YOUR SOURCE FOR LEVERAGED AND MANAGEMENT BUYOUTS

Buyouts

www.buyoutsnews.com

November 14, 2011

GUEST ARTICLE

Deal Terms: When Market Standard Isn't

By Alexander B. Temel and William H. Schwab, Latham & Watkins LLP

What you think is the market standard may no longer be. When negotiating material deal points with sellers, buyers are often guided by their perception of the market standard. To the extent that market standards are relevant in this choppy and unpredictable economic environment identifying them is a challenge. Relying on the latest published deal term survey is not as helpful as it used to be since investment conditions and terms change so rapidly. Pursuing a specific provision based on a misconceived perception of the market standard can very quickly undercut the buyer's credibility. Identifying the new market standard has become a perpetually evolving science. This article identifies a number of emerging trends in middle market acquisitions on certain key deal points. In many cases, a new market standard has emerged—at least for now!

Alexander B. Temel

Working Capital Adjustments, Claims And Escrows

According to published market surveys of acquisitions ranging from $100-$500 million in deal value that closed in 2007 and 2008, only 60-70 percent included purchase price adjustments for working capital or other similar metrics (referred to herein as working capital adjustments). The figure increased to 79 percent in 2009. Interestingly, only 10-20 percent of the transactions with working capital adjustments included separate escrows and working capital adjustment claims were made only 30 percent of the time.

These historical statistics are not consistent with our recent experiences. Aside from distressed deals done on an "as is" basis, the vast majority (more than 90 percent) of deals in the current marketplace include working capital adjustments. In those deals, approximately half have separate short-term escrows to secure buyers against adjustment shortfalls. In the deals that do not have separate escrows, we typically see either an increase in the size of indemnity escrow or a one-way adjuster at closing (vs. the more historically common two-way adjuster at closing) followed by a final two-way true up. We also have seen a material increase in the number of working capital adjustment claims, now in more than 75 percent of deals (see table below).

Working Capital Purchase Price Adjustments

Transactions With:	2007-2009	2010-2011
Adjustments Mechanism	60%-70%	90%-95%
Dedicated Escrows	10%-20%	50+%
Adjustment Claims	30%	75+%

We believe that buyers' heightened emphasis on financial and accounting diligence over the past few years has driven the increase in the use of working capital adjustments and the reliance on separate escrows. As the likelihood and frequency of claims increases, buyers are much more sensitive to having a pre-wired mechanic and source of funds to adjust purchase prices. To the extent a deal's dynamics do not allow for a separate escrow or an increase in the indemnity escrow tied directly to potential working capital shortfalls, many buyers have turned to one-way adjusters at closing. Under this approach, the seller provides its estimate at closing and, to the extent that the estimated working capital number is below the applicable target, the purchase price is adjusted downward. If, however, the estimate is greater than the target, the purchase price is not adjusted upward until post-closing after the buyer has audited the seller's estimate.

Indemnification

Consistent with our experience with working capital adjustments, buyers, especially private equity investors, have become more focused on getting adequate protection on the indemnity front. Interestingly, though, while buyers are more cautious with respect to their ability to recover in the event of a breach, escrow and indemnity caps are trending downward. We believe that this apparent contradiction is driven by two factors. First, buyers appear to have grown comfortable with the trade-off between greater certainty of recovery on smaller material amounts and giving up the potential of a larger recovery from a massive indemnification claim. Second, in circumstances where an entire escrow (or cap, if applicable) might be in play, buyers have found that in many cases these situations involve fraud and result in buyer having additional remedies or a loss that is so far in excess of any escrow or cap that the incremental protection of a slightly higher escrow or cap will likely have no material economic value.

- **Escrows.** There has been an interesting shift in the size of indemnity escrows over the past 5 to 6 years. Our experience is that the historical notion of a 10-15 percent market standard is no longer accurate (escrow sizes are expressed herein as a percentage of purchase price). According to published studies, there was a dramatic shift from 2006 to 2008 from small escrows (defined as 7 percent or less) to mid-sized escrows (defined as greater than 7 percent but less than 10 percent). Small escrows decreased by 50 percent, while mid-sized escrows increased almost two fold. In our

THOMSON REUTERS

experience, the trend toward mid-size escrows and 10 percent escrows has continued to increase in today's market—now representing approximately 60 percent of total deals vs. approximately 35 percent and 43 percent 2006 and 2008, respectively. Also, we have found that the specific number of mid-sized escrows has dramatically increased as well—now at 35 percent.

Indemnification—Mid-sized Escrows Popular

Escrow Sizes	2006	2008	2010-2011
7% or less	35%	26%	5%
Between 7% & 10%	15%	27%	35%
10%	20%	16%	25%
Between 10% & 15%	16%	16%	30%
Greater than 15%	13%	10%	5%

We see the decrease in the size of escrows as a reflection of the increasingly competitive environment of the past three years. In most cases, double digit escrows in acquisition bids are now considered a negative factor in evaluating bids. For the reasons discussed above, bidders appear more willing than before to sacrifice downside protection on major indemnity claims in exchange for strengthening their bids.

- **Baskets/Deductibles/Thresholds.** Market surveys in 2007 found that buyers accepted an indemnity deductible (recovery only available after a certain loss threshold is reached and then only to the extent of the amount above such threshold) in 67 percent of transactions. Surveys aggregating data from 2002 to 2009 found that 80 percent of buyers accepted an indemnity deductible. Our recent experience is that buyers are now rejecting deductibles and deductibles are no longer the market standard. There has been a definite shift to indemnity thresholds (recovery to the first dollar after a certain threshold is reached). In our experience, thresholds have been used in more than 75 percent of recent transactions. Contrary to our expectations, we are not seeing the increased use of thresholds resulting in higher nominal threshold numbers. We believe that buyers have shifted from deductibles to thresholds in an effort to counterbalance the negative impact of generally lower escrows and a principled belief that a deductible is effectively just a purchase price reduction as it results in an unrecoverable loss for the buyer.

- **Anti-Sandbagging.** Lawyers regularly debate the appropriateness of including in the purchase agreement a sandbagging or anti-sandbagging provision. Anti-sandbagging provisions are designed to limit a buyer's legal recourse for damages arising out of any matters known or identified by it prior to the closing.

William H. Schwab

While it can be argued that the basic premise is not unreasonable, buyers have historically resisted these types of provisions for a number of reasons, including that they shift the burden to the buyer to disprove its knowledge of a specific matter and places a material burden on buyer to identify the potential magnitude of any item of which it has knowledge prior to the closing. According to market surveys, in 2007, only 59 percent of purchase agreements included a specific provision, of which 85 percent included an anti-sandbagging prohibition and 15 percent explicitly made pre-existing knowledge irrelevant in connection with a buyer's pursuit of a remedy claim. Currently, we are seeing a significant majority of transactions (more than 80 percent) including explicit provisions providing that a buyer's right to recovery is not limited by any pre-closing knowledge. The increased emphasis on an explicit provision is attributable in part to certain case law in jurisdictions like New York that has limited recovery where buyers had knowledge of an underlying fact and did not include an explicit provision allowing for recovery. In order to avoid the automatic seller defense of "you knew about the problem and closed anyway," it is imperative that buyers attempt to protect themselves with the inclusion of an explicit provision which does not limit recovery based on pre-closing knowledge of the buyer or its representatives.

- **Definition of Losses.** While our experience in recent transactions demonstrates that there is no market standard for the inclusion of consequential damages or diminution in value within the definition of losses, the issue is now negotiated in almost all transactions. While in a majority of transactions consequential damages and diminution in value are explicitly excluded, we have seen a recent trend where diminution of value and other multiplier-like calculations are included in the final documentation. Interestingly, according to market studies of deals in 2007, purchase agreements were silent on this issue approximately 65 percent of the time. In our experience, silence typically means that the point was not negotiated and the lack of inclusion means that the parties will need to litigate the point if there is ever a dispute.

- **Materiality Scrapes.** Materiality scrapes can be used in two different circumstances relating to indemnification. First, in determining whether a breach of a representation or covenant has occurred, the inclusion of any materiality or knowledge qualifier is ignored completely. Thus, in determining whether there is a breach of a representation stating "the company is in compliance in all material respects with applicable law", any violation—whether material or not—is a breach. Second, once a breach has occurred, in determining the amount of the damages incurred, the calculation is done irrespective of any qualifiers. Under this formulation, the materiality qualifier doesn't serve as a de facto indemnity basket. According to published surveys, 78 percent of purchase agreements in 2007 did not include materiality scrapes. Of the limited transactions that did include them (22 percent), 72 percent included scrapes for both the determination of an initial breach and the calculation of losses and only 28 percent had a scrape limited only to the calculation of losses. Our recent experience shows a definitive change in the "market standard." Rarely, if ever (less than 5 percent) do we see a full scrape for both the determination of breaches and the calculation of losses. Now, however, we are now seeing a scrape with respect to the calculation of damages in roughly 80 percent of all transactions (and almost all transactions in which it is discussed). We interpret the high inclusion of this provision as a recognition by buyers and sellers that the scrape in connection with the calculation of losses is representative of how buyers and sellers think about indemnification recovery at a business level.

Our recent experience has shown that the standards that defined the market in recent memory for purchase price adjustments and indemnification are no longer representative of current market conditions. In reality, the changes in "market standards" expand well beyond these two areas. In negotiating terms, investment professionals need to be aware that their perceptions of "market standards" may no longer be accurate in both a positive and negative way. ❖

Alexander B. Temel and William H. Schwab are both attorneys at Latham & Watkins LLP.

(#71158) Reprinted with permission from the November 14, 2011 issue of Thomson Reuters Buyouts. Copyright 2011 Thomson Reuters.
To subscribe to Thomson Reuters Buyouts contact Greg Winterton at greg.winterton@thomsonreuters.com.
For more information about reprints from Thomson Reuters Buyouts please contact PARS International Corp. at 212-221-9595 x426.