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M&A Expense Funds: Why Sellers Should Establish One, How Large It Should Be, and Other Considerations

M&A expense funds are often arranged in contracts to allow the shareholder representative to pay for any third-party expenses that may arise after closing, such as engaging attorneys or accountants for any post-closing disputes. Generally, those funds are held separately from the escrow and can be released at the sole discretion of the shareholder representative. SRS Acquiom believes the selling shareholders should establish an expense fund in most M&A transactions.

Reasons for Establishing M&A Expense Funds

Many top litigators suggest that perhaps the best reason for establishing an expense fund is that its existence can be one of the biggest deterrents to post-closing claims. Most sophisticated strategic buyers would prefer not to bring a post-closing claim, but they will do so if necessary. Buyers will generally approach M&A deals with the hope that everything about the target company was accurately represented to them, and they acquired the company they were expecting to acquire. Some buyers, however, may look at the indemnification escrow as an opportunity to get some money back to improve their returns on the M&A deal. If these buyers know that the shareholder representative has the resources available to defend against a claim, they will more rigorously evaluate the merits of their post-closing claim and the probability of success.

If an expense fund does not exist, the shareholder representative may not have funds to effectively represent the selling shareholders. Shareholders can always gather funds, but the window for responding to escrow disputes is usually limited. By the time funds become available, the response period may have elapsed. Buyers also may count on shareholders' reluctance to reach into their pockets to pay expenses after the initial payout.

The size of the fund needs to be meaningful compared to the size of the potential claims to be a sincere deterrent to potential claims and a valuable tool for the former shareholders. Regardless of the amount, however, SRS Acquiom considers expense funds a best practice. Having funds set aside to quickly mount defenses against post-closing claims more than offsets any cost of the holdback in most M&A deals.

Potential Benefits of Establishing an M&A Expense Fund

“A genuine deterrent to claims requires a meaningful fund relative to the size of potential claims.”

Establishing an expense fund at closing generally works in the best interest of all shareholders, but especially the larger ones. At closing, every shareholder contributes to the expense fund on a pro rata basis. At the end of the post-closing period, the balance of the expense fund is distributed back to the shareholders. In contrast, if no expense fund is established and a dispute arises that the shareholders elect to fight, it is likely that a few of the larger shareholders will end up funding more than their pro rata portion of expenses. For investment funds, this may require them to use a portion of their management fees to fund such expenses or require a claw-back of merger consideration previously distributed to their limited partners. In either case, establishing an expense fund at closing mitigates this exposure.

Buyers may want an expense fund to be available if there are terms in the merger agreement that obligate the parties to split the expenses of items such as escrow banking fees, audits, or arbitration.

Many agreements contain a mechanism stating that the parties will attempt to resolve any disputes for some defined period and, if they are unsuccessful, an independent accountant or arbitrator will be appointed. If the expenses of the accounting firm or arbitrator are to be split between the buyer and the selling shareholders, or if expenses are to be paid by the loser in the dispute, the buyer will want some peace of mind that the selling shareholder group will be able to meet its portion of any such obligations. An expense fund provides an easy means of collection.

Appropriate Size of an M&A Expense Fund

As with most issues in a merger agreement, the amount of the expense fund depends on different factors. A genuine deterrent to claims – one that is useful to former shareholders – requires a meaningful fund relative to the size of potential claims. According to the 2020 SRS Acquiom M&A Deal Terms Study, the average size of an expense fund in 2019 was 0.47% of the transaction value, with a median of 0.22%.

Except possibly for small transactions, SRS Acquiom recommends a minimum escrow expense fund of \$100,000. If, however, the escrow is larger or the earnout potential is significant, it may be appropriate to reserve between \$250,000 and \$500,000. Our company has seen expense reserves established at closing as high as \$4 million. It depends on the amount of potential upside and the complexity of the merger terms.

SRS Acquiom’s data reveals that M&A deals with the following conditions may be better supported by a larger expense fund:

Working-capital adjustments

Working-capital adjustments often require post-closing effort and increase the likelihood that expense escrow funds will need to be used. If so, this would then decrease the funds available for other possible claims. Therefore, all else being equal, the selling shareholders should consider having a larger expense fund when working-capital adjustments are included in the transaction than when such a mechanism is excluded.

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Milestones or earnouts

M&A deals with contingent consideration timelines years beyond closing are more likely to require counsel at some point to connect with buyer counsel, or formally amend earnout obligations by buyers. Data from the SRS Acquiom 2019 Life Sciences Study reveals that on average, 40% of life sciences M&A with mature earnout milestones have some sort of dispute. Specifically, there is a good chance that your M&A deal will require serious milestone advocacy post-closing—and this is on top of the risk of dispute inherent in non-milestone M&A deals. If these terms are included in your M&A deal, you might want to consider an expense fund that is several times larger than what might be included in a M&A deal without milestones and earnouts since the associated legal costs and amounts in an earnout dispute can be substantial.

Intellectual property assets

Litigation over technology assets is a common post-closing issue. While intellectual property (IP) litigation costs are falling, the outlay can still be significant. Since the behavior of third-party patent trolls can be unpredictable, protection of IP rights should be considered even when the sellers feel they have taken appropriate steps prior to closing.

Disclosed litigation

If litigation against the company is ongoing at the time of closing, the spending is not likely to stop once the M&A deal closes. In some M&A deals, the representative controls that litigation and is responsible for the resulting legal expenses. Even where the buyer controls litigation, there is significant risk of a dispute about the final indemnity of the matter.

Multiple escrow releases

In our experience, M&A deals with an escrow to be released in several tranches (e.g., half of the escrow six months after closing and the other half after one year), lead to increased claim activity and disputes, which are more likely to require involvement of outside counsel to resolve.

Cross-border components

M&A deals where the buyer, selling company, or subsidiaries are located outside the U.S. often require specialty counsel to resolve disputes. Examples include hiring counsel or tax experts to address foreign tax audits or counsel that specializes in employment laws of foreign countries. Certain jurisdictions are also more expensive to litigate.

A buyer power ratio of more than 100

A 2017 joint study between SRS Acquiom and the American Bar Association revealed that in M&A deals where the buyer's market cap is more than 100 times the M&A deal purchase price, many negotiated M&A deal points will likely come out in the buyer's favor. This can increase the types of possible indemnification claims and/or the length of representation survival periods, which can in turn require increased use of outside counsel or tax experts.

As a general rule, while SRS Acquiom understands the desire to not tie up funds unnecessarily, it is better to have more money than needed in an expense fund than to not have enough. Having too much just means that some merger proceeds were delayed in disbursement, but having too little means that the major shareholders have to navigate the issues they were seeking to avoid when setting up the fund in the first place.

Mechanics of Establishing an M&A Expense Fund

In rare circumstances, SRS Acquiom has seen expense funds established through a voluntary holdback of some of the buyer shares distributed in a non-cash acquisition. Depending on the marketability of the buyer's securities, this can be problematic when a dispute expense is incurred. Selling shares may delay deployment of dispute resources, create additional transaction expenses or, if the buyer's shares decline in value, may be insufficient to cover costs. If this occurs, selling shareholders, particularly the larger ones, may have to contribute to a new cash expense fund. Therefore, SRS Acquiom recommends that shareholders establish expense funds using company cash, if available (with a corresponding reduction in consideration paid to shareholders), or allocating any cash proceeds to the expense fund prior to distribution to the shareholders. In rare cases, because expense funds also have benefits to the buyer, some buyers may be willing to distribute limited cash to fund the expense fund, even in those transactions primarily structured as a non-cash (stock) transaction.

Some selling shareholders establish the funding for defense of claims separately through a contribution agreement. If all the indemnifying shareholders are likely to have significant cash resources for the foreseeable future and are ongoing entities, a contribution agreement, which requires the signatories to contribute for a specified purpose if called upon by the shareholder representative, may avoid the need to tie up cash in an expense fund, while also providing the deterrent effect and resources in the

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event of a later dispute. This type of arrangement carries risks, of course, as it is difficult to predict if a particular indemnitor will be able and willing to honor the contribution commitment at a later time. Indemnitors will also be reluctant to sign such an agreement unless there are caps on their funding obligations.

M&A Contract Language to Support Establishing an Expense Fund

It is relatively straightforward to add M&A contract language to an M&A deal in process to support the establishment of an expense fund. The language should not only address the founding of the expense fund but also govern the disbursement of the fund.

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Typical language to set up an expense fund might include the following:

Buyer shall deduct the Escrow Expense Amount from the Total Consideration and deposit with the Escrow Agent such Escrow Expense Amount without any act of the Indemnifying Parties, such deposit of the Escrow Expense Amount to constitute a separate escrow fund to be governed by the terms set forth herein. The Escrow Expense Amount shall be available solely to (i) compensate the shareholders' representative in accordance with the terms hereof, and (ii) pay any third-party expenses incurred by the shareholders' representative in connection with the defense, investigation, or settlement of any claim from an Indemnified Party or any Third-Party Claim under or related to this Agreement, as well as any costs and expenses associated with the Escrow Expense Amount. The shareholders' representative shall have full discretion over the Escrow Expense Amount, and the Escrow Agent shall follow any lawful directive of the shareholders' representative regarding the use or disbursement of all or a portion of the Escrow Expense Amount to third parties and in amounts authorized in writing by the shareholder's representative.

As an alternative to forming an expense fund or to better enable the selling shareholders to realistically assume control of costly third-party litigation matters, some parties add a term stating the selling shareholders' portion of third-party expenses will be paid from the escrow. If the parties take this route, they should include a clear mechanism for payment in the merger agreement to avoid complications in timely payment of monthly legal bills.

Where to Hold the Expense Fund

Once an expense fund has been created, the parties have to determine where to hold it. The most common options are to either hold the fund with an escrow bank or in an account controlled by the shareholder representative. There are pros and cons to each. If it is held with an escrow bank, the parties will typically need a separate agreement to document the arrangement, which adds slightly to the M&A deal's complexity. Additionally, banks will often charge fees to establish and maintain such an account but may provide the parties the opportunity to earn some interest.

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If the account is held by the shareholder representative, the arrangement is typically simpler. If this is the route taken, ensure the account is properly established. The money should be set up in client fund accounts that are not comingled with the representative's own assets. In addition, the account should be titled as a fiduciary account. At SRS Acquiom, accounts are titled “Shareholder Representative Services FBO Clients.” If completed properly, the shareholders should also be protected against any risks of bankruptcy or insolvency of the representative, and increased FDIC insurance coverage may be available.

Holding Indemnity Escrow Funds in an Escrow Bank

For expense funds held by an escrow bank, the shareholders will want to ensure a few terms are included in the applicable escrow agreement. First, the money should be released solely on the instructions of the representative without requiring any consent or input from the buyer. The expense fund is a set-aside of shareholder money, and the buyer should not have anything to say in when or how the money is spent. Second, the shareholders will want to make clear the buyer does not receive any reports or updates regarding the balance in the expense fund. If the parties are in a dispute, neither side will want the other to know what resources they have available to pursue the matter.

When establishing an expense fund with an escrow bank, the shareholder representative is typically required to provide its own taxpayer ID. While any investment earnings belong to the shareholder beneficiaries and not the shareholder representative, the escrow bank will report such earnings to tax authorities under the taxpayer ID of the shareholder representative.

To avoid paying taxes on income that does not belong to investment earnings or having unreported income generating a tax audit, the shareholder representative should treat such earnings on a “nominee” basis. Some escrow banks may honor such treatment and issue 1099s to each of the beneficiary shareholders rather than to the shareholder representative. Typically, this status can be selected by properly filling out a W-9 tax form when the account is established. If the shareholder representative does receive a 1099 to report such income under its taxpayer ID, the representative should report such income on the tax return as nominee earnings and show a deduction for that portion that does not belong to the representative. In addition, the representative should issue 1099s to each shareholder beneficiary to whom such earnings properly belong, which can be a substantial and tedious project.

M&A Contract Language to Support the Release of Expense Funds

The expense fund is usually referenced in the merger agreement, the escrow agreement, or both. Once the escrow is released, any earnouts have either been missed or paid, and the selling shareholders are comfortable the risk of any additional post-closing issues has lapsed, they will generally instruct the shareholder representative to release the balance of any expense fund to the shareholders.

In connection with this, SRS Acquiom suggests the shareholders avoid firmly establishing the release date of the expense fund (such as at the end of the escrow period). Instead, shareholders should leave it to the discretion of the shareholder representative (as directed by the Advisory Committee), since issues could remain after the escrow is released. It simply is not possible to know at the time of closing when the time will be right for the shareholders to determine that the risk of additional issues is acceptably low to justify the expense fund being terminated. Suggested bad language to watch out for and what SRS Acquiom believes to generally be a better alternative are outlined below.

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Weaker 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.

Stronger language:

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

Tax Treatment of Escrow Payments

When establishing the expense fund, shareholders should consider the expense fund tax treatment. In many cases, the shareholders would prefer the expense fund to be considered as part of an installment sale and only taxable upon ultimate receipt. The simplest way for this to occur is for the shareholder representative to forward any remaining expense funds to the buyer's paying agent at the end of the transaction.

Taking advantage of installment tax treatment for expense funds might not be desirable or available in all M&A deals. For instance, the buyer might not want to be involved with any of the necessary release logistics. This often occurs when there is a buyer hold-back rather than an escrow or where indemnification is limited to milestone payments. If installment sale treatment is not used, the expense fund will be deemed distributed by the buyer to the shareholders at closing. In this situation, selling shareholders should be aware the buyer (or its paying agent) may issue a Form 1099-B that includes the expense fund amount despite the shareholders not receiving those funds. Because expense funds will continue to be at risk until released, selling shareholders should consult their tax advisors as to the appropriate tax treatment of such amounts.

New Financing Options for Expense Funds

For many years, an inadequate expense fund meant that shareholders would either have to accept their fate or seek replenishment through an arduous process to gather funds. However, a new market of litigation financiers has recently emerged to provide third-party funding for offensive shareholder lawsuits. Firms like Legalist, LexShares, and Burford Capital are among the most visible players; however, we expect more to follow.

“Litigation financiers are taking roughly 10 to 20 percent of recovery following return of their initial investments.”

In exchange for their infusion of capital, litigation financiers are taking roughly 10 to 20 percent of recovery following return of their initial investments. Although terms vary by M&A deal, most investors do not require repayment in the absence of recovery. This means shareholders can proceed with litigation they could not otherwise afford, with very little downside if things go awry.

Although litigation finance does create new opportunities, it is not a panacea. As an initial matter, litigation financiers are primarily interested in cash payouts. On M&A deals where sellers are after additional shares (especially if illiquid) or equitable remedies, it may be difficult or impossible to negotiate financing. Even if cash is available, financing also requires the sellers to forfeit a decent slice of their proverbial pie. More importantly, financing is simply not available for any litigation defense because there is no potential payout. Since defense work (either directly against buyer, or against third-party claims) comprises a significant percentage of post-closing disputes, litigation finance is not a reliable substitute for an adequate shareholder expense fund.

To achieve the greatest value on post-closing matters, shareholders are best served by establishing a well-stocked expense fund at closing. Any amount not used will be distributed back to the sellers after the dispute period has ended, but having enough to meaningfully engage with either the buyer or third parties is likely to result in better post-closing outcomes across the board.

Commonly Asked Questions About Expense Funds

Often, the expense fund is one of the last items discussed before closing, when everyone is tired and just wants to get the M&A deal done. But expense funds are crucial and shareholders, lawyers, and buyers should know what they are, how they are established, and what affects their size. Below are the four most common expense fund questions received at SRS Acquiom, and answers based on our experience.

What is an expense fund and how does it differ from an escrow?

An expense fund is a “rainy-day” or “fighting” fund set aside at closing to fund legal, accounting, and other expenses shareholders and their shareholder representative may incur after closing. Like the escrow fund, the expense fund is typically made up of pro rata contributions from all shareholders. While the buyer can make claims against the escrow for indemnification claims, the expense fund is solely for the use of the

shareholders and their representative. Absent specific and highly unusual agreement to the contrary, the buyer can never claim expense funds for any reason.

While an escrow sits with a bank or other third party for a defined time period, the shareholder representative typically holds the expense fund until the shareholders determine that all open issues in the M&A deal are finished. That end date can mean the claims period has expired with no issues, all milestones have been met or otherwise concluded, or any final disputes holding up the escrow have been resolved. The shareholder representative then directs the distribution of the remainder of the expense fund directly to the sellers.

“Without an expense fund, or if the fund is too small, individual shareholders may need to cover post-closing expenses with voluntary contributions from their own accounts.”

Escrows and expense funds may be treated differently for tax purposes because, unlike an escrow, the money in the expense fund has already been relinquished by the buyer. Consult your tax professional regarding treatments of your merger proceeds.

Why does my M&A deal need an expense fund?

Post-closing disputes are far more common and expensive than most people think: Nearly two-thirds of M&A deals have a post-closing claim against the escrow. While not all disputes require tapping the expense fund, many do. Disputes that call for an outside firm include formal litigation or arbitration, disputes that are headed in that direction, or issues requiring specialized legal or accounting knowledge.

Without an expense fund, or if the fund is too small, individual shareholders may need to cover post-closing expenses with voluntary contributions from their own accounts. While it is sometimes possible for these contributions to be reimbursed from the final escrow release, post-closing contributions are inconvenient for all parties and involve an outlay of post-closing cash from shareholders on short notice.

How do shareholders establish or refill an expense fund?

Shareholders usually work with their shareholder representative to establish the expense fund shortly before signing the definitive agreement. At closing, the expense fund is then deducted off the top of any closing proceeds before distribution to shareholders.

When the definitive agreement provides for an expense fund, all M&A deal parties, including the buyer, will know how much the shareholders have set aside. The definitive agreement generally does not require disclosure of any future additions to the expense fund by shareholders.

If additional contributions are necessary, the shareholder representative can enter into a side agreement with contributing shareholders under whatever terms the representative and contributing shareholders consider necessary for the best interests of all shareholders. Typically, such an agreement would provide for reimbursement, if possible, from the escrow fund when the escrow is released. However, whether reimbursement is possible depends on the structure of the M&A deal.

How much to put into the expense fund?

How much is put into the expense fund depends on M&A deal structure and risk factors. Absent special circumstances, SRS Acquiom recommends at least \$100,000 for smaller M&A deals and \$250,000 to \$500,000 to adequately fund defense of escrow claims for a standard M&A deal with no known issues or earnouts.

Shareholders include funds at the end of their life-cycle or individual investors. Some shareholder groups have no problem contributing additional funds in the event of litigation. Others find it a challenge. In our experience, individual investors are less interested in contributing funds post-closing. Similarly, depleted investment funds may not have the depth available to contribute. Shareholder should plan ahead by creating a larger expense fund.

“By its very existence, an expense fund communicates shareholders have sufficient financial depth to defend against unsubstantiated claims.”

M&A Expense Fund Best Practices

An expense fund is a voluntary fund set aside out of merger consideration by the shareholders at closing for potential third-party expenses that might be incurred during the post-closing period. Such costs or expenses typically include legal or accounting fees that need to be incurred to protect the shareholders' interests should any disputes arise relating to the merger transaction.

A shareholder representative can effectively negotiate an M&A deal without an expense fund; however, SRS Acquiom considers this approach to be risky and not a best practice. By its very existence, an expense fund communicates shareholders have sufficient financial depth to defend against unsubstantiated claims. It also reduces the risk of being caught without sufficient funds should claims arise. Any funds remaining after the M&A deal closing can be redistributed to shareholders.

Incorporating language to support an expense claim is a straightforward exercise, both for the fund's existence and the conditions of disbursement. SRS Acquiom recommends that the language to release unused funds not be bound to a post-closing time limit. Rather, disbursement should be left to the discretion of the shareholder representative (as directed by the Advisory committee), since issues could remain after the escrow is released.

To achieve the greatest value on post-closing matters, shareholders are best served by establishing a well-stocked expense fund at closing.

About SRS Acquiom

SRS Acquiom offers the most comprehensive platform to help deal parties manage complex financial transactions within mergers & acquisitions and bilateral or syndicated loan deals. Our solutions include paying and escrow agent services, online document solicitation and reporting, representations and warranties insurance brokerage, professional shareholder representation, and for loan and credit transactions, independent administrative, collateral and sub-agent services. Since 2007, we have helped businesses, investors, lenders, and advisors complete transactions as efficiently and effectively as possible so they can focus on building strong businesses and maximizing value.

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