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APPENDIX "A" TO THE STRATEGIC ROLE OF THE CFO IN M&A TRANSACTIONS

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LIMITING THE EFFECT OF REPRESENTATIONS, WARRANTIES AND INDEMNITIES – "LUDMER'S TOP 25"

Here's a list of the "Top 25" ways to limit exposure on representations and warranties when you are selling a business. It will be rare to win all of these battles in a single deal (in fact they represent a compilation of "best practices" from many deals). Try to suggest alternative language which should meet the basic objectives of the purchaser, rather than merely identifying problems with the purchaser's draft agreement and attempting to rely on superior bargaining power.

1. Do a very thorough job on the disclosure schedules (which, in effect, are qualifications to the representations), including interviews with senior officers and mid-level employees of the vendor and the vendor's professional advisors (be sure to include officers and senior employees of subsidiary companies and foreign professional advisors to the company and its subsidiaries). Consider bargaining for the ability to update or improve schedules during the period between execution of the definitive agreement and the closing, with limited recourse. See comments in paragraph 5 below regarding the questionable loyalty of the seller's employees.

    - Canvass the views of the seller's third party advisors such as insurance brokers, IP, pension and labour counsel and the external accountants. Typical corporate, governmental and litigation searches should be completed by the seller against itself and its affiliates.

    - Search for unregistered encumbrances such as PMSI clauses contained in standard-form purchase agreements.

    - Include on the litigation disclosure schedule the list of litigation being defended by the seller's insurers. Note that, since policies often provide defence cost coverage which is broader than liability coverage, the fact that a particular matter is being defended by the insurers does not mean that there will be full coverage (i.e. deductibles/co-insurance requirements/exclusions - e.g. gross negligence, drunk driving, environmental).

    - Read all material contracts.

- Note that where a seller refuses on ethical grounds to make a representation and warranty because of lack of knowledge of the matter, it is typically still asked to indemnify the purchaser with respect to the particular matter and the comments below regarding limiting the effect of indemnities would still be applicable. Attempt to identify as early as possible in the negotiation process which disclosures the purchaser will insist on being indemnified for, as there may be an opportunity to mitigate the exposure under the indemnity given enough time and the opportunity to re-negotiate third party arrangements prior to the announcement of the transaction.

2. Obtain a general exclusion for matters in respect of which an accrual, reserve or contingency is reflected on the existing financial statements of the seller or in respect of which the purchaser is given a credit as part of the post-closing audit and purchase price adjustment process. In addition, the financial statements representation should merely track the language of the auditors' report (to go further and state that they are "true and correct" imposes a full prior-period indemnity on the seller). For accounts receivable, state that while the reserve was established in accordance with GAAP, "no representation is made that the net book value of the accounts receivable will be collected subsequent to closing". Particularly in deals where the pricing is not related to interim financial statements, ensure that the interim financial statement representation is very "soft".

3. Obtain an exclusion for matters otherwise disclosed under the agreement or in the schedules, even though it was omitted for a particular representation and warranty. Purchasers will want to ensure that the language of the exclusion requires that the particular problem or exposure is listed in the Schedules, rather than risk that a mere reference to a type of asset or activity would foreclose all remedies that have any relation thereto in any context.

4. Obtain a general exclusion for matters which the purchaser ought reasonably to have been aware of, based on disclosures in the course of the due diligence process (in respect of which there should be a detailed record). Failing that, obtain a representation by the purchaser that it is not aware of any breaches of the seller's representations as a result of its due diligence. Note that as a result of extensive due diligence and divided loyalties of employees of the acquired company (a typical purchaser strategy during the due diligence process is to attempt to co-opt the seller's employees), at some point in the transaction the purchaser will know more about the target than the vendor, particularly if the target is an independently-managed subsidiary of a foreign parent. The purchaser's confirmation that it is not aware of any breaches should, in a deal with an interim period, be reconfirmed on closing (i.e. the purchaser can't close and sue on breaches known at closing). Purchasers will insist on retaining the ability to refuse to close and sue for their expenses.

   - In particular, have the purchaser "buy-in" to the accounting discretion exercised by the seller in finalizing its financial statements (through the release of auditors' working papers and conferences between the external accountants for the company and the purchaser). All of these matters should then be scheduled to the agreement and the purchaser deemed to have accepted them.

- The treatment of potential exposure for tax reassessments that have been fully disclosed to the purchaser over the course of due diligence should vary slightly for the benefit of the purchaser. The parties should settle on the wording of the areas of tax exposure and counsel should deliver privileged communications to their respective clients as to what has been disclosed and deemed to be accepted by the purchaser.

- For transactions where the purchaser is already familiar with the company (such as one shareholder buying out another), extend the "deemed knowledge" of the purchaser to: (i) matters reflected in the minutes of directors meetings which the purchaser's representatives would have been entitled to attend; (ii) matters conducted at the request of the purchaser; and (iii) communications between the company's advisors and the purchaser.

5. Limit statements to the "actual knowledge" of the seller (particularly where there are references to "pending or threatened" matters). As to potential legal proceedings, awareness should be limited to proceedings which might "reasonably" be commenced. Consider defining "knowledge" as being that of certain specified officers and employees of the seller and, possibly, of the parent company. State whether a review of all the books and records of the company is required (i.e. whether matters reflected in the books and records are deemed to be within the knowledge of the particular employees). Confirm that no enquiries need be made with governmental authorities or outside professional advisors as to their knowledge. The employees assisting in the transaction may shortly thereafter become employees of the purchaser. Accordingly their allegiance is sometimes in doubt. To buttress the definition of "actual knowledge" referred to above, attempt to obtain a certificate from such employees that they have reviewed the representations, warranties and schedules and are satisfied with the accuracy thereof. For the same reason, representatives of the parent of the seller (or counsel) should sit-in on all due diligence meetings between employees of the business being sold and representatives of the purchaser. Purchasers may request the addition of "after due enquiry" for specific representations.

6. Try to use "fabric softeners" such as: (i) "[... in aggregate] materially and adversely in relation to the Company and its Subsidiaries taken as a whole" (for example, to be used in the "absence of changes since ..." representation). A purchaser may wish to define "materially" (often 5-10% of the deal); and (ii) "reasonable" or "reasonably".

7. The survival clause – representations, warranties and indemnities are typically limited to claims made within 2-3 years after closing.

   - In particular, where a matter such as environmental exposure or intellectual property exposure could be settled by an allocation of risk tied to further investigations which could not be completed prior to closing, provide that the particular representations and warranties expire at the conclusion of a reasonable period which would allow for Phase 2 environmental testing or a world-wide patent search, as examples. Any matters which would come to the attention of the purchaser after the period for the specified testing or searching would not be allowed. Negotiation would therefore have to take place with regard to the scope of the post-closing investigations and who would be responsible for the cost. Negotiation will also take place as to whether there is ongoing responsibility for matters not necessarily obtainable from the search. Responsibility of the vendor should be limited to remediation of the proposed problem and should not extend to lost profit or opportunities on the part of the purchaser.

   - For taxes this is typically 60 days after the last day on which a tax assessment for the prior period could be rendered (with an exception if there has been fraud or fraudulent misrepresentation in the preparation of federal/provincial/local tax returns or in any information given to governmental authorities under taxation legislation) .

   - Matters in respect of which "fraud" can be proven often go on for whatever period is allowed in the *Limitations Act* (Ontario) (arguably even if there is no explicit statement on the point). Avoid using the term "fraudulent misrepresentation", as this involves the concept of "recklessness" (rather than wilful omission) and therefore creates much uncertainty.

   - Certain "fundamental" representations should <u>not</u> be time-limited (e.g. title to shares and assets -which can be found within various representations- and matters pertaining to the tax structure of the transaction).

8. Set a cap for the indemnities in the aggregate and sub-caps for particular indemnities. Consider sharing the risk (i.e. a 50/50 split of future claims over the *de minimus*) either globally or as a means of settling specific representations (this is a good response to the typical purchaser's argument concerning "risk allocation"). The limits could also decline with the passage of time. Similarly, if the purchaser has contracted for an escrow of funds to serve as security for the vendor's representations, funds could be released in stages and the vendor could suggest that the indemnities be limited to the escrow fund. There should, at a minimum, be a cap limited to the cash portion of the purchase price, which could rise as payments of principal on the balance of sale ("VTB") are made (i.e. exclude outstanding VTB and exclude non-cash consideration).

9. Where there is more than one vendor, make the obligations several (on a proportionate basis) rather than joint and several.

10. Establish a *de minimus* level before which no claims can be made (this can be in the aggregate and a sub-limit per claim). This is often 1-2% of the purchase price and is called the "basket clause". Consider asking for the *de minimus* amount to be "free" - i.e. only the amount of claims in excess of the *de minimus* amount can be claimed (rather than a claim for all damages once aggregate claims exceed the *de minimus*). There can be separate *de minimus* amounts for various matters (e.g. all prior period taxes are typically for the account of the seller and basket clauses should exclude representations limited to knowledge). Note that, unless this is made explicit, separate specific indemnities will not benefit from the *de minimus* clause (which typically refers only to breaches of representations). The clause should not apply to covenants (i.e. covenants relating to assumed contracts, the balance of the purchase price, accounts receivable re-purchase obligations, etc.). *De minimus* clauses will often not apply to representations as to "knowledge" or which are otherwise heavily qualified, as a matter of principle.

11. Pay attention to the drafting of the indemnity clause.

    - Indemnities should only be on an "after tax basis", as the problem may be deductible to the purchaser (note that this works both ways, as indemnity clauses are now typically grossed-up for the tax which the purchaser or company would have to pay upon receipt of the indemnification payment - GST , QST and HST applies here as well). Consider fixing a deemed tax rate for these purposes, as the tax status (i.e. profit/loss position) of the purchased company could change as a result of the subsequent operation of the business by the purchaser. If substantial tax losses are being left behind (including those generated by the transaction) try to get the ability to shelter any tax reassessments from the past against such losses (note that only non-capital <u>business</u> (as opposed to property) losses will survive a change of control and certain taxes (e.g. Part XIII withholding taxes, property taxes, GST and sales taxes etc.) can't be offset against such loss carry-forwards). No indemnification for taxes should be made to the extent that the increased tax burden was reserved for on the closing financial statements. Further, the net value of any benefit that results, directly or indirectly, from the post-closing assessment should reduce the amount of the indemnity obligation (for example, should a deduction be denied in one year, but permitted in another year through capital cost allowance or otherwise, then the net present value of the future deduction should be credited against the seller's indemnity obligation). The seller should have control of the settlement process with the taxation authorities for those periods for which it is responsible (see discussion below) and should be entitled to any future refunds accruing to the purchaser/purchased company if assessments for those periods are successfully defended in future.

- As indicated in the immediately preceding point, consider the income tax consequences applicable to the indemnification payment itself (as well as GST, QST and HST issues). A seller will want to specify that any such payment is deemed to constitute a deductible type of payment and the purchaser will want the payment characterised as a reduction of the purchase price *ab initio,* with the parties obligated to re-file tax returns, etc. Sellers will often be agreeable as this will at least reduce the proceeds of sale for tax purposes.

- Consider establishing a definition of "Loss", which would serve to limit exposure with regard to professional fees ("reasonable"), consequential economic loss (scope of foreseeable losses) and confirm that no indemnification will be made for lost profit or other opportunities as a result of the problem which is being remedied. This latter point is particularly important, for example, if a problem arises concerning the purchased intellectual property which results in lost sales or if a purchaser refuses to close as a result of a failure of a condition (e.g. representations/covenants).

- Where applicable, limit the extent of indemnities to the portion of the company not already owned by the purchaser (i.e. if a 30% shareholder which has been relatively passively involved in the company is buying out the 70% holder which had actually been running it, only 70% of losses should be indemnified for, since the purchaser had already been exposed to losses as to its 30% interest in the company). Similarly, limit indemnification to the portion of the purchase price not represented by remaining VTB payments (see discussion in paragraph 8).

- Indemnification from the seller should be considered a remedy of the last resort. The purchaser should be obligated to continue to maintain appropriate insurance and to claim against company insurance policies if the matter is otherwise insurable. The purchaser should also be required to exercise other remedies that might be available (such as claiming over against a third party that might have supplied components for the products of the company that was purchased) before seeking recourse from the seller under the representations and warranties.

- In addition, the indemnifying party should be subrogated to any rights of the purchaser or the company being purchased to pursue an insurance company or third party for compensation, in the event that the purchaser was not able to recover from them.

- Try to avoid full prior period indemnities. Argue that the business is being sold "as a going concern" and all businesses have a few "warts". This is essentially an argument of risk allocation for contingent liabilities (known and unknown).

- Provide that the purchase agreement cannot be assigned without consent (which can be arbitrarily withheld). The purchaser should not be able to "flip" the acquired company and pass the seller's exposure on to a third party. Purchasers will argue that they bought and paid for the representation and warranty pattern and what they do with it is their business.

- Provide for seller control of third party disputes (particularly tax - possibly even control of the preparation of the terminal tax return) and for the purchaser's indemnity to be reduced (to the extent of consequential increased cost) if, through its fault, the seller does not receive notice of any potential claim for indemnification in time to effectively contest the determination of any liability susceptible of being contested.

- Provide for sufficient co-operation and record maintenance for the seller to properly assert defences to third party (including tax) claims. Purchasers will ask to be reimbursed for related expenses.

- Carefully consider advisability of arbitration procedures and local jurisdiction for dispute settlement.

- Purchasers will want to provide for the indemnity to be grossed-up for applicable GST/HST/QST.

- Carefully review the indemnity obligations against the negotiated qualifications to the representation and warranty pattern and verify whether the business deal is appropriately reflected in the indemnity pattern. For example, a full prior-period contract or environmental indemnity (the effect of which is to supersede any qualifications in the related representation and warranty pattern) might not be appropriate if the purchase price was reflective of the risks involved. Note, however, that purchasers will often demand specific indemnities where the seller has qualified representations to its knowledge (see discussion at paragraph 1).

12. Where real estate is involved, representations should be limited to that typical for stand-alone real estate transactions (i.e. title is not warranted - though a statement of beneficial ownership of whatever title a nominee subsidiary holds is often given). Watch for references to real estate terminology in the definition of "Encumbrance", which might create confusion if the intent is not to speak to title. Only negative comfort should be given, in the form of qualifications such as "to the actual knowledge of ...". Be careful about any other representation concerning "property" and "conduct of the business", as these can be construed as relating to real property (see paragraph 13). Don't represent that "leases" exist if a particular location is being operated under an "offer to lease", as the purchaser might subsequently assert a right of indemnity concerning lease negotiation costs. Be clear as to whether representations are being given re status as owner, lessor,

lessee, sublessor or sublessee. Avoid representing status regarding municipal by-laws and compliance with leases in relation to actions of the tenants or subtenants. Try to qualify disclosure regarding repair and maintenance work by some standard of materiality, as day-to-day work (including municipal work orders) is common.

13. Make sure that exposure is not created under "general" representations, notwithstanding the highly negotiated disclosure under more specific representations.

- Watch for representations as to compliance with laws and governmental requirements generally, as exceptions will have to be created for the more specifically negotiated clauses concerning particular legal aspects (such as real estate, pensions, licensing, etc.). Further, a materiality qualification is warranted.

- Similarly, representations as to the status of "property" should be restricted to <u>tangible</u> property and not IP. Representations as to "marketable" ownership of property used in the business must be qualified by: (i) references to real property leases and equipment leases (even if there is no PPSA registration); (ii) the terms of licenses themselves (in the case of licensed IP); (iii) restrictions on assignment or loss of certain rights on assignment contained in leases and contracts; and (iv) exceptions to real estate title.

- Where applicable, the seller should argue that the transaction primarily relates to the acquisition of specific assets rather than an ongoing business (or that the purchaser intends to fundamentally transform the business) and that, therefore, representations concerning the seller and the seller's business can be avoided.

14. Give consideration to qualifications for specific assets or operations:

- In addition, title to assets should be qualified by a standard list of "permitted encumbrances" (such as common law and statutory liens). Special exceptions are required for title to real estate, leases and IP.

- Statements as to assignability of contracts and intellectual property often raise concerns.

- Equipment can be purchased on an "as is/where is" basis or "having regard to its age and normal wear and tear excepted".

- Inventories always contain some obsolescent or damaged goods and are subject to significant valuation issues which should be addressed.

- The purchaser should be asked to rely on the manufacturer's warranty. Include a waiver of express and implied warranties and conditions under the *Sale of Goods Act* (Ontario) and similar legislation.

- If assets or operations relate to foreign jurisdictions, obtain appropriate advice from local counsel (note that even certain terminology must be reviewed, such as the addition of "legal hypothec" as a type of "Encumbrance").

- Consider exclusions for assets not "used for the conduct of the Business" (i.e. redundant or discontinued assets).

15. Restrict the definition of "Contracts" that have to be specifically disclosed by establishing a threshold tied to the remaining contract term or the ability to terminate a Contract on notice or based on a dollar threshold. (Note that the concept of "assumed contracts" in an asset transaction should be left as broad as possible so that the purchaser assumes all of the on-going obligations of the business, even if not specifically identified). Be very careful with representations as to the status of Contracts. There are always some defaults and therefore a materiality threshold is warranted. A representation that there is currently no default is effectively a broad "prior period indemnity", which may not be appropriate in the circumstances. Sellers should attempt to exclude ordinary course omissions, deficiencies and over-due payments where formal written demand has not been made. Compromise language is as follows:

> "The Corporation has not received formal written notice pursuant to its material Contracts that the other party or parties thereto intend to exercise their rights to cancel such material Contracts or commence legal proceedings, in each case as a result of default or alleged default of the Corporation thereunder. The Corporation has not received formal written notice pursuant to its material Contracts pursuant to which the other party or parties thereto which are account debtors of the Corporation demand repayment of monies already received by the Corporation pursuant to such material Contracts or indicate an indication to offset against future payments due by such account debtors claims in respect of a default or alleged default of the Corporation thereunder."

16. "In the ordinary course of business". There is some jurisprudence concerning this phrase. (Sometimes purchasers will wish to reduce the effect of this phrase by adding "consistent with past practices and not individually or collectively materially adverse").

17. "In the seller's opinion" (particularly re: representations containing subjective elements, such as: (i) future prospects or possible future problems; (ii) "adequacy" of property, facilities, insurance, etc.; (iii) materiality; (iv) whether conditions imposed on licenses, etc. are unduly burdensome; (v) that the purchased assets constitute all property "useful" to the business "as presently contemplated to be conducted"; and (vi) relationships with customers and suppliers and whether there has been any "intimation" of a change).

18. The "Just Say No" defence or "Satisfy Yourself" (which can be used, for example, in response to a request for summaries of leases, insurance and other contracts to be scheduled, a statement that the company holds all permits, registrations and licenses necessary to carry on its business and that no governmental consent is needed to complete the transaction and in connection with statements concerning the future, general economic conditions or pending changes to laws regulating the industry). This can also be justified in situations where the price reflects a distress sale and is typical in certain situations such as a purchase from a receiver.

19. Crystallize unwritten understandings with customers and suppliers regarding rebates, pricing and volumes. Crystallize unwritten understandings with employees as to bonuses and other entitlements.

20. If there is an "interim period", consider specifying particular representations the breach of which can only give rise to a claim for damages and which should not be a basis of avoiding a transaction.

21. The concept of "in good standing" may not have any meaning in specialized areas of law (such as pensions and intellectual property).

22. Intellectual property representations and indemnities require specialized expertise and should be limited to third party rights in the particular jurisdiction, not world-wide. Similarly, tax, real estate, labour and environmental representations and indemnities require specialized expertise.

23. Purchasers sometimes ask for a general representation which would have the effect of making all of the specific representations and warranties redundant. There are typically two aspects to the clause. One would indicate that all of the representations and warranties do not "omit to state any fact necessary to make the statements therein not misleading". The other would state that other than as disclosed there are no other facts known to the seller which should be disclosed in order to make any of the representations not misleading or which would otherwise be material to the purchaser in evaluating the purchased business. These should be absolutely resisted as they increase the potential for disputes in future and provide an easy mechanism for a purchaser to off-set deferred payments. The purchaser should be asked to craft additional specific representations and warranties concerning matters important to it. This should not be a burden imposed on the seller.

24. "except for such consents, licenses, approvals as have been obtained or the lack of which do not, in the aggregate, materially impact the business of the Company" – use this language in relation to disclosure of required permits and consents. Purchasers will often want to add: "...been obtained irrevocably and unconditionally (or subject to disclosed

conditions, restrictions and undertakings which the purchaser judges to be not materially adverse in the aggregate or impractical).

25. "which have not been satisfied, remedied, etc. in all material respects" - use this language in relation to disclosure of past environmental or other breaches of law and past judgments, as this reduces the disclosure obligation.