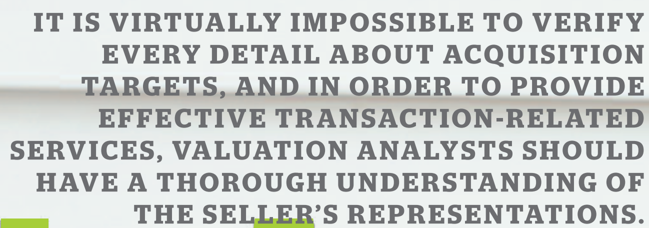
Seller In Acquisition



IT IS VIRTUALLY IMPOSSIBLE TO VERIFY EVERY DETAIL ABOUT ACQUISITION TARGETS, AND IN ORDER TO PROVIDE EFFECTIVE TRANSACTION-RELATED SERVICES, VALUATION ANALYSTS SHOULD HAVE A THOROUGH UNDERSTANDING OF THE SELLER'S REPRESENTATIONS.

Representations Agreements

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Despite their relative anonymity in the media, seller representations and warranties are among the most important provisions of purchase agreements.[1] This article sheds light on this infrequently discussed, yet important, component of nearly every mergers and acquisition (M&A) transaction.

Transactional Due Diligence

A primary purpose of performing transactional due diligence is to identify any topics covered by the seller's representations. In M&A transactions, buyers are typically at an informational disadvantage relative to the seller. This is because the buyer lacks the seller's level of knowledge of the target. Since no buyer can reasonably expect to verify every detail during pre-closing transactional due diligence, the seller typically provides the buyer with various representations and warranties.

A representation is a "statement made by one of two contracting parties to the other, before or at the time of making the contract, in regard to some fact, circumstance, or state of facts pertinent to the contract, which is influential in bringing about the agreement."[2]

Three-Fold Purpose. Seller representations exist because it is virtually impossible for the buyer to verify every detail about the target. Even the most experienced buyer will fail to uncover or verify every fact or assumption about the target company that may affect the transaction purchase price. Therefore, buyers typically demand representations from the seller in order to complete the M&A transaction. The seller's representations and warranties serve a three-fold purpose from the buyer's perspective:

1. To assist the buyer in understanding the business it is purchasing.
2. To protect the buyer by allowing it to abort the transaction before the closing if it finds the representations to be misleading.
3. To enable the buyer to recover damages if the seller's representations and warranties materially or fraudulently misrepresent the financial reality of the target business.[3]

The buyer relies on the seller's representations and warranties as all-inclusive of the target company's financial position. For example, the seller may represent that "neither the description of the business and properties of the corporation and subsidiary, nor the financial statements, contain any untrue statement of a material fact or omit to state any material fact necessary to make the statements or information therein not misleading."[4] Many of the topics typically covered by the seller's representations and warranties are presented in Exhibit 1.

Specific Language

The specific representation and warranty conditions are unique to a subject transaction, and negotiated between the buyer and the seller. These conditions are included in the transaction agreement,[5] and each of these items can be further described in a supporting schedule or exhibit. Representations can address the most contested aspects of a transaction, or simply include standard language that is present in virtually all transactions.

The exact wording of the representations is negotiated by representatives for the buyer and the seller. Naturally, the buyer prefers stringent language and broad warranties, while the seller prefers the opposite. For example, the seller may want the litigation representation to say, "To the best of the seller's knowledge, there is no material litigation…." Conversely, the buyer may want this same representation to say, "There is no litigation…."

Scope. Sometimes, "the representations and warranties contemplated by the purchase or other agreement, as well as the opinions to be delivered on closing, serve to define and focus due diligence activities."[6] If the representations are narrower than the buyer anticipated, additional due diligence may be required. If the representations specifically exempt certain issues, this may be a sign that there is a problem or that the seller does not have specific knowledge of those issues.

How much or how little the seller is willing to represent to the buyer can affect how much the buyer is willing to pay to acquire the target. If the buyer perceives that the seller's representations are narrow and include ambiguous language, then the buyer may perceive the investment to be riskier—and the buyer may demand a lower price to offset the additional risk.

Accuracy Timeframe

Of course, transactions are not negotiated, executed, and completed all on the same day. Therefore, seller's representations are specific to a particular point in time. Representations can be accurate:

1. As of the date of the financial statements.

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2. As of the closing.
3. At signing of the purchase agreement.
4. For some period after the closing of the transaction.
5. Some combination of items one through four above, depending on the specific representation and the goals of the parties.

"As of" time frame representations are specified in the transaction agreement. Certain representations, such as the legal right for the seller to complete a transaction, may be true throughout the entire diligence period. Other representations, such as the accuracy of the target's financial statements, may be true only as of the date of the financial statements. For representations such as these, it is customary for the seller to represent that there have been no *material adverse events* (MAE) for the target between (1) the date the representation is valid (e.g., the date of the financial statements) and (2) the closing of the transaction. Such MAE representations are common in M&A transactions and typically required in purchase agreements.

Misrepresentations and Fraud

If any part of the representations (including an MAE representation) turns out to be false, the seller may be liable for all economic damages incurred by the buyer. The buyer and seller can negotiate the seller's liability for misrepresenting facts in a number of ways, including:

- Holding back a portion of the purchase price for a specified period.[7]
- Incorporating liability provisions in the indemnification clause of the transaction agreement.
- Using specific language in the transaction agreement (e.g., does the seller represent something to be true, or does it represent that something is *materially* true *to the best of its knowledge?*).

Generally, sellers will provide certain indemnification provisions regarding the financial condition of the target company. Such provisions typically address items disclosed in the seller's representations and warranties.

Distortions. Fraudulent financial statements are meant to distort the actual financial condition of the target company and present it in a better light. Examples of fraudulent financial statements include presenting a false increase in revenue or profits, a betterment of the general financial condition of assets, or a lessening of liabilities. Financial statements may also fail to accrue certain expenses, improperly recognize revenue, or improperly classify items.

Liability for misrepresentations is negotiable.

Effect on Purchase Price

When misrepresentations overstate financial conditions, such as the target's historical earnings, they may cause the buyer to overpay. "A material misrepresentation may cause a buyer to reach a conclusion different from the conclusion that would have been reached in the absence of such a misrepresentation."[8] In other words, in cases where a buyer had known of the financial statement misrepresentation, it may have determined a different purchase price.

1 Horwich, *Professional's Guide to Purchase and Sale of a Business; Taxation, Valuation, Law, and Accounting* (Aspen Publishers, 2003), page 435.

2 Black's Law Dictionary online (thelawdictionary.org/letter/r/page/59/).

3 See Weil, Frank, Hughes, and Wagner, eds., *Litigation Services Handbook: The Role of the Financial Expert, 4th ed.*, (Wiley, 2007); AICPA Practice Aid, *Mergers and Acquisition Disputes* (AICPA, 2012), Chapter 5.

4 Horwich, note 1, *supra,* page 556.

5 Note that the term transaction agreement is used in this article to broadly consider all forms of agreements, such as asset purchase agreements, merger agreements, stock purchase agreements, and other similar transaction-related agreements.

6 Bryer and Simensky, eds., *Intellectual Property Assets in Mergers and Acquisitions* (Wiley, 2001).

7 See Miller, *The CPA's Role in Buying or Selling a Business* (AICPA, 2011) ("Virtually all transactions will require the seller to be contingently liable for a percentage of the transaction price as a form of insurance for the buyer against seller misrepresentations.)"

8 *Mergers and Acquisition Disputes,* note 3, *supra.*

EXHIBIT 1
Common Topics of Seller's Representations and Warranties

- Corporate authority to execute the transaction agreement.
- Organization, standing, and qualification of the target company.
- Subsidiaries of the target company.
- Financial statements of the target company, including:
  1. The nature of the financial statements.
  2. The target company's assets, such as real property, inventory, other tangible personal property, accounts receivable, trade names, trademarks, copyrights, patents and patent rights, trade secrets, and other intangible property.
  3. All debts, obligations, and liabilities of the target company.
  4. Statements to ensure that target tangible and intangible assets and liabilities are what the buyer expects them to be, and that the buyer is acquiring the assets unencumbered (unless otherwise stated).
- Tax returns and audits of the target company.
- Capital structure of the target company.
- The solvency of the target company immediately after closing.
- Identification of customers and the seller's interest in customers, suppliers, and competitors.
- Existing employment contracts.
- Corporate documents and other contracts, agreements, and obligations.
- Compliance with relevant authorities.
- Existence of known or impending litigation.
- Identification and compensation of officers and directors.
- Statements regarding changes or the absence of changes to the financial position, operations, liabilities, assets, business, or prospects of the target company since the date of the last audited financial statements.
- Statements to ensure the information in the shareholder proxy statement and other materials is true and not misleading.
- The statement of full disclosure.

Hypothetical. For example, assume that a target company was purchased for $500 million and that its reported annual earnings before interest, taxes, depreciation, and amortization (EBITDA) was $50 million. The transaction-implied pricing multiple is therefore ten times annual EBITDA. Subsequently, the buyer discovers that the seller overstated EBITDA by $10 million as a result of a material misrepresentation regarding the target's inventory reserves. The inventory reserve adjustment may have a one-time effect on the balance sheet, and on the latest 12-month EBITDA. However, if the buyer relied on the represented EBITDA (of $50 million) to determine the purchase price, the buyer may allege that it bargained for a business worth $500 million and received a business worth only $400 million. The revised $400 million valuation is calculated as the actual EBITDA of $40 million multiplied by the transaction pricing multiple of 10x.

Material Effect Question. An important question to consider when evaluating financial statement misrepresentations is whether making an adjustment bears a material effect on the target's future performance.

> A one-time adjustment [to the financial statements] may affect the buyer's perception of value of the company into future periods. Alternatively this may be an item that is not expected to occur in the future and, therefore, would not impact the perception of value.[9]

If the adjustment for the misrepresentation relates to one-time nonrecurring costs, then the adjustment may have no bearing on the future earnings stream of the target company. However, if the adjustment relates to

The buyer is typically entitled to the benefit of the bargain.

incremental ongoing expenses which are expected to continue in the future, such as an ordinary operating expense reflected in the interim financial statements, it may affect future earnings. In such cases the buyer's valuation of the target company may therefore be affected. These unrecorded or misrepresented items would have altered the buyer's valuation in determining the acquisition price.

Effect on Future Periods

The buyer has to consider whether the target's business has been damaged into the future as a result of a misrepresentation. Determining the occurrence of a permanent impairment to the value of the business as a result of misstatements and the making of adjustments is predicated on assessing the following factors:[10]

- How the misstatement affects future periods.
- Whether the buyer based its expectations on future performance.
- Whether the target's business was significantly devalued after the acquisition.
- Whether the misstatement would be considered material to a willing buyer.

Economic Damages

The next section of this discussion summarizes the buyer's recourse, if material misstatements are discovered. In instances where the buyer's expectations were materially affected because the seller has misrepresented the financial condition of the target company, the buyer is typically entitled to the benefit of the bargain.[11] This benefit is estimated as the difference between the value bargained for and the value actually received in a transaction.[12]

The following factors are typically considered in determining the benefit of the bargain (i.e., the amount of economic damages):[13]

- If it relates to a one-time adjustment, does the misrepresentation have an effect on the valuation analysis that was performed by the buyer to determine the purchase price?
- Does the claim relate to working capital or indemnity?
- Did the buyer have knowledge of the material misrepresentations?
- What time period does the disputed adjustment affect (current or long-term)?
- What effect does the adjustment have on the target company earnings or cash flow?
- How does the adjustment affect the overall risk profile of the target company?
- Does the adjustment have an effect on the comparability of the target company to guideline companies, if the valuation pricing multiple was calculated based on reference to guideline companies?

Damage Estimates. The economic damages stemming from seller's misrepresentations can be estimated based on a dollar-for-dollar price adjustment, or on a price adjustment based on a pricing multiple applied to adjusted earnings.[14]

In claims that result from items that have a one-time effect on the target company and that do not affect future financial condition (or cash flow), the damages are typically estimated on a dollar-for-dollar price adjustment basis. For example, a working capital adjustment claim is typically measured on a dollar-for-dollar basis. Comparatively, an indemnity claim can result in damages measured on either a dollar-for-dollar basis (for a finite time period or in perpetuity) or on a multiple-times-adjusted-earnings basis.

Adjustments on historical earnings are likely to continue in future periods and imply permanent impairment to the value of the business.[15] This situation would typically result in economic damages being measured based on a pricing multiple applied to adjusted earnings. The economic damages multiple of earnings estimate may be based on the difference of (1) the initial multiple of earnings-based value that was *represented* and (2) the multiple of earnings-based value *actually received*.

Conclusion

The seller's representations are an integral part of nearly every M&A purchase agreement and typically required by corporate buyers in order to complete a transaction. The buyer lacks the seller's level of knowledge about the target, and this knowledge imbalance puts the buyer at an informational disadvantage. The seller's representations generally give the buyer certain rights, including (1) the right to back out of the deal if material misstatements are discovered prior to the deal closing, and (2) the right to recover economic damages if material misstatements are discovered after the subject deal closes.

By understanding the role played by seller's representations, valuation analysts and other transaction professionals can provide more effective financial advisory services to M&A participants. ●

[9] *Id.* [10] *Id.* [11] *Id.* [12] *Id.* [13] *Id.* [14] *Id.* [15] *Id.*