Introduction

Parties to M&A transactions allocate the risk of post-closing losses by negotiating for the seller to make representations and warranties ("R&Ws") concerning the affairs of the business being sold. Merely including strong R&Ws in deal documents does not guarantee that the buyer will be able to obtain a satisfactory recovery in the event of post-closing losses. Buyers can maximize the value of R&Ws by giving careful forethought to common pitfalls along the road to recovery that may limit the value of their contractual rights.

Getting the Right Reps and Getting the Reps Right

A buyer intent on protecting itself from post-closing losses should begin by identifying the most important risks that it faces so that it can determine which R&Ws it will require from a seller. Some risks are so common that they are almost always addressed in M&A transaction documents. One recent study found that 63 percent of post-closing claims for R&W breaches arose from only four kinds of representations: those related to taxes (26 percent of claims), undisclosed liabilities (14 percent), intellectual property (12 percent), and financial statements (11 percent).¹ Buyers represented by sophisticated counsel will likely include R&Ws covering these well-known risks in their commercial agreements. Depending on deal circumstances, less-common representations, such as those regarding accounts receivable, inventory, and product liabilities, may be necessary to include as well.

Boilerplate R&W provisions regarding common risks provide a good starting point for drafting and negotiations, but may not provide sufficient protection on their own. Transacting parties and their counsel must collaborate to identify post-closing risks that are unique to a particular company, industry, or transaction and craft R&Ws that suit the situation at hand. At the same time, they should be mindful of the inherent tension between drafting the “perfect” contract and closing the deal in a timely and cost-effective manner. To that end, the magnitude, as well as the probability, of a given risk should be considered.

Including an R&W in a transaction document is only productive if it is carefully tailored to the risk it addresses. Otherwise, the buyer may find after a dispute arises, that it cannot recover for a post-closing loss that it thought was covered by the R&Ws.² This can be avoided by brainstorming specific loss scenarios that might arise after closing and assessing whether, and how, they could be covered by proposed contractual language. Litigators can even be invited to provide their perspective during the brainstorming, drafting, and negotiating processes.

How to Overcome Impediments to Recovery

A buyer that can irrefutably prove that its counterparty has breached its R&Ws may nonetheless face significant, if not insurmountable, hurdles in attempting to obtain compensation for its losses. These hurdles may include structural impediments to recovery, such as strategic or economic reasons that it would be unwise to pursue a claim or legal impediments, such as state laws and contract terms that stand in the way of recovery.

Structural Impediments

Structural impediments to recovery are practical factors or business realities that weigh negatively in the cost-benefit analysis that an injured party conducts when deciding whether to pursue a claim. One such impediment is that the cost of bringing the claim may outweigh the recovery, either because the defendant lacks sufficient funds to pay the claim or because the amount at risk is too small.

The problem of the judgment-proof seller can be alleviated by ensuring that a reliable source of funds is available to satisfy any indemnification claims that may arise. For example, the deal documents can provide for the buyer to deposit a portion of the purchase price in an escrow account, to be released only after the survival periods for the R&Ws most important to the buyer have expired. Alternatively, the buyer can holdback part of the purchase price or implement a performance-based earnout structure in which indemnification obligations can be offset against post-closing payments otherwise owed to the seller.

Even if the injured party can collect damages from a designated pool of funds, it will not be worthwhile to do so if attorney fees and other costs of enforcement would eat up the recovery. To address this concern, deal documents can be drafted to minimize the costs of post-closing disputes, such as by including a mandatory arbitration clause requiring disputes to be resolved through a mechanism that is usually less expensive than traditional litigation. However, buyers should be aware that arbitration is not a panacea; because it limits their procedural rights and may reduce the pressure to settle.

There may also be non-financial costs of pursuing a breach claim such as where business operations and relationships would be damaged by raising a claim. For example, a buyer may be hesitant to file a claim that is adverse to an individual seller who is still involved in the business as a management team member or where a seller is a key customer or supplier. In these scenarios, the buyer’s interests may be best served by recognizing that strong R&Ws are not particularly useful because they are not likely to be enforced. The buyer could then expend its efforts (and negotiating capital) focusing on other deal terms that offer a better value proposition.

Legal Impediments

Proving that a counterparty has breached its R&Ws will not lead to the desired recovery if the breaching party can point to a contractual provision or law that limits the amount of damages it must pay or precludes liability altogether. Commercial contracts often include limitations on what kinds of damages can be recovered and in what amount. Disclaimers of liability often exclude a laundry list of all damages other than those that are both direct and compensatory, barring those that constitute consequential, incidental, punitive, and numerous other kinds of damages. Such “extraordinary” forms of damages are often incorrectly assumed to be excessive, unpredictable, and unfair to recover. However, scholarly work in this area has promoted awareness of the true legal meanings of these terms. Buyers should not take it as a foregone conclusion that they must accept the broad waivers of entire classes of damages that sellers often propose.

Limitations on the amount of damages that may be recovered can take many forms. The two basic structures that are typically used include a “basket” that must be filled before bringing a claim (essentially, a deductible) and a cap on the total amount that may be recovered. The dollar amounts for the cap and basket are typically determined by applying an accepted percentage to the total purchase price. However, buyers can usually negotiate to have certain breaches (such as breaches of R&Ws that are classified as “fundamental”) carved-out from these limitations on recovery.

One argument that a seller may use to defend against a breach claim is that the claim is time barred under a statute of limitations found in state law or a survival period in the contract. The statute of limitations for breach of contract varies by state, with Delaware allowing three years to bring a claim, New York allowing six, and Illinois allowing ten. Buyers should ensure that the applicable statute of limitations will not run sooner than they will be able to discover a post-closing loss. This can be accomplished by selecting the law of a state with a long limitations period to govern the contract or by selecting Delaware law and invoking a statute that Delaware enacted in 2014 to allow parties to contracts worth more than $100,000 to extend the statute of limitations on breach claims to up to 20 years.

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4 10 Del. C. § 8106(a).
5 N.Y. C.P.L.R. § 213(2).
7 10 Del. C. § 8106(c).
Restrictions on “sandbagging,” or pursuing a claim for a breach that the buyer knew about at the time of closing, can also be an impediment to recovery. States have varying default rules regarding sandbagging: as a general matter, Delaware seems to permit it\(^8\) and California seems to prohibit it,\(^9\) while New York seems to take a more nuanced, fact-specific approach.\(^10\) Parties may agree to override these default rules via an explicit contractual provision. However, buyers who wish to have the right to sandbag claims may have more success including a choice of law clause for Delaware and remaining silent about sandbagging than drawing attention to the issue by proposing an explicit pro-sandbagging provision.

R&W Insurance

Parties to M&A transactions can shift some of the risk of R&W breaches to a third party (rather than allocating it between themselves) by purchasing R&W insurance. R&W policies can be structured to cover either the seller or the buyer and can serve to supplement or replace more traditional routes of recovery. The chief benefits of R&W insurance include providing buyers with a reliable source of funds to satisfy claims and providing sellers with certainty about the amount of transaction proceeds that they will be able to keep.

To date, underwriters have not publicized comprehensive data about payouts under R&W policies. Insurers do have a strong incentive to process claims fairly — their business model depends on private equity sponsors, serial acquirers, and law firms viewing the policies as fair and useful. Additionally, state law often provides that insurers owe policyholders a special duty to approve valid claims, above and beyond the duties that parties to other kinds of contracts ordinarily owe each other. Nonetheless, purchasing insurance does not guarantee successful recovery for all R&W breaches: the policies typically exclude certain types of claims, and coverage limits may prevent a buyer from obtaining full recovery for a particularly large breach.

Conclusion

The road to recovery for breaches of R&Ws can be long and difficult, but it can be made more navigable by keeping these tips in mind:

- Evaluate the post-closing risks applicable to a particular transaction to determine which R&Ws should be included. Draft each representation carefully to ensure that it will provide the intended level of protection in the event that a dispute arises.
- Brainstorm risk event scenarios. Consider potential legal and practical impediments that might stand in the way of enforcing R&Ws to recover for the associated losses.
- Implement an escrow, earnout, insurance policy, or other solution to ensure that a reliable source of funds is available to collect on claims.
- Consider how every provision in a contract affects your ability to recover for a breach. Even bulletproof R&Ws can be undermined by unfavorable indemnification provisions, a liability cap, or a limited survival period.
- Pay as much attention to what's not in the contract as to what is in it. When default rules such as state contract laws are in play, reading the deal documents alone is not enough to become fully informed about your right to recovery.

Most importantly, seek the advice of experienced counsel who can guide you through the negotiation process to maximize the value of your contractual provisions.

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