Tales *from the M&A* Trenches

PRE-CLOSING PRACTICES TO MITIGATE POST-CLOSING RISKS

Paul Koenig and Mark Vogel
Managing Directors and Co-Founders
SRS | Shareholder Representative Services

With editorial comments provided by
Diane Holt Frankle, Esq., Kaye Scholer LLP

THIRD EDITION

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Introduction

In 2007, SRS | Shareholder Representative Services created the role of professional shareholder representative and has now served as the representative on hundreds of M&A transactions. We have managed scores of claims, releases, accounting adjustments, earn-out disputes and other matters. We have worked with institutional investors, founders, and companies represented by some of the best M&A lawyers in the country. While having a shareholder representative in these transactions is nothing new, SRS is the first company to offer dedicated services as a professional, independent agent of the shareholders. SRS now has served as a shareholder representative more often than any other company, firm, or individual. No one else comes close.

This experience has given SRS a unique perspective on M&A deals. Most M&A attorneys do the majority of their work on a transaction prior to closing and may have little or no idea whether any issues arise afterward. Because SRS' job starts at the closing, we see a portion of the process of selling a company that most deal professionals experience rarely, if ever. This has enabled us to identify transaction terms that can become problematic later, and ways to potentially address these issues during negotiation and in the drafting process. *Tales from the M&A Trenches* is a culmination of that experience, distilled into drafting tips, flags, and best practices.

In this edition, we are privileged to have feedback and input from Diane Holt Frankle of Kaye Scholer LLP. Diane is one of the leading M&A attorneys in the country and frequently represents buyers on sophisticated acquisition transactions. Because SRS is always on the sell-side of deals by virtue of our role in the transaction, we asked Diane to review this manual and provide thoughts and feedback from the buyer's perspective. Her suggestions are incorporated in the text.

We want to thank Diane for her time and efforts in optimizing the value of *Tales* to the community and for providing an alternative point of view.

While *Tales* is a manual of ideas, the data that backs it up is important to M&A professionals too. The SRS M&A Post-Closing Claims Study details what really happens after closing and serves as a complementary resource. That study shows that a claim or dispute arises after closing in 56% of transactions, and in those deals with claims, the amount of losses alleged is an average of 51% of the escrow. Although *Tales* is intended to help mitigate some of these challenges, buyers and sellers need to be prepared to potentially expend time and resources after closing. We find that indemnification claims take an average of eight months to resolve, and 4% of the deals with claims result in litigation or arbitration.

The purpose of this manual is to flag potential issues that could cause unnecessary disputes after closings. In general, the buyer and seller both view the merger as creating a new partnership and would like to avoid problems, if possible. This manual is not meant to advocate on behalf of either of the parties.

Please also note that this manual is not meant to be an exhaustive list of all negotiating points in a merger agreement, or even of the most material points. This content is focused on specific technical issues related to post-closing matters. Many of the suggestions will not work in every deal, and there are counterpoints to many of the issues raised. This manual is meant simply to flag issues that deal attorneys and principals may wish to consider further before finalizing their transactions.

As a final note, *Tales* is a working document that will continue to evolve over time, and we welcome any feedback or comments you may have. Our goal is to provide a tool that allows the deal-

making community to materially advance discussions and best practices used in merger transactions. We look forward to your participation via tales@shareholderrep.com.

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"Across our client base over the last several years, we have noticed a disturbing trend – the relative size and frequency of post-closing escrow claims in M&A transactions are on the rise."

Al Browne and Rob Hadfield
Partners, Cooley LLP
Business Law Section Newsletter,
Boston Bar Association, Volume 6 (Spring 2011)

Notes

Merger Agreement Issues

Introduction

The merger agreement is the primary document that governs the terms and conditions detailing the acquisition of one company by another.

There are many legal and business considerations involved in drafting a merger agreement, not the least of which are the business terms themselves. There are a wide variety of other issues that need to be considered, including tax, securities law, corporate law, and accounting matters. Extensive materials exist on most of those subjects. We focus here on issues that are rarely, if ever, on that standard list, and that often are not covered in the merger agreement terms.

1. The Problems with Pro Ratas

Pro rata formulas are often complicated and mistakes are frequently made.

Many shareholders think that when you sell a company, each security holder simply gets their percentage of the proceeds. In reality, however, the formulas are often much more complicated and mistakes are frequently made. SRS has worked on numerous transactions in which the spreadsheet delivered at closing contains inaccuracies, does not match the formula contained in the document or fails to account for potential changes to distribution pro rata percentages. While most attorneys are aware of these issues, the M&A community may not realize the magnitude and frequency of the problem. A friend of ours who is the general counsel of a large investment fund told us that the greatest value he provided to the fund in his early years on the job was identifying mistakes or unresolved issues in capitalization tables in connection with M&A transactions. He said the errors or adjustments amounted to millions of dollars that would have been misallocated. In SRS' experience, we find that upwards of a third of the spreadsheets we receive have issues that require further clarification before distributions can be accurately made. There are several common reasons for this, such as the complications of taking into account the liquidation preferences and participation caps attributable to the preferred stock, whether and to what extent holders of options or unvested stock participate in various distributions, and the often complicated terms of management carveout plans.

Below is a summary of some of the major challenges we see with these calculations and payouts.

Are the parties that participate in the closing payment the same as those that participate in the escrows or other future payments, and are the percentages the same?

This can be a complicated issue that is often missed. We have seen several agreements that have a single definition of "Pro Rata" when that is not what is intended. As an example, suppose a company that has raised $20M is sold in a transaction that pays $19M at closing with a $5M escrow. If the investors are entitled to their money back first but no more, there is a complicated question of which shareholders "own" the escrow and in which percentages and to what extent. The preferred investors will presumably take all of the $19M paid at closing, but one can see how determining who should receive payouts from the escrow is more complex. You can also see how this answer might change based on how much of the escrow is paid out to the shareholders. Payment caps or forfeiture provisions in management incentive plans or in individual agreements with continuing employees may also result in a recalculation of post-closing distribution percentages that is not accurately reflected on the closing spreadsheet or in the deal documents.

When employees participate in the escrow, are their contributions pre-tax or net of withholding for purposes of determining pro rata allocations?

We have seen it done both ways and it may depend on the source of the contribution (options or employee bonus/management carve-out), the tax treatment of the deal and whether it is an indemnification escrow or the establishment of an expense fund. In most cases, contributions to indemnification escrows are subject to substantial risk of forfeiture (i.e., indemnification claims) and therefore no taxable event occurs until the escrow is released. In this case, the contribution to the escrow is most likely considered to have been made on a pre-tax basis for purposes of pro rata calculations.

Also available as part of the eCourse
Say What? A Litigator's Look at Deal Provisions; plus Developments in Seller Liability in M&A

First appeared as part of the conference materials for the
8th Annual Mergers and Acquisitions Institute session
"Developments in Seller Liability in M&A"