

Trends in Private Company M&A Transactions: “10b-5 Representations”

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In merger and acquisition (“M&A”) transactions, the definitive purchase agreement (e.g., asset purchase agreement, stock purchase agreement, or merger agreement) typically contains representations and warranties that the seller makes with respect to the target company.[2] The scope and detail of these representations and warranties are often heavily negotiated and tailored to reflect not only the nature of the target and its business, financial condition, and operations, but also the relative negotiating strength of the buyer and seller.

One representation and warranty that the buyer often requests is commonly referred to as a “10b-5 representation.” This name is a reference to the Securities and Exchange Commission’s Rule 10b-5, promulgated under Section 10(b) of the Securities Exchange Act of 1934. Clause (b) of Rule 10b-5 makes it unlawful (if using interstate commerce, the mails, or any national securities exchange), in connection with the purchase or sale of any security, to “make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.”[3] Most 10b-5 representations track this language at least in part.

This article summarizes the most common formulations for 10b-5 representations and examines the trends in practice with respect to 10b-5 representations in private company M&A transactions.

The ABA Studies

Every other year since 2005 the American Bar Association (“ABA”) has released its Private Target Mergers and Acquisitions Deal Point Studies (the “ABA studies”).[4] The ABA studies examine purchase agreements of publicly available transactions involving private companies that occurred in the year prior to each study (and in the case of the 2017 study, including the first half of 2017). These transactions range in size but are generally considered as within the “middle market” for M&A transactions; the average transaction value within the 2017 study was \$176.3 million.

10b-5 representations are among the many provisions reviewed in the ABA studies. The “sample” 10b-5 representation referred to in the ABA studies is taken from the ABA’s Model Asset Purchase Agreement, and is commonly referred to as the transaction-related version, reads as follows:

No representation or warranty or other statement made by Seller or any Shareholder in this Agreement, the Disclosure Schedules attached hereto, the certificates delivered pursuant to Section ___ or otherwise in connection with the Contemplated Transactions contains any untrue statement of material fact or omits to state a material fact necessary to make the statements in this Agreement, in light of the circumstances in which they were made, not misleading.[5]

Relying on the ABA studies to be precisely reflective of market practice regarding 10b-5 representations is an inexact science, in part because:

- there are different versions of 10b-5 representations, and the ABA studies do not specify which versions were included in the deals under review (or how many of those deals used the model ABA representation above, or another variation); and
- 10b-5 representations are often negotiated or discussed in connection with “full disclosure” representations. The relationship between 10b-5 and full disclosure representations is discussed below. The six most recent ABA studies differentiated between 10b-5 and full disclosure representations, but the 2005 study did not (and that study, while using the same sample 10b-5 representation as the subsequent six, set forth its results under the title of “full disclosure representations”).

However, many M&A lawyers consider the ABA studies as generally reflective of market practices. Further, even if it is impossible to discern the exact versions of 10b-5 representations included within the study—a problem likely inherent in categorizing any particular type of M&A representation—the studies should provide a reliable picture of how often 10b-5 representations (broadly described) are included within private company M&A transactions.

Common Variations of 10b-5 Representations

While there are many variations of 10b-5 representations, three variations discussed here are most commonly seen in purchase agreements. Despite their differences, all three variations refer to: (i) untrue statements; and (ii) statements made *misleading by omission*.

1. The “Agreement Only” 10b-5 Representation

a. Sample Language: None of the representations and warranties in Article ___ of this Agreement, taking into account the Disclosure Schedules attached hereto, contain any untrue statement of a material fact or omit a material fact necessary to make each statement contained herein or therein, in light of the circumstances in which they were made, not misleading.[6]

b. Observations: When referring only to statements in the purchase agreement, the untrue statement portion of a 10b-5 representation is arguably circular and confusing. If a representation in the agreement contains an untrue statement of material fact, then it's hard to imagine how the primary representation has not been breached. The statements in a representation or warranty are either correct or incorrect (which seems logically the same as being true or untrue). In other words, a negotiated representation related to a particular topic stands on its own with respect to the truthfulness of statements contained therein.

The value to the buyer of this agreement only 10b-5 representation, if any, is therefore due to the misleading by omission aspect, which arguably adds an additional standard that may be broader than a true or untrue standard. However, it is difficult to imagine how a specific representation (with or without related disclosures) could be true and correct (i.e., not breached), and yet still be misleading. If an environmental problem at the target arises or is discovered following the closing of the transaction, and that issue is not contrary to the environmental representation in the purchase agreement (which is often heavily negotiated), does that problem amount to an "omission" that has made the relevant environmental representation misleading? How is that the right result if the buyer is a sophisticated party negotiating the topic-oriented representations and warranties?

2. The "Agreement and Related Materials" 10b-5 Representation

a. Sample Language: None of the representations or warranties in this Article ___ nor any of the Exhibits or Schedules attached hereto, nor any of the certificates delivered pursuant to Section ___, contain any untrue statement of a material fact or omit a material fact necessary to make each statement contained herein or therein, in light of the circumstances in which they were made, not misleading.

b. Observations: This variation of the 10b-5 representation contains the same circularity problems discussed in the agreement only variation insofar as it covers the truthfulness of the statements made in other representations and warranties in the purchase agreement. However, unlike the agreement only variation, it goes beyond the purchase agreement's representations and warranties to apply to any closing certificates and schedules or exhibits attached to the purchase agreement. This broadens the scope of the representation considerably and even covers materials such as company promotional materials attached to a disclosure schedule (which is not unusual). Conceptually, this makes sense as it is easy to understand how sales or other promotional materials might be found to be misleading by omission of a material fact even if a negotiated representation or warranty in the principal agreement is not breached.

3. The "Transaction Related" 10b-5 Representation

a. Sample Language: No representation or warranty or other statement made by Seller or any Shareholder in this Agreement, the Disclosure Schedules attached hereto, the certificates delivered pursuant to Section ___ or otherwise in connection with the Contemplated Transactions contains any untrue statement of material fact or omits to state a material fact necessary to make the statements in this Agreement, in light of the circumstances in which they were made, not misleading.

b. Observations: This variation of the 10b-5 representation is the broadest, and most pro-buyer, of the three. It is also the variation reflected in the ABA Model APA, though, in the authors' experience, is not commonly seen in practice. Significantly, this version covers not only representations and warranties, but also any statements within closing certificates or schedules (including attachments), and any statements that the seller makes *in connection with* the transactions. This last point is critical because by its terms the representation is not limited to the

four corners of the transaction documents but arguably includes statements made during business meetings, management presentations, due diligence production, conference calls, and otherwise.

Knowledge Qualifiers in 10b-5 Representations

10b-5 representations generally do not include knowledge qualifiers – i.e., they are given as “flat” representations. Over the seven ABA studies, 10b-5 representations were knowledge qualified in 13 to 27% of the transactions reviewed. Thus, although knowledge-qualified 10b-5 representations are included in some purchase agreements, their use is somewhat limited in practice.

Relationship of 10b-5 and Full Disclosure Representations

As noted above, 10b-5 representations are often discussed in connection with full disclosure representations, though the two are different in approach and focus. The following is an example of a full disclosure representation, as set forth in the ABA Model APA:

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.

A full disclosure representation is highly buyer-oriented, and (as reflected in the ABA studies), relatively rare, particularly in the absence of an accompanying 10b-5 representation.[7] The link between 10b-5 and full disclosure representations in the ABA studies may simply be the result of the buyers’ relative negotiating strength in those deals.

Another version of a full disclosure representation, arguably narrower in scope than the representation above, focuses on the buyer's due diligence checklist and may appear as: *Seller has provided to the Buyer all information and materials responsive to the Buyer's due diligence checklist attached hereto as Schedule ____*. This representation may be appropriate where there is reason for the buyer to have concerns with the sellers’ disclosures or the disclosure process, and may focus the seller on the specific diligence checklist responses.

Trends in Usage of 10b-5 Provisions

According to the ABA studies, 10b-5 representations were reported in 59%, 62%, and 67% of reported transactions in the first three studies, respectively.[8] However, since 2011 there has been a marked decline in the use of 10b-5 representations with the representation appearing in only 35% (2011), 36% (2013), 23% (2015), and 25% (2017) of reported transactions in those studies. In short, 10b-5 representations are becoming increasingly less common since their use peaked at nearly 70% of reported transactions in 2008. This has been a sharp decline, as the representation now appears in only one quarter of reported transactions.

Conclusion

Based on the ABA studies, there has been a pronounced decline in the inclusion of 10b-5 representations in private company M&A transactions during the approximately 12 years covered by the studies. Whether or not a 10b-5 representation is included in a purchase agreement is often heavily negotiated. As discussed above, the different variations of these representations significantly impact risk allocation as between buyer and seller. Counsel on both sides of an M&A transaction should consider these issues carefully when negotiating 10b-5 representations.

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[2] Note that within this article we use the terms "seller" and "target" in the context of a stock purchase transaction – the "seller" would be the selling shareholder(s) making the representations and warranties in the M&A documents, and the "target" would be the company being acquired. In an asset purchase transaction, the "seller" would be the target company itself but for consistency we are using "seller" and "target" in a stock purchase setting. In addition, the terms "target" and "Company" are used interchangeably.

[3] [17 C.F.R. 240.10b-5\(b\)](#). A buyer in a private M&A stock deal may already be protected by Rule 10b-5, but including a 10b-5 representation in the purchase agreement gives the seller a contractual claim under the purchase agreement's indemnification provisions and does not require the buyer to prove the seller's knowledge of the untruth or omission, or the buyer's reliance on the same

[4] A project of the M&A Market Trends Subcommittee of the Mergers & Acquisitions Committee of the ABA's Business Law Section. References to years within the charts referenced in this article are to the respective years of the ABA studies. This article looks at 10b-5 representations in U.S. private company M&A transactions only; it does not for example examine 10b-5 representations in other types of transactions or public company M&A transactions.

[5] A.B.A., [Model Asset Purchase Agreement Section 3.22 Representations and Warranties of Seller and Shareholders](#) (2001).

[6] Buyer's counsel will advise buyer that this type of 10b-5 representation is intended to catch any issues or matters that would otherwise fall through the cracks and not be picked up by the more specific representations and warranties elsewhere in the agreement. Though the least pro-buyer of the three, seller's counsel will resist including even this iteration of a 10b-5 representation, and may even instead push for a separate provision commonly found in M&A

purchase agreements—the “no implied representations” provision. The no implied representations representation is considered a pro-seller provision which states that the only representations and warranties being made in connection with the transaction are those within the purchase agreement (and perhaps other identified closing documents), and/or that the buyer is not relying on any representations and warranties other than those in the transaction documents. The provision included depends on the relative negotiating strength of the parties.

[7] For example, the 2017 ABA study showed that only 7% of reported transactions included full disclosure representations, 6% when a 10b-5 representation was included and 1% in the absence of a 10b-5 representation. The 2015 ABA study reflected 6% of reported transactions as including full disclosure representations, 4% when a 10b-5 representation was included and 2% in the absence of a 10b-5 representation.

[8] As noted above, the 2005 ABA study did not differentiate between 10b-5 and full disclosure representations. Thus, the 59% figure cited may include some full disclosure representations that are not 10b-5 representations.