SEYFARTH SHAW

Middle-Market M&A SurveyBook

2019 Survey of Key M&A Deal Terms

Introduction

Seyfarth Shaw LLP is pleased to present the 6th edition of its Middle-Market M&A SurveyBook ("Survey") which analyzes key transaction terms from more than 160 middle-market private target acquisition agreements signed in 2018.[1] The information presented is intended to serve as a guide to buyers, sellers and deal professionals on "what's market" when negotiating these terms in private target acquisition agreements in 2019.

The Survey focuses on key deal terms, including those comprising the "indemnity package" included in almost all private target acquisition agreements to address a seller's potential post-closing liability to a buyer and to set the parameters of a buyer's ability to claw back purchase price from a seller. Each deal, of course, has unique facts and circumstances that affect the negotiation of the acquisition agreement, including, significantly, the relative leverage of the buyer and seller. It is nonetheless helpful when negotiating an acquisition agreement to have a strong understanding of where the terms of your "indemnity package" fall in the current market spectrum.

Given the substantial and continued growth in the use of representation and warranty ("R&W") insurance in private middle-market M&A transactions, in this year's Survey we have tracked data from deals that included R&W insurance separately from deals where no R&W insurance was utilized. More than 40% of the transactions reviewed for the Survey included R&W insurance, representing an increase of greater than 10% from 2017. Buyers increasingly use R&W insurance in acquisition proposals to make their bids more competitive and attractive to sellers. Not surprisingly, the terms of the typical indemnity package differ substantially between transactions in which R&W insurance is utilized and non-R&W insurance deals. For example, the indemnity escrow amount and indemnity cap size are typically drastically lower in transactions using R&W insurance as compared to transactions that do not use such insurance. In 2018, we also saw a growing number of "no survival" private target acquisitions, in which the buyer's only recourse for breaches of representations and warranties was to the R&W insurance policy, or to an escrow related to the amount of the policy deductible, and then to the R&W insurance policy.

This year's Survey also considers the number of private target acquisition agreements that included "fraud" exceptions to certain limitations on buyers' indemnification rights and remedies, such as caps and baskets, and whether and how "fraud" was defined across those transactions. Furthermore, it reviews the governing law chosen by the parties to the 2018 private target acquisition agreements surveyed. As an additional reference tool for deal makers, we have included a summary of important distinctions between Delaware and New York law on several key issues commonly addressed in private target acquisition agreements.

Overall, general market sentiment indicates that 2019 will be another very active year for M&A deals, and the data analyzed for the Survey suggests that the private target middle-market M&A environment will likely continue its seller-friendly trend. While tariffs and trade tensions, rising interest rates, and regulatory uncertainties (e.g., Brexit, antitrust and foreign investment regulations, etc.) are likely to deter some M&A activity this year, deployable capital, or "dry

powder," remains at record-high levels on the balance sheets of private equity funds and strategic acquirers.[2] Private equity funds also continue to maintain healthy fundraising trends, with the average middle-market buyout fund size growing and approaching $1 billion in 2018.[3] In addition to strategic acquirers and private equity firms, an increasing number of sovereign wealth funds, pension funds, and family offices with additional available capital are competing for a limited supply of attractive targets in the M&A market, continuing the upward trend of transaction multiples to sustained high levels.[4] A desire to expand geographically, diversify products and services, enhance technological capabilities, and acquire talent ("acqui-hiring") in a contracted labor market are among the most frequently cited strategic drivers of M&A activity forecasted for 2019.[5] We expect "add-on" acquisition activity to comprise a high percentage of middle-market deal value in 2019 as private equity-backed platforms continue to grow their businesses and improve fund performance through add-on investments.[6]

We hope that you find the information presented in this Survey valuable. If you would like more information regarding the data presented, we welcome the opportunity to further discuss our findings with you.

What's Inside:

[1] For purposes of this Survey, "middle-market" means transactions with a purchase price of less than $1 billion, and "purchase price" means the total cash consideration paid by the buyer in a transaction but does not include contingent purchase price payments (e.g., earnouts). This Survey does not include any transactions that involved the payment of consideration other than cash.

[2] Deals Year-End Review and 2019 Outlook, PWC.

[3] Pitchbook 2018 Annual US PE Middle Market Report.

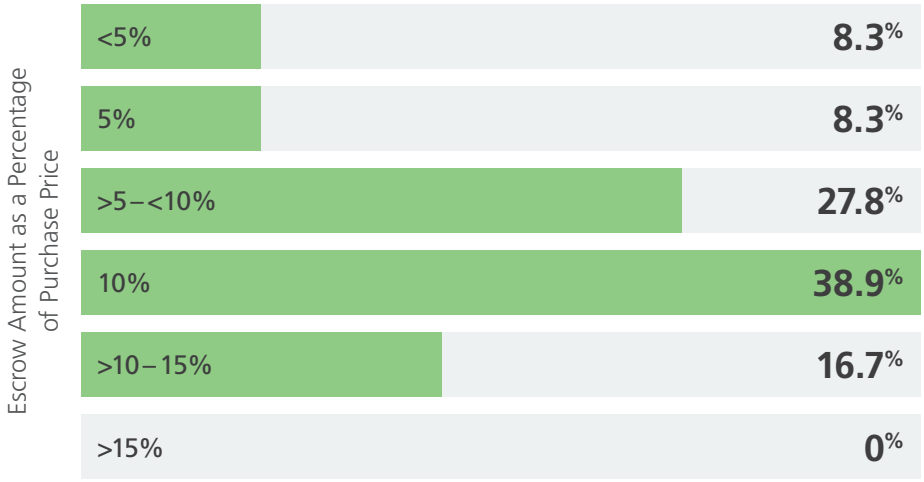
[4] Quarton International North American Middle Market M&A Update - Fourth Quarter 2018.

[5] The State of the Deal: M&A Trends 2019, Deloitte.

[6] See third note above.

Indemnity Escrow Amount

NO R&W INSURANCE



Percentage of Deals Surveyed Providing for Indemnity Escrow

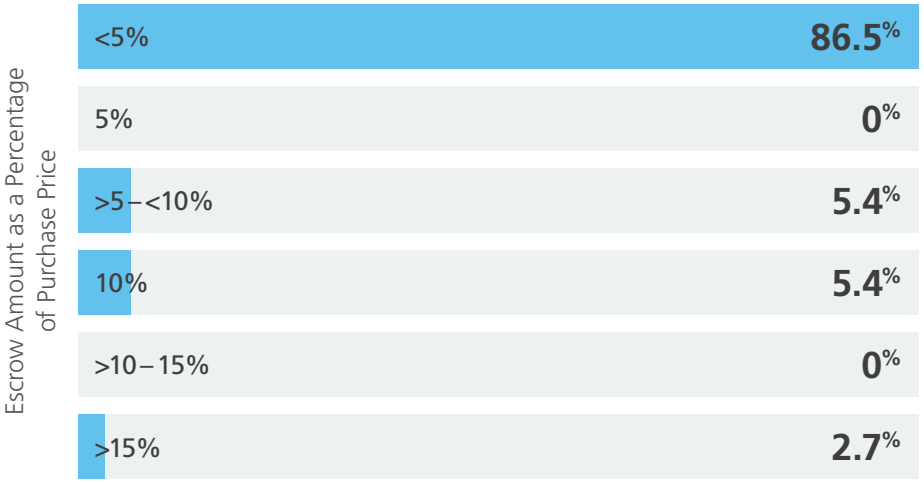
OBSERVATIONS

- Approximately 37.5% of the non-insured deals surveyed provided for an indemnity escrow.
- The median escrow amount in 2018 for the non-insured deals surveyed was approximately 10% of the purchase price, with approximately 83% of the non-insured deals having an indemnity escrow amount of 10% or less, but only about 16% of the non-insured deals having an indemnity escrow amount of 5% or less.

* **IMPORTANT NOTE:** Data included under "no R&W insurance" sections reflects deals where no R&W insurance was utilized, or where we were unable to confirm whether R&W insurance was used based on a review of the acquisition, as confirmed by the acquisition agreement. Data included under "R&W insurance" sections reflects deals where R&W insurance was used.

Indemnity Escrow Amount

R&W INSURANCE



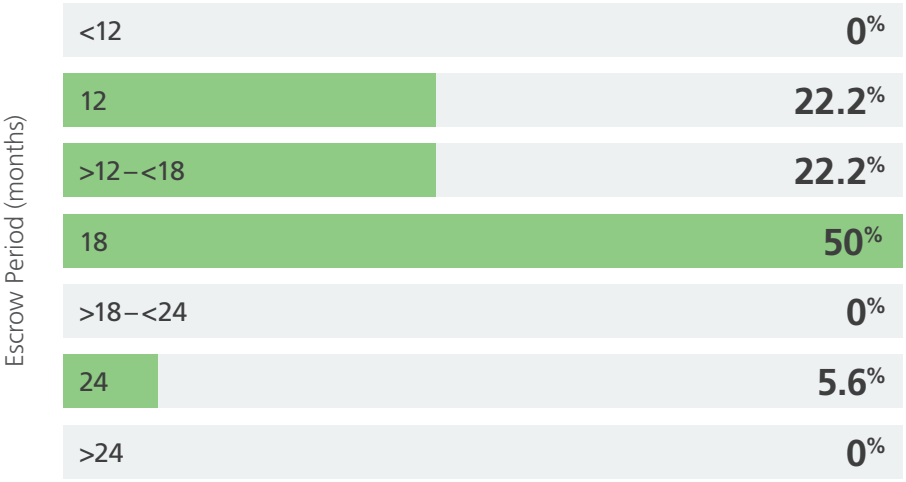
Percentage of Deals Surveyed Providing for Indemnity Escrow

OBSERVATIONS

- Approximately 55% of the insured deals surveyed provided for an indemnity escrow.
- The median escrow amount in 2018 for the insured deals surveyed was approximately 0.9% of the purchase price. It is plain to see the dramatic impact that R&W insurance has on the indemnity escrow amount (0.9% versus 10%).
- The vast majority of insured deals had an indemnity escrow amount of less than 5% and, of those deals, nearly 94% had an escrow amount of 0.5%. This is consistent with the prevailing R&W insurance structure of including a retention (deductible) equal to approximately 1% of deal value. Typically, the buyer and seller will effectively split the retention amount under the policy through a basket in the purchase agreement of 0.5% of the purchase price and an indemnity escrow amount of 0.5% of the purchase price (which also typically reflects the indemnity cap size under the purchase agreement). The use of R&W insurance can reduce the indemnity cap (along with the correlating escrow amount) to effectively cover (with the basket under the purchase agreement) the retention under the R&W insurance policy.

Indemnity Escrow Period

NO R&W INSURANCE



Percentage of Deals Surveyed Providing for Indemnity Escrow

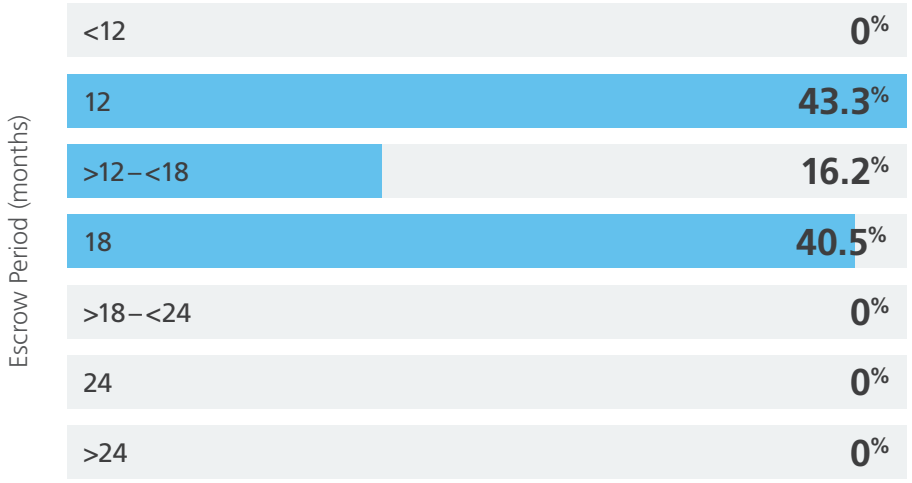
OBSERVATIONS

Of the non-insured deals surveyed which provided for an indemnity escrow:

- Approximately 94% had an indemnity escrow period of 12-18 months.
- The median indemnity escrow period was 18 months.

Indemnity Escrow Period

R&W INSURANCE



Percentage of Deals Surveyed Providing for Indemnity Escrow

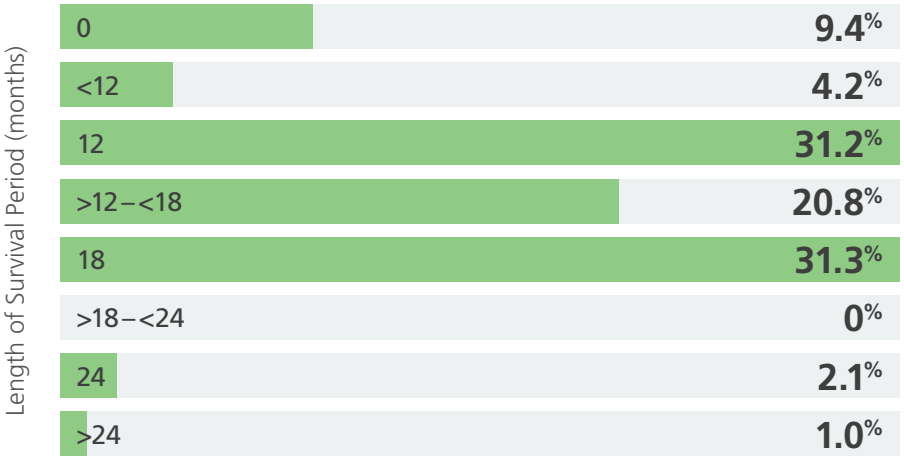
OBSERVATIONS

Of the insured deals surveyed which provided for an indemnity escrow:

- 100% had an indemnity escrow period of 12-18 months.
- The median indemnity escrow period was 15 months.

Representation & Warranty General Survival Period

NO R&W INSURANCE

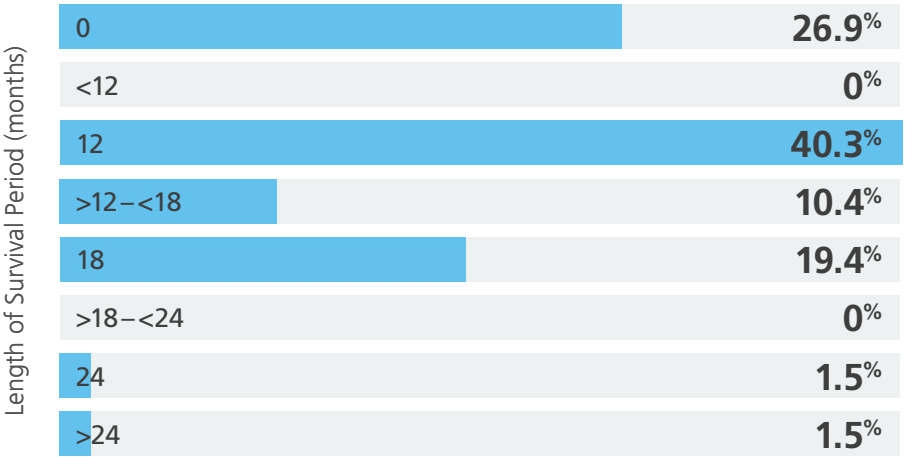


OBSERVATIONS

- The median general survival period for non-insured deals surveyed was 15 months. This has remained consistent since 2013.
- Only approximately 3% of deals surveyed had survival periods of greater than 18 months which is the lowest percentage since 2013.

Representation & Warranty General Survival Period

R&W INSURANCE

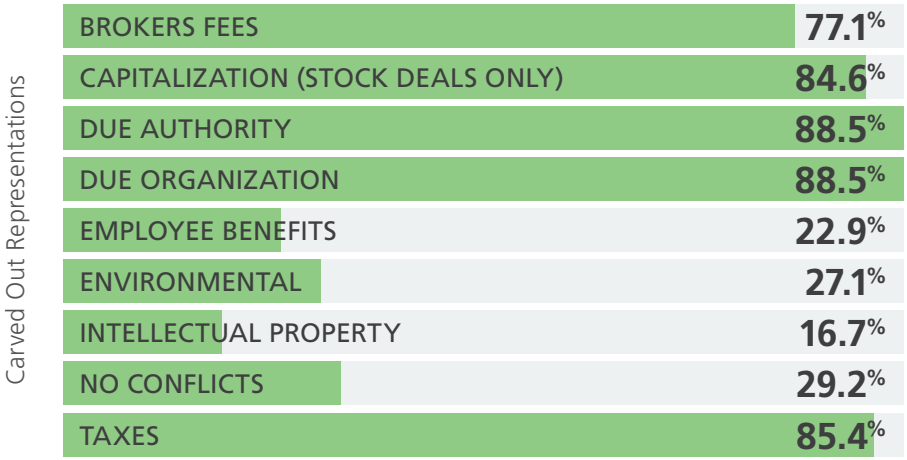


OBSERVATIONS

- The median general survival period for insured deals surveyed was 12 months, which is consistent with 2017.
- 26.9% of insured deals were "no survival" deals in which the seller had no obligation to indemnify the buyer for breaches of the general representations and warranties. Of course, the R&W insurance policy makes a "no survival" framework more palatable for a buyer as the policy typically provides coverage for breaches of general representations for three years.

Carve Outs to General Survival Period

NO R&W INSURANCE



Percentage of Deals Surveyed in Which Applicable Representation Was Carved Out

OBSERVATIONS

Employee Benefits

- The percentage of non-insured deals surveyed that carved out representations and warranties regarding employee benefits was approximately 23% in 2018.

Environmental

- The percentage of non-insured deals surveyed that carved out representations and warranties regarding environmental matters was approximately 27% in 2018.

Carve Outs to General Survival Period

R&W INSURANCE

Percentage of Deals Surveyed in Which Applicable Representation Was Carved Out

OBSERVATIONS

Employee Benefits

- The percentage of insured deals surveyed that carved out representations and warranties regarding employee benefits was approximately 12% in 2018.

Environmental

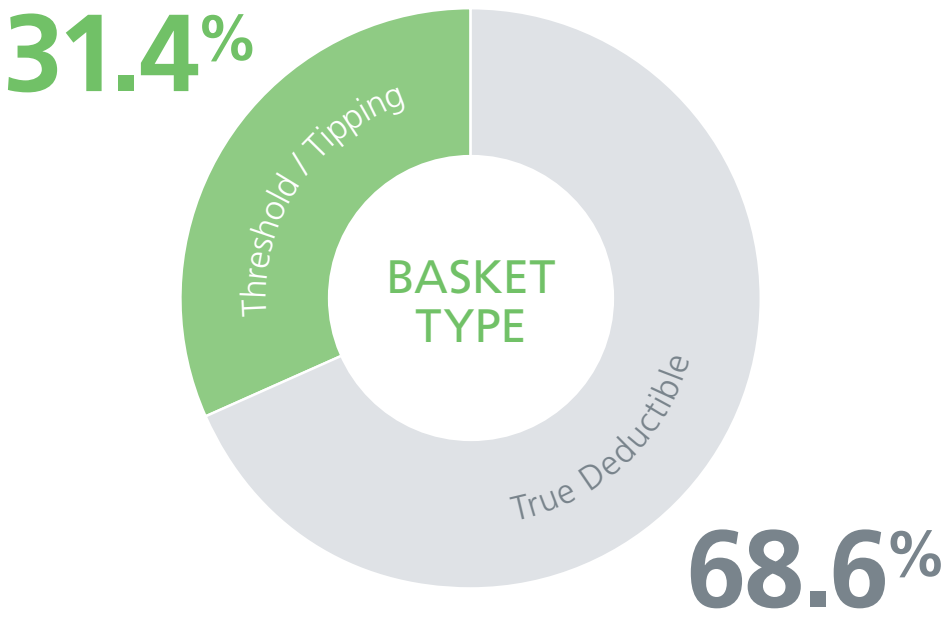
- The percentage of insured deals surveyed that carved out representations and warranties regarding environmental matters was approximately 10% in 2018.

Due Authority, Due Organization and Capitalization

- Less than 70% of insured deals surveyed carved out representations and warranties regarding Due Authority and Due Organization, as compared to the approximately 85% or greater of non-insured deals that carved out these same representations and warranties. This was also the case for Capitalization representations in stock deals.
- In insured deals, the R&W insurance policy generally provides six years of coverage for "fundamental" representations.

Indemnity Basket Type

NO R&W INSURANCE

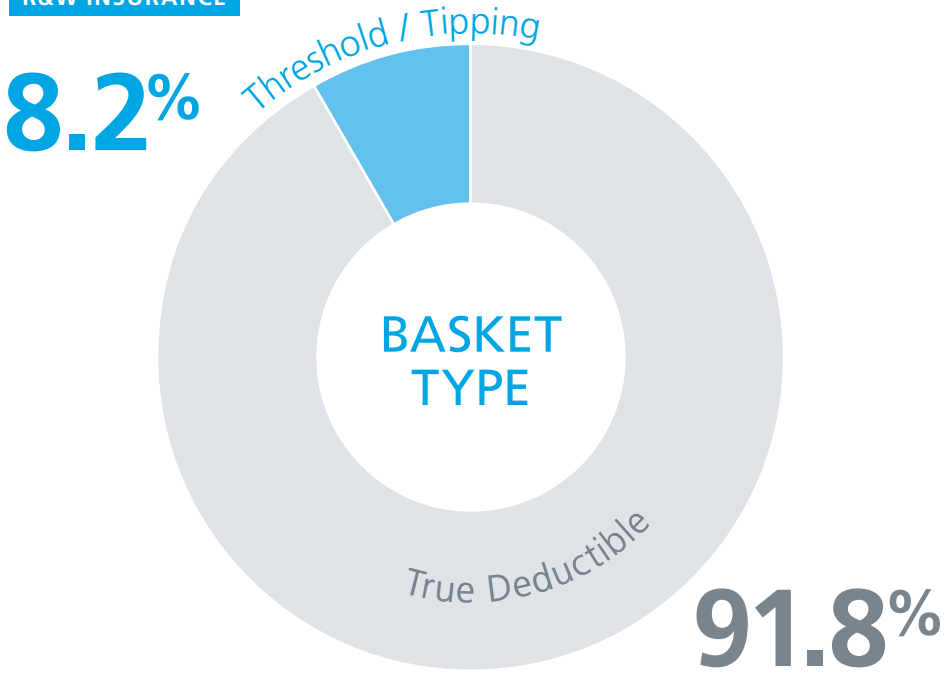


OBSERVATIONS

- Approximately 90% of non-insured deals surveyed provided for an indemnity basket.
- Of the non-insured deals providing for an indemnity basket, approximately 31% were structured as threshold/tipping baskets, and approximately 69% were structured as a deductible.
- This is generally consistent with past years (76% in 2017, 72% in 2016, and 75% in 2015 used a deductible).

Indemnity Basket Type

R&W INSURANCE

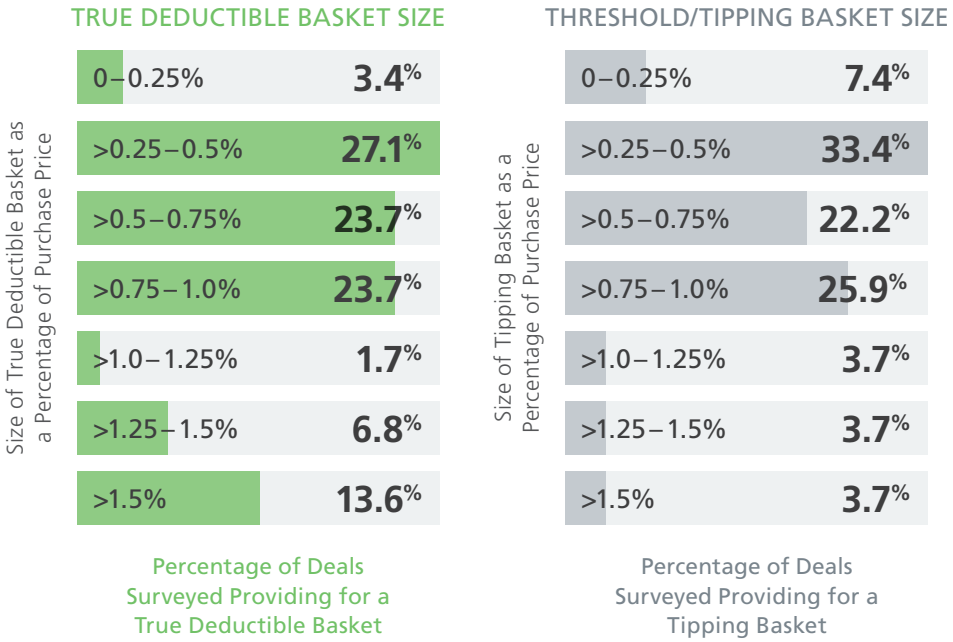


OBSERVATIONS

- Approximately 73% of insured deals surveyed provided for an indemnity basket, compared to approximately 81% in 2017. The relative infrequency of indemnity baskets in insured deals versus non-insured deals is likely due to the increase in "no survival" deals when insurance is used, and therefore a basket is not relevant.
- Of the insured deals providing for an indemnity basket, approximately 8% were structured as threshold/tipping baskets, and approximately 92% were structured as a deductible, an increase from 2017 (86%).

Indemnity Basket Size

NO R&W INSURANCE

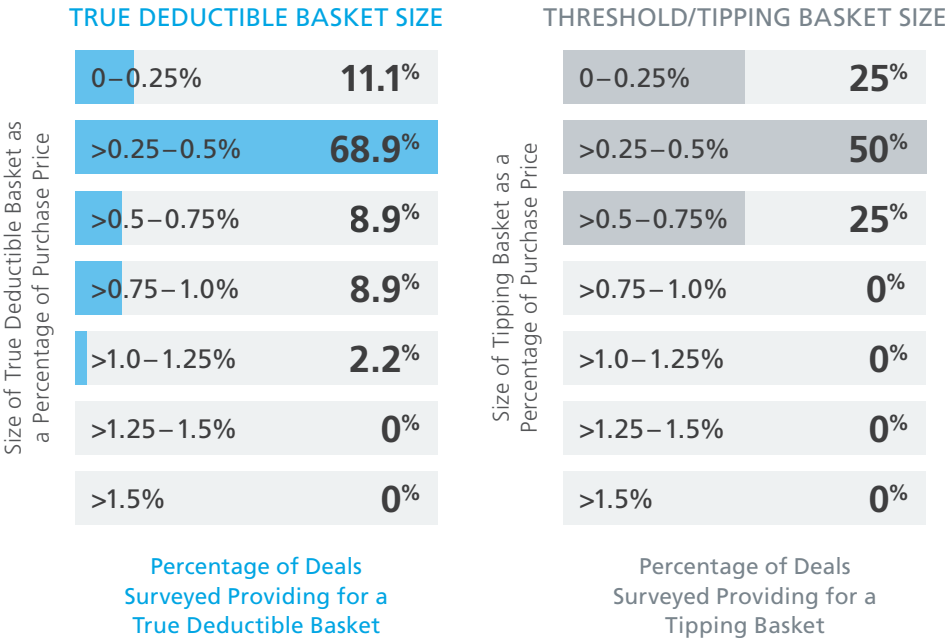


OBSERVATIONS

- The median deductible basket size in non-insured deals surveyed in 2018 was 0.8% of the purchase price.
- Approximately 78% of deals had a deductible basket size of 1% or less, and approximately 54% had a deductible basket size of 0.75% or less.

Indemnity Basket Size

R&W INSURANCE

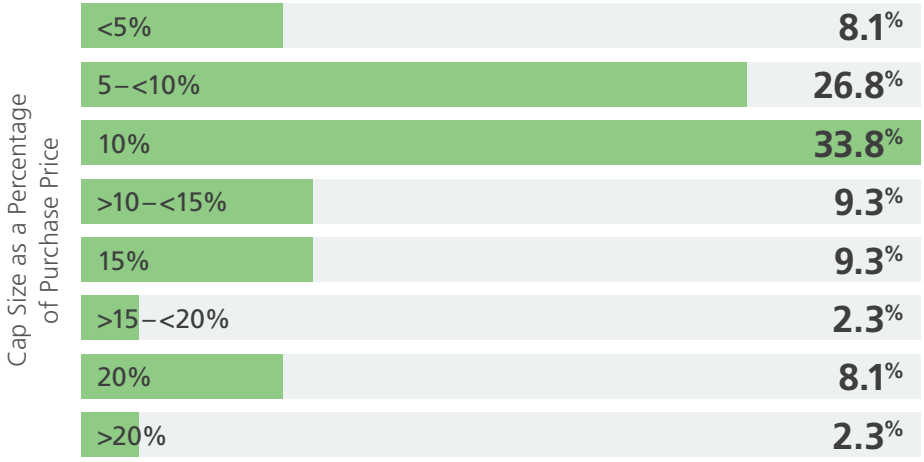


OBSERVATIONS

- The median deductible basket size in insured deals surveyed in 2018 was 0.5% of the purchase price, which is the same as 2017.
- 80% of deals had a deductible basket size of 0.5% or less, and approximately 90% had a deductible basket size of 0.75% or less.

Indemnity Cap Size

NO R&W INSURANCE



Percentage of Deals Surveyed Providing for Indemnity Cap

OBSERVATIONS

- Approximately 90% of non-insured deals surveyed had an indemnity cap.
- The median indemnity cap for non-insured deals surveyed was 10% in 2018.
- Approximately 69% had an indemnity cap of 10% or less, and approximately 87% had an indemnity cap of 15% or less.

Indemnity Cap Size

R&W INSURANCE

Percentage of Deals Surveyed Providing for Indemnity Cap

OBSERVATIONS

- Approximately 78% of insured deals surveyed had an indemnity cap.
- The median indemnity cap for insured deals surveyed was 0.5% in 2018.
- As is evident when compared to non-insured deals, the use of R&W insurance typically greatly reduces the seller's indemnity cap under the purchase agreement (this is due to the fact that the buyer can seek recourse under the R&W insurance policy).

Fraud Exceptions and Definitions

Private target middle-market acquisition agreements often include fraud exceptions to certain limitations on buyers' indemnification rights and remedies, such as caps and baskets. Unless "fraud" is carefully defined in the agreement, however, a seller may find itself subject to post-closing liability for more than intended by the fraud exception.

In this year's Survey, we analyzed the percentage of deals that included fraud carve outs to certain limitations on liability. We also tracked the percentage of deals that limited fraud to intentional acts, and the percentage of deals that limited fraud to the representations and warranties made in the acquisition agreement.

NO R&W INSURANCE	R&W INSURANCE
Fraud Exception	
Approximately 86% of non-insured deals surveyed in 2018 included fraud exceptions to certain indemnity provisions of the agreement (such as a fraud exception to exclusive remedies, limitations on indemnification obligations, survival, etc.).	Approximately 99% of insured deals surveyed in 2018 included fraud exceptions to certain indemnity provisions of the agreement.
Fraud Defined	
Of the non-insured deals that included a fraud exception, only about 37% defined the term "fraud."	Of the insured deals that included a fraud exception, approximately 65% defined the term "fraud."
Of the non-insured deals that defined the term "fraud," approximately 39% limited fraud to fraud committed in the making of the representations and warranties contained in the agreement only.	Of the insured deals that defined the term "fraud," approximately 67% limited fraud to fraud committed in the making of the representations and warranties contained in the agreement only.
Of the non-insured deals that defined the term "fraud," approximately 81% included an intent prong in the fraud definition.	Of the insured deals that defined the term "fraud," approximately 77% included an intent prong in the fraud definition.

Below are a few examples of fraud definitions based on the agreements reviewed for the Survey, ordered from most to least seller protective. Note that the most seller protective of the definitions also limits fraud to a particular universe of individuals with actual knowledge of the fraud.

- **"Fraud"** means, with respect to any party hereto, an actual and intentional fraud with respect to the making of the representations and warranties under this Agreement (as modified by the Disclosure Schedules); provided, however, that such actual and intentional fraud of such party shall only be deemed to exist if any of the individuals identified in the definition of "Knowledge" had actual knowledge (as opposed to imputed or constructive knowledge) that the representations and warranties made by such party under this Agreement were actually materially inaccurate, incomplete or untrue when made, with the express intention that the other party rely thereon to the material detriment of such other party and upon which such other party has relied to its detriment.
- **"Fraud"** means actual and intentional fraud by an agent of the Seller Group with respect to the making of the representations and warranties pursuant to Article II, with the express intention that Purchaser rely thereon to its detriment.
- **"Fraud"** means any fraud claim that requires as an element knowing, willful or intentional misrepresentation with the intent to deceive, malice or similar intent, but not (i) any claim that requires only negligence, recklessness or similar constructive knowledge concepts or (ii) any claim of fraud by innocent misrepresentation.
- **"Fraud"** means fraud, active concealment or intentional misrepresentation.

Choice of Governing Law Delaware v. New York Summary

The Survey results revealed that Delaware and New York are the most popular "governing law" choices.

NO R&W INSURANCE	R&W INSURANCE
Of the non-insured deals surveyed in 2018, the governing law for 54% was Delaware, 19% New York, and 27% "Other."	Of the insured deals surveyed in 2018, the governing law for 81% was Delaware, 18% New York, and 1% "Other."

Delaware and New York both have extensive and well developed case law involving complex commercial issues and are known for generally giving deference to parties' freedom of contract. However, the legal standards applied by Delaware and New York courts differ with respect to several important issues to be considered by parties in the M&A context, as summarized in the following table.

DELAWARE	NEW YORK
Statute of Limitations for Breach of Contract	
Length: 3 years. Parties may shorten or extend (to up to 20 years for contracts involving $100,000 or more).	Length: 6 years. Parties may contractually shorten but not extend the statute of limitations with clear and explicit contractual provisions.
Sandbagging	
The majority view has been that, absent an anti-sandbagging provision, buyers are entitled to indemnification for breaches of the seller's representations and warranties even if the buyer had pre-closing knowledge of the seller's breach. However, a footnote in a 2018 Delaware Supreme Court case (*Eagle Force Holdings v. Campbell*) created some ambiguity regarding the impact of silence on sandbagging. As a result, we would expect to see fewer Delaware law contracts remain silent on sandbagging.	There have been instances where New York Courts have found that a buyer waived a breach where, in the absence of a pro-sandbagging provision, the seller (versus a third party) was the source of the buyer's knowledge of the breach.
Good Faith Negotiations	
Likely to be held enforceable even if material terms remain to be negotiated.	Generally will not enforce a duty to negotiate in good faith if material terms are unsettled at the time of the agreement to negotiate.

DELAWARE	NEW YORK
Common Law Fraud Claims and Disclaimers of Reliance	
A "preponderance of the evidence" is required to establish a fraud claim. A seller's disclaimer of "no other representations and warranties" alone is not sufficient to bar extra contractual fraud claims – a buyer acknowledgment of non-reliance on representations and warranties outside the purchase agreement is also required.	"Clear and convincing evidence" is required to establish a fraud claim. The contract needs to be specific as to the representations being disclaimed (unlike Delaware, no "omnibus" disclaimers). New York courts do not seem to be as focused on the buyer's statement of non-reliance and have allowed non-reliance based on a seller's disclaimer of extra contractual representations and warranties with no buyer statement of non-reliance. Recognizes a highly fact-specific and evolving "peculiar knowledge" exception where misrepresented facts were within the exclusive knowledge of the seller or buyer's reasonable diligence could not have uncovered and, absent a contractual stipulation that the buyer is aware the seller has material information beyond the buyer's ability to discover, may not enforce the disclaimer.
Specific Performance	
Requires "clear and convincing evidence" of the elements of specific performance. Courts tend to accept a contractual stipulation that the non-breaching party would suffer irreparable harm in the absence of the specific performance remedy as evidence of the same. Often expedites proceedings for specific performance in the M&A context; proceedings can be completed within several months.	Parties must establish the elements of specific performance by the lower standard of a "preponderance of the evidence." Requires proof beyond a contractual stipulation that irreparable harm would occur if the contract were not specifically performed (but may be less likely to find that irreparable harm would occur in the absence of such a contractual stipulation). No expedited specific performance proceedings.
Control of Attorney-Client Privilege in Mergers	
Control of attorney-client privilege over communications related to merger negotiations passes to the buyer in the absence of an express contractual provision to the contrary.	The seller or its designee retains control of attorney client privilege over communications related to merger negotiations.
Common Interest Doctrine	
Common interest doctrine broadly applied; non-adverse parties that share a common legal interest (e.g. seller and financial adviser who share the potential legal risk of accepting the deal at issue) may share protected information without waiving the privilege.	Common interest doctrine more narrowly applied; parties with a common legal interest may share information protected by the attorney-client privilege without waiving the privilege only if the communications relate to pending or reasonably anticipated litigation.

M&A Forecast: Spotlight on Cannabis

To date, 33 states – plus Washington, D.C., Puerto Rico, and Guam – have legalized some form of marijuana. With more states moving to legalize, continued industry growth is inevitable and will likely lead to an uptick in M&A activity as businesses seek both to increase market share and integrate vertically within the industry. Following are 10 factors that we believe will have an impact on M&A activity in the marijuana industry in 2019:

1. **Federal Law –** As long as federal law prohibits the possession, use, sale, processing and distribution of marijuana, many investment bankers, public companies, and others will stay on the sidelines.

2. **Lack of Access to Banking –** Because marijuana remains illegal under federal law, most banks and other financial institutions will not risk providing banking services to the marijuana industry. Without access to banking, the industry cannot grow to its full potential.

3. **Consolidation –** The battle is on for market share and many large companies already in the industry are making acquisitions in anticipation of federal legalization. Even though it may be years away, the widely held expectation is that valuations will grow dramatically when that occurs.

4. **Market Growth –** By some estimates, marijuana is a $10 billion industry. Despite federal law prohibitions and limited access to banking, that number is anticipated to increase dramatically over the next few years, creating greater opportunities both for existing businesses and new entrants into the market.

5. **Medical Marijuana Research –** As scientific research into the effects of various chemical compounds found in medical marijuana increases, the potential for medical benefits, and therefore, demand for medical marijuana, should increase too. To date, one drug containing chemical compound found in marijuana has been approved by the Food and Drug Administration. This could translate to a spotlight on biotech and pharma companies doing medical marijuana research as targets for acquisition.

6 **Private Equity –** Capitalizing on the lack of access to public capital markets in the U.S. and lack of access to banking, PE funds are increasingly investing in the marijuana industry, making capital available for acquisitions and expansion.

7 **Cross Border M&A –** As more and more countries, such as Canada, legalize marijuana, it is expected that companies based in those countries will come to the U.S. in pursuit of strategic acquisitions.

8 **Valuations –** Despite the challenges, marijuana is a hot industry and valuations are relatively high. For many casual investors, the "cool" factor outweighs any real scrutiny into valuations, and for strategic investors seeking either vertical integration or market share, valuations are not as critical.

9 **Uncertainty Over Federal Enforcement –** Historically, the industry was able to rely on the Cole Memorandum and Department of Justice guidelines which generally indicated a "hands-off" approach to state legal marijuana businesses. On January 4, 2018, however, the Attorney General revoked the Cole Memorandum creating uncertainty as to what extent, if at all, federal authorities would seek to enforce federal marijuana laws against state legal businesses. This uncertainty has had a negative impact on expansion and growth.

10 **Branding –** Marijuana is a commodity. As the market moves from flower to manufactured products, such as edibles, tinctures, topicals, etc., branding will become increasingly important to sales and market share, and a company with branded products could be a more attractive acquisition target, or better able to raise money in the capital markets.

Seyfarth's Cannabis Law Practice is a multi-disciplinary group experienced in counseling marijuana-related businesses (MRBs) on corporate, banking, tax, real estate, regulatory, international business, and other issues. The group has represented MRBs in a range of transactions, including purchase and sale of businesses, purchase, sale and leasing of commercial real estate, wholesale and retail supply contracts, distribution contracts, and other commercial contracts, among others. Learn more: www.seyfarth.com/Cannabis-Law-Practice

Glossary

Indemnity Escrow Amount

The indemnity escrow amount is the portion of the purchase price held in escrow to serve as a fund to satisfy indemnification claims against the seller.

Indemnity Escrow Period

The indemnity escrow period is the length of time after the transaction closing date that the indemnity escrow amount is held before being released to the seller.

Representation & Warranty Survival Period

The survival period is the length of time after the transaction closing date during which a party may make claims for breaches of representations and warranties.

Carve Outs to General Survival Period

Certain specified representations and warranties may be carved out of the general survival period for representations and warranties and survive for a longer period of time.

Indemnity Basket

An indemnity basket requires a party to incur a certain amount of indemnifiable losses before it can seek indemnification from the other party. There are generally two types of baskets: true deductibles and threshold/tipping baskets. With a true deductible, the indemnifying party is only responsible for losses exceeding the basket amount. With a threshold/tipping basket, the indemnifying party is responsible for all losses from dollar one once a party's indemnifiable losses reach the basket amount. Indemnity baskets typically apply only to breaches of "general" representations and warranties.

Indemnity Cap

The indemnity cap limits a party's maximum liability under the indemnification provisions to a stated dollar amount. Indemnity caps typically only apply to breaches of "general" representations and warranties.

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Seyfarth's Leading Middle-Market M&A Practice

Recognized as a leading middle-market M&A (sub-$500m) practice by *The Legal 500* (2012-2018).

U.S. News & World Report: Best Lawyers "Best Law Firms" recognized Seyfarth's Corporate Law (2016-2019) and Mergers & Acquisitions Law (2017-2018) practices.

> Seyfarth has "a very responsive, knowledgeable, lean practice, which has lawyers who are courteous and succinct."
>
> – Client quote, *The Legal 500*

> Seyfarth is "highly regarded for its deep knowledge of corporate law and M&A expertise."
>
> – Client quote, *The Legal 500*

> Seyfarth's "counsel during M&A procedures is consistently accurate and timely, and the team's knowledge and expertise proves invaluable."
>
> – Client quote, *The Legal 500*

> The Seyfarth team "works with clients to help them build their businesses in an efficient and high-quality manner."
>
> – Client quote, *The Legal 500*

SEYFARTH SHAW

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