








Mitigating Risk – Diligence Process



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    graph LR
      A[Identify a Risk] --> B[Value It]
      B --> C[What is the Probability of it Happening?]
  
```

- ▶ Rely on your deal team
- ▶ Do you have other protection?
 - ▶ Insurance policies, contract rights, etc.
- ▶ Can you mitigate the risk?
- ▶ Materiality threshold – for the deal & as an organization

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Protective Drafting – Indemnification Market Terms

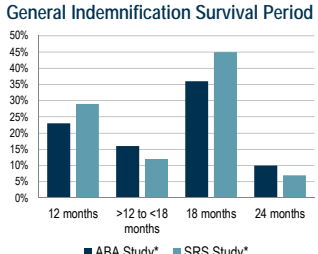
Structuring Indemnification

- ▶ The “Package” Deal
 - ▶ Compromises
 - ▶ Different ways to address the same issue
- ▶ Identity of the parties – Leverage
- ▶ Terms change significantly if Representation and Warranty Insurance is used

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Protective Drafting – Indemnification Market Terms

General Indemnification Survival Period



Survival Period	ABA Study*	SRS Study*
12 months	~25%	~30%
>12 to <18 months	~15%	~12%
18 months	~35%	~45%
24 months	~10%	~8%

Houlihan Study[†]
 Mean = 18 months
 Median = 18 months
 Range = 6 to 96 months

Deals with express “no survival” provisions increased from 2% in 2012 to 6% in 2014 (ABA Study)

*ABA Study = Private Target Mergers & Acquisitions Deal Points Study (Including Transactions Completed in 2014), published by the Market Trends Subcommittee of the Mergers and Acquisitions Committee of the American Bar Association Business Law Section. †SRS Study = 2016 SRS M&A Deal Terms Study, published by SRS | Acquiror LLC. ‡Houlihan Study = Purchase Agreement Study for Transactions Completed in 2014 and Prior Years, published by Houlihan Lokey’s Mergers & Acquisitions Group.
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Protective Drafting – Indemnification Market Terms

General Indemnification Basket*

	ABA Study (65% of deals)	SRS Study (30% of deals)	Houlihan Study (69% of deals)
Deductible:	0.65%	0.74%	0.80%
Mean	0.60%	0.71%	0.70%
Median	0.47%	0.54%	0.70%
Range	0.04% – 4.20%	0.07% – 2.30%	0.00% – 8.20%

	ABA Study (26% of deals)	SRS Study (64% of deals)	Houlihan Study (19% of deals)
First Dollar:	0.47%	0.67%	0.70%
Mean	0.47%	0.54%	0.70%
Median	0.05% – 1.25%	0.04% – 2.00%	0.10% – 2.90%
Range	0.05% – 1.25%	0.04% – 2.00%	0.10% – 2.90%

	ABA Study	SRS Study	Houlihan Study
All Baskets:	0.65%	0.67%	0.80%
Mean	0.60%	0.56%	0.70%
Median	0.50% or less = 52% of deals	0.50% or less = 39% of deals	0.00 – 8.20%
Range	>0.50 – 1.00% = 38% of deals	>0.50 – 1.00% = 49% of deals	
	>1.00 – 2.00% = 9% of deals	>1.00 – 2.00% = 11% of deals	

* Shown as percentages of transaction value. *All Baskets* includes combination baskets as well as deductibles/first dollar. Percentage of deals (with survival provisions) with a General Indemnification Basket: ABA Study, 98%; SRS Study, 98%; and Houlihan Study, 84%.

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Protective Drafting – Indemnification Market Terms

Escrow/Holdback Percentage*

	ABA Study	SRS Study	Houlihan Study
Mean	9.14%	11.10%	7.50%
Median	7.50%	10.00%	7.00%
Range	0.75 – 53.68%	0.50 – 63.300%	0.10 – 28.30%

* Shown as percentages of transaction value. Percentage of deals (with survival provisions) with an Escrow/Holdback: ABA Study, 79%; SRS Study, N/A; and Houlihan Study, 82%

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Protective Drafting – Indemnification Market Terms

Escrow/Holdback Time Period*

	ABA Study	SRS Study	Houlihan Study
Mean	[Not addressed]	N/A	19 months
Median	[Not addressed]	18 months	18 months
Range		12 months = 26%	1 – 96 months
		18 months = 43%	
		24 months = 8%	

* Percentage of deals (with survival provisions) with an Escrow/Holdback: ABA Study, 79%; SRS Study, N/A; and Houlihan Study, 82%.

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Protective Drafting – Indemnification Market Terms

General Indemnification Cap*

	ABA Study	SRS Study	Houlihan Study
Mean	13.20%	13.90%	13.80%
Median	10.00%	10.50%	10.00%
Range	0.30% – 100.00%	0.50% – 100.00%	0.50% – 100.00%
	<10% = 50% of deals 10% = 9% of deals >10 – 15% = 22% of deals	<10% = 27% of deals 10% = 23% of deals >10 – 15% = 32% of deals	

* Percentage of deals (with survival provisions) with a General Indemnification Cap: ABA Study, 100%; SRS Study, N/A; and Houlihan Study, 84%.

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Protective Drafting – Indemnification Market Terms

Trend: Materiality Scrape used with Increasing Frequency

	2012 ABA Study	2014 ABA Study
Materiality Scrape	28%	70%
“Double” (Scrape for determination of whether a breach occurred and amount of damages)	59%	57%
Single (Scrape for determination of amount of damages only)	41%	43%

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Deciding Whether to Make an Indemnification Claim

- ▶ Activity across all deals was frequent
 - ▶ 68% of expired-escrow deals* had post-closing activity relating to indemnification claims, purchase price adjustments, or earnouts
 - ▶ 18% of expired-escrow deals had at least one claim made in the final week of the escrow period
- ▶ Claim activity was significant in deals with claims
 - ▶ The average deal with claims had 2.7 claims seeking a total of 24% of the escrow
 - ▶ 18% of deals with claims had claims exceeding half of the escrow
 - ▶ 9% of deals with claims had claims litigated or arbitrated, driving use of expense funds

Source: SRS Study
*Expired-escrow deals include deals where selling shareholders have no further escrow-based indemnification obligations.

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Deciding Whether to Make an Indemnification Claim

- ▶ Auction vs. Traditional Deal
- ▶ Strategic vs. Private Equity
- ▶ Are any of the sellers on your management team?
- ▶ What is the amount of the claim?
- ▶ Are funds available? (holdback, escrow, rep and warranty insurance, chasing individual sellers?)
- ▶ Is there a professional seller representative?

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Most Common Post-Closing Claim Types

Data set: SRS Study all deals closing 2010-2014

Subject matter as % of the # of claims (977 claims)

Subset: breaches of R&W (573 claims)

* Claims pursuant to a post-closing purchase price adjustment mechanism (e.g. working capital).

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The Interplay of Rep and Warranty Insurance

Diligence	<ul style="list-style-type: none"> Should not change approach Will need to afford time for insurer participation
Representations and Warranties	<ul style="list-style-type: none"> Should not change approach generally Fewer qualifiers (materiality, knowledge); include scrape
Indemnification Terms	<ul style="list-style-type: none"> Small escrow Silent on consequential, multiple, etc. damages Perhaps a separate cap for excluded claims or fundamental reps
Likelihood of Making a Claim	<ul style="list-style-type: none"> Increased

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The Interplay of Rep and Warranty Insurance

- ▶ Industry-wide, known claims payments have ranged up to approx. \$390M
- ▶ Insurers have dedicated claims professionals and law firm relationships to offer claims solutions
- ▶ Brokers and independent advisors serve as advocates for insureds
- ▶ Financial statements, taxes, and contracts are the most frequently alleged breaches.

Category	Percentage of Claims
Financial Statements	~28%
Compliance with Laws	~8%
Tax	~13%
Litigation	~10%
Intellectual Property	~10%
Contracts	~10%
Employee Benefits	~10%
Other	~15%

Source: AIG's Representations and Warranties Insurance Global Claims Study Covering 2011 to 2014

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The Interplay of Rep and Warranty Insurance

Claims Paying Experience?

Asahi
Related to Asahi's 2011 acquisition of Pacific Equity Partners and Unitas - \$180M paid by insurers

Lixil
Related to Lixil's 2013 acquisition of Grohe Group – €360M claim

Anecdotal
*AIG paid three claims in excess of \$20 million in 2014 for financial statements and related breaches and over \$100 million for R&WI related claims around the world.
*Concord investigated the magnitude of the damages (including the degree to which future EBITDA would be adversely affected) and amicably resolved the claim using a multiple-based calculation amounting to approximately \$7.5 million about the applicable retention amount, which Concord then promptly paid."

Ageas v. Kwik-Fit
Breach of financial statement re – two aspects of bad debt reserves inaccurate. Coverage dispute over calculation of covered Loss – Consequential damages covered (i.e., coverage for the amount that insured overpaid based upon inaccurate information/breached rep).

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