

SHAREHOLDER REPRESENTATION

M&A Merger Agreements: Efficient Drafting

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Drafting an M&A merger agreement can be one of the most important (and time-consuming) aspects of an M&A transaction. Engaged on more than 6,000 deals to date, SRS Acquiom has a unique vantage point to witness the various forms that drafting can take. Below, we offer easy implemented suggestions to optimize the mechanics of your working capital, basket, carveouts, expense funds, and more.

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Working Capital—Shareholder Representative Review Rights

Buyers typically have 60 to 90 days following the closing date to finalize a proposed closing date balance sheet, working capital adjustments, and net working capital calculation. In contrast, under most merger agreements, the shareholder representative may have only 20 or 30 days to review, research, and approve or object to that submission. In some cases, the agreement even compels arbitration after this period. Both can be problematic.

It typically takes longer than 20-30 days, however, for a shareholder representative to review working capital calculations when material adjustments might be made because both the number of issues and the complexity of such issues tend to increase as the amount of the adjustment increases. To address this, consider adding additional time for the shareholder representative's review of the buyer's calculations when the adjustment being sought is more than a certain threshold. SRS Acquiom suggests language along these lines:

If the Buyer shall deliver an Adjusted Working Capital Statement to the shareholder representative, then the shareholder representative may dispute any item or amount set forth in the Adjusted Working Capital Statement at any time within thirty (30) calendar days following receipt of the Adjusted Working Capital Statement provided that such response period shall be increased to sixty (60) calendar days if that the Adjusted Working Capital Statement delivered by Buyer would, if accepted, result in a Shortfall Amount of more than [\$].

Relatedly, agreements often specify the amount of time the parties must negotiate in good faith to resolve any disputes raised by the shareholder representative, after which period some agreements require the matter to be immediately submitted to accounting or legal arbitration. This is often premature if the timeframe for good-faith negotiations is set at 30 days or fewer and can be used by one party or the other to impose leverage, which quickly ramps up the cost to resolve the

working capital adjustment. SRS Acquiom suggests setting a longer contractual period for good-faith negotiations (e.g., 60 or more days) and using “may” language for submitting unresolved disputes to accounting arbitration. This still allows the parties to mutually agree to engage in accounting arbitration earlier if necessary due to a deadlock between the parties.

Indemnification—Make Sure M&A Baskets Are Structured for Their Intended Purpose

Most merger agreements have a concept of a “basket” in the indemnification section. The idea is that the buyer should not be permitted to bring indemnification claims, with some exceptions, until the damages rise to some level of materiality in the context of the overall deal.

The threshold should be met only after the buyer has suffered actual damages more than the basket amount.

In our view, this threshold should be met only after the buyer has suffered actual damages in excess of the basket amount, rather than once the buyer has merely asserted damages more than the threshold amount. Otherwise, the buyer could circumvent the purpose of the basket and seek recovery for all claims by simply submitting tenuous claims that have only a remote possibility of actual damages.

The type of language SRS Acquiom believes is flawed in connection with this issue is like this:

Buyer shall not be entitled to indemnification unless and until the aggregate amount of claims submitted by Buyer exceeds \$X.

or more vaguely:

Buyer shall not be entitled to indemnification unless and until the aggregate amount of losses for which they seek to be indemnified exceeds \$X.

To avoid this uncertainty and potential ability to circumvent the intent of the basket, SRS Acquiom suggests language that is more precise:

Buyer shall not be entitled to indemnification hereunder unless and until the aggregate amount of actual losses for which they are entitled to indemnification hereunder exceeds \$X.

Clarify the Exclusivity of M&A Carveouts

M&A agreements frequently contain carveouts to caps on levels of indemnification coverage for various types of claims. A typical formulation may specify that the selling stockholders' exposure to loss for claims related to most types of breaches of representations or warranties is limited to the escrow but that the buyer can recover for losses more than the escrow for matters such as intellectual property, capitalization, tax, and other similar issues.

Many M&A agreements, however, do not address whether these limits are inclusive or exclusive of each other. For instance, if the agreement says most claims are limited to the escrow amount, but tax matters can go up to 50% of the purchase price, could the buyer recover the escrow amount plus the 50% tax cap or is their total potential recovery limited to 50% of the purchase price? Many selling stockholders, if asked, would say that their maximum potential risk in this transaction is 50%, but that might not be the case. Losses more than 50% potentially could occur if, for example, the buyer brought a customer contract claim that wiped out the escrow and then separately brought a tax claim equal to 50% of the purchase price (for a total recovery of 60% of the purchase price if the escrow amount was 10%). If this is not what the parties intend, they should make clear that the exposure on the tax matters in this example is equal to 50% of the purchase price less amounts paid on any other claims.

In the experience of the SRS Acquiom team, this point frequently is not well defined in merger agreements, and the merger parties should clarify

whether indemnification caps are intended to be inclusive or exclusive of each other.

Pay Attention to Shareholders and Post-Closing Payments When Selling <100%

Some transactions result in a sale of a majority of a business but not the entirety. When these occur, special issues may arise.

First, if shareholders are selling different percentages in the transaction, be aware that there is a greater risk of the stockholders not being in full alignment on all issues than is the case when the entire company is sold. For instance, if the company has excess cash and has the choice to either pay a dividend shortly before closing or have that cash result in an increase in a purchase price adjustment, then economic differences will result. A dividend would presumably be paid to all shareholders based on the number of shares held pre-closing (ignoring for these purposes the impact of any preferences or similar terms). In contrast, when the cash is retained, there is a resulting increase in a purchase price adjustment that would be paid based on the number of shares sold in the transaction rather than the number of shares held pre-closing.

Second, to the extent that there are any post-closing payments contemplated, such as future earnouts, make sure it is clear how those payments will be made. There could be a material difference between those payments being funded by the buyer making another payment itself versus those payments coming from the company that the pre-closing shareholders continue to own in part. For example, if \$1 million is to be paid in an earnout and the selling stockholders continue to own 25% of the business after closing, then that earnout payment from the company, rather than from the buyer, reduces the value of the business by \$1 million. The actual economic benefit of the earnout payment to those stockholders is \$750,000 rather than \$1 million. The merger parties should be clear on the intent of how any of those payments will be made. This is in

contrast to a sale of the entire business where the shareholders likely do not care how the buyer funds those obligations.

Resolve Vendor Complications in M&A Transactions

Vendor relationships often change or end after a merger or acquisition. Existing agreements, when informal or improperly documented, can lead to third-party claims impacting both buyer and seller. In a recent SRS Acquiom case, an acquired company in the U.S. had been purchasing products at a fixed price per unit from multiple vendors overseas. The parties had an informal understanding that if the vendors' costs exceeded a certain threshold, then the company would compensate the vendors accordingly. However, the agreements and formula for calculating the additional costs were not clearly documented or formally executed by the parties.

After the acquisition, the buyer terminated these relationships. The vendors submitted invoices for reimbursement based on their interpretations of the informal agreements, and as part of the working capital adjustment, the buyer then submitted a claim of well over \$1 million against the escrow stemming from these invoices.

A forensic accounting team from SRS Acquiom spent ten days analyzing the vendors' claims, gathering more information from the acquired company's CFO and CEO, and comparing the new claims to past practices. Their conclusion: The vendors' claims were overstated. Because the arrangements had been in place for months prior to the acquisition, the team could document the actual terms of the arrangements, identify miscalculations made by the vendors, and convince the buyer that the results of this analysis refuted the vendors' claims. Ultimately, this enabled the buyer to contest the vendors' claims and reduce the payout from escrow by \$1 million.

There are several lessons to be learned to avoid unexpected and inflated claims from vendors that are subject to post-closing indemnification by the selling shareholders:

First, do a contract review to ensure that all obligations are well documented and understood by both the vendor and the company. Many issues we've seen have arisen from informal or verbal contractual relationships or contracts that have not been fully executed.

Second, discuss with the buyer's acquisition team their plans for vendor relationships post-closing and build a vendor transition plan, if necessary. Many issues can be avoided with effective communication between the buyer, company, and vendors. Surprise terminations can lead to inflated final invoices, especially when the company is purchased by a large, well-established acquirer.

Finally, make sure that the post-closing acquisition team is provided with a list of each vendor's primary sales representative, and other important contacts at the vendor and, if appropriate, do transition calls or meetings. Transitioning personal relationships can go a long way toward avoiding post-closing claims from vendor bills.

Clarify the Treatment of Net Payments and Claims in Post-Closing M&A Agreements

Suppose a buyer recovers a \$1 million tax refund after closing that is to be paid to the sellers under the terms of the merger agreement but incurs \$100,000 in professional fees in connection with such collection. The buyer may assume that it should pay the sellers the \$900,000 net amount, but a question sometimes remains as to whether this is the proper treatment. The alternative may be that the buyer should pay the sellers the \$1 million gross amount collected and take \$100,000 from the escrow.

There are three practical consequences to the distinction between these options. First, if the buyer takes the fees from escrow, it reduces the amount the sellers continue to have at risk and the amount that the buyer has available for protection should it later be entitled to indemnification for certain other types of claims. Second, taking the fees from escrow

puts more money in the sellers' pockets now. Since escrows may have months or years remaining, this can have a significant impact on cash flows. Third, a claim against the escrow could be subject to a basket, potentially resulting in such expenses being paid by the buyer rather than the shareholders.

Many merger agreements do not make clear which option is the intended treatment. Because both sides have reasonable positions, clarification in the agreement can eliminate a potential controversy.

Selling Your Company May Require Multiple Law Firms

SRS Acquiom has seen a fair amount of deals where a separate firm represents the interests of a stockholder or group of stockholders. The stockholders will do this for at least two reasons.

First: To ensure that their interests are fully protected with respect to issues such as how merger proceeds are distributed, whether third parties are receiving payments that could reduce the amount paid to stockholders, and what liabilities are being assumed by the stockholders or their representatives in connection with the transaction.

Second: To ensure that at least one of the attorneys for separate stockholder counsel who represent the sell-side in connection with the deal will continue to be available to the shareholders after the closing of the transaction.

The selling company's attorneys may be conflicted from assisting the selling stockholders after closing. The company (rather than the stockholders) was that firm's client, and when that client was merged into the buyer, the buyer may own that attorney-client relationship after closing. In contrast, a lawyer who represented the stockholders in the deal will not have any such conflict.

Access to Information Post-Closing

SRS Acquiom sees deals in which the parties do not address what information the shareholder representative will be entitled to receive after closing in the event there is a claim, dispute, or similar issue. This can raise significant issues with no clear answers. For example, if the buyer submits an indemnification claim, a logical reaction from the representative might be to say that it has a few questions and would like to see certain related materials such as work papers, technical documents, or correspondence. The representative might reasonably request to speak with the employees of the buyers who worked on the matter to ask some questions.

Buyers may resist providing all or certain of those materials for a variety of reasons. Often, the issues are sensitive from a confidentiality perspective, and the buyer may want to limit access to the related materials as much as possible. Of course, the buyer might want to deny access for purely strategic reasons related to the dispute, figuring that it is to their advantage for the representative to know as little as possible. Finally, the buyer might not want to incur the time or expense of providing access to the applicable personnel or copies of the documents. Even if the parties agree that access to some information is reasonable, they can differ on how much is appropriate.

To help with this problem, the parties should set forth the rules related to access of information in the merger agreement.

Sample Language:

Following the delivery of [the Closing Statement]/ [each Earnout Report]/[a Notice of Claim], the [Shareholder Representative] and its representatives and agents shall be given all such access (including electronic access, to the extent available) as they may reasonably require to the books and records of the [Surviving Corporation] and reasonable

access to such personnel or representatives of the [Surviving Corporation] and [Buyer], including but not limited to the individuals responsible for [preparing the [Closing Statement]/Earnout Report]]/[the matters that are subject of the [Notice of Claim]], as they may reasonably require for the purposes of resolving any disputes or responding to any matters or inquiries raised in the [Closing Statement]/[Earnout Report]/[Notice of Claim].

A related issue is whether the representative should be given a copy of the documents placed in the data room that was prepared in connection with the deal's due diligence process at the time of closing. The target company may want to provide the shareholder representative with an electronic archive of the data room prior to closing, so it is not reliant on what the buyer may choose to later disclose. Buyers may, however, resist allowing the target to provide the electronic archive to the representative, claiming that it has confidential information that it will own after closing, there is no outstanding claim at the time, and providing access to all information is overkill. One solution may be to require that the data room archive be placed in escrow and released to the representative at such time the buyer makes a claim.

Release of Expense Funds

Avoid hard coding the release date of the expense fund (such as at the end of the escrow period). Instead, leave this to the discretion of the Shareholder Representative (as directed by the Advisory Committee), since issues could remain after the escrow is released.

Simple Language:

At the end of the Escrow Period, the remaining balance of the Escrow Amount (less any outstanding Claims) and the Expense Fund shall be released to the Shareholders.

Better Language:

As soon as practicable following the completion of the Representative's responsibilities, the Representative will deliver any remaining balance of the Expense Fund to the Paying Agent for further distribution to the Shareholders.

Confidentiality Provisions

Ensure that any confidentiality provisions that the Shareholder Representative is subjected to are flexible enough to permit the Shareholder Representative to communicate with, at a minimum, the Advisory Committee. Without this, it can be very difficult to address claims.

Sample Language:

Following Closing, the Representative shall be permitted to disclose information as required by law or to employees, advisors, agents, or consultants of the Representative and to the Shareholders, in each case that have a need to know such information and that are subject to confidentiality obligations with respect thereto.

Resignation/Removal/Replacement Provision

Make sure to cover what happens if there is no Shareholder Representative at any point.

Sample Language:

*The Representative may resign or be removed at any time by the Required Majority. If at any time there is no Representative, the Required Majority, acting via written consent, may exercise the powers and authority of the Representative hereunder.**

Exculpation/Indemnity

If you have an advisory committee to the Shareholder Representative, include them in the indemnification terms.

Sample Language:

Neither the Shareholder Representative nor any member of the Advisory Committee established under the Shareholder Representative's engagement letter (collectively, the "Representative Group") shall incur any liability of any kind . . . and the Shareholders shall indemnify the Representative Group from and against any and all losses . . .

Scope of Agency

Have Shareholder Representative's authority cover the full set of payees that are receiving consideration, not just the stockholders (i.e., don't overlook option holders, warrant holders, or others receiving proceeds).

Avoid Express Restrictions

Generally avoid having express restrictions on the Shareholder Representative's authority in the merger agreement, which is better for both parties; restrictions can be built into the engagement letter or side letter where they are governed by the Advisory Committee's authority instead of being hard coded in the merger agreement.

Buyers want to be able to rely on the Shareholder Representative's actions without being responsible for determining if other conditions were met. Sellers want to be able to change authorities without requiring an amendment to the merger agreement.

Holding the Expense Fund

It's usually a best practice to have the Shareholder Representative hold the expense fund rather than the escrow agent, for a few reasons:

- To be able to act quickly. Having to send instruction letters to a bank can cause delays.
- To avoid the possibility of funds being locked up if there is a dispute over their distribution.
- To avoid additional fees.

Watch for Non-Accounting Issues in Working Capital Adjustments

Items that should be indemnification claims often are included either by accident or design in the working capital adjustment. Examples include:

- Tax compliance
- Reserves for litigation
- Capitalization errors

Including these in working capital adjustments is not typically advisable. These require legal analysis to resolve, but accountants can't provide a legal analysis or opinion. If it goes to accounting arbitration, the arbitrators only know how to address the accounting issue.

We recommend including clear language to keep these issues separate from the working capital adjustment process. They are more appropriately treated as indemnification matters. If legal issues must be included at this stage, consider alternatives to accounting arbitration for dispute resolution.

Watch for Overlap in Definitions

Best Practices:

Go through a detailed general ledger with the CFO with each of the accounting definitions.

There should be no overlap of Cash, Net Working Capital, Indebtedness, Unpaid Transaction Expenses, etc.

Simple Example:

“Cash” is defined as cash plus cash equivalents, including accounts receivable.

“Net Working Capital” is defined as Current Assets minus Current Liabilities.

“Current Assets” is defined as Cash and other current assets in accordance with GAAP.

“Current Liabilities” is defined as current liabilities in accordance with GAAP.

The Problems:

You might have just counted accounts receivable twice.

You might be including transaction expenses in Current Liabilities even if they already reduced the closing purchase price.

Better Definitions:

“Current Assets” is defined as Cash and other current assets not already included in Cash in accordance with GAAP.

“Current Liabilities” is defined as current liabilities in accordance with GAAP other than those already factored into the Closing Purchase Price.

Post-Close Drafting Considerations in M&A Transactions

Did you know two-thirds of deals have material post-closing issues? These issues can surface in purchase agreements, earnouts, cap tables, paying agents, escrow, and other post-closing matters related to the shareholder representative and expense funds.

SRS Acquiom has served as shareholder representative on more than 3,000 transactions and has negotiated and resolved more than 3,200 claims, resulting in a 53% claims reduction percentage for our clients.

Draft Your Next Agreement as Efficiently as Possible

In summary, M&A deal parties encounter many pitfalls when embarking upon the journey to craft an efficient M&A merger agreement. Even the most common components of an M&A agreement (such as working capital, baskets, and carveouts) can fall victim to grey areas. Layering in less common challenges—like partial sales, vendor complications, treatment of net payments or claims—only makes the problem more challenging. SRS Acquiom has the technology and resources that help simplify the complexities associated with M&A deal journeys. Our unique perspective gives our team the ability to offer tips to help your M&A deals run more efficiently. Paying attention to the points above when crafting your next M&A merger agreement may help your next deal run more smoothly.

About the Author



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Casey is a Managing Director at SRS Acquiom. His team is responsible for managing post-closing escrow claims, earnouts, working capital, tax, and other disputes on behalf of the company's clients, post-closing distribution of merger proceeds, and other activities related to serving as the shareholder representative. Casey has represented shareholders' interests on hundreds of deals, defending claims up to \$400 million and administering life sciences deals with as much as \$1 billion in contingent consideration. Before joining SRS Acquiom, Casey represented Fortune 50 clients as a litigation attorney nationally and internationally in a variety of fields.

Casey holds a J.D. from the University of California, Berkeley (Boalt Hall) and a B.S. in economics from Arizona State University's Barrett Honors College.

About SRS Acquiom

SRS Acquiom delivers the smartest way to run a deal™ with solutions that reduce the administrative burden in complex transactions. Our M&A services include paying and escrow agent services, online document solicitation and reporting, and professional shareholder representation. For loan and credit transactions, we provide independent Administrative Agent, Collateral Agent, Sub-Agent, and Successor Agent services. Since 2007, we have helped sophisticated deal parties get deals done more efficiently, enabling them to focus on building great businesses and maximizing value.