

---

**HOLLAND & HART** LLP



**Review of an Asset Purchase Agreement – Part II  
ISB Business and Corporate Law Section  
March 12, 2014**

**Bret Busacker, Brian Hansen, and Claire Rosston**

---

# Today's Focus



- Employees and benefit plans (Article IX)
  - Evaluation of employee benefits issues
  - Asset v. stock deals
  - Representations and warranties
  - Beyond the basic issues
- Indemnification (Article XIII)
  - Limitations
  - Procedure
  - Escrow
  - Sandbagging
  - Exclusive remedy

# Employee Benefits Issues



- Understand the deal
- Understand your role in the deal
- Evaluate the sophistication of the benefits personnel you are working with on both sides of the transaction
  - How much help do the parties need
  - What is the probability that there are problems
- Evaluate the types of benefits that are involved in the transaction

# Asset v. Stock Deals



## ■ Stock deals

- buyer becomes responsible for all benefits plans maintained by the target, and all related obligations, assets and liabilities
- Things to consider:
  - The integration of buyer and seller plans (freeze, merge, continue separately)
  - The risks associated with the types of benefits maintained by seller
  - Protecting buyer from seller's mistakes
  - Mitigating impact on employees

# Asset v. Stock Deals



## ■ Asset deals

- Buyer can refuse to assume any seller plans
- Buyer may assume some and not assume others, but it is typically best to decide to either assume all or none
- If buyer decides to assume the benefits obligations may still negotiate to shift historical liabilities back to seller
  - Requires artful drafting and thoughtful understanding of where latent liabilities may come from
  - If elect to assume, consider the issues identified in a stock sale in the integration process
- If assume none of the benefits, it is still best to do some due diligence to make sure there are no surprises



# Typical Employee Benefits Reps & Warranties



- Seller provides schedule of benefit plans and has made available all governing plan documents and related documents for each benefit plan
- Compliance with laws (ERISA, COBRA, HIPAA, tax code qualification requirements, 5500s, reporting and disclosure requirements, and other applicable laws)
- Compliance with plan terms
- No fiduciary breaches or prohibited transactions
- All contributions and premiums have been timely paid
- Defined benefit plans are fully funded (or no defined benefit plans)
- No claims, or pending or threatened lawsuits
- No ERISA Title IV liabilities (e.g., no withdrawal liability from multiemployer plan)
- No material “reportable event”

# Beyond the Basic Issues



- Benefit plans and their issues
  - Not all benefits plans create the same issues
  - The following benefit plans often create the most problems:
    - Defined benefit plans
    - 401(k) plans in stock deals
    - Employee stock ownership plans
    - Self-insured medical plans
    - Executive arrangements
  - We will discuss the general benefit issues and identify the unique concerns with these plans

# Beyond the Basic Issues



## Defined benefit plans

- Plans that provided a benefit based on years of service and age (and not an account balance)
- Regulated by the PBGC and may require additional notices and communication with the PBGC by seller
- Defined benefit plans may create a significant source of liability; need to be sure to understand whether the liability has been properly determined
- Withdrawal liability for multiemployer plans

# Beyond the Basic Issues



## 401(k) plans

- In an asset deal seller typically keeps 401(k) plan
  - Buyer may amend plan to permit immediately eligibility of new employees
  - Buyer/seller may assist employees in making rollovers to buyer's plan
- In a stock deal, plan goes with the company sponsoring the plan
  - Buyer/seller need to decide whether seller's plan should become part of buyer's benefits
  - If buyer does not want seller's plan, plan should be terminated prior to the sale
- What to do with service credit/vesting?

# Beyond the Basic Issues



## Employee stock ownership plans

- Often involve more complex funding structures
- In an asset deal, plan participants must be informed of the details of the transaction and vote
- Results in a three-party negotiation between the trustee, seller/management, and buyer
- Buyer should watch closely for any prohibited transactions or fiduciary breaches
- Will require changes to the standard purchase agreement provisions to reflect to ESOP

# Beyond the Basic Issues



## Health and welfare plans

- Insured plans create minimal risk of liability because the insurance company bears the risk of loss
- Need to notify the insurance company of any type of changes to the employee demographic from sale
- COBRA – Communicate with insurance companies
- Other pre-closing considerations:
  - Eligibility for coverage in new employer plan
  - Coordinating deductibles and out of pocket maximums
  - Will changes to the plans be required to cover new employees
  - Transition services issues to bridge short plan-year period

# Beyond the Basic Issues



## Health and welfare plans – Self-insured plan issues

- Self-insured plans create significant potential of liability to buyer
  - Does buyer have a self-insured plan that will cover targets employees
  - Is buyer assuming the obligations of seller's self-insured plan
- Need to review the stop loss coverage carefully and understand its restrictions and structure
- COBRA – Watch for unexpected costs
- Transition services period – MEWA issues

# Beyond the Basic Issues



- Tying up the executive team
  - Determine the value of the executive team to the transaction
  - If management is key to the value of the business, negotiate employment/retention packages
- When negotiating with executive team or conducting due diligence, consider the following tax issues:
  - Section 409A
  - Section 280G

# Beyond the Basic Issues



- Severance agreements
  - Will the transactions trigger severance
  - Stock v. asset deals may have different result
  - Can payments be delayed or modified
- Modifying options
  - May extend exercise period of “in the money” options for original term (not to exceed 10 years from grant date)
  - May extend underwater options
  - Cash-outs and transaction based compensation
  - May substitute options

# Beyond the Basic Issues



- Triggering payment of nonqualified plans
  - Review plan documents to determine if transaction triggers payment
  - Determine if possible to modify the plan so that no “separation from service” occurs in an asset deal
  - Determine if possible to delay vesting on a change in control if arrangement satisfies the requirements of transaction-based compensation
  - Evaluate whether buyer or seller wants to terminate sellers nonqualified plans
  - Look for a rabbi trust that funds the plans and determine if the transaction triggers rights

# Beyond the Basic Issues



- Change in control payments (Section 280G)
  - Payments made in connection with a change in control may be subject to an excise tax if they are “ excess parachute payments”
  - An excess parachute payment is a payment made to a disqualified individual due to change in control, where the amount exceeds 3x average comp for last 5 years (the excess parachute payment is the amount over 1x)
  - Excess parachute payments include the value of accelerated payments and accelerated vesting of equity
  - Excess parachute payments exclude qualified plan payments, reasonable compensation, and payments approved by 75% of shareholders of non-public company



# Indemnification



- Is a remedy for damages resulting from a false representation, a breach of the APA, or other liabilities allocated to one party
- Basics
  - Who is indemnifying whom
  - For what
  - For how long (“survivability period”: typical range of 6-24 months, with 18 months in 44% of deals\*)
  - For how much

\* All statistics are for 2012 deals from the advance copy of the ABA’s 2013 Private Target Mergers & Acquisitions Deal Points Study

# Limitations



- **Basket or deductible (approx. 96% of deals)**
  - “Tipping” or “first dollar” basket : once threshold is hit, liable for all losses (approx. 32% of deals)
  - True deductible: liable for all losses over minimum amount (approx. 59% of deals)
  - Hybrid: once threshold is hit, liable for losses for a certain amount (approx. 5% of deals)
  - Generally less than 1% of deal value (mean deal value of all baskets other than hybrids = about ½%)
  
- **Materiality scrap**
  - Usually either for purposes of the indemnification section or for the sole purpose of determining damages, the representations and warranties are not qualified by any materiality reference (less than a 1/3 of deals with baskets)

# Limitations Continued



- Caps
  - More than 90% of deals had caps (mean value of cap in all deals with determinable caps = 16.6% of the deal value)
  - Negotiated item and depends on seller's negotiating power and buyer's concerns about due diligence discoveries
  
- Also may limit:
  - Consequential, incidental and punitive damages
  - No indemnification to the extent indemnified party reaps a tax benefit from the loss or losses are covered by insurance
  
- Mitigation requirement

# Procedure



- How to notify a party of a claim
- Which party controls third-party litigation
- Ability to participate in third-party litigation
- Ability to settle a third-party claim with or without consent
- Requirement to cooperate or mitigate claims

# Escrow



- Third-party agent holds a portion of the purchase price (nearly 90% of deals)
- Is exclusive remedy for claims in about  $\frac{1}{3}$  of deals
- Term usually matches survival of representations (e.g., 18 months)
- Size depends on buyer's concerns from due diligence – less than 15% of deal value in nearly 95% of deals (mean = 7.83% of deal value)

# Sandbagging



- “Sandbagging” is when buyer:
  - Knows of a breach of a representation or warranty pre-closing;
  - Does not inform seller it has such knowledge; and
  - Brings a claim under the indemnification provision post-closing

# 3 Approaches to Sandbagging



- Anti-sandbagging clause (seller-friendly)
  - “No claim for indemnity for a breach of a particular representation, warranty or covenant shall be made after the Closing if Buyer had Knowledge (including by virtue of any Disclosure Schedule) of such breach as of the Closing.”
- Silence – **MOST COMMON OUTCOME**
  - The state-law default rule will apply to either allow or bar sandbagging.
  - Appears to be undecided in Idaho
  - Delaware takes the “modern” pro-sandbagging approach

## 3 Approaches Continued



- Pro-sandbagging clause (buyer-friendly)
  - “The right to indemnification, reimbursement or other remedy based upon such representations, warranties, covenants and obligations shall not be affected by any investigation (including any environmental investigation or assessment) conducted with respect to, or any Knowledge acquired (or capable of being acquired) at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of or compliance with any such representation, warranty, covenant or obligation.”

# Exclusive Remedy



- While some buyers try to maintain their right to bring other causes of action, most buyers agree to indemnification as the exclusive remedy (nearly 95% of deals)
- Exclusive remedy provisions often exclude:
  - Claims based on fraud, criminal activity or willful misconduct
  - Claims for equitable relief