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ARTICLE

Defining "Knowledge" in a Purchase Agreement

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"The devil is in the details," is the raison d'etre of the transactional lawyer. One such detail that mergers and acquisition lawyers lovingly nibble on, and quibble over, are knowledge qualifications in the representations and warranties of a purchase agreement and the corresponding definition given to knowledge in the purchase agreement.

A knowledge qualification is applied to representations and warranties in order to limit their scope. For example, consider the following variations of the same representation:

Example 1: "There is no threatened litigation against the Company."

Example 2: "To Seller's Knowledge, there is no threatened litigation against the Company."

The difference between these two representations is how the risk of the unknown is allocated. The knowledge qualification in the second example serves to shift risk of any unknown threatened litigation away from the seller and onto the buyer. This type of knowledge qualification is often viewed as acceptable when the representation involves a potential third-party claim (and is often viewed by buyers as an unacceptable risk-shifting device in other contexts).

Understanding the precise nature of the risk-allocation in a knowledge-qualified representation also requires understanding what it means for a party to have "knowledge." Taking a step back, why define knowledge in the first place?

WHY DEFINE KNOWLEDGE?

Parties define knowledge so that the rules of the game are clear. Fundamentally, knowledge definitions seek to delineate whose knowledge matters for the purposes of determining whether a knowledge-qualified representation has been breached. The reason this is important is because, absent a contractual limitation, courts may be willing to

impute knowledge to a pool of people that is larger than intended. Specifically, "[a]n employee's knowledge can be imputed to her employer if she becomes aware of the knowledge while she is in the scope of employment, her 'knowledge … pertain[s] to [her] duties' as an employee, and she has the 'authority to act' on the knowledge."[1]

As a result, if a representation were simply qualified by the "knowledge of the Company," there is a significant risk that a court could impute the knowledge of employees who were not even involved in preparing or reviewing the representations and warranties in the purchase agreement — something that sellers want to avoid. In addition, there are potential defenses to the imputation of knowledge in an agency relationship (e.g., an employee was not acting within the scope of their employment when they acquired the knowledge). A prudent buyer may want to dispense with these kinds of defenses by expressly providing that the knowledge of a certain employee counts (no matter how acquired).

The importance of these concerns has resulted in a nearly universal trend[2] to tie the definition of knowledge to a list of knowledge parties (i.e., a list of persons or specifically identified titles). In other words, practitioners use the knowledge definition to tell a court whose knowledge can (and should) be imputed to the seller.

CONSTRUCTIVE VS. ACTUAL KNOWLEDGE

That matter resolved, the next question becomes what it means for a listed knowledge party to have knowledge. This isn't arm-chair philosophy. Practitioners must decide whether they should instruct the court, in its evaluation of whether a person had knowledge, to apply either an objective or subjective test. If a court applies an objective test to knowledge, it will look to what a reasonable person should have known. This is constructive knowledge, which, as defined by Black's Law Dictionary (10th ed. 2014), is "knowledge that one using reasonable care or diligence should have, and therefore that is attributed by law to a given person."

Constructive knowledge definitions will often expressly include language referencing a duty of inquiry or reasonable investigation. This language is often similar to the due diligence defense under Section 11(c) of the Securities Act of 1933. Section 11(a) of the '33 Act imposes liability upon certain persons for material misstatements in a registration statement. One of the defenses available to such persons is a "due diligence defense." This is the defense that after reasonable investigation, the defendant had reasonable grounds to believe (and did believe) in the truth of the misstatement. In interpreting the due diligence defense, courts have consistently acknowledged the facts and circumstances nature of the inquiry. Nonetheless, the standard of investigation required is clear: one of "a reasonable man in the management of his own property." This standard goes beyond simply asking questions and may require further action under certain facts and circumstances.[3]

Conversely, applying a subjective test, a court will (at least in theory) look to what a person actually knew. This is actual knowledge, which Black's Law Dictionary (10th ed. 2014) defines as "direct and clear knowledge, as distinguished from constructive knowledge."

Notwithstanding conventional wisdom that constructive and actual knowledge are different species, the practical relationship may be better understood as one of degrees. A trier of fact cannot (yet) plug a human brain into a computer and ascertain what it knew and when it knew it. Actual knowledge can be demonstrated through circumstantial evidence and if the circumstances are such that the defendant "must have known," an inference of actual knowledge is permitted.[4]

Furthermore, one of the key understood distinctions between actual knowledge and constructive knowledge is the duty of inquiry imposed by a constructive knowledge standard. Even where a party is subjected to an actual knowledge standard, however, they cannot simply stick their head in the sand. In a recent U.S. Supreme Court case, the doctrine of willful blindness was adapted from criminal law and applied in a civil patent infringement case. The Supreme Court described the doctrine as follows:

The doctrine of willful blindness is well established in criminal law. Many criminal statutes require proof that a defendant acted knowingly or willfully, and courts applying the doctrine of willful blindness hold that defendants cannot escape the reach of these statutes by deliberately shielding themselves from clear evidence of critical facts that are strongly suggested by the circumstances. The traditional rationale for this doctrine is that defendants who

behave in this manner are just as culpable as those who have actual knowledge … It is also said that persons who know enough to blind themselves to direct proof of critical facts in effect have actual knowledge of those facts.[5]

A similar rationale was applied in Agranoff v. Miller,[6] when then-Vice Chancellor Leo Strine, indicated a similar willingness to apply the doctrine in the corporate context, saying, "Calculated, self-chosen and willful ignorance by Miller of the actual terms of a restriction about which he had actual knowledge does not render him an innocent purchaser for value."

Nonetheless, sellers will prefer an actual knowledge definition, because it is generally viewed as a less stringent standard. Conversely, buyers will favor a constructive knowledge definition, because it is generally viewed as a more stringent standard. There are strong arguments for each. In favor of an actual knowledge test, sellers typically argue:

- Constructive knowledge injects the kind of uncertainty and 20/20 hindsight that including a knowledge definition is intended to avoid.
- In an M&A transaction, only a limited number of employees are "under the tent" and the practical reality is that inquiries cannot be made of employees who do not have knowledge of the transaction.
- A constructive knowledge standard may loop in employees that will transfer with the business to the buyer and the loyalty of those employees will naturally shift to the buyer by the time a dispute over who had knowledge arises.
- The buyer is fairly protected if the list of knowledge parties is lengthy and/or covers each of the functional operational and financial heads.

Conversely, in favor a constructive knowledge standard, buyers typically argue:

- The buyer is relying on diligence provided by the seller to identify appropriate knowledge parties and it should have a contractual backstop to that diligence to ensure that the sellers are asking the right questions of the right personnel.
- Liability should not be allocated to the buyer simply because the seller has chosen not to bring certain employees "under the tent." Fairness dictates that liability should lie with the seller for its refusal to bring employees under the tent and a constructive knowledge achieves this standard.

MARKET SHIFT

Notwithstanding the strong arguments that each side can proffer, according to the ABA Private Target Mergers & Acquisitions Deal Point Study for 2016-2017, there has been a steady and inexorable shift in the market toward the use of a constructive knowledge standard. Twelve years ago, constructive knowledge was used in a narrow majority of deals (61 percent of the time). Today, the constructive knowledge standard is used a fulsome 82 percent of the time.

We found this shift toward a buyer-friendly knowledge definition particularly interesting because it occurred during a time period when the deal landscape has been predominately seller-friendly. This is likely driven by more impactful market shifts at play, which are changing how parties think about risk allocation.

The ABA Deal Study found that nearly a third of private M&A deals expressly referenced representation and warranty insurance. As a result, and not surprisingly, nearly a third of the deals surveyed had escrows or holdbacks that were less than 3 percent of transaction value. It was not too long ago when market indemnity ranges were 5-10 percent, with even 10-20 percent indemnity packages not unusual. In that world, the representations and warranties operated as a lawyer's battleground, where the diligent and detail-oriented could win meaningful risk allocation points. In a world in which sellers often had significant post-closing exposure, these battles at the margin really mattered.

In today's climate, however, where sellers often have significantly less post-closing liability exposure for breaches of representations and warranties, sellers have been deincentivized to fight over risk-allocation points. This dynamic

has led to a general willingness by sellers to provide buyers with more fulsome representations than may have been customary in the past. The approach, within the bounds of reason, is that if the seller believes a representation is true, it will lean toward providing the representation. While sellers will still often fight over materiality qualifiers, the principled basis for doing so is that materiality qualifiers can provide the seller with valuable insulation against fraud claims. Knowledge qualifiers, on the other hand, are different — they merely allocate risk of the unknown. In this context, the benefit to sellers of haggling over the knowledge definition is diminishing.

Most thoughtful practitioners are able to reach a middle ground on the knowledge definition, particularly in this new market era where sellers have less skin in the game. Buyers will often live with an actual knowledge standard if the knowledge parties include the functional heads of the relevant departments at the target company. Conversely, sellers will often understand a buyer's need for a constructive knowledge standard if there is a short list of knowledge parties. The destinations are the same, even if the paths are different.

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[1] Hecksher v. Fairwinds Baptist Church, Inc., 115 A.3d 1187, 1200 (Del., 2015).

[2] 98 percent of all deals surveyed in the ABA Private Target Mergers & Acquisitions Deal Point Study for 2016-2017 included a list of knowledge parties.

[3] See, e.g., In re: Worldcom Inc. SEC Litig., 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

[4] See, e.g., Donchin v. Guerrero, 41 Cal.Rptr.2d 192, 34 Cal.App.4th 1832 (Cal. App. 2 Dist., 1995); see also Dougherty v. Hibbits, No. N14C-05-105 PRW, 2015 WL 5168157 (Del. Super., 2015).

[5] Global-Tech Appliances, Inc. v. SEB S.A., 563 U.S. 754, 766 (2011).

[6] Agranoff v. Miller, 1999 WL 219650 (Del. Ch., 1999),

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