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MERGER AGREEMENTS

Trends in M&A Provisions: No Undisclosed Liabilities Representations

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In merger and acquisition (''M&A'') transactions, the definitive purchase agreement contains representations and warranties made by the seller with respect to the target company.[1] 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, operations and financial condition, but also the relative negotiating strength of the buyer and seller. Representations and warranties provide information to the buyer and also allocate risk as between buyer and seller with respect to the matters covered by the representations and warranties.

One type of representation and warranty commonly requested by a buyer is a representation that the target company has ''no undisclosed liabilities.'' This representation is especially important to both seller and buyer because it can significantly impact the relative risk allocation as between the parties for undisclosed—or otherwise unknown—liabilities of the target.

In 2005, 2007, 2009, 2011 and 2013, the American Bar Association (ABA) released its Private Target Mergers and Acquisitions Deal Points Studies (the ''ABA studies''). The ABA studies looked at the M&A agreements of publicly available transactions that occurred in the year prior to each study. In each year, the studies reviewed 128, 143, 106, 100 and 136 private company transactions, respectively. These transactions ranged in size from $17 million to $4.7 billion, across a broad range of industry sectors.

This article examines trends in the usage of ''no undisclosed liabilities'' (NUL) representations in private

[1] 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 ''target company'' are used interchangeably.

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company M&A transactions, as reflected in the ABA studies.[2]

What is a ''No Undisclosed Liabilities'' (NUL) Representation?

NUL representations take various forms, but as a general matter in these representations the seller will make statements to the buyer ''certifying'' as to the absence of target liabilities (whether as to specific types of liabilities or all liabilities) which are not otherwise identified or disclosed. As a general matter, an NUL representation is often one of the principal representations within an M&A purchase agreement pursuant to which the seller and buyer allocate risk of unknown target liabilities as amongst the two parties.[3]

The buyer will typically want a seller's NUL representation to be as unqualified as possible, with minimal exceptions and covering the maximum universe of potential liabilities. The seller, of course, will seek to reduce its exposure by limiting the scope of liabilities subject to the NUL representation and by incorporating as many exceptions and qualifiers as possible.

A buyer-friendly version of a NUL representation may read along the following lines:

> *The Target has no liabilities of any type whatsoever except for: (i) liabilities reflected or reserved against in the Latest Balance Sheet; and (ii) those liabilities set forth on Schedule X.*

On the other hand, the seller's efforts to limit its potential liability for breach of a NUL representation usually take one or more of the following forms:

1. Limiting the Subject Liabilities to GAAP Balance Sheet Liabilities In part because an NUL representation often references a target's balance sheet, a seller can be expected to argue that the NUL representation should apply not to all liabilities, but rather only to the sub-set of liabilities required under applicable accounting standards to be reported on a balance sheet. An example of this type of NUL representation is as follows:

> *The Target has no liability of a nature required to be disclosed in a balance sheet prepared in accordance with GAAP except for: (i) liabilities reflected or reserved against in the Latest Balance Sheet; and (ii) those liabilities set forth on Schedule X.*

Pursuant to this type of representation, the seller needs to disclose liabilities only of the type required to be reflected as liabilities on a balance sheet prepared in accordance with Generally Accepted Accounting Principles (''GAAP''). Not all liabilities need be reported under GAAP. For example, under GAAP, the disclosure of contingent liabilities depends upon a number of different factors as to relative probability and the like. In addition, an operating business will generally have many ordinary course business liabilities— including, significantly, normal contract obligations— which are not typically liabilities included in a GAAP balance sheet. And, of course, by definition, truly ''unknown'' liabilities cannot be disclosed at all. In short, GAAP liabilities can be a relatively narrow subset of a target's ''total'' known and unknown liabilities.

2. Adding Ordinary Course Exceptions Often a seller will seek to include a carve-out from a NUL representation for ordinary course liabilities incurred since the balance sheet date.

> The Target has no liability of the nature required to be disclosed in a balance sheet prepared in accordance with GAAP except for: (i) liabilities reflected or reserved against in the Latest Balance Sheet; (ii) liabilities incurred in the Ordinary Course of Business since the date of the Latest Balance Sheet; and (iii) those liabilities set forth on Schedule X.

3. Including Knowledge or Materiality Qualifiers The seller may also limit a NUL representation by having the representation made to the seller's knowledge and/or to undisclosed liabilities above a materiality or other threshold.[4]

4. Excluding Liabilities which are the Subject of Other Representations A seller may also object to a NUL representation as being overly broad, and, with respect to any specific topic, potentially in conflict with other representations in the purchase agreement specifically covering that topic. For example, if the purchase agreement has a detailed representation regarding environmental matters which requires disclosure of liabilities arising under environmental laws in excess of $10,000, should the NUL representation separately require disclosure of environmental liabilities *below* $10,000?

Such a ''topic-oriented'' limitation to the NUL representation may read as follows:

> *The Target has no liability . . . except for: . . . (iv) liabilities which are disclosed on any other Schedules or which are not required to be disclosed under any representation or warranty in Article X because of a materiality, dollar or knowledge threshold or qualifier.*

The Buyer's Position

The buyer's arguments for insisting upon a NUL representation, and for keeping that representation as broad as possible, simply reflect a preference that as between the buyer and the seller, the seller should bear at least some risk of undisclosed or unknown liabilities. In practice, however, where NUL representations are present, they are usually included within the category of seller representations that have an indemnity ''basket and cap''—i.e., a minimum level of buyer loss before seller responsibility kicks in, as well as a stated maxi-

[2] This article looks at the usage of NUL representations in private company M&A transactions as reflected in the ABA studies. It does not cover NUL representations in other types of transactions or in public-to-public M&A transactions.

[3] The NUL representation is usually not the only representation dealing with unknown liabilities. Instead, unknown target liabilities are typically addressed in different ways throughout the M&A purchase agreement. For example, if a seller provides a normal representation that the target has complied with all applicable laws during the past three years, unless that representation is ''knowledge qualified,'' the seller, by making that ''flat''—i.e., unqualified—representation, has assumed, vis a vis the buyer, the risk of unknown liabilities arising from legal non-compliance during the relevant period.

[4] Trends in the usage of knowledge qualifiers generally, and of ''materiality scrapes'' are the subjects of other Goulston & Storrs articles in this series. See http://www.goulstonstorrs.com/site/PracticesIndustries/Corporate/MergersAcquisitions/WhatsMarket.

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mum amount of seller liability. Thus, in this context, the buyer is already assuming some of the risk of unknown liabilities even with the normal NUL representation (specifically, those within the ''basket'' and above the ''cap'').

A buyer will often argue that the seller is in a better position than the buyer to assess the risk of unknown liabilities because of the seller's familiarity with the past and current operations of the target company, and therefore should be expected to ''stand behind'' that assessment.

The Seller's Position

Of course, the seller will have its own points of view about a NUL representation, as follows:

1. If the purchase agreement covers in great detail all aspects of the target's business, why is a broader ''catch-all'' representation needed or appropriate?

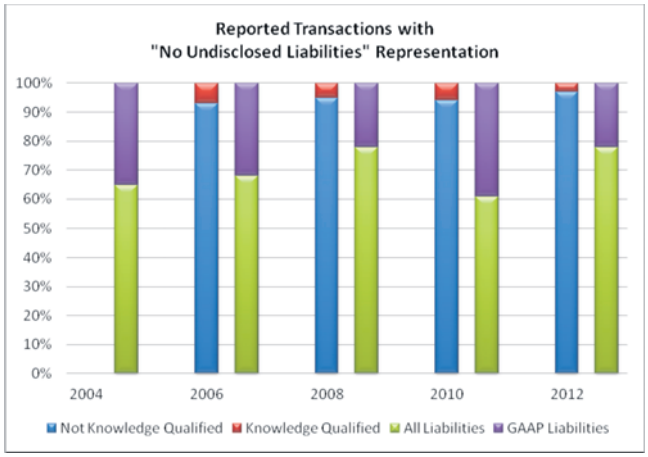
2. If the parties have agreed that certain types of contracts and other liabilities are not required to be disclosed under specific seller representations, why should those thresholds be ignored for a NUL representation?

3. Other provisions in the purchase agreement afford the buyer adequate protection against certain liabilities. Most often cited in this regard are the standard seller representations with respect to the target's financial statements and that no material adverse effect has occurred since a specified date.

Trends in Usage of ''No Undisclosed Liabilities'' Representation

According to the ABA studies, purchase agreements in M&A transactions consistently included a NUL representation. Specifically, in transactions in 2004, 2006, 2008, 2010 and 2012, a NUL representation was included in 92%, 93%, 97%, 96% and 94%, respectively, of the subject agreements.

Of those representations appearing in 2012, only 3% contained a knowledge qualifier and 22% were limited by GAAP. As the graph below portrays, the overwhelming absence of a knowledge qualifier in 2012 transactions was consistent with the results of prior years. In addition, the majority of NUL representations have not included a GAAP qualifier in the years studied.[5]



* Data of knowledge qualifiers not available for 2004 transactions

Conclusion

The NUL representation, of one type or another, continues to be commonly seen in private company M&A transactions. Attempts by sellers to use knowledge qualifiers to limit the types of liabilities required to be disclosed seem to be met with very little success, and the more seller-friendly ''GAAP-only'' variation continues to be a minority approach (though much more common than knowledge qualifiers). As discussed above, the qualifiers that can be used to limit the scope of this representation will impact allocation of undisclosed liabilities as between buyer and seller. Counsel on both sides of an M&A transaction should consider these issues carefully when negotiating a NUL representation.

[5] Note that the ABA studies do not look at the usage of the ''ordinary course of business'' exception described above, which is a commonly used exception. The ABA studies also do not cover the ''otherwise disclosed or not required to be disclosed'' exception discussed above — this exception, however, is not seen in practice as frequently as the ''ordinary course of business'' exception.