

A PRESENTATION AT THE ACC SOUTH FLORIDA'S 14TH ANNUAL CLE CONFERENCE

A Primer on M&A and Navigating Antitrust Risks: An Introductory M&A Guide for Inhouse Counsel

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Nicholas is a seasoned, strategic practitioner who is “service-oriented and provides simple answers to complicated issues.” With more than 20 years of experience, his diverse corporate practice focuses on complex domestic and cross-border M&A transactions, national and international private equity, joint ventures, and restructurings. He has extensive experience in the energy, infrastructure, financial services, media, and telecommunications sectors, representing clients in the United States, Latin America, and Europe.

Nicholas is a partner in Winston’s Miami office. His experience includes representing strategic and private equity investors on complex and sophisticated business acquisitions and divestitures, strategic investments, corporate restructurings and recapitalizations, asset acquisition and sale transactions, joint ventures and other strategic partnering arrangements. He also has extensive experience in a wide array of industries, including technology, software, energy, infrastructure, financial services, media, agriculture, and telecommunications.

Nicholas has represented companies such as Advent International; Brookfield Asset Management; Citigroup Global Markets; Enjoy, S.A.; General Electric; GIC Special Investments (Government of Singapore Investment Corporation); Intesa Sanpaolo S.p.A.; Kans Capital; Mapei International; Mastercard International; Millicom International Cellular SA; NII Holdings/Nexte;; Ospraie Management; and Verint Systems. He advised Advent International in its acquisition of the largest airport operator group in the Dominican Republic, which was recognized by the *International Financial Law Review* as the 2008 Private Equity Deal of the Year for the Americas. Nicholas also advised NII Holdings, Inc. in its US\$178 million sale of Nextel Argentina to Grupo Clarin, which *LatinFinance* named as its 2015 Domestic M&A Deal of the Year.

Chambers notes that Nicholas is “is very diligent and responsive” (2021). He is also the sole recipient of *Lexology*'s 2019 Client Choice Award (M&A) (Florida), which recognizes law firm partners who provide exceptional client care and provide significant value to clients' businesses above and beyond others in the market.

Nicholas was appointed to serve on the U.S.-Colombia Business Council’s Board of Directors. He was born in Medellin, Colombia, and is fluent in Spanish.

Services

Mergers & Acquisitions
Private Equity Transactions

Admissions

Florida
New York

Education

Columbia University, MBA
St. John's University, JD
New York University, BA

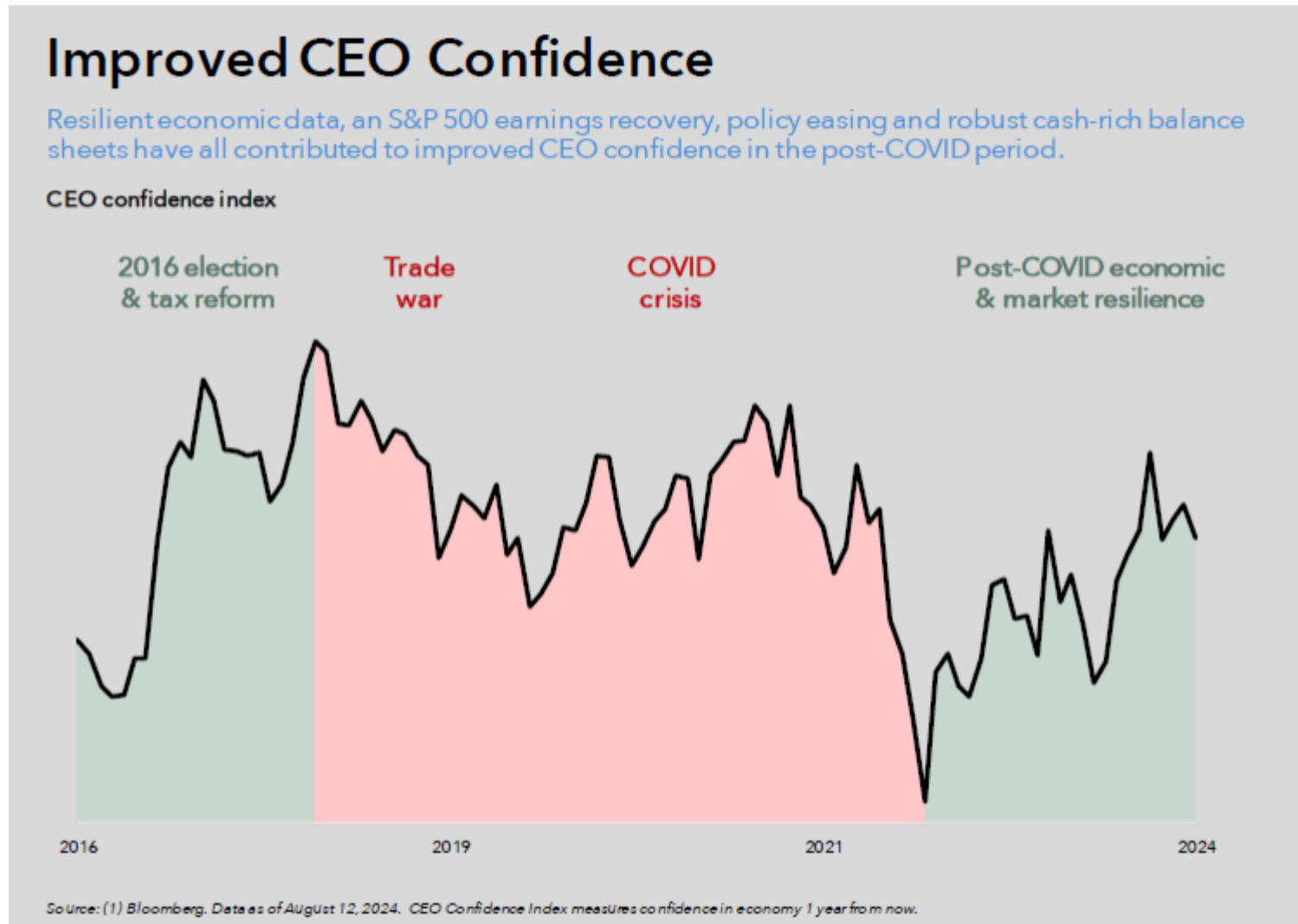
Agenda

- M&A Activity & Trends
- “Hot Button” Issues for Acquirors
- Principal Concerns for Inhouse Counsel
- Letter of Intent
- Basic transaction structures
- Purchase agreement mechanics
 - Working capital/debt concepts and purchase price adjustments
 - Closing conditions
 - Reps & warranties
 - Covenants
 - Indemnification
- Representations and Warranty Insurance

Why has M&A Declined Since 2021?

“The M&A market has declined with both volume and value down from recent peaks in 2021 and early 2022. This shouldn’t be a great surprise since interest rates have been increasing, while valuation expectations have remained high. Meanwhile, uncertainty around recession—What defines one? Are we still anticipating one?—remains persistent.”

M&A Confidence



Source: MUFG, “Early Innings of a Global M&A Recovery – Key Trends in 2024 Deal Making Activity,” August 2024

M&A Global Activity

Early Innings of Global M&A Recovery

Stronger earnings, higher equities and resurgent financing markets have precipitated a global M&A recovery, albeit one still in its early stages after dampened activity the prior two years. Nonetheless, higher interest rates have dampened sponsor led activity while a tighter global regulatory backdrop has discouraged some deals and prolonged the timetables for others.

Global M&A Deal Activity (1H 2023 & 1H 2024)

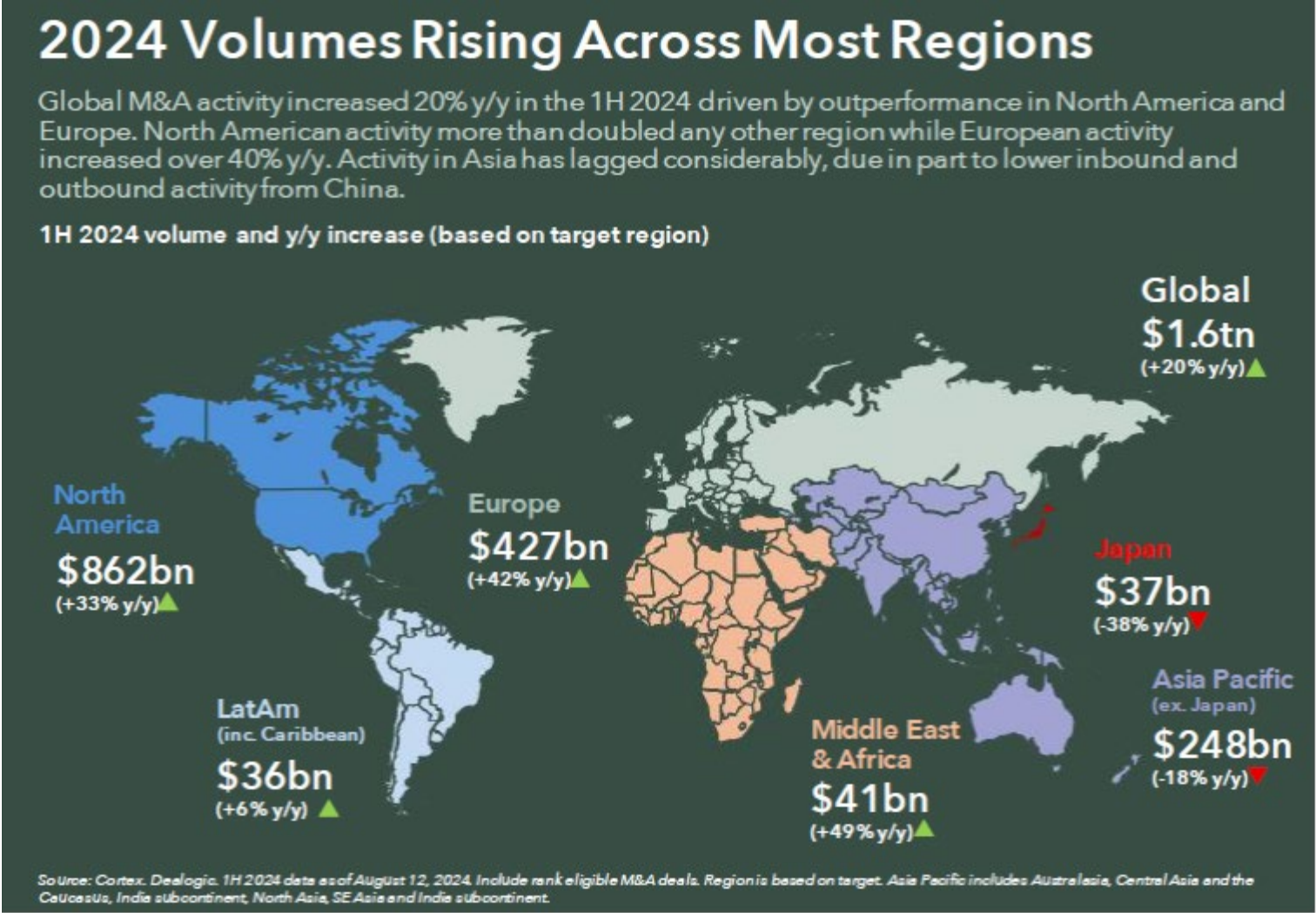


The resurgence of “megadeal” activity in 2024 – both scale and scope transactions – are a sign of the renewed strength in the post-COVID global M&A market.

Source: (1) Cortex, Dealogic. 1H 2024 data as of August 12, 2024. Includes rank eligible, M&A deals.

Source: MUFG, “Early Innings of a Global M&A Recovery – Key Trends in 2024 Deal Making Activity,” August 2024

Rising M&A Tides



Source: MUFG, “Early Innings of a Global M&A Recovery – Key Trends in 2024 Deal Making Activity,” August 2024

Key Factors Driving a Global M&A Recovery

Key Drivers of Global M&A Recovery

Against a resilient though volatile macro backdrop, the global M&A recovery in 2024 has been driven by both scale (synergies) and scope (growth-oriented) transactions.

Catalysts for 2024 deal activity

Macro & Market Drivers



Moderating inflation;
policy easing & declining rates



Equity market & acquisition
currency strength



Converging buyer / seller
valuation expectations



Abundant global capital;
Record PE dry powder (\$2.6 tn)



Resilience & depth of
IG financing markets

Corporate Strategy Drivers



Generate growth > organic
alternatives; shareholder activism



Strong, cash-rich
balance sheets



Access to technology, innovation
(digital, AI, automation)



Restructuring;
divesting non-core businesses



Capturing synergies; optimizing
business; diversification

Source: MUFG, "Early Innings of a Global M&A Recovery – Key Trends in 2024 Deal Making Activity," August 2024

Letter of Intent (LOI)

- **Seller's Perspective**

- Maximum leverage point in negotiations
- Agreement on structure (e.g., stock vs. asset)
- Prefers specific vs. general terms (e.g., indemnification survivability, caps and thresholds)
- Can establish rules for further due diligence and process

- **Purchaser's Perspective**

- Wants seller exclusivity covenant ("no shop")
- Obtain full due diligence rights
- Prefers general vs. specific terms
- Offer is non-binding; however, some terms are legally binding (e.g., exclusivity)

- **Engage the Appropriate Legal Counsel**

“Hot Button” Issues

- Continued Expansion in Use of Rep & Warranty Insurance
- Heightened Antitrust Scrutiny by DOJ
- Hot Areas in Due Diligence

Continued Expansion in Use of Rep & Warranty Insurance

- Although originally utilized by PE firms, the use of rep and warranty insurance (RWI) has become more and more ubiquitous in M&A transactions; strategic buyers are embracing its use with increasing frequency.
- PE sellers frequently insist upon RWI as the sole source of post-closing recourse; consequently, strategic bidders are “playing ball.”
- In competitive bid situations, buy-side use of RWI can enhance overall attractiveness of bids.
- Generally speaking, RWI carriers appear to be paying valid claims that are timely made; most common claims involve financial statement errors and undisclosed liabilities.

Continued Expansion in Use of Rep & Warranty Insurance

- A refresher on the basics of RWI:
 - Duration of coverage: 3 years for general reps; 6 years for “fundamental” and tax reps – important to specifically negotiate for treatment of IP reps as fundamental
 - Coverage Limits: Typically, 7.5% - 12.5% (with 10% being the sweet spot) of enterprise value / purchase price (higher coverage percentages are available)
 - Retention / Deductible: Generally, it was 1% of enterprise value but has decreased to .5% - .75%, with a drop down after 12 months
 - Typical Premiums: 2.00% to 3.5% of coverage amount, with larger deals getting lower end of range
 - NOTE: Who bears risk of loss up to retention amount is negotiable (100% buyer, 50/50 split, etc.); which, is also applicable to the premium cost (100% seller, 50/50 split, etc.)

Heightened Antitrust Scrutiny by DOJ

- DOJ more closely scrutinizing sufficiency of merging parties searches for Item 4(c) and 4(d) documents
 - Require production to DOJ of all documents prepared by or for officers or directors that analyze a transaction with respect to competition, synergies and related topics
 - DOJ believes companies have been lax in searching for and producing these documents – as result, DOJ may take a closer look at the search processes used by filers
 - Civil penalties for violating these requirements can accrue at the rate of \$51,744 per day
 - Upshots:
 - preemptive education of business development and deal team personnel is the best way to get in front of this issue;
 - careful and thorough document screening and search processes – and full disclosure of responsive documents -- are essential!

Heightened Antitrust Scrutiny by DOJ

- In December 2023, the DOJ and the FTC jointly issued the 2023 Merger Guidelines.
 - The merger guidelines signal that the Agencies will continue to pursue an aggressive enforcement agenda.
 - Some transactions may be small enough to avoid the HSR notice filings; however, DOJ has signaled that just because a transaction is not reportable for HSR purposes does not make it immune from challenge under the antitrust laws.
 - A market share of 30% or more held by the acquiring firm can now trigger a presumption that the transaction is anticompetitive, even when acquiring a small firm with minimal market share.
 - The Agencies will focus on the impact of transactions on competition for workers, creators, suppliers, or other providers rather than just consumers.
 - Industries such as private equity, known for their “roll-up” strategies, have increasingly found themselves under closer scrutiny during this administration. The Final Guidelines make clear that the Agencies will now analyze not just a single proposed transaction but a series of mergers in the aggregate.
 - Technology companies accused of “killer acquisitions” are subject to closer agency review, as we have discussed previously.

Hot Areas in Due Diligence

- Be alert for “Greenwashing” and other sources of future exposure from a target’s over-promising and under-delivering on ESG commitments.
 - Does target have substantiation for its publicly stated claims, achievements?
- Use of Artificial Intelligence by Targets.
- Consider whether current IP representations adequately capture issues raised by use of artificial intelligence technology or data by targets.
- Are targets using data sets or training data that were obtained without an agreement? Consider whether all legal rights necessary to use such data have been obtained since many data sets are readily accessible.
- Cybersecurity issues.
- Foreign Software Development and Inadequate IP Assignments.
- Much software development continues to be done overseas, particularly in Asia and Eastern Europe.

Hot Areas in Due Diligence

- IP ownership rights in software must be transferred in accordance with local laws where developers are located. Many targets fail to obtain assignments that comply with local law and mistakenly believe foreign developers can sign the same form of IP assignment used for U.S.-based developers.
- Carve-Outs and Spin-Outs – Complications
- Important to understand and negotiate what “carve out” financial statements will be provided by seller.
- When a seller wants to do a carve out, whether of a business line via an asset sale or by selling a subsidiary or affiliate, confirm whether buyer will get the benefit of important licensed IP rights under proposed deal structure.
 - This becomes potentially complex when the selling entity also exercises rights in the same licensed IP.

Hot Areas in Due Diligence

- Spinout transactions often have unique IP license issues because IP license rights may not necessarily have been formally obtained to clearly cover subsidiaries.
 - Confirm whether IP license rights exercised by a subsidiary can be as clearly exercised once a sold entity is no longer a subsidiary of a licensed parent.
- If business is spun out through an asset sale, consider whether key IP licenses can be partially assigned if the selling entity also needs to retain rights in the licensed IP.

Strategically Guiding an M&A Transaction

- Understand the internal investment hurdles and key risks so they can be effectively managed or mitigated.
- Understand the risks and issues associated with the counterparty (large institutional seller v. a family-owned business).
- Structuring and tax issues (for example, if there is a gap in valuation consider utilizing an earnout).
- Coordinating due diligence.
 - Present risks in a simple manner, noting risks and countermeasures or mitigating factors.
 - Identify any critical issues or deal killers from the outset.
- Integration will be a critical phase (liaising with all the necessary internal teams).

LOI – How Much Detail to Include

- **Advantages**

- Memorializes parties' agreement – avoid misunderstandings or changes of heart
- May reveal irreconcilable disagreements or business issues that would make negotiation of an agreement unproductive
- Shows commitment to the deal

- **Disadvantages**

- May become so-time consuming that the deal becomes stalled
- Will reduce Purchaser's leverage on certain deal points versus negotiating these points after a sufficient due diligence process (i.e., at the point in time when the Sellers are resigned to selling the business and will fight less)

Transaction Structure – Asset Purchase

- **Advantages**

- Depending on what country target is in, pick and choose assets and liabilities to be assumed
 - Generally, preferred Purchaser structure; can contractually limit exposure to Seller's pre-closing liabilities
 - Assume only specifically identified pre-closing liabilities of Seller
- Pick and choose employees to be hired (in the U.S., at least)
- Tax consequences generally more favorable for Purchaser (i.e., step-up in basis for all acquired assets)
- ***NOTE – hybrid deal structure is a stock deal with asset deal treatment***

- **Disadvantages**

- More complex purchase agreement and other documentation to transfer assets
- Assignment of contracts, licenses, and permits may require third-party consents (i.e., diligence and timing issues)
- Employee liabilities may be triggered if certain employees are not hired (especially outside U.S.)
- Tax consequences can be negative for Sellers (i.e., double taxation on proceeds)

Transaction Structure – Stock Purchase

- **Advantages**

- Simplicity: generally fewer issues regarding transfer of assets, assignment of contracts, termination of employees, etc.

- **Disadvantages**

- Assumption of liabilities – generally, Purchaser assumes all pre-closing liabilities (i.e., there may be successor liability)
- Minority shareholders may hold out – requires agreement of all shareholders
 - Although note that a merger structure can usually be used to work around minority shareholders in many countries
- Tax consequences generally more favorable for Seller

Transaction Parties

- Consider transaction structure – asset vs. stock
- Who is selling what?
 - For Seller, need creditworthy Purchaser
 - For Purchaser, is Seller/Target sufficient?
 - Or is it necessary to include Seller's parent? Stockholders? Other guarantors?
 - To whom does Purchaser have recourse after closing?
 - Stockholders (will they be your employees after closing?)
 - Escrow/holdback
 - Post-closing covenants and indemnities

Purchase Agreement - General

- Reflects the negotiated deal and due diligence results
- Binding terms and conditions of acquisition
- Risk allocation between Purchaser and Seller
- Governs parties' conduct prior to closing
 - Conduct of business prior to closing
 - Regulatory approvals
- Governs parties' rights and obligations after closing
 - Non-compete
 - Indemnification
 - Employee rights
- Substantive structure of purchase agreement generally similar across jurisdictions – or at least similar concepts – even though the format may be very different

Purchase Agreement – Working Capital

- Working capital adjustments
 - Define “working capital” – essentially current assets minus current liabilities (cash, debt and transaction expenses typically excluded and adjusted separately)
 - Calculations generally are consistent with GAAP and the target’s past practices or another agreed upon method (often set forth on an exhibit as a set of accounting principles)
 - Determine target net working capital
 - Estimate an adjustment at closing
 - Final adjustment determined post-closing (e.g., 60-90 days thereafter)
 - Third-party auditor typically resolves disputes
- Adjustment mechanisms (collar, dollar-for-dollar, cap)
- Cash v. Restricted Cash (cash trapped in a jurisdiction)

Purchase Agreement – Debt and Debt-Like Items

- Debt reduction, in principle, is not controversial – indebtedness for borrowed money, interest, any amounts required for payoff at closing, etc.
- Debt-like items, however, are sometimes heavily negotiated
- Example buyer-friendly definition on next slide
- Be cognizant of overlap with WC and transaction expenses and communicate with legal and finance teams.

Purchase Agreement – Debt vs WC

“**Indebtedness**“ means:

- (i) any indebtedness evidenced by any note, debenture or other debt instrument or debt security,
- (ii) any indebtedness for borrowed money or issued in substitution for or exchange of indebtedness for borrowed money (including all obligations arising from bank overdrafts),
- (iii) any liabilities for any drawn on letters of credit, performance bonds, surety bonds and similar obligations,
- (iv) any obligations under any leases classified (or that should be classified) as a capital lease or finance lease in the Financial Statements or in accordance with GAAP,
- (v) any deferred revenue,**
- (vi) any loans/advances payable to, and any declared but unpaid dividends to, any shareholders or related parties,
- (vii) all unpaid income Taxes for any pre-Completion Tax period (calculated on a jurisdiction-by-jurisdiction basis with zero dollars (\$0) being the lowest amount for a jurisdiction),**
- (viii) all unpaid sales and use Taxes (whether or not the Acquired Companies filed relevant Tax returns) for any pre-Completion Tax period (calculated on a jurisdiction-by-jurisdiction basis with zero dollars (\$0) being the lowest amount for a jurisdiction),**
- (ix) all liabilities for deferred and unpaid purchase price of assets, property, securities or services, including all earn-out payments, seller notes and other similar payments (whether contingent or otherwise) calculated as the maximum amount payable under or pursuant to such obligation,
- (x) all interest rate swaps, forward contracts, currency or other hedging arrangements,
- (xi) with respect to the foregoing clauses (i) through (x), any guarantees made by the Acquired Companies in connection therewith, and any other financial guarantees of the Acquired Companies of any kind,
- (xii) with respect to the foregoing clauses (i) through (xi), all accrued interest thereon, if any, and any premiums, fees, expenses and penalties (including prepayment and breakage or early termination fees) associated with the repayment of such Indebtedness on the Closing Date, and
- (xiii) **(xiii) any amounts due to or in respect of current or former employees with respect to (a) accrued and unpaid vacation days or paid-time off, (b) bonus or commission amounts related to the pre-Closing period (regardless of whether or not accrued), except for any such amounts included in the calculation of Transaction Expenses), and (c) severance payments or other similar obligations related to the termination of any former employees (including the employer portion of any related payroll and other employment Taxes for the foregoing items (b) and (c)).**

Purchase Agreement – Reps & Warranties

- **Seller reps and warranties are statements of fact and assurances**
 - Given at signing and closing
- **Purpose**
 - Risk allocation
 - Disclosure to supplement or confirm due diligence
 - Pre-closing: Form basis of closing condition—so-called “bring down”
 - Post-closing: Serve as basis for indemnification
- **Need to coordinate review of disclosure schedules with due diligence review**

Purchase Agreement – Reps & Warranties

Customary Seller Representations & Warranties (Buyer's are much more limited)

- Organization, Standing and Power
- Financial Statements
 - Identify early in transaction process
what representations Seller can rep to
- Absence of Undisclosed Liabilities
- Absence of Certain Changes
- Licenses and Permits
- Litigation; Compliance with Laws
- Product Liability
- Intellectual Property
- Taxes
- Environmental Matters
- Employee Benefits; Employee Matters
- Related Party Transactions
- Real Property
- Insurance
- Material Contracts
- Compliance (anti-corruption; export controls)

Purchase Agreement – Covenants

- **Pre-closing Covenants**

- Operation/preservation of business prior to closing — restrictions relating to conduct of business in the ordinary course
 - Diligence will inform (e.g., no amending contracts, no terminating certain employees)
 - Important – Buyer’s best chance to terminate a deal may be to argue the pre-closing operation covenant was breached
- Allowing purchaser access to target premises, employees, information
- Third party consents—effort standard to obtain prior to closing
- Government approvals (e.g., HSR)
- Regulated industries (e.g., utilities and military contractors)
- Confidentiality/publicity

- **Post-closing Covenants**

- Seller non-compete
- Seller non-solicit/non-hire of employees
- Purchaser to maintain compensation/benefits for specified period
- In an earn-out situation, restrictions on Purchaser’s running the business

Purchase Agreement – Restrictive Covenants

- **Seller non-compete**
 - Substance of terms is very jurisdictionally dependent
 - Parties subject to non-compete
 - From Purchaser perspective, anyone getting proceeds
 - Definition of restricted business
 - Length of non-compete
 - Territory of non-compete
 - Employment agreements vs. purchase agreement (i.e., generally stronger in purchase agreement)...law is developing rapidly on enforceability of restrictive covenants
- **Seller non-solicit/non-hire of employees**

Purchase Agreement – Closing

- Simultaneous v. bifurcated sign and close
- Simultaneous preferred
- When to bifurcate
 - Third party consents and approvals – antitrust authorities; customers, suppliers / vendors
 - Transaction structure matters.
 - Financing

Purchase Agreement – Closing Conditions

- Bring-down of reps and warranties
 - Standards
- Bring-down of covenants
- HSR and other antitrust approvals
- Other governmental approvals (e.g., ITAR, CFIUS)
- No injunction or other legal impediments to closing
- Third party consents
- Other closing deliverables
- Completion of employment/consulting agreements
- No MAE

Purchase Agreement – Termination

- Permits Purchaser or Seller to terminate definitive agreement under certain circumstances
- Party seeking termination cannot be in breach of definitive agreement
- Common termination rights:
 - Failure of other party to fulfill closing conditions
 - Failure to obtain antitrust/regulatory approvals
 - Material breach by other party of definitive agreement
 - Transaction not closed by agreed upon outside date
 - Mutual agreement of Purchaser/Seller
- Break-up fees sometimes payable if agreement is terminated
 - For example, in a competitive auction situation where Purchaser is competitor and there is HSR risk
 - Sole recourse for Sellers in PE Transactions

Purchase Agreement – Indemnification

- Indemnification is a post-closing remedy for damages incurred under purchase agreement arising from:
 - Breaches of reps and warranties
 - Breaches of covenants
 - Specifically identified liabilities (e.g., taxes, litigation or ENV issues)
- What is indemnity / who does it benefit
 - Breach of contract
 - Unlimited liability
- Indemnifying Party
 - Sellers of target (or target in asset deal); Guarantors

Purchase Agreement – Indemnification

- Joint and several liability vs. several liability
 - Sellers always want several liability (which may not be ideal for Purchaser)
- 3 major elements limiting liability:
 - Survival Periods
 - Deductibles (Baskets)
 - Caps
- What is market?
- Escrow and R&W Insurance

Purchase Agreement – Indemnification

- What is a survival period (RWI)?
- Survival period for general reps is usually between 12 months – 2 years
- Fundamental reps usually do not expire (e.g., ownership, etc.) (although PE sellers prefer to place a time limit)
- Certain other reps also may survive for longer periods of time
 - Taxes, ERISA, environmental (among others) often survive for a longer period of time
 - Survival period for these reps differ (defined number of years/statute of limitations/indefinitely)
- Covenants typically survive in accordance with their terms or until expiration of SOL with respect to subject matter of applicable covenant

Purchase Agreement – Indemnification Limitations

- **Types of Deductibles**

- “Basket” (deductible) – indemnify only for damages in excess of the threshold
- “Tipping basket” – indemnify for all damages once a threshold is met; back to dollar one
 - Much less common and larger amount
- Generally, size of basket is 0.5-1.0% of purchase price
- Size of transaction impacts basket as % of transaction value, but not always (e.g., big or tiny deals)
- “Mini-basket” – *de minimis* claim threshold (i.e., no individual claim may be made unless the damages exceed a threshold amount) (seller friendly concept)

- **Matters Subject to Deductibles**

- Breaches of general reps and warranties generally subject to deductibles
 - Breaches of certain fundamental reps and warranties generally not subject to deductibles
 - Breaches of covenants and specifically identified liabilities generally not subject to deductibles (“specific indemnities”)
- **Materiality Scrape (consider exclusions, e.g. “Material” Contracts and MAE reps)**

Purchase Agreement – Indemnification Limitations

- Amount of indemnification cap
 - Should only apply to reps and warranties
 - Typically one cap for general reps and another cap for fundamental reps
 - Fundamental reps usually capped at the purchase price
 - Covenants and specific indemnities capped at purchase price
 - Debt and transaction expenses (to the extent not picked up in PP adjustment) usually capped at purchase price
- Specific Indemnities (e.g., ongoing litigation or compliance with regulatory orders)
- Other limitations to consider
 - Diligence will drive considerations

Purchase Agreement – Escrow

- When is escrow used? vs. Holdback? vs. R&W insurance?
 - Size of deal
 - Public vs. private target
- Is the escrow the Purchaser's sole recourse?
 - Depends on sellers – consider practical realities of situation (i.e., seller credit risk following closing) – but generally yes
- Typical size of escrow
 - Depends on deal size, diligence issues identified and leverage situation (i.e., auction or not), but typically 5% to 10% (this is impacted by RWI)
- Length of escrow
 - Typically matches the survival period of general reps (i.e., 12-24 months)
- Escrow release mechanics
 - One-time release vs. staged releases
 - Indemnification and PP adjustment escrows

R&W Insurance Overview

- Protects an insured from unanticipated and ***unknown*** losses that may arise subsequent to the closing
- Generally, covers all representations and warranties in the purchase agreement and pre-closing taxes
- R&W insurance policies are purchased by both private equity and strategic buyers
- R&W insurance policies does not cover breaches of covenants, purchase price adjustments and forward-looking statements

Basic Mechanics

- Coverage Limits: Typically, 7.5% to 12.5% of Transaction Value
- Policy Costs
 - Premium: Typically, 2% to 3.5% of coverage amount
 - Underwriting Fee: \$40K to \$50K
 - Industry specific considerations / pricing
- Retention
 - Similar to a deductible
 - It was typically 1% of transaction value, but now oftentimes are receiving quotes for retentions ranging between 0.5% and 0.75%.
 - Dropdown after a year
- Split Retention vs. No Seller Retention

Basic Mechanics (cont.)

- Interaction between Purchase Agreement and Policy Terms
 - Generally, indemnification claims for breaches of reps are satisfied in following order:
 1. The Purchase Agreement indemnification deductible (50% of retention)
 2. The Purchase Agreement indemnification escrow (50% of retention)
 3. The R&W insurance policy (the retention amount has been exhausted by the deductible and the indemnification escrow)

* Note that fundamentals and tax are typically carved out and are dollar-one for the seller until the retention is exceeded, and then recourse to RWI policy
- Becoming more seller-friendly
 - The construct above is fairly traditional, but terms are becoming more seller friendly as negotiated between the buyer and seller
 - Sellers are occasionally taking responsibility for the full retention, even for fundamentals and tax

Scope of Coverage

- Will cover reps/warranties and pre-closing taxes
- Will not cover breach of covenants or specifically identified contingent liabilities
 - May create unexpected gap for buyer (which may need to be negotiated with seller)
- Uncovered losses not counted against policy retention
- Changes in reps and warranties in purchase agreement may impact coverage availability and premiums
 - Need to keep insurance carrier informed during negotiation process and be responsive to carrier's diligence requests
- Indemnification provisions in purchase agreement have to be negotiated side-by-side with insurance policy

Who Pays?

- Negotiated between Buyer and Seller
- Both parties typically benefit, so premiums are historically split 50/50
 - Although in 2021 and 2022, many buyer's paid 100%

Costs/Challenges To Use of R&W Insurance

- Cost of policy—adds to transaction costs
- Introduction of a third party to negotiation and includes lots of additional legal time for RWI-driven due diligence (and more detailed memo)
- Potential coverage risk and common policy exclusions
 - Need for additional negotiations with seller
- Potential timing risk
- No true “off-the-shelf” product—significant negotiation often present; however, insurers more frequently start with legal counsel’s “form” agreement

Benefits to Buyer

- Can be obtained without the knowledge of the seller
- Coverage for liabilities where creditworthiness of seller(s) or ability to collect from multiple sellers a concern
- May ease tension where buyer seeks indemnification from former shareholder management members who are employed by buyer after the closing
- Coverage amounts, retention amounts (deductibles) and negotiated terms position the buyer to more easily accept indemnification terms from a seller on limited terms (e.g., short survival periods and modest liability caps and escrow amounts)
- Increased protection against loss from breach of seller's representations and warranties (dollar limit/policy terms exceed survival period)
- Added benefit of obtaining deal protection from a more financially viable entity

Benefits to Seller

- Reduce risk of lost dollars from unknown future losses (arising from breach)
- Ability to receive more of the purchase price upfront instead of tying it up in escrows and holdbacks
- Can ease tension among sellers related to the often-contentious point of several or joint and several liability
- Ability to make a “cleaner exit” from the investment with limited (if any) indemnification obligations, providing greater certainty of deal proceeds

Policy Overview

- **Process:**

- **Step 1:** <1 week to receive initial indications from market with basic information (draft transaction document, financials, summary of target)
 - Carve-out financials have become difficult for coverage
 - Small deals have become difficult for coverage, but this is coming back around
- **Step 2:** 1-2-week underwriting process for insurance carrier to complete due diligence/underwriting
 - Policy drafting typically done in tandem with buyer's deal attorneys to ensure terms of policy align with transaction document
 - 14 days is fairly typical to complete – got a bit longer in 2021 and early 2022 given massive M&A volumes

Policy Overview (continued)

- **Common Policy Exclusions**

- “Actual knowledge” of breach
- Fines and penalties (uninsurable by law)
- Asbestos
- Environmental (varies by industry/target/ carrier)
- Underfunded pension liabilities
- Medicare/Medicaid exclusions (compliance)
- Purchase price or working capital adjustments
- Specific reserves on financial statements
- Forward-looking statements

- **Common Policy Conditions**

- Defense expenses included as covered cost/within definition of loss
- Subrogation against seller limited to fraud
- Policy assignable with consent
- Buyer’s knowledge limited to deal team members

Example of R&W Insurance from a Recent Transaction

- The policy may "layer in" above the coverage provided by a seller through indemnification. However, since the cost of the policy increases with coverage amounts and policy periods, an insured may choose less coverage than would typically be offered by a seller as indemnification for certain breaches.

Provision	Acquisition Agreement Coverage	Insurance Coverage
Fundamental Reps	5 years (less competitive deals would be indefinite)	6 years
Operational Reps	12 months	3 years
Environmental Reps	12 months (no history of environmental issues)	3 years (option to seek separate environmental insurance policy)
TAX and ERISA Reps	Statute of Limitations	6 years
Dollar Thresholds		
De Minimis	\$50,000	None
Deductible/Retention for Operational and Environmental Reps	0.5%-1.0% of purchase price	1% of purchase price with step down in retention to 0.5% of purchase price after 12 months
Deductible/Retention for Fundamental, TAX and ERISA Reps	None	<i>Same as above</i> - 1% of purchase price with step down in retention to 0.5% of purchase price after 12 months
Indemnity Cap / Policy Limits	1% of purchase price (matches escrow)	7.5%-12.5% of purchase price
Limitations		
Consequential Damages, Lost Profit, Multiple of Earnings	Silent	Silent

Underwriting Focus by Insurer (Due Diligence)

- Industry/Deal Characteristic Specific Issues:
 - Healthcare—regulatory and government billing issues
 - Financial
 - Technology
 - Education
 - Adequacy of Due Diligence (third party due diligence)
- Heightened Areas of Concern:
 - Financials (carve-out or unaudited, and high multiples)
 - Product Liability
 - Environmental
 - Healthcare—government billing
 - Tax
 - Labor Issues
 - Data Privacy and Security

Key Takeaways

- Carefully consider and negotiate your insurance policy just as you would negotiate an indemnification provision in a purchase agreement.
- Indemnification provisions in purchase agreement have to be negotiated side-by-side with insurance policy
 - Consider those areas that are likely to be excluded from the policy
 - Negotiate earlier in the process for greater indemnification of such excluded items
- Work with high-quality, high-volume brokers. If you have a claim, involve your broker early in the claims process. Future business from your broker is one of the most significant “checks and balances” on an insurer’s claims handling process.

Key Takeaways (continued)

- “Actual Knowledge” Exclusion
 - R&W insurance policies exclude matters of which the buyer has "actual knowledge" (akin to an "anti-sandbagging" provision in a purchase agreement).
 - Best Practices
 1. If buyer’s due diligence has uncovered a matter that would constitute a breach of the reps and warranties and the seller has not disclosed it, we recommend addressing the issue with the seller prior to signing (either via purchase price reduction, specific indemnity or other method).
 2. Provide **all** diligence information to the Insurer (whether it asks for it or not) and retain records of what was transmitted/accessed. You want the Insurer to have the same “actual knowledge” as you with respect to information learned in diligence.
 3. Provide your Quality of Earnings report (and all drafts) to the Insurer. Understand it will be used against you in subsequent litigation with the Insurer.
 4. Clearly articulate to the Insurer in writing how the purchase price was calculated. Be specific about the EBITDA, the TTM period in which it was calculated, and the multiple that was used or any other valuation metric used to determine the purchase price. The Insurer will already be focused on this, but it will set the table in potential future multiples claim.

QUESTIONS?