

Shoe is on the Other Foot When Management Buys

Reps and Warranties In An MBO

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Representations and warranties play several roles in mergers and acquisitions. One is to help establish or confirm the value of the asset being offered by each side - Seller and Buyer. If Buyer offers cash for Seller's shares or assets, Buyer reps are usually brief because the value of cash is easily established. If either party is transferring shares or non-cash assets to the other, it usually provides more extensive reps and warranties. In this fashion, the parties establish parity between the value of the interests acquired and the consideration given in exchange.

In a conventional transaction, Target's management knows considerably more about Target's legal, operational and financial status than Buyer does, even if Buyer has performed a searching due diligence review. Because of this, Seller typically provides extensive reps to validate Target's worth. Such is not the case however when Target's management is the Buyer (an MBO).

This outcome can arise in at least four divestment scenarios in which Buyer will possess more knowledge about Target than the Divestor: (i) when a financial investor sells the controlling interest in one of its portfolio companies to the company's management; (ii) when a non-U.S. owner with a "hands off" management style sells the company to its local management; (iii) when, in a family-owned business setting, an older owner has turned over de facto control of the company to its management; and (iv) when the owner has died and the estate is selling decedent's interest to management. For purposes of this article, it is these four types of divestor to which we refer. Sometimes the MBO group may (now joined by a financial investor) comprise the same people from whom Buyer made its acquisition.

In any MBO situation, Buyer likely possesses the greater knowledge of the Target's business, thereby turning conventional wisdom on its head regarding the rules for establishing Target's value, and the drafting and negotiation of each party's reps and warranties.

THE CONVENTIONAL SOLUTION

If the parties ignore management's special familiarity with the Target, Divestor will provide the normal, extensive seller type reps and warranties regarding Target, its balance sheet, operations, prospects, etc. In this case, to avoid potential liability for breach of representation, Divestor will need to conduct a thorough due diligence investigation. Given an MBO, this exercise should be viewed as a mis-allocation of time and money.

The true risk in a management buyout is on Divestor's side. Does management know something about the Target that could change its value dramatically in Divestor's eyes?

Normal benefits of Buyer due diligence include becoming familiar with the Target in order to operate and integrate it post-merger. Divestor has no such need. Due diligence and Divestor reps can also usefully separate Seller's pre-sale puffing about its business from reality. However, it is less likely that the Divestor described here will engage in extensive puffing except possibly as to general matters such as industry prospects. Further, given the MBO Buyer's pre-existing knowledge of Target, it needs no help in establishing the rough equivalency of the Target versus the purchase price.

Finally, the basis for Seller reps is often predicated on discussions Buyers have with management, but in an MBO, management is the other side. Requiring Divestors to make extensive reps and warranties is both unnecessary and unfair because with extensive Divestor reps MBO buyers obtain an insurance policy from Divestor when Buyer should really be self insuring. Counsel for both sides may be tempted to follow the normal protocol and negotiate Divestor's reps based on a combination of Buyer's law firm's standard reps and warranties, and/or those mirroring the ones given when Divestor purchased the Target. Divestor might then try to insert qualifiers to reduce its risks, such as "to Divestor's knowledge" and "no material defects" or increase the threshold or limit the cap for indemnity claims.

These solutions move in the right direction, but they are half measures that ignore the fundamental differences created by an MBO.

OUR PERSPECTIVE

We believe that MBO Divestors should provide only limited reps and warranties, and that Buyer should give more extensive ones than those found in the conventional deal. In an MBO share sale, Divestor can reasonably be required to represent that the shares have been fully paid, are non-assessable, not subject to liens or restrictions on transfer, and that no options are outstanding, since these are subjects uniquely within Divestor's control. In contrast, in an MBO asset sale, the MBO group will have as good or better knowledge than Divestor as to whether the assets are owned by the company or are subject to liens. Of course Divestor should be required to provide a Section 10b-5 type rep, generally to the effect that Divestor knows nothing that might materially and adversely affect Target's business or prospects.

The true risk in an MBO is on Divestor's side.

Does management know something about the Target that could change its value dramatically in Divestor's eyes? As a practical matter, the non-disclosed data must be positive information about the Target. Management will (except for triggered liabilities discussed

below) tell Divestor any bad news about the company to drive down the purchase price. For example, does management (but not Divestor) know that a patent is about to be granted, that a lucrative contract is about to be signed, that litigation is about to be settled or that earnings have been understated?

A strong Divestor may insert a provision giving it a participation in the sale price of the company if all or a portion of its shares or assets are sold within a finite period, with Divestor's participation in such a transaction declining over time. Although such provisions are difficult to draft in detail, even a short provision should smoke out any MBO management plans in this direction.

Worse yet, has management arranged to sell the company to a third party shortly after the closing at a much higher price and pocket the difference between what it will receive in the "flip" and what it paid in the MBO? In such circumstances, Divestor may reasonably turn to the MBO Buyer for assurances in the form of reps that there is no material, undisclosed positive information. The stronger the Divestor's bargaining power, the more likely it will be, that Buyer's reps will be extensive.

As added protection, a strong Divestor may insert a provision giving it a participation in the sale price of the company if all or a portion of its shares or assets are sold within a finite period, with Divestor's participation in such a transaction declining over time. Although such provisions are difficult to draft in detail, even a short provision should smoke out any MBO management plans in this direction, Divestor may consider inserting a legend on Buyer's stock or even taking a lien on the assets, permitting the filing of a UCC-1. Another measure would be to have Divestor retain a seat on Target's board, thereby providing Divestor with notice of any proposed asset sale.

A typical M&A negotiating point is whether Buyer should be able to bring post-closing claims based on breaches of reps of which Buyer was aware before the closing, essentially a price adjustment mechanism. The "anti-sandbagging" provision requires Buyer to waive such claims if it elects to close the transaction. The counter argument is that Buyer should have the "benefit of the bargain" and retain the right to such post-closing price adjustments despite its knowledge since Target is, after all, worth less than was represented.

In our MBO scenario, Divestor would make only bare bones reps, thus minimizing the problem from its perspective. In the remote circumstance involving Divestor's pre-closing knowledge of positive developments at Target that have not been disclosed by the MBO Buyer, there should generally be no right by

Divestor to claim against Buyer post-closing. To permit such a right would turn the protective shield we propose for Divestors into a sword.

Despite our suggestion that reps of the parties be modest, we propose that each party be required to confirm its reps as of the closing. To the extent covered by its reps, if Divestor has learned something negative and material about Target between signing and closing, it should disclose it to Buyer. Buyer should be compelled to do likewise

respecting positive information pertaining to its reps since both such events effect the equivalency of the consideration, and should permit re-pricing.

Because provisions such as the ones we advocate differ from the norm, we recommend explanatory contract language, noting the circumstances that justify the change from the typical format for reps and warranties. Such language should assert that the purchase price reflects this arrangement and the corresponding allocations of risk. It would include the conventional recital that Buyer is fully familiar with Target's operations and has had full access to its books and records, customers and suppliers.

Typically Buyer's counsel provides the first drafts of Seller's reps because Buyer usually knows better which aspects of the company are critical to it and which ones are most difficult to assess absent such contractual assurances. In the MBO, however, this protocol is much less important. If Buyer and Divestor agree that the traditional rep mechanisms do not apply, either side's counsel can efficiently create the first draft of the purchase agreement. But if, for reasons particular to the fact pattern, Divestor hopes to obtain extensive reps from Buyer, Divestor's attorneys should seek to provide the first draft of the purchase agreement.

If management is made up largely of "home boys" (i.e., native to the area, with little capital of their own), the local institution providing financing may, in some respects, be Buyer's alter ego. If Divestor helps finance the sale by taking a portion of the purchase price over time in subordinated notes, the financial institution may turn out to be Divestor's nemesis, blocking payment of the additional purchase price. The obvious counter measure in such situations is for Divestor to receive as much money as possible at closing. A bit less drastic is to negotiate a strong inter-creditor agreement. Besides the normal triggers in such agreements that could block payments to Divestor, the institution should be obligated to report any MBO Buyer default to Divestor,

promptly and in detail sufficient to provide Divestor with necessary information regarding the company's status under the intercreditor agreement. Divestor should also attempt to negotiate a right to participate in any discussions between the Target and the Buyer's financing institution.

UNDISCLOSED LIABILITIES

The MBO purchase may trigger Divestor liabilities it never bargained for. Consider the following two situations: (i) in the employment arena, Target may contribute to a multi-employer benefits plan whereby selling the Target assets constitutes a withdrawal from the plan and gives rise to potential claims against the Target for underfunding; or the employees are terminated by Divestor with the expectation of having them hired by the MBO buyer, an event which may trigger severance claims against Divestor, particularly if the MBO Buyer later goes bankrupt; and (ii) in the environmental area, state laws create cleanup obligations on environmentally impacted properties. Should Divestor own such properties, it could still be liable for cleanup costs despite its sale of Target to the MBO Buyer.

Both situations present liabilities the MBO group may not want to disclose to Divestor. They would not drive down the price paid by Buyer because the liability stays with Divestor. But Divestor, once aware of these risks, would clearly try to shift them to Buyer through raising the asking price, demanding stronger Buyer reps and covenants or electing not to do the deal. In any case, circumstances like these require greater Divestor investigation.

The parties' ability to adjust the purchase price where good things happen to the MBO Target between contract signing and closing may not be totally satisfactory to either. If the need for an upward price adjustment occurs pre-closing, Buyer and Divestor may renegotiate the price, or walk away. If Buyer has a strong financial partner, additional funds may be available. In many cases, though, Buyer will have already exhausted its financial sources. In that instance, Divestor may have to find another buyer, accept the original price or seek to obtain additional payments following the closing through the issuance of "seller paper".

If a breach of the MBO Buyer's reps is discovered after the closing, the alternatives are even more troublesome. The MBO Buyer is likely to have few assets at risk other than the company it buys. Even if Buyer has a strong financial partner, that partner is not likely to contractually permit its other assets to be put at risk by a lawsuit brought by Divestor causing it to shy away from making reps and providing indemnifications.

To assert claims against the MBO Buyer post-closing may simply result in Divestor taking back the company it sought to dispose of or putting it out of business

by selling off its assets piecemeal. By definition, pre-sale management will be directly and negatively affected. Divestor will not want MBO management to stay since it had proved itself to be untruthful, and such management will likely not want to re-assume a role subservient to the old owners. As a result, Divestor will require new management and probably find itself in a worse position than it had been pre-sale.

Given these alternatives, in judging competing offers Divestor should weigh the different risks presented by various bidders: (i) a third party with its own management; (ii) a third party who needs Divestor's existing management (and who may offer existing management some post-closing participation); and (iii) the MBO group. Divestor's comfort levels with potential Buyers will vary, depending on the bidder's identity, and should therefore affect its assessment of the viability of competing bids. If all bids are about the same as to price and terms, the MBO group's bid would be the least attractive and the bidder with its own management the most desirable since, for the reasons set forth above, the former puts Divestor at the greatest risk and the latter at the least. If the MBO group is the only bidder, Divestor should discount the value of the price to be received based on its judgment of the seriousness of the risks described above.

In conclusion, MBO's are different from normal M&A transactions - Buyer's and Divestor's familiarity with the Target are reversed. The parties should recognize this fundamental fact early in the negotiations, and understand that changes from the norm respecting the drafting of reps are required. They should anticipate problems unique to the MBO and allocate their time and legal budget in a manner that confers maximum benefits to each side.



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