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Purchase and Sale Agreements: the Seller's Perspective

Once the sale price has been agreed, many sellers believe the rest is just paperwork. Think again, as many important issues still need to be decided and the owner needs to stay involved.

by Mark D. Working

Many an owner involved in the sale of a business thinks that once the price is agreed the heavy lifting has been accomplished, and they have little interest in the remaining aspects of the transaction. We think that it is a mistake for a seller not to be acquainted with all aspects of the transaction documentation. Although it may look like many pages of legalese, most of the issues are business issues and have some bearing on the economics to the parties. We also advise prospective sellers to demand from their transaction team (investment bankers, lawyers, etc.) a clear understanding of the full scope of a deal in advance of documentation negotiations.

By acquainting oneself with the architecture of the deal and making sure that a business perspective drives the process throughout, the path to completion can be smoothed and the probability of closing enhanced. Failure to do so opens the process to a potentially protracted series of skirmishes on fine points that most owners don't understand or appreciate. These "victories" may not be worth the cost of the argument and can lead to a process in which the professional advisors lose sight of the forest, in the midst of a battle over each tree. The result can be an expensive stalemate that creates growing frustrations and leads to irrational decisions that may jeopardize an otherwise highly desirable transaction.

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Parties to a transaction care about the details, and it would be Pollyannaish to think that simply knowing all the issues in advance will make the process a breeze. However, there is no question that difficult issues and the tone and/or principles that guide how a transaction is negotiated are easier to deal with at the beginning, when the parties hear each other and have not buried themselves behind righteous positions.

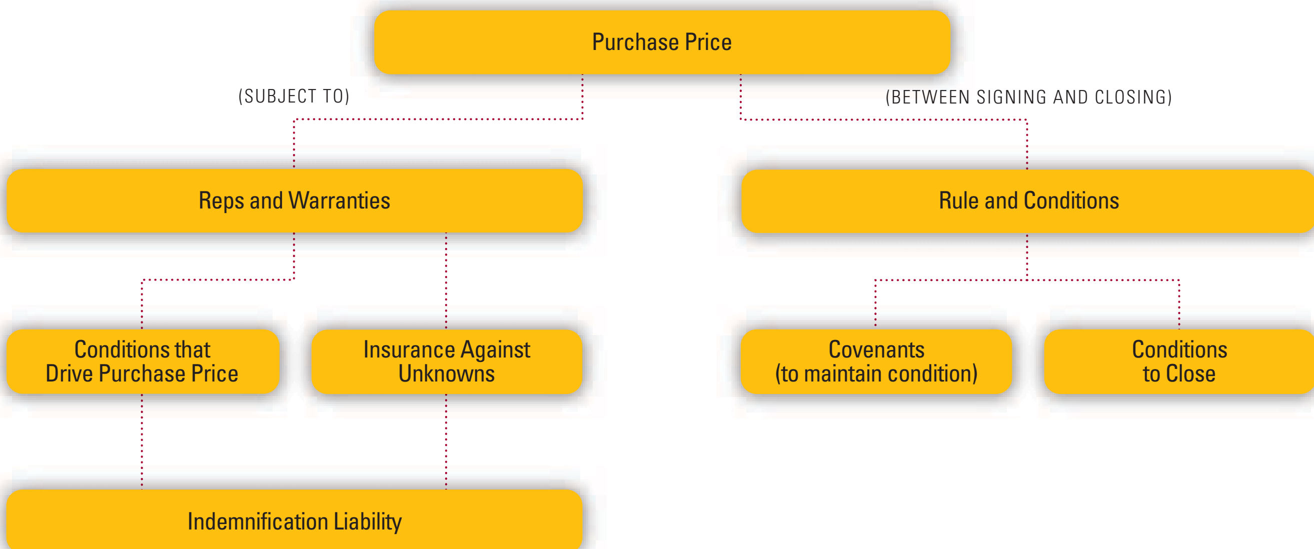
UNDERSTANDING A PURCHASE AND SALE AGREEMENT FROM THE SELLER'S PERSPECTIVE

The purchase and sale agreement is the document that memorializes the agreement between buyer and seller, regarding the sale of the business. Although the effort to achieve both precision and clarity often results in reams of legalese, this agreement focuses on only a few major topics:

1. The Structure
Definition of what is being sold (e.g., stock, assets, and precisely which ones);

2. Price
The amount, timing, and currency in which the purchase price is to be paid (cash, stock, note, contingent payment);

3. Representations and Warranties
The promises made regarding the condition of the business being sold, including the ab-



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sence of unknown or undisclosed liabilities;
4. Indemnification
The seller's obligation to protect the buyer against broken promises or other identified risks;
5. Conditions Precedent
The specific conditions that must be satisfied by both parties prior to closing; and
6. Covenants
The rights and responsibilities of each party (whether between the date of signing and closing, or even after closing).

The diagram above illustrates the basic components of a purchase agreement.

Within this framework issues other than purchase price can be very meaningful for the seller and require attention to the details.

Seller's Representations and Warranties serve three purposes. First, is the seller's formal disclosure of the pertinent facts regarding the business, upon which the buyer has based the purchase price. Secondly, these disclosures provide the basis for the allocation of risk between the parties. If one or more of the disclosures prove untrue in some material way, the buyer wants an avenue to recover a portion of the purchase price. Finally, the breach of a representation may give the buyer the opportunity not to close the transaction.

Eyes invariably glaze over when owners look at these provisions. In reality, only owners or managers have sufficient knowledge to answer the questions and the insight necessary

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to weigh their importance and consequences. If a representation or warranty proves to be inaccurate, it is the seller, not the professional advisors, who knows whether it could damage the buyer. Most disagreements revolve around the extent to which the statements made are absolutely correct or are subject to the knowledge of the seller, and what standards the seller should have pursued to gain knowledge on the particular issue.

Seller's Indemnification Liability is simply the exposure that the seller retains after the sale closes for claims of breaches of representations and warranties or other specified risks. This is always heavily negotiated and carefully documented. The headline transaction price should be less material than what

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the seller ends up keeping when everything is said and done. The battle over indemnification usually is in terms of establishing certain limits and constraints on the dollar amount of claims required before they matter (to reduce the incentive to "nickel and dime"), the absolute limit of liability, and the window of time in which claims can be submitted.

There is no inherently right answer to setting these limits, or that there even should be limits, other than that less and shorter are better from the seller's perspective. There is, however, market information regarding the limits and timeframes set in other transactions, which can be useful guides. There also are arguments that can be made that certain risks are part of the business, as well as due diligence that can provide comfort as to the likelihood of unfavorable outcomes. This is all about allocating the risk of the unknown and the unexpected. The bottom line is that limits on indemnification are sought in order to provide certainty for sellers, within reasonable ranges of safety for the buyer.

Covenants are contractual promises that establish rules of behavior. The primary focus of covenants is actions between signing of the purchase agreement and closing, which can be a lengthy period depending on the number and nature of the conditions precedent to closing. Covenants can be a reliable source of controversy. The buyer wants to assure that

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the conditions that were in effect when the deal was signed will still be in effect when it closes. This means some control over the decisions the owner can make without the buyer's consent. The natural point of conflict is the seller's sometimes-countervailing desire to assure that the business is not unreasonably constrained from making business decisions in a dynamic market, particularly where there may be no certainty of a closing. The buyer's second objective is allocation of risk, in the event that a representation or warranty is breached prior to closing. Issues include whether the parties, or either party, have responsibilities to disclose knowledge of this changing condition. Does the seller have to fix the condition, and at what cost and on what terms? Or, does the seller have to close and bear the indemnification responsibility of a breach of representation? Does the buyer have to close, or does this reopen negotiations?

Conditions Precedent defines what must occur prior to closing to meet the expectations of each party. This boils down to whether the purchase agreement is a commitment

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or an option to purchase. For example, if closing of the transaction is subject to approvals by a board or the arrangement of financing, in practical terms the buyer may have no real commitment to complete the transaction. In that context, a major issue is the level of effort and expense required of each party to remove closing conditions, as well as the consequences for not doing so.

Owners need to understand the "gaming" aspect of negotiations. As an example, it may be a "win" for the buyer if closing is conditioned upon arranging financing satisfactory to the buyer, in its sole discretion, while simultaneously gaining agreement that the seller will be obligated to close if the financing is arranged. In this situation, the buyer has a practical "out" if conditions change, but the seller may not have the reciprocal right.

THE IMPORTANCE OF DETERMINING THE APPROACH IN ADVANCE

The point of this article is not to understate or over-simplify the challenges of documenting a buyout transaction. It is a complex

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process where a multitude of variations for balancing different promises and conditions that make up a deal can lead to active, expensive, and time-intensive negotiations. Owners are well advised to assemble a knowledgeable and experienced team of advisors. This team should be expected to advise the owner how to balance the risks and responsibilities of seller and buyer and how these positions should be negotiated. Otherwise, owners may hear from their advisors that the buyer team is "totally unreasonable" and find themselves at an impasse. In the trenches of transaction negotiations, battles over nuances can take on unreasonable levels of importance and, once a point of ultimate frustration is reached, it can be very difficult to resolve conflicts.

It is far more productive to deal with contentious issues early in the transaction, when the parties are more inclined to hear each other. Obviously, the best environment for the seller to negotiate these parameters is when there is competition from different suitors. Competition forces a cost to be assigned to gamesmanship and disagreement over relatively unimportant provisions, and allows clarity to be achieved in a more timely manner. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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