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SELLER BEWARE

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The traditional caveat usually applies to buyers, and to guard against buyer risks, purchase agreements typically contain everything from lengthy representations and warranties to elaborate indemnification provisions — the majority of which are designed to provide protections to the buyer. Effective representation of a seller, however, requires that seller's counsel not merely react to the buyer protections, but take proactive steps to consider protections for the seller in the acquisition agreement, as well. Here are five items that are often overlooked by sellers in a buyer's draft.

Structuring leveraged buyout financed purchase price payments

A typical structure in which the buyer is financing the purchase price by borrowing against assets of the target involves the target taking out a loan to finance a closing dividend payment to the seller as a material component of the purchase price. Although a seller may be indifferent to receiving that portion of the purchase price from the buyer or in the form of a dividend from the company it is selling, such a debt-financed purchase price payment structure involves significant risks for the seller. In the event that after closing, the sold company files for bankruptcy or otherwise becomes insolvent, a bankruptcy trustee could argue that payment of the debt-financed dividend rendered the target insolvent and that the dividend should be brought back into the bankruptcy estate. To protect itself against these risks, a prudent seller would need to consider obtaining a closing solvency opinion and/or otherwise pre-emptively structuring protection with the aid of bankruptcy counsel.

Effectively providing for time limits on representations and warranties

A common seller protection is a limited survival period on representations and warranties, with certain exceptions, in some cases, for fundamental representations that last indefinitely. Such a protection allows the seller a point of time, at which it knows that it will not be at risk for returning money to a buyer due to a breach of representations and warranties. However, to avoid ambiguity, any language shortening the survival period for a representation and warranty should not just state that the representations or warranties expire within a certain time frame, but that any action for a breach of such representation or warranty must be brought, or notice of a claim given, before expiration of the survival period. Secondly, in structuring a survival period on representations and warranties, it is important to consider the state law governing the transaction documents. Some state statutes restrict the degree to which parties may by contractual arrangement shorten a period for claims to less than what is provided for in the statute of limitations for a contract breach generally.

Appropriately analyzing the impact of noncompete provisions

In order to ensure that a buyer gets "the benefit of its bargain" in an acquisition, the buyer will usually require that the seller not compete with the business being sold for a duration of time. While this is a legitimate provision for a buyer to include in a draft, attention must also be paid to any restrictions on the use of confidential information by the seller post-closing, and any such restrictions on the use of confidential information must be read in connection with any noncompete restrictions. If a confidential-information provision lasts indefinitely and confidential information is drafted to include trade secrets or business know-how, a seller who starts a competing business after the expiration of the noncompete may still leave itself open to allegations that it was using trade secrets or know-how in violation of a still-surviving confidentiality provision, unless the confidentiality provision is appropriately understood and care is taken to document continued compliance with it.

Structuring post-closing consideration payments

In an environment where buyer financing is limited, transactions are increasingly making use of seller financing, earnouts or other forms of deferred or contingent payments. In the event that a seller agrees to accept a portion of the purchase price in the form of a deferred payment, it must give careful consideration to the ability of the purchaser under any credit documents to make any such payments. For example, in many cases, a buyer in a leveraged buyout scenario will take out a large credit facility that will require that any payments on seller notes or earnouts be subordinated to the bank lender's right of payment. Without a thorough understanding of the risks presented by the buyer's financing structure, a seller may find itself not receiving a deferred payment that it had been relying upon due to an issue with the purchaser's senior credit facility. In addition, the use of deferred payments requires that sellers work closely with counsel to identify any post-closing covenants, accounting standards or controls for the sold business that will increase the chances that the sold company will be in a position to make any deferred payments. With respect to earnouts in particular, without effective protections, sellers often lose the benefit of their bargain when a buyer introduces new accounting measures or otherwise changes the operation of the business post-closing in a manner that impedes any negotiated earnout targets from being met.

Effectiveness of caps on post-closing liabilities

A crucial risk management issue for a seller in a traditional merger or acquisition is to understand how much, if any, of the purchase price it may be obligated to return. To manage these risks, a seller will typically provide that (i) its post-closing liabilities for breaches of representations and warranties are limited to a certain percentage of the purchase price and (ii) such liability limited provisions are the exclusive remedy for violations of the purchase agreement and related documents. Although the plain meaning of these provisions may be clear, there have been a number of cases where buyers have attempted to void seller protections when a post-closing dispute arises. Drafting these provisions in a manner that proactively manages this risk requires an understanding of the applicable state law (including an awareness of any exceptions to liability caps or exclusive remedy provisions that may exist under the applicable common law regardless of whether they are explicitly provided for or not in the relevant contract), as some states will go further than others in enforcing carefully drafted post-closing liability protections.

Selling a business will involve a number of risks. However, a well-drafted purchase agreement can serve as an effective tool for mitigating a seller's post-closing exposure.

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