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Managing seller risk in M&A transactions

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You've decided to sell your company. You've found the right buyer, the parties are completing due diligence and are negotiating the purchase agreement. It might seem like the perfect time to focus on managing your post-closing risk. After all, that's what you are paying legal counsel to do — draft an ironclad agreement that protects you. However, if you wait to manage your risk until the due diligence or purchase agreement phase, then it might already be too late.

Many provisions get negotiated at the purchase agreement phase to protect sellers. Such provisions include negotiating a working capital methodology schedule with appropriate principles and benchmarks to determine target working capital, inserting "knowledge" and "materiality" qualifiers in the representations and warranties to limit risk shifting, including a deductible to reduce liability for incidental losses, negotiating a damages cap so the entire purchase price isn't in jeopardy, and limiting earnouts and seller notes so that more of the purchase price is paid in cash at closing. The preparation of thorough disclosure schedules to the purchase agreement is also an important protective measure for sellers to reduce the risk of post-closing indemnification claims.

A strong purchase agreement is certainly a key component to managing risk. However, to get a deal done, a seller may not be able to get all of the protections it wants into the purchase agreement. Mitigating risk in an M&A transaction should begin long before a purchase agreement is negotiated, or even before a buyer shows interest in the company.

Self-assessment is one of the most important steps a seller can take to mitigate its risk in an M&A transaction. While a company should always be assessing its business activities, it is even more critical to identify actual or perceived issues with the business when a sale transaction is under consideration — or even just a possibility. For example, is the company collecting taxes and filing returns in every jurisdiction where filings are required? Does it have adequate compliance policies in place? Are there any minority shareholder or key employee issues that need to be addressed? Are there any material issues with customer or vendor contracts or other performance issues?

A seller that can identify potential issues and either remedy them, start the correction process, or have an explanation that limits the potential negative impact of such information is better able to manage its own

risk. This ground work can put the seller in position to push back if the buyer tries to introduce its own "protective" measures in the purchase agreement, and may even forestall a buyer from introducing such measures.

Such buyer protective measures can include lowering the purchase price, requiring a larger indemnification escrow that lasts for a longer period of time, introducing special escrows, having longer survival periods for representations and warranties, or requiring specific indemnities not subject to caps and deductibles.

There will always be business issues that will need to be addressed when negotiating an M&A transaction. But if a seller does its own proactive "due diligence" and can take corrective measures and control the narrative before issues are discovered by the buyer, it will strengthen its negotiating position, protect transaction value and reduce its post-closing risk.

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