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Indemnification: Trends and Hot Topics

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Today's Presenters

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Indemnification: Trends and Hot Topics ⁵ Agenda

- Impact of Buyer's Market on Indemnification Provisions
- Reassessing Common Provisions Favorable to Sellers
- Purchase Price Adjustments and Double-Dipping
- Trends and Pitfalls in Dispute Resolution
- Evaluating Creditworthiness of Indemnitors
- Recent Case Law Regarding Indemnification Provisions

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Indemnification: Trends and Hot Topics ⁶

Impact of Buyer's Market

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Impact of Buyer's Market Materiality Scrapes

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- Definition of "Materiality Scrape"
- The inclusion of materiality scrapes has risen with the emergence of a buyer's market
 - According to a 2007 ABA Study (reflecting 2006 data), materiality scrapes were included in 22% of 143 transactions analyzed*
 - This trend is expected to continue in the current buyer-friendly environment
- Sellers could use the presence of materiality scrapes to negotiate for other provisions, including higher baskets and true deductibles
- Materiality scrapes provide an incentive for sellers to list all items or include a "catch-all" provision in the disclosure schedules

*Source: 2007 Private Target Mergers & Acquisitions Deal Points Study

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Impact of Buyer's Market Materiality Scrapes (cont'd.)

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Alternatives to Materiality Scrapes:

- Use dollar thresholds to determine whether immaterial matters constitute a breach
 - This provides certainty, but also invites arbitrariness
- Use materiality to determine whether a breach has occurred, but disregard when calculating damages
- Use materiality to calculate damages, but not to determine whether a breach has occurred
- Include materiality scrapes only on certain agreed-upon representations

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Impact of Buyer's Market Survival Periods

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- Survival periods are expected to increase in the current buyer's market
 - By 2007, typical survival periods had decreased from 24 months to 18 months*
 - Some survival periods lasted only one audit cycle
 - In 2008 and 2009, the market average is expected to be at or above 24 months

*Source: M&A Deal Term Trends for 2008/2009, Near Earth LLC

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Impact of Buyer's Market Survival Periods (cont'd.)

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- Recent cases have illustrated the importance of clear survival period provisions
- A survival period *must be explicit* and is to be *construed against* the party invoking the provision (*Western Filter* (9th Cir. 2008))
 - The 9th Cir. found the provision to be ambiguous and to only limit the time period for which a breach could occur or be discovered
 - The court found that the provision did not serve as a contractual statute of limitations

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Impact of Buyer's Market Survival Periods (cont'd.)

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- An indemnity claim is not ripe until underlying liability has been established (*LaPoint v. AmerisourceBergan; Millsboro v. Construction Management* (Del. Super Ct. 2009))
 - Seller that had prevailed on claim for breach of a merger agreement had a right to subsequently bring a claim for attorneys' fees related to the prior claim
 - Statute of Limitations for indemnification claims do not begin to accrue until there is a final determination establishing liability

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Impact of Buyer's Market Survival Periods (cont'd.)

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- Important to clarify when statute of limitations begins to run (*Schrader-Bridgeport v. ArvinMeritor* (W. Dist. N.C. 2008))
 - Indemnification provision in purchase agreement was ambiguous as to whether the statute of limitations for environmental remediation began to run on the Closing Date or each time funds were spent for environmental remediation

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Impact of Buyer's Market Baskets

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- Basket amounts are decreasing
 - As of early 2008, the mean basket was approximately 0.8% of the Purchase Price*
- More first-dollar baskets instead of deductible baskets
- Buyers may also request:
 - Baskets that only relate to breaches of reps and warranties, and not to specific indemnity provisions
 - Materiality scrapes related to the basket
 - The inclusion of carve-outs in the basket, in addition to capitalization, due organization, due authority, and ownership of shares

*Source: Houlihan Lokey Purchase Agreement Study, July 2008

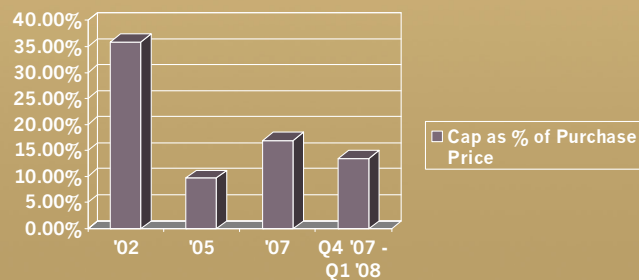
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Impact of Buyer's Market Caps

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- Caps are expected to increase
 - From 2002-2008, the average cap was 15.7% of the purchase price, and only 2% had a cap of 100% of the purchase price
 - However, in Q4 2007 to Q1 2008, just before the current recessionary climate, the average cap was 13.9% of the purchase price*



*Source: Houlihan Lokey Purchase Agreement Study, July 2008

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Impact of Buyer's Market Caps (cont'd.)

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- If cap is less than 100% of purchase price, buyer may push to include carve-outs:
 - For Seller's breach of covenant
 - For specific indemnity provisions
 - For certain reps and warranties
 - Similar to carve-outs for survival periods

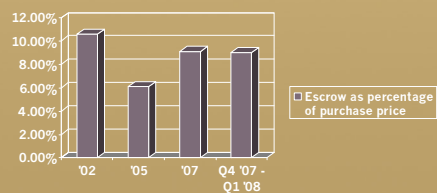
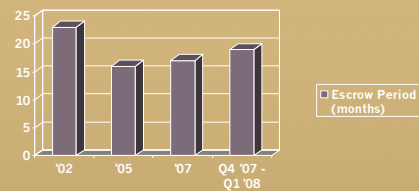
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Impact of Buyer's Market Escrow

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- Buyers are once again increasingly pushing for an escrow or holdback to support indemnity claims
- From 2002-2008, the average escrow period was 18 months and the average escrow amount was 8.1% of the purchase price*



* Source: Houlihan Lokey Purchase Agreement Study, July 2008

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Impact of Buyer's Market Closing Deals Without Credit

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- Important to understand how indemnification provisions are affected by new terms and structures used to get deals done in tight credit markets
- Some currently used terms and structures include:
 - Post-Closing purchase price payments; Earnouts; Simultaneous Acquisitions; and Payments in Kind

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Impact of Buyer's Market Closing Deals Without Credit (cont'd.)

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- Post-Closing Purchase Price Payments
 - How does the delay affect the survival clause?
- Earnouts
 - Increased risk of litigation or arbitration
- Simultaneous Acquisitions
 - Structure cap and baskets as first-come, first-serve or pro-rata based on purchase price?
- Payments in Kind
 - Two-party indemnification for swapped assets or stock

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Indemnification: Trends and Hot Topics

Reassessing Provisions Regarded as Seller-Friendly

Reassessing Common Provisions Consequential Damages

- Boilerplate provisions commonly exclude more than consequential damages
 - Often exclude: Consequential, Incidental, Indirect, Special, Punitive Damages, Loss of Revenue/Income/Profits

Reassessing Common Provisions Consequential Damages (cont'd.)

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- Consequential damages:
 - Compensate the buyer for real loses resulting from seller's breach of a representation or warranty
- Incidental damages:
 - Include expenses incurred by non-breaching party to avoid other losses caused by the breach

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Reassessing Common Provisions Consequential Damages (cont'd.)

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- Incidental damages likely include out-of-pocket expenses incurred by buyers to remedy problems resulting from Seller's breach
- Thus, Buyers should seek to exclude incidental damages from waiver provisions, although they are commonly excluded in boilerplate provisions

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Reassessing Common Provisions Fraud Exclusion

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- Contractual survival periods of representations and warranties generally apply only to contractual rights
- Fraud & Misrepresentation claims are based in tort law – thus often not subject to survival period

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Reassessing Common Provisions Fraud Exclusion (cont'd.)

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- Not all states allow parties to limit their liability for tort-based claims such as fraud and misrepresentation (*Cerabio LLC v. Wright Med. Tech Inc. (7th Cir. 2005)*)
- Certain types of tort claims may not be excluded: (*DynCorp v. GTE Corp. (S.D.N.Y. 2002)*)
 - When a Seller has ‘peculiar’ knowledge that could not be discovered by Buyer
 - When a Seller denies existence of information requested by Buyer

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Indemnification: Trends and Hot Topics

Purchase Price Adjustment and Double-Dipping

Purchase Price Adjustment and Double-Dipping

- *Brim Holding Co. v. Province* (Tenn. 2008)
 - Stock purchaser entitled to reimbursement for payment of claim specifically included in indemnification clause, *even though* purchaser had already received compensation for such claim as part of a post-closing working capital adjustment
- *Finnerty v. Radio Shack* (Mich. 2008)
 - Magistrate imposed successor liability on asset purchaser for excluded claim, noting that buyer could have protected itself by paying a lower purchase price (reversed by District Court)

Indemnification: Trends and Hot Topics

Trends and Pitfalls in Dispute Resolution

Trends and Pitfalls in Dispute Resolution

Market Observations

- Fewer deals
- Increased focus on contract details
- More robust dialogue/documentation regarding accounting & financial reporting issues
- More robust evaluation of business post-closing
- Increased appetite to dispute post-closing issues

Trends and Pitfalls in Dispute Resolution

- Interplay between Indemnification, Representation & Warranty and other clauses
- Purchase Price Adjustment Clauses
 - Net Asset Adjustments
 - Working Capital Adjustments
- Earn-out Clauses

Trends and Pitfalls in Dispute Resolution

- Relevant example clauses:
- Purchase price adjustment based upon changes in working capital
- Representation & Warranties
 - Financial statements (true, correct, complete, GAAP, etc.)
 - Undisclosed liabilities
 - Material adverse change/effect
- Example – vacation liability not accrued

Trends and Pitfalls in Dispute Resolution

- Were the financial statements subject to the reps and warranties correct?
- Was this liability disclosed?
- What is the economic impact, if any?
- How does the indemnification clause interact with the working capital adjustment clause?

Trends and Pitfalls in Dispute Resolution

- Can a buyer effectively collect twice?
 - Working capital adjustment
 - Indemnification
 - Dollar for dollar v. multiple
 - Material adverse change

Trends and Pitfalls in Dispute Resolution

- What are the typical dispute resolution mechanisms?
 - Litigation/arbitration (indemnification)
 - Neutral accountant (working capital adjustment, earn-outs)

Trends and Pitfalls in Dispute Resolution

- Dispute process seldom defined in agreements
- Legal vs. accounting issues
 - Multiple proceedings may exist
- Arbitrator selection issues
- Arbitration procedural issues

Trends and Pitfalls in Dispute Resolution

■ Arbitrator selection issues

- Firm conflicts
- Individual conflicts
- Industry experience
- Functional expertise
- Prior neutral experience

Trends and Pitfalls in Dispute Resolution

■ Arbitration procedural issues

- Timing v. agreement expectations
- Discovery (typically not well defined)
- Submission of briefs
 - simultaneous
 - staggered
- Interrogatories/arbitrator questions
- Hearing
- Decision letter format

Indemnification: Trends and Hot Topics

Evaluating and Addressing Creditworthiness of Indemnitors

Creditworthiness of Indemnitors

- Importance of Escrow or Set-off Rights
 - Buyer's indemnification claims are *unsecured claims*
 - This has heightened relevance if seller files for bankruptcy post closing
 - Escrow
 - Portion of purchase price may be placed in escrow
 - 2007 – Q1 2008, the average escrow was 9% of the purchase price*
 - Procedures for drawing escrow funds are critical
 - Escrow provide funds for all indemnification amounts? First or final amounts?
 - Escrow limited to certain types of claims, e.g. environmental
 - Term of escrow account

*Source: Houlihan Lokey Purchase Agreement Study, July 2008

Creditworthiness of Indemnitors

- Set-off Rights
 - Allow buyer to deduct indemnification amounts against future transaction payments or earn-out payments
 - Procedures for identifying setoff payments are critical
 - Time period of payments v. time of allowable indemnification claims
 - Limited to certain types of claims, e.g. environmental
 - Thresholds / materiality qualifiers
 - Joint and Several Liability
 - Impact on buyer
 - Impact among sellers

Indemnification: Trends and Hot Topics

Other Recent Indemnification Case Law

Recent Indemnification Case Law

Indemnity for Sellers' Directors

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- *Indiana State Dist. Council of Laborers v. Brukhart* (Tenn. App. Ct.)
 - Court refused to dismiss a duty of loyalty claim by Seller's shareholders against Seller's directors premised on the inclusion of customary director indemnity provisions
 - A third party can extend indemnifications to Seller's directors for breaches of loyalty and good faith
 - However, the court found that the *extended indemnifications constituted a breach the directors' duty of loyalty to the Seller's shareholders*
 - The directors were accused of "engineering a merger" that included the provision that created their defense

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2009 Indemnification Case Law

Attorneys' Fees

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- *Free Motion Fitness v. Wells Fargo* (Utah)
 - Without express language, Sellers do not have a right to *indemnification for fees and costs incurred in defending against Buyers' claims* that, if successful, would require indemnification by Sellers
- *Oldenburg v. Frontier-Kemper* (Wisc.)
 - Purchase agreement must clearly provide for *attorneys' fees* incurred by Seller in *enforcing indemnification* provision

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Questions & Answers

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