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State of the Art: Critical Developments and Trends in M&A

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Outline

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Working Capital Disputes

What is a Working Capital Adjustment?

The purchase price for a company to be acquired typically contemplates a "normal" level of working capital. A working capital adjustment seeks to adjust for any deviation in the delivered working capital versus this assumed "normal" level.

- *Definition of working capital adjustment*
  - Working capital adjustment = <u>actual</u> working capital at closing less <u>target</u> ("peg") working capital.
  - Target working capital amount will be a specific agreed amount set forth in the acquisition agreement.

- *Purpose of working capital adjustment*
  - From Seller's perspective: Compensate for deviations from the target working capital amount.
  - From Buyer's perspective: Ensure that the acquired company will have sufficient working capital for a smooth transition and continued operations in the ordinary course after the acquisition is complete.
    - Buyer does not want to have to borrow or contribute additional capital for the acquired business to run normally.

Determining Working Capital

A primary driver of working capital adjustment disputes concerns the accounting principles used to calculate working capital.

- *What accounting policies will govern?* Each of the party's different purposes for the working capital adjustment color its views of the appropriate accounting policies:
  - Buyer generally wants "in accordance with GAAP, consistently applied."
  - Seller generally wants consistency with the prior accounting methodology and practices used as the basis for calculating target working capital.
- *Conflicts often arise as to whether GAAP or consistency takes precedence.*
  - Seller may have used a consistent practice, but historical practice may not have been in compliance with GAAP, or may simply have resulted from Seller's bad accounting practices.
  - Buyer wants ability to go back and challenge the GAAP basis of original balance sheet amounts.
- *Even if GAAP is followed, it may not be followed consistently....*
  - GAAP itself in many circumstances permits different methodologies in producing GAAP-compliant financials.
  - Variations in GAAP methodologies, such as for inventory valuation, can dramatically affect the calculation.
  - Amounts that require estimation and judgement can lead to disputes.
    - *e.g.*, accounts receivable allowance, inventory allowance, reserves for contingent liabilities, revenue recognition.

Determining Working Capital

- What amounts are generally included in or excluded from working capital?

Components Generally Included	Components Generally Excluded
Trade receivables	Cash (depends on treatment of cash)
Inventory	Interest receivables
Prepaid expenses	Fixed assets
Trade accounts payable	Goodwill
Accrued wages and bonuses (< 1 year)	Lines of credit
Accrued vacation (< 1 year)	Long-term debt
Accrued medical insurance	Current portion of long-term debt
Other accrued operating expenses	Past-due accounts payable
Deferred revenue (if cannot negotiate as net debt)	Restructuring reserves
	Pension liability
	Deferred taxes

Tax assets and liabilities are often excluded from the calculation of net working capital; alternatively, the current portion of certain tax liabilities may be included in the calculation of the target and actual working capital numbers.

Chicago Bridge v. Westinghouse (Del. Sup. Ct. 2017)

- Chicago Bridge agreed to sell a subsidiary, Stone, to Westinghouse for a purchase price of $0 but with Westinghouse assuming all of the liabilities of Stone.
  - The purchase agreement included a purchase price adjustment for working capital.
  - In the purchase agreement, Westinghouse agreed that its sole remedy if Chicago Bridge breached its representations and warranties was to refuse to close the transaction.
- After closing, Westinghouse sought to utilize the working capital adjustment dispute resolution mechanism to allege that Chicago Bridge's historical financial statements were not based on a proper application of GAAP, which required a working capital adjustment in Westinghouse's favor.
- The Delaware Supreme Court held that, because courts must read the specific provisions of the contract in light of the entire contract (particularly the liability bar in the contract at issue), Westinghouse's claim regarding GAAP noncompliance was not a claim for the auditor appointed in the purchase agreement to resolve working capital disputes.
  - Chief Justice Strine stated that "the True Up is an important, but narrow, subordinate, and cabined remedy available to address any developments affecting Stone's working capital that occurred in the period between signing and closing."
  - Strine cautioned that the holding was influenced by the unusual set of facts, especially the complete bar on liability.

What Does *Chicago Bridge* Mean for Working Capital Negotiations and Disputes?

- This decision leaves open the question of whether the Delaware courts would view the true-up process contained in traditional agreements, where the buyer is not subject to a liability bar, in the same limited way.
- Some buyers will be tempted to argue that this case represents a narrow holding that does not preclude buyers in the traditional context from bringing claims regarding GAAP compliance in the post-closing purchase price adjustment true-up process.
- In contrast, some sellers will be tempted to argue that Chief Justice Strine's pronouncement that the true-up process is only intended to account for changes in the target's business between signing and closing forecloses buyers from asserting that the working capital calculation was not performed in accordance with GAAP.
- Certainly the deal terms at issue in this case were unusual, and the imposition of a liability bar seems to have weighed heavily on the outcome.
- It is unclear whether a purchase agreement without a liability bar, and with unambiguous language subjecting the working capital calculation to a GAAP standard, would lead to a different result.
- In any event, this case should serve as a reminder that, even in a traditional acquisition agreement, post-closing purchase price adjustments should be drafted with specificity and with the buyer's and seller's divergent viewpoints on the purpose of the working capital adjustment in mind.

Chicago Bridge likely is too facts-dependent to be of much use to buyers or sellers at the negotiating table or in a working capital dispute.

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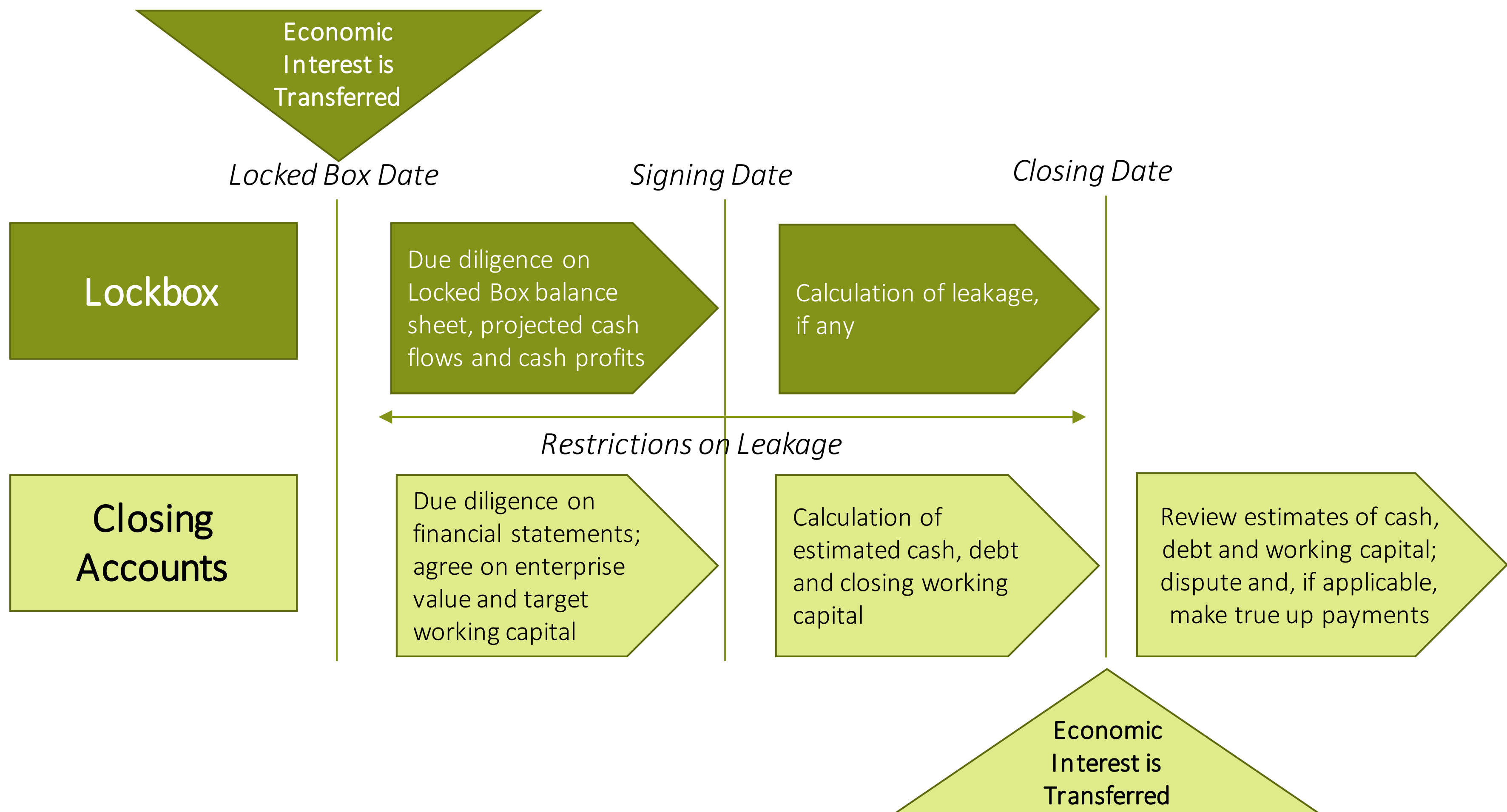
“Lockbox” Deal Structures

What is a Lockbox?

The target is sold at a fixed price based on a pre-signing balance sheet. As a result, the economic ownership of the target effectively passes to the buyer as of the date of such balance sheet, known as the "Locked Box" date.

- *"Closing Accounts" Approach*
  - Typically, in U.S. private mergers and acquisitions, the parties agree on a headline purchase price and then adjust it at closing for debt, cash and normalized working capital.
  - The "closing accounts" approach typically involves a post-closing true-up period during which the parties attempt to verify and, if applicable, correct the adjustments made at closing.
  - This process can involve uncertainty and lengthy post-closing disputes regarding the final purchase price.
- *"Lockbox" Approach*
  - Common in both the UK and Europe, the target is sold at a fixed price based on a pre-signing balance sheet that is either audited or otherwise agreed by the parties.
  - No broad-based purchase price adjustment at closing; instead, the purchase price is reduced only in the event of "leakage" – i.e., transfers of value from the target company to its owners after the "Locked Box" date (e.g., via dividends or payment of seller transaction expenses)
  - A key advantage is that parties are in agreement on major purchase price components and their impact on the headline purchase price. As a result, uncertainty regarding the final purchase price is reduced.

Timeline of Lockbox v. Closing Accounts Approach



* Figure above adapted from PwC's "To Lock or Not to Lock" January 2014 publication.

Pros and Cons of the Lockbox Structure*

Pros	Cons
Reduces Uncertainty and Risk of Post-Closing Disputes. Permits the parties to agree on the major purchase price components and their impact on the headline purchase price in advance, which significantly reduces the likelihood and impact of post-closing disputes.	**Value Shift.** Results in a value shift to buyer if the target's performance improves considerably between the "Locked Box" date and closing, or conversely, to seller, if the business underperforms during such period.
Streamlines Plain-Vanilla Deals involving an acquisition of the entire business (where there is no room for significant leakage).	**Carveout Transactions.** Problematic in carveout transactions, where the target business usually does not have stand-alone historical balance sheets and the risk of leakage (e.g. via intracompany transfers) can be greater.
Attractive to Private Equity Sellers. Permits a clean exit with no post-closing adjustment or related escrow mechanisms.	**Unfamiliar to U.S. Dealmakers.** U.S. dealmakers may be unaccustomed to this approach and may prefer the more familiar "closing accounts" approach.
Expedites Negotiations. Agreeing on the deal economics up-front can result in simpler and quicker deal negotiations and mechanics.	**Front-Loaded Diligence.** Requires thorough pre-signing diligence of the target's financials.

* From "Expert Analysis: A Primer on "Locked-Box" Deals", dated November 15, 2017, by John Pollack and Pavel Shaitanoff

Calculating Purchase Price

- Target is ***evaluated*** as of ***a fixed date*** (e.g., as of December 31 or as of another date on which financial statements/management accounts are prepared).
  - Such date is called the ***"Locked Box Date"***

- Parties usually negotiate ***up front*** the amount of the enterprise value and the amounts to be deducted and added to arrive at the Lockbox equity value.

Leakage Definition

- *Leakage may be defined to include:*
  - Dividends or distributions made by the target to the sellers
  - Management fees, monitoring fees, and other amounts payable to sellers or their affiliates
  - Exit fees and bonuses
  - Transaction costs
    - Fees of seller's advisors that have been paid by the target
    - Fees incurred by the target in connection with the transaction (e.g., data room, out of pocket expenses, travel expenses)
  - Indemnity obligations paid by the target
  - Taxes payable by target as a result of the above

Strategies in Responding to a Lockbox Proposal

If you are approached with a lockbox proposal, you may be (a) the seller and normalized working capital is trending up (i.e., the buyer wants the benefit of the growing working capital) or (b) you are the buyer and the seller is in the UK or Europe or the seller is a private equity firm looking for a clean exit.

- *If you are the seller you may*:
  - Make sure any "leakage" concept is narrowly defined, and avoid any post-closing adjustment or indemnification for leakage
  - If working capital is trending up, seek a later "Locked Box" date to capture more value.
  - Add a "ticking fee" to the purchase price (to reduce the value shift)
  - Introduce a tax make-whole provision if the target is a pass-through entity (so the seller is not paying taxes on income that is for the buyer's benefit)

- *If you are the buyer you may*:
  - Craft a "leakage" concept that encompasses any potential value transfer, and consider requesting an adjustment or indemnification for leakage
  - If working capital is trending up, seek an earlier "Locked Box" date to capture more value
  - Ensure the "Locked Box" financial statements have been properly vetted and that target management has "skin in the game" (potentially through post-closing equity or other compensation arrangements)
  - If the "Locked Box" balance sheet is unaudited, obtain appropriate representations from the seller

Other Buyer Protections

- *Leakage Protection.* Purchase agreement should contain sufficient protection (e.g., representations and covenants) against leakage after the Locked Box Date
  - *Sample Representations*
    - No dividends, transaction costs or other leakage payments have been made since the Locked Box Date
    - The target has been and will be run in the ordinary course of business since the Locked Box Date
    - Outstanding debt as of the Locked Box Date
    - Financial statements and management accounts were accurate as of the Locked Box Date
  - *Sample Covenants*
    - Covenants not to make or permit any "leakage" payments between signing and closing (other than any permitted leakage agreed at signing and/or set forth on a schedule)
    - Covenants that the target will be run in the ordinary course of business
      - The "ordinary course" definition and the interim operating covenant should be defined in detail and tailored according to in-depth discussions with management
    - Seller should provide buyer with frequent (e.g., monthly) financial updates and management accounts in the period between signing and closing

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Developments in Appraisal

Overview of Appraisal

- Appraisal allows disgruntled stockholders in a merger transaction to petition a court to independently determine the "fair value" of their shares
- The appraised price can be equal to, greater than, or less than the negotiated deal price
  - Thus, appraisal presents a distinct risk to acquirors, who may be required through the appraisal process to pay more than the negotiated deal price
- Appraisal rights vary from state-to-state; this discussion focuses on Delaware, where there have been recent developments
- Appraisal is available only in certain transactions – in Delaware, appraisal is typically available in merger transactions involving an all-cash or a mixed cash & stock purchase price
- In Delaware, stockholders seeking appraisal receive interest on the appraised value of the target's stock from the effective date of the merger through the date of payment at a statutory rate of 5% over the Federal Reserve discount rate

Defining Features of Delaware Appraisal Actions

- A Judge is tasked with being an Investment Banker
  - Most judges (*i.e.*, lawyers) are not trained as investment bankers – but the appraisal statute requires that the judge make an economic determination as to the value of a business
- Chancery Court has Wide Discretion
  - The appraisal statute does not mandate that the Chancery Court use any particular methodology to determine fair value
  - Common to have 'dueling experts', each who apply different methodologies and come to wildly different conclusions
  - Judge does not have to pick one expert's methodology – instead, the judge is free to pick and chose, and even do his / her own analysis
- Interest Component Minimizes Risk for "Appraisal Arbitrageurs"
  - In a low interest rate environment, the guaranteed statutory interest (currently 6.75%, calculated as the 5% plus the current Federal Reserve discount rate of 1.75%) is an attractive return
  - Even if the Chancery Court decides that fair value is less than the deal price, the interest component minimizes this risk for those seeking appraisal

Defining Features of Delaware Appraisal Actions

- <u>Historically, the Negotiated Deal Price Received Significant Weight</u>
  - Historically, the Chancery Court gave the negotiated deal price significant, or even dispositive, weight in its analysis when all or some of the following factors were present:
    - The transaction was subject to an effective market check
    - The transaction involved disinterested parties
    - The expert financial analysis presented in court was deemed unreliable
  - But, in 2016, this deference started to soften

Delaware Appraisal: Case Law Developments

- ***2016: Chancery Court Waivers on the Primacy of Merger Price***
  - In re: Appraisal of Dell Inc. The Chancery Court held that the merger price in a transaction that was negotiated in a lengthy, well-run, arms-length sale process and approved by a majority of the target's unaffiliated stockholders did not represent fair market value. The court focused on several factors that it believed undercut the legitimacy of the merger price, and used its own in-house discounted cash flow analysis in determining that fair market value was 28% higher than the merger price.
  - In re Appraisal of DFC Global Corp. The Chancery Court held that the deal price determined in an arms-length transaction that was subject to a robust market check did not represent fair market value, finding that the transaction price and management's projections were unreliable because of tremendous regulatory uncertainty surrounding the target's business. The court found that the DCF analysis, multiple based comparative company analysis, and transaction price were each imperfect. However, after making certain adjustments, the court weighed all three methodologies equally and determined that fair value was 7% higher than the deal price.
  - Dunmire et al. v. Farmers & Merchants Bancorp of Western Pennsylvania, Inc. The Chancery Court found that the actual merger price did not represent the fair market value of the company at the time of the transaction because of what the court viewed as flaws in the sale process. The court placed no weight on the merger price as an indicator of fair value and disregarded the valuation models proposed by the parties' respective experts, instead applying the court's independent valuation analysis, and determining that fair value was 11% higher than the deal price.

Delaware Appraisal: Case Law Developments

- ***2017: Chancery Court Offers Acquirors a Favorable Course Correction***
  - In re Appraisal of PetSmart, Inc. The Chancery Court held that the merger price resulting from a well-run, robust sale process constituted the best evidence of fair value. The petitioners had urged the court to rely on a DCF analysis based on PetSmart management projections, but the court found the projections to be unreliable because (1) management did not have a history of creating (or any experience with) long-term projections, (2) management's short-term projections were frequently inaccurate, (3) the projections were not created in the ordinary course of business but rather for use in the auction process, and (4) management created the projections while under pressure to be aggressive, on the expectation that potential bidders would discount such projections.
  - In re Appraisal of SWS Group, Inc. Both parties argued that the deal price did not constitute fair value, albeit for different reasons – the petitioners argued that the sales process was fundamentally flawed, while the target company argued that the deal price was inflated due to synergies that, under the Delaware appraisal statute, should not be included in determining fair value. The Chancery Court agreed that it was improper to give effect to such synergies and determined (using its own DCF analysis) that the fair value was below the deal price, noting that this was a "synergies-driven transaction whereby the acquiror shared value arising from the merger" with the target stockholders.

Delaware Appraisal: Case Law Developments

- *2017 Continued: Delaware Supreme Court Endorses Reliance on Merger Price in* DFC Global *Appeal*
  - In August, the Supreme Court reversed and remanded the *DFC Global* case.
  - While the court refused to establish a presumption in favor of the merger price in arms-length transactions with robust market checks, it strongly endorsed reliance on the merger price in such circumstances, noting that the "sale value resulting from a robust market check will often be the most reliable evidence of fair value."
  - Likewise, the court found no basis for the Chancery Court weighing the DCF analysis, multiple based comparative company analysis, and merger price equally
  - In addition, the court found no basis for the Chancery Court:
    - determining the merger price to be unreliable because of regulatory uncertainty, noting that the market and potential bidders had effectively priced this uncertainty into the company's valuation
    - increasing the perpetuity growth rate used in the DCF model (which pushed up the company's valuation), noting that the management projections underpinning the DCF model already were optimistic and designed to drive up the bidding price (echoing the reasoning of the Chancery Court in *PetSmart*).
  - Finally, in a win for private equity firms and other financial buyers, the court rejected the Chancery Court's decision not to give dispositive weight to the merger price on the basis that the buyer was a financial buyer focused on "achieving a certain internal rate of return and on reaching a deal within its financing constraints, rather than on…fair value." The court noted that this so-called "private equity carve out," which has been raised in other Chancery Court opinions, is not "grounded in economic literature."

Delaware Appraisal: Case Law Developments

- *2017 Continued: Delaware Supreme Court Decides ????? In* Dell
  - Decision in Dell expected shortly
  - Oral arguments suggest an opinion similar to *DFC Global*, which places strong weight on the deal price

The Current State of Play

- The good news:
  - After a period of significant uncertainty, it appears that the deal price should now be respected more often than not, at least in arms-length transactions with robust market checks
  - Stockholders will be discouraged from seeking appraisal in strategic transactions, since the Chancery Court is willing to find an appraised value below the deal price in transactions that involve synergies
- The bad news:
  - Appraisal remains appraisal – *i.e.*, a mechanism for stockholders to obtain value above and beyond the negotiated deal price
  - Appraisal arbitrage, where hedge funds "invest" in appraisal actions, remains a viable strategy, particularly in the current interest rate environment
  - At its core, appraisal remains an exercise where a judge (*i.e.*, a lawyer) is required to make a financial, rather than legal, determination
- Dell decision still to come – could be good or bad (but probably will be good)

Practical Advice

- Appraisal risk is borne solely by the buyer
- Buyers can protect themselves through one or more of the following:
  - Include a closing condition that "fewer than X%" of the target's shares have sought appraisal
  - In private company deals, include indemnification for any amounts incurred in connection with an appraisal action
  - In deals with undesirable optics (*e.g.*, a low or even no premium to the trading price), be aggressive on the PR front and try to preemptively show how the deal price is fair. In particular, tout any synergies, and how those synergies are being shared with target stockholders
  - Be cognizant of the fact that a negative recommendation from ISS or Glass Lewis could encourage appraisal actions
  - Include the costs of appraisal in pricing the deal (*i.e.*, appraisal won't be an unexpected increase to the deal price if it was included in the financial model)

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Developments in Representation and Warranty Insurance

Representation and Warranty Insurance: Overview

- Provides coverage for financial losses resulting from breaches of representations and warranties made by the target company or sellers in an acquisition agreement.
- R&W insurance generally covers all reps in the agreement (subject to certain exceptions) and can separately cover a pre-closing tax indemnity.
- Buy-side and sell-side policies are available.
  - Buy-side policies can either serve as the buyer's primary source of indemnification recovery or can extend an indemnification package (e.g., excess coverage).
  - Sell-side policies insure the seller against its indemnification obligations to the buyer under the acquisition agreement.
- Primary policies will be subject to a retention amount (e.g., a deductible) of between 0.5-1.5% of deal value.
- When a buy-side policy is used, sellers may retain exposure for losses for breaches of reps and warranties up to the retention amount, subject to a market basket/deductible.

Representation and Warranty Insurance: Trends

- Surge in global demand
- Buyer-side policies dominate
- Requirement that buyer utilize R&W insurance has become standard in competitive auctions
- Record demand attracting new underwriters

Representation and Warranty Insurance: Trends

- Competitive dynamic in marketplace driving changes to coverage
  - Insurers willing to provide coverage even if no seller "skin in the game" (i.e., no seller post-closing indemnity obligation)
  - Longer Standard Coverage Periods
    - Most policies provide for a standard three-year survival period, regardless of survival period specified in acquisition agreement.
    - Customary fundamental and certain other negotiated extended survival reps (e.g., tax and environmental) survive for the shorter of six years or applicable statute of limitations period.
  - More Coverage Exclusions
    - Underwriters' due diligence and claims experience driving more coverage limitations and exclusions
    - Matters more likely to be excluded: transfer taxes and ability to utilize pre-closing tax attributes (e.g., NOLs), health care compliance, cybersecurity and data privacy matters, product liability, environmental matters, FCPA, and certain labor and employment matters, such as Fair Labor Standards Act and wage/hour matters

Representation and Warranty Insurance: Trends

- Expansion of Universe of Covered Losses
  - <u>**Unless**</u> specifically excluded from indemnity under acquisition agreement, now fairly typical for policies to cover:
    - Consequential damages
    - Damages based on multiplier
    - Diminution in value
    - Punitive damages paid to third party
  - Changes to Retention Concept
    - Retention amounts typically automatically “step down” at a specified period of time following closing
    - Retention amounts generally trending downward
  - Standard Inclusion of Full “Materiality Scrapes”
  - Increased Streamlining of Underwriting Process
    - Shorter, more concentrated underwriting due diligence
    - Carriers know they have to move fast to make product appealing in marketplace
    - Insurance is seen as much less of a delay factor in transactions

Representation and Warranty Insurance: Issues to Watch

- *Treatment of tax liabilities*
  - Buyers should be careful before agreeing that representation and warranty insurance will be the sole recourse for post-closing claims.
  - Our watch/your watch treatment for tax liabilities and specific tax indemnity from the seller (not subject to deductible or cap) would be customary in non-R&W insurance deals.
  - Representation and warranty insurance does not cover known tax liabilities.
- *Issues that arise between signing and closing*
  - In situations where coverage is bound at signing, and there is an interim period between signing and closing, "new" matters both occurring **and** discovered by the insured in the interim period between signing and closing will not be covered.
- *No coverage for covenant breaches*
  - Representation and warranty insurance will not cover breaches of covenants.
  - If post-closing recourse for covenant breaches is desired, indemnification provisions addressing such recourse should be included in the agreement.
- *Application of retention and insurance coverage cap to fundamental reps*
  - In typical deals without representation and warranty insurance, recourse for breaches of fundamental representations would not be subject to a deductible or a cap less than the purchase price.

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Recent M&A-Related SEC Guidance

Use of Non-GAAP Financial Measures in M&A Projections

- On October 17, 2017, the SEC's Division of Corporation Finance issued new guidance regarding the use of non-GAAP financial measures in M&A disclosures.

- As a general practice, targets frequently disclose management projections and forecasts upon which the target's financial advisors rely in order to, among other things, render an opinion in connection with a proposed M&A transaction.

- Recent lawsuits in connection with public M&A transactions have alleged that the disclosure of financial projections in a target's proxy statement or tender offer materials violates federal securities laws when such disclosure does not also present (i) the most directly comparable GAAP financial measure and (ii) a reconciliation of such financial measure to the projected financial information, in each case as required under Regulation G.

Use of Non-GAAP Financial Measures in M&A Projections *(continued)*

The SEC's new guidance makes clear that financial measures included in forecasts provided to financial advisors are **not** "non-GAAP financial measures" if:

(1) the financial measures are included in forecasts provided to the financial advisor for the purpose of rendering an opinion that that is materially related to the business combination transaction; and

(2) the forecasts are being disclosed in order to comply with Item 1015 of Regulation M-A or requirements under state or foreign law, including case law, regarding disclosure of the financial advisor's analyses or substantive work.

This new guidance provides comfort that financial projections prepared by management and used by financial advisors to render an opinion materially related to an M&A transaction are not subject to Regulation G or Item 10(e) of Regulation S-K.

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Fraud Carve-Outs

Overview

The core issue is whether an acquisition agreement *limits a remedy for fraud* against seller:

1. Solely with respect to *specific representations in the four corners of the agreement*; or
2. Also for *fraudulent information provided by the seller during negotiations* (e.g., in management presentations, a data room, discussions, etc.)

- Buyers routinely agree to anti-reliance disclaimers in M&A agreements. At the same time, buyers have increasingly demanded and obtained fraud carve-outs, which generally provide that various provisions of the contract apply "except in cases of fraud."
- Reliance disclaimers and fraud carve-outs, however, typically conflict as an anti-reliance disclaimer intends to exclude extra-contractual fraud claims that the fraud carve-out intends to preserve.
- In most acquisition agreements, claims for fraud are not subject to the negotiated indemnification limitations, meaning the ability to bring a fraud claim for extra-contractual fraud claims has significant consequences.
  - E.g., what kinds of claims and what types of fraud are covered under the fraud carve-out?

Non-Reliance and Fraud Carve-outs, a Review

Jurisdiction	Law
Delaware	Without an express carve-out for fraud, a four corners limitation clause and an anti-reliance clause will preclude a claim for fraud on extra-contractual representations.
New York	Same as Delaware, except New York courts will recognize a "peculiar knowledge" exception to non-reliance provisions—e.g. if a seller has unique knowledge of a misrepresented fact, the contractual non-reliance provision may not defeat a fraud claim.
California	California courts generally hold that it is against public policy to allow a party to contractually absolve itself of liability for its own willful and negligent fraud.

What Happens When the Fraud Carve-Out Is Not Defined: EMSI Acquisition

- As described above, non-reliance clauses are intended to preclude any fraud claim based upon alleged extra-contractual representations made outside the four corners of the written agreement, which are designed to exclude extra-contractual claims beyond negotiated indemnification and loss provisions.
  - Delaware public policy does not permit the enforcement of a contractual provision within the four corners of the written agreement itself, which the seller knows to be false.
  - However, by sanctioning non-reliance provisions, Delaware law permits parties to contractually allocate the risk of intentional fraud by the target's management to the buyer, where the seller was unaware of such intentional fraud by the target.
  - This is especially important for private equity sellers, who are unaware of misrepresentations made by the target. In most cases, a private equity seller is merely an investor in, rather than an operator of, its portfolio companies, even when certain private equity professionals may be on the board of the target.

What Happens When the Fraud Carve-Out Is Not Defined: EMSI Acquisition *(continued)*

In *EMSI Acquisition Inc. v. Contrarian Funds LLC, C.A. No. 12648-VCS (Del. Ch. May 3, 2017)*, the Delaware Court of Chancery found that due to an ambiguous fraud carve-out clause, uncapped indemnifications claims could be sought from **all of the shareholder sellers** for alleged fraud even though only a couple of the sellers had knowledge of such alleged fraud.

- Other than two of the sellers who were involved in the target's management and had knowledge of the alleged fraud, the other shareholder sellers were institutional investors who were not involved in managing the target. Such institutional investors would likely not have been liable if the buyer were forced to limit its claims to common law fraud.
- The Purchase Agreement contained:
  - an indemnity cap (which had already been reached by previous claims), and
  - a carve-out permitting uncapped claims for "any action or claim based upon fraud in connection with the transactions" (instead of a fraud carve-out limited to common law fraud)
  - Importantly, both of the foregoing provisions were preceded by a "[n]otwithstanding anything in this Agreement to the contrary" clause. As a result, the two provisions directly contradicted one another.
- The court reasoned that this language created ambiguity about whether fraud-based claims, based on claims made outside the four corners of the contract, could be asserted (i) on an uncapped basis and (ii) against all sellers (even if institutional investors did not have knowledge of the fraud).

Lessons Learned from EMSI Acquisition

Define "Fraud"

Limit your "Fraud" definition to include only common law fraud and limit who may be liable for such fraud claims (e.g., ensure that the fraud of the target's management is not attributed to the target's institutional shareholders).

Clarify Relation to Indemnity Provisions

Determine whether claims for "Fraud" (as defined in the Agreement) must be made as tort-based claims outside of the indemnity or must instead be made within the carefully crafted and agreed indemnity provisions of the Agreement.

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Termination Fees and Willful Breach

An Overview of Termination Fees

- Termination fees (a.k.a., breakup fees, reverse breakup fees, reverse termination fees, closing failure fees, financing failure fees, etc.) are easily misunderstood, in part, because these fees take a wide range of forms and serve a wide range of functions
- The traditional "breakup fee" included in a public company merger agreement is payable by the seller and is designed to protect the deal from a third party interloper who seeks to break up the transaction
  - It is not designed to allocate risk
  - It is typically payable in circumstances in which there has been no breach of the merger agreement
- The traditional private equity style "reverse termination fee" is usually constructed as liquidated damages designed to compensate the target company because the buyer has breached by failing to close the deal
  - This fee is designed to allocate risk between the parties – specifically, the risk of whether or not financing for the transaction will be obtained
  - It is payable only following a breach
- Reverse termination fees payable in the event of a failure to obtain a required regulatory approval, such as antitrust or CFIUS, are somewhat common in transactions involving material regulatory risk and serve a hybrid of the functions of the fees described above
  - Like the private equity style reverse termination, it is designed to allocate risk
  - Like the traditional public company style breakup fee, it is payable in circumstances in which there has not been a breach

Exclusion for Willful Breach

- In deals that contain termination fees payable by the buyer (*e.g.*, the traditional private equity reverse termination fee), most agreements provide that the termination fee will be the "sole and exclusive remedy" of the party entitled to receive the fee
  - In other words, the aggrieved party is entitled to the fee and nothing more
  - This construct reduces the uncertainty and expense of litigation by pre-defining the parties' remedies
- However, acquisition agreements sometimes exclude from the sole-remedy concept claims for "willful breach"
  - The logic behind this exclusion is that the buyer should not be able to willfully breach merely by choosing to pay the fee instead of complying
  - If there is an exclusion for willful breach, it typically means that the aggrieved party can collect both the fee and also money damages on top of the fee
- Although this exclusion may seem logical, it creates significant risk for the buyer because it turns the termination fee into a floor on damages, rather than a cap
  - For example, when faced with a breach, the seller will be highly motivated to take the fee and also declare the breach 'willful' (regardless of the facts)
  - Once the breach is alleged to be willful, the seller can then sue the buyer for damages, above and beyond the fee
  - This exact scenario is playing out in the Anthem / Cigna lawsuit

Anthem / Cigna Litigation

- In July 2015, health insurers Anthem and Cigna announced a deal pursuant to which Anthem would acquire Cigna for approximately $48 billion
- The deal presented antitrust risk and on February 8, 2017, a U.S. District Court blocked the merger
- In the wake of the ruling, Cigna filed suit against Anthem in Delaware Chancery Court seeking to (1) terminate the merger agreement, (2) obtain a $1.85 billion reverse termination fee payable for the failure to obtain antitrust approval, and (3) obtain more than $13 billion in damages for Anthem's alleged willful breach
- Anthem filed counterclaims seeking to prevent Cigna from terminating the merger agreement and collecting the reverse termination fee on the grounds that Cigna had willfully breached the merger agreement as well as to collect damages suffered as a result of Cigna's breaches
- Several weeks later, Anthem delivered a notice to Cigna terminating the merger and declaring that Cigna was not entitled to receive the reverse termination fee because Cigna's willful breaches
- The litigation in Delaware chancery court is ongoing, with Cigna continuing to seek payment of the $1.85 billion reverse termination fee and more than $13 billion in damages above and beyond the fee

Anthem / Cigna Merger Agreement

- The Anthem / Cigna merger agreement provided that the $1.85 billion reverse termination fee would be Cigna's sole remedy in the event the parties did not receive antitrust approval, *so long as* Anthem had not willfully breached
  - Cigna claims that Anthem willfully breached by unilaterally conducting a poor antitrust strategy
- The merger agreement also provided that Anthem would not be required to pay the reverse termination fee to Cigna if Cigna willfully breached its obligations under the merger agreement
  - Anthem claims Cigna intentionally undermined the deal by refusing to cooperate in the antitrust strategy
- The merger agreement defines "Willful Breach" as "a material breach of [the merger agreement] that is the consequence of an act or omission by a party with the actual knowledge that the taking of such act or failure to take such action would be a material breach of [the merger agreement.]"
  - In other words, the party must know that its action constituted a breach
  - This requirement to demonstrate actual knowledge will add additional complexity to the litigation

Initial Lessons from Anthem / Cigna

- Exceptions to a termination fee for "willful breach" can easily lead to litigation, regardless of how "willful breach" is defined
  - The seller will have a reason to see every breach as 'willful'
  - This diminishes the utility of the termination fee, which is often included to minimize the possibility of litigation
- If a willful breach exception is included, it is a good idea to include a specific definition of willful breach
  - Including a knowledge component creates a heightened standard of proving willful breach
- The determination of whether a party is in willful breach is extremely fact specific and thus not easy to resolve
  - This leads to particularly complex and time consuming litigation
- If a willful breach exception is included, consider adding provisions that encourage the parties to take the termination fee, rather than suing for damages. For example, consider providing:
  - A party is not entitled to recover both the termination fee and also damages on top of the fee
  - If a party sues for damages, that party cannot later recover the termination fee if its lawsuit is unsuccessful
  - The loser pays the winner's legal fees in any suit for damages.

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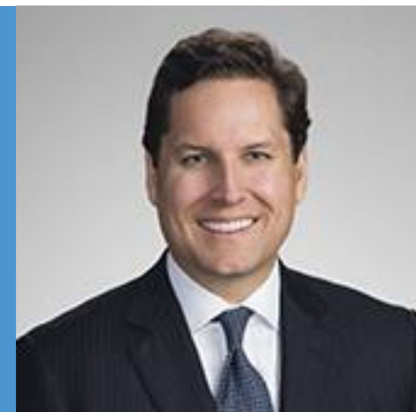

Robert B. Little is a partner in Gibson, Dunn & Crutcher's Dallas office. He is a member of the firm's Mergers and Acquisitions, Capital Markets, Energy and Infrastructure, Private Equity, Securities Regulation and Corporate Governance, and Global Finance practice groups. Mr. Little serves on the Gibson Dunn Hiring Committee and is the hiring partner for the Dallas office.

Described by clients in *Chambers USA* 2017 as an "efficient, practical and proactive lawyer who is oriented to problem solving," Mr. Little's practice focuses on corporate transactions, including mergers and acquisitions, securities offerings, joint ventures, investments in public and private entities, and commercial transactions. He also advises business organizations regarding matters such as securities law disclosure, corporate governance, and fiduciary obligations. In addition, he represents investment funds and their sponsors along with investors in such funds. Mr. Little has represented clients in a variety of industries, including energy, retail, technology, transportation, manufacturing, and financial services.

In 2013, Mr. Little was the youngest corporate M&A lawyer in Texas to receive a ranking by *Chambers USA: America's Leading Lawyers for Business*. *Chambers* noted that Mr. Little "attracted a raft of glowing comments, with one interviewee noting: 'He is very personable and one of the best lawyers in negotiations at keeping the relationship with the other side good. He is a fantastic lawyer with great commercial and interpersonal skills.'" *Chambers* 2014 observed that he has a "remarkable grasp of legal issues" and "provides outstanding legal work." The 2015 edition noted that he "receives extensive praise from clients and peers who describe him as 'extremely thorough and very knowledgeable.'" In 2016, *Chambers* observed that clients praise him for being "strategic, super-responsive [and] a fast learner of industries" and having "an excellent approach to complex and highly contested negotiations."

Mr. Little received his law degree in 1998 with highest honors from The University of Texas School of Law, where he was named a Chancellor and a member of Order of the Coif and served as Articles Editor of the *Texas Law Review*. He also holds a B.A. from Baylor University, where he graduated *summa cum laude* in 1995. He previously served as a law clerk to The Honorable Patrick Higginbotham of the U.S. Court of Appeals for the Fifth Circuit.

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Ms. Choh graduated from the University of Pennsylvania in 1997 receiving a B.A. in International Relations. She earned her law degree from the University of Southern California Law School in 2002 where she was a senior editor on the *Southern California Law Review* and elected to the Order of the Coif. Ms. Choh was also previously appointed by Los Angeles Mayor Antonio Villaraigosa to serve on the Los Angeles Convention Center Authority and currently serves on the Executive Committee of the Business and Corporations Law Section of the Los Angeles County Bar Association. Ms. Choh is a member of the firm's Diversity Committee, Professional Development Committee and Associate Compensation Committee.

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Mr. Corsico received his law degree, magna cum laude, from Northwestern University School of Law in 2003, where he was a member of the Order of the Coif, served on the Northwestern University Law Review and was awarded Senior Research Honors. He received a bachelor of science in electrical engineering from Cornell University in 2000.