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Business Law Update

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Mergers & Acquisitions

Recent Developments: Trends in Indemnification and Escrow Protection in Private Acquisition Agreements

By Michael J. Hagan

The indemnification provisions in a merger or stock or asset acquisition agreement, backstopping properly drafted representations, warranties and covenants, provide the most critical protection for a buyer's investment in an acquired entity or assets. As the indemnification provisions play a significant role in allocating risk of loss between a buyer and a seller, they tend to be among the most vigorously negotiated transaction terms after the basic acquisition price. This article summarizes market trends in core indemnification provisions in certain recent private merger or stock or asset acquisition agreements. One key takeaway is that the terms governing escrow funds securing indemnification obligations of sellers merit the most exacting attention. This is particularly so where, as is often the case in the current market, the seller is a private equity fund or other financial investor and there may not exist post-closing a substantial going concern with assets to satisfy indemnification claims of the buyer.

The key provisions in indemnification negotiations include the duration of the indemnification period (referred to as the survival period), the scope of the losses that will be covered, the limitations on liability (including caps and baskets governing the amount recoverable), whether alternative remedies are available and the nature of the collateral securing the indemnification obligations. A review of a number of 2012 disclosed transactions indicates that the range of survival periods runs from 15 months (in an asset sale) to two years, with all survival periods lasting at least through one full audit cycle. Certain fundamental matters, such as stock ownership, title to assets, tax and ERISA matters, and environmental representations run either indefinitely or through the expiration of the applicable statute of limitations. In a number of indemnification instances, specific is procured for targeted exposures, such as pre-closing tax liabilities, known or suspected environmental conditions,

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pending regulatory fines or penalties, or employee liabilities.

Caps and baskets remain a hotly negotiated subject matter. The terms of the surveyed transactions tend to split fairly evenly between deals where the basket is a "tipping basket," meaning the buyer can recover from the first dollar after a claim threshold is met, and where the basket is, in effect, a deductible constituting a cost absorbed by the buyer. Regardless of the basket structure, the recent trend appears to be supportive of very low baskets, most frequently in the range of 0.25 to 0.75 percent of the purchase consideration. Caps tend to be in the range of 10 to 20 percent of the purchase price. Frequently, caps will be tiered, such that there may be a limitation of 10 to 20 percent of the purchase consideration for most claims. However, a higher potential recovery may be provided for fundamental matters such as title to stock (recovery up to the purchase price in most instances) or for specified liabilities such as tax matters or environmental claims.

Understandably, sellers are eager to box in their exposure, and most recent buyers appear willing to agree that the indemnification provisions are the exclusive remedy available in a claim for damages. With thorough representations, warranties and covenants supported by properly drafted indemnification provisions and a satisfactory indemnity cap, the buyer should not be foregoing much, if any, protection by agreeing to restrict its damages claims to those provided in the indemnification provisions. Contractual claims would arguably be duplicative of a claim of breach of a representation, warranty or covenant, and non-contract claims, such as tortious interference post-closing, should also be addressed in the acquisition agreement. Fraud and willful misconduct are generally exceptions to this limitation.

Approximately two-thirds of surveyed 2012 private transactions provide for some collateral. Occasionally, the collateral included a pledge of stock consideration received by the sellers. Of course, this arrangement presents a risk for the acquirer, as the value of the equity of the combined businesses may drop in proportion to the gravity of any indemnification claims secured by that equity. Most often, however, in a transaction involving cash consideration, the collateral consists of a portion of the sale proceeds that are deposited into an escrow account with a third-party financial institution. The range of the escrow amount tends to be approximately 10 to 15 percent of the purchase consideration. In some instances, where the seller will either cease to exist or not have substantial post-closing assets and the indemnification provisions are the exclusive remedy, the escrow amount can range as high as 25 percent of the purchase price. In a number of the transactions surveyed, the escrow arrangements provide for a step-down in the escrow over the term of the escrow period. As a rule, the escrow period is coterminous with the survival period, which, as noted, tends to run between 15 months and two years. However, if a portion of the escrow is earmarked for specific potential liabilities, such as taxes or environmental issues, the escrow period for that amount will generally be coterminous with the applicable statute of limitations.

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In addition, an escrow can serve multiple purposes. The parties will often rely upon an escrow deposit to address any post-closing adjustments that may be necessary as against an interim unaudited closing date balance sheet. Some transactions provide for multiple escrows to address post-closing adjustments, indemnification claims and the costs and expenses of the escrow agent.

Not surprisingly, the buyer and seller will often negotiate extensively regarding the terms governing a call upon the escrow. On this question, the comparative eagerness of one party over the other to complete the transaction and its respective negotiating leverage will frequently come into play. The seller does not want to grant blank check writing authority to the buyer over the escrow. Conversely, the buyer will be loath to have to litigate or arbitrate each effort to draw upon the escrow. It is in the interests of both parties to seek to agree in advance to the extent practicable on the events or conditions that would authorize a draw upon the escrow. In the case of known actual or contingent liabilities, the issue may be more the scope of remediation or cure rather than whether the buyer has recourse to the escrow. To the extent a party may anticipate the likely draws upon an escrow deposit, that party may more accurately price the transaction to meet its requirements.

For more information about private acquisitions, please contact Michael J. Hagan.

Deductibility of Success-Based Transaction Fees Update

By Francesco A. Ferrante

Two recent IRS releases confirmed certain points regarding the deductibility of success-based fees in stock acquisitions for federal income tax purposes. A fuller explanation of the tax issues associated with investment banking fees was distributed by our firm. There are additional requirements associated with the deductibility of investment banking fees beyond what is covered in this article.

In the context of drafting and negotiating investment bankers' engagement letters, consideration should be given to maximizing the amount conditioned on the closing, to the extent possible.

Pre-Closing Nonrefundable Payments to Investment Bankers Not Eligible for Safe Harbor Tax Deduction Treatment

Many investment bankers' engagement letters provide for a fixed fee paid on certain events prior to closing, such as on the signing of a merger agreement or on shareholder approval of the acquisition. The amounts paid on these pre-closing events are not refundable in the event the transaction does not close, and they are treated as a prepayment against the aggregate fee that would otherwise be payable at closing.

Last year the IRS issued Rev. Proc. 2011-29, which provides a safe harbor allowing for the deductibility of 70 percent of the investment banking fees that are contingent on closing. This rule is favorable because it avoids the documentation that would be necessary (under pre-existing regulations) for deductibility based on the investment banker's efforts allocated to periods prior to certain bright-line dates (e.g., letter of intent date) – a difficult task.

Chief Counsel Advice 201234027 concludes that "success-based fees" within the meaning of the Rev. Proc. excludes nonrefundable payments that are not contingent on the successful closing of a transaction. This means that payments due and payable on the signing of a merger document or shareholder approval (rather than on the closing) are not success-based fees within the meaning of the IRS safe-harbor guidance. If a taxpayer has to rely on the bright-line date test, pre-closing investment bankers' fees related to an acquisition are generally more difficult to deduct, rather than capitalize. This is because of the inability to obtain the requisite information from investment bankers (and the challenge with properly documenting the timeline of services rendered) and because the bright-line test might allow only a small portion of such fees to be deductible even if proper documentation can be developed.

An interesting aspect of the IRS release is that pre-closing payments contingent on shareholder approval could, in certain instances, be very close in time to the closing. It is unclear from the release at what point in the timeline shareholder approval was obtained.

Go Shop Provision in Agreement Does Not Delay Bright-Line Date

A second IRS release (CCA201234026) discusses the application of the bright-line date in the situation where the merger agreement contained a "go shop" provision and the favorable Rev. Proc. 2011-29 70 percent safe harbor is not used by the taxpayer. In situations where the parties do not have a letter of intent or an exclusivity agreement, the merger agreement might mark the bright-line date. In that case, the documentation needs to illustrate how much of the success-based fees and related investment bankers' services are allocable to periods prior to such date.

The IRS concludes that though the merger agreement contains a go shop provision, it does not delay the bright-line date. This is consistent with the IRS position that the nonbinding aspect of a letter of intent does not delay the bright-line date. Because a letter of intent is signed early in the acquisition process, the deduction available without regard to Rev. Proc. 2011-29 would be less than 70 percent.

In many instances, the favorable safe harbor of Rev. Proc. 2011-29 provides a better tax result than the application of the bright-line date that has existed in the regulations for eight years. The taxpayer in the recent release might have been striving for a deduction that exceeds 70 percent of the success-based fee under the bright-line test.

For additional information on success-based fees, contact Francesco A. Ferrante.

International

Bribery and Other Suspect Payments in International Transactions

by Paul Allaer

When doing business internationally, U.S. companies are reminded time and again that they need to comply to the fullest with all provisions of the Foreign Corrupt Practices Act (FCPA). At its core, it is illegal under the FCPA to pay or offer bribes to "foreign officials" to get business. A foreign official is anyone in government employ, including at state-owned enterprises. When doing business in countries like China and similar jurisdictions where the state controls a sizeable portion of the economy, U.S. companies are urged to proceed with the greatest caution. (As an additional note, the FCPA also imposes strict recordkeeping requirements, which are outside the scope of this article. Contact us for more information.)

Enforcement of the FCPA has increased significantly since 2009, when the Obama administration took office. Given the potential for sizeable penalties, U.S. companies must continue to give proper attention to full compliance with the act.

However, it is equally important to understand what the FCPA does not cover, but which may be covered by other laws. The FCPA does not address dealings with "non-officials," i.e., dealings with private third parties. In discussions with clients, I term those private third party dealings as "suspect payments." Here are a couple of examples:

- A U.S. manufacturer works with a sales agent in China to expand its market opportunities. At some point, the Chinese sales agent requests that his commission be paid into a bank account in Hong Kong.

- The Thai subsidiary of a U.S. manufacturer is about to land a sizeable order from a customer in Thailand. Before the purchase order is signed, the procurement director of the Thai customer requests that 5 percent of the purchase order be paid into his bank account.

As neither of the above scenarios is covered under the FCPA, the question is whether there would be any violation under applicable local law (in the first instance, Chinese law; in the second instance, Thai law). In particular, the second scenario, commonly referred to as a "kickback," is a situation regularly encountered by U.S. companies involved in international transactions.

Let us examine this in further detail using the following hypothetical: Does the fact that a portion of the purchase price paid by a foreign customer was redirected to one or more of the customer's employees (in the form of money or a gift) constitute a violation of local law? The answer depends on the country. If we apply the laws in Thailand, South Korea or China, we see the following results:

- South Korea: It is illegal, whether the customer is a private party or a government-owned or -controlled entity, but penalties are higher when public officials are involved.

- Thailand: It is illegal if the customer is a government-owned or -controlled entity, except if (i) the amount is below THB 3,000 (approximately US$100) or (ii) the amount is paid to the state agency itself. But such payment is legal if the customer is a non-government-owned or - controlled entity, except if it is paid to a "person responsible for the business operation of a company."

- China: It is legal, whether or not the customer is a government-owned or - controlled entity, assuming (i) the purpose of the payment is "proper," and (ii) the amount of the payment is "reasonable."

In other words: three countries, three different outcomes.

How can U.S. companies doing business globally navigate this issue when the laws vary widely from country to country? There are two basic options to consider:

1) Comply with all applicable laws on a country-by-country basis; or

2) Develop one set of standards that meets the requirements of all countries with which the company many have dealings.

From a risk mitigation perspective, it may be preferable to develop a global standard that is promulgated throughout the organization and from which exceptions would require particular scrutiny. However, there is no "right" or "wrong" solution here. The main thing is that companies give proper consideration to these issues, make a decision and implement it throughout the organization.

A more detailed panel discussion on these issues will take place in Washington, D.C. on October 11 at the American University's International Legal Studies Conference, during which practitioners from the United States, China, the UK, Brazil, Russia, Vietnam and Mexico will provide an overview of their respective regulatory environments and how companies doing business internationally can cope from a practical perspective. For more information, please visit http://www.wcl.american.edu/ilsp/anniversary/.

For more information about the FCPA and related issues, contact Paul Allaer.

Securities

New SEC Disclosure Requirements for Use of "Conflict Minerals" and for Government Payments

By James A. Losey, Matthew R. Nicely and Frank D. Chaiken

On August 22, 2012, the Securities and Exchange Commission (SEC) approved two final rules imposing new disclosure requirements on publicly-traded companies that use "conflict minerals," or are involved in the commercial development of oil, natural gas or minerals and making payments to governments. The first rule requires publicly-traded companies to disclose certain conflict minerals or derivatives used in their production processes. These disclosure requirements could affect a broad spectrum of companies and numerous product markets: e.g., consumer electronics, medical equipment, high-speed tools, machine parts, glass and lamps. The second rule requires disclosure by oil, gas, and minerals companies of certain payments to non-U.S. governments or to the U.S. federal government.

Both reporting requirements were established under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in July 2010 but did not take effect until the SEC finished its rulemaking process. The SEC estimates that thousands of companies will be subject to the disclosure requirements. Further, the SEC estimates that the conflict minerals rule will impose $3-4 billion in compliance costs on companies, and that the rule requiring disclosure of government payments will impose upwards of $1 billion dollars in compliance costs.

Conflict Minerals Rule

1. Companies subject to or affected by the reporting requirements

Under the SEC's final rule, the reporting requirements apply to companies using so-called conflict minerals, i.e., columbite-tantalite, cassiterite, gold, wolframite or their derivatives in products or their production process. Cassiterite is commonly used in producing tin, such as for joining pipes and electronic circuits. Columbite-tantalite is the ore from which tantalum is extracted. Tantalum is commonly used in electronic components, computers, videogame consoles, digital cameras, carbide tools and jet engine components. Gold is also commonly used in electronic, communications and aerospace equipment. Wolframite is the ore used to produce tungsten, which is used in metal wires, electrodes, and in lighting, electronic, electrical, heating and welding applications.

The reporting requirement only applies for publicly-traded companies using minerals that are "necessary to the functionality or production of a product manufactured by such person." Dodd-Frank stipulated that the reporting requirements also applied to entities contracting for the manufacture of products using the listed conflicts minerals. However, the final rule clarifies that companies will not be required to disclose the use of such minerals if they do not exercise influence over the manufacturing of an item. Thus, companies that, for example, merely affix their brand to a manufactured item, or repair a product manufactured by a third party are not subject to the disclosure requirements.

Many companies that are not subject to the disclosure requirements will, nonetheless, be affected by the final rule. For example, any upstream supplier of a publicly traded company using minerals in its production process will likely be called upon to document the country or origin and chain of custody of the minerals. In short, entire supply chains for the listed minerals, including the non-U.S. companies in those supply chains, will be affected by the final rule.

2. Due diligence to ascertain the origin of the conflict minerals

Under the final rule, companies subject to the reporting requirements must conduct a "reasonable country of origin inquiry" to determine whether the minerals it uses are from the DRC or surrounding countries (i.e., Angola, Burundi, Central African Republic, Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda and Zambia) (DRC countries). The final rule declines to define what constitutes a reasonable country-of-origin inquiry, other than to say that the inquiry must be in good faith and be reasonably designed to determine whether any of the minerals originated from DRC countries. The final rule clarifies, however, that scrap or recycled minerals are deemed to be conflict-free minerals.

If a company knows its minerals are not originating from DRC countries or has no reason to believe its minerals may have originated from DRC countries, the inquiry is over.

Similarly, if a company knows its minerals are from scrap or recycled sources, or has no reason to believe the minerals may not be from scrap or recycled sources, the inquiry is over. If, however, a company knows or has reason to believe it obtains minerals from DRC countries, and the

company knows or has reason to believe its minerals are not from scrap or recycled sources, the company must prepare a more detailed Conflict Minerals Report.

3. Public disclosure of findings and conflict minerals reports

If a company determines that either it obtains minerals from a non-DRC country or that its minerals are from scrap or recycled sources, the company must only disclose this finding in the new "Form SD." This form requires a brief description of the company's due diligence efforts and the results of those efforts. In addition, the company must make its findings available on its website.

If, however, a company determines that its minerals are from DRC countries (and not scrap or recycled), the company must prepare a "Conflict Minerals Report." This report must declare the minerals are one of the following: "DRC Conflict Free," "Not Been Found to Be DRC Conflict Free," or "DRC Conflict Undeterminable." Companies are permitted to declare minerals as "DRC Conflict Undeterminable" for the initial period of two years (or four years for smaller reporting companies). In preparing the Conflict Minerals Report, a company must show that it used nationally or internationally recognized due diligence measures to determine the source of its minerals. In addition, companies declaring that the minerals are "DRC Conflict Free" must obtain an independent private sector audit of their Conflict Minerals Report.

The first disclosures under the conflict minerals rule are due by May 31, 2014, for calendar year of 2013.

4. Timing for filing disclosure

The first disclosures under the conflict minerals rule are due by May 31, 2014, for calendar year of 2013.

Disclosure of Payments to Governments

1. Companies subject to reporting requirement

The SEC also approved last week a final rule requiring publicly-traded companies involved in the oil, natural gas, or minerals sectors to disclose certain payments made by the company, or entities controlled by the company (e.g., a subsidiary) to non-U.S. governments or the U.S. federal government. This requirement applies to all companies required to file an annual report with the SEC and which are involved in the commercial development of oil, natural gas or minerals. The term "commercial development of oil, natural gas or minerals" includes exploration, extraction, processing, export and other significant actions relating to oil, natural gas or minerals or licensing associated with those activities.

2. Types of payments covered

Many kinds of payments to the government must be reported, including taxes, royalties, fees, production entitlements, bonuses, dividends and infrastructure improvements. Payments that are *de minimis* – which the final rule defines as payments (whether single payments, or a series of related payments) that do not equal or exceed $100,000 – do not need to be reported. If a payment is subject to the reporting requirements, companies must disclose, among other details, the amount of the payment, the recipient and for which project the payment was made.

3. Timing for filing disclosure report

The disclosure is required to be filed within 150 days after the end of a company's fiscal year. The new rules begin to apply for any fiscal year ending after September 30, 2013 (i.e., a company whose fiscal year ends October 31 would be required to prepare a report disclosing payments made from November 1, 2012 through October 31, 2013).

For more information about conflict minerals issues, contact James A. Losey, Matthew R. Nicely or Frank D. Chaiken.

Industry Spotlight – Transportation

A Sole-Purpose LLC – No Place for Corporate Aircraft

By Patricia N. Snyder, Brent Connor and Charles A. Hunnicutt

Your client calls to say she is buying a plane to use in her business and for vacation trips to the Caribbean. She wants your help in negotiating the contract and closing the deal. Considering the potential for liability, you are thinking of setting up a separate sole-purpose LLC to own and operate the aircraft.

Tread carefully. This is a complex regulatory area where the rules can be counterintuitive and mutually inconsistent.

A company whose sole business is to operate an aircraft can easily run afoul of FAA rules, because it can be found to be in the business of providing air transportation for compensation – just like an airline. No profit motive is required.

And, just like airlines, a company that provides air transportation for compensation is subject to extensive safety, security and economic regulation.

Without careful planning, the use of a sole-purpose LLC could inadvertently expose your client to violations of FAA rules. Worse, her insurer might deny claims if she is operating in violation of federal safety laws. There also could be a claim by the Internal Revenue Service for uncollected passenger taxes that apply to commercial air transportation, plus interest and penalties.

We help clients plan for safe and legal operations, exploring regulatory exceptions and other practical workarounds that may be available, after carefully considering each client's needs. We have helped companies plan for aircraft operations that comply with FAA and tax rules and preserve the integrity of their insurance coverage.

For additional information about sole-purpose LLCs, contact Patricia N. Snyder, Brent Connor or Charles A. Hunnicutt.