

# Tales *from the M&A* Trenches

**PRE-CLOSING PRACTICES TO  
MITIGATE POST-CLOSING RISKS**

**Paul Koenig and Mark Vogel**

Managing Directors and Co-Founders

**SRS** | Shareholder Representative Services

With editorial comments provided by  
Diane Holt Frankle, Esq., Kaye Scholer LLP

**THIRD EDITION**

Printed by **RR DONNELLEY**

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Representative  
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# Introduction

In 2007, SRS | Shareholder Representative Services created the role of professional shareholder representative and has now served as the representative on hundreds of M&A transactions. We have managed scores of claims, releases, accounting adjustments, earn-out disputes and other matters. We have worked with institutional investors, founders, and companies represented by some of the best M&A lawyers in the country. While having a shareholder representative in these transactions is nothing new, SRS is the first company to offer dedicated services as a professional, independent agent of the shareholders. SRS now has served as a shareholder representative more often than any other company, firm, or individual. No one else comes close.

This experience has given SRS a unique perspective on M&A deals. Most M&A attorneys do the majority of their work on a transaction prior to closing and may have little or no idea whether any issues arise afterward. Because SRS' job starts at the closing, we see a portion of the process of selling a company that most deal professionals experience rarely, if ever. This has enabled us to identify transaction terms that can become problematic later, and ways to potentially address these issues during negotiation and in the drafting process. *Tales from the M&A Trenches* is a culmination of that experience, distilled into drafting tips, flags, and best practices.

In this edition, we are privileged to have feedback and input from Diane Holt Frankle of Kaye Scholer LLP. Diane is one of the leading M&A attorneys in the country and frequently represents buyers on sophisticated acquisition transactions. Because SRS is always on the sell-side of deals by virtue of our role in the transaction, we asked Diane to review this manual and provide thoughts and feedback from the buyer's perspective. Her suggestions are incorporated in the text.



We want to thank Diane for her time and efforts in optimizing the value of *Tales* to the community and for providing an alternative point of view.

While *Tales* is a manual of ideas, the data that backs it up is important to M&A professionals too. The SRS M&A Post-Closing Claims Study details what really happens after closing and serves as a complementary resource. That study shows that a claim or dispute arises after closing in 56% of transactions, and in those deals with claims, the amount of losses alleged is an average of 51% of the escrow. Although *Tales* is intended to help mitigate some of these challenges, buyers and sellers need to be prepared to potentially expend time and resources after closing. We find that indemnification claims take an average of eight months to resolve, and 4% of the deals with claims result in litigation or arbitration.

The purpose of this manual is to flag potential issues that could cause unnecessary disputes after closings. In general, the buyer and seller both view the merger as creating a new partnership and would like to avoid problems, if possible. This manual is not meant to advocate on behalf of either of the parties.

Please also note that this manual is not meant to be an exhaustive list of all negotiating points in a merger agreement, or even of the most material points. This content is focused on specific technical issues related to post-closing matters. Many of the suggestions will not work in every deal, and there are counterpoints to many of the issues raised. This manual is meant simply to flag issues that deal attorneys and principals may wish to consider further before finalizing their transactions.

As a final note, *Tales* is a working document that will continue to evolve over time, and we welcome any feedback or comments you may have. Our goal is to provide a tool that allows the deal-

making community to materially advance discussions and best practices used in merger transactions. We look forward to your participation via [tales@shareholderrep.com](mailto:tales@shareholderrep.com).



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“Across our client base over the last several years, we have noticed a disturbing trend – the relative size and frequency of post-closing escrow claims in M&A transactions are on the rise.”

**Al Browne and Rob Hadfield**  
**Partners, Cooley LLP**  
**Business Law Section Newsletter,**  
**Boston Bar Association, Volume 6 (Spring 2011)**

## Notes

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# Merger Agreement Issues

## Introduction

The merger agreement is the primary document that governs the terms and conditions detailing the acquisition of one company by another.

There are many legal and business considerations involved in drafting a merger agreement, not the least of which are the business terms themselves. There are a wide variety of other issues that need to be considered, including tax, securities law, corporate law, and accounting matters. Extensive materials exist on most of those subjects. We focus here on issues that are rarely, if ever, on that standard list, and that often are not covered in the merger agreement terms.

## 1. The Problems with Pro Ratas

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**Pro rata formulas are often complicated and mistakes are frequently made.**

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Many shareholders think that when you sell a company, each security holder simply gets their percentage of the proceeds. In reality, however, the formulas are often much more complicated and mistakes are frequently made. SRS has worked on numerous transactions in which the spreadsheet

delivered at closing contains inaccuracies, does not match the formula contained in the document or fails to account for potential changes to distribution pro rata percentages. While most attorneys are aware of these issues, the M&A community may not realize the magnitude and frequency of the problem. A friend of ours who is the general counsel of a large investment fund told us that the greatest value he provided to the fund in his early years on the job was identifying mistakes or unresolved issues in capitalization tables in connection with M&A transactions. He said the errors or adjustments amounted to millions of dollars that would have been misallocated. In SRS' experience, we find that upwards of a third of the spreadsheets we receive have issues that require further clarification before distributions can be accurately made. There are several common reasons for this, such as the complications of taking into account the liquidation preferences and participation caps attributable to the preferred stock, whether and to what extent holders of options or unvested stock participate in various distributions, and the often complicated terms of management carveout plans.

Below is a summary of some of the major challenges we see with these calculations and payouts.

*Are the parties that participate in the closing payment the same as those that participate in the escrows or other future payments, and are the percentages the same?*

This can be a complicated issue that is often missed. We have seen several agreements that have a single definition of “Pro Rata” when that is not what is intended. As an example, suppose a company that has raised \$20M is sold in a transaction that pays \$19M at closing with a \$5M escrow. If the investors are entitled to their money back first but no more, there is a complicated question of which shareholders “own” the escrow and in which percentages and to what extent. The preferred investors will presumably take all of the \$19M paid at closing, but one can see how determining who should receive payouts from the escrow is more complex. You can also see how this answer might change based on how much of the escrow is paid out to the shareholders. Payment caps or forfeiture provisions in management incentive plans or in individual agreements with continuing employees may also result in a recalculation of post-closing distribution percentages that is not accurately reflected on the closing spreadsheet or in the deal documents.

*When employees participate in the escrow, are their contributions pre-tax or net of withholding for purposes of determining pro rata allocations?*

We have seen it done both ways and it may depend on the source of the contribution (options or employee bonus/management carve-out), the tax treatment of the deal and whether it is an indemnification escrow or the establishment of an expense fund. In most cases, contributions to indemnification escrows are subject to substantial risk of forfeiture (i.e., indemnification claims) and therefore no taxable event occurs until the escrow is released. In this case, the contribution to the escrow is most likely considered to have been made on a pre-tax basis for purposes of pro rata calculations.

With expense funds, whether contributions are considered pre-tax or after-tax typically depends on the agreement between the buyer and the sellers. If the buyer agrees to treat the expense fund as part of the installment sale, then contributions to expense funds from employees are typically considered to have been done pre-tax. If the sellers do not want the buyer involved in treatment of the expense funds, however, then the gross proceeds typically are deemed distributed at closing and the expense fund is established on an after-tax basis.

*Will the pro rata percentages change if certain events occur such as employees leaving prior to the end of the escrow period or if there are payment caps under relevant management incentive plans?*

Some agreements will say that optionholders or holders of unvested stock (or related phantom or derivative units) will only participate in disbursements if they are still employed at the time the applicable payment becomes due. If they leave, there is a question as to whether their portion of future payments should be reallocated among the other securities holders (which gives an odd incentive to knock off your co-workers) or should go back to the buyer. Either way, the pro rata percentages can shift as you go along, making the calculation of final payout amounts and splits complicated. Similar issues are raised when there are payment caps under management incentive plans because the pro rata percentages change with respect to distributions in excess of the cap.

*What happens if a mistake is discovered after closing?*

If mistakes in pro rata calculations are discovered after closing, a question arises as to how to determine what the parties intended to do and whether the shareholder representative has the power to make appropriate adjustments. This can take the parties into tricky territory, because the shareholder representative likely has the authority to make clarifying or correcting amendments, but may lack the authority to change the fundamental deal terms without prior stockholder approval.

## 2. Definition of Merger Consideration

Merger agreements sometimes fail to describe the merger consideration as well as they should. Suppose there is a merger with a \$100 million purchase price and a 10% escrow. In such a case, the merger agreement should probably say that the purchase price is \$90 million plus whatever balance remains in the escrow account after the completion of the escrow process. It generally should NOT say that the merger consideration is \$100 million, 10% of which is being held in escrow.

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**Merger consideration should be defined as the amount paid at closing plus whatever balance remains at the end point of the escrow process.**

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While that may seem like splitting hairs, the reason is to make sure that no shareholder has any argument that it is entitled to the full purchase price, without any portion being subject to escrow. Since shareholders typically do not sign the merger agreement or escrow agreement, there always has been some level of question as to whether certain of the terms of those agreements are enforceable against them. The potential issue with merger consideration, if it is defined as the full purchase price with a portion subject to escrow, is that shareholders could try to argue that an escrow agreement is not binding on them for lack of privity of contract, and that they are therefore entitled to their portion of the full purchase price. This risk is especially acute if a shareholder exercises dissenter's rights and points to the term of the merger agreement specifying the full price per share as evidence of the fair market value that should be received. This potentially provides another avenue for such a dissident shareholder to receive the full purchase price free of any escrow obligations.

While this risk may be low, defining the merger consideration as the amount paid at closing plus whatever balance happens to remain at the end of the escrow process should eliminate this concern.



### 3. Damages Based on Financial Misstatements

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**Parties should define in the merger agreement how such damages are to be calculated.**

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There are many nuances to the definition of damages in merger agreements: Should they be net of insurance proceeds? Should tax impacts be taken into account? One issue that can have a significant impact on damages calculations and is often less than clear is the calculation of loss related to a misstatement of financial statements.

Sellers will typically assume that if there was a mistake in the financial statements, the amount of damages would be equal to the amount of any misstatement. For example, if the income statement understated revenue by \$250,000, a seller might assume this would be the amount of a possible indemnification claim.

Buyers, on the other hand, will sometimes make the argument that they determined the purchase price based on some multiple of revenues or EBITDA and if the applicable variable has been misstated, the amount of loss must be equal to that misstatement times the multiplier. In other words, the argument goes that if a hypothetical buyer is willing to pay 10X revenue and revenue is misstated by \$1 million, the amount of the buyer's alleged loss is \$10 million, because that is how much less the buyer would have paid for the business had the misstatement been identified prior to closing.

The buyer's position puts the sellers in a very difficult spot. In many cases, the selling shareholders may not even be aware of the buyer's original methodology for determining purchase price. Even if they were aware that the buyer's pricing was determined by a multiple analysis, they also recognize that many other variables were likely at play during the negotiation of the merger that im-

pacted price. The final purchase price is often based on projected future revenues (rather than past revenues included in the financial statements in question), strategic or synergistic analyses and/or the outcome of a competitive bidding situation. Therefore, when sellers hear the argument from a buyer that it paid a multiple of some variable and wants that to be the basis of damages, they often are unable to confirm whether such claim is legitimate.

To avoid this risk, the parties should define in the merger agreement how such damages are to be calculated. If they want to limit the damages to the amount of any misstatement, we suggest including language such as the following:

*Notwithstanding anything herein to the contrary, no party shall be liable to the other for any consequential, special, incidental, exemplary, or punitive damages or for diminution in value, lost profits or lost business opportunity that arise out of or relate to this Agreement or any liability or responsibility assumed or retained hereunder.*

If buyers insist on an ability to seek to recover diminution in value and/or lost profits, sellers should nonetheless seek to make it clear that the damages are not subject to a multiplier, with language such as the following:

*The Indemnified Parties shall not use “multiple of profits” or “multiple of cash flow” or any similar valuation methodology in calculating the amount of any Losses in the nature of “lost profits” or “diminution in value”.*

Alternatively, if the calculation of damages for financial misstatements is to be multiplied by something, make that clear. We suggest language such as:

*The parties agree that the purchase price was based in significant part on the Seller’s Financial Statements. In the event of*

*any Misstatement that impacts Net Income or Shareholder Equity, the amount of damages for which the Buyer shall be entitled to indemnification shall be equal to the amount of such Misstatement multiplied by Z.*

Either way, have this discussion prior to closing and try to make the answer clear in the documents.

#### 4. Assuming Defense of Third-Party Claims: the Moral Hazard Problem

The dispute resolution terms in merger agreements are technical and cause many non-lawyers to glaze over when reading them. Details about who controls the defense of third party claims, jurisdiction, arbitration procedures and other similar terms are not fun to read but can be very important if problems do arise later.

One particular issue worthy of special attention is which party controls the defense of third party claims. There are good arguments on each side for wanting this control. On the buyer's side, the third-party claim is usually a claim against the combined company, and the buyer will want to control its exposure to such proceedings. On the seller's side, if the claim relates to an indemnifiable matter, any payment of fees or settlement amounts is likely to come from the escrow, so the selling stockholders are most likely the ones ultimately paying the bill.

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**If the party that controls the defense is not the party responsible for any related payments, there can be a moral hazard problem.**

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If the party that controls the defense is not the party responsible for any related payments, there can be a moral hazard problem. It is certainly possible that the party with control of such matter will behave differently if it is not their own money at stake. For instance, if the buyer controls the litigation but the payments are to come from the escrow, the buyer might be tempted to hire more expensive counsel than they otherwise would and might be motivated to agree to settlement terms early to avoid spending more time on the matter. Similarly, if the shareholders control the defense of a claim that will be subject to the indemnification basket or that might otherwise not be paid from the escrow, they might behave differently.

Even if behavior is not driven by the moral hazard issues, the parties may simply disagree on how best to handle the third-party dispute. One side might be used to hiring premier law firms and paying a premium, while the other possibly has a history of looking for value in service providers. In such case, neither may like the way the other would manage the defense.

There are checks to this behavior in most merger agreements, such as requiring the other party's reasonable consent to any settlement, but the moral hazard risk remains to at least some extent. To address it, we suggest focusing on which party is likely to bear the economic risk in the event of various third party claims and ensure that they are involved, or at least have the opportunity to be involved, with the process. We suggest that this be done in greater detail than just having a right to approve of any final settlement terms. For instance, the sellers might want to include terms that say sellers have a right to consent to selection of counsel, or alternatively that the parties need to reasonably agree on the selection of counsel, the strategy and/or the budget. Sellers might argue that as long as the shareholders are responsible for the bill, the buyer arguably should be willing to give the sellers a say in such matters. There might need to be exceptions for matters such as equitable claims and sizeable third-party claims in excess of the escrow.

More typically, the buyer will agree to language clarifying the right of "the indemnifying parties, at their sole option and expense, to participate in, but not to determine or conduct, the defense of a third party claim." While not as favorable, this still gives sellers a seat at the table. A seller who is facing potential large third party claims may address the moral hazard problem by crafting a provision by which buyer has some responsibility for sharing the risk, by for example limiting or eliminating the indemnifying party's exposure for third party claims after a certain dollar threshold, to give the buyer a financial incentive to settle or

resolve claims cost-effectively. Buyers are often reluctant to allow sellers to assume the defense of third party claims with any potential impact on the ongoing business or liability above the escrow.

We note also that selling stockholders can potentially increase their exposure to a claim if they have the right to assume the defense but elect not to do so. Attorneys for the target company will want to weigh this risk against the risk of the moral hazard problem and talk to their clients about their appetite for taking over the defense of third party claims that may arise in the first instance. On the other hand, sellers may want to include a provision making clear that in the event the buyer does not elect to proceed with the defense of any such third party claim, the indemnifying parties may proceed with the defense of such claim. This preserves the seller's right to act in the event buyer simply fails to mount a defense.

The last thing either side to the merger wants is to resolve the third-party claim and then discover they now have to navigate a related dispute between the buyer and shareholder representative over the process of getting to that resolution. Addressing the moral hazard concerns early may help to avoid this.

## 5. Avoiding Improper Lock-up of Escrow Money

Most sophisticated buyers would prefer not to need to bring an indemnification claim after closing a merger transaction. It sometimes happens, however, that a buyer will bring a claim that the selling shareholders and their representative believe is either invalid or so tenuous as not to warrant tying up escrow funds indefinitely. This risk can be even greater if the merger agreement allows the acquirer to bring an indemnification claim for any damages that it “reasonably anticipates” it might suffer. In that case, the buyer may assert a claim based on a theory of hypothetical losses that it may someday suffer, even if such theory is far-fetched. Some buyers simply take the position that the risk, even if remote, is not their problem or theirs to assume. They may assert that the money must remain in escrow until the risk is eliminated completely.

Selling shareholders have a thorny problem in these cases. The escrow bank is not going to weigh in on this, since it will only release the money either on receipt of a court order or on joint instructions. The buyer does not care if the money stays in the account indefinitely. It either effectively gets a no-cost insurance policy against a hypothetical risk, or it can try to use this as a tactic to attempt to re-cut the deal that was agreed to at closing. Put simply, tying up as much money as possible for as long as possible is, all else being equal, a good thing for buyers (ignoring the impact on future relationships between the parties) and a very bad thing for sellers.

In these situations, the shareholders are left with two unattractive options: sue the buyer to compel release of the funds or wait for the statute of limitations related to the claim to run out. Waiting for the statute of limitations to expire is tough, but suing the buyer is not an appealing option, either. The buyer is usually a much larger company with greater resources. Fighting to compel the release of money can be expensive, which can eat up a good

portion of the funds the shareholders are hoping to recover. If there is no expense account set aside in the escrow for disputes, the shareholders may have to write checks to fund the litigation. What options do the former shareholders have when the escrow period ends and claims have been made that the former shareholders believe are either invalid or of little merit? No agreement can guarantee that a buyer will not lock up funds unnecessarily. The following suggestions, however, may help mitigate the risk:

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**Tying up as much money as possible for as long as possible is, all else being equal, a good thing for buyers and a very bad thing for sellers.**

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- **Define what constitutes a third party claim (and what does not).** A claim from a third party should be a live lawsuit or a written threat stating that the party has a specific grievance and will pursue legal remedies if it does not get adequate satisfaction of that grievance. Questions from third parties that are answered without any subsequent communications generally should not be considered claims.
- **Require the buyer to accrue for the potential loss on its balance sheet.** If the buyer truly has a reasonable anticipation of a measurable loss, it typically should be accruing for that loss on its balance sheet. Sellers may argue that if the buyer does not think that there is a reasonable anticipation of a concrete loss under GAAP, then arguably there should not be a reasonable anticipation for indemnification purposes either. Buyers may respond that potential claims do not meet the accounting standard for accrual but still are real threats for which indemnity is required.
- **Allow the shareholder representative to assume the defense of third party claims.** If the representative thinks a third party



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**What options do the former shareholders have when the escrow period ends and claims have been made which the former shareholders believe are either invalid or of little merit?**

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claim is frivolous, let the representative try to settle it quickly. The shareholders will sometimes prefer to pay out a little to settle even a frivolous claim rather than having the escrow funds tied up indefinitely.

- **Include a time period during which the buyer must have heard from the third party before the claim is deemed dormant.** If the third party grumbled about something a long time ago but has said nothing since, it may be time to conclude that the risk of the is-

sue becoming a claim is small enough that the parties should consider the issue dead. We note that this approach is tricky and it may be difficult to agree on a reasonable time period to establish repose, but it is a question of where to draw the line with risk allocation. At some point, it does not make sense to continue to tie up funds to protect against issues that have become remote risks with the passage of time.

- **Provide for arbitration or mediation with the loser paying the winner's fees.** To address the circumstance where the former shareholders feel strongly that there is no real claim, allow for a resolution of the question of whether the claim is still an indemnifiable risk by an arbitrator and require the loser to pay the winner's fees, so that the shareholders do not have to deplete a meaningful chunk of their escrow balance if they are right.
- **Establish an expense escrow.** An expense escrow is a separate fund that is created to pay for legal fees or other costs or expenses the former shareholders may incur in defending against claims or otherwise protecting their rights after the

merger closes. When such a fund exists, the buyer may be less likely to bring a weak or frivolous claim because it knows the former shareholders have the means to fight it.

- **Provide for conditional releases.** If certain conditions have been met (such as the passage of a specified amount of time), provide that the shareholders can compel that the escrow money related to that claim be released to them, so long as they agree to refund that money to the buyer in the unlikely event that the issue resurfaces and results in losses that would have been indemnifiable.

Buyers may not agree to many of these suggested alternatives, although they generally will not be able to object to the establishment of a separate expense escrow.

## 6. Enforceability of Representation and Warranty Survival Periods - *Western Filter v. Argan*

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### A stated escrow period may not be respected.

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The Ninth Circuit Court of Appeals released a quirky decision in the *Western Filter v. Argan*<sup>1</sup> case. Among other things, the court said that a stated survival period of representations and warranties may not be respected unless the agreement specifically makes clear that it is the parties' intent to shorten the otherwise applicable statute of limitations period by virtue of the stated survival period. In other words, in a merger agreement, if the parties agree that the representations and warranties are to survive for a specified number of months after closing, and that claims and notices for breaches must be brought within that period, there is some risk that a court would allow indemnification claims to be brought after the expiration of that period unless the parties specifically state that their intent is to shorten the statute of limitations.

We disagree with the court's analysis and this opinion, but it should still be addressed in merger agreements so long as the decision remains good law.

To address this, we suggest language such as the following:

*It is the express intent of the parties that, if the applicable survival period for an item as contemplated by this Section [\_\_\_] is shorter than the statute of limitations that would otherwise have been applicable to such item, then, by contract, the applicable statute of limitations with respect to such item shall be reduced to the shortened survival period contemplated hereby.*

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<sup>1</sup> See *Western Filter Corporation v. Argan, Inc.*, 540 F.3d 947 (9th Circuit, August 25, 2008).

*The parties further acknowledge that the time periods set forth in this Section [ ] for the assertion of claims under this Agreement are the result of arms'-length negotiation among the parties and that they intend for the time periods to be enforced as agreed by the parties.*

## 7. Establishing an Expense Fund

We believe that the selling shareholders should establish an expense fund in most merger transactions. An expense fund is a voluntary fund set aside out of merger consideration by the shareholders at closing for potential third-party expenses that might be incurred during the post-closing period. Such costs or expenses typically include legal or accounting fees that need to be incurred in protecting these shareholders' interests should any disputes arise relating to the merger transaction.

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**Many top litigators suggest that establishing an expense fund is one of the biggest deterrents to claims.**

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Perhaps the best reason for establishing an expense fund is that many top litigators suggest that its existence can be one of the biggest deterrents to claims. Most sophisticated strategic buyers would prefer not to bring a claim. They will do so if necessary, but they will generally approach deals with the hope that everything about

the target company was accurately represented to them, and they got the company they were expecting to get. Some buyers, however, may look at the escrow as an opportunity to get some money back to improve their returns on the deal. If such buyers know that the shareholder representative has the resources available to defend against a claim, they will more rigorously evaluate the merits of their claim and the probability of success.

If an expense fund does not exist, the shareholder representative may not have funds to effectively represent the selling shareholders. Shareholders can always pass the hat around, but the window for responding to disputes is usually limited. By the time funds become available, the response period may have elapsed. Buyers also can count on shareholders' reluctance to reach into their pockets to pay expenses after the initial payout.

Establishing an expense fund at closing generally works in the best interests of all the shareholders, but especially the larger ones. At closing, every shareholder contributes to the expense fund on a pro-rata basis. At the end of the post-closing period, the balance of the expense fund is distributed back to the shareholders. In contrast, if no expense fund is established and a dispute arises that the shareholders elect to fight, it is likely that a few of the large shareholders will end up funding more than their pro-rata portion of expenses. For venture capital funds, this may require them to use a portion of their management fees to fund dispute expenses or require a claw-back of merger consideration previously distributed to their limited partners. In either case, establishing an expense fund at closing mitigates this exposure.

Buyers may also want an expense fund to be available if there are terms in the merger agreement that obligate the parties to split the expenses of items such as audits or arbitration. Many agreements contain a mechanism stating that the parties will attempt to resolve any disputes for some defined period and, if they are unsuccessful, an independent accountant or arbitrator will be appointed. If the expenses of the accounting firm or arbitrator are to be split between the buyer and the former selling shareholders, or will be paid by the loser in the dispute, the buyer will want some comfort that the selling shareholder group will be able to meet its portion of any such obligations. An expense fund can provide an easy means of collection.

What is the appropriate amount for an expense fund? As with most things in a merger agreement, it depends. Except possibly for pretty small transactions, SRS recommends a minimum escrow expense fund of \$100,000. If, however, the escrow is larger or the earn-out potential is significant, it may be appropriate to reserve between \$250,000 and \$500,000. We've seen expense reserves established at closing as high as \$4 million. It really depends on the amount of potential upside and the complexity of the company or merger terms. To be a real deterrent to potential claims and a real

tool for the former shareholders, it needs to be meaningful compared to the size of the potential claims. According to the 2011 *SRS M&A Deal Terms Study*, the average size of an expense fund was 0.51% of the transaction value if the deal included earn-out provisions and 0.4% for deals without earn-outs.

Regardless of the amount, SRS considers expense funds a best practice. Having funds set aside to quickly mount defenses against claims more than offsets any cost of the holdback in most deals. As a general rule, while we understand the desire not to tie up funds unnecessarily, it is better to have more money than needed in an expense fund than to not have enough. Having too much just means that some merger proceeds were delayed in disbursement, but having too little means that the major shareholders have to navigate the issues they were seeking to avoid when setting up the fund in the first place.

Typical language might include the following:

*Buyer shall deduct the Escrow Expense Amount from the Total Consideration and deposit with the Escrow Agent such Escrow Expense Amount without any act of the Indemnifying Parties, such deposit of the Escrow Expense Amount to constitute a separate escrow fund to be governed by the terms set forth herein. The Escrow Expense Amount shall be available solely to (i) compensate the Shareholders' Representative in accordance with the terms hereof, and (ii) pay any third-party expenses incurred by the Shareholders' Representative in connection with the defense, investigation, or settlement of any claim from an Indemnified Party or any Third Party Claim under or related to this Agreement, as well as any costs and expenses associated with the Escrow Expense Amount. The Shareholders' Representative shall have full discretion over the Escrow Expense Amount, and the Escrow Agent shall follow any lawful directive of the Shareholders' Representative regarding the use or disbursement of all or a portion of*

*the Escrow Expense Amount to third parties and in amounts authorized in writing by the Shareholder's Representative.*

As a second choice alternative to forming an expense fund, consider adding a term stating that the selling shareholders' portion of third party expenses will be paid from the escrow, or make sure to figure out some other mechanism for payment. Otherwise, if it ends up being necessary to hire attorneys or other professionals, payment will almost always be problematic.

In rare circumstances SRS has seen expense funds established through a voluntary holdback of some of the buyer shares distributed in a non-cash acquisition. Depending on the marketability of the buyer's securities, this can be problematic when a dispute expense is incurred. Selling shares may delay deployment of dispute resources, create additional transaction expenses or, if the buyer's shares decline in value, may be insufficient to cover shareholder costs. If this occurs, selling shareholders, particularly the larger ones, may have to contribute to a new cash expense fund. Therefore, SRS recommends that shareholders establish expense funds using company cash, if available (with a corresponding reduction in consideration paid to stockholders), or allocating any cash proceeds to the expense fund prior to distribution to the shareholders. In rare cases, because expense funds also have benefits to the buyer, some buyers may be willing to distribute limited cash to fund the expense fund, even in those transactions primarily structured as a non-cash (stock) transaction.

Some selling shareholders establish the funding for defense of claims separately through a contribution agreement. If all the indemnifying stockholders are likely to have significant cash resources for the foreseeable future and are ongoing entities, a contribution agreement, which requires the signatories to contribute for a specified purpose if called upon by the stockholder representative, may avoid the need to tie up cash in an expense fund, while also providing the deterrent effect and resources in the



event of a later dispute. This type of arrangement carries risks, of course, as it is difficult to predict if a particular indemnitor will be able and willing to honor the contribution commitment at a later time. Indemnitors will also be reluctant to sign such an agreement unless there are caps on their funding obligations.

## 8. Where to Hold the Expense Fund

Once an expense fund has been created, the parties have to determine where to hold it. In our experience, the most common options are to either hold it with an escrow bank or in an account controlled by the shareholder representative. There are pros and cons to each. If it is held with an escrow bank, you will typically need

a separate agreement to document the arrangement, which adds slightly to the deal's complexity. Additionally, banks will often charge fees to establish and maintain such an account, but may provide the parties the opportunity to earn some interest.

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**If the expense fund account is held by the shareholder representative, the arrangement is typically simpler.**

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If the account is held by the shareholder representative, the arrangement is typically simpler. If this is done, however, ensure that the account is properly established. The money should be set up in client funds accounts that are not co-mingled with the representative's own assets. In addition, the account should be titled as a fiduciary account. At SRS, our accounts are titled as "Shareholder Representative Service FBO Clients". If done properly, the shareholders should also be protected against any risks of bankruptcy or insolvency of the representative and increased FDIC insurance coverage may be available.

For expense funds held by an escrow bank, the stockholders will want to ensure that a few terms are included in the applicable escrow agreement. First the money should be released solely on the instructions of the representative without requiring any consent or input from the buyer. The expense fund is a set aside of stockholder money, and the buyer should not have anything to do with when or how it is spent. Second, the stockholders will want to make clear that the buyer does not receive any reports or updates

regarding the balance in the expense fund. If the parties are in a dispute, neither side will want the other to know what resources it has available to pursue the matter.

When establishing the expense fund, shareholders should consider its tax treatment. In many cases, the shareholders would prefer the expense fund to be considered as part of an installment sale and only taxable upon ultimate receipt. The simplest way for this to occur is for the shareholder representative to forward any remaining expense funds to the buyer's paying agent at the end of the transaction.

Taking advantage of installment tax treatment for expense funds might not be desirable or available in all deals. For instance, the buyer might not want to be involved with any of the necessary release logistics. This often occurs when there is a buyer hold-back rather than an escrow or where indemnification is limited to milestone payments. If installment sale treatment is not utilized, the expense fund will be deemed distributed by the buyer to the shareholders at closing. Selling shareholders should be aware that, in this situation, the buyer (or its paying agent) may issue a Form 1099-B that includes the expense fund amount despite the shareholders not receiving those funds. Because expense funds will continue to be at risk until released, selling shareholders should consult their tax advisors as to the appropriate tax treatment of such amounts.

When establishing an expense fund with an escrow bank, the shareholder representative is typically required to provide their own taxpayer ID. While any investment earnings belong to the shareholder beneficiaries and not the shareholder representative, the escrow bank will report such earnings to tax authorities under the taxpayer ID of the shareholder representative. In order to avoid paying taxes on income that does not belong to them or having unreported income generating a tax audit, the shareholder

representative should treat such earnings on a “nominee” basis. Some escrow banks may honor such treatment and issue 1099s to each of the beneficiary shareholders rather than to the shareholder representative. Typically this status can be selected by properly filling out a W-9 tax form when the account is established. If the shareholder representative does receive a 1099 reporting such income under their taxpayer ID, they should report such income on their tax return as nominee earnings and show a deduction for that portion that does not belong to them. In addition, they should issue 1099s to each shareholder beneficiary to whom such earnings properly belong.

## 9. Disbursement of Funds – Who Touches the Money?

We occasionally see merger agreements in which the acquirer or escrow bank is to pay some portion of merger consideration or the balance of the escrow fund to the shareholder representative, with the representative then being responsible for disbursing the money to the former shareholders. In most cases where material dollar amounts are involved, this is not the best practice.

First, it may be difficult to impossible for the representative to make any payments that are deemed compensation and are subject to withholding taxes. The representative is not the employer and does not have the authority to act in such capacity for withholding purposes without some complicated arrangements, such as grants of powers of attorney. Second, the representative is not a regulated bank in the business of handling distributions like this. While it is highly unlikely, if the money were to disappear after hitting the representative's account, no attorney would want to explain why the deal structure allowed that to happen. Third, if the representative is insolvent when the money hits their account, it could get tied up in a bankruptcy or similar proceeding unnecessarily. In either case, the shareholders are not going to be happy that the agreement allowed the money to sit for even a second in some third party's bank account. To avoid this, the money should go either directly from the acquirer to the shareholders, or from the acquirer to a bank, acting as a paying agent, and then on to the shareholders.

When funds do flow through the representative, such as is the case when the representative is holding expense funds, ensure that the representative knows how to properly hold them to ensure the assets are safely held and invested to minimize potential exposure to claims from creditors. Additionally, payment processing is a complex business. Make sure your representative knows how to efficiently process wires, checks and ACH transactions for the best interest of the recipients or instruct them to hire a third-party paying agent who does.

## 10. The Reason for the Stockholder Representative's Authority

According to Delaware counsel we have spoken with, most merger agreements improperly draft the language appointing the stockholder representative. The typical merger agreement will essentially provide that the representative is appointed the agent and attorney in fact of the stockholders to take a list of actions on their behalf

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**Most merger agreements improperly draft the language appointing the stockholder representative.**

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under the merger agreement. A recent Delaware case, *Aveta Inc. v. Cavallieri*,<sup>1</sup> however, stated that agency is not necessarily the reason the actions of a representative would be enforced against stockholders who are not a party to the merger agreement.

According to the *Aveta* opinion, agency principles do apply against stockholders who are a party to the merger agreement. With respect to other stockholders, however, the court applied the applicable corporate statutory law rather than agency principles. While agency principles might not apply because those stockholders did not sign the agreement appointing the stockholder representative their agent, the court said that under Delaware statutory law, the terms of a merger agreement may be made dependent upon facts ascertainable outside of the agreement. For instance, a purchase price or interest rate used in a merger agreement can be determined by a market price or rate determined outside the merger agreement, so long as such provisions have been adopted in conformance with applicable fiduciary obligations. Similarly, the agreement may provide that certain determinations or actions of a representative are facts ascertainable outside the agreement, and the contract can bind the stockholders to such facts.

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<sup>1</sup> See *Aveta Inc. v. Cavallieri*, 23 A.3d 157 (Del. Ch. 2010).

To address this issue, practitioners might want to change the language of merger agreements appointing the representative. We would suggest considering a provision such as the following:

*The Representative is hereby appointed the agent and attorney in fact of the stockholders to take the actions set forth herein. All such actions shall be deemed to be facts ascertainable outside the merger agreement and shall be binding on the stockholders.*

We suggest keeping the language regarding agency because it might still have some effect but adding the underlined section to ensure the agreement falls within the reasoning of *Aveta*. Of course, other changes to the merger agreement might be advisable to ensure that it conforms with the concept of “facts ascertainable” as contemplated by the Delaware statute.

Ensuring that the concept of “facts ascertainable” is clear in the merger agreement is especially important where there are option holders who will have the options cashed out in connection with the merger with a portion of the proceeds being subject to an escrow or future earn-outs. They generally do not sign a letter of transmittal, so an agency analysis is even tougher with respect to their deemed appointment of the representative.<sup>2</sup> In such circumstances, the statutorily recognized principle of “facts ascertainable” may be critical to ensuring their portion of the escrow or earn-out is subject to the merger agreement terms.

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<sup>2</sup> Even signing a letter of transmittal may not be enough to create an agency relationship given the fact that the corporation is obligated to pay the merger consideration by statute. See *Roam-Tel Partners v AT&T Mobility Wireless*, 2010 WL 5276991, at \*6 (Del. Ch. Dec. 17, 2010).

## 11. The Scope of Power of the Shareholder Representative

Some shareholders, especially large corporate shareholders, express concern over the ability of the shareholder representative to change the terms of the merger agreement after closing.<sup>1</sup> Because they are large organizations, they want to understand and control the terms of any agreements under which they have obligations or liabilities. This is certainly understandable. As extreme examples, some shareholders have wondered whether the broad powers typically granted to a representative would give it the ability to enter into a settlement agreement that would restrict the ability of the selling shareholders to take some action, such as executing a non-competition agreement. While that would be tough to enforce, the question about where the line should be drawn on the limits of the representative's authority is a good one.

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**The question about where the line should be drawn on the limits of the representative's authority is a good one.**

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This potential desire of these shareholders to define and curtail the powers of the representative is in conflict with the typical desire of the buyer for these powers to be as broad as possible. The buyer wants to know that any action that may need to be taken after closing can be taken by the buyer and the representative acting alone. Buyers do not want additional approvals to be needed for some actions, but not for others.

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<sup>1</sup> We note that it would be very difficult to enforce a settlement between the representative and the buyer that would require a payment from shareholders in excess of the escrow or that would require the shareholders to take, or refrain from taking some action. As a result, most buyers will insist that the shareholders directly agree to such settlements. Nevertheless, some corporate stockholders will not be sufficiently comfortable with this and will request language included in this article.



As a legal matter, we question whether any amendment that fundamentally changes the terms of the deal that were approved by the Board and shareholders would be enforceable. We understand, however, that it is difficult to define what would constitute such a fundamental change.

This is a hard problem to navigate. If it becomes an issue on one of your transactions, we suggest adding language such as the following:

*The Securityholders hereby constitute and appoint the Representative as attorney-in-fact for the Securityholders with [broad powers to take any actions necessary under the merger agreement following closing]; provided, however, that the Representative shall not have the power or authority to execute an amendment, waiver, document or other instrument that, notwithstanding any other provision to the contrary, increases in any material respect the obligations or liabilities, or decreases the benefits, of any Securityholder without the prior written consent of that Securityholder.*

This leaves some ambiguity regarding materiality. However, it seems to be a possible compromise between the desires of some shareholders to know that the deal cannot be materially changed without consent, and the buyer's desire that the representative have the power to take most actions that may arise after closing.

## 12. The Representative's Access to Information After Closing

We see several deals in which the parties do not address what information the shareholder representative will be entitled to receive after closing in the event there is a claim, dispute or similar issue. This can raise significant issues with no clear answer. For example, if the buyer submits an indemnification claim, a logical reaction from the representative might be to say that it has a few questions and would like to see certain related materials such as work papers, technical documents or correspondence. The representative might also reasonably request to speak with the employees of the buyers who worked on the matter to ask some questions.

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**Even if the parties agree that access to some information is reasonable, they can differ on how much is appropriate.**

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Buyers may resist providing all or certain of those materials for a variety of reasons. Often, the issues are sensitive from a confidentiality perspective, and the buyer may want to limit access to the related materials as much as possible. Of course, the buyer might want to deny access for purely strategic reasons related to the dispute, figuring that it is to their advantage for the representative to know as little as possible. Finally, the buyer might not want to incur the time or expense of providing access to the applicable personnel or copies of the documents. Even if the parties agree that access to some information is reasonable, they can differ on how much is appropriate.

To help with this problem, the parties should set forth the rules related to the access of information in the merger agreement. Our suggested language to address this is:

*Following the delivery of [the Closing Statement]/[each Earn-out Report]/[a Notice of Claim], the [Shareholder Representa-*

*tive] and its representatives and agents shall be given all such access (including electronic access, to the extent available) as they may reasonably require to the books and records of the [Surviving Corporation] and reasonable access to such personnel or representatives of the [Surviving Corporation] and [Buyer], including but not limited to the individuals responsible for [preparing the [Closing Statement]/Earn-out Report]]/[the matters that are subject of the [Notice of Claim]], as they may reasonably require for the purposes of resolving any disputes or responding to any matters or inquiries raised in the [Closing Statement]/[Earn-out Report]/[Notice of Claim].*

A related issue is whether the representative should be given a copy of the documents placed in the data room that was prepared in connection with the deal's due diligence process at the time of closing. The target company may want to provide the shareholder representative with an electronic archive of the data room prior to closing so that it is not reliant on what the buyer may choose to later disclose. Buyers may, however, resist allowing the target to provide the electronic archive to the representative, claiming it has confidential information that it will own after closing, there is no outstanding claim at the time, and providing access to all information is potentially overkill. One solution may be to require the data room archive to be placed in escrow and released to the representative at such time the buyer makes a claim.

### 13. Information Sharing between the Shareholder Representative and Shareholders

A standard provision in merger agreements says that the parties to the agreement shall not communicate any of the terms therein or any matters related thereto to any third party, subject to some standard exceptions. While this sounds reasonable enough, it fails to take into account that a shareholder representative will often need to communicate certain information to the former shareholders, who are not parties to the merger agreement. For instance, if a claim arises, the representative will often need or want to tell all or certain of the former shareholders about the claim and get their feedback on how they think the representative should proceed. Additionally, the representative will often need to communicate something to the former shareholders related to the claim once it is resolved if there was a related payout to let them know why their escrow interest has been reduced.

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**The representative should either be able to communicate with the shareholders or should be able to communicate with at least a subset of shareholders who are also bound by confidentiality obligations.**

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On the other hand, since many claims relate to sensitive subjects, the buyer will likely want protection that information will not be broadly distributed, especially when there are hundreds of former shareholders.

To resolve this, we suggest the representative should either be able to communicate with the shareholders or should be able to communicate with at least a subset of shareholders who are also bound by confidentiality obligations. Language such as this can be added to the end of the confidentiality section of merger agreements:

*The Shareholder Representative may disclose information as required by law or to employees, advisors or consultants of the Shareholder Representative and the Shareholders, in each case who have a need to know such information, provided that such persons either (A) agree to observe the terms of this Section \_\_\_\_ or (B) are bound by obligations of confidentiality to the Shareholder Representative of at least as high a standard as those imposed on the Shareholder Representative under this Section \_\_\_\_.*

With respect to communications among shareholders or between shareholders and the shareholder representative, the parties should ensure that such communications remain privileged, especially when the buyer has made an indemnification claim or the shareholders believe that buyer has breached one of its obligations under the merger agreement. When the shareholders elect to have conferences and/or phone calls to discuss matters either in arbitration or litigation or likely to result in a dispute, they are advised to have the shareholder representative and counsel for the indemnifying stockholders included in all such calls and conferences. Including counsel should maintain privilege as to discussions for which privilege is available. Including the shareholder representative works to protect the shareholders from unnecessary fiduciary risk.

## 14. Representations and Warranties from the Shareholder Representative

Occasionally we will see merger agreements in which one of the parties asks the shareholder representative to make certain representations and warranties. These typically include provisions such as representing that the representative is authorized to enter into the transaction, that doing so will not create any conflicts with laws or third-party contracts, and that the transaction is enforceable in accordance with its terms.

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**Having the representative give representations and warranties is unusual and not best practice.**

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Having the representative give such representations and warranties is unusual, and in our view, not best practice. First, the shareholder representative is an agent to help the principals to a transaction consummate the deal. It does not seem proper that they would have to subject themselves to a risk of a claim in connection with providing that service. Second, there is not a powerful reason for needing these. The shareholder representative is not integral to the transaction, and its signature agreeing to be bound by the terms of the merger agreement should be sufficient to protect the interests of the parties. We note that we rarely see transactions in which similar representations are requested from the escrow bank or paying agent.

Finally, and perhaps most importantly, it is not clear that the shareholder representative can give each of these representations. While they seem simple enough, there is some inherent ambiguity regarding the enforceability of the terms of the merger agreement against any shareholder representative. The representative is acting as the agent of a group of principals who do not sign the agreement. While recent case law all indicates that the

appointment of the representative most likely is enforceable against all of the shareholders,<sup>1</sup> there remains some degree of uncertainty that makes this difficult for the representative to effectively ensure that the agreement is wholly enforceable. For instance, we note that Delaware courts have determined that certain actions taken by a representative are enforceable based on agency principles against shareholders who are a party to the agreement while other actions might be enforceable based on contract law principles of facts “ascertainable” outside of such agreement. The analysis is complicated and might depend on the specific facts of a transactions. As a result, it is not appropriate to ask the representative to ensure enforceability.

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<sup>1</sup> See *Aveta Inc. v. Cavallieri*, 23 A.3d 157 (Del. Ch. 2010); *Coughlan v. NXP B.V.*, C.A. No 5110-CC (Del. Ch. 2010).

## 15. Resignation or Removal of the Shareholder Representative

Merger agreements should make clear that the shareholder representative can resign or be removed by the selling shareholders at any time. The representative is the agent of a shareholder group, and that group should be able to designate a substitute whenever they wish. While this may seem obvious, we have seen situations in which a buyer will argue that a representative is not allowed to resign because the buyer relied upon that person serving as the representative in agreeing to enter into the transaction. There is an easy fix to avoid having this problem.

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**Merger agreements should make clear that the shareholder representative can resign or be removed by the selling shareholders at any time.**

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Specifically, avoid language such as this:

*If any Shareholder Representative dies or becomes legally incapacitated, or is otherwise similarly unable to carry out his duties hereunder, then the other Company Shareholders shall designate a single individual to replace any deceased or legally incapacitated or otherwise similarly unable Shareholder Representative as a successor Shareholder Representative hereunder.*

This sort of language could inadvertently imply that a representative is entitled to resign or be replaced only if he or she dies or becomes incapacitated. Instead, consider language such as the following:

*If any Shareholder Representative dies or becomes legally incapacitated, or is otherwise similarly unable to carry out his duties hereunder, or resigns or is otherwise removed by the*



*Company Shareholders, then the other Company Shareholders shall designate a replacement Shareholder Representative as a successor Shareholder Representative hereunder.*

In addition, it may be advisable to add a sentence that the representative can resign any time, and to provide for a replacement representative if the shareholders do not otherwise designate a replacement. For instance, language such as the following may be advisable:

*If a Shareholder Representative resigns or is otherwise removed for any reason, the Company Shareholders shall designate a replacement Shareholder Representative within [ ] days. If no such replacement Shareholder Representative is so designated, the Company Shareholder with the then-largest percentage interest in the Escrow Fund, or in any outstanding claim if the Escrow Fund has been fully depleted, shall be deemed to be the Shareholder Representative, and shall have all rights and obligations of a Shareholder Representative hereunder.*

## 16. Waiving Conflict of Seller's Counsel

In most mergers, the buyer and seller are each represented by legal counsel. It would be logical for the shareholders of the selling company to assume the law firm that “sat on their side of the table” in the negotiation phase of the transaction would continue to be available to represent their interests after closing. After all, the selling shareholders were the owners of the selling company, and thus were the ones whose economic interests the selling company’s lawyers were seeking to protect in negotiating the deal.

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**Some buyers maintain that the law firm that did the deal on behalf of the target company cannot represent the selling shareholders or their shareholder representative post-closing.**

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Unfortunately, whether that law firm can continue to represent the selling shareholders or the shareholder representative post-closing is not always clear. The law firm’s client is usually the selling company, not its shareholders. At closing, the company that was acquired is now a part of the buyer. Therefore, the legal privilege and attorney-client relationship arguably flow to the buyer with respect to certain matters.<sup>1</sup> This means that the selling company’s counsel may be conflicted out of taking a position that is contrary to the interests of the combined company, since this combined company includes its current or former client.

Many stockholders do not see that coming. While there is limited applicable case law on this issue, and some ambiguity about its

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<sup>1</sup> See *Tekni-Plex, Inc. v. Meyner & Landis*, 89 N.Y.2d 123 (1996). This analysis is especially tricky in the context of an asset sale. See, for example, *Postorivo v. AG Paintball Holdings, Inc.*, 2008 WL 343856 (Del. Ch. Feb 7, 2008); *Coffin v. Bowater, Inc.*, 2005 WL 5885367 (D. Maine May 13, 2005) and *Soverain Software LLC v. Gap, Inc.*, 340 F. Supp2d 760 (E.D. Tex. 2004).

proper analysis, some buyers take the position that the conflict exists and that the firm that did the deal on behalf of the target company cannot represent the selling shareholders or their shareholder representative post-closing. In our experience, most law firms will back away if the buyer makes this assertion rather than fighting the issue in court or taking any actions that could risk claims of ethical violations.

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**The general assumption that you can have candid communications with your lawyer and the opposing side will never hear anything about it may be on shaky ground.**

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Additionally, if the buyer becomes the “client” after closing, it may suddenly own rights to some or all of the pre-closing communications with the target’s law firm. That is not something the average shareholder or manager thinks about when speaking with the attorney. The general assumption is that you can have candid communications with your lawyer and the opposing side will never hear anything about it. In the merger context, that assumption may be on shaky ground.

The limited case law on this contains a somewhat convoluted analysis that tries to make a distinction between whether pre-closing communications relate to the merger transaction itself or to the general operations of the business, with buyers owning general communications but not communications that are specific to the deal. The problem is that those issues are heavily intertwined, which makes it pretty hard to accurately predict whether a court would put certain communications in the “general ops” bucket or the “deal” bucket. Also remember that the buyer generally takes all the target’s assets in the merger, including the files and servers on which company emails likely exist. Therefore, even if the buyer cannot get what it is looking for from the target’s law firm, the correspondence may be readily available to it anyway.

To address the conflicts issue, we suggest that the selling company consider adding language to the merger agreement that specifically says that the selling company and the buyer waive this possible conflict of interest, and agree that the seller's law firm can represent the selling shareholders and their representative after closing with respect to issues related to the merger agreement.

Possible language for this could be the following:

*Each of the parties hereto acknowledges and agrees, on its own behalf and on behalf of its directors, members, partners, officers, employees, and Affiliates that the Company is the client of [Law Firm] ("Firm"), and not any of its individual Equityholders. After the Closing, it is possible that Firm will represent the Equityholders, the Shareholder Representative and their respective Affiliates (individually and collectively, the "Seller Group") in connection with the transactions contemplated herein or in the Escrow Agreement, the Escrow Fund and any claims made thereunder pursuant to this Agreement or the Escrow Agreement. Parent and the Company hereby agree that Firm (or any successor) may represent the Seller Group in the future in connection with issues that may arise under this Agreement or the Escrow Agreement, the administration of the Escrow Fund and any claims that may be made thereunder pursuant to this Agreement or the Escrow Agreement. Firm (or any successor) may serve as counsel to all or a portion of the Seller Group or any director, member, partner, officer, employee, representative, or Affiliate of the Seller Group, in connection with any litigation, claim or obligation arising out of or relating to this Agreement, the Escrow Agreement, or the transactions contemplated by this Agreement or the Escrow Agreement. Each of the parties hereto consents thereto, and waives any conflict of interest arising therefrom, and each such party shall cause any Affiliate thereof to consent to waive any conflict of interest arising from such represen-*

*tation. Each of the parties hereto acknowledges that such consent and waiver is voluntary, that it has been carefully considered, and that the parties have consulted with counsel or have been advised they should do so in this connection.*

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**There are clear problems inherent in concluding that the sell-side law firm effectively switches loyalties at closing.**

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We note that while the selling stockholders would like to have the flexibility to retain the law firm that represented the target company on the transaction should they choose to do so, there might be times when they would elect to use someone else. This can occur either when another law firm has greater expertise related to the issue at hand or when the dispute

involves the interpretation of certain provisions of the merger contract. Some clients will consider whether they believe they will get more objective advice from a different law firm rather than the firm that agreed to the merger agreement terms. For instance, if a mistake was made in drafting or a provision could have been done better, will the firm that negotiated the agreement be able to give the client the same level of candid advice that an independent firm could provide? This concern applies to the buyer as well.

In addition to the concerns regarding privilege, the selling company may want to discuss communications policies related to what should be in writing, including attorney's notes. Seller's counsel may want to add headers to written communications with the client that say "Attorney Client Privileged for the Purposes of Potential Merger Agreement" to try to make clear that these are not communications related to general operations. Regardless, the selling company's agents and its attorneys will want to be careful about written communications generally.

Finally, out of an abundance of caution, we suggest that counsel should discuss these issues with their client early in the process

of a working through a merger transaction and establish a communications policy regarding how they will communicate with each other. Given the uncertainty and risks around these matters, it seems prudent that the client would be made aware of the issues and that the parties would agree on whether, for instance, certain communications should be in writing.

For a related discussion on hiring investor counsel, see “Selling Your Company May Require Multiple Law Firms.”

## 17. Satisfying Basket Thresholds

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**The threshold should be met only after the buyer has suffered actual damages in excess of the basket amount.**

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Most merger agreements have a concept of a “basket” in the indemnification section. The idea is that the buyer should not be permitted to bring indemnification claims, with some exceptions, until the damages rise to some level of materiality in the context of the overall deal.

In our view, this threshold should be met only after the buyer has suffered actual damages in excess of the basket amount, rather than once the buyer has merely asserted damages in excess of the threshold amount. Otherwise, the buyer could circumvent the purpose of the basket and seek recovery for all claims by simply submitting tenuous claims that have only a remote possibility of actual damages.

The type of language we believe is flawed in connection with this issue might be similar to this:

*Buyer shall not be entitled to indemnification unless and until the aggregate amount of claims submitted by Buyer exceeds \$X.*

or more vaguely:

*Buyer shall not be entitled to indemnification unless and until the aggregate amount of losses for which it seeks to be indemnified exceeds \$X.*

To avoid this uncertainty and potential ability to circumvent the intent of the basket, we suggest language that is more like this:

*Buyer shall not be entitled to indemnification hereunder unless and until the aggregate amount of actual losses for which it is entitled to indemnification hereunder exceeds \$X.*

## 18. Preparing and Filing Tax Returns

Virtually all merger agreements include a tax matters section in which obligations related to the post-closing preparation, review and filing of pre-closing and straddle period tax returns are clearly specified. These sections of the merger agreement may also clarify which party is responsible for any taxes required to be paid post-closing as a result of pre-closing activity, and which party may get the benefits of certain tax issues such as NOL carryback refunds, collection of pre-closing tax year refunds, or overpayment of estimated taxes.

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**Though it may seem simple, it is impractical for the shareholder representative to prepare the tax return.**

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It is often appropriate for the shareholder representative to have a role in reviewing and approving any tax return related to pre-closing activity, especially if the return would result in either a payment by the shareholders for taxes due or receipt of a tax refund due the shareholders. Merger agreements, however, sometimes suggest that the shareholder representative will be responsible for the post-closing preparation and filing of pre-closing tax returns. Buyers may request this for their own convenience, since any taxes owed on the return are likely indemnified against by the selling shareholders.

Though it may seem simple, it is usually impractical for the shareholder representative to prepare the tax return. First, this is the company's tax return and, unless the transaction was structured as an asset sale, the filing entity has been merged into the buyer. Therefore, it is the surviving entity's legal obligation to file any tax return post-closing. Second, the shareholder representative cannot sign it. Tax returns of a corporation must be signed by an officer or director of the corporation. Neither the shareholder representative nor the former shareholders are the taxpayer or an agent of the taxpayer.



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**Sellers should try to provide their representative with the last three years of tax reporting as well as audited annual and non-audited interim financial statements.**

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As a practical matter, even if the representative could somehow prepare and file the return, the books and records necessary to prepare it now belong to the buyer. More important, the confidential relationship with the company's prior tax preparers is also now owned by the buyer. Finally, most tax preparers (especially the major accounting firms) require a relationship with the taxpayer, which, at this point, is the surviving entity.

Who pays for tax preparation, and who is responsible for paying pre-closing taxes or has ownership of any tax benefits, can be subjects of negotiation. If shareholders have tax obligations or rights, all applicable tax returns required to be filed post-closing should be approved by the shareholder representative and subject to the dispute resolution mechanism specified in the merger agreement.

To facilitate the shareholder representative's review of the pre-closing tax returns, the parties should define the information rights of the representative post-closing, including what constitutes reasonable access to the books and records of the surviving corporation and reasonable consultation rights with the finance/tax staff of the buyer and the company's outside tax preparer. The sellers should also provide their representative with the last three years of tax reporting as well as audited annual and non-audited interim financial statements. These statements can contain important information regarding the target companies past accounting practices and prior determinations made by management. Sellers should consider requesting that the pre-closing tax return be prepared by the same firm that prepared the last tax return filed by the taxpayer prior to closing and that any subsequent returns be prepared in a manner consistent with that return. Finally, because closing date tax returns

may include transactions that only occur as a result of the merger, the parties should define which taxable income, expenses or net operating losses are to be included or excluded from calculations for purposes of any purchase price adjustments or possible indemnification claims.

We note that in circumstances where the target company was a partnership or an LLC taxed as a partnership, the selling parties properly want control of the preparation of the tax return because taxes are required to be reported and paid on each partner or member's individual tax returns. In these cases, the parties should negotiate a broad cooperation agreement with respect to the preparation and filing of the target's tax return and ensure that any engagement agreement between the target and its tax preparer include the shareholder representative as a party or third party beneficiary entitled to give direction.

## 19. In What Capacity Should the Shareholder Representative Sign the Merger Agreement?

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**Signing in an individual capacity opens the signer to the potential of being sued personally.**

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We have seen many contracts in which the shareholder representative signs the merger agreement in his or her individual capacity. This is surprising, because these are people who have been well trained not to sign other agreements as individuals, but instead in their capacity as an officer or agent

of some entity. They seem to forget this basic prudence when they sign on to serve as a shareholder representative. Signing in an individual capacity opens the signer to the potential of being sued personally. Even though the representative typically is granted broad indemnification in the merger agreements, getting sued personally can cause significant short-term disruptions. As an example, a good friend of ours was sued as a representative at a time he was applying for a mortgage, and the bank had no choice but to freeze his loan application until the suit was cleared up.

A particularly ironic reason we've heard for having an individual as the representative instead of the participating venture fund (which is typically the shareholder in the acquired company) is that the fund cannot subject itself to that kind of risk. It seems very strange that the fund and the fund managers are comfortable subjecting their principals to whatever the risk turns out to be.

If an individual has to be the shareholder representative to get a deal closed, our view is that the agreement should make clear in the introductory paragraph and the signature block that such person is signing *“solely in his/her capacity as the [Shareholder Representative] as agent for and on behalf of the Shareholders.”* The representative may still get sued, but hopefully it would be in his or her capacity as an agent for the principals in the deal (meaning

that it is really the principals who are being sued) and not as an individual. While this language may not be bulletproof, it should mitigate the personal risk.

“Over the past couple of years, a number of selling shareholders have begun focusing on how escrows and earn-outs should impact the distribution of deal consideration. In years past where multiples were so much higher and a return of invested capital was taken for granted, very little attention was given to this issue.”

**Alexander Temel**

**Partner, Latham & Watkins LLP**

**Venture Capital Review, Issue 25 (Spring 2010)**

**Notes**

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# Escrow Agreement Issues

## Introduction

Most sales of private companies include some form of holdback of a portion of the merger consideration. These funds are available if the buyer believes that it is entitled to be reimbursed for certain damages it may suffer in connection with the acquisition, generally as a result of any inaccurate representations or warranties of the seller about its business. These holdbacks are typically held in a third party escrow fund with an independent bank.

Some of the issues we typically see in escrow agreements are discussed in this section.

## 1. Where's my Payment? Issues when the Paying Agent is Different from the Escrow Bank

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**Issues can arise when the parties decide to use an escrow agent that is different from the paying agent.**

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Generally, the buyer is the payor of merger consideration and also the withholding agent if any tax withholding is required. The buyer is also responsible for any related tax reporting. In many deals, buyers hire paying agents to facilitate this process. Paying agents will act as an exchange agent, verifying ownership, collecting

shareholder payment instructions, and receiving W-9 and W-8 tax forms to determine if any tax withholding is required on the part of the buyer.

Issues can arise when the parties decide to use an escrow agent that is different from the paying agent or establish accounts with different divisions of the same bank. The escrow banking relationship is a separate legal relationship from the paying agent relationship even when the same bank is performing both roles. The paying agent agreement is typically only between the buyer and the bank. The escrow relationship is a three-way relationship between the buyer, the shareholder representative and the bank. Unless otherwise instructed, banks do not share information between accounts, particularly when the account holders are not identical. Because of this, escrow agents often need to re-collect payment instructions from each shareholder and also independently collect and review W-9 and W-8 tax forms. Further, because the escrow agent did not serve as the exchange agent, it is likely unaware of whether all shareholders have submitted their share certificates, executed the letters of transmittal and fully completed the exchange process. Having to re-verify and re-collect this information can delay payments at the end of escrow periods. There are some simple fixes, however, that the parties can do at closing to avoid this.

Best practice is for the paying agent to be engaged by the buyer for all payments, both at closing and afterwards, including the distribution of excess working capital, tax refunds, earn-out consideration, escrow release payments and excess expense fund distributions. The paying agent will then know which shareholders have fully completed the exchange process and, if payments were successfully made at closing, it will have all the information to release deferred and contingent funds in the most timely way. With this structure, when any funds need to be distributed to shareholders, they are delivered to the paying agent. This applies even in those circumstances where the parties elect to use a separate escrow agreement. In those cases, the escrow agent is simply instructed to deliver released funds to the paying agent for further distribution to the buyer, selling shareholders or any applicable third parties.

Sometimes the parties elect to have an escrow agent act as a separate paying agent solely with respect to escrow release payments. While less efficient than having a single paying agent, the parties should ensure that all information provided to the paying agent at closing can be shared with the shareholder representative and escrow bank. This should be documented in the paying agent agreement with the buyer providing explicit instruction that information under that agreement, including copies of payment instructions, status of exchanges, lists of unrepresented shareholders and completed tax forms shall be shared.



## 2. Accounting for Unclaimed Transaction Proceeds

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**Eventually unclaimed merger consideration will be deemed abandoned and escheat to the state after a period of time provided by statute.**

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Unclaimed merger consideration is generally a liability of the buyer to non-redeeming selling shareholders. This is why merger agreements usually provide that unclaimed closing consideration will be held by or returned to the buyer after a specified period of time, typically one year following the closing date. Eventually, however, this unclaimed property will be deemed abandoned and escheat to the state

after a period of time provided by statute. Under these laws, the buyer is generally considered the holder of these funds, even when the funds are held by a paying agent or escrow agent. Thus, the buyer is ultimately responsible for determining which state's laws apply, reporting any abandoned property to the applicable state treasurer and transferring that property. Failure to comply with these rules can result in penalties or fines.

Although this concept is often addressed with respect to closing consideration, surprisingly, it is rarely addressed with respect to post-closing escrow payments or otherwise mentioned in escrow agreements. Future escrow payments that remain undistributed due to non-redeeming selling shareholders should presumably be handled in the same manner. When escrow agreements are silent on this issue, it can leave the parties to that agreement uncertain as to how long an escrow account should remain open or how the remaining escrow funds should eventually be distributed.

This presents one of several reasons why a shareholder representative should resist the notion of accepting released escrow funds for further distribution to shareholders. Accepting such funds could deem the representative the holder of any unclaimed property and

subject it to the reporting, recordkeeping and property transfer requirements of multiple and varying state escheat laws.

Sometimes SRS is asked, “but why can’t you just re-allocate the unclaimed consideration to the other shareholders pro rata?”

Intuitively, this has some appeal. The selling shareholders might argue that the buyer should have to pay the full purchase price for the business, and that amount should be split among whichever shareholders can be located. Unfortunately, that is not the way the law works. Merger consideration payable to a shareholder is generally considered property of that shareholder under abandoned property laws, and these laws provide no authority that we are aware of for re-allocation. Rather, they preserve the right of the lost shareholder to claim those funds from either the buyer or the state. Therefore, the buyer is effectively paying the full purchase price with some shareholders simply failing to claim their portion.

### 3. How and When to Use Rep and Warranty Insurance

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**The parties on many deals decline to purchase rep and warranty insurance because they perceive the cost to be too great for the risk that is being mitigated.**

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Representation and warranty insurance (RWI) has been in the marketplace for some time but is not used in many merger transactions. At a high level, the product provides insurance against certain indemnifiable losses that may be incurred if there has been a breach of a representation or warranty. The insurer takes a fee in exchange for assuming the risk of such loss. Often, the insurance will only provide excess coverage in the event losses are greater than the escrow

amount or will only insure against certain types of claims (such as environmental or intellectual property matters).

In our experience, the parties on many deals decline to purchase this product because they perceive the cost to be too great for the risk that is being mitigated.<sup>1</sup> Since it is rare for escrows to be wiped out completely, having insurance that provides coverage above the escrow is not typically seen as something that has a high probability of coming into play. Similarly, if there is a known risk related to a certain issue, the insurance provider understandably is going to charge a high premium to have exposure to that risk.

There are, however, situations in which the product makes sense and is used. First, some pooled investment vehicles like venture and private equity funds will need a high level of certainty that under no circumstances will they be required to contribute money back in connection with a transaction. For instance, some end-of-

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<sup>1</sup> We note, however, that the use of RWI seems to be on the rise.

life funds will be looking to wrap up operations and dissolve the fund. In order to do so, they will want to know that all remaining liabilities and contingent liabilities have been satisfied. Other funds simply will want to distribute closing proceeds to their investors as quickly as possible without holding more than is necessary as reserves. In either case, they might use RWI to get comfort that even in the unlikely event that a claim exceeds the escrow amount, the former stockholders should not need to pay back any portion of the closing proceeds. Note, however, that RWI usually only lowers this risk rather than wholly eliminating it. In the extreme example of a claim that would require repayment of the entire purchase price or any amount in excess of the RWI coverage, the stockholders would still be on the hook. Even if the buyer in the merger agrees that most claims are limited to the escrow plus insurance, there could still be exposure to claims of fraud.

Second, on some transactions a specific operational issue related to the target company presents a hurdle to getting the deal closed. Either it is unusually risky, or the nature of the issue presents bigger issues for the buyer, or there is some other similar problem. For instance, the buyer could say that it acknowledges that the risk of a claim that the target improperly paid a foreign official seems to be low but that the buyer cannot have any exposure to it whatsoever. In that sort of case, the parties might want to specifically insure against such issue if it can be done at a reasonable price.

The challenge with RWI policies is that they are complicated and can contain numerous exceptions. Sellers need to understand the risks implicit in the representations and warranties given by the target company to the buyer and ensure that the policy covers such risks. Particular attention should be paid to the circumstances under which payments will and will not be made under the policy. As noted above, many will not pay anything prior to the escrow first being extinguished. Other restrictions include caps on

total payouts, and limits on the time in which the claim must be submitted. Additionally, the administrator of such a policy (usually the shareholder representative) needs to be fully aware of the required claim policies and procedures. Similar to the timelines required under merger agreements for responding to claims, RWI policies often have strict guidelines for reporting claims that might be payable by the insurance provider. Failure to comply with such terms could limit the insured's ability to recover under the policy. Further, RWI policies may limit the representative from selection of counsel or may only partially cover the cost of such counsel. Given all these restrictions, the shareholders need to make sure the policy really provides the protection they think they are getting.

When purchasing RWI, sellers are advised to consult with specialized insurance counsel for negotiating such coverage. There are also specialized consultants that can assist in risk analysis and negotiation of coverage that are unaffiliated with the insurance companies and insurance brokers. Finally, sellers should ensure the shareholder representative is familiar with such policies, has negotiated their role in such coverage and has the necessary experience to ensure compliance with the administrative and claim obligations required under such policies.

RWI may be a valuable adjunct to the management of investor risk with respect to M&A post-closing claims, but buying the product and managing claims requires specialized expertise.

## 4. Who Should Indemnify the Escrow Bank?

The escrow agreement in many M&A deals contains a section that says the buyer and the shareholder representative jointly and severally will indemnify the escrow agent against all acts performed by it, absent gross negligence or willful misconduct. Many representatives assume they have no choice but to accept this.

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**It should be the principals to the deal, i.e. those benefiting from the transaction, who provide any necessary indemnification.**

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Our view is that the representative should start with the position that indemnification can come solely from the buyer. The typical buyer is a major corporation with significant assets. The typical representative is an individual or a comparatively small entity. Adding the representative to the indemnification clause gives the escrow agent little additional protection.

Moreover, the representative is just an agent in the transaction, not one of the principal parties. Generally, it is not appropriate to ask a person who is acting only as an agent for some of the parties to the transaction to take the risk of providing indemnification to an escrow bank.

If it is necessary for the representative to provide this indemnification, it should make clear that it is acting in that capacity as the agent of the shareholders and, in that capacity, is committing the shareholders to the indemnification terms. The representative should not give the indemnification personally. As mentioned above, it should be the principals to the deal, i.e. those benefiting from the transaction, who provide any necessary indemnification.

In response to this position, we've heard arguments that the representative receives indemnification from the selling shareholders,

so it is not really taking any risk by indemnifying the escrow bank. The problem with this is that even if the representative in turn has indemnification from the shareholders for any losses incurred, it should not have to take the risk of having a payment obligation it then hopes to be able to recoup.

Below are four alternatives to the typical form language that we believe do a better job of recognizing that the representative is acting as an agent only, and should not be subject to this indemnification risk. They are in descending order from language we believe to be the most favorable to the selling shareholders and their representative to the least favorable (but still preferable to language that simply says that the buyer and the representative jointly and severally indemnify the escrow agent).

**Alternative 1:** *Buyer agrees to indemnify the Escrow Agent for, and hold it harmless against, any loss, liability or expense incurred without gross negligence or willful misconduct on the part of Escrow Agent, arising out of or in connection with its carrying out of its duties hereunder. [Buyer shall be entitled to be reimbursed out of the Escrow Fund for fifty percent (50%) of any amount that Buyer is required to pay to the Escrow Agent pursuant to this Section.]*

**Alternative 2:** *Buyer and the Shareholder Representative (solely through the Escrow Fund and not directly) agree to indemnify the Escrow Agent for, and hold it harmless against, any loss, liability or expense incurred without gross negligence or willful misconduct on the part of Escrow Agent, arising out of or in connection with its carrying out of its duties hereunder. Buyer, on the one hand, and the Escrow Fund, on the other hand, shall each be liable for one-half of such amounts. In the event the Escrow Fund is insufficient to cover the one-half of such amounts for which it is responsible, such shortfall shall be paid by Buyer.*

**Alternative 3:** *Buyer and the Shareholders agree to indemnify the Escrow Agent for, and hold it harmless against, any loss, liability or expense incurred without gross negligence or willful misconduct on the part of Escrow Agent, arising out of or in connection with its carrying out of its duties hereunder.*

**Alternative 4:** *Buyer and the Shareholder Representative (solely as agent for and on behalf of the Shareholders and not individually) agree to indemnify the Escrow Agent for, and hold it harmless against, any loss, liability or expense incurred without gross negligence or willful misconduct on the part of Escrow Agent, arising out of or in connection with its carrying out of its duties hereunder.*



## 5. Automatic Release at Expiration of the Escrow Period?

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**The proper way to conceptualize the escrow is that it is really the shareholders' money.**

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Many escrow agreements state that the balance, less any pending claims, will be released upon the escrow agent's receipt of joint written instructions from the buyer and the representative or a court order. Attorneys for the selling company should consider whether joint instructions should be required for a release upon the expiration of the escrow period.

If no claims have been brought during the claims period (or the claims are less than the escrow amount), the balance of the money should not be held up while the parties wait for joint written instructions. Delays can happen for many reasons, from simple administrative lags to possible gamesmanship on the part of the buyer. Selling shareholders who want their money do not want to be at the mercy of buyers agreeing to execute a release. A buyer could potentially use the necessary release as negotiating leverage, knowing that the only other way sellers can get their money is to sue for breach of contract.

Buyers may resist automatic releases, saying that any money that goes out under any circumstances should be approved by both sides, and that they are subject to the same disadvantages any time escrow funds are owed to them. In other words, an escrow payment to the buyer requires the signature of the representative, who must give it in good faith, so why should releases to the shareholders be any different?

Either way, the parties should consider and specifically define what is necessary to release the balance of escrow funds at the end of the escrow period.

## 6. Cross-border Transactions; Watch Out for FBAR

Parties involved in a transaction in which escrows are held in accounts domiciled outside the US may need to comply with Report of Foreign Bank and Financial Accounts (FBAR) regulations. Most people have never heard of FBAR and don't know much about these rules, but failure to comply can result in significant penalties. Since many investors do not track or carefully consider where the escrows related to their deals are held, they may need to audit whether any of them are held abroad.

FBAR, established under the Bank Secrecy Act, is part of the US Government's fight against clandestine funding of international terrorism. It requires reporting if the taxpayer has is a financial interest greater than \$10,000 in, or signature authority over, any account(s) in a foreign country at any time during the calendar year.

Whether an escrow is in a foreign account may not be immediately apparent to shareholders. For example, JPMorgan Chase Bank is a US bank, but if an escrow goes into its Hong Kong branch, that account is a foreign financial account. Since many buyers and investors have pro rata interests in escrows in excess of \$10,000, they will need to look at this issue carefully. They also will need to look closely at any escrow for which they are serving as the shareholder representative, because that representative almost always has signature authority over the account.

The penalties for non-compliance can be quite severe, consisting of the possibility of forfeiture of up to the greater of 50% of the account value at the time of violation or \$100,000. Criminal penalties may also apply in certain defined circumstances.

The FBAR filing is due by June 30th of the year following the year that the account holder meets the \$10,000 threshold. There

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**Given the complexity, fickle nature, and draconian penalties of the FBAR regulation, we advise all shareholders to look at all of their escrows to determine whether any are held in foreign accounts.**

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is also a FBAR box that may need to be checked on taxpayers' individual income tax returns (Form 1040 Schedule B, lines 7a and 7b), and on other business entity filings on their due dates. Making the issue even more complex, it should be noted that the reporting requirements extend to certain beneficial owners of the underlying economic interest, not just to the holder of record.

Given the complexity, fickle nature, and draconian penalties of the FBAR regulation, we advise all shareholders to look at each of their escrows to determine whether any are held in foreign accounts, and consult their tax and legal advisors as to whether FBAR applies for both individual 1040 filers and for business entities. Going forward, this issue should be considered any time a foreign escrow account is contemplated.

## 7. Rounding Merger Consideration and Other Allocations

All distributions to shareholders, whether initial merger consideration, post-closing adjustments, earn-out payments or escrow releases, need to be allocated among the recipients. While some merger agreements specify the required decimal significance of pro-rata percent ownership, they rarely take into account the issue that paying agents cannot pay fractions of cents or shares.

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**When creating spreadsheet allocation formulas, use the ROUND function.**

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Drafters of spreadsheets often forget that most spreadsheet programs display rounding. When we review spreadsheets at SRS, we typically find that the sum of the allocations when rounded to the nearest cent or share does not add up to the total to be distributed.

We suggest an easy fix. When creating the spreadsheet allocation formulas, be sure to use the built-in ROUND function. If allocating currency, set the ROUND decimal significance to 2; for share distributions, set the ROUND decimal significance to 0. Typically, the sum of the rounded allocations will be slightly higher or lower than the total to be distributed. SRS recommends allocating the difference to the largest shareholder by lot. Our experience is that the largest shareholder will not be concerned about a few cents' difference, but the smallest shareholder will calculate their proceeds to the penny.

## 8. Perfected Security Interest in Escrow Funds

We have seen a couple of escrow agreements in which one of the parties wants to have a perfected, first priority security interest in the escrow funds. This presents an inherent conflict with the purpose of an escrow.

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**We do not believe it is best practice for a buyer to be granted a security interest in the escrow.**

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First, if the definition of merger consideration is properly drafted, arguably the escrow funds should not be subject to any party's bankruptcy proceedings should that happen during the escrow period. Second, the escrow money is supposed to be in a neutral fund that no single party to the merger can control. This is in-

consistent with granting a perfected security interest in cash, since that generally requires one of the parties to be granted a control account agreement or to have possession of the cash. We are not sure how to reconcile those conflicting objectives. If it is the buyer that feels strongly about this, the parties should consider simply doing a holdback rather than an escrow account.

As a general rule we do not believe it is best practice for a party to be granted a security interest in the escrow. In our view, this is unusual, cumbersome and probably unnecessary.

## 9. Tax Reporting and Payments to Employees

In most transactions, employee shareholders (and vested options holders), share in the proceeds of the merger and escrow. Paying those employee shareholders in a merger can get a little confusing. When distributions are made at closing (or later on due to escrow releases or earn-outs), some employees receive their payments through the escrow/paying agent while others receive payments from

the buyer, and still others receive payments from both. To add to the confusion, some employees get 1099-Bs while others receive W-2 tax forms, even after they leave the selling or buying company.

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**Shareholder representatives and company buyers need to be aware of the proper tax treatment for each shareholder participating in escrows.**

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*Why?*

It all depends on how the employee received his or her shares. If an employee is a shareholder who either purchased shares or received shares and executed a Section 83b election, then any merger-related payout generally is considered an “investment.” Those employees usually receive payments through the paying/escrow agent, and the proceeds are reported on 1099-B tax forms.

In contrast, if an employee received restricted stock and did not make an 83b election, or exercised vested options (or net-exercised) at closing, then any receipt of funds is usually considered “compensation”. As is true of other employee compensation, it generally is paid via payroll and reported on the W-2 tax form, even if the individual is no longer an employee when the payment is made.

Because of this distinction, shareholder representatives and company buyers need to be aware of the proper tax treatment for each

shareholder participating in escrows (and other deferred payments of merger consideration), and ensure that the routing of funds in the merger and escrow agreements is correct and reported on the appropriate tax forms. Typically that means that proceeds needing to be treated as employee compensation will be routed back to the surviving corporation for payment, while all other payments can be made by the escrow or paying agent.

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**It can be more expensive for a buyer to pay the purchase price if a portion of it is to be treated as compensation.**

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The parties also need to consider the economic implications of the classification of the payment to the merged company. As a general rule, compensation is subject to employer payroll taxes, while capital gains or losses are not.<sup>1</sup> The parties to the merger should be cognizant of the appropriate tax treatment because it could be more expensive for a buyer to pay

the purchase price if a portion of it is to be treated as wages. If a portion of the purchase price is deemed to be compensation, the parties should ensure that this is properly contemplated in the agreements. We have seen transactions in which the buyer submitted an indemnification claim for its employer payroll tax obligations, alleging that it constituted an undisclosed liability. Some claims for employer payroll taxes will be submitted even when no such obligation exists because it was assumed that such payment must be treated as compensation. To avoid these problems, the parties should carefully consider who is being paid in the merger, determine how to classify those payments prior to closing, and negotiate the economic deal regarding any related tax payment obligations prior to closing.

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<sup>1</sup> We note, however, that compensation related to a disqualifying disposition of options might not be considered wages for the purposes of federal tax withholding and employer payroll taxes.

Finally, as address in the “Disbursement of Funds – Who Touches the Money?” article above, the parties need to consider the mechanics of how any payments deemed to be compensation will be made. Generally these need to be run through the Buyer’s payroll, even if other payments are made directly from a paying agent.



## 10. Taxation of Interest Earned on the Escrow

### Actual vs. Imputed

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**The actual interest earned in the escrow is irrelevant for determining taxable interest.**

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During the life of the post-closing period, most escrows are invested in short-term, highly liquid instruments such as bank money market accounts or money market funds. Any investment earnings generally are deemed taxable to the buyer. At the end of the escrow period, assuming no claims are made, the balance of the escrow

account is distributed to the selling shareholders, plus any investment earnings. As a result, it is not unusual for shareholders to ask how much of the escrow distribution is related to interest. In other words, how much of the distribution should be treated as capital gain and how much is recognized as ordinary income?

In the current interest rate environment, it would be easy to say “not much” is interest. Most escrows today are invested in accounts paying 0.10% or less, and many pay no interest at all. When it comes to the tax rules, it is not necessarily that easy because of the rules regarding imputed interest and OID – original interest discounts.

When a merger agreement includes a distribution of an escrow in a future tax year, that transaction is often structured as an installment sale. Further, unless the merger agreement calls for a specified rate of interest to be paid during the escrow period (which most do not), the actual interest earned through the investment choice is irrelevant for determining taxable interest. Instead, the IRS requires the recipient to “impute” interest based on the IRS’s own determination of applicable federal rates (so-called AFRs). Therefore, while the escrow itself may have earned no interest, as of January 2012, the IRS determined that the short-term AFR (less

than three years) was actually 0.19%. This often results in more of an escrow distribution being taxed as ordinary income than if the investment earnings were based on actual interest earned.

Merger parties should also consider when investment earnings become taxable. In most escrows, investment earnings are credited to the account on a monthly basis, and most bank systems assume that a taxable event has occurred at that time. The merger parties may, however, want to discuss with their tax advisors whether they can take the position that no taxable event has occurred at such time because the funds remain “locked up” under the terms of the escrow agreement. Therefore, the parties may assert that there has been no constructive receipt of funds by either party (or taxable event) until the escrow is distributed. If the parties wish to avoid this possible ambiguity on proper income recognition treatment, they should make it explicitly clear in the escrow agreement that tax reporting and withholding, if necessary, should only be done upon distribution and not when investment earnings are credited to the account.

All of this is just another example of why it is important to understand the transaction structure of your particular merger and to seek expert tax advice.

## 11. Distribution of Escrow Release Payments

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**Have the distribution payments default to what the shareholder requests at closing.**

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At closing, most shareholders are given an option when submitting their letter of transmittal as to how they want their merger consideration distributed – by check or by wire. We’ve recently noticed that this choice does not necessarily apply to payments under the escrow agreement. In fact,

many escrow agreements specifically require payment by check for distribution to shareholders.

Escrow banks seem to prefer issuing checks if left to their own decision for several reasons that are good for them. Checks must be deposited, which provides a signature verification mechanism for the bank. In addition, banks are concerned about their liability if an electronic payment goes awry. Probably most important, checks generate additional float income for the bank. The parties should ensure that the bank never issues cashier’s checks, especially for escrow releases and other payments subsequent to closing. Cashier’s checks are “near cash” and there are special laws and regulations regarding their negotiation. Among the problems with this, they can be very difficult to cancel or stop payment if it is later discovered that a mistake was made or a check was mailed to a prior address. Therefore, they should be avoided for this purpose.

Shareholders, in contrast, often prefer the convenience and immediacy of electronic payments, especially those who have requested a wire transfer at closing. This is especially true for shareholders located outside the country of the escrow bank or those receiving a large amount. The combination of snail mail time and the difficulty of negotiating checks in a non-local currency can significantly delay receipt of good funds by foreign shareholders.

To address these concerns, when negotiating escrow agreements, SRS recommends having escrow release payments made by the original paying agent and having the payment method default to which ever method the shareholder requested at closing. It will streamline the process and ensure that shareholder expectations are met.

“I was a shareholder representative in a merger that ended up having issues surrounding the working capital balances and inventory/warranty reserves. I’m not an accountant, but felt like one after spending nearly ten hours a week for several months trying to decipher what happened and conducting interviews with all former executives and investors.”

**Anonymous Shareholder**

**Notes**

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# Working Capital Issues

## Introduction

Working capital adjustments are common in merger agreements. They are basically purchase price adjustments based on a specified formula in the agreement. A high percentage of these adjustments result in post-closing disputes for reasons including imprecise formulas and vagaries of GAAP rules. Because of the large number of issues related to working capital definitions and mechanisms, we thought that they warranted their own section in this manual.

More specifically, many agreements adjust the closing date merger consideration upward or downward based on a good faith estimate by the target company as to its closing date working capital. Other agreements use a threshold amount for that determination. When these estimates or thresholds are made, there is typically a timeframe after closing for the buyer to close the books of the target company and determine the actual net working capital as of the closing date. Once determined, the merger agreement may provide for a true-up process with an opportunity for the shareholder representative to review, approve, or dispute the buyer's final closing date balance sheet and net working capital calculation.

Working capital adjustments are meant to be true-ups of accounts between what was known at closing and what becomes known during the days subsequent to closing as the buyer performs a formal close of the target company's books and records. For example, at closing the target company may not know its sales in the few days before the closing date, employees may submit expense reports late, or vendors may submit final bills for pre-closing expenses subsequent to the closing date. The buyer then has time to review these items and make closing date adjustments, subject to the rules and procedures specified in the merger agreement.

In order to minimize the potential for disputes related to working capital adjustments, we offer the following comments to use in merger agreements.

## 1. Indemnification Claim OR Working Capital Adjustment?

### *OSI Systems v. Instrumentarium*

There are several potential claims for losses under a merger agreement that the buyer could bring as either a working capital adjustment or a claim for indemnification. For instance, if the selling company failed to disclose the existence of a short-term contractual liability, the buyer could likely claim either that this should reduce the calculation of the closing working capital balance, or that it is a breach of a representation or warranty entitling the buyer to compensation for damages. The question arises as to whether the buyer should in all circumstances have full discretion over its choice of remedies, or whether there are limitations as to which type of claim may be brought under various circumstances. The practical difference is that working capital claims typically are not subject to the indemnification baskets or caps, but claims of breaches of most representations or warranties are.

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**Working capital claims typically are not subject to indemnification baskets or caps, but claims of breaches of representations or warranties are.**

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This issue was addressed by the Delaware Chancery Court in *OSI Systems, Inc. v. Instrumentarium Corporation*.<sup>1</sup> In *OSI*, the buyer tried to bring a working capital claim that would have resulted in a 54% adjustment to the purchase price. Much of the adjustment it sought was based on the buyer's allegations that the selling company used improper accounting principles in preparing its estimated closing balance sheet. The court found that working capital adjustments should be limited to changes in the amounts of working capital applying consistent accounting principles, and that any

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<sup>1</sup> *OSI Systems, Inc. v. Instrumentarium Corporation*, 892 A.2d 1086 (Del. Ch. Ct. 2006).



claims alleging that such principles were improper or inconsistent with GAAP must be brought as indemnification claims.

This ruling is important for merger parties and their advisors to consider in drafting merger agreements and in the event of a dispute related to working capital. If a dispute arises, the attorneys representing the shareholder representative or the selling shareholders may want to argue that the scope of issues that an independent accounting firm is permitted to consider is limited, and that it must apply the accounting principles used by the selling company at closing.

Additionally, we suggest that the parties should strongly consider making clear what adjustments they desire to permit as working capital adjustments in their merger agreement. That is, specify in the merger agreement whether working capital adjustments are permitted only to the extent of any changes that occur if consistent principles are applied and whether any claims that such principles are improper can be brought only as indemnification claims.

## 2. Working Capital Adjustment AND Indemnification Claim? No “Second Bite at the Apple”

What happens if working capital adjustments are determined through the dispute process to be invalid adjustments, and the dispute resolver (e.g., independent accounting firm, mediator or arbitrator) rules in favor of the selling shareholders? Should the buyer be able to revisit the issue as a breach of a representation or warranty?

A buyer may argue that a “second bite at the apple” is allowable because there could be claims knocked out of the working capital calculation that still constitute a breach of a representation or warranty. For instance, an independent accountant may have determined that a liability should not be included in working capital because it is a long-term liability rather than a short-term liability. It could, however, still be a breach of a representation if it is a liability that was not properly disclosed. In this case, the accountant’s determination should not preclude the buyer from bringing an indemnification claim.

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**Counsel especially familiar with accounting issues should help define the circumstances in which a claim may be denied under the working capital provisions, but might be properly indemnifiable.**

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On the other hand, their determination made in connection with the working capital dispute process may be that the buyer’s position is factually invalid. The buyer, nevertheless, might bring, or threaten to bring, the same issue as an indemnification claim. This is basically a way to get a free appeal on the accountant’s ruling. Note that it is very difficult for the shareholders to do the same thing when they lose on a working capital issue, because there typically is no second venue to have the issue reviewed again under the merger agreement.

In order to address this issue in merger agreements with working capital adjustments, consider adding language such as this:

*In the event that Buyer believes there are any facts or circumstances that are the basis for any adjustments to the [Preliminary Working Capital Statement] delivered by the Company at Closing, Buyer shall be permitted to pursue a remedy based on such facts or circumstances either as an adjustment to the Preliminary Working Capital Statement (“Adjustment”) or as an indemnification claim, but not both, other than as set forth below. Nothing in the preceding sentence shall prevent Buyer from bringing an indemnification claim based on the same facts and circumstances as a proposed Adjustment if a final, independent determination is made that (i) the proposed Adjustment is not proper based solely on the long-term or short-term nature of the applicable asset or liability, (ii) the proposed Adjustment is not being considered in connection with Working Capital because it is determined to be a legal issue rather than an accounting issue or (iii) [\_\_\_\_\_].*

Alternatively, a seller may negotiate for language that provides for an election of remedies by the buyer, so that if a working capital adjustment is sought, there is no indemnification available for the facts underlying the notice of purchase price adjustment.

Counsel especially familiar with accounting issues should help define the circumstances in which a claim may be denied under the working capital provisions, but might be properly indemnifiable. While many auditors are not familiar with these issues, accounting firms often have specialized technical groups to handle such problems. When drafting a provision along these lines, we suggest that you seek this specialized level of expertise, which is normally beyond a discussion with the individual who handles the company’s audits.

### 3. Definition of Working Capital

Working capital can be both more and less than meets the eye. Intuitively it seems sufficient to calculate net working capital as the difference between current assets and current liabilities as determined according to GAAP and the historical practices of the target company. The reality, however, is that GAAP provides no single answer on many accounting issues. Moreover, the company whose financials are being dissected may have changed its accounting policies over its life. Many controversies come down to differences between the company's accounting policies and those of the buyer when a buyer comes to believe post-closing that the target company's accounting policies were incorrect or improper. Conceptually, we believe that net working capital should be thought of as the company's final closing balance sheet, and not the buyer's opening balance sheet.

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**We believe that net working capital is based on the company's final closing balance sheet, and not the buyer's opening balance sheet.**

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In order to provide clarity to both the buyer and the shareholder representative, consider the following suggestions for preparing the final closing balance sheet and the net working capital calculations:

- 1) Attach as an exhibit to the merger agreement a particular set of financial statements, and note that the final closing balance sheet should be determined with the same accounting policies and procedures used in the preparation of the exhibit.
- 2) Do not define assets and liabilities merely by customary account names. Include as an attachment the company's chart of accounts, with account numbers, and define inclusions and

exclusions to working capital by specific account name and number.

3) Include as an exhibit specific accounting procedures and policies used to determine any estimates or cut-offs, such as inventory reserves, allowances for bad debts, or accrued liabilities. Often these policies may already be documented in the notes to the company's audited financial statements.

In summary, be precise to avoid future disputes. The parties' attorneys and accountants need to work intensely and cooperatively to try to ensure that the merger agreement specifically defines how to treat issues that may have accounting rule ambiguity, or in which management made judgment calls prior to closing.

#### 4. Beware of Non-Cash Items, Especially Deferred Tax Assets and Liabilities

Net working capital is supposed to represent those assets and liabilities that are expected to have a short-term impact on cash and equity. Current assets are generally those that are expected to generate cash within twelve months. Current liabilities are generally those that are expected to use cash within the same time frame.

Looking at the name alone, most people think that deferred tax assets and liabilities refer to expected tax refunds or taxes due. Deferred tax assets and liabilities, however, are not the actual taxes, but simply an accounting concept. They refer to “timing differences,” an accounting term used to describe a situation in which certain revenue and expenses are recognized differently for tax purposes and book purposes, and are non-cash in nature. Even though they may be classified as short-term on the balance sheet, the calculation is derived from the classification of the underlying asset or liability that has the timing difference for tax purposes. It does not necessarily follow that the deferred tax asset or liability will have any impact on cash within twelve months, or ever.

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**We have seen large adjustments made to the purchase price for reasons that will never affect the combined company's actual cash position or value.**

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SRS recommends that the parties to a merger go line by line through the target company's chart of accounts to determine which items impact the value of the business, and therefore should be included in working capital calculations, and which do not. Non-cash items, such as deferred tax assets and liabilities, often should be specifically excluded from the definition of working capital in merger agreements. If they are not excluded in your

transaction, pay special attention to their anticipated impact on determining the estimated balance sheet or any target level of net working capital. Otherwise, one of the parties might find the economic deal changed for reasons that do not make sense. We have seen large adjustments made to the purchase price for reasons that will never affect the combined company's actual cash position or value. This result can be hard for selling shareholders or the buyer to countenance, especially if they realize the impact after it is too late to change.

## 5. Buyer's Obligation to Provide Access to Books and Records

Working capital adjustments can be very complicated. The buyer has information and resource advantages because it controls the books and records, typically has large internal and external accounting teams, and typically has 60 to 90 days following closing to prepare its report. In contrast, the shareholder representa-

tive usually has 20 to 30 days to answer, does not have control of the applicable files and typically has limited accounting resources available. Therefore, it's important that the agreements set forth terms that will work for both sides in a way that does not prolong the process unnecessarily but provides for sufficient time to complete the applicable tasks. Since the shareholder representative generally has fewer resources and limited access to materials, it is important that the process also contemplates a level of cooperation between the parties.

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**Buyer will use reasonable efforts to provide access to the books and records of the Company electronically.**

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Two critical additions are included in the language below to try to address this:

*The Representative shall be granted access during business hours to the books, records and accounting work papers of the Company to conduct its review, and the Buyer shall use commercially reasonable efforts to respond promptly, in good faith and as fully and accurately as is reasonably possible to inquiries from the Representative related to such review. Buyer will use reasonable efforts to provide access to the books and records of the Company electronically, and shall transmit financial statements, general journals and trial balances of the Company and its subsidiaries in formats such as Excel spreadsheets, or searchable Word or pdf documents.*



If the underlined portions are omitted, a shareholder representative could find itself unnecessarily burdened in attempting to prepare a response. A buyer could respond to a representative's request for additional information by simply saying, "You can have access to the files if you'd like, but we're not going to have our people spend any time on this. Oh, and by the way, the files are in 17 different countries. Please let us know what you'd like to see." While that may sound outrageous, it is an answer that we have received. This tends to lead to disputes that should have been avoided.

It is also helpful if the buyer has an obligation to make its people and former employees available to answer questions. For instance, if the files are hundreds of pages of paper, the representative will want to be able to ask the buyer to point to certain calculations or data rather than searching for a needle in a haystack.

## 6. Consequences of Buyer Not Delivering Adjustment Statements

A typical working capital section contains language along the lines of the following:

- a. At closing, Seller shall deliver its working capital statement.
- b. As soon as possible following closing, but within 60 days thereof, Buyer shall deliver notice of any adjustments to that statement.
- c. The Shareholder Representative shall then have 20 days to dispute any of the adjustments. If the Shareholder Representative fails to respond within such time period, it shall be deemed to have accepted Buyer's calculations.
- d. Once there is a final agreed-upon figure, appropriate purchase price or escrow adjustments will be made.

One related detail that is often left unclear is what happens if the buyer fails to deliver the notice of adjustments within the required time frame? Has it forfeited its right to do so? If so, does that mean that the working capital statement delivered by the seller at closing is the final statement, and that the buyer has no right to object to it?

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**If the buyer fails to deliver the notice of adjustments within the required time frame... has it forfeited its right to do so?**

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Most buyers will object to that conclusion. Their position will be that if they deliver their calculations late, the selling shareholders are only entitled to any damages resulting from the late delivery. This rarely would result in any identifiable damages. This essentially could give buyers the right to deliver their calculations within any reasonable timeframe.

The parties should consider whether that is the outcome they desire. There is an argument that both parties should be obligated to meet the agreed upon timeframe rather than there being consequences if one side misses their deadline but no consequences if the other side does so.

To avoid this issue, consider adding a sentence to the merger agreement that specifically says something like this:

*If Buyer fails to deliver notice of any adjustments within such day period, the Shareholder Representative shall have the right, at its election, to either (i) determine that the Working Capital Statement delivered by the Seller at Closing shall be deemed for all purposes hereunder to be the final statement for purposes of calculating the [Closing Working Capital Balance], and such determination shall be binding on the Buyer with the Buyer having no further rights to object or require adjustments thereto or (ii) require the Buyer to deliver such Working Capital Statement within ten (10) days of the Shareholder Representative's demand therefor.*

Note that which of these options the shareholder representative elects to choose will likely depend on whether the price adjustment is one-way or two-way (meaning is it an adjustment that can only decrease the purchase price or is it an adjustment that can increase or decrease the purchase price). If it is a two-way adjustment mechanism, the shareholder representative may demand that the Buyer deliver the statement if it thinks a positive price adjustment will result.

## 7. Additional Response Time if Adjustments are Substantial

Buyers typically have 60 to 90 days following the closing date to finalize a proposed closing date balance sheet, working capital adjustments and net working capital calculation. In contrast, under most merger agreements, the shareholder representative may have only 20 or 30 days to review, research and approve or object to that submission.

It typically takes longer for a shareholder representative to review working capital calculations when material adjustments might be made, because both the number of issues and the complexity of such issues tend to increase as the amount of the adjustment gets bigger. To address this, consider adding additional time for the shareholder representative's review of the buyer's calculations when the adjustment being sought is in excess of a certain threshold. We would suggest language along these lines:

*In the event that Buyer shall deliver an Adjusted Working Capital Statement to the Shareholder Representative, then the Shareholder Representative may dispute any item or amount set forth in the Adjusted Working Capital Statement at any time within thirty (30) calendar days following receipt of the Adjusted Working Capital Statement; provided, however, that such response period shall be increased to sixty (60) calendar days in the event that the Adjusted Working Capital Statement delivered by Buyer would, if accepted, result in a Shortfall Amount of more than [\$ ].*

“Trends [related to venture-backed exits] emerge and evolve over time based on many economic and industry-specific factors. The venture industry has embraced the need for an experienced, stable shareholder representative that will remain dedicated for years into the future.”

**Mark Heesen**

**President, National Venture Capital Association**

## Notes

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# Miscellaneous

## Introduction

In this section are flags and best practices that don't fall squarely within one of the other sections. Although each may appear to stand alone, all are issues that we see come up repeatedly in merger transactions.

## 1. Selling Your Company May Require Multiple Law Firms

Typically, M&A deals have been negotiated by two law firms—one for the buyer and one for the selling company. Recently, however, we’ve seen a trend toward having a separate firm that represents the interests of a stockholder or group of stockholders.

The stockholders will do this for a couple reasons. The first is to ensure that their interests are fully protected with respect to issues such as how merger proceeds are distributed, whether third parties are receiving payments that could reduce the amount paid to stockholders, and what liabilities are being assumed by the stockholders or their representatives in connection with the transaction.

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**We’ve seen a trend toward having a separate firm that represents the interests of a stockholder or group of stockholders.**

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The second reason for separate stockholder counsel is to ensure that at least one of the attorneys who represented the sell-side in connection with the deal will continue to be available to the shareholders after the closing of the transaction.<sup>1</sup> The selling company’s attorneys may be conflicted out from assisting the selling stockholders after closing. The company (rather

than the stockholders) was that firm’s client, and that client was merged into the buyer, which means the buyer may own that attorney-client relationship after closing. In contrast, a lawyer who represented the stockholders in the deal will not have any such conflict.

Similarly, the question has been raised as to whether the party agreeing to serve as the shareholder representative following

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<sup>1</sup> Refer to the article, “Waiving Conflict of Seller’s Counsel,” for more information on this topic.

closing should be separately represented. Whoever assumes that job is taking on significant responsibility and potential liability and should make sure they fully understand and agree to the terms applicable to them in the agreement. While seller's counsel may consider it part of their job to negotiate for favorable terms applicable to the shareholder representative in some cases, the representative typically is not their client. In fact, the interests of the representative are to some degree in conflict with the interests of their client (or the beneficial owners of their client) on issues such as the level of indemnification the representative receives from the selling shareholders and the duties the representative owes to such shareholders. We have seen several agreements in which the final document contained terms that, in our view, representatives never should have agreed to and likely would not have had they been separately represented in the negotiating process.

Our suggestion is that anyone considering serving as the representative on a volunteer basis should tell the company that their willingness to possibly take the job is dependent on them first being represented by separate counsel in connection with the negotiations, and that they will expect the company to be responsible for payment of the related legal expenses regardless of whether they eventually agree to accept the position. Even with separate representation, the person may elect not to accept the position, but the separate representation should be a condition to be met before other factors will even be considered. This should be acceptable to the company because having a strong representative is in the best interests of all of its shareholders, and this should be a necessary step in making that happen.



## 2. Shareholder Releases and Letters of Transmittal

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**Even with good exits, a shareholder can always try to argue that the company could have done better.**

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Any time a board or the majority shareholders approve the sale of a company, they run some risk that an objecting shareholder may sue them for an alleged breach of fiduciary duties in taking that action. While a number of steps can be taken to significantly reduce this risk, it typically cannot be eliminated entirely.

Even with good exits, a shareholder can always try to argue that the company could have done better. Recent cases, such as *In re Trados*,<sup>1</sup> are concrete examples of the litigation risks inherent in approving mergers.

To address these risks, some practitioners put release language in the letters of transmittal that shareholders must execute in order to receive their merger consideration. Proposed language would say generally that the signing shareholder releases the board, the other shareholders, the selling company, the buyer, and everyone else related to the deal, from any and all claims related to the merger, and waives any right to bring a suit related to the transaction.

While that language has obvious appeal for the parties tasked with considering whether to approve the transaction, there are some potential challenges. First, it works only if a shareholder sends in his or her letter of transmittal. If a shareholder is not getting consideration in the transaction, or feels that the consideration is insufficient, he or she likely will not agree to a release. Second, it is questionable whether a company can withhold merger consideration that a shareholder is entitled to receive if that shareholder

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<sup>1</sup> *In Re: Trados Incorporated Shareholder Litigation*, No. 1512-CC (July 24, 2009).

does not agree to sign a release that there is arguably no obligation to sign. This will put the parties in a difficult spot if the shareholder demands the money but will not agree to any release of claims.

The third reason is related to the second. If a shareholder is entitled to receive merger consideration regardless of whether he or she signs a release, the shareholder could argue that the release is not enforceable even if signed, because of lack of consideration. In other words, it can be argued that the shareholder agreed to the burdens of a release but got nothing in return that he or she was not already entitled to receive. One possible fix to provide greater comfort on these issues would be to specifically state

in the merger agreement that each shareholder's right to receive its portion of the merger agreement is subject to its execution of a letter of transmittal that contains the desired release language. A shareholder could potentially challenge this requirement, but most will not. A more aggressive approach would be to add a term in the merger agreement that says a portion of the merger consideration is being paid in exchange for the acquired shares, and a portion is being paid in exchange for the release of all parties as sought by the buyer. This is similar to transaction structures in which the buyer requires a portion of the purchase price to be considered as payment in exchange for noncompetition agreements from the shareholders to ensure their enforceability.

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**Put a term in the agreement that says a portion of the merger consideration is being paid in exchange for the acquired shares, and a portion is being paid in exchange for the release of all parties.**

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If you are considering adding a release to a letter of transmittal, the implications should be reviewed by tax and corporate counsel.

### 3. Contribution and Joinder Agreements

Recently, we have seen more transactions in which the acquiring company requires the selling shareholders to enter into side agreements to ensure that certain terms of the merger agreement are enforceable against them. Since selling shareholders generally do not sign merger agreements, there have been questions as to whether some agreement terms can be fully enforced. To mitigate any risks associated with this potential ambiguity about enforceability, the parties will sometimes resort to one of several solutions.

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**Recently, we have seen more transactions in which the acquiring company requires the selling shareholders to enter into side agreements to ensure that certain terms of the merger agreement are enforceable against them.**

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One simple method, although leaving some lingering question as to enforceability, is simply to require each shareholder to deliver a letter of transmittal that contains terms saying that the shareholder agrees to be bound by the terms of the merger agreement. The potential issue is whether a shareholder could later claim that this term should not be enforced because it was buried in a document that should do nothing but serve to deliver their stock, that it was in 6 point font, etc.

To add a higher level of protection, the parties can use joinder or contribution agreements. Joinder agreements are generally agreements in which individual shareholders specifically agree that they will be subject to all or certain terms of the merger agreement. These agreements may contain additional obligations that the buyer requires of major shareholders, such as voting agreements.

Contribution agreements are generally agreements in which the shareholders agree that if any shareholder pays more than its pro

rata share of any post-closing liability, the other shareholders will reimburse the paying shareholder as necessary so that the net result is everyone being responsible for their pro rata portion. This tends to be important if the shareholders are jointly and severally liable for any obligation.

The primary downside to using either of these agreements is that it adds time and cost to try to get them signed individually by a number of shareholders prior to closing. This is especially true if there are any shareholders who push back or want to make comments to the documents. If any shareholders are receiving little or no consideration in the transaction, they may not be inclined to be terribly cooperative in reviewing and signing any additional agreements.

Whether side agreements such as these are necessary or advisable is a difficult analysis that must be done on a deal-by-deal basis.

## 4. Why Your Governing Documents May Not Work

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**Many portfolio company charters don't work that well in addressing how money should be split among the shareholders when the company is sold.**

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A lot of venture firms have been disappointed recently to discover that their older portfolio company charters do not work as well as they would have hoped in addressing how money should be split among the shareholders when the company is sold. Many of those documents contain a provision that says that the preferred shareholders can either take their liquidation preference or take the portion of pro-

ceeds they would get if they converted their preferred shares into shares of common stock, but not both. This is the so-called “non-participating” preferred stock, but a similar issue can arise if the preferred stock participates up to a cap. This creates a problem if a sale contains a large amount of contingent consideration because the preferred shareholders may be stuck with the difficult choice of either (i) taking their preference from the payment made at closing but forfeiting the right to fully participate in the upside potential of possible future payments or (ii) converting to common stock and not getting all of their money back at closing in hopes that enough of the subsequent payments are made to make them better off.

It can also raise an uncertainty as to whether the preferred shareholders should have a portion of their merger proceeds subject to the terms of the escrow, or what their pro rata portion of such risk should be. Common shareholders may believe that all contributions to the escrow account should be made pro rata based on gross merger proceeds receivable by all shareholders while preferred holders may think that any losses from the escrow should come solely from the common if they would otherwise result in the preferred holders getting less than their full preference.<sup>1</sup>

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<sup>1</sup> See “*The Problem with Pro Ratas*” article.

The acquiring entity may have no opinion on this or may prefer that the preferred holders have a pro rata stake in the escrow to ensure that the largest shareholders (who likely have representatives on the Board) have “skin in the game” with respect to the escrow and the quality of the representations and warranties.

The typical forms of company formation documents have been widely used in the industry for decades. They have now been improved, but may still exist with some companies. Why have these potentially problematic formulas been broadly accepted for so long?

It’s not totally clear, but there are a few explanations that seem to make sense. First, the parties may not want to navigate these issues when consummating a financing of a portfolio company. They may view these risks as somewhat remote or may want to stick with more material issues to start the relationship with the entrepreneur on favorable terms. In other words, the parties pick their battles and choose to punt on these issues.

Second, some of these forms were originally drafted when the pooling of interests accounting rules were still live. Under those rules, the contingent consideration component of a deal couldn’t be very large for the transaction to still qualify for pooling treatment. Therefore, the difficult issues described above didn’t come up very often. Third, during the dot com boom, venture firms were not that interested in the exits that just got them their money back or a small return. The venture model focused on having a portfolio with a few home runs, and frankly, nobody focused much on the singles and doubles. Singles and doubles are much more important in today’s model.

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**Investors and entrepreneurs should discuss allocation of sale proceeds at the investment stage to avoid inter-shareholder controversies when trying to finalize a merger.**

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The major law firms serving the venture community have terms in their standard forms that can address these issues, but on many deals they are not used. While the issues may seem insignificant (and maybe not even contemplated) when term sheets are negotiated, they can become tricky. Investors and entrepreneurs should strongly consider having this discussion at the investment stage to avoid having to deal with inter-shareholder controversies when trying to finalize a sale or merger of the company.

The company and investors should also review other corporate documents that might come into play after closing, such as options plans and confidentiality agreements executed by key employees, directors and shareholders.

### **Option Plan Issues**

While the provisions of the merger agreement usually address the treatment of company options and warrants, holders of such securities typically do not sign the merger agreement, any related consents or letters of transmittal. In order to address this, the company might consider including language in their warrants, option plan and option grants that states that as a condition to the receipt of the security, the recipient agrees that the instrument will be subject to the terms of any merger agreement or similar transaction the company may enter into, including providing explicit consent to the appointment of a shareholder representative that will be authorized to act on the recipient's behalf with respect to their interest in any escrows or contingent consideration.

### **Confidentiality Agreements**

Companies typically require their staff to execute employee invention and confidentiality agreements. In addition, similar confidentiality agreements may be executed between the company and its directors, consultants and independent contractors. At closing, the beneficiary of this confidentiality obligation transfers to the buyer as the new owner of the target company. When a claim

arises, we have seen buyers assert that former employees, directors, contractors and shareholders have a duty of confidentiality and cannot discuss the issues and facts arising from the claim with the shareholder representative, counsel or even amongst themselves.

While we believe that employees, directors and shareholders should be able to defend against claims during the claims dispute process through their agents and counsel, companies and investors are advised to review their forms of confidentiality agreements, and may consider adding language to specifically permit disclosure of confidential information to shareholder counsel and the shareholder representative if the company is acquired and a post-closing dispute arises.



## 5. Your Relationship with Your Shareholder Representative

What should selling shareholders expect from the person or entity they elect to serve as their shareholder representative following the closing of a sale of the business? What functions should the representative perform on behalf of the group it is representing? Historically, the parties assumed the answer was “not much.” The representative typically assumed there was nothing to do unless the buyer made a claim, and the shareholders usually expected not to hear much until the final disbursement of any remaining escrow balances unless they asked a specific question (and maybe not even then).

Recently, however, many shareholders have come to expect more. At a high level, shareholders need to have confidence that the representative (i) has the experience and expertise to protect their interest and (ii) is established and stable enough to know they will continue to be there until the multi-year process is completed. Anyone agreeing to serve as the representative should view it as a serious responsibility. The shareholders expect that such person will diligently look after their interests and keep them informed as to the status of their remaining financial stake in the transaction. Specifically, the shareholders should ask the representative to commit to performing the following tasks and should believe that the representative has the following traits:

- 1) *Commitment and Resources.* The representative should be committed to actively managing the post-closing process. This includes making sure the person has enough time and the appropriate resources available to devote to any issue that may arise rather than giving it minimal attention. This also means getting comfort that the representative will be responsive to shareholder questions and requests. Shareholders often need information following closing for reporting, audit responses or other similar matters. They need to know their representative is not going to ignore their emails.

2) *Experience*. The representative should have experience managing similar transactions and the types of issues that may arise, including substantial experience managing complex indemnification claims, earnout disputes and working capital adjustments. Ideally, the Representative would have experience with both legal and accounting issues as these are the types of matters that tend to arise most frequently.

3) *Stability*. Representatives are often tasked with maintaining files related to the transaction. The shareholders need to know their Representative is well established and organized and is not likely to change jobs or otherwise quit or go away in the middle of the post-closing process. If the representative changes jobs (or the point person for an institutional representative leaves), they are unlikely to remain focused or committed to the remaining tasks of being a representative.

4) *Management of Disputes*. This is the most important responsibility of a representative. The representative should have experience with investigation, negotiation, and dispute resolution and should have the resources available to thoroughly protect shareholders' interests.

5) *Independence*. The representative should not work for the buying company, a law firm, have another job or have team members with other jobs. If they do, they will have conflicts and competing demands on their time.

6) *Term Tracking*. The representative needs to understand and record the important terms of the transaction for ready availability should an issue arise or a shareholder have a question. The representative also needs to know what rights were negotiated on behalf of the sellers to ensure no such rights are inadvertently forfeited or forgotten.

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**When considering who should serve as your shareholder representative, you should have a conversation regarding the expectation of the relationship.**

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7) *Disbursement of Proceeds.* The Representative needs to have the ability to track each shareholder's interest in escrows or earn-outs to ensure funds are promptly and correctly distributed at the appropriate time. This can be difficult if there are large numbers of shareholders or option-holders, so the Representative must have the appropriate administrative capabilities. The task is even more

complicated if withholding is required.

8) *Shareholder Reporting and Responsiveness.* The shareholders should expect the Representative to keep them reasonably informed should any issues arise that could impact the timing or amount of any applicable payments. Periodic reporting should be requested as well so the shareholders understand whether there have been any changes to their economic interests.

9) *Taxes.* Merger agreements may require the Representative to perform tax reviews or to prepare and file certain tax returns. Some agreements also require the Representative to prepare tax forms such as Form 1099 for mailing to the shareholders. The shareholders should have comfort that the Representative has the skills and resources necessary to complete such tasks.

10) *Date Tracking.* The Representative should have processes and systems in place to track any important dates related to the transaction to ensure no such dates are missed. These dates can occur years into the future, so it is critical that the Representative's systems are sophisticated and will be maintained for long periods. It is not enough to just enter a few dates onto a laptop.

11) *Account Reconciliation.* The Representative typically will get monthly bank statements from the escrow bank. The shareholders need to know that such statements will be carefully reviewed to ensure they are accurate and that no unauthorized charges have been made.

When considering who should serve as your shareholder representative, you should have a conversation regarding the expectations for the terms of the relationship. Significant dollars are often involved, and frustration or problems can arise when the Representative has a very different vision of the job from that held by the shareholders.

## 6. Sales Taxes: Whose Tax is it Anyway?

One type of indemnification claim that SRS sees repeatedly relates to sales tax exposure of the target company. These claims tend to be complicated because they often involve an assessment of the target company's interactions with customers in multiple states and the application of each state's tax laws.

Additionally, the exposure on these claims can be significant because tax issues, including sales tax, generally fall outside of the standard limitations of time or amount provided for in the indemnification sections of the merger agreement. That means that the indemnification obligations of the shareholders may extend well beyond any escrow period, may not be subject to a basket or caps generally applicable to other kinds of claims.

Because the analysis is so difficult, buyers often are uncertain what the exposure might be after closing. After taking over the company, they may learn that the target company was selling its products or services in many states and that sales taxes were not collected. Often, the buyer may know nothing further and might assert an indemnification claim for estimated or uncertain damages. In most cases, the buyer just wants to ensure that it will not suffer penalties or losses should there be noncompliance with any tax laws. If the representative is able to demonstrate that less is owed in taxes, the buyer is usually happy to reduce the amount of the indemnification claim. The problem is that many representatives have no idea where to start in trying to navigate this mess. Below is our outline of the issues to consider in attempting to reduce this sales tax exposure should you find yourself in this quandary.

### 1. Whose tax is it?

The first question to ask is whether any tax that may be due was or is the responsibility of the target company. Under most state laws, and as stated in most sales contracts, taxes on the purchase of goods (and, in some cases, services) are the responsibility of the

purchaser. Failure to collect sales taxes may result in penalties and interest assessed against the vendor, but, in the end, the purchaser generally is responsible for the payment of the applicable taxes.

## **2. Has the Statute of Limitations Period Expired?**

The shareholder representative should get a detailed account on a state by state basis to determine where the buyer believes it has potential exposure and for what tax years the buyer believes such exposure exists. In some cases, the statute of limitations for sales tax collection may have already expired, and no further action is required for those tax periods. This can quickly narrow the scope of the exposure and open issues.

## **3. Does Nexus Exist?**

In other cases, the target company may have had no sales tax nexus. In states where the vendor has nexus (typically where (i) it has a physical location; (ii) there are resident employees working in the state; (iii) the business has real or personal property in the state, or; (iv) there are employees who regularly solicit business in the state), the vendor may have the responsibility to collect sales tax as an agent of the state. Simply selling a product or service in a state does not itself mean there was a collection obligation.

In states where the vendor does not have nexus and, therefore, typically has no obligation to collect sales tax, the purchaser might still have the obligation to pay taxes on its taxable purchases. The obligation to report those purchases and pay use tax falls on the purchaser and not the vendor. Nexus is, however, quite complex, and it is not unusual for emerging companies to inadvertently trip the nexus requirement and not realize that it had an obligation to collect taxes on its sales in other states.

## **4. Who was the Purchaser of the Goods or Services?**

Even if it is determined that nexus did exist and the statute of limitations has not expired, there still may be no sales tax exposure.

Many sales are exempt from sales tax in specific circumstances. For example, if a customer is a reseller and does not consume the product, the sale might be exempt from the requirement to collect and remand the tax. Certain other customers, such as schools, may be exempt from sales tax in some jurisdictions. Lastly, certain products and services might also be exempt, such as training or hardware and software maintenance. It is important to perform an analysis of each purchaser and each invoice. Reseller certificates from purchasers exempt from sales tax may be in the target company files or can be obtained from the purchaser as evidence that no sales tax was due.

### **5. Did the Purchaser Already Pay the Tax?**

Prior to paying sales tax on any particular sale, the parties should contact the customers to see if they have already paid the applicable use tax. Many corporate purchasers will pay this tax even if the seller fails to collect the related sales tax. If the purchaser has done so, no further tax should be owed. If it has not, the target company should first try to collect the sales tax. The easiest way to do this is to re-invoice the customer assessing sales tax against taxable items, but reflecting that the invoice was partially paid. Included with the invoice should be an affidavit for the customer to confirm whether they had separately paid use tax on the purchased items. Any sales tax received can be remitted to the taxing authority taking advantage of amnesty and other provisions to minimize or abate interest or penalties on late filing and payment.

The bottom line is that the potential tax liability can often be reduced significantly if the related facts are investigated and the proper steps are taken to mitigate the exposure. When going through this process, it is important to note that supporting detail, including exemption and resale certificates, invoices and other records must be available to defend the company in the event of a sales tax audit. Without proper documentation, a vendor can be held liable for tax not collected from a customer.

## **7. In Earn-outs, Focus on Outcomes Rather than Milestones Envisioned Today**

When companies develop their product or service, there tend to be many unpredictable turns in the road. Companies start down one path, figure out that a different strategy makes more sense, and make appropriate changes. While this seems obvious, it is surprisingly difficult to account for when the parties negotiate and define the terms of earn-outs. We often see earn-out provisions with deadlines or specific requirements that appear to be one way, but not the only way, to reflect the value of the business acquired.

The result is that earn-outs sometimes are technically missed but for reasons that are caused by changes in business strategy that do not necessarily mean that the buyer is not getting the value sought from the company purchased.

This is especially true in life sciences transactions because the earn-outs in those transactions tend to be long and complex, and it is much more common for those development and regulatory plans to change over time than for them to play out as planned. For instance, the parties might determine at the time of closing that a milestone payment should be made upon the first patient dosing in a phase II study in Europe, provided it starts by a certain date. A typical diligence provision may require the buyer to use efforts that are commercially reasonable in the industry to achieve the milestones. Months or years later, the buyer might have determined for legitimate business reasons that it makes more sense to do a somewhat different phase II study in India rather than Europe, and the change has resulted in a delay of several months. The result is that the parties may know in advance that the milestone defined at closing will not be technically achieved, because of likely changes in the execution of the business plan, even though the development of the drug or product is proceeding and value is being created.



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**Earn-outs are sometimes technically missed for reasons that are caused by changes in business strategy, while the buyer may still be getting the value sought from the company purchased.**

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The outcome in this scenario tends to be disputes over significant sums of money with no clearly right answer. Moreover, other aspects of the buyer-seller relationship (such as an escrow release) are often impacted because this uncertain potential earn-out dispute can be foreseen by both parties long before the milestone is actually missed. To avoid this, we suggest that the parties acknowledge at closing that nobody really knows how the future development will progress and avoid setting milestones tied to the plan as it exists at closing, especially

for tests that will be years out into the future. Instead, our suggestion is that they focus on the results of what would constitute “success” with respect to this acquisition, or clear value inflection points that cannot be bypassed. If the goal is to take a product to market, base the milestones on an event or outcome demonstrating that fact, rather than worrying about how you got there. Also where development cycles are long and interim milestones are necessary, consider providing for an alternative or second milestone as an opportunity to receive the milestone payment (perhaps in an adjusted amount) if plans change and the first designated milestone is bypassed or delayed rather than simply having failed.

## 8. Relationship Management with the Buyer in Earn-out Situations

Earn-outs sometimes seem like great ways for buyers and sellers to achieve common goals. Buyers mitigate acquisition risk, and sellers get all or some of their capital back (possibly with some initial return) and are relieved of future funding responsibilities. A crucial difference between a merger and other types of collaborations, such as strategic partnerships, however, is that the selling shareholders no longer have a company and may not have a management team inside the larger corporation to advocate for the program or control its progress.

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**Sellers must successfully navigate the internal relationships, politics, and various strategic motivations of their large company partner to get their product approved and to market.**

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In some cases, the management team of the seller may join the buyer and continue to drive the development with the support that they need. In other cases, managers might move on to other projects or new companies. Regardless, selling shareholders seeking the earn-out payments may not have the level of the information and influence they were accustomed to receiving with an independent company and management team.

Selling shareholders will often seek out the former management and employees of the target company to keep an ear on the buyer's progress towards meeting any earn-out milestones. When these resources work for the buyer, shareholders should be mindful of the employee's confidentiality obligations to their employer. Buyers may assert that the employee is bound by confidentiality agreements, and the shareholders may be putting the employee at legal risk by asking questions related to confidential or proprietary information. In addition, buyers may assert that the selling share-

holders are interfering with the management of the company they purchased. To resolve these issues, we recommend making it clear in the information rights section of the merger agreement that access to employees (whether former or current) is expressly permitted to the stockholders and their representative for the purpose of evaluating any earn-out and claim provisions of the agreement.

In the end, sellers face many of the same challenges they do with all types of partnerships – they must successfully navigate the internal relationships, politics, and various strategic motivations of their large company partner to get their product approved and to market. Once their startup is acquired, however, the mechanisms, tactics, and people necessary to do so change.

Successful relationship management in a merger begins with selection of the acquirer. Savvy investors may favor an acquirer that has a genuine interest in retaining key members of seller's management that are likely to have ongoing professional and financial interests in seeing the acquired programs succeed. In negotiating the earn-out terms, it is advisable to select M&A counsel with attorneys who have expertise in negotiating milestone provisions of mergers or corporate partnering agreements. Finally, investors should make sure that the shareholder representative they select has the mission, time, resources and expertise to manage effectively the ongoing relationship with the acquirer.

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## About SRS | Shareholder Representative Services

**The deal doesn't end at closing.** Private company sales involve working capital true-ups, analyses of pre-closing tax obligations and rights, indemnification claims for breaches of representations and warranties, escrow holdbacks and earn-out provisions. In more than half of all deals, real problems arise that require investigation, negotiation and litigation management experience gained through repeat management of post-closing disputes. Only a dedicated team of forensic accountants, tax professionals, M&A and corporate attorneys, bankers, compliance officers and business negotiators can effectively serve shareholder interests after closing. You need the only specialized post-closing team that has served on hundreds of transactions. You need SRS.

**Broad Team of Experts** | When you engage a shareholder representative, consider who is going to do the work if an issue arises. SRS' senior-level staff of over 30 corporate and litigation attorneys, forensic accountants, tax professionals, entrepreneurs and negotiators, is the most experienced team ever assembled for post-closing management.

**Proven Track Record** | In over 250 deals, comprising over \$25 billion in merger consideration, SRS has investigated, negotiated and, when necessary, litigated hundreds of indemnification claims and earn-out disputes, purchase price adjustments, tax reviews, and escrow distributions. No one else comes close.

**Post-Closing Expertise** | M&A professionals rely on SRS' experience, data studies, and training materials to mitigate and prepare for issues that may arise after closing. Having managed many transactions through final escrow release and earn-out milestone payments, SRS is the only firm with comprehensive post-closing management expertise.

**State-of-the-Art Systems** | SRS ComPort™, SRS' operational, tracking and reporting system is the most sophisticated tool ever used by a shareholder representative. More than 30,000 shareholders, including hundreds of sophisticated institutional investors, rely on our comprehensive portfolio of services for monitoring and protecting all of their post-closing interests, rights and obligations.

For more information visit [www.shareholderrep.com](http://www.shareholderrep.com)

## About the Authors

### **Paul Koenig**

Paul is an attorney and entrepreneur who co-founded Shareholder Representative Services. Paul manages operations and heads the professional team at SRS.

Before forming SRS, Paul practiced law at some of the nation's most prestigious law firms. He specialized in representing both public and companies in mergers and acquisitions (M&A), debt and equity financings, company formations, and securities issuance and compliance. Paul also represented many venture capital investors in connection with private equity financings and other transactions. Based on this experience, he has a strong understanding of both investment fund operations and the sale of portfolio companies.

Paul was one of the founding partners of Kendall, Koenig & Oelsner, a Denver-based corporate and business law firm with a very strong practice in mergers and acquisitions, securities and venture capital finance. Prior to that, he was an attorney in the Chicago office of Latham & Watkins, and in the Colorado office of Cooley LLP. Paul graduated from Northwestern University School of Law and received his B.B.A. in Finance from the University of Iowa.

**Mark Vogel**

Mark is a serial entrepreneur and accomplished business executive who co-founded Shareholder Representative Services. He manages operations at SRS, including finance, sales and customer service.

Before joining SRS, Mark was a founder of three venture-backed start-ups in the areas of Internet and network-based data management and embedded/intelligent device software technology, Aria International, Transilluminant Corporation, and Encirq Corporation. Prior to founding these start-ups, Mark spent over 20 years in financial services, principally at Bank of America. During his tenure at BofA, Mark created the Online Banking Group and was a member of teams that developed the first corporate data warehouse, the first mortgage-backed securities, the first foreign currency traveler's checks and the first interactive trading and trader communications systems.

Mark holds a Master of Science degree from Stanford University in Operations Research and a Bachelor of Arts degree from Temple University in Mathematics and Accounting.



## **Diane Holt Frankle**

Diane Holt Frankle is a partner in the Silicon Valley office of Kaye Scholer LLP. Ms. Frankle concentrates her practice in mergers and acquisitions, corporate governance, public company reporting obligations, and antitakeover counseling. Ms. Frankle co-chairs the ABA Delaware Business Law Forum and the Joint Task Force on Governance Issues in Business Combinations and is a regular speaker at conferences covering trends in mergers and acquisitions, corporate governance, the fiduciary duties of directors, and federal and state securities laws.

Ms. Frankle represents both public and private companies in a broad range of industries in acquisition transactions. She also counsels boards, committees and management on a wide variety of corporate governance and disclosure issues, and internal investigations. Ms. Frankle is an active member of the ABA M&A Committee and served on the ABA Committee on Corporate Laws from 2005-2011. She was the editor of the ABA Model Merger Agreement for the Acquisition of a Public Company (2011). She is listed in the Best Lawyers in America, *Who's Who's Legal: The International Who's Who of Business Lawyers*, *Chambers Global Guide*, and in *San Francisco* magazine as one of Northern California's Super Lawyers for her mergers and acquisitions practice. Ms. Frankle received her J.D. *magna cum laude* from Georgetown University Law Center in 1979.

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