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MANAGING POST-DEAL RISK

Post-Closing Liability — In General

Attendant to every sale of a business, there are risks of post-closing financial loss for parties involved that are not necessarily related to the purchaser's ability to profitably operate the acquired business. A purchaser is generally concerned that it will be subject to liability for problems of the seller (*e.g.*, environmental or tax liabilities) that it did not discover during due diligence or which were not disclosed to the purchaser by the seller pursuant to an acquisition agreement. Alternatively, a seller is generally concerned that it will be subject to post-closing liability for problems created by purchaser after closing. As a result, parties to the sale of a business will generally allocate the risk associated with post-closing liabilities in two ways: first, by selecting a certain structure for their transaction; and, second, by including indemnification provisions in the definitive acquisition agreement.

Structuring the Transaction

Unlike the risk of loss associated with a breach of a representation, warranty or covenant which is present in every sale of a business, allocating the risk related to a company's liabilities (*e.g.*, trade debt) existing at closing can be achieved through the selection of a particular transaction structure. As a general rule, in a merger, the surviving entity assumes all of the liabilities of the non-survivor by operation of law. Similarly, in an acquisition of all of the stock of a company, the company remains liable for its obligations and, therefore, the purchaser of the stock bears the economic risk of such obligations by virtue of its stock ownership. Conversely, in a transaction structured as a purchase of assets, the general rule is that a purchaser only becomes liable for those liabilities

expressly assumed by it. [1] As an illustration, the accounts payable of a company not surviving a merger transaction will become the obligation of the surviving company. On the other hand, in an a sset purchase transaction, specific liabilities such as accounts payable can be excluded from the transaction (*i.e.*, not assumed by the purchaser). Thus, from a purchaser's perspective, an asset sale may be advantageous for managing post-deal risk if the purchaser does not intend to assume all of the seller's liabilities at closing.

Indemnification

In addition to allocating post-closing risk by selecting a certain transaction structure, parties may also allocate risk through contract. In general, this is achieved through the inclusion of an indemnification provision in the acquisition document whereby one party agrees to reimburse the other for losses suffered in connection with certain liabilities. Purchasers generally seek indemnification for damages or third-party claims arising out of the breach by seller of representations and warranties or covenants and liabilities arising from occurrences prior to closing (*e.g.*, undisclosed tax liabilities of seller). Sellers generally seek indemnification for damages or third party claims arising from post-closing occurrences (*e.g.*, environmental problems caused by the purchaser after the closing). As an example, assume a seller represents that its liabilities (all of which are being assumed by purchaser) are $1,000,000. After closing, the purchaser discovers that seller had an additional $400,000 in trade debt that was not disclosed and had to be paid by purchaser. The seller would be liable under an indemnification provision for such $400,000.

As a general matter, there is no indemnification in mergers and acquisitions involving two public companies, and the acquisition agreement often states that the representations and warranties terminate at closing. Alternatively, in most transactions involving privately-held companies, indemnification sections are generally present. The reasons for such distinction are (a) that public stockholders will generally not agree to permit a "holdback" of part of the purchase price and (b) the practical difficulties for purchasers in obtaining recourse against a large number of public stockholders once the purchase price is paid. However, in privately-held companies or even in public company transactions where there is a large block

stockholder, it is often appropriate to seek indemnification from the stockholders or at least the large block stockholder. In order to secure the indemnification obligations of sellers in these situations, purchasers will "holdback" in escrow a portion of the purchase price (as discussed below).

Sellers and purchasers should also be aware of the following variables with respect to indemnification:

Survival of Representations and Warranties. Representations and warranties are a "snapshot" of facts about the purchaser and seller as of the date made (*e.g.*, no tax liabilities, financial statements are accurate, etc.). One way parties attempt to allocate the risk of loss with respect to breaches of the representations and warranties is to limit their scope. This may be achieved by the parties agreeing to a "cut-off" date until which the representations and warranties survive the closing.

It is important from a purchaser's perspective that the acquisition document expressly state that the representations and warranties survive closing for a specified period of time and that the purchaser is entitled to indemnification for damages caused by a breach of representations and warranties. Sellers should attempt to limit the risk by minimizing the survival period of such representations and warranties.

In fact, the parties may negotiate separate survival periods for the various representations and warranties depending on the nature of the business and the risks involved. For instance, sellers and purchasers may be willing to agree to a survival period of 1-3 years for most representations and warranties. However, purchasers often insist that representations and warranties for (i) items that are difficult to discover and (ii) long-term potential liabilities such as tax, environmental and benefits plans matters survive until the applicable statute of limitations periods with respect thereto have expired.

Baskets and Ceilings. Sellers will argue the parties should agree that until the post-closing losses reach a certain amount, a seller should not be subject to the burden of indemnifying the purchaser. Otherwise, according to sellers, every minor misstatement and mistake will result in the purchaser calling for reimbursement. The purchaser will counter that the seller is requesting an additional

materiality standard which was most likely covered in the representation itself, and that the seller is therefore attempting to have the limitation apply twice. The parties often then agree to a concept similar to an insurance deductible called a "basket." When a basket is employed, the party giving indemnification is only liable for damages in excess of a specified basket amount. Regardless of the procedure, the primary issue is the amount of the basket. Purchaser's counsel are generally advised to determine the amount of the basket after due diligence and disclosure are complete. If purchaser has determined there are no significant problems, a low basket amount can become a useful negotiating tool for purchaser to gain an even more important concession.

In any event, there are several key issues to be considered when resolving this issue. First, the purchaser should consider whether there are certain post-closing liabilities which should not be limited by the procedure adopted (*e.g.*, environmental liabilities). Second, if a basket is adopted, the parties should agree whether the seller will be liable for all losses after the basket amount is reached (a true deductible) or for every dollar beginning at dollar one (*i.e.*, if the basket is $100,000 and indemnifiable losses of $101,000 are suffered, is seller responsible for $101,000 or only $1,000). Whether or not a basket is established, the seller will argue that its liability should be limited to a portion of the purchase price. Again, depending on the type of business being sold, purchasers will generally resist such a "ceiling" for certain liabilities (*e.g.*, environmental) or in general.

Holdbacks and Set-offs. Once the purchase price is paid, it is often difficult for purchasers to track down individual shareholders in order to seek payment for indemnification claims. Instead, purchasers often require a specified percentage of the purchase price (whether cash or stock) to be deposited into an escrow for all or a portion of the survival period. If a legitimate indemnification claim arises, purchasers can seek reimbursement out of such escrow account.

Assuming that the seller is amenable to the concept of a holdback, it will want to ensure that it receives interest on the funds in escrow or that it receives a favorable valuation for indemnification purposes of any of purchaser's stock (if the sale consideration is stock) held in escrow. Sellers will also desire to fulfill any

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indemnification obligations with such stock. Purchasers will want to ensure that the holdback is sufficient to cover the risk and that it will be able to easily obtain access to such escrow deposit for legitimate indemnification claims.

As a final note, if there is any form of deferred purchase price (*i.e.*, seller note, non-compete payments, consulting payments, etc.), purchasers will also likely require the ability to set-off from such obligations any indemnification claims. Sellers will seek to ensure that the order and priority of such set-offs are to their advantage and to ensure that set-offs are not available against legitimate employment and consulting arrangements compensating them for services rendered.

Conclusion

A properly drafted indemnification provision is an important protective device for purchasers in acquisition transactions. These provisions provide integral back-end protection for purchasers and, where applicable, sellers.

The foregoing article is intended to be merely a brief summary of indemnification provisions and is not a substitute for professional advice. Indemnification provisions have many nuances which are beyond the summary scope of this article. Please consult your professional advisor when faced with these issues.

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[1]One major exception is if the transaction is subject to attack as a "fraudulent conveyance" whereby the transaction would be deemed designed to hinder or defraud the seller's creditors. One example is where a seller would retain trade debt without means to pay.

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