Representations and Warranties in M&A Transactions

What are a representation and warranty? What about indemnification? At their core, they are promises to the buyer about the current and future state of a seller's business and a means for a buyer to recover damages if the promises turn out to be false.

Whether a stock or asset deal, they make up significant sections in the primary transaction agreement (Asset Purchase Agreement or Stock Purchase Agreement). Since these are terms in a contract, they should be taken seriously. Read every representation and warranty carefully to make sure they accurately reflect your business because you will be responsible for living up to them.

Representations and Warranties are more commonly referred to as "reps and warranties" or, simply, "reps." If you don't understand the reps, don't hesitate to ask your lawyer to explain it to you in plain English.

Representations & Warranties

Think about representations as your promises of the current state of the business. These promises assure the buyer that your business is operating the way you say it is. Warranties are a future outlook on the health of the seller's company between typically a 12 to 24-month timeframe after closing.

A buyer-friendly agreement would include broad and discretionary language to cover as many issues as possible at a high level. Still, a seller-friendly agreement would consist of narrowly tailored language to specify the exact terms being promised. Reps play an important risk-shifting role in a deal. The buyer expects the seller to take on the risk of losses that could result from false statements. Broader language provides comfort and certainty for the buyer to price the deal and plan for future operations.

Reps and warranties are often lengthy, and a substantial amount of the time and energy in closing a deal is spent on negotiating them. Which reps are given in an agreement varies quite a bit based on the transaction. A few factors that influence this are the type of deal, purchase price, what is uncovered in due diligence, current market norms, and the lawyers' past practices.

Here are a few typical provisions (not an exhaustive list):

Organization and Good Standing

Your business is properly organized and in good standing with the state of its formation.

Capitalization and Ownership

A promise that your cap table is accurate and the information about the authorized and issued equity in your business.

Financial Statements

Your financial statements have been audited and present fairly and accurately. Meaning, you own your assets and have no more liabilities than presented in the financial statements.

Intellectual Property

You own the intellectual property (IP) you say you do, including trademarks, copyrights, patents, and any other IP transferring with the deal.

Issues often appear when proper IP assignment terms are not in service agreements or the founders didn't sign PIIA agreements transferring IP to the company or conducted initial research for a public university or government agency. Depending on the size of the deal, this can be a problematic area due to patent trolls.

Material Contracts

You may need to include a list of your material contracts in a schedule attached to the agreement and rep that they are not at risk of termination.

Tax

Your taxes have been properly filed and paid. The buyer wants protection in the event the IRS comes knocking post-closing for back taxes.

Compliance with Laws

The buyer will ask the seller to represent that it is in compliance with the law expressly. The seller should try to negotiate qualifiers (i.e., language that says "to the seller's best knowledge") and a time restriction.

Indemnities

Indemnification protects a party from losses associated with broken promises or statements of fact in the transaction agreement. The breaching party must pay up and make the other party "whole" again.

For example, consider a seller that represents the business complies with the law, but in actuality, the business has been violating a permitting law for two years before closing the deal. Because the seller represented that it complied with the law, it may have to indemnify the buyer and provide payment to the buyer for the $25,000 permitting fine.

In most cases, the seller will indemnify the buyer for any misrepresentations in the reps. This section may extend to officers, directors, or founders personally. The parties heavily negotiate this section because the buyer wants protection for its purchase, but the seller wants to relinquish risk and responsibility after the deal closes.

Here are the essential questions to consider:

Who?

Will both buyer and seller have some indemnification protection? Will any founders, directors, or officers be on the hook, personally, for indemnification obligations?

What?

Often, when any of the following provisions are breached, the indemnities trigger protection for the non-breaching party: representations and warranties, covenants, environmental concerns, or pending litigation.

When?

Stipulates the time period during which a party can be held liable for losses. Typically, the expiration date is 12 to 24 months after the closing date.

How Much?

The party being indemnified desires that the entire loss be covered; however, the parties can negotiate for a "basket" and a "cap."

- A basket provides a threshold amount whereby the indemnifying party does not have to cover losses until they exceed the threshold. The basket can be structured so that once the threshold is reached, (1) the indemnifying party is responsible for all losses, or (2) the indemnifying party is liable only for losses over the threshold.
- A cap creates a maximum liability amount.

Typically, some of the purchase price is held in escrow (~10%) to cover indemnification obligations for the agreed-upon time frame. Once the time frame passes, the seller receives the remaining escrow balance *less* any indemnification obligations. It is also common that attorney's fees are covered, and the indemnifying party will cover the indemnified party's fees.