



HOT TOPICS IN PRIVATE-COMPANY M&A

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THE ROAD AHEAD

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THE ROAD AHEAD

- **Panelist Introductions**
- **Agenda**
 - **Part I:** Dealmaking in the Current Environment
 - **Part II:** No Indemnity Deals
 - **Part III:** Current Trends in R&W Insurance Policy Terms and Claims
 - **Part IV:** Heightened Diligence Environment and Recent Areas of Focus
 - **Part V:** Earnouts
 - **Part VI:** Who's Watching?
 - **Part VII:** Minority Investing
 - **Part VIII:** Q&A

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DEALMAKING IN THE CURRENT ENVIRONMENT

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U.S. M&A DEAL ECONOMY'S LEAD-UP TO 2022



- *Driving Factors:*
 - Momentum in the Second Half of 2020: low interest rates, government support of the economy, the promise of vaccine rollout, focus on technology
 - Continuing in 2021: low interest rates, historic levels of dry powder and easy access to capital, recovering global economy, regulatory and tax uncertainty
- *Result:*
 - 2021 was a record year for U.S. M&A
 - Record deal value (\$2.6 Trillion) and deal volume (7,896 Transactions)

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POST-2021 IMPACT: NEED FOR SPEED

- *Contributing Factors:*

- Increased competition for quality assets in industries poised to weather the high inflation and rising interest rate environment
- Significant levels of dry powder remain (in excess of \$1.4T allocated to the U.S. market as of August 2022)
 - Full equity backstops
- Access to private debt and willingness of direct lenders to offer covenant-lite loans
- Representation and warranty insurance
- Sellers seek certainty of closing



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TAKEAWAYS FOR FUTURE DEALMAKING: STAYING AHEAD



- **Build Relationships and Ensure Capacity**

- Investment bankers
- Financing
- Third party diligence providers
- Insurance brokers and underwriters (RWI, cyber, product liability)

- **Prepare for the Type of Bid Process and Target**

- Proprietary/Auction
- PE-backed/Founder

- **Internal Alignment and Advance Planning**

- Coordinated efforts
- Diligence
- Execution

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NO INDEMNITY DEALS

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NO INDEMNITY DEALS



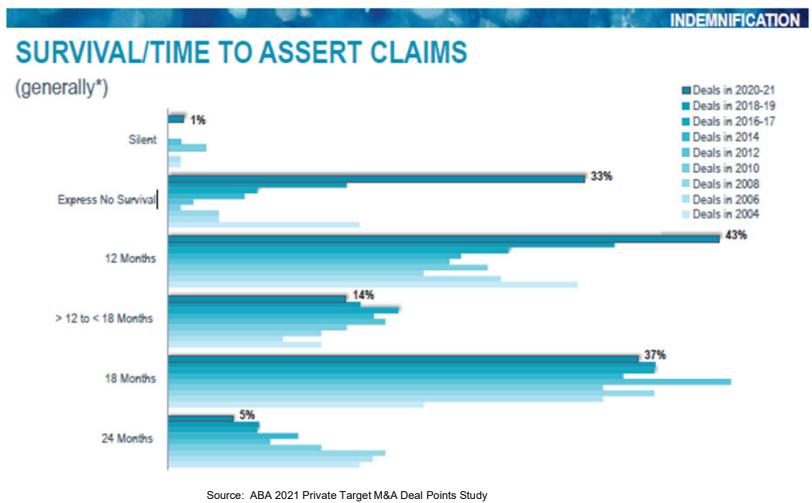
- Do people really do these deals?
- When is this type of deal appropriate?
 - Competitive auction
 - Private equity seller
 - Distressed seller
- How do I get comfortable with this type of deal?
 - Extensive due diligence
 - Representation and warranty insurance (RWI)

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NO INDEMNITY DEALS

- Key features is non-survival of representations and warranties



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NO INDEMNITY DEALS

- Another key feature is lack of any indemnification, even for:
 - Pre-closing taxes
 - Breaches of covenants
 - Unpaid debt and selling expenses
- But...
 - May be indemnity for issues specifically identified in diligence and carved-out from the RWI

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NO INDEMNITY DEALS

- So, what recourse does the buyer have?
 - RWI
 - Breach of contract claim for covenants that survive closing
 - Specific performance
 - Fraud



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NO INDEMNITY DEALS

- Sell-side definition
 - “**Fraud**” means, with respect to any party to this Agreement, (a) a false representation of material fact made in this Agreement by such party; (b) with actual (as opposed to imputed or constructive) knowledge by such party that such representation is false; (c) with an intention to induce the party to whom such representation is made to act or refrain from acting in reliance upon it (as opposed to reckless or negligent indifference to the truth); (d) causing that other party, in justifiable reliance upon such false representation and with ignorance to the falsity of such representation, to take or refrain from taking action; and (e) causing such other party to suffer damage by reason of such reliance.

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NO INDEMNITY DEALS

- Fraud – a simpler approach:
 - “**Fraud**” means intentional fraud under Delaware common law (which, for the avoidance of doubt, shall not include any theory of fraud based on recklessness, negligence or imputed knowledge) by a party hereto with respect to any representation or warranty contained in this Agreement.



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NO INDEMNITY DEALS

- Does this work?
 - Cannot eliminate liability for contractual fraud
 - Can limit fraud to intentional fraud under Delaware law
 - Can limit fraud to four corners of the agreement but...
 - The buyer MUST clearly state that it is not relying on any other reps or warranties
 - An “exclusive remedies”, “entire agreement” or “integration” clause will not be sufficient
 - Can try to limit to parties to the agreement but...
 - The person who told the lie or who knew the lie was being told cannot be insulated (even with a non-recourse provision)
 - Subrogation provision in RWI



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- What's the big deal?
 - Claims of fraud cost little to allege, are difficult to quickly dispose of, and can lead to unpredictable results



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CURRENT TRENDS IN R&W INSURANCE POLICY TERMS AND CLAIMS

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RECENT TRENDS

Impact of 2021 Capacity Constraints	Trends in 2022	Carryover from 2021
<ul style="list-style-type: none"> Increased premiums and fees Extended underwriting timelines Less desirable terms and limited flexibility Very selective NBIL submissions 	<ul style="list-style-type: none"> Competitive Premiums Reversion to expedited underwriting Aggressive competition on NBIL terms 	<ul style="list-style-type: none"> Increased underwriting focus on workforce dependability Continued resistance to COVID-19-related Coverage

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CERTAIN STANDARD EXCLUSIONS

COVID-19 Impact & Relief	Limit to claims based on COVID-19 sickness & repayment/forgiveness of PPP loans.
Known Breaches	Critical importance of "Actual Knowledge" standard; balancing third party diligence engagements.
Interim Breaches	Considerations for interim activities and information sharing (e.g., disclosure schedules updates).
Forward-Looking Statements	Require <u>specificity</u> in the NBIL.
Deemed Modifications & Disclosures	Again, require <u>specificity</u> in the NBIL.

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CLAIMS EXPERIENCE

Most Common Claims

- Financial Statements (21%)
- Tax (19%)
- Compliance with Laws (16%)
- Material Contracts (12%)
- Employee-Related (8%)
- Litigation (8%)
- Intellectual Property (7%)
- Operations-Related (5%)
- Environmental (3%)
- Fundamentals (1%)

Average Claim Size

- < \$1 million (43%)
- \$1 million - \$10 million (43%)
- > \$10 million (14%)

*Claims that exceed policy limits typically involve accounting, financial, or material contracts issues with large losses calculated based on a multiple of EBITDA applied to recurring loss over an extended period

Source: AIG 2021 M&A Claims Study

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HEIGHTENED DILIGENCE ENVIRONMENT AND RECENT AREAS OF FOCUS

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HEIGHTENED DILIGENCE AREAS IN THE RWI NBIL



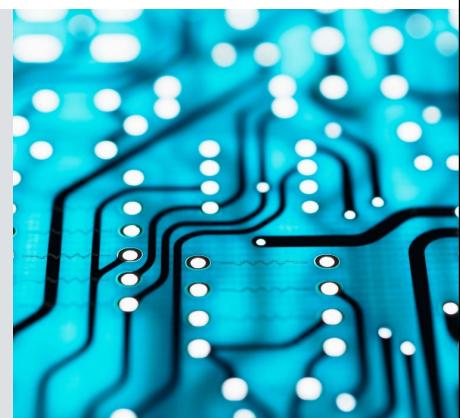
- *Every Deal:*
 - COVID-19 impact
 - Data privacy and cyber security (underlying insurance)
 - International trade (Ukraine and Russia)
 - Wage and hour and employee classification
- *Deal-specific:* Government contracts; product liability/recall and product warranties; environmental matters; recent acquisitions/divestitures; supply chain

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IMPORTANCE OF THIRD-PARTY DILIGENCE PROVIDERS

- *Focus on Technology:*
 - Data privacy and cyber security
 - Source Code Audit
- *Focus on Product Liability and Sustainability:*
 - Product recall and safety
 - Product stewardship



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EARNOUTS

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EARNOOUTS

- Bridging the valuation gap
- Common in some industries
- PE sellers do not like
- Often based on future revenues or earnings (EBITDA)
- Seller-favorable covenants (operate business in ordinary course, operate to maximize earnings, operate as stand-alone business, etc.) can be the subject of extensive negotiation, but often end up being relatively limited
- Subordination issues
- Buyer often has right to offset earnout against indemnity payments



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WHO'S WATCHING?

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HEIGHTENED REGULATORY SCRUTINY



- *Hart Scott Rodino (HSR) Approval (FTC and DOJ)*
 - Changing environment: increased scrutiny (duration and scope) of both business-to-business and individual seller non-compete and non-solicitation of employees
 - Caution: remain aware of reasonableness (business justification, product and geographic scope, employee coverage, duration)
- *Committee on Foreign Investment in the United States (CFIUS) Review*
 - Review of a record number of transactions for national security risks: certain transactions require filings while others are voluntary and CFIUS has the authority to review transactions for which filings were not made
- *Proposed New Agency to Complement CFIUS ("Reverse" CFIUS)*
 - Review of certain outbound investments impacting supply chain security, domestic production and manufacturing capacities in or to a "country of concern"

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BUYING FROM FINANCIAL SPONSORS

- *Post-Closing Restrictive Covenant Obligations*
 - Financial sponsors will not agree to non-compete, but should be able to bind their “controlled affiliates”
 - Buyers can seek comfort through the following restrictions:
 - Confidentiality
 - Non-acquisition of specific targets for a limited period of time
 - Non-solicitation/non-hire of specific employees for a limited period of time



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MINORITY INVESTING (BRIEFLY)

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NOT JUST A TOOL FOR PRIVATE EQUITY

Structure	Governance & Minority Rights	Strategies
<ul style="list-style-type: none">• Flexible capital structures<ul style="list-style-type: none">– Preferred equity<ul style="list-style-type: none">• Redeemable• Convertible– Warrants• Flexible economics<ul style="list-style-type: none">– Priority– Dividends– Participation– Fees / Expenses	<ul style="list-style-type: none">• Board representation / observation• Negative control rights• Liquidity rights• Other minority rights	<ul style="list-style-type: none">• Financial investment• Strategic M&A opportunities• Strategic operational opportunities

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QUESTIONS?



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