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You Can't HANDLE the Truth!: 4th Annual Deal Points Study

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As promised last year, we are back with more riveting deal point discussion, this time with the 2004 edition of our Annual Deal Points Study. This year we have even expanded our Study to include a review of additional deal points.

As many of you know, several years ago, we grew weary of opposing lawyers who unequivocally asserted that they knew "the market" for a particular deal point. So, in 1999, unable to sit through another hollow bluster from Know-it-All Deal Lawyer, we began analyzing publicly-available acquisition agreements involving public buyers of private targets with transaction values ranging from $25 to $150 million. The result was the first installment of our now annual Deal Points Study, which was and remains our humble effort to separate fact from fiction regarding how M&A deal points, ranging from indemnity baskets and caps to walk rights, are *really* being negotiated. So, if you want the truth (and you believe you can handle it), we are pleased to provide you with some of our findings.

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You Can't HANDLE the Truth!:. . .

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As we always do, we will assume, by virtue of this study appearing in *The M&A Lawyer*, that the reader has a better-than-pedestrian knowledge of M&A terms and concepts. Also, please remember that our observations in this article do not necessarily reflect the views of our respective firms. In fact, we reserve the right to flip-flop depending on who we represent at the time.

Indemnity Baskets and Caps

We begin with what is typically (but maybe unadvisedly) one of the last points to be negotiated in a deal: indemnity baskets and caps. For the 83 deals we reviewed, which were completed in 2003 (which we refer to in this article as the "2003 deals"), we found that almost 88% of those deals had indemnity baskets. This is an increase of almost 10% from 2002 deals and reflects the continuation of a steady increase since 1999. If you assume, *arguendo*, that indemnity provisions work principally in the buyer's favor, does this steady increase in the number of baskets indicate that buyers are having more success in securing indemnity? We think the answer is a definite "probably."

So, what was market for baskets for 2003 deals? Well, the answer depends on whether it is a "deductible" or a "first-dollar" basket. As with our prior studies, we first separated the deals with baskets subset into further subsets of deals with a deductible basket and deals with a first-dollar basket. Out of the deals with baskets subset, we found that 52% were of the deductible variety and 38% were of the first-dollar variety. To the mathematician who is saying "but that only adds up to 90%," we hasten to point out that the other 10% is attributable to the "double-trigger" or "combination" baskets (*i.e.,* where both deductible and first-dollar components are involved). The following is an example of a combination basket:

> "Sellers will have no liability (for indemnification or otherwise) with respect to the matters described in this Section 6, until the total of all Damages with respect to such matters exceeds $150,000 (the "Basket"), and then only for the amount by which such Damages exceed $75,000."

(EDO Corporation acquisition of Darlington, Inc.)

The following table summarizes our findings regarding the size of baskets as a percentage of the purchase price for 2003 deals:

Basket Type	***1/2% or less***	***>1/2% to 1%***	***>1% to 2%***
Deductible	**53.5%**	**41.8%**	**4.7%**
First-Dollar	**73.3%**	**16.7%**	**10%**

Interestingly, first-dollar baskets of 1/2% or less are almost 20% more likely to occur than deductible baskets of the same size. Our finding that only 14.7% of the deductible and first-dollar baskets ranged from >1% to 2% of the deal's purchase price continues to challenge conventional wisdom that baskets typically end up in that range.

And what about indemnity caps? In 2003 deals, we continued to see a dearth of purchase price caps (only 5.8%, which is down from 22% in 2002). In fact, almost 50% of the deals within the caps subset are grouped between 10% and 25% of the purchase price. If you include caps of 10% or less, then the percentage of deals with caps of 25% or less jumps to just over 60%. Again, we remind readers that this deal point is particularly sensitive to the nature of our sample (*i.e.*, public companies buying private targets where the buyer's stock is usually in play as a component of consideration). So, we seriously doubt if sellers, as a group, are getting this favorable cap treatment in private/private, all cash deals.

The "No Undisclosed Liabilities" Representation

We have all seen the buyer-friendly version of this representation which typically reads something like this:

> "Except as set forth in Part 3.10 of the Disclosure Letter, the Target Companies have no liabilities or obligations of any nature (whether known or unknown and whether absolute, accrued, contingent, or otherwise) except for liabilities or obligations reflected or reserved against in the Target Balance Sheets and current liabilities incurred in the Ordinary Course of Business since the respective dates thereof."

Among the many objections a seller may assert regarding this representation, is the catch-all nature of the liabilities covered. One objection, in particular, is that the burden is placed on the seller to disclose contingent liabilities. As sellers often lament, this can be tantamount to a disclosure limbo-contest where instead of seeing "how low can you go?", the seller is saddled with trying to determine "how contingent is contingent?" In response to such a provision, a seller could assert that the liabilities covered by this representation be limited to liabilities of the nature required to be disclosed on financial statements prepared in accordance with generally accepted accounting principles.

Our study found that, in approximately 79% of 2003 deals, buyers prevailed in negotiating the broader "all liabilities" representation. With 2003 still being a "down year" for M&A activity and the "Golden Rule" (*i.e*, they who have the gold, make the rules) clearly still in force, it is not particularly surprising that buyers appear to have prevailed in allocating this level of risk to sellers. On the other hand, a seller referring to our study could validly maintain that the "all liabilities" formulation is not always a foregone conclusion because sellers successfully negotiated the narrower "GAAP liabilities" exception in approximately 20% of 2003 deals. If the target is subject to competitive bidding, a seller may often have sufficient leverage to successfully secure a "GAAP liabilities" limitation. In fact, if a seller has enough leverage, it may even be able to negotiate out the "no undisclosed liabilities" representation in its entirety. Our study found that 5% of 2003 deals did not include this representation.

The "Full Disclosure (10b-5)" Representation

As we all know, buyers often insist, even after the seller has given 25 plus pages of exhaustive representations, that the seller also add a "full disclosure" representation. Inspired by Rule 10b-5, these provisions typically read something like this:

> "No representation or warranty or other statement made by Seller or either Shareholder in this Agreement in connection with the Contemplated Transactions contains any untrue statement or omits to state a material fact necessary to make any of them, in light of the circumstances in which it was made, not misleading."

Buyers will be very insistent that this representation is standard. Our study found, however, that a full disclosure representation appeared in only 64% of 2003 deals. With sellers successfully keeping this representation out more than one-third of the time, buyers' counsel should not be surprised in 2004 when faced with an emboldened seller claiming that this representation is not necessarily standard operating procedure.

How Wrong Can the Seller Be?

At the suggestion of our good friend, Rick Climan, Head of M&A at Cooley Godward LLP (who, in his spare time, is the Chair of the ABA's 900-member Negotiated Acquisitions Committee), we took a look at the "accuracy of seller's representations" as a condition to buyer's obligation to close. In particular, we investigated just how wrong a seller's representations could be before the buyer would be able to walk the deal. As you know, the "accuracy of seller's representations" closing condition effectively converts each one of the seller's representations into a walk right in the buyer's favor. To many of us, this condition truly is "The Mother of all Walk Rights."

Before getting into how wrong can a seller be, we first reviewed 2003 deals to see, for the purposes of this closing condition, at what point in time did a seller's representations have to be accurate. Here is a sample of the buyer-friendly version we've all seen:

> "***Accuracy of Representations and Warranties***. Each of the representations and warranties made by the Company in this Agreement shall have been accurate in all respects as of the date of this Agreement, and shall be accurate in all respects as of the Closing Date as if made on the Closing Date."

Most M&A lawyers say that the "double bring down" formulation of this condition (*i.e.*, seller's representations must be accurate on the date the agreement is signed and again as if made on the closing date) is market. Our study, however, found that only 70% of the 2003 deals contained both the "true when made" and "true at closing" components. (The other 30% contained only the "true at closing" component.) We believe this clearly challenges the conventional wisdom that a double bring down is a *fait accompli.*

So how wrong can a seller be before the buyer can walk? To make that determination, we analyzed how often the accuracy of seller's representations was qualified by materiality for purposes of a walk right. We found that 82% of the time a seller's representations must be materially wrong before a buyer's walk right can be triggered (*i.e.*, the seller's representations must be accurate in all *material* respects). Out of the materiality qualifier subset, 26% of the sellers successfully negotiated the higher "material adverse effect" standard.

In several of the 2003 deals, we noticed efforts to quantify "materiality" by setting a dollar-based hurdle. This is the same concept that is often applied to indemnity baskets but, in this instance, is applied to walk rights. Sellers should be mindful that too low a hurdle may effectively eviscerate any real benefit of a materiality cushion.

As we sliced and diced this condition further, we took a look at the double materiality issue. We were curious to know, if a buyer conceded to a materiality qualifier regarding the accuracy of a seller's representations, did the buyer close the door on double or even triple dipping on materiality? According to our study, the answer is yes—most of the time. Of the 2003 deals with an accuracy of representations condition, we found approximately 60% of this subset expressly disregarded the effect of other materiality qualifiers contained in specific seller representations. A provision that addresses the double materiality issue typically reads like this:

> "The representations and warranties of the Company contained in this Agreement shall be true and correct in all material respects (**except for those representations and warranties that are by their terms qualified by a standard of materiality, which representations and warranties shall have been true and correct in all respects**) (emphasis added)"

(Informatica Corporation acquisition of Striva Corporation)

In place of the double materiality neutralizing language contained in the provision above, it also is not uncommon to have a provision in a walk right condition that essentially states that any materiality qualifiers in the representations and warranties should be completely disregarded. So, how wrong can the seller be when double materiality is present in the context of a walk right condition? Some might say "completely."

Delivery of Legal Opinions

Our study found that, in just over 68% of the deals, the seller's legal opinion was required as a closing condition. With almost one-third of the deals not requiring the seller's legal opinion, opinions no longer seem to be a foregone conclusion. According to Bill Payne, Head of M&A at Dorsey Whitney, LLP, "you can expect the percentage of deals with opinions to be trending down because more and more M&A lawyers understand the benefit/burden equation for legal opinions and have determined that due diligence and adequate reps are a better way to go." We think Bill is right on the money, especially in light of the findings in our study.

So, Does Size Matter?

As we have mentioned, our Study focuses on middle market deals. But do our middle market findings remain consistent if we increase the transaction values of the deals reviewed? In other words … does size *really* matter? To address this question, we conducted a similar search using the LiveEdgar's M&A Database, but increased the transaction values to range from $500 million to $2.5 billion. Our search yielded only six deals. Why so few? Probably because most targets in the $500 million to $2.5 billion range are publicly traded. Attempts to expand the pool of deals including public targets is problematic because acquisitions of public targets are materially different from acquisitions of private targets (for example, post-closing indemnity is virtually non-existent in public company deals).

As if that were not limiting enough, the definitive acquisition agreements in four of the six "big deals" were not publicly available. While there are many reasons why a definitive acquisition agreement might not be made public, the simple fact may be that the values of our "big targets" were less than 10% of each buyer's total assets (see the Instructions to Item 2 of Form 8-K).

So, without a reliable number of "big deals" to compare, we are not able to provide you with any definitive findings because to do so would reduce us to the anecdotal advocates we sought to challenge in the first place! Now, we are not saying that anecdotal experience is not important. To the contrary, our own experience influences how we negotiate deals; but is it at least slightly presumptuous for one to think that experience is a proxy for what is market? In the final analysis, we believe that a combination of the empirical and the anecdotal provides the most powerful negotiating position. In any event, if you're still dying to know, then we dutifully report it appears that size does *not* matter… at least according to an analysis of an unreliable sample of two "big deals."

If all of this leaves you wanting more, we encourage you to email us for a complete copy of the study[1] so you too can be the center of attention at your next cocktail party! M&A

1 If you would like a copy of the complete Study, please e-mail either author: Wilson.Chu@HaynesBoone.com or lglasgow@gardere.com.