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Why a Properly Sized Expense Fund Can Be Good for Buyers and Sellers

Be Prepared to See the M&A Deal All the Way Through

“Nobody cares how good your case is if you don’t have the money to prove it.” As harsh as this sounds, it’s often true in post-closing M&A disputes. The selling shareholders may have a great claim against the buyer for an earnout payment (or a rock-solid defense to the buyer’s indemnification claims), but if the shareholders have not reserved enough in their post-closing expense fund, they may have brought a knife to a gunfight.

This shareholder expense fund plays a critical role in post-closing strategy and dispute management and may even present some advantages for buyers. However, with legal billing rates increasing over the past several years, it is important that shareholder expense funds keep pace.

For those that cannot, the market has responded by providing an alternative to traditional expense accounts. A burgeoning sector of litigation financiers has emerged to provide contingency-like funding that can allow sellers to pursue meritorious offensive litigation. While litigation finance creates new opportunities for some, its applications and benefits are limited. The best way to adequately protect merger parties’ rights post-closing is (still) to adjust the expense fund to the cost of anticipated issues.

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Why an M&A Expense Fund?

On most M&A transactions, there is work to be done after closing. Most deals have escrows, holdbacks, or at least tax matters that extend for several years after the signatures dry. A sizeable percentage of deals also have earnouts or milestones where over 50% of the deal consideration may be contingent on future events. For these reasons, [SRS Acquiom](#) (“SRSA”) advises shareholders to reserve a portion of the deal value in a shareholder expense fund to be used as needed for counsel, tax experts, or other costs. At minimum, we recommend at least \$250,000 on deals without earnouts or other known issues.

Several factors warrant larger-than average expense funds. Deals with earnouts, multiple escrow releases, or post-closing payouts are prime examples. Risk is also a key variable, so expense funds should be larger on deals with ongoing litigation, significant intellectual property assets, or specifically indemnified matters. International deals present similarly expensive post-closing challenges and should have expense funds to match.

Notwithstanding the critical importance of shareholder expense funds, they are generally an afterthought. The parties have often spent months on the details of the M&A transaction, and the expense fund is given little consideration, both literally and figuratively. However, failure to set aside enough can prove to be a very costly mistake for all.

Size Matters

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The presence of an adequate expense fund presents a number of strategic advantages, regardless of whether or how much is spent. In fact, our experience suggests that a larger expense fund is less likely to be depleted than a smaller one based upon the additional leverage it provides.

The expense fund amount is typically determined at the time of closing and held by the shareholders' representative “to be used for the purposes of paying directly, or reimbursing the shareholder representative for, any third-party expenses...” The absence of adequate expense fund can make sellers extremely vulnerable. Here's why:

- **Money is Power.** There are many instances after closing where the sellers are entitled to money, either from an earnout or an escrow, or need to be able to assume or assist in the defense of a third-party claim. It can be very challenging to adequately protect rights unless the other party knows the sellers are able escalate to litigation. Even absent any disputes, the financial ability to pay expenses of third-party advisors can cause things to move more smoothly on routine processes like purchase price adjustments, tax return reviews, and escrow releases.
- **Control Saves Costs.** Many merger agreements give the shareholders the option to assert control over certain third-party claims. Exercising this right is generally advisable because it allows the sellers to select counsel, keep close tabs on legal fees, and dictate the most cost-effective strategy for resolution. Of course, the ability of the sellers to make this choice is directly dependent on the expense fund. If the expense fund is inadequate, sellers can find themselves having to defer to the buyer on how to proceed with the defense of a claim.

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- **Mutually Assured Depletion.** In many cases, having the money to sue reduces the likelihood that you’ll ever have to do it. Litigation is expensive for everyone, and if the claiming party knows that the sellers have a trial-sized expense fund, they have significantly more incentive to be reasonable early so as to save themselves the cost of that fight. Even if the merits are grey, the prospect of an expensive legal battle usually gets savvy parties to consider early resolution. Conversely, the claiming party loses some incentive to settle if they know the sellers can’t afford to go the distance.

Best for Both Sides?

In addition to the more obvious shareholder advantages described above, buyers may also benefit from an adequate shareholder reserve. For example, shareholders who are able to control third-party claims can alleviate much of the burden from buyers by handling the claims on their own time and dime. When the shareholders are paying, buyers can also trust that they will be motivated to resolve the claims as efficiently and effectively as possible.

Funding defensive litigation from the shareholder expense fund rather than the escrow also ensures that more escrowed funds will be available for other contingencies that can arise post-closing. This can prove especially valuable on deals where escrowed funds are limited or post-closing liabilities are greater than anticipated. In light of these potential positives, buyers may be wise to devote more consideration to the size of the shareholder expense fund.

Finally, many buyers prefer that the sellers be represented by sophisticated legal counsel both with respect to the negotiation of the merger agreement and any post-closing disputes. These buyers know that good opposing counsel will understand the issue and will be able to have a reasonable discussion to drive to a sensible resolution. Having a properly sized expense fund can help ensure this.

The Rising Cost of Good Representation

Despite the strategic advantages of an adequate expense fund, rising legal costs have made “having enough” more difficult. According to Thomson Reuters’ 2018 Report on the State of the Legal Market, law firms raised their standard rates by approximately 3.1% in 2017 (after increasing 2.9% in 2016 and 2.5% in 2015). For the Am Law 100 firms, Thomson Reuters’ Q1 2018 Executive Report indicates that billing rate growth has jumped from 3.3% to 4.5% since Q1 2016, after a 2.7% increase in 2015.

The 2018 CounselLink Enterprise Management Report issued by LexisNexis confirms the same trend. In 2017, LexisNexis observed a 8% rate increase from 2016 among the largest law firms. Among legal sectors, M&A and IP-Patent have seen some of the largest growth in partner hourly rates, with M&A growing at over 4% year-over-year for

the past three years (almost 13% since 2015) and IP-Patent growing almost 14%. Notably, these areas are also among the most common for post-closing disputes.

It is important that the size of expense funds keeps pace with these trends to ensure the same level of representation can be provided going forward.

New Financing Options

“ A new market of litigation financiers has recently emerged to provide third-party funding for offensive shareholder lawsuits.

For many years, an inadequate expense fund meant that shareholders would either have to accept their fate or seek replenishment through an arduous “pass the hat” process. 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.

In exchange for their infusion of capital, litigation financiers are taking roughly 10-20 percent of recovery following return of their initial investments. Although terms vary by deal, most investors do not require repayment in the absence of recovery. This means that shareholders have the opportunity to 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 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 most bang for their buck 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 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.

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- [Establishing an Expense Fund](#)
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