

Trends in M&A Provisions: Compliance with Laws Representations

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In merger and acquisition (“M&A”) transactions, the definitive purchase agreement (whether asset purchase agreement, stock purchase agreement, or merger agreement) typically contains representations, warranties, and covenants, along with related indemnification obligations. One common representation that the seller gives [ii] is that the target has operated its business in accordance with applicable laws (often referred to a “compliance with laws” representation). While sellers generally do not object to giving a representation that addresses legal compliance, they usually seek to include certain limitations that narrow the representation’s scope.

Compliance with Laws Representations

A typical, though buyer-friendly, compliance with laws representation [iii] may read:

The Company is in compliance, and since _____, 20__ has been in compliance, with all applicable laws, ordinances, codes, rules, requirements and regulations of foreign, federal, state and local governments and all agencies thereof relating to the operation of its business and the maintenance and operation of its properties and assets. No notices have been received by, and no claims have been filed against, the Company alleging a violation of any such laws, ordinances, codes, rules, requirements or regulations, and, to the knowledge of the Shareholders, the Company has not been subject to any adverse inspection, finding, investigation, penalty assessment, audit or other compliance or enforcement action. The Company has not made any bribes, kickback payments or other similar payments of cash or other consideration, including payments to customers or clients or employees of customers or clients for purposes of doing business with such Persons.

The compliance with laws representation is usually broad and does not focus on any specific aspect of non-compliance or any particular set of laws or regulations. Accordingly, it often covers the same ground as more topic-oriented representations which include legal compliance issues within a narrower context. For example, seller representations regarding environmental issues, operating permits, labor and employment matters, and employee benefits typically include concepts of legal compliance within those areas (e.g., that the seller has complied with all environmental laws, etc.). To avoid confusion, the parties often include a clarifying statement within the compliance with law representation stating that the representation does not address the specific legal compliance areas within the more focused representations. [iv]

Negotiation of the compliance with laws representation, and related seller disclosures, can often help a buyer in its diligence of the target. Rushna Heneghan, Deputy General Counsel at Charles River Laboratories, says “[w]hen we are looking at an acquisition target, the compliance with laws rep serves two purposes. It allocates responsibility as between buyer and seller for compliance issues, but it will also, hopefully, prompt a seller to raise any such issues or concerns during the disclosure process.” This is helpful because the buyer can then consider the disclosed information in assessing the overall risk profile of the target. “While the rep itself is important,” continues Ms. Heneghan, “I’d much rather know the underlying compliance problems than close the transaction with a strong indemnity claim for breach of the rep.”

Buyer and Seller Approaches

As reflected below, compliance with laws representations are seen in virtually every M&A deal. So, unlike many other components in an M&A purchase agreement, sellers generally do not argue against including such a representation. Instead, the negotiation between buyer and seller tends to focus on potential limitations to the representation, most notably along the following lines:

- **Knowledge Qualifiers:** Should the representation be qualified by the “knowledge” of one or more seller-related individuals? [v]
- **Past and Present Compliance:** Should the representation cover past as well as present compliance? If so, should past compliance be limited by time (e.g., compliance during the past X years)?
- **Notices of Investigations:** Should “compliance with laws” extend to notices of investigations by government entities or similar parties?
- **Notices of Violations:** Similarly, should “compliance with laws” extend to notices of violations?

Trends in Compliance With Laws Reps Provisions

Every other year since 2005 the American Bar Association (“ABA”) has released its Private Target Mergers and Acquisitions Deal Point Studies (the “ABA studies”). 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. [vi]

According to the ABA studies, compliance with laws representations were included in all or almost all (98% to 100%) of the transactions reviewed over the past six ABA studies.[vii] In addition, as reflected in the ABA studies:

- the compliance with laws representation is rarely qualified by knowledge;
- the representation sometimes addresses past compliance as well as present compliance (though this has dropped off in prevalence in the past three ABA studies); [viii] and

- more often than not the representation does not cover notices of investigations but usually does cover notices of violations (though there was a sharp drop-off with respect to notices of violations in the most recent ABA study).

Conclusion

Compliance with laws representations are almost always, barring highly unusual circumstances, present in M&A purchase agreements. The negotiation between buyer and seller typically focuses on the scope of the representation, not whether to include the representation. The use of knowledge qualifiers continues to be rare, appearing in only 1% of reviewed transactions in 2017 study. Although parties still negotiate the representation to cover past as well as current compliance, the inclusion of past compliance has become the minority approach (reflecting a decrease in usage from 76% in the 2007 ABA study to 31% in the 2017 ABA study). Additionally, over the last six ABA studies, inclusion of notices of investigations has been more the exception rather than the rule. In contrast, including notices of violations had been more common over five of the last six ABA studies (ranging from 59% and 77% in the five studies between 2007 and 2015). However, the inclusion of notices of violation dropped sharply to 35% in the 2017 ABA study.

The compliance with laws representation is likely to continue to be one of the less controversial components of an M&A negotiation, but there still remain potential scope limitations to be worked out between buyer and seller, which can shift underlying risk in one direction or the other.

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[ii] Note that within this article we use the terms "seller" and "company" 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 purchase agreement, and the "company" 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 "company" in a stock purchase setting.

[iii] We are using the terms "typical" and "buyer-friendly" in the same sentence because, as shown by the ABA studies in the discussion following, compliance with laws representations are seen in almost every M&A transaction, and more often than not have pro-buyer features.

[iv] This is particularly true if the compliance with laws representation is treated differently for indemnity purposes, whether in terms of its survival period and/or caps and baskets, than the more topic-focused representations.

[v] See Avery and Crossley, Trends in M&A Provisions: Use of Knowledge Qualifiers for Representations and Warranties, Bloomberg Law, Apr. 2018, reprinted on Goulston & Storrs' "What's Market" web page at <https://www.goulstonstorrs.com/whats-market/> and on Bloomberg Law at https://www.bloomberglaw.com/page/infocus_dealpoints.

[vi] This article looks at the compliance with laws representations in private company M&A transactions as reflected in the ABA studies. This article does not cover such representations in other types of transactions or in public-to-public M&A transactions.

[vii] The 2005 ABA study did not look at compliance with laws representations.

[viii] It is unclear what may have caused a considerable drop-off in past compliance coverage by the compliance with laws representation in the 2013, 2015 and 2017 studies, particularly given the relative stability and consistency on this specific issue over the past ABA three studies but also in light of the stability or at least "smooth trending" of the other compliance with laws issues over the six ABA studies that examined the representation. That only approximately one-third of compliance with laws representations covered at least some time period of past compliance for transactions in the three most recent ABA studies is not consistent with the authors' experience. To the contrary, we see inclusion of past compliance within compliance with laws representations much more frequently in practice.