# M&A TODAY

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**Save the Date! - The 2016 M&A Panel Series kicks off on Friday, April 29th**

Like last year, we are planning on a series of panel discussions focused on M&A that should be both informative and engaging. All our latest event news can be found at *www.mbbp.com/events/*

## Tips for Enforcing Indemnification Provisions

Your company has completed an acquisition of a strategic partner for a purchase price of $40 million. In the representations and warranties in the acquisition agreement, the seller informed you that its financial statements were true and correct as of the date of the closing. Post-transaction you discover that the financial statements, as presented, were inaccurate and misleading. What recourse do you have? Typically, acquisition agreements (stock, asset purchase and merger agreements) contain indemnification provisions that provide contractual remedies for resolving post-transaction claims for breaches of representations and warranties, breaches of covenants and third-party claims. When determining whether or not to make an indemnification claim, you should consider the following:

**Identify Time Periods for Asserting Indemnification Rights**

The acquisition agreement will generally provide time periods within which to assert an indemnification claim. For most claims, the time period will expire between 12 and 24 months after the closing. Common exceptions include fundamental representations (authority to enter into the transaction, ownership of shares and organization and qualification) and specific representations regarding tax matters, environmental issues and intellectual property matters. You should evaluate your potential claims carefully to determine which specific representations and warranties (and the corresponding claims period) are applicable, so that you do not miss the applicable deadline for asserting.

**Provide Notice in a Timely Fashion**

A party asserting an indemnification claim must make sure to assert a claim within the specified time period. It is generally not necessary that the claim be resolved prior to the expiration of the applicable time period – in most cases, as long as the indemnification claim is timely asserted the ability of a party to assert the indemnification claims will be preserved until the claim has been finally resolved. While fraud or other intentionally misconduct on the part of the indemnifying party may serve to extend the applicable time period to bring a claim, it is important to comply with the specific terms of the acquisition agreement and provide timely and detailed notice of the claim to the indemnifying party.

**Notify All Concerned Parties**

The indemnification provisions will outline the steps necessary to properly assert a claim. One requirement will be to notify the proper parties. It is imperative to provide notice to all concerned parties. These may include some or all of the following: the indemnifying party, counsel to the indemnifying party, a stockholder representative and an escrow agent, if an escrow has been established. Putting an escrow agent on notice is critically important to avoid funds from being released that may be otherwise available to satisfy a claim in whole or in part.

**Understand Limitations on Recovery**

Many indemnification provisions provide limitations on the amount a party can recover for losses. Such provisions include deductibles and baskets (which serve as minimum dollar thresholds before which losses may not be recoverable). In addition, indemnification provisions commonly include caps on recovery. Similar to the survival provisions, there are generally exceptions to limitations on recovery. For example, the ability to recover for breaches of fundamental representations and tax matters may be uncapped. Additionally, issues of particular importance such as environmental matters and breaches of particular laws may have specific caps that are higher than the general indemnification cap and such provisions may also exclude deductibles and baskets. Further, claims for losses based on fraud or other intentional misconduct may not be subject to applicable limitations. In crafting indemnification claims, all potential theories of recovery should be considered to maximize the potential claim.

**Exclusive Remedy**

In many instances acquisition agreements provide that the indemnification provisions serve as the sole and exclusive source of recovery in connection with post-transaction claims, other than for claims involving fraud or intentional misconduct. Absent a public policy argument against such a provision, the ability of a party to assert a common law claim for losses for post-transaction claims may be limited to the contract language set forth in the indemnification provision.

**Scope of Damages**

Definitions of losses and/or damages in indemnification provisions set forth the types of losses/damages that a party may recover against the indemnifying party. For example, losses/damages may include attorneys' fees and consequential or indirect damages (including losses related to lost profits and/or diminution in value losses) which may significantly expand the potential scope of recovery. Careful attention should be paid to these definitions when structuring a claim, in that the claim should be as broad as possible yet only include damages permitted under the terms of the acquisition agreement.

**Claims Process/Dispute Resolution**

A well-crafted indemnification provision outlines the steps necessary to assert and resolve an indemnification claim. The steps include asserting the claim, responding to same and the methodology for ultimately determining the merits of the claim. It is incumbent upon the parties asserting and defending a claim to make sure to follow the claims process to avoid missing a necessary deadline or otherwise risk properly pursuing or defending the claim.

For more information regarding enforcement of indemnification provisions please contact John J. Tumilty at *jtumilty@mbbp.com* or Joseph C. Marrow at *jmarrow@mbbp.com*.

## Permanent Exclusion of Gain on Sales of Qualified Small Business Stock

Holders of certain qualified small business stock (QSBS) can permanently exclude 100% of up to $10 million[1] of gain realized on the sale of QSBS. The benefit, provided for under Section 1202 of the Internal Revenue Code, was recently made permanent as part of the Protecting Americans from Tax Hikes Act (PATH) in December 2015. Prior to PATH, the 100% exclusion had expired at the end of 2014.

1 (or, if greater, 10 times the adjusted basis of the QSBS issued and disposed of that year)

Entrepreneurs and investors will, of course want to consider the QSBS benefit when structuring investments; but QSBS benefits are sure to be an important consideration for both buyers and sellers when evaluating the economics of an exit transaction.

**Basic Requirements for the Taxpayer/Shareholder:**

The taxpayer/shareholder may not be a corporation, but can hold the investment through an investment partnership under certain circumstances. For example, the taxpayer/shareholder must have held the interest in the partnership on the same date it acquired the QSBS and until the earlier of the sale or other disposition.

The taxpayer/shareholder must have received the QSBS as an "original issuance," meaning when the company was formed, either directly, or through an underwriter, for money, property or for services provided for the issuing corporation; and must have held the QSBS for more than five years.

The 100% exclusion applies to QSBS acquired after September 27, 2010. QSBS's acquired between August 10, 1993 and September 27, 2010 may qualify for a 50% or 75% exclusion, depending on the date of the acquisition of the QSBS.

**Basic Requirements for the Issuing Corporation:**

The tax benefit provided by Section 1202 applies only to equity investments in C-corporations conducting permitted active trades or businesses. Professional services, financial institutions, farming and most hospitality businesses do not qualify. The issuing corporation must use 80% of its assets in active conduct of one or more permitted active trades or businesses.

Prior to and subsequent to the taxpayer/shareholder's investment, the issuing corporation's gross assets must never have exceeded $50 million.

**Exit Planning:**

When an exit is contemplated prior to the required 5-year holding period, the shareholder/investor may want to structure the exit in a manner that could preserve the QSBS benefit for a later disposition of the equity consideration received.

If properly structured, QSBS of an issuing corporation can be exchanged for stock of another corporation; with the replacement stock received qualifying as QSBS. For example, if a corporation is acquired by another corporation in a reorganization that qualifies as a tax-deferred reorganization under IRC Section 368, the acquirer stock received by holders of QSBS of the issuing corporation can qualify as QSBS going forward. If the acquiring corporation qualifies as a qualified small business, then all of the stock received can be QSBS. If the acquirer is not a qualified small business, then the stock of the acquirer can be QSBS only to the extent of the gain that would have been recognized at the time of the Reorganization if the target's QSBS had been sold in a taxable transaction at that time.

For more information on this topic, please contact Robert M. Finkel at *rfinkel@mbbp.com.*

## IP Due Diligence: Patentability vs. Patent Infringement

M&A transactions often require IP due diligence investigations when technology is involved, and it can be critically important to understand issues like what technology is owned by a company, what technological developments are in the pipeline that can be protected with patents, and whether the company has freedom-to-operate by making and selling their current or planned goods and services without infringing another's patent rights. Understanding the difference between patentability and patent infringement is important to understanding the overall IP position.

At first glance, "patentability" and "patent infringement" are similar terms, but in actuality they have very different meanings and it is important to be clear on those differences. For example, even if your invention is deemed patentable, that designation does not automatically mean a product embodying your invention would not infringe another's patent.

If you are granted a patent (meaning a patent application was filed, it was examined by a patent office, the examiner deemed the invention "patentable", and a patent was granted) you do not simultaneously acquire the affirmative right to use or practice the invention. Rather, a granted patent gives you, the patent owner, the right to exclude others from making, using, selling, or importing, the invention or more specifically a product or service embodying the invention. However, someone else may have obtained a patent that covers some portion of your product or service, which would prevent you from having freedom-to-operate.

For example, assume you are the inventor of the automobile. The basic components that you think of, design, and implement yourself are the automobile frame and body, which sits on four wheels, is steerable with a steering wheel, and is powered by an engine. You apply for, and receive a patent, claiming "an automobile with four wheels, a steering wheel, and an engine." However, before you invented the automobile, and unknown to you, Inventor B invented and patented the engine. Both of these patents are possible. Inventor B's engine patent was obtained before you invented the automobile, so there was no prior art teaching an engine. At the time the engine patent application was filed by Inventor B, it was new and nonobvious relative to any of the known prior art. However, it only covered an engine itself, not what to do with the engine. Then you came along and you figured out the other components that resulted in the invention of the automobile (the body, the four wheels, the steering, plus the engine). Your automobile was new and nonobvious relative to the prior art of the engine. Just because the engine existed, there was nothing about the engine that would necessarily lead one to think of the automobile. So you are able to patent the automobile, which includes the engine.

To make, use, and sell automobiles, you need to make, use, and sell engines as a component of the automobile. By making, using, or selling an engine, you are infringing Inventor B's patent on the engine. So you either cannot proceed, or you need to obtain from Inventor B a license to the patent on the engine (or to buy the patent from Inventor B, or if they sell engines then buy your engines from Inventor B) in order to proceed with making, using, or selling automobiles. Inventor B, on the other hand, can make, use, or sell engines as long as he is not doing so together in automobiles, because you own the patent rights to automobiles. To infringe your patent, Inventor B would have to make and/or sell not only the engine, but also the body, the wheels, and the steering mechanism, as required by the claims of your patent.

It is also important to note that the patentability analysis looks at all things that would qualify as prior art (e.g., publications, products, public disclosures, patents, etc.). Whether or not an invention is patentable over the prior art requires looking at everything that is taught in these prior art documents and items. So, if a patent examiner is using another patent as a prior art reference to argue that your invention is not patentable, the examiner is allowed to consider and use anything in the patent reference (the detailed description, the summary, the figures, etc.) to determine whether it "teaches" your invention. Likewise, published patent applications are equally relevant as prior art as a granted patent; what is important in considering patentability is the information described anywhere in the document, whether or not an examiner has reviewed it and allowed a patent.

In contrast, the patent infringement analysis looks only at the "Claims" section of a granted patent. The "Claims" section of a patent is found at the end of the patent in the form of numbered paragraphs beginning with "Claim 1" and going on from there. To infringe a patent, a product or service must contain all of the elements of at least one claim of the granted patent. In the example of the automobile patent, if Inventor C makes, uses, or sells an automobile that has only three wheels, and your granted patent requires in "Claim 1" that the automobile have "four wheels", then Inventor C's automobile does not infringe your patent. This is true even if in the detailed description in your patent you discuss the possibility that your automobile could have three wheels or four wheels. If the claims at the end of your patent only specify a requirement of four wheels, not three, then there is no patent infringement. This is why patent attorneys spend a lot of time and effort to understand all variations of an invention. Conscientious patent attorneys try to draft claim sets that are broad enough in scope to capture obvious variations of an invention, but not so broad as to be un-patentable over the prior art that an examiner may uncover and use against the inventor during patent prosecution. As a quick aside, the way a patent attorney would deal with the three versus four wheel problem above is to claim "at least three wheels" in the patent claim, which would include three, four, or more wheels.

Patentability is about whether the claims at the end of the patent application have enough distinguishing requirements to be considered directed to a new and nonobvious invention in view of any prior art that is known and considered during the examination process by the patent examiner. The patent examiner compares the claims of the patent application with any relevant prior art they can find. If the claims are too broad, then a negotiation ensues between the applicant and the examiner, adding limitations to the claims to narrow down the scope and distinguish the claimed invention from the known prior art. Patent infringement is about whether the requirements of the claims of a granted patent (not a pending application) are entirely met by the accused product or service. To be infringed, all requirements of at least one claim must be met by the infringing product or service.

In the M&A context, when technology will be essential to future growth, it is important to ask the target company for an assessment of the likely patentability of key technologies in the pipeline, to also ask whether a freedom-to-operate review has been performed to establish if the technology can be practiced, and finally to verify whether the company has been approached by any patent owners regarding infringement of another's patent rights.

For more information about patentability versus patent infringement, IP due diligence, or any patent or intellectual property related matter, please contact Sean D. Detweiler at *sdetweiler@mbbp.com.*

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