the buyer must be prepared to seek recourse for breaches of those covenants through other means. The only remedy available to the buyer in that situation may be to sue the seller for breach of contract.

Conclusion

As deal makers and their counsel hope for a busy 2015, exceptional M&A practitioners will deliver value by understanding hot button deal points and protecting their clients from outcomes that are inconsistent with their clients' expectations. As the M&A practice continues to evolve and respond to market conditions, we can expect new attention to be paid to some old language in M&A agreements and for new concepts and products, such as representation and warranty insurance, to accommodate and bridge the competing interests of buyers and sellers.