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### MERGERS & ACQUISITIONS

#### Trends in M&A Transactions

## Use of Knowledge Qualifiers for Representations and Warranties



BY DANIEL AVERY AND KYLE S. CROSSLEY

In merger and acquisition (“M&A”) transactions, the definitive purchase agreement typically contains representations and warranties made by the seller with respect to the target company.<sup>1</sup> The scope and detail of these representations and warranties are often

<sup>1</sup> 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.

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heavily negotiated and tailored to reflect both the nature of the target and its business, financial condition and operations, but also the relative negotiating strength of the buyer and seller. Representations and warranties not only provide information to the buyer, but also operate to allocate risk as between buyer and seller with respect to the matters covered by the representations and warranties.

Representations and warranties usually survive for specifically negotiated time periods following the closing—often 12-24 months—though certain “fundamental” representations (such as those relating to title to stock or assets, taxes, etc.) often survive indefinitely or for the applicable statute of limitations.

In negotiating the M&A purchase agreement, the seller has an incentive to keep its representations and warranties as narrowly drawn as possible; the buyer, of course, wants those representations and warranties to cast a wide net. One way a seller tries to achieve its objectives is to qualify the representations and warranties to its “knowledge.”<sup>2</sup> The buyer, on the other hand, wants the seller’s representations and warranties to be unqualified (i.e., “flat” representations and warranties, not qualified by knowledge or anything else).

Even when the “knowledge” concept is agreed as between seller and buyer, the scope of that “knowledge” needs to be determined. Is the “knowledge” only “actual” knowledge, or does it include “constructive” knowledge? And whose “knowledge” is relevant for purposes of the representations and warranties qualified by knowledge?

This article examines the use of knowledge qualifiers in private company M&A transactions, and trends in that usage as reported by American Bar Association (ABA) studies.<sup>3</sup>

<sup>2</sup> In addition to knowledge, there are other possible qualifiers, including qualifiers relating to materiality, material adverse effect (MAE), and dollar thresholds.

<sup>3</sup> This article looks at knowledge qualifiers in U.S. private company M&A transactions only; it does not for example ex-

## Knowledge Qualifiers

A knowledge qualifier limits the reach of a contractual provision so that the provision only applies to what the relevant party “knows.” A buyer, as noted above, prefers that the seller’s representations and warranties are effective regardless of whether the seller had “knowledge” of the particular matter.

An example of a representation and warranty made to “knowledge” is as follows:

“The Seller *has no knowledge* of any breach or anticipated breach by the other parties to any Contract to which the Company is party.”

Sometimes, a representation and warranty will have some but not all portions qualified by knowledge. Three examples follow:

- “No third party has made any claim asserting that any Intellectual Property Rights owned or held by the Company should be transferred to or placed under the control of a third party, nor has any third party made a request or demand that any such transfer be made by the Company other than in an arm’s length transaction and in exchange for full and fair market value; and to the Seller’s knowledge, the Intellectual Property Rights owned by or licensed to the Company have not been infringed, misappropriated or conflicted by other Persons.”

- “No notices have been received by and no claims have been filed against the Company alleging a violation of any applicable laws, ordinances, codes, rules, requirements or regulations, and, to the knowledge of the Seller, the Company has not been subject to any adverse inspection, finding, investigation, penalty assessment, audit or other compliance or enforcement action.”

- “There are no (and, during the five years preceding the date hereof, there have not been any) actions, suits, proceedings, orders, investigations or claims pending or, to the Seller’s knowledge, threatened against or affecting the Company or the Assets (or to the Seller’s knowledge, pending or threatened against or affecting any of the officers, directors or employees of the Company with respect to their business activities).”

## Defining Knowledge

A buyer’s agreement that a particular seller representation and warranty will be qualified by knowledge usually is not the end of the discussion. The parties then will negotiate the scope of the seller’s “knowledge.”<sup>4</sup> In general, there are two principal components to this discussion: (i) first, whether the seller’s knowledge is “actual” knowledge only, or whether it includes “constructive” knowledge as well; and (ii) second, whether the seller’s knowledge is to be tied to the knowledge of specifically identified persons (or categories of persons).

As to the first point—actual vs. actual and constructive knowledge—an example of an “actual only” knowledge definition is as follows:

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amine knowledge qualifiers in other types of transactions or public company M&A transactions.

<sup>4</sup> As noted below, while sellers and buyers occasionally leave “knowledge” undefined, this is a fairly rare practice.

- “‘Knowledge’ means, when referring to the ‘knowledge’ of the Seller, or any similar phrase or qualification based on knowledge, the actual and conscious knowledge (but excluding any constructive knowledge) of . . . .”

“Constructive” knowledge is, in effect, imputed knowledge in this context, so there are different variations of this concept. Constructive knowledge could be defined, for example, as the knowledge that any given individual would be expected to learn after some reasonable level of diligence, or what that individual would be expected to know in his or her capacity as an officer, director, or employee, etc. (as applicable) of the target. For example:

- “‘Knowledge’ means, when referring to the ‘knowledge’ of the Seller, or any similar phrase or qualification based on knowledge, the actual knowledge of [named individuals], and the knowledge that each such person would have reasonably obtained after making due and appropriate inquiry with respect to the particular matter in question.”

- “‘Knowledge’ means, when referring to the ‘knowledge’ of the Seller, or any similar phrase or qualification based on knowledge, the actual knowledge of [named individuals], and the knowledge that each such person would have reasonably obtained after making due and appropriate inquiry with respect to the particular matter in question, including, without limitation, inquiry of [employee X with respect to general topic Y, etc.].”

- “‘Knowledge’ means, when referring to the ‘knowledge’ of the Seller, or any similar phrase or qualification based on knowledge, the actual knowledge of [named individuals], and the knowledge that each such person would have reasonably obtained in the performance of each such person’s duties as [Chief Executive Officer, President, etc.] of the Company.”

As to the second point—identification of one or more persons whose knowledge is taken into account for the knowledge definition—buyers and sellers often negotiate who is included within the “knowledge group,” and who is not.

From a buyer’s perspective, the knowledge group should include those individuals having control over, and in any event those most likely to have knowledge of relevant facts with respect to, the items covered by the relevant representations and warranties qualified by knowledge. In smaller, closely held corporations with a small group of shareholders active in the business, it may be appropriate to have all shareholders in the knowledge group. When the seller is a larger company with multiple operational functions, specific individuals might be included as to particular areas—e.g., including the seller’s human resources director as to the employment and HR representations only, the risk management director with respect to insurance, etc.

## Trends as to Knowledge Qualifiers

In 2005, 2007, 2009 and 2011, the American Bar Association released its Private Target Mergers and Acquisitions Deal Points Studies.<sup>5</sup> These studies looked at

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<sup>5</sup> A project of the Mergers & Acquisitions Market Trends Subcommittee of the Mergers & Acquisitions Committee (for-

private company M&A transactions that occurred in the year prior to each study. While the scope and presentation is not always identical, these four studies provide a means to see how parties to M&A transactions are resolving many key deal points, and to determine whether there are any trends or changes in these deal points over several years. Although many law firms, accounting firms, investment bankers and other professionals also publish “deal point studies,” those tend to focus on a limited number of key points (often just one topic, such as the study of “material adverse effect” clauses). The ABA studies are generally considered by practitioners as reflective of broader “market” parameters for any covered topic in the private company M&A world.

The study results from 2005, 2007, 2009, and 2011 show that knowledge is almost always defined in the private company transactions reviewed; only 4 percent

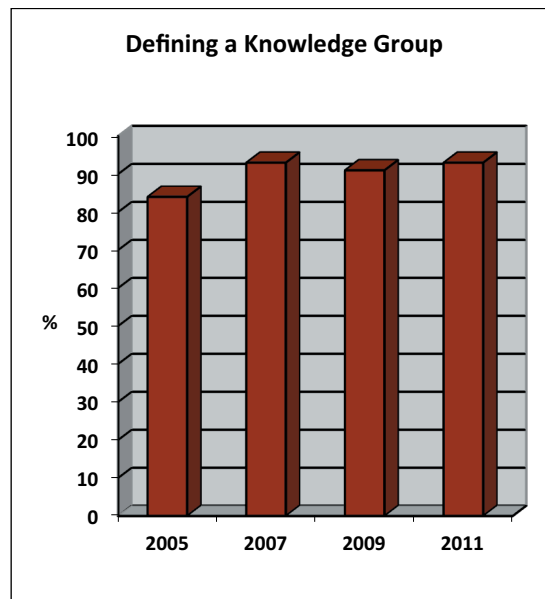
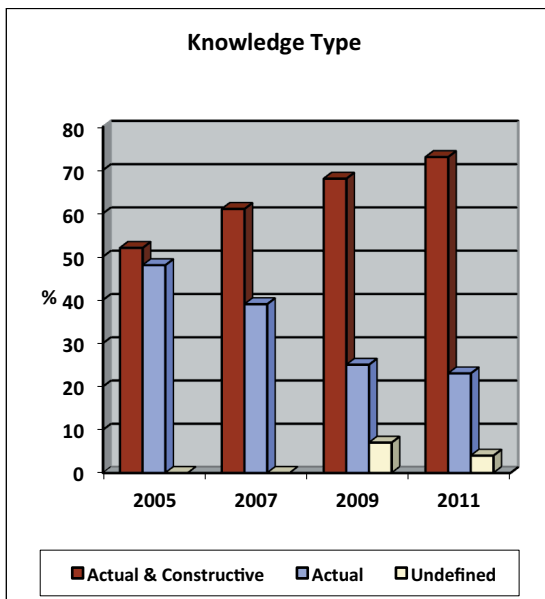
merly called the Committee on Negotiated Acquisitions) of the ABA’s Business Law Section.

of those M&A deals in the 2011 study left knowledge undefined.

Secondly, the trends reveal that the definition of knowledge is increasingly including both constructive and actual knowledge (instead of mere actual knowledge). In fact, defining knowledge as both actual and constructive has increased from 52 percent of reviewed M&A deals in 2005 to 73 percent in 2011.

At the same time, a fairly consistent, very large majority of reviewed M&A deals have defined a knowledge group or limited knowledge to include specific individuals. In 2011, 93 percent of M&A deals referred to a limited knowledge group or specific individuals whose sole knowledge was subject to the representation.

These charts portray the trends (as reflected in the ABA studies) in the definition of knowledge towards both actual and constructive knowledge, as well as the consistently high percentage of deals that define a specific knowledge group.



### Conclusion

Buyers and sellers will be expected to negotiate: (i) which seller representations and warranties are to be qualified by knowledge; (ii) how knowledge is to be defined (i.e., actual knowledge only, or actual and constructive knowledge); and (iii) who is in the knowledge group. As a general proposition (and there are always exceptions to reflect the particulars of any given transaction), knowledge qualifiers are usually most appropriate for facts or matters which are outside the seller’s control or which cannot reasonably be determined

through the seller’s diligence—for example, whether or not litigation is being “threatened” but not yet asserted in the form of a demand notice or complaint.

Counsel on both sides of an M&A deal should carefully consider the use of knowledge qualifiers, both as to which representations they qualify, and also as to whether the qualifiers include actual knowledge or both actual and constructive knowledge, and who is included in the knowledge group. Use of knowledge qualifiers can operate to shift risk for post-closing problems as between buyer and seller, and therefore should be tailored specifically to any particular transaction.