The Importance of Sellers’ Representations in M&A Transaction Purchase Agreements

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It is virtually impossible for the corporate buyer to verify every detail about an acquisition transaction target. For this reason, the corporate buyer typically demands representations from the corporate seller in order to complete the acquisition transaction. Valuation analysts and other transaction professionals should understand such sellers’ representations in order to provide effective transaction-related consulting services. This discussion summarizes both what a seller’s representation is and why a seller’s representation is an integral part of the transaction purchase agreements.

INTRODUCTION

The financial press rarely covers the details of the seller’s representations and warranties when reporting about a proposed merger and acquisition (M&A) transaction. Instead, the transaction components that receive the press coverage often include topics such as any proposed employee layoffs and plant closures, expected post-deal synergies, the implied pricing multiples, and the like.

In spite of such relative anonymity in the media, the seller’s representations and warranties “are among the most important provisions of the [purchase] agreement.”¹ They can affect the transaction price, whether or not a deal gets done at all, and what recourse the corporate buyer has if it is faced with a negative unexpected surprise.

In addition, seller’s representations made prior to the deal closing:

1. give the buyer an opportunity to walk away from the proposed deal if any material inaccuracies are discovered prior to the transaction closing and
2. provide the buyer with recourse if any material inaccuracies are discovered after the transaction closing.

This discussion explores important components of nearly every M&A transaction purchase agreement—the seller’s representations and warranties. It is important to understand the acquisition transaction due diligence process in order to understand the seller’s representations. First, this discussion presents an overview of transaction due diligence, including financial statements and the role of the independent auditor in the issuance of financial statements. Second, this discussion presents an overview of the seller’s representations in an M&A transaction.

M&A TRANSACTION DUE DILIGENCE

Let’s assume that a corporate parent or other institutional entity (the “seller”) owns a business entity (the “target”) that it may be willing to sell.

Prior to contacting the executive officers of the seller, the officers of the potential acquiring company (the “buyer”) typically develop a basic understanding of the target’s business. This information about the target may include data from publicly available sources, such as Securities and Exchange Commission (SEC) Forms 10-Q or 10-K. Or it may include anecdotal data that the buyer has learned over many years of competing in the same (or complementary) industry as the target.
This understanding of the target business may include general knowledge of the target’s (1) operations; (2) financial performance; (3) industry; (4) key management; (5) strengths, weaknesses, opportunities, and threats; and (6) other similar attributes. Based on these data, the buyer may even have an idea about the price that it will offer to acquire or merge with the target.

However, prior to completing an M&A transaction, the buyer will want to have more than a basic understanding of the target. This enhanced knowledge of the target is developed during the buyer’s due diligence process. Due diligence is “the methodical investigation of all the legal, financial, and strategic facets of a company and a transaction. It is a process that involves obtaining and verifying very detailed information about a company that is not usually found in its public documents.”

The due diligence process typically begins even before the buyer contacts the target to discuss a possible merger or acquisition. And, the due diligence process continues after the transaction is closed. Often, the buyer engages a third-party financial advisory firm to assist in conducting the due diligence.

The primary purposes of due diligence are as follows:

1. To validate the proposed transaction assumptions
2. To unearth possible problems (e.g., limit the buyer’s liability)
3. To plan for an orderly ownership transition

The objectives of due diligence (which are implicit in the above list) are as follows:

1. To fulfill the duty of care of the buy-side individuals responsible for completing the proposed M&A transaction
2. To identify any items to be covered by the seller’s representations and warranties

These due diligence purposes and objectives can be resolved in a wide variety of ways. The typical due diligence procure can include any of the following activities:

- Preparing written document and information requests for the target, and reviewing and responding to the information supplied by the target
- Hiring outside consultants (often accounting, legal, valuation, and other specialists) to analyze certain aspects of the target

Due diligence is often an iterative process between the buyer and the seller. The process typically involves identifying issues and resolving those issues to the satisfaction of the buyer.

**Financial Statements**

The buyer typically conducts financial statement due diligence in order to evaluate the liabilities it will assume and the assets it will receive in the proposed M&A transaction.

Buyers generally prefer to structure transactions so as to avoid uncertainties or contingent liabilities. Sellers generally prefer to structure transactions so as to relieve them of further exposure to any recorded or contingent liabilities.

As both parties seek to identify, quantify, and limit their risks, the contract provisions allocating risks between the parties take the form of representations, warranties, covenants, and indemnifications. The transaction agreements often include clauses related to accounting and financial reporting issues, which affect the purchase price determination.

The buyer typically determines a purchase price based on information in the target financial statements and the trend of the target’s earnings. A buyer generally relies on audited financial statements (if available) and unaudited financial statements in the acquisition valuation analysis. This is because the target financial statements encompass all aspects of the target company’s financial position and results of operations.

The buyer relies on the target’s historical financial statements to fairly present the following:

1. The existence of and cost of all assets and liabilities of the target company
2. The revenue and operating expenses associated with the target company’s results of operations

The seller often represents that the target financial statements were prepared in accordance with generally accepted accounting principles (GAAP). The seller may also warrant that no undisclosed liabilities exist regarding the target. This
representation provides the buyer with assurance that it is only acquiring the liabilities that are disclosed on the target balance sheet.

The buyer, however, may request that any contingent liabilities not required to be recorded under GAAP also be footnoted on the target balance sheet. The reason for this buyer request is to have the disclosed contingent liabilities covered by the seller’s representation. The buyer may also require the seller to warrant that the target financial statements do not contain any material misstatements.

In an M&A transaction, the buyer is essentially acquiring an anticipated stream of future cash flow. Thus, the buyer’s anticipated stream of target company cash flow has a significant impact on the purchase price offer for the target company.

Other factors can also influence the buyer’s purchase price offer, such as negotiating leverage, the presence of competing bidders, tax issues, and expected synergies. The buyer’s purchase price offer may also consider the amount of working capital needed to support the ongoing operations of the target business.

To determine the purchase price, the buyer may rely on generally accepted business valuation methods that incorporate information contained in the target financial statements, such as a multiple of earnings pricing metric. Earnings before interest and taxes (EBIT) or earnings before interest, taxes, depreciation, and amortization (EBITDA) are common valuation-related financial metrics. “Buyers often use multiples of [financial] metrics to provide broad pricing guidelines.”

The Role of the Independent Auditor and the Independent Audit in the Issuance of Financial Statements
Financial statements issued with an independent auditor’s report can provide users of the financial statements with some level of confidence regarding the quality, consistency, and reliability of the financial statement information.

This confidence occurs because audited financial statements include the auditor’s opinion as to whether the financial statements:

1. are prepared in accordance with an applicable financial reporting framework, such as GAAP;
2. are prepared on a consistent basis for all reporting periods; and
3. are free from material misstatements, when taken as a whole.

Audited financial statements, however, do not provide a guaranty that the issued financial statements are free of errors. One reason for this is that the auditor has no responsibility to plan and perform the audit to detect misstatements that are not material to the financial statements as a whole.

The role of the independent auditor in conducting an audit of financial statements in accordance with generally accepted auditing standards (GAAS) is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatements.

This compliance with GAAS allows the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with GAAS.

In general, an audit includes examining, on a test basis, evidence supporting the amounts and disclosures in an entity’s financial statements. An audit also includes assessing the accounting principles used and any significant estimates made by the entity management, as well as evaluating the overall financial statement presentation. The development and presentation of the financial statements is, however, the responsibility of the company management. The auditor’s responsibility is to express an opinion of the financial statements based on the audit.

U.S. Auditing Standards—AICPA [Clarified] (AU-C) 200, Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards, summarizes the auditor’s responsibility as follows:

As the basis for the auditor’s opinion, GAAS require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is a high, but not absolute, level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. Reasonable assurance is not an absolute level of assurance because there are inherent limitations of an audit that result in most of the audit evidence, on which the auditor draws conclusions and bases the auditor’s opinion, being persuasive rather than conclusive.

Given the auditor’s responsibility to obtain reasonable assurance about whether the financial
statements as a whole are free from material misstatement, the concept of materiality, (that is, what is or what is not material) is important to the audit process. The concept of materiality is discussed next.

The Concept of Materiality and the Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in accordance with GAAP often requires the use of estimates and assumptions, such as the estimates that support a fair value measurement. These estimates and assumptions can affect the reported amounts of assets, liabilities, revenue, expense, and related disclosures of contingent liabilities. Estimates are based on both subjective and objective factors and, as a result, require management’s judgment.

The entity’s actual results could (and often do) differ from the estimates used by management to prepare the entity’s financial statements. For this reason, the concept of materiality is inherent in GAAP and in most financial reporting frameworks.

Materiality is defined in International Accounting Standards (IAS) 8, as follows:

Omissions or misstatements of items are material if they could, by their size or nature, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements.10

For financial statements issued by entities that report under GAAP, a definition of materiality is found in Financial Accounting Concepts Statement 2, Qualitative Characteristics of Accounting Information:

The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

These accounting definitions of materiality are discussed in the context of the preparation and fair presentation of financial statements.

Although various financial reporting frameworks may define materiality in different terms, they generally focus on the following concepts:11

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users of the financial statements.
- Judgments about materiality are made in light of surrounding circumstances and are affected by the size or nature of a misstatement, or a combination of both.
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.12

What is apparent from the above discussion is that the concept of materiality, as it relates to financial statements, is complex. And, in general, the concept of materiality is not based on a simple calculation or numerical threshold.

The Responsibility of Both the Auditor and the Financial Statement Preparer with Regard to the Use of Estimates

Accounting estimates are an integral part of the preparation of financial statements and are typically based on management’s judgment. These accounting estimates are the responsibility of management. The auditor is responsible for evaluating whether the accounting estimates made by management are reasonable and include adequate financial statement disclosures.

GAAP often requires the financial statement preparer (i.e., the company management) to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue, and expense, and related disclosures of contingent liabilities.

Examples of estimates used by company management in the preparation of financial statements include fair value measurements, net realizable value of inventory, remaining useful lives of assets, present value discount rates, the timing of certain events, contingent liabilities, asset impairments, pension benefit obligations, and warranty expense.

According to GAAP, management is responsible for establishing a process for preparing accounting estimates that encompass management’s knowledge and experience about past and current events and certain assumptions about future events.

The auditor’s responsibility regarding financial statement accounting estimates is to obtain sufficient and appropriate audit evidence about whether:
1. the accounting estimates, whether recognized or disclosed, are reasonable, and
2. the related financial statement accounting disclosures are adequate.13

To assess the risk of material misstatement of the accounting estimates, the auditor is required to obtain an understanding of the subject entity and its environment, including the entity’s internal accounting controls.14

According to the AICPA AU-C 540, Auditing Accounting Estimates, as part of the audit risk assessment, the auditor should obtain an understanding of:

1. the applicable financial reporting framework requirements relevant to accounting estimates, including the related disclosures;
2. how management identifies transactions, events, and conditions that may give rise to the need for accounting estimates; and
3. how management makes the accounting estimates and the data on which the accounting estimates are based.

By understanding the entity’s internal controls, the auditor can evaluate whether management’s accounting estimates are reasonable in the context of the financial statements taken as a whole. This in turn allows the auditor to express an opinion as to whether the financial statements are:

1. prepared in accordance with an applicable financial reporting framework and
2. free from material misstatements, when taken as a whole.

**SELLER’S REPRESENTATIONS**

A primary purpose of transaction due diligence is to identify any topics to be covered by the seller’s representations.

Even if the buyer conducts a thorough due diligence, the buyer typically is 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 about the target during pre-closing transaction 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.”16

Seller representations exist because it is virtually impossible for the buyer to verify every detail about the target. 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 from not having full insight into the business that it is purchasing, by allowing the buyer to abort the transaction if it finds the representations misleading before the closing
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 business17

Knowing that even the most experienced buyer will fail to uncover or verify every target fact or assumption, the buyer typically demands representations from the seller in order to complete the M&A transaction.

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 “[n]either 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.”18

Many of the topics typically covered by the seller’s representations and warranties are presented in Table 1.

The specific representation and warranty conditions are unique to the subject transaction, and
they are specifically negotiated between the buyer and the seller. These conditions are included in the transaction agreement.19

Each of these (and other) items can be further described in a supporting schedule or exhibit to the transaction agreement. Representations can include the most contested aspects of a transaction, or they can include standard language that is present in virtually all transactions.

The exact wording of the seller’s representations is negotiated between the buyer’s representatives and the seller’s representatives. Naturally, the buyer prefers stringent language and broad warranties, and 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. . . .”

“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.”20

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

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Table 1
Common Topics of Seller’s Representations and Warranties

<table>
<thead>
<tr>
<th>Common Topics of Seller’s Representations and Warranties</th>
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<tbody>
<tr>
<td>- Corporate authority to execute the transaction agreement</td>
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<td>- Organization, standing, and qualification of the target company</td>
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<td>- Subsidiaries of the target company</td>
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<td>- Financial statements of the target company, including the following:</td>
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<td>- Tax returns and audits of the target company</td>
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<td>- Capital structure of the target company</td>
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<td>- The solvency of the target company immediately after closing</td>
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<td>- Identification of customers and the seller’s interest in customers, suppliers, and competitors</td>
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<td>- Existing employment contracts</td>
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<td>- Corporate documents and other contracts, agreements, and obligations</td>
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<td>- Compliance with relevant authorities</td>
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<td>- Existence of known or impending litigation</td>
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<tr>
<td>- Identification and compensation of officers and directors</td>
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<tr>
<td>- 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</td>
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<td>- Statements to ensure the information in the shareholder proxy statement and other materials is true and not misleading</td>
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<td>- The statement of full disclosure</td>
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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.

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. Depending on the specific representation and the goals of the parties, representations can be accurate (1) as of the date of the financial statements, (2) at closing, (3) at signing, (4) for some period after the closing of the transaction, or (5) for some combination of items one through four.

The “as of” timeframe 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 only be true 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.

This MAE representation is common in M&A transactions.

Misrepresentations and Fraudulent Statements

Buyers typically require that a seller’s representation (including an MAE representation) be included in the purchase agreement. This is because if any part of the seller’s representations turns out to be false, the seller may be liable for any 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 the following:

- Holding back a portion of the purchase price for a specified period of time. According to The CPA’s Role in Buying or Selling a Business, “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.”
- The indemnification clause in the transaction agreement.

By the 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, the seller will make certain indemnification provisions regarding the financial condition of the target company. Indemnification provisions typically address items disclosed in the seller’s representations and warranties. This is because, despite conducting thorough due diligence prior to a transaction, the buyer may not discover certain conditions until after the transaction has closed.

Fraudulent financial statements are meant to distort the actual financial condition of the target company and to present the target company in a better light. Fraudulent financial statements may involve presenting an increase in revenue or profits, a betterment of the financial condition of the assets, or a lessening of the liabilities, among other things.

Financial statement misrepresentations may include failure to accrue certain expenses, improperly recognized revenue, or improperly classified items. These misrepresentations can overstate the target’s historical earnings and, therefore, may cause the buyer to overpay for the target. “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.”

Had the buyer known of the financial statement misrepresentation, he or she may have determined a different purchase price.

For example, let’s assume that a target company was purchased for $500 million and that its reported annual EBITDA was $50 million. Therefore, the transaction implied pricing multiple is 10 times annual EBITDA. Subsequently, the buyer discovers that the seller overstated EBITDA by $10 million as a result of material misrepresentation regarding the target 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.
An important question to consider when evaluating financial statement misrepresentations is whether a disputed 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.”

If the disputed adjustment relates to one-time nonrecurring costs, such as costs to execute the particular transaction, then the adjustment may have no bearing on the future earnings stream of the target company. However, if the adjustment relates to incremental ongoing expenses for the target company, such as an ordinary operating expense reflected in the interim financial statements, which are expected to continue in the future, there may be an impact on future earnings.

Therefore, there may be an impact on the buyer’s valuation of the target company. These unrecorded or misrepresented items would have altered the buyer’s valuation in determining the acquisition price.

The buyer has to consider the effect of the disputed adjustment amount on future periods, and the buyer has to consider whether the target’s business has been damaged into the future as a result of a misrepresentation.

ECONOMIC DAMAGES

In instances where the buyer’s expectations were materially affected because the seller has materially misrepresented the financial condition of the target company, the buyer is typically entitled to the benefit of the bargain.24

This benefit is estimated as the difference between the value bargained for and the value actually received in a transaction.25

In determining the economic damages that result from seller’s misrepresentations, the following factors are typically considered:26

- Did the one-time-effect item have an impact on the valuation analysis 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 item affect (current or long-term)?
- What impact does the item have on the target company earnings or cash flow?
- How does the item affect the overall risk profile of the target company?
- Does the item have an impact on the comparability of the target company to guideline companies, if the valuation pricing multiple was based on such guideline companies?

The economic damages stemming from seller’s misrepresentations can be estimated based on a dollar-for-dollar price adjustment or a price adjustment based on a pricing multiple applied to adjusted earnings.27

In claims that result from items that have a one-time effect on the target company and that do not affect the future financial condition or cash flow of the target company, 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 into perpetuity) or on a multiple-times-adjusted-earnings basis.

The impact of the disputed adjustment on historical earnings that is likely to continue in future periods implies the occurrence of permanent impairment to the value of the business.28 This situation would typically result in economic damages measured based on a pricing multiple applied to
adjusted earnings. The economic damages multiple of earnings estimate may be based on the difference of the following:

1. The initial multiple of earnings-based value represented
2. The multiple of earnings-based value actually received

**CONCLUSION**

The seller’s representation is an integral part of nearly every transaction purchase agreement. A seller’s representation, typically, is required by the corporate buyer in order to complete an M&A transaction. This is because the buyer lacks the seller’s level of knowledge of the target. This knowledge imbalance puts the buyer at an informational disadvantage relative to the seller.

The seller’s representation generally gives the buyer certain rights, including the following:

1. The right to back out of the deal if material misstatements are discovered prior to the deal closing
2. The right to recover economic damages if material misstatements are discovered after the subject deal closes

By understanding what a seller’s representation is and why it is an important part of the transaction purchase agreement, the valuation analyst and other transaction professionals can provide more effective financial advisory services to M&A transaction participants.

**Notes:**

3. Ibid, 696.
5. Paragraph .07 of U.S. Auditing Standards—AICPA [Clarified] (AU-C) 200, *Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with Generally Accepted Auditing Standards*.
7. Ibid.
8. AU-C standards are a codification of Statements of Auditing Standards (SAS) Nos. 122-127 and certain interpretations issued by the Auditing Standards Board (ASB). The ASB is the senior technical body of the American Institute of Certified Public Accountants (AICPA).
11. Paragraph .02 of section AU-C 320, *Materiality in Planning and Performing an Audit*.
12. Ibid.
14. Paragraph .08 of section AU-C 540.
15. Ibid.
16. Black’s Law Dictionary online (thelawdictionary.org/letter/r/page/59/).
19. Note that we use the term transaction agreement to broadly consider all forms of agreements, such as asset purchase agreements, merger agreements, stock purchase agreements, and other similar transaction-related agreements.
22. Ibid.
23. Ibid.
24. Ibid.
25. Ibid.
26. Ibid.
27. Ibid.
28. Ibid.

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