Mergers & Acquisitions

A Roundtable Discussion

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MICHAEL PHILLIPS, FLOYD ADVISORY: I'd like to begin with some recent decisions coming out of the Delaware courts, as they often have a significant impact on the M&A landscape. It will be interesting to discuss the impact of some of those key decisions, both from a deal negotiation standpoint as well as any M&A litigation considerations that might come out of those.

Although it's not the most recent of the court decisions that we'll discuss today, I thought we'd start with last year's Delaware Supreme Court decision in the *Chicago Bridge v. Westinghouse* case. This particular decision provided some interesting insight on the court's view of what types of financial reporting issues are subject to a financial statement representation dispute process as opposed to a purchase price adjustment process. This decision also provided some guidance on the role and scope of accountants, who often serve in a dispute resolution role in these types of matters.

MATTHEW SOLUM, KIRKLAND & ELLIS: *Chicago Bridge* is an important case in the sense that the Delaware Supreme Court reversed a lower court decision and determined that the GAAP compliance issues ought to be raised in the indemnity context in light of the provisions in the agreement that were at issue. The purchase price in that deal was $0. ... The purchase price adjustment post-closing that was being sought was more than $2 billion. So it was a $2 billion issue and the parties went forward to decide whether that issue ought to be submitted to the purchase price adjustment process. The Delaware Supreme Court ultimately said the claim that there was significant GAAP compliance should be raised as part of an indemnity process, if at all, rather than through the purchase price adjustment process.

Among other things, the court looked at the notion that the arbitrator or the decider of that dispute was described as an "expert," not an "arbitrator." I think people who spend time thinking about disputes in the context of buying and selling private companies have really taken a close look at this decision to try and think about how to arrange their potential claims, and the rights and obligations of the parties and how to allocate that as between indemnity and purchase price adjustment processes.

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PHILLIPS: Any insights from the finance and accounting perspective of these situations?

WILLIAM SHEA, FLOYD ADVISORY: This is obviously a case that has had some fairly major ramifications on some of the work that we do. In the last year, we've seen this cited in the parties' submissions. It affects the strategy from both the buyer and the seller's perspective on how to present your position when you get to these disputes. Oftentimes, one party may be trying to take a step back. What was the negotiating history? What was the intent here?

What we're talking about is applying the language of the agreement itself. Anything else, any sort of extrinsic evidence, wouldn't necessarily survive into those disputes if you apply the *Chicago Bridge* decision broadly.

From an accounting perspective, what we typically do in our role as advisors to either the buyer or the seller [is] think through the issues and tie them back into the language of the agreement and the consistency of the prior accounting practices.

PHILLIPS: Is there any impact from this decision on deal negotiations?

TAYLOR HART, ROPES & GRAY: One of the practical problems with the approach to all of this if you're relying on an indemnity for GAAP compliance, especially in the last few years, [is] how seller-friendly contracts have become. It's a seller's market. Prices are very high these days. Many of these deals are auction processes where they're very competitive, and the number of deals that are done on a no indemnity basis but could be done with reps and warranties insurance are a pretty significant percentage. If it's a no indemnity deal where you don't have the ability to bring an indemnification claim for GAAP compliance, it makes these issues even more important.

As a result, in a very seller-friendly environment with auction processes, you also have to be mindful of how much you're touching these and other provisions in the contract in light of other competitive bids. So while these issues are certainly a significant focus in any negotiation, I think the practical approach sometimes trumps in light of a competitive environment.

SHEA: Something else this case covers is the applicability of the consistency test versus the bifurcated test. What this decision really focuses on is the use of the consistency test. Meaning, is the ultimate closing calculation [and] final working capital closing statement consistent with the historical calculations, the estimated statement [and] the target? That's the bright line test, versus the bifurcated test when we're also talking about GAAP compliance.

PHILLIPS: Why don't we turn to the recent Delaware Chancery Court decision in *Penton v. Informa*. It's very common that accountants or other professionals may serve in a dispute resolution role in purchase price disputes. This decision establishes some case law on the issue of serving in those dispute resolution roles and whether [you] should be acting as an arbitrator or acting as an expert.

SOLUM: The issue in the case was whether the decider of the dispute could take into account extrinsic evidence — the negotiation history, the drafts of the agreements — to better understand what the parties meant when they used the words they used in the ultimate signed and executed agreement. Here, the parties had a dispute before they went to the purchase price process over whether that extrinsic evidence could be relied upon by the decider in that matter. The party that wanted to exclude that evidence was saying, "Wait a second, the decider is described as an expert, not an arbitrator, and that's meaningful." They wanted to go to court to get an understanding that the decider could not rely on extrinsic evidence.

The judge in the case really went through the case law around expert versus arbitrator in a number of other states to try and understand how states deal with this issue. Although other Delaware decisions had touched on the topic, this was the first real deep dive on whether expert versus arbitrator has an impact on the scope of the matter to be decided. Ultimately, the judge in the *Penton* case decided that it is a meaningful distinction and that the decider in that matter could not rely upon or consider extrinsic evidence.

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Now people are looking at that distinction and trying to try to assess other issues like, if someone is an expert [and] not an arbitrator, does that mean that they should not be deciding disputes around discovery or what documents ought to be produced? And what does that mean with respect to whether some other ancillary issues, like whether someone can change their position in a purchase price dispute process, can be decided by the arbitrator or decider in the matter?

PHILLIPS: Let's talk about some of those practical implications. As a litigator in these types of disputes, would you have a preference for the person sitting in that dispute resolution role to act as an arbitrator, with a little bit more authority and leeway, or to be more limited as an expert?

SOLUM: It really depends. Oftentimes, the parties jointly empower the arbitrator to decide specific issues: for example, to decide whether the buyer or seller can change their position or to decide whether the buyer of the business who now owns the business ought to produce additional documents to the seller of the business. I think that's a process for negotiation when one is engaging an arbitrator, and having either the word "expert" or "arbitrator" in the purchase price dispute provision will help inform that negotiation.

PHILLIPS: It would be interesting to hear thoughts around serving in that role as an accountant and some of the considerations.

SHEA: We encounter [this] both when we're acting as a neutral or if we're advising the buyer or the seller. There is usually some broad language in the purchase agreement that might have some guidelines on the authority of the decider, but usually there's a negotiation between buyer, seller and the decider on the scope of the decider's review.

Serving in that role, as accountants, we've got to be careful about playing judge. Some

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terminology that we use internally is, are we applying or are we interpreting? Certainly when designated as an expert versus an arbitrator, that decider has got to be very careful to be in the seat of applying and not trying to interpret meaning that's not explicit.

And speaking quite frankly, that fits the profile of what the parties want an accounting expert to be doing, given that person's likely expertise and skill set.

A lot of times, it depends on the facts and circumstances of the case itself, but if you've negotiated for an expert role, it's likely because you believe your side or your positions are strongest on plain application of the words of the contract. If you feel like you've got issues where intent was lost in the ultimate draft or the ultimate final product that was agreed upon by the parties, you may want to be looking at an arbitrator and introducing some drafting evidence or intent-of-the-parties type information and positioning your themes that way.

HART: The tough part of that is it can cut both ways and you may not really know which way you want it to be until the dispute comes, which is after you've already negotiated and entered into the contract.

PHILLIPS: You never know when you're drafting what the issues will be eventually. Now that this decision is out there, I think it will cause the firms that serve in these neutral roles to raise the risk flag a little bit more about how they approach these types of engagements.

One of the challenges when we serve in these roles is sometimes the issues aren't truly applying accounting concepts and it's more of trying to interpret the parties' intent. I think we are better suited for the former than the latter.

When we see a purchase agreement, nine times out of ten, it has language that says that the accountant serving in that role should serve as an "expert" and not as an "arbitrator." Do you anticipate because of this decision there will be any changes to that standard language?

HART: I think, in light of this case, people will be more thoughtful about the inclusion of that language. But given that it's pretty standard and again, going back to the seller-friendly nature of the market recently, [and] not knowing how it may impact you later in some potential dispute, is this necessarily something that you want to fall on your sword over as part of negotiations in a competitive process? We'll see how that plays out over time. I haven't seen a lot of it yet.

SHEA: I don't mean to belabor this, but I find it interesting that for a long time we've referred to these engagements as arbitrations even if they weren't, in fact, true arbitrations. And I think, at least in the last few months, in my own experience there's a lot more thought that goes into throwing that word around. There are a lot of boilerplate-type engagement letters that these deciders will put out as a first draft and there are some careful markups happening from the legal side to make sure that the role is supposed to be an expert and we're not invoking the idea of an arbitration proceeding in any way, shape or form.

PHILLIPS: Let's move on to the last decision that we'll touch upon, the *Akorn v. Fresenius* decision coming out of the Delaware Chancery Court and later confirmed in the Delaware Supreme Court. This is the first time that a Delaware court has allowed a buyer to terminate a deal altogether based on a material adverse event.

This seems like a big deal, and it was a big deal in this particular case because it was a substantial acquisition, close to a $5 billion deal.

SOLUM: At the Delaware Chancery Court level, the judge determined that there was a material adverse event, a general MAE. He also determined that there was a breach of the representations that rose to the level of an MAE. And then he determined that there was a breach of the operating covenant, meaning that the business would be operated in the ordinary course of all material respects between sign and close.

The case went up to the Delaware Supreme Court, and the Delaware Supreme Court affirmed that there were facts sufficient to support the first two of those conclusions and did not yet address the third because it determined it didn't need to do so.

The trial court opinion is a 247-page opinion. The Delaware Supreme Court was a little bit nicer to practitioners in the sense that it's a terse three-page opinion that one can digest pretty quickly. But it's worth going through the trial court opinion to better understand how a trial court would go about thinking about each of those aspects that I just referred to: a general MAE, breach of rep leading to an MAE, and the operating covenant under the agreement.

In particular, Footnote 740 gives you the scope of the opinion, where the judge at the trial court level went through and assessed a number of the economic metrics associated with his decision. He determined there was no bright line for determining that an MAE or MAC had been triggered but he did go through and assess a number of facts to figure out whether this was the right ultimate finding.

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PHILLIPS: I imagine this decision has put a scare into some prospective sellers. Have any clients reacted to this?

HART: I don't think there's been a ton of difference in terms of approach so far. But it's very important and something to be thoughtful about in terms of potential approaches, and the opinion is very detailed and does provide a lot of helpful insight as to how the Delaware courts will think about an MAE going forward. I do think that this case was a bit unique in terms of the court being able to find an MAE, where in other deals you wouldn't have these same circumstances.

The reason we have always had MAE provisions in agreements is that a court could find an MAE one day, and now that day has come. And the opinion is instructive as to the things that could rise to an MAE. But I think in this case it was a bit unique.

The opinion is also instructive on other aspects of Delaware law that they refer to in terms of "levels in materiality" and "compliance in all material respects with covenants" and other things that I think make it a very interesting and useful decision.

PHILLIPS: Apart from some of the recent key decisions we've discussed, let's discuss some other trends that you may be experiencing, whether it's in deal negotiations or any other hot topics on the litigation front.

HART: Maybe not specific to litigation but just in terms of approach and some of the issues that we're seeing more often, one of the things [is] the "#MeToo" movement. We have seen where people have been including representations and warranties around past claims or settlements to get at whether there is anything lurking at target companies.

In terms of some of the bigger things that I think we're seeing and the way people are approaching deals, one of them is the competitive nature of [the market]. In many of these auction processes, people are taking various aggressive bidding steps to try and improve their positioning to try and win an auction and be successful in getting the deal.

People are agreeing to be able to close very quickly. Some say they will close within 30 days or 45 days or sometimes even less. There have even been some circumstances where people will close as soon as the conditions for closing are satisfied. With early termination of HSR approval — if that's the only real condition with timing implications — that could mean being forced to close in around two weeks.

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Those things can be attractive to a seller. It obviously shortens the amount of time between signing and closing, gets them to a closing faster, gets them their money faster and reduces the risk of things like an MAE or something happening to the business in between signing and closing.

Another thing we've seen, particularly in the private equity context, is people being pushed to do full equity backstops of the financing instead of having reverse termination fees that provide some protection if the financing doesn't come through. More and more people are getting pushed to consider doing that in auction processes.

Rep and warranty insurance is another significant trend where it's become almost universal in the middle market that just about every deal these days includes some form of rep and warranty insurance. There are different approaches, but sellers are insisting on it in most cases in those deals of a certain size to limit their risk so they can walk away freely, or with minimal amounts at risk.

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PHILLIPS: What's the perspective from the finance and accounting advisory role? Any trends that you're experiencing?

SHEA: This dovetails with the decisions we've been talking about here, how they affect post-acquisition disputes in a lot of cases and the forum for that. One thing that we've seen with some of our clients in the last couple years is going through these post-acquisition dispute processes and the effect on everything. But then it gets to [the question of] how do we do better to avoid the risk in any sort of arbitration or expert determination process, and leaving sometimes substantial economic swings to the whims of those types of processes.

Where we've done a lot of work is in pre-deal, "risk mitigation" settings with real emphasis on the drafting of purchase and sale agreements. We're doing more work up front with clients on defining the standards in these post-closing calculations, going beyond broad-strokes type provisions and really getting into very specific balance sheet rules, and walking through them from a working capital perspective. This creates specific calculation steps that the parties are going to be beholden to to create an apples-to-apples closing statement against the target formulation and the estimated statement put forth at the time of the close.

There, you get into a lot of the themes from the *Chicago Bridge* decision in that apples-to-apples type comparison environment, doing even more to make sure both parties have their eyes open at signing as to, "Here's what you will be doing when you prepare the closing statement." So we avoid that surprise claim post-close from a seller's perspective, once you lose control of the books and records, which, by the way, is another important consideration. We'll often work to make sure we gather the necessary closing package so there is no issue with discovery or access to the books and records if there is a dispute.

PHILLIPS: One trend that we are seeing is we're being asked to get involved in a lot more reps and warranties insurance claims than we have in the past. I think some of that is just that it's a relatively new product. But it would be interesting to hear whether others are seeing more activity in that reps and warranties insurance claims area.

SOLUM: In the last handful of years, the rep and warranty insurance product has become very popular [for] deal practitioners and clients. As a result we're now seeing a shift in the claims. We're seeing more and more activity where buyers are asserting claims against the rep and warranty insurers. And we certainly are seeing that play out in the marketplace. It's certainly a growing trend.

HART: It's also something that is important on the front end when we're going out and working with the broker to get quotes that come back from different insurers. Because of the explosion of the use of it in the last couple years, there are a lot of new entrants to the market, new insurers that have started writing rep and warranty policies. And then there are others who have been in the market for a long time who are very committed to the market.

One of the things we are talking with our clients about when they're evaluating quotes is not just looking at pricing and terms and potential exclusions or areas of heightened underwriting

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risk but also looking at the insurers themselves and how long they've been in the market, how committed they are to the market to the extent that we have some insight into their claims history and whether they're harder or easier to deal with. That can be really important in terms of who you select because, if you're selecting somebody that's new to the market, they may be more risk averse and have no claims history and so it might be cheaper, but you may end up having a more difficult time placing the policy in the first place, and if you have a claim down the road, then it may be harder to pursue. Some of them are also large players in providing other types of insurance to clients, so those broader relationships can also be a factor.

PHILLIPS: Are you finding that some of that information, some of that history is available out there publicly or is it more of kind of working through your channels?

HART: It's more working through the experience that we have with them, as little is publicly available.

PHILLIPS: So in advising buyers when they're making these claims, what are some of the key considerations that they should be thinking through?

SHEA: The product has exploded. I think it's going to be interesting to follow the cycles of this: What the claims history and the payouts might be and whether or not there comes a time where the claim payouts and the ultimate after effect here dries up a bit and what the market response is.

But as far as advising buyers on preparing claims, you've got to tether what you're doing to the audience a bit. Obviously the focus is going to be on first establishing a breach, and the most common when we worked with this is the standard rep to the accuracy of the financial statements.

Establishing that breach and establishing the misstatement of the financial statements and the lasting damage that results from that is obviously very important.

There are certainly valuation considerations at play a lot of times in these because you're going to be looking at potentially falling back on a purchase price. A lot of times we'll deal with where a buyer has priced its deal based on a review of the historical financial statements and is relying on the rep that sellers made to the accuracy of those financial statements and priced the deal off of a trailing period of results. If there are misstatements inherent in those financial statements, then what is the ultimate effect on the multiple burden that was paid at the time of the purchase price?

The key is matching that damage claim directly to the breach. There is the occasional [desire] to establish a change in accounting estimate or accrual processes and bring those into the space where there is a distinction between the damage that was incurred by the buyer and what really should have been handled through a purchase price true-up provision or the working capital process.

That's what we've been working with and doing in that space with our clients who are putting forth these claims against these policies.

PHILLIPS: I think sometimes the easier aspect of the claim is proving the breach. The more challenging aspect is: how were you damaged? That requires a lot of careful consideration up front by the buyer in determining or making a decision as to whether to move forward with the claim in the first place.

SHEA: That's right. It really should be, if you are able to articulate that there is an ongoing loss of value and/or that the process by which the purchase price was determined was materially affected by whatever the established breach was, is [the client] going to make a claim against the purchase price?