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IN$IGHT
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Hanging on to the Purchase Price

Representations and warranties can have a significant effect on the purchase price of your business.

by William S. Hanneman

TYPE OF RISK	EXAMPLES
1. Ownership and authority	▪ ownership of stock or assets ▪ lien or other priority to assets ▪ authority to complete the transaction
2. Quality of assets and operations	▪ defects in tangible or intangible assets ▪ ability of operations to “produce” as expected ▪ existence of all requirements to operate ▪ strength of contracts and relationships ▪ commitment of essential people ▪ accuracy of financial reporting
3. Unknown liabilities	▪ tax obligations ▪ environment liabilities ▪ employee claims ▪ product liability

Previous issues of *INSIGHT* have offered guidance on how to evaluate an acquisition candidate in accordance with a strategic vision, design a due diligence investigation to objectively ferret out the important details about the target company (and incorporate those realities into the conclusions of value), and, most recently, calibrate the purchase price to the target's working capital cycle. Even with all of that hard work to arrive at a purchase price, a variety of issues remain that can meaningfully impact the economics of the deal for both buyer and seller. These are the promises regarding the condition of the business and the absence of negative factors that may affect its future performance, commonly referred to as representations and warranties, and the indemnity obligations that support these promises.

Some buyers and sellers view representations and warranties as the sole purview of attorneys, in effect segregating the transaction between price and terms. In our experience, this is a mistake that can have significant negative consequences.

BALANCING RISK PERSPECTIVES

Understandably, the seller wants to walk away clean with all of the sale price, while the buyer demands protection from risks that were not of its making. The normal state of affairs is that sellers, who have often lived intimately with these risks for years, judge them to be minimal. At the same time, buyers, who are often new to the industry or at least new to the particular business, view them as monumental. Balancing these perspectives without objective connections to the transaction economics results in higher costs, longer closing periods, and a higher risk of failure.

The process of purchasing and selling a business forces a more systematic sifting of information and identification of risks than is the case during normal business operations. In addition, simply undertaking a transaction may interject new specific risks. For example, if the business has more financial leverage post-transaction, there is likely to be less tolerance for swings in performance or unexpected costs.

The process of selling a business is likely to identify and focus considerable attention on risks in three general categories:

Undoubtedly, the first objective is to mitigate any of these risks so that the list of issues to discuss is shortened. Lawsuits can be settled, back taxes paid, and accounting treatments adjusted. If they can't be mitigated, both real and perceived risks must be quantified and, through a process of negotiation, allocated among the parties. The results of that effort are the basis for a series of representations, warranties, and the allocation of risk through indemnification obligations.

While there certainly are “average” ranges for indemnification limits, the fact is that no two businesses are alike. Forcing a standard template on a unique set of circumstances is analogous to jamming a square peg in a round hole. It can be done, but it is seldom a proper fit. Although an interesting reflection of market terms, the average indemnification terms in the last 20 transactions in unrelated industries serves as a poor benchmark for any particular situation.

EXPECTED VALUE

Categorizing risks in a specific situation according to the potential cost, the probability of occurrence and the duration of the exposure provides a framework for assigning an economic value to each of the risks. The expected economic value is a product of the potential cost of a particular risk and the probability of its occurrence. The duration requires an estimate of how long the exposure continues (i.e., does it expire according to a statute of limitations, resolve itself by flowing through the business, or is it indefinitely ongoing?).

Type of Risk	Potential Cost	X	Probability of Occurrence	=	Expected Value	Duration

This framework has been used successfully to weigh risks for the purpose of negotiating the amount and survivability of indemnity obligations.

Unquestionably, many of these risks require subjective judgment because they are difficult to quantify. However, this process provides a sense of relative value to evaluate trade-offs and suggest creative solutions to what might appear to be intractable problems, and, perhaps most importantly, provides common decision criteria for the negotiating team. Debates about facts can replace emotional arguments.

Due to often gaping differences between the buyer's and seller's perceptions of risk, allocating those risks in a business sale transaction can be more difficult than negotiating the purchase price. Crafting the best combination

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of price and post-closing risk requires that members of the negotiating team have a common understanding of the tradeoffs and where lines should be drawn. Those conclusions must be considered in relation to the alternatives that are in hand. Situations have arisen more than once where tens of millions of dollars separated the top two purchase offers, yet deal-threatening arguments erupted over risks that were worth substantially less. Such discussions can unravel a desirable transaction.

THE SELLER MUST THINK LIKE A BUYER

The best way to limit risk indemnification is to define and resolve risks in advance of entering the market to sell a business. Good records and attention to detail makes it possible to quantify and weigh real risk issues and reduce the potential for negative events. Surprises in due diligence feed uncertainty and simply aggravate divergent perceptions of risk. As difficult as it might be when contemplating these risks, the seller and its team must think like a buyer and honestly consider both the appropriate amount of indemnification reasonably required to provide comfort and the total economic difference between alternatives. ❖

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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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