

PENNSYLVANIA BAR INSTITUTE
UNDERSTANDING DAMAGES & INDEMNITIES
IN COMMERCIAL CONTRACTS
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**DAMAGES UNDER
MERGER AND ACQUISITION AGREEMENTS**

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Overview

- > Common contexts in which acquisition agreements can be breached.
- > Damages outside of contractual indemnification.
- > Damage under contractual indemnification and related provisions.
- > What should we do differently?

Frequently Used Terms

- > **Model APA** - 2001 American Bar Association Model Asset Purchase Agreement. See Appendix to Outline.
- > **Private Deal Points Study** - 2009 American Bar Association Private Target Mergers & Acquisitions Deal Point Study.
- > **Sample Provisions** - Sample provisions from typical stock purchase and asset purchase agreements (not from any particular form).

Other Useful Resources

- > **ABA Model SPA** - 1995 Model Stock Purchase Agreement. New version due in August 2010.
- > **Commentary** to Model APA and SPA.
- > **Bryans Outline** (updated by Jacobs) - Major Indemnification Issues in Acquisition Agreements Outline (Pennsylvania Bar Institute 2010).
- > **Dillport** - Breaches and Remedies (Practicing Law Institute 1981).
- > **West and Duran**, Reassessing the “Consequences” of Consequential Damage Waivers in Acquisition Agreements, 63 The Business Lawyer 777 (2008).

Damages Vary Depending on Nature of Breach and Cause of Action

- > **Fraud in Inception** - restore the buyer and seller to their respective positions prior to entering into the contract; restitution.
- > **Breach of Contract** - give non-breaching party the benefit of the bargain, although reliance or restitution remedies may also be available.
- > **Fraud/Intentional Misrepresentation** - punitive damages available.

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Indemnification as Exclusive Remedy

- > **Threshold Issue** – Are remedies or damages limited to indemnification provisions in acquisition agreement?
- > No, if acquisition agreement does not contain indemnification provisions or is otherwise silent on remedies (uncommon).
- > No, if indemnification is not the exclusive remedy (the approach in Model APA).
- > Possibly not, for certain matters, like fraud, unconscionability, and equitable remedies.
- > If indemnification is not exclusive remedy, all other common law and statutory remedies are available.
- > **Practice Pointer** – forget all the carefully drafted caps, baskets, and survival periods if indemnification is not exclusive remedy.

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Indemnification as Exclusive Remedy

- > Sellers love it; buyers usually do too.
- > Model APA § 13.6 (waiver; cumulative remedies):
The rights and remedies of the parties to this Agreement are **cumulative and not alternative**.
- > Model APA § 13.5 (enforceability)
. . . Breach of this Agreement by Seller . . . could not be adequately compensated . . . by monetary damages alone. Accordingly, **in addition to any other right or remedy to which Buyer may be entitled, at law or in equity**, it shall be entitled to enforce any provision of this Agreement by a decree of specific performance . . .

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- > Sample provision:

The parties ... agree that their sole and exclusive remedy with respect to any and all claims (other than claims arising from fraud, criminal activity or willful misconduct on the part of a party . . .) for any breach of any representation, warranty, covenant, agreement or obligation set forth herein or otherwise relating to the subject matter of this Agreement, **shall be pursuant to the indemnification provisions set forth in this Article X. . . [waiver provision] . . . Nothing in this paragraph shall limit any Person's right to seek and obtain any equitable relief . . . or to seek any remedy on account of any Person's fraudulent, criminal or intentional misconduct.**

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Private Deal Points Study

- > **Exclusive Remedy** – In 85% of deals, indemnification was the exclusive remedy.

- > **Common carve-outs include:**
 - Fraud: 69%
 - Equitable remedies: 35%
 - Intentional misrepresentation: 27%

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Outside Contractual Indemnification

- > Fraud in the Inception

- > Common Law Breach of Contract

- > Common Law Fraud

- > Securities Antifraud Laws

- > Article 2 of the Uniform Commercial Code

- > Penalties (e.g., liquidated damages), Unconscionability, and Equitable Relief

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Common Law Breach of Contract

- > **Expectation Interest** - puts the injured party in the position it would have been in if the contract had been fully performed (the benefit of the bargain).
- > **Reliance Interest** - gives the injured party losses incurred by it in reliance on the contract. Typically an alternative to expectation interest.
- > **Restitution Interest** - object is not to protect a party's expectation or reliance interests, but to prevent unjust enrichment and force defendant to disgorge the benefit received.

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Damages Included in Expectation Interest

- > Direct Damages
- > Incidental Damages
- > Consequential Damages
- > No Punitive Damages for Breach

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Direct Damages

- > **Direct Damages** - damages that naturally and ordinarily follow from the breach.
 - E.g., lost profits because revenues of the acquired business were less than represented
- > Calculating Direct Damages
 - **Dollar-for-dollar** - appropriate when damages are one time in nature or otherwise will not affect future earnings of the business. E.g., undisclosed lawsuit.
 - **Market/multiple** – appropriate when damages are recurring in nature or reduce future earnings.

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Example – Multiple of Earning

- > \$500 purchase price based on 5 times earnings of \$100.
- > After closing, the buyer discovers that earnings are only \$75 due to an undisclosed \$25 liability.
- > Are buyer's lost profits \$25 (the difference in earnings) or \$125 (the difference in earnings times the multiple)?
- > Address valuation methodology in the acquisition agreement to avoid doubt.

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Incidental Damages

- > Incidental damages - generally defined as any reasonable expense incident to the delay or breach.
- > Example - Seller represented the target had a required permit when it did not. Incidental damages would include legal fees and government filing fees the buyer incurs to obtain the permit.

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Consequential Damages

- > Damages that do not flow directly and immediately from the breach, but are a foreseeable and probable result of the breach by the defendant at the time the contract was made.
- > These damages, unlike direct damages, result from special circumstances.
- > Availability depends on the injuring party's awareness of those special circumstances.
- > See West and Duran, *Reassessing the "Consequences" of Consequential Damage Waivers in Acquisition Agreements*.

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Example

- > Buyer acquires a widget manufacturing business as an addition to its widget existing business.
- > Target's factory is better for building widgets, so buyer moves its operations into Target's factory.
- > Seller was aware of buyer's intent to use the Target factory for all buyer's operations.
- > In the purchase agreement, seller represented that Target held all required permits.
- > After closing, buyer discovers Target was missing a required permit, and the factory must be shut down until the permit is secured.
- > Buyer is unable to perform on Target's customer contracts and its own customer contracts.

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Example (cont.)

- > The lost profits as a result of buyer's inability to perform on Target's contracts with customers are direct damages, *i.e.*, damages that directly and ordinarily would be expected to result from a breach that shuts down the Target's factory.
- > Lost profits on buyer's inability to perform on its own previously existing contracts are consequential damages, because they are not damages that would ordinarily be expected to result from the breach in this example.
- > Because seller knew buyer would use the factory for buyer's business, damages flowing from the stoppage of buyer's business were foreseeable.

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Punitive Damages

- > Punitive damages are tort-based damages designed to punish the wrongdoer and deter both the wrongdoer and others from engaging in similar acts in the future.
- > Typically not recoverable in common law breach of contract actions.
- > Not uncommon for an acquisition agreement to specify that a buyer can recover punitive damages imposed against the target company for acts or omissions prior to closing.

Expectation, Reliance and Restitution - Example

- > Joe signs a contract with Sam to form a new business in reliance on Sam's representations about profits of the new business.
- > Joe sells his business, moves across the country to join Sam in the new business, and Sam promptly breaches the contract.
- > Expectation interest damages fail because Joe cannot prove prospective profits for the new business with certainty.
- > Restitution was not an appropriate remedy because Sam received no benefit to disgorge.
- > Joe is entitled to reliance interest damages equal to losses incurred in the sale of his business and moving across country in reliance on the contract.

OVERVIEW - INDEMNIFICATION PROVISIONS

- > Attempt to eliminate the unknowns associated with common law breach of contract and similar remedies.
- > Allocate, prior to any breach, the risk of losses between the parties.
- > Often include protection against both first-party and third-party claims.
- > Add precision to claims for breach of contract.

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Common Areas Addressed in Indemnification

- > Types of Indemnity Claims; Claimants
- > Survival Periods
- > Direct vs Third-Party Claims
- > Procedures to Assert Claims
- > Caps, Baskets and Thresholds
- > Certain Defenses (Pro and Anti-sandbagging)
- > Sources of Payment and Security
- > Dispute Resolution
- > Adjustments (tax and insurance benefits)

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Types of Claims - Damages

- > “Damages” or “Losses” often broadly defined.
- > Boilerplate definitions often not sufficient to protect interest of parties.
- > Model APA § 11.2 defines Damages as: **[1]** ...any loss, liability, claim, damage, expense (including costs of **[2]** investigation and defense and reasonable attorneys’ fees and expenses) or **[3]** diminution of value, **[4]** whether or not involving a Third-Party Claim (collectively, “Damages”).

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APA Model Definition of Damages

- > [1] Broadly defines direct damages (any loss, liability, claim, damage, expense), but does not address consequential or incidental damages.
- > [2] Covers cost of investigation and defense, and attorney fees (not all recoverable at common law).
- > [3] Includes diminution of value, but what about when purchase price based on multiples of earnings methodology?
- > [4] Includes first-party claims, which were generally not permitted at common law.
- > Does not address punitive damages or penalties.

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Sample Definition of Damages

- > “Losses” shall mean any and all demands, claims, actions or causes of action, assessments, losses, diminution in value, damages (**[1] including special and consequential damages**), liabilities, costs, and expenses, **[2] including interest, penalties**, costs of investigation, and defense, and reasonable attorneys’ and **[3] other professional fees and expenses.**

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Damages Waivers

- > Sellers often seek waivers of certain categories of damages, like consequential damages.
- > “Boilerplate” waiver language in a seller’s first draft invariably is extremely broad – often excludes direct damages like loss of future revenue, income or profits, diminution in value, or multiple of earnings damages.
- > **Practice Pointer.** A buyer should carefully review each exclusion in view of the different types of damages a buyer might sustain.

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Sample Damage Waiver

In no event shall Seller be liable to Buyer, whether in contract, warranty, tort (including negligence or strict liability) or otherwise **for** any special, indirect, **incidental** or consequential damages of any kind or nature whatsoever, [including] [or any] **loss of future revenue, income or profits [, or any diminution of value or multiples of earnings damages].**

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Private Deal Points Study

- > **Consequential Damages.**
 - 49% of deals were silent
 - 43% expressly exclude
 - 8% expressly include
- > **Is silence golden?** Drafters representing buyers should consider whether it's better for acquisition agreements to remain silent and leave open the possibility of recovery, or to explicitly address the issue and open the matter to objection by the seller.

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Private Deal Points Study (cont.)

- > **Diminution in value:**
 - 58% of deals are silent
 - 27% expressly include
 - 15% expressly exclude diminution of value
- > **Incidental damages:**
 - 56% of deals are silent
 - 36% expressly exclude
 - 8% expressly include
- > **Punitive Damages:**
 - 52% of deals are silent
 - 47% expressly exclude
 - 1% expressly include

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SURVIVAL

- > To form the basis for post-closing liability, representations, warranties, and covenants should survive the closing.
- > An express survival provision avoids the possibility that representations and warranties “merge” with the sale of a company and thus cannot form the basis of a remedy post-closing (real property doctrine).
- > Acquisition agreements typically expressly state that representations, warranties and covenants survive the closing for a specified period.
- > Certain fundamental representations, along with covenants and agreements, might survive longer than the general survival period.
- > A buyer may be able to recover under common law principles like fraud and intentional misrepresentation even if no survival. ³⁰

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Model APA Section 11.1 (Survival)

All representations, warranties, covenants and obligations in this Agreement, the Disclosure Letter, the supplements to the Disclosure Letter, the certificates delivered pursuant to Section 2.7 and any other certificate or document delivered pursuant to this Agreement **shall survive the Closing** and the consummation of the Contemplated Transactions, subject to Section 11.7 [time limitations].

Sample Provision - Survival

The representations and warranties shall survive the Closing and shall remain in full force and effect until the date that is [NUMBER] years from the Closing Date.

Carve Out Provision

... provided, however, the **Fundamental Representations shall survive indefinitely** and the representations and warranties set forth in Section 3.xx [Tax] and Section 3.yy [Employee Benefits] shall **survive for the full period of all applicable statutes of limitations (giving effect to any waiver, mitigation, or extension thereof) plus 60 days**. All covenants and agreements of the parties contained herein shall survive the Closing indefinitely or for the period explicitly specified therein.

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Private Deal Points Study

- > Survival periods
 - 38% of deals had survival period of 18 months.
 - 88% had survival period of 12-24 months.
- > Carve outs from general survival period:

– Taxes (Rep):	74%
– Capitalization (Rep):	62%
– Due authority (Rep):	64%
– Due organization (Rep):	44%
– Ownership of shares (Rep):	39%
– Fraud:	37%
– Breach of Seller's Covenants:	36%
– Environmental (Rep):	33%

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Baskets and Thresholds

- > A basket or threshold provides that an indemnifying party is not liable for breaches of certain provisions until a specified minimum amount is exceeded.
- > Sellers frequently request a basket or threshold to avoid dealing with small claims.
- > Basket or threshold may not apply to:
 - breaches of covenants, agreements and obligations, excluded assets, or excluded liabilities; and
 - fundamental representations and certain known matters (e.g., a known patent challenge).
- > Basket or threshold may not apply to matters of which a seller had knowledge or a willful failure by the seller to comply with a covenant or agreement (seller should not benefit from intentional misconduct).

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Deductible Basket

- > Seller is only liable for losses over a minimum deductible.
- > Sample Provision:

Seller . . . **shall have no liability** (for indemnification or otherwise) with respect to claims under Section 11.2(a) [breach of representations and warranties] **until the total of all Damages with respect to such matters exceeds \$ _____** (the “Deductible”), in which event Seller and Shareholders **shall only be required to pay or be liable for Damages in excess of the Deductible.**

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Threshold/First Dollar/Tipping Basket

- > Seller is liable for the total amount of losses from the first dollar once the minimum threshold amount is exceeded.
- > The basket fills up and then tips over for first dollar coverage.
- > Often used for risks and liabilities that are not covered by typical representations of the sellers but rather by specific indemnification provisions, such as the acquisition of retained liabilities or tax liabilities arising from pre-closing tax periods.

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Threshold/Tipping Basket - Sample Provision

Seller . . . shall **have no liability** (for indemnification or otherwise) with respect to claims under Section 11.2(a) [breach of representations and warranties] **until the total of all Damages** with respect to such matters **exceeds \$ _____**, in which event Seller . . . **shall be required to pay or be liable for all such Damages from the first dollar.**

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Combination: Model APA Section 11.5

Seller . . . **shall have no liability** (for indemnification or otherwise) with respect to claims under Section 11.2(a) [breaches of representations and warranties] **until the total of all Damages** with respect to such matters **exceeds _____** dollars (\$_____) **and then only for the amount by which such Damages exceed _____** dollars (\$_____).

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Materiality Scrape

- > If the agreement contains reps and warranties qualified by materiality and also a basket or threshold, double materiality is imposed - i.e., once to qualify as a breach of the rep and a second time to exceed the basket or threshold.
- > The theory is that because a basket provides a level of materiality negotiated by the parties, additional materiality qualifiers should be ignored.
- > To avoid double materiality, a buyer should attempt to include a “materiality scrape,” which states that materiality or similar qualifiers for a rep are ignored (scraped) when determining indemnification obligations.

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Materiality Scrape – Sample Provision

For purposes of this Article VIII [Indemnification article], **any inaccuracy in or breach of any representation or warranty shall be determined without regard to any materiality**, Material Adverse Effect or other similar qualification contained in or otherwise applicable to such representation or warranty.

Private Deal Points Study

- > 47% of deals had a deductible basket
- > 36% had first dollar/threshold basket
- > 12% had a combination
- > Basket Amounts as a Percentage of Purchase Price:
 - 0.5% or less: 44% of deals
 - >0.5% to 1%: 45% of deals
- > Carve Outs:
 - Fraud: 59%
 - Capitalization (rep): 57%
 - Taxes (rep): 57%
 - Due authority (rep): 55%
 - Intentional breach of reps: 41%
 - Broker's fees (rep): 40%
- > Other carve outs include: due organization, title to assets, employee benefits/ERISA, and no conflicts

Caps

- > A cap limits the indemnifying party's obligation to a maximum amount.
- > Typical carve outs include:
 - Fraud;
 - intentional breaches of representations; and
 - breaches of representations the inaccuracy of which the seller had knowledge prior to the closing.
- > Similar to the reasoning behind excluding intentional breaches from caps, a buyer wants to be sure that a seller is not limiting its liability by failing to disclose knowledge of breached representations.
- > No caps is Model APA.

Cap - Sample Provision

Other than with respect to claims based upon, arising out of, with respect to or by reason of fraud or any inaccuracy in or breach of the **Buyer Basket Exclusions**, **the Buyer Indemnified Persons shall not be indemnified** pursuant to Section 11.2 with respect to any claim **if the aggregate amount of all Damages** for which Buyer Indemnified Persons have received indemnification pursuant to Section 11.2 (other than those based upon, arising out of, with respect to or by reason of fraud or any inaccuracy in or breach of the Buyer Basket Exclusions) **has exceeded \$[NUMBER]**.

And the rest . . .

The Buyer Indemnified Persons **shall not be indemnified** pursuant to Section 11.2 with respect to any claim based upon, arising out of, with respect to or by reason of any inaccuracy in or breach of the **Buyer Basket Exclusions if the aggregate amount of all Damages** for which Buyer Indemnified Persons have received indemnification pursuant to Section 11.2 (other than those based upon, arising out of, with respect to or by reason of fraud) **has exceeded the Purchase Price**. The Buyer Indemnified Persons shall be fully indemnified with respect to any claim based upon, arising out of, with respect to or by reason of fraud of Seller or any Shareholder.

Buyer's Knowledge; Sandbagging

- > Should a buyer be precluded from asserting a claim for indemnification for a breach of a seller's representation that the buyer knew to be false prior to closing?
- > A "pro-sandbagging" provision provides that a buyer's indemnification rights are not affected by buyer's knowledge.
- > An "anti-sandbagging" provision says the opposite.

Pro-sandbagging: Model APA § 11.1

The right to indemnification, reimbursement or other remedy based upon such representations, warranties, covenants and obligations **shall not be affected by any investigation (including any environmental investigation or assessment) conducted with respect to, or any Knowledge acquired (or capable of being acquired) at any time**, whether before or after the **execution** and delivery of this Agreement **or the Closing Date**, with respect to **the accuracy or inaccuracy of or compliance with** any such **representation**, warranty, covenant or obligation.

Pro-Sandbagging: § 11.1 (cont.)

The waiver of any condition based upon the accuracy of any representation or warranty, or on the performance of or compliance with any covenant or obligation, **will not affect the right to indemnification**, reimbursement or other remedy based upon such representations, warranties, covenants and obligations.

Anti-sandbagging: Sample Provision

Seller shall not be liable with respect to any Damages **arising out of matters within the knowledge of Buyer** at the closing date.

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Example: Buyer's Knowledge

- > Seller enters into an APA to sell substantially all the assets of a family business.
- > The agreement has the following clauses:
 - No Material Adverse Change rep;
 - Survival of reps, warranties and covenants;
 - Non-waiver of any contract terms unless in signed writing.
- > Buyer becomes aware prior to closing of breach of the MAC rep because earnings during the period specified in the MAC clause substantially decreased.
- > Buyer closes with knowledge of the change in seller's financial condition.
- > Buyer sues for breach of an express warranty, and Seller asserts Buyer did not rely on the rep.

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Case Law – Buyer’s Knowledge

- > *Giuffrida v. American Family Brands, Inc.*, Lexis 5588 (E.D. Pa. 1998).
- > Judge O’Neill predicted PA law.
- > Held that PA Supreme Court would not require a buyer to prove reliance for breach of warranty claim.
- > Relied on APA non-waiver and survival provisions to conclude the APA unambiguously preserved buyer’s breach of warranty claim.
- > Distinguish “pro-seller” cases requiring reliance when no express provision preserving a breach of warranty claim (E.g., *CBS, Inc. v. Ziff-Davis Publishing Co.*, 553 N.E. 2d 997 (N.Y. 1990)).

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Non-reliance/No Other Representations

- > A non-reliance or “no other representations” provision limits a seller’s representations to those explicitly set forth in the agreement (and limits a buyer’s indemnification rights to breaches of those representations).
- > 45% of agreements surveyed in the Private Deal Points Study contained non-reliance/no other representations provisions.

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Sample Provision

Buyer acknowledges that the Seller has not made and is not making any representations or warranties whatsoever regarding the subject matter of this Agreement, express or implied, **except as set forth in Section 3** [Representations and Warranties] of this Agreement, **and that it is not relying and has not relied on any representations** or warranties whatsoever regarding the subject matter of this Agreement, **express or implied, except for the representations and warranties set forth in Section 3 of this Agreement.**

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10b-5 Rep: The Other Side of the Coin

The Model APA goes the opposite way and imposes strict liability on a seller for untrue statements or failures to state material facts necessary to make statements not misleading.

Section 3.33 of the Model APA, a so-called “10b-5 rep,” imposes a high standard of accuracy on a seller by transforming every statement made by a seller into a representation.

There is no requirement of reliance by the buyer and Section 3.33 is not qualified by the seller’s knowledge.

Section 3.33(c) also forces the seller to represent that there are no facts, to its knowledge, that may materially affect the assets, business, etc.

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Model APA Section 3.33

- (a) No representation or warranty or other statement made by Seller . . . in this Agreement or in connection with the Contemplated Transactions contains any untrue statement or omits to state a material fact necessary to make any of them, in light of the circumstances in which it was made, not misleading.
- (b) No notice given by Seller . . . pursuant to this Agreement will contain any untrue statement or omit to state a material fact necessary to make the statements in such notice or in this Agreement and in the Disclosure Letter, in light of the circumstances in which they were made, not misleading.
- (c) Seller does not have Knowledge of any fact that has specific application to Seller (other than general economic or industry conditions) and that may materially adversely affect the assets, business, prospects, financial condition, or results of operations of Seller that has not been set forth in this Agreement or the Disclosure Letter.

Security Devices: Setoff

- > An express setoff provision permits the buyer to withhold any future payments due the seller if the seller owes indemnification or other amounts to the buyer instead of relying on the buyer's common law rights of setoff.
- > The common law right of setoff is likely far more limited than contractual setoff, as the common law right includes certain restrictions, such as mutuality of parties.

Escrows and Hold-backs

- > A common method for securing a seller's indemnification obligation is to place a portion of the purchase price into an escrow account or hold-back a portion of the purchase price.
- > The escrow or held-back amount will be used to satisfy the seller's obligations to pay any potential indemnification claims.
- > The amount can be the exclusive source of indemnification.
- > The escrow or hold-back amount may effectively serve as a cap, such as when the seller has few assets or will liquidate shortly following closing.

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Private Deal Points Study

- > 81% of deals had an escrow or hold-back.
 - >5% to 7% of transaction value: 10% of deals
 - >7% to < 10% of transaction value: 27%
 - 10% of transaction value: 16%
 - >10% to 15% of transaction value: 16%
 - >15% to 20% of transaction value: 9%
- > In 48% of deals, escrow or hold-back was not the exclusive remedy.
- > In 27% of deals, escrow or hold-back was exclusive remedy.

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Purchase Price Adjustments and Earn-Outs

- > A purchase price adjustment provides for an adjustment to the purchase price paid by the buyer for the business, typically based on the target company's financial condition as of the closing date of the transaction.
- > Under an earn-out, some or all of the purchase price is calculated by reference to the performance of the business over a period of time after the closing.
- > While setoff is often available with respect to amounts a buyer might owe under a purchase price adjustment, setoff is of limited value as most purchase price adjustment mechanisms result in a final adjustment within a relatively short time after closing (say six months).
- > Earn-outs are often of greater value from a security point of view, as they sometimes require payments to the seller over several years.

Thanks for Attending

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