Alamo Corporate Group Inc.

Independent Services for Business Buyers & Sellers

REPRESENTATIONS AND WARRANTIES

Both parties and their advisors must understand that Representations and Warranties are not a measure of anyone's honesty, sincerity, or integrity, but a method of allocating some of the risks inherent in any transaction. After all, buyers and sellers are entitled to all the benefits of their bargain – nothing more and nothing less.

In almost any sale of a business, the seller makes certain representations. These Representations and Warranties may focus on various legal, financial, or environmental aspects of the sale such as: undisclosed liabilities, pending litigation and tax issues. Their purpose is to insure that the seller is truthfully and accurately representing the business and warranting that none of these issues will impede the closing or impact the new ownership. The purchasing entity also represents and warrants, for example, that it has the financial capability to purchase the business.

These representations and warranties are usually included in the final agreement between the buyer and the seller. They can be as simple as the seller warranting to the buyer that there is a clear and marketable title to the business being sold. They can also be a lot more complicated. For example, they may not only contain a warranty or representation, but also provide for a remedy if things aren't as stated or certain future events happen. These are much more important in a stock sale than one of just assets. In the stock sale, the buyer is assuming all of the outstanding issues, risks and, any future problems. The seller might warrant that there is no pending litigation and then a disgruntled customer files a post-closing lawsuit. The final agreement might state that an agreed-upon dollar amount would be set aside to cover such contingencies. This remedy is known as an indemnification. The purpose of an indemnification is to provide a solution to a breach of the representations and warranties.

Representations and warranties should be discussed and agreed upon in the early negotiations of the sale. These early discussions can clear up future misunderstandings and provide a safety net for both parties. There is probably little point in continuing negotiations if the representations and warranties can't be mutually agreed upon at the outset. Intermediaries generally prefer to get agreement on them prior to a Letter of Intent being prepared. From a seller's standpoint, the company should not be taken off the market prior to a general understanding of the Representations and Warranties.

They are one of the most important aspects of any final agreement. The buyer obviously wants to have as many of them, and as broad in scope, as possible. They create a sort of built-in insurance policy. The seller, on the other hand, would like there to be none, or as few and as restricted as possible.

Problems can develop when the buyer, for example, inserts among the representations and warranties, an item that is open-ended or beyond the seller's control. For example, the seller warrants that there are no equipment leases or equipment rental agreements other than described in Schedule F. The buyer doesn't want to be responsible for any equipment agreements that have not been mentioned. However,

the seller wants to limit the company's exposure. Keep in mind that in privately held companies, the owner is usually responsible for any indemnification of the representations and warranties, so he or she is very concerned with them. The seller's lawyer might limit the exposure to a dollar amount along with a time period – say three years. Or, as is most common, the buyer agrees to absorb any of the leases up to a dollar amount, anything over which the seller must cover. This means that if some equipment leases do turn-up after the closing, assuming that there has not been any fraud or deception, the method of handling them has already been covered in the agreement.

This time period on the Representations and Warranties is a big concern for sellers. The time periods for the Representations and Warranties surviving the closing can be a deal-killer in the seller's eyes. How long should a seller be responsible for them? Obviously, this is a critical area and has to be carefully negotiated between the parties. Some Representations and Warranties that might survive the closing would be matters of litigation, insurance and employee issues. Today, an important post-closing issue can be the intellectual property that may be included in the sale. The buyer entity wants to protect itself from any attack on the ownership of the intellectual property, as it may be a key ingredient of the acquisition. Placing a cap on the dollar amount that the seller and/or his or her company is responsible for and placing reasonable time frames on this section of the agreement can usually resolve this sensitive area.

Sellers often want to couch their Representations and Warranties by using the term "material" in them. In other words, the defect must be material to be considered for any type of remedy. Some sellers even want to limit their exposure by stating that the representation is to the sellers' best knowledge. Experts feel that the buyer is buying the business and anything that makes the deal riskier threatens the sale. The seller's claim that to the best of his knowledge there is no other litigation, except what has been revealed, doesn't provide the buyer the protection that he or she needs. Since the words "material" or "sellers' best knowledge" might be considered vague or ambiguous, placing dollar limits can usually resolve them.

What all this means is that the Representations and Warranties are a big part of the deal. They should not be left to the last. Many sales have fallen apart because a Representation or Warranty and Indemnification were just not acceptable to the seller, or to the firm's board of directors. The buyer's due diligence should uncover many of the issues that will be subsequently incorporated in the agreement as Representations and Warranties and be addressed prior to the drafting of the agreement. The drafting of them should be left to the pros.

Too many deals have fallen apart, or been delayed, because the buyer or his advisors decided, at the last minute, to insert a "surprise" representation or warranty, that the seller not only did not agree to, but had not even seen – causing the seller to become disillusioned with the buyer.

Representations and Warranties should be discussed early in a transaction, perhaps be part of the deal structure items. And, any changes made after the due diligence period should be disclosed (or proposed) well before the final draft of documents is circulated.

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Note: The above article is not intended to provide legal advice. It is designed merely to offer some insight into the subject of Representations and Warranties. For more information, the reader is advised to consult an attorney, intermediary or other competent advisor.

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Alamo Corporate Group and its advisors have specialized in ownership transfers of closely held companies since the late 1980's. We offer a range of intermediary services including mergers, acquisitions, divestitures, buyer identification, management buyouts, debt restructuring and in very limited instances, acquisition searches for high net worth individuals and private equity groups.

Alamo's primary purpose is to provide an extremely confidential national service that brings buyers and sellers together through our extensive contacts in the financial and intermediary communities.

Our process is very structured, as experience has shown us that while each buyer and seller is somewhat unique, there are enough similarities that specific steps must be followed in order for transactions to close. Confidentiality is guarded throughout each step of the process.

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