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The Changing Legal Landscape and Matters Affecting M&A Documentation

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Introduction

The legal and financial landscape for mergers and acquisitions (M&A) is constantly changing and evolving. Regardless of the state of the overall economy, a large part of our job as counsel is to (1) assist our clients in navigating such changing M&A market and landscape, (2) keep abreast of changes in case law and legislation that may affect such M&A documentation and (3) advise our clients on what is "market" with respect to the key provisions and issues of M&A documentation. This chapter begins with a short summary of recent developments and our expectations for the upcoming year. It then focuses on recent M&A case law and the deal provisions that are foremost on the mind as a result.

State of the Market and M&A Trends

The Market

2015 was a banner year for M&A deals. Through November of 2015, over $4 trillion in M&A transactions had been announced around the world, currently making 2015 the second highest (after 2007) year for M&A activity in history.[1] If M&A activity continues at this pace through the end of 2015, this year may even surpass 2007's M&A activity. Although the 2016 M&A market outlook is not as rosy, we anticipate that M&A activity will continue at a healthy pace in 2016, especially in the United States.

For one, we expect that the Federal Reserve will finally raise interest rates. The Federal Reserve's policy rate has not seen an increase since 2006 and has remained at or near zero for almost eight years. While interest rates should still be near historical lows, debt financed M&A activity in 2016 will not be as attractive as it was in 2015. Higher interest rates are also expected to hamper the US stock market's growth.[2] In fact, certain individuals believe that 2016 may even result in negative US stock market returns.[3] While we do not

[1] Number of $5 Billion-plus Takeover Deals Hit Record, Reuters (Nov. 20, 2015). Available at: http://www.cnbc.com/2015/11/20/number-of-5-billion-plus-takeover-deals-hit-record.html.
[2] Rich Miller. Goldman Sees Yellen Call Limiting 2016 US Stock Market Gains (Nov. 19, 2015). Available at: http://www.bloomberg.com/news/articles/2015-11-19/goldman-sees-yellen-call-limiting-2016-u-s-stock-market-gains.
[3] Akin Oyedele. One of the Most Bullish Wall Street Strategists Just Offered One of the Most Bearish Outlooks for 2016 We've Read Yet (Nov. 27, 2015). Available at: http://www.businessinsider.com/bmo-belski-2016-stock-market-outlook-2015-11.

anticipate negative returns, we do expect the markets to end the 2016 calendar year generally flat to slightly positive. It is not just higher interest rates that will affect the market. Low commodity prices and the strength of the US dollar will affect overseas profits for US companies. Furthermore, while the Chinese economy is expected to continue to grow, China's economic growth numbers are lower than they used to be. In fact, since 2010, the Chinese economy has slowed down each year.

For 2016, the International Monetary Fund (IMF) is projecting 6.3 percent growth for China,[4] and many would argue that such projected rate is inflated. 2016 will be the first time that China has posted less than 7 percent growth since the 2008 financial crisis.[5] The less than stellar news regarding China is tempered by the overall global economic outlook. The IMF is projecting a global growth rate of 3.6 percent. That rate is generally in line with the average global growth rate from 1980 through 2014, 3.5 percent.[6] Furthermore, US GDP growth is estimated at 2.8 percent for 2016, which is slightly higher than 2015's 2.5 percent.[7] We note that 2016 is an election year in the United States. Generally, investors and companies are more reticent during election years about engaging in M&A activity. Surprisingly, however, the US candidates for both the Democratic and the Republican parties in the United States are generally seen as "business friendly." Therefore, we do not expect that the US general election will greatly hamper economic activity or M&A transactions.

M&A Trends

It is worth noting that for 2015, deals worth $10 billion or more represented 37 percent of global M&A deal activity. In contrast, over the prior five-year period, deals of such size usually represented only about one-fifth of all M&A transactions.[8] While mega deals will continue to

[4] Katy Barnato. Why China "Spillover" Poses Risks for the Euro Zone (11/25/15). Available at: http://www.cnbc.com/2015/11/25/china-slowdown-hitting-euro-zone-trade-ecb.html.
[5] Peter Coy. Economy 2016: Here's What You Need to Know (Nov. 5, 2015). Available at: http://www.bloomberg.com/news/features/2015-11-05/economy-2016-here-s-what-you-need-to-know.
[6] *Id*.
[7] David Payne. GDP Growth to Accelerate Despite Strong Dollar's Drag (Nov. 24, 2015). Available at: http://www.kiplinger.com/article/business/T019-C000-S010-gdp-growth-rate-and-forecast.html.
[8] 2015 M&A Deals Worth More than Federal Budget (11/21/15). Available at: http://www.zacks.com/stock/news/197766/2015-mampa-deals-worth-more-than-federal-budget.

make headlines in 2016, we anticipate that they will represent a lower percentage of the overall deal volume.

In the first half of 2015, consideration for more than half of all US M&A deals valued at $100 million or more included a stock component.[9] We anticipate that the percentage of deals involving stock as all or a portion of the purchase price will continue to grow. At the same time, the use of cash or debt to finance M&A acquisitions should decrease. Unlike in a cash transaction, where the selling shareholder's consideration is a definite and, usually, easier to quantify amount, stock transactions permit sellers and acquirers to share the risks and the rewards relating to the ongoing performance of the acquired entity. In addition, the issuance of equity generally gives rise to more flexible and varied deal structures. Accordingly, we expect that M&A practitioners will be more creative and attempt to use innovative deal structures to ensure favorable outcomes for their clients.

We also predict that the increased incidence of M&A litigation will finally plateau. Over the past few years, more than 90 percent of M&A deals valued at $100 million or more resulted in shareholder litigation. In turn, the vast majority of such litigation is settled prior to trial.[10] These suits are usually settled via an agreement requiring the public company to make additional or supplemental disclosures. These settlements do not increase shareholder consideration. However, plaintiff's attorneys are handsomely rewarded with lucrative attorney's fees, which are included and approved as part of the settlement. Increasingly, however, plaintiff's attorneys are finding resistance in obtaining approval for "disclosure-only settlements." In a recent case, the Delaware Court of Chancery rejected one such disclosure-only settlement and went on to say: "I think that we have reached a point where we have to acknowledge that settling for disclosure only and giving the type of expansive release that has been given has created a real systemic problem. We've all talked about it now for a couple years. It's not new to anybody. But when you get the sue-on-every-deal phenomenon and the cases-as-inventory phenomenon, it is a problem. It is

[9] Practical Law Corporate & Securities. What's Market: 2015 Mid-year Public M&A Wrap-up (Jul. 30, 2015). Available at: http://us.practicallaw.com/2-617-7303.

[10] Cornerstone Research, Shareholder Litigation Involving Mergers and Acquisitions, Review of 2013 M&A Litigation: https://www.cornerstone.com/CMSPages/ GetFile.aspx ?guid=73882c85-ea7b-4b3c-a75f-40830eab34b6 (last visited Nov. 30, 2014).

a systemic problem."[11] Similarly in New York, the New York Supreme Court for New York County recently refused to approve a disclosure-only settlement. In the scathing court opinion, the judge characterized the settlement as follows: "This proposed settlement offers nothing to shareholders except that attorneys they did not hire will receive a $375,000 fee and the corporate officers who were accused of wrongdoing, will receive general releases."[12] Given the unfriendly reception disclosure-only settlements are receiving in the US court system, we anticipate seeing a small respite to the now automatic knee-jerk reaction to the announcement of an M&A transaction: M&A shareholder litigation.

We also expect that the use of private capital will continue to increase. Companies are well aware that US securities registration requirements and ongoing reporting requirements for publicly traded companies are expensive, onerous, and generally time-consuming. The increase in private investors and venture capitalists is permitting companies to avoid the pitfalls of being a public company for longer periods of time.

Developments in the Law Affecting M&A Documentation

While it is extremely important for an M&A practitioner to keep abreast of current events and US and world economics, it is imperative that the practitioner also continue to educate himself or herself and continue to be informed of legal developments. A few of the many legal developments in the United States are summarized below.

Amendment to Regulation A Rules

Section 5 of the Securities Act of 1933[13] (as amended, the "Securities Act") forbids the use of any means of interstate commerce or mails to sell or offer to sell securities without first filing a registration statement with the Securities and Exchange Commission (SEC). Pursuant to the Securities

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[11] *In Re Aruba Networks, Inc. Stockholder Litigation Settlement Hearing and Rulings of the Court*, Cons. C.A. No. 10765-VCL (Del. Ch. Oct. 9, 2015). Available at: http://us.practicallaw.com/cs/Satellite?blobcol=urldata&blobheader=application%2Fpdf &blobkey=id&blobtable=MungoBlobs&blobwhere=1247772599260&ssbinary=true (Last visited Nov. 28, 2015).

[12] *In the Matter of Allied Healthcare Shareholder Litigation*, 2015 WL 6499467 (10/23/15).

[13] Securities Act of 1933, 15 U.S.C.A. § 77e.

Exchange Act of 1934[14] (as amended, the "Exchange Act"), the secondary trading of such securities is regulated. In addition, the Exchange Act[15] imposes on issuers regular reporting requirements on certain forms that must be filed with the SEC. Regulation A, promulgated under the Securities Act, provides an exemption from the Securities Act registration requirements for smaller securities offerings by private (non-SEC reporting) US and Canadian companies. While an offering pursuant to Regulation A involves a filing process, these filings are simpler than registration pursuant to Section 5 of the Securities Act and fewer ongoing filings are required.

Earlier this year, the SEC revised Regulation A to provide for two tiers: (1) Tier 1, for securities offerings of up to $20 million in a twelve-month period (a "Tier 1 Issuer"), and (2) Tier 2, for securities offerings of up to $50 million in a twelve-month period (a "Tier 2 Issuer"). An issuer of $20 million or less of securities can elect to proceed under either Tier 1 or Tier 2. Each Tier 2 Issuer is, with certain exceptions, required to include audited financial statements in their offering documents and to file annual, semiannual, and ongoing current reports with the SEC. In addition, purchasers in an offering by a Tier 2 Issuer must be "accredited investors"[16] or subject to certain limitations on their investments. Tier 1 Issuers are not required to make ongoing filings with the SEC. However, Tier 1 Issuers must provide the SEC with sales information and to provide certain updates to previously disclosed information by filing a Form 1-Z exit report with the Commission not later than thirty days after termination or completion of an offering. In addition, Tier 1 Issuers must also comply with state registration requirements.[17]

The revised Regulation A, commonly referred to as Regulation A+, provides companies with a new framework for avoiding the extensive

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[14] Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78a et seq.
[15] *Id.*
[16] "Accredited Investor" is defined in Rule 501(a) of Regulation D, 17 C.F.R. § 230.501(a), to include: (1) directors, executive officers, and general partners of the issuer; (2) individuals with a net worth in excess of $1 million (excluding such person's primary residence); (3) individuals with income in excess of $200,000 in each of the two most recent years or joint income with that person's spouse in excess of $300,000 in each of those years and having a reasonable expectation of reaching the same income level in the current year; and (4) any entity in which all of the equity owners are accredited investors.
[17] SEC Release Nos. 33-9741, 34-71120, and 39-2493; File No. S7-11-13-Amendments for Small and Additional Issues Exemptions under the Securities Act.

securities registration requirements imposed on companies going public. Smaller companies may now offer and sell up to $50 million of securities in a twelve-month period, subject to eligibility, disclosure, and reporting requirements that are less onerous than the usual public offering requirements of the Securities Act. Prior to its revision, Regulation A was not widely used. The SEC hopes that the revisions to Regulation A will make it more attractive to companies looking to raise capital.

It remains to be seen whether Regulation A will become a widely used mechanism for avoiding the full-blown registration requirements of the Securities Act.[18] On the one hand, for Tier 1 Issuers, investors are not required to be accredited investors, thus increasing the potential investor base. In addition, the disclosure requirements under Regulation A are fewer than the requirements for a full-blown public offering. On the other, raising money pursuant to Regulation A, even for a Tier 1 Issuer, remains a complicated and regulated affair and it is estimated that a Regulation A offering will cost a company upwards of $100,000 or more once you take into account legal and accounting fees.[19] As a result, it may be easier, and cheaper, for companies seeking to raise capital to conduct a private placement to accredited investors pursuant to Rule 506(b) or Rule 506(c) of Regulation D exemptions to the Securities Act registration requirements,[20] even if such private placement results in the issuance of "restricted" securities to the investors.[21]

Changes to Delaware Law

Given the prevalence of companies and corporations organized in Delaware, developments in Delaware law and Delaware case law tend to be closely watched and scrutinized by M&A practitioners.[22] Effective as of August 1, 2015, several amendments were made to the Delaware General

[18] Securities Act, *See* 15 U.S.C.A. §§77a et seq.
[19] Louis Basenese, Crowdfunding Investors Rejoice! (Almost…) (April 8, 2015) Available at: http://www.wallstreetdaily.com/2015/04/08/crowdfunding-regulation-a-plus/ (Last visited Dec. 11, 2015).
[20] See 17 C.F.R. § 230.506(b), (c).
[21] Restricted securities are subject to certain holding periods and may not generally be sold in the open market.
[22] According to the Delaware Department of State, the state of Delaware is the state of formation or incorporation for over one million entities and for more than 60 percent of Fortune 500 companies. *See* http://corplaw.delaware.gov/eng/why_delaware.shtml.

Corporation Law (as amended, the DGCL). Three of these amendments are of importance to M&A practitioners: (1) the ban on fee shifting bylaws, (2) the codification of forum selection provisions, and (3) revisions to stock issuance provisions. Each of these is discussed in turn.

Ban on Fee-Shifting Bylaws

Fee-shifting provisions require that the losing party in a litigation pay the litigation costs, including attorney's fees, incurred by the prevailing party. These types of provisions are uncommon in the United States because of a general concern that such provisions may have a chilling effect on legitimate shareholder litigation. In mid-2014, the Delaware Supreme Court in *ATP Tour, Inc. et al. v. Deutscher Tennis Bund* held that "fee-shifting provisions in a non-stock corporation's bylaws can be valid and enforceable under Delaware law."[23] In the wake of the *ATP Tour* decision, many companies formed in Delaware began amending their bylaws to adopt fee-shifting provisions on the theory that, if fee-shifting provisions were enforceable for non-stock corporations, such provisions would also be enforceable for stock corporations. In response to the Delaware Supreme Court's decision in *ATP Tour*, the 2015 revisions to the DGCL now explicitly provide that neither the certificate of incorporation nor the bylaws of a corporation may contain provisions that "would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim."[24] An "internal corporate claim" refers to any claim for which the DGCL confers jurisdiction on the Delaware courts and claims for breaches of fiduciary duty and of duty of loyalty claims against officers and directors. These are just the types of claims that arise in the litigation related to M&A transactions.

Approval of Forum Selection Provisions

While Delaware corporations may not allocate legal fees, a new provision to the DGCL does codify the increasingly common practice of including

[23] No. 534, 2013 (Del. May 8, 2014). Available at: http://courts.delaware.gov/opinions/download.aspx?ID=205490.
[24] Del. Code Ann. tit. 8, §§102(f), 109(b). Available at: http://delcode.delaware.gov/title8/c001/sc01/index.shtml.

forum selection provisions in bylaws. Specifically, the DGCL permits a corporation to include a provision in its certificate of incorporation or bylaws, which requires that all "internal corporate claims," such as breaches of fiduciary duty and of duty of loyalty claims against officers and directors, be brought exclusively in the courts within the state of Delaware. Furthermore, any provision prohibiting claims from being adjudicated in the courts of the state of Delaware are void.[25]

The combined result of the ban on fee-shifting provisions and the approval of forum selection provisions helps to ensure that Delaware remains the jurisdiction of choice for corporations and, as a result, litigation relating to M&A transactions.

Stock Issuances

Another revision to the DGCL that may affect M&A transactions is revisions to the laws regarding issuance of stock. Delaware law generally permits a corporation's board of directors to authorize the issuance of stock in consideration for cash, property, and/or other benefits to the corporation. The revised Section 152 of the DGCL[26] provides Delaware corporations with even greater flexibility with respect to the consideration received in exchange for stock. Now, a corporation's board of directors, by resolution, may authorize the issuance of stock in one or more transactions and "in such numbers and at such times as are set forth in or determined by or in the manner set forth in the resolution, which may include a determination or action by any person or body." The person or body making the determination is not required to be the board of directors of such corporation so long as the resolutions approved by the corporation's board fixes (i) the maximum number of shares to be issued, (ii) the time period during which such share issuances could occur, and (iii) the minimum consideration for the shares. Such minimum consideration may be determined by the board by reference to a formula which may be dependent of facts not within such formula. The revised Section 152 effectively permits a board of directors to delegate to officers the authority to issue stock. Furthermore, the revised Section 152 clarifies that so-called

[25] Del. Code Ann. tit. 8, § 115 Available at: http://delcode.delaware.gov/title8/c001/sc01/index.shtml.
[26] Del. Code Ann. tit. 8, § 152.

"at-the-market" offerings (an "ATM Offering") are valid. An ATM offering is a type of follow-on offering of stock used by some publicly traded companies to continue capital raising efforts over a period of time. Pursuant to an ATM offering, publicly traded companies sell newly issued shares into the secondary trading market through a select broker-dealer at the then prevailing market prices.

Case Law Affecting M&A Documentation

It is not just changes in Delaware law that affect M&A transactions. M&A practitioners must also keep abreast of Delaware state court decisions. Within the past year, several of these decisions have influenced M&A documentation or remind M&A practitioners of potential pitfalls.

Cigna Health and Life Ins. Co. v. Audax Health Solutions, Inc.

One recent and very instructive case is *Cigna Health and Life Ins. Co. v. Audax Health Solutions, Inc.*[27] The *Cigna Health* case arises out of the acquisition of Audax Health Solutions, Inc. (Audax), then owned in part by Cigna Health and Life Insurance Company (Cigna), by Optum Services, Inc. (Optum) via a merger that was approved by a majority of Audax shareholders but not Cigna. The terms of the merger agreement conditioned receipt of the merger consideration on execution of a letter of transmittal, in form and substance reasonably acceptable to Optum. The form and terms of the letter of transmittal were not included in the merger agreement. The letter of transmittal required stockholders of Audax to (i) release any claims against Audax and Optum, and (ii) to agree to the terms of the merger agreement which, in turn, included provisions requiring the indemnification of Optum by the selling stockholders for any breaches of the representation and warranties in the merger agreement. Despite consummation of the merger, Optum refused to pay the merger consideration to Cigna because Cigna refused to execute the letter of transmittal.

As in *Cigna Health*, it is standard practice to include a release of claims from the selling stockholders in favor of the company being sold. When representing the purchaser, an experienced M&A practitioner will usually

[27] C.A. No. 9405-VCP (Del. Ch. Ct. Nov. 26, 2014). Available at: http://courts.delaware.gov/opinions/download.aspx?ID=215350.

insist on including such a release in the merger or purchase and sale agreement. Furthermore, in transactions involving the acquisition of a private target company, it is also common for the merger or purchase and sale agreement to include so-called "fundamental" representations and warranties such as title, enforceability of the agreement, and corporate authority, which are subject to longer survival periods.[28] A purchaser will usually request (and if the purchaser has enough leverage, obtain) that a portion of the purchase price or consideration paid to the sellers be held in escrow to cover any post-closing indemnification claims relating to breaches of representations or warranties. Such held back consideration is released post-closing after the expiration of a set period of time during which the purchaser may raise claims regarding breaches of representations and warranties.

In *Cigna Health*, the Delaware Court of Chancery held that the merger consideration was a preexisting obligation of Optum arising under the merger agreement and Cigna's right to the merger consideration vested upon consummation of the merger. Therefore, the release of claims set forth in the letter of transmittal was invalid because there was no separate consideration for such release. Furthermore, the Delaware Court of Chancery held that indemnification provisions which (i) were not capped (and instead placed the entire merger consideration at risk), and (ii) were of indefinite duration were unenforceable against selling shareholders who had not executed the merger agreement or ancillary documents for the transaction in question.

Cigna Health reinforces our longstanding practice of including any stockholder releases in the merger agreement itself. When representing the purchaser, an M&A practitioner could also suggest to his client that a portion of the merger consideration be specifically contingent on the affirmative consent by company stockholders to the release of claims. *Cigna Health* also implies that caps on the amount of damages and clearly defined survival periods benefit not just the sellers in an M&A transaction. When representing the purchaser, we suggest that the merger or purchase and sale agreement explicitly state that fundamental representations and warranties survive for a period equal to the statute of limitations and that damages for

[28] Outside of environmental representations and fundamental representations, representations and warranties typically survive the closing of a transaction for a period of one to three years.

indemnity claims be capped at the purchase price.[29] The inclusion of these provisions will help a purchaser ensure that the indemnification provisions in a purchase agreement are enforceable in the event of a dispute. Moreover, indemnification provisions should be complemented with the use of an escrow to ensure that damages may be collected.

In re AbbVie Inc. Stockholder Derivative Litigation

Another interesting case is *In re AbbVie Inc. Stockholder Derivative Litigation*, a case that arose from the spin-off of AbbVie from Abbott Laboratories.[30] Abbott formed AbbVie as a wholly owned subsidiary and transferred to it certain assets and liabilities. In connection with such transfers, Abbott and AbbVie provided each other with mutual releases. At that time, Abbott was a defendant in a lawsuit relating to the transferred assets and liabilities. Thereafter, Abbott distributed 100 percent of the stock of AbbVie to its stockholders. Plaintiffs in *In re AbbVie* were AbbVie shareholders who sought to invalidate the releases to permit AbbVie to bring claims against Abbott's directors. Such plaintiff stockholders alleged that Abbott's directors were improperly conflicted when approving the release, because the release prohibited AbbVie from bringing a cause of action against Abbott or its directors. The Delaware Court of Chancery found that the plaintiff stockholders did not have standing to sue because they were not stockholders of AbbVie at the time the releases were executed. In its decision, the court characterized the mutual release in the context of a spin-off transaction as a method "via which the two entities ensured their full legal separation, free of entanglement."[31] The court's decision confirmed that the commonplace use of mutual releases in the context of spin-off transactions is enforceable and desirable.

Lazard Technology Partners LLC v. Qinetiq North America Operations LLC

In *Lazard Technology Partners LLC v. Qinetiq North America Operations LLC*, a dispute arose with respect to a merger agreement that provided for earnout payments to the former stockholders of the acquired company in the event that the acquired company met certain revenue targets. The merger

[29] Each state has its own statute of limitations. Delaware has a three-year statute of limitations whereas New York has a six-year statute of limitations.
[30] 2015 WL 4464505, C.A. No. 9983-VCG (Del. Ch. July 21, 2015).
[31] 2015 WL 4464505, at *6.

agreement also contained a provision prohibiting the purchaser from "taking any action to divert or defer [revenue] with the intent of reducing or limiting the earnout payment." When the acquired company failed to meet the revenue targets, the former stockholders brought suit against the purchaser of the acquired company, alleging that the purchaser breached the above referenced covenant as well as the merger agreement's covenant of good faith and fair dealing. The court interpreted the covenant to only bar the purchaser from taking steps that were "specifically motivated by a desire to avoid the earn-out." The covenant specifically stated the requirements for the earnout provisions but left the purchaser free to direct the business of the acquired company after the closing so long as the purchaser did not purposefully act to reduce or limit the earnout payment. The plaintiff's sellers could not rely on the implied covenant of good faith and fair dealing for protection.[32]

The court's decision in *Lazard* reinforces its decision a few weeks earlier in *Nationwide Emerging Managers, LLC v. Northpointe Holdings, LLC*, where the court noted: "When a buyer and seller negotiate a detailed contract, Delaware law requires that the contract's express terms be honored, and prevents a party who has after-the-fact regrets from using the implied covenant of good faith and fair dealing to obtain in court what it could not get at the bargaining table."[33]

The decision in *Lazard* highlights the importance of careful drafting and negotiation. Once an M&A agreement is signed parties to a transaction will have a tough time relying on anything other than the four corners of the contract. Sellers who are entitled to earnout payments should not simply rely on the implied covenant of good faith to impose obligations on the purchaser. Especially in the context of an M&A transaction where a seller is entitled to earnout payments, thought should be given to how best to ensure that the purchaser will not game the system to avoid additional payouts to the seller. A seller should not trust that the purchaser will act in good faith and should instead negotiate to ensure that any necessary protections are included in the transaction documents.

[32] *Lazard Technology Partners, LLC v. Qinetiq North America Operations LLC,* 114 A.3d 193 (Del. 2015). Also available at: http://courts.delaware.gov/opinions/download.aspx?ID=222690.

[33] *Nationwide Emerging Managers, LLC v. Northpointe Holdings, LLC,* 112 A.3d 878 (Del. 2015).

Halpin v. Riverstone Nat'l, Inc.

We also note interesting dicta relating to appraisal rights in the *Halpin v. Riverstone Nat'l, Inc.* case.[34] In *Halpin*, minority common stockholders sought to exercise their appraisal rights after the consummation of a squeeze-out merger approved by a controlling stockholder that owned 91 percent of a corporation's stock. The corporation's stockholders had previously executed a stockholder's agreement that contained a customary drag-along right permitting the controlling stockholder to cause the minority stockholders to agree to a change of control transaction approved by such controlling stockholder. In this case, the controlling stockholder failed to properly exercise its drag-along rights and, therefore, the court declined to enforce the drag-along provision. It is interesting to note that, while the court acknowledged that Delaware courts had not addressed whether common stockholders can, by contract, waive their statutory appraisal rights in a squeeze-out merger of a corporation, for purposes of the court's decision, the court assumed that a common stockholder could waive its appraisal rights. Furthermore, the court's decision emphasizes the importance of reviewing and properly following the provision of a stockholder's agreement in connection with an M&A transaction. In fact, the backbone of any successful M&A transaction is careful and thorough due diligence. Due diligence will inform not just the transaction steps and closing conditions but also the substance and scope of your representations and warranties.

Fox v. CDX Holdings, Inc.

In another recent Delaware case, *Fox v. CDX Holdings, Inc.*, the Delaware Court of Chancery clarified the interaction between a merger agreement and a stock option plan.[35] The suit in question was the result of a class action by stock option holders in a target company whose stock options were cancelled and cashed out. The merger plan contemplated that the stock option holders would receive a considerably lower amount of consideration than was contemplated in the stock option plan governing the cancelled stock options. The court held that the relationship between a company and its option holders is a contractual relationship governed by the stock option plan for such options and not Delaware's merger statutes.

[34] 2015 WL 854724, C.A. No. 9796-VCG (Del. Ch. Feb. 26, 2015).
[35] *Fox v. CDX Holdings, Inc.*, 2015 WL 4571398 (Del. Ch. 2015).

In the context of an M&A transaction, the company must look to its stock option plan documentation, which will dictate how such stock options will be addressed in the context of a merger.

M&A practitioners should carefully review any stock option and incentive plans of a target company. If the underlying stock option plan of the target provides for treatment of issued stock options that is different from the treatment contemplated by the merger agreement, prior to consummating the merger, the target company will need to amend its stock option plan to ensure that the stock option plan and the merger plan provide for the identical treatment of issued stock options in the context of a merger.

From a broader perspective, *Fox* serves as a warning to the parties of any M&A transaction that in any circumstance where the transaction documents bind other parties that are not signatories to such documents, great care must be taken to ensure not just compliance with the law but also compliance with the contractual obligations of a target company.

A Focus on Legal Negotiations and M&A Documentation

The holdings in *Lazard*, *Halpin*, and *Fox* reinforce the importance of thorough due diligence, skillful negotiation, and careful drafting. In the paragraphs below, we focus on three of the more heavily negotiated M&A document sections from the perspective of an M&A practitioner. Note that, given the length of this chapter, our review of these M&A deal provisions is necessarily incomplete.

Representations and Warranties and Related Due Diligence

Every M&A transaction should begin with carefully conducted due diligence. Due diligence refers to a series of exercises conducted to (1) uncover information material to the transaction, (2) evaluate the merits and pitfalls of a transaction, and (3) limit liability. Diligence conducted by a purchaser or acquirer enables such purchaser to understand the business of the target company and identify any material concerns that must be addressed in the M&A documentation and in continuing to operate the business.

Once diligence is concluded, M&A counsel will draft representations and warranties. Representations are statements of facts existing at the time the purchase agreement is executed (and, usually, on the date of closing of the transaction). A warranty is an undertaking that a certain fact in relation to the subject of the agreement is or shall be as it is described in such agreement. Representations and warranties serve as an inducement for the purchaser and seller(s) to enter into an agreement and allocate risk between the purchaser and seller(s). Furthermore, it is these representations and warranties that serve as the underpinning for indemnification claims in the case of a breach or inaccuracy.

Generally, in M&A transactions, it is the sellers and the target company that make the bulk of all representations and warranties because those representations and warranties will permit the purchaser to know material facts with respect to the target company's operations. If a representation or warranty is inaccurate, the non-breaching party may have a right to sue for damages. For these reasons, when representing the purchaser, in addition to deal specific representations and warranties, we attempt to include unqualified catch-all representations from the seller and/or target company such as (i) representations with respect to no undisclosed liabilities other than those reflected in the financials provided, (ii) compliance with applicable laws, (iii) no material misrepresentations, and (iv) full disclosure representations.[36] To bolster representations and warranties, we also usually include a covenant requiring the seller to notify the purchaser in the event of a breach of any representation, warranty, or covenant prior to the consummation of the M&A transaction.

Because the seller(s) and target company make the bulk of representations and warranties in an agreement, it is in the best interests of these parties to limit the scope of representations and warranties. For these reasons, when representing a seller, we include a statement to the effect that there are no other representations or warranties made by the seller other than those set forth in the purchase or merger agreement and that the purchaser has not relied on any matters other than those covered by the representations and warranties. It is also to the benefit of the seller if the representations and warranties made by the seller are limited by knowledge and materiality qualifiers. A knowledge qualifier limits a representation or warranty to what is known by the party making such representation or warranty. Parties usually

[36] Representations with respect to misrepresentations are commonly referred to as 10b-5 representations.

further negotiate "knowledge" by determining whether actual or constructive knowledge is in question, which individual persons' knowledge matters and whether there is an obligation on these persons to inquire and become informed. In the context of private M&A transactions, knowledge is increasingly limited to a list of specific individuals with actual or constructive knowledge of the fact set forth in a representation or warranty. A materiality qualifier usually either limits the representation and warranty by material compliance or limits breaches of a representation or warranty only to those matters that have a material effect on the target company or transaction.

Furthermore, when representing the target company or seller, we usually attempt to include an anti-sandbagging provision. This provision generally provides that the seller will not be liable for damages arising out of any breach that the purchaser was aware of (or should have been aware of) prior to closing (as a result of the materials and information provided to the purchaser in connection with the purchaser's due diligence). In contrast, when representing the purchaser or acquirer, we attempt to include a pro-sandbagging provision which provides that the purchaser's right to indemnification or to seek another remedy for a breach of a representation or warranty is not affected by any actual (or constructive) knowledge of the purchaser obtained before or after the execution of the transaction agreement. We note, however, that the inclusion of sandbagging provisions in agreements is a heavily negotiated matter. As a result, more and more agreements are now silent with respect to the matter.[37]

Another important point in M&A negotiations is the applicable survival period for representations and warranties. Survival is the length of time following the closing during which (i) the seller is responsible for providing

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[37] *See* American Bar Association, 2013 Private Target Deal Points Study. Available at: http://www.americanbar.org/groups/business_law/news/2015/01/m_a_deal_points_stud.html-91k (Last visited Dec. 11, 2015).
Where a merger or purchase and sale agreement is silent with respect to sandbagging, state law will determine whether a purchaser may sandbag the seller. In New York, generally, the courts have held that "where a buyer closes on a contract in the full knowledge and acceptance of facts disclosed by the seller which would constitute a breach of warranty under the terms of the contract, the buyer should be foreclosed from later asserting the breach." See *Galli v.Metz*, 973 F.2d 145 (2d Cir. 1992). Notwithstanding the foregoing, this should not be taken as a hard and fast rule; the results of cases relating to sandbagging vary depending on the knowledge of the purchaser and when such knowledge was acquired.

indemnification to the purchaser, or (ii) the purchaser is responsible for providing indemnification to the seller. Representations and warranties and indemnification rights relating to breaches thereof should survive for a period of time sufficient for problems to be discovered. In a transaction involving non-publicly traded companies, tax, environmental and fundamental representations usually survive indefinitely or until the statute of limitations. However, representations and warranties (other than tax, fundamental, and environmental representations and warranties) usually survive for the benefit of the purchaser for a period of one to three years. On average, purchasers and sellers usually agree that representations and warranties should have a survival period of around eighteen months.[38]

Financial Provisions

Other heavily negotiated provisions in M&A documentation are the financial provisions affecting the total consideration exchanged between the purchaser and the seller: (i) post-closing purchase price adjustments, and (ii) earnouts.

Post-Closing Purchase Price Adjustments

Though not always present in transaction documents, in recent years, a majority of M&A documentation we prepared included a post-closing purchase price adjustment for the transaction purchase price.[39] Usually, the purpose of the adjustment is to permit the parties to reflect differences between the estimated and actual working capital of a target company. Purchase price adjustments may also be used to address indemnification claims, earnings, and other financial variables. Generally, we are seeing increased creativity in the use of post-closing adjustments. In certain instances, parties are agreeing to a threshold difference amount before an adjustment to the purchase price is required, thus saving parties from arguing over *de minimis* amounts post-closing. Also, in cases where the adjustment is in favor of the purchaser, we are seeing provisions permitting the purchaser to recoup the adjustment amount from funds held in escrow

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[38] *See* 2014 SRS/Acquion M&A Deal Terms Study. Available at: http://cdn.srsacquiom.com/wp-content/uploads/2014-SRSAcquiom-MA-Deal-Terms-Study.pdf (Last visited Dec. 7, 2015).

[39] For similar conclusions, *see* 2014 SRS/Acquion M&A Deal Terms Study. Available at: http://cdn.srsacquiom.com/wp-content/uploads/2014-SRSAcquiom-MA-Deal-Terms-Study.pdf (Last visited Dec. 7, 2015).

for the satisfaction of indemnity claims. This gives the purchaser access to readily available funds and prevents the seller from having to make out-of-pocket payments.

Earnouts

In the context of an M&A transaction, an earnout usually consists of a right of the seller to additional payments that are contingent on the future performance of the target company. While earnouts are not present in a majority of M&A transactions,[40] when a transaction does include an earnout as part of the consideration, great care should be taken in drafting the relevant provisions to ensure clarity relating to performance metrics and targets, payment calculations, and the measurement process for such earnouts.[41] While earnouts may be calculated based on a variety of metrics such as EBITDA or net income, most often, parties to a transaction agree to calculate earnings based on revenue.[42] Earnouts usually provide for contingent payments for several years after closing. The average length of an earnout period is between two and three years. From the seller's perspective, an earnout represents an increase in the purchase price, which is paid over time. From the purchaser's perspective, the earnout permits the purchaser to defer a portion of the purchase price, aligns the interests of the sellers and purchaser with respect to the future success of the acquired business, and protects the purchaser from overpaying in the event the business is not as successful as expected.

We note that, in representing a seller who is entitled to an earnout, an M&A practitioner should attempt to include in the agreement: (i) covenants requiring the purchaser to run the acquired business in accordance with past practices and run the acquired business in a manner that will maximize earnout payments, and (ii) provisions causing an acceleration of such earnout payments in the event the acquired business is sold or undergoes a change of control after the initial sale. From the purchaser's perspective, it is best to avoid any covenant instructing the purchaser as to how to manage

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[40] Note that earnouts are more prevalent in biopharmaceutical deals and in deals where sellers remain as employees of, or service providers to, the acquired company.

[41] According to the 2013 Private Target M&A Deal Points Study, only about a quarter of deals involved the payment of earnout consideration. *Supra* at note 37.

[42] *Supra* at note 37.

the business and affairs of the acquired company. Also, it is helpful to the purchaser to be able to offset damages from indemnification claims against future earnout payments.

Indemnification

Indemnification provisions afford each party with a post-closing, contractual monetary remedy in the event that such party suffers damages due to specified categories of indemnified events such as (i) breaches of representations and warranties by the seller or the purchaser; (ii) breach of covenants by the seller or the purchaser; (iii) failure of the seller to discharge specified liabilities (i.e., taxes and product liability) or of the purchaser to discharge assumed liabilities; and (iv) damages arising from the past or future conduct of the business by the other party. In the event that a purchase agreement does not contain an indemnification provision, a party that suffers damages may assert claims under other provisions of the merger or purchase agreement for breach of covenant or misrepresentation, claims for common law fraud, claims for violations of antifraud provisions of securities laws (not available for asset purchase), and claims for rescission and restitution (which may not be available if restoring parties to pre-closing status is not feasible due to changes in the business that have been implemented). It is becoming standard practice, however, for the indemnification provision to be the exclusive remedy for breaches of the terms and provisions of an M&A agreement other than for fraud or equitable relief.[43]

Oftentimes, much of the time involved in negotiating M&A documentation is allocated to negotiations with respect to the scope of indemnities, with the purchaser's counsel looking for a more expansive indemnification and the seller's counsel attempting to limit the scope of the indemnity and the parties providing the indemnity. In stock transactions, it may be appropriate to subject different selling stockholders to different levels of indemnification responsibility. In asset transactions, it may be appropriate to insist on an indemnity from the parent entity, as well as from the entity selling the assets. Note, however, that relying on selling stockholders who

[43] The 2014 SRS/Acquion M&A Deal Terms Study shows that only 1 percent of deals in the subset of deals reviewed provided that indemnity was not the exclusive remedy in the event of a breach. *See supra* at note 38.

are part of management and will be key employees of the continuing business to provide indemnities may not provide realistic protection for a purchaser. If a purchase agreement provides for more than one indemnitor, parties must also negotiate whether the indemnitors will be subject to joint and several liability or several but not joint liability. Joint and several liability makes each of the sellers liable for the entire indemnified loss suffered by the purchaser regardless of such seller's degree of fault. Accordingly, counsel for the sellers should vehemently oppose the imposition of joint and several liability.

The scope of indemnification may also be affected by the presence of a materiality scrape. A materiality scrape is a provision which states that, for purposes of indemnification, materiality qualifiers will not be taken into account when determining whether a representation, warranty, or covenant has been breached. According to the 2013 Private Target M&A Deal Points Study published by the American Bar Association, only 28 percent of all deals analyzed contained a materiality scrape.[44] Seller's counsel should oppose the inclusion of a materiality scrape in the purchase and sale or merger agreement. At the very least, the application of the materiality scrape should be limited to the calculation of damages arising out of an indemnifiable breach so that the materiality scrape does not affect the determination of whether there is a breach.

Other limitations on indemnification provisions are caps and baskets. A cap is a maximum amount of damages or losses an indemnitor, usually the seller, may be obligated to pay the party seeking indemnification, usually the purchaser. Caps are generally below the purchase price and are based on a percentage of the purchase price, usually between 10 percent and 15 percent, but we often assist purchasers to negotiate much higher caps.[45] We note that, generally, fraud, negligence, and "knowledge" prior to closing are generally not subject to the cap. When amounts are held in escrow for the satisfaction of indemnification claims, we often see that such escrow will be equal to the cap.[46] A basket is a minimum amount of damages or losses that must be exceeded before an indemnitor is obligated to pay the party seeking

[44] Supra at note 38.
[45] According to one recent study, the average cap was 12.9 percent of the transaction value. *See Supra* at note 32.
[46] *Id.*

indemnification. Baskets protect sellers from small and nuisance claims. Baskets may be limited to certain categories of claims and structured in a few ways, but deductible and tipping baskets are the two most common types of baskets. With a deductible basket, the seller is only responsible for damages exceeding a threshold amount. For example, with a deductible basket of $1,000, if a claim of $1,500 is made then the seller must pay $500. On the other hand, with a tipping basket, the seller is responsible for all damages once the damages reach a threshold amount. For example, with a tipping basket of $1,000, if a claim of $1,500 is made, then the seller must pay $1,500. For M&A transactions that include an indemnity basket, the basket is usually less than 2 percent of the purchase price.[47]

Finally, indemnification provisions may be modified to take into account tax effects, insurance proceeds, and mitigation of damages. The majority of M&A transaction documentation includes provisions requiring that the amount of indemnifiable loss be reduced to take into account insurance recoveries received (or receivable) by the purchaser. An M&A practitioner representing the purchaser may also request that the indemnification payment be increased to include an additional amount to offset any taxes the purchaser will be required to pay as a result of the seller's indemnity payment. On the other hand, an M&A practitioner representing the seller should also consider (i) including a provision requiring the amount of indemnifiable loss to be reduced by any benefits to the purchaser in the form of tax deductions resulting from the indemnifiable loss; (ii) excluding consequential or punitive damages; (iii) including an obligation on the parties to mitigate losses; and (iv) including a contributory negligence provision, which insulates the indemnifying party from liability to the extent loss was attributable to gross negligence or willful misconduct of the indemnified party.

When representing the purchaser, serious thought should be given as to how indemnifiable losses will be paid. Usually, the parties agree to escrow a portion of the purchase price. The escrowed portion of the purchase price is held by a third party. Sellers generally try to limit escrows because it

[47] According to the 2013 Private Target M&A Deal Points Study, 56 percent of all deals had an indemnity basket equal to .5 percent or less of the transaction value, 32 percent of all deals had an indemnity basket greater than .5 percent but less than 1 percent of transaction value, 11 percent of all deals had an indemnity basket equal to more than 1 percent but less than 2 percent of transaction value, and 1 percent of all deals had an indemnity basket equal to more than 2 percent of transaction value. *Supra* at Note 31.

delays their receipt of proceeds and because escrows are a readily available and attractive target for purchasers. We note, however, that an escrow is more favorable to a seller than a holdback. When there is a holdback, the purchaser retains a portion of the purchase price to cover claims. After a set period of time has elapsed, the purchaser then pays out any remaining purchase price in excess of amounts claimed by the purchaser. When a portion of the transaction consideration consists of an earnout or seller note, another option is to permit the purchaser to set off amounts owed against such earnout or seller note.

Conclusion

In striving to best serve our clients, experienced M&A practitioners understand the value of remaining informed about market and M&A trends, legal developments, and recent case law. Only by remaining informed about the marketplace, recent legal developments and decisions, and being knowledgeable about M&A documentation will we be able to ensure favorable outcomes for our clients. As we now know, 2015 was a great year for M&A deals. While we do not expect a second blockbuster year, 2016 should bring a healthy mix of M&A transactions in the United States including not just mega deals, but also middle market M&As. That transactional size mix should be accompanied by increasing deal structure variety and increased use of stock consideration.

Regardless of the level of M&A activity, recent case law has especially focused our attention on the need for careful drafting, especially with respect to representations and warranties, financial provisions and indemnification provisions, as well as on the importance of performing detailed due diligence prior to drafting M&A documentation. M&A practitioners must meticulously examine the target company's contracts and existing rights and obligations and ensure that transaction documents contain all deal protections necessary to address any concerns or matters raised in the diligence process. Only then will we be able to minimize M&A transaction risks.

Key Takeaways

- Keep abreast of current events and US and world economics to best serve your M&A clients. Also, continue to educate yourself and be informed of recent legal developments, including Delaware state court decisions.

- Include any stockholder releases in the merger agreement itself. When representing the purchaser, suggest to your client that a portion of the merger consideration be specifically contingent on the affirmative consent by company stockholders to the release of claims. When representing the purchaser, ensure that the merger or purchase and sale agreement explicitly state that fundamental representations and warranties survive for a period equal to the statute of limitations and that damages for indemnity claims be capped at the purchase price.
- Careful drafting and negotiation of an M&A agreement is of the utmost importance. Sellers who are entitled to earnout payments should not simply rely on the implied covenant of good faith to impose obligations on the purchaser. Thought should be given to how best to ensure that the purchaser will not game the system to avoid earnout payments to the seller.
- The backbone of any successful M&A transaction is careful and thorough due diligence. Due diligence will inform not just the transaction steps and closing conditions but also the substance and scope of your representations and warranties.
- Carefully review any stock option and incentive plans of a target company. If the underlying stock option plan of the target provides for treatment of issued stock options that is different from the treatment contemplated by the merger agreement, prior to consummating the merger, the target company will need to amend its stock option plan to ensure that the stock option plan and the merger plan provide for the identical treatment of issued stock options in the context of a merger.
- In any circumstance where the M&A transaction documents bind other parties that are not signatories to such documents, great care must be taken to ensure compliance with the law but also compliance with any contractual obligations of a target company to such other parties.
- When representing the purchaser, avoid any covenant instructing the purchaser as to how to manage the business and affairs of the acquired company after the closing. Also, it is helpful to the purchaser to be able to offset damages from indemnification claims against future earnout payments.

- Meticulously examine the target company's contracts and existing rights and obligations and ensure that transaction documents contain all deal protections necessary to address any concerns or matters raised in the diligence process.

Irwin A. Kishner is the chairman of Herrick, Feinstein LLP's Executive Committee and a member of the firm's Corporate Department. He is also the past chair of the firm's Corporate Department, a role in which he served from January 1998 to January 2014.

Mr. Kishner concentrates his practice in general corporation law with an emphasis on sophisticated transactional work, including mergers and acquisitions, sports law, private equity, securities law, corporate restructurings and reorganizations, new media law, venture capital, joint venture, entertainment law, corporate finance and lending, intellectual property and licensing, employment law, equity and debt offerings, and syndications in both the public and private context.

Mr. Kishner has handled numerous mergers and acquisitions, both hostile and friendly, on behalf of acquirers, targets, and investment banks. The range of transactions includes proxy contests, joint ventures, self-tender offers, third party and spin-offs, taking public companies private, and other forms of corporate restructurings. Mr. Kishner's practice also includes advising financial institutions on regulatory issues and on derivatives and other financial instruments, as well as representation of private equity and venture capital funds and investors in fund formation (onshore and offshore), acquisitions, and sales of portfolio companies. He has successfully structured, negotiated, supervised, and closed many financing and capital raising transactions, including private placements, initial public offerings, PIPEs, hedge fund convertible security investments, secured and mezzanine loan facilities, project finance, workouts, reorganizations, equity and debt restructurings, and negotiation of intercreditor relationships. Mr. Kishner has also represented clients in a number of high-profile senior executive employment and severance agreements and compensation packages as well as numerous corporations in the administration and establishment of employee compensation plans. Corporate boards and audit and special committees also turn to Mr. Kishner for advice on such matters as corporate governance and corporate restructurings.

Mr. Kishner represents a number of professional sports franchises and has acted as primary counsel on several high-profile team acquisitions and dispositions in all of the major sports leagues; cable television and radio contracts; Internet and intellectual property rights; joint ventures; credit facilities; advertising and sponsorship contracts; development and naming *rights agreements; franchise transfers and financings; major event and tournament promotions; and seat license agreements for stadiums and arenas. He has acted as lead counsel in all aspects of eleven major stadium transactions, most significantly the new Yankee Stadium, and also represents financial institutions and bond insurers in stadium finance matters and loans to teams and team owners.*

Mr. Kishner's experience includes representation of the New York Yankees in their joint venture effort with Manchester City to create Major League Soccer's New York City Football Club (NYCFC), and the continuing representation of the Club across a range of transactions. He recently advised Legends Hospitality in the deal to develop and operate the observation deck at the top of One World Trade Center, and was lead counsel to the New York Yankees and Yankee Global Enterprises in News Corp's 2012 acquisition of 49 percent of the Yankees Entertainment and Sports Network (YES), and 21st Century Fox's ensuing 2014 acquisition, which raised its ownership stake in YES to 80 percent.

Mr. Kishner advises clients in transactions throughout North America, South America, Europe (including Eastern Europe), and Asia. His clients are involved in a wide range of industries including sports, e-commerce, real estate, engineering, entertainment, manufacturing, franchise, retail, distribution, consumer products, natural resources, consulting, health care, and other service businesses.

Mr. Kishner frequently lectures, and appears on television and radio, on such topics as M&A, private equity, venture capital, sports financing, structured premium finance and life settlements transactions, and executive compensation, among others. Before joining Herrick, Mr. Kishner was an associate in Shearman & Sterling's mergers and acquisitions department where he participated in several high-profile hostile tender offers and numerous public and privately negotiated divestitures and acquisitions.

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