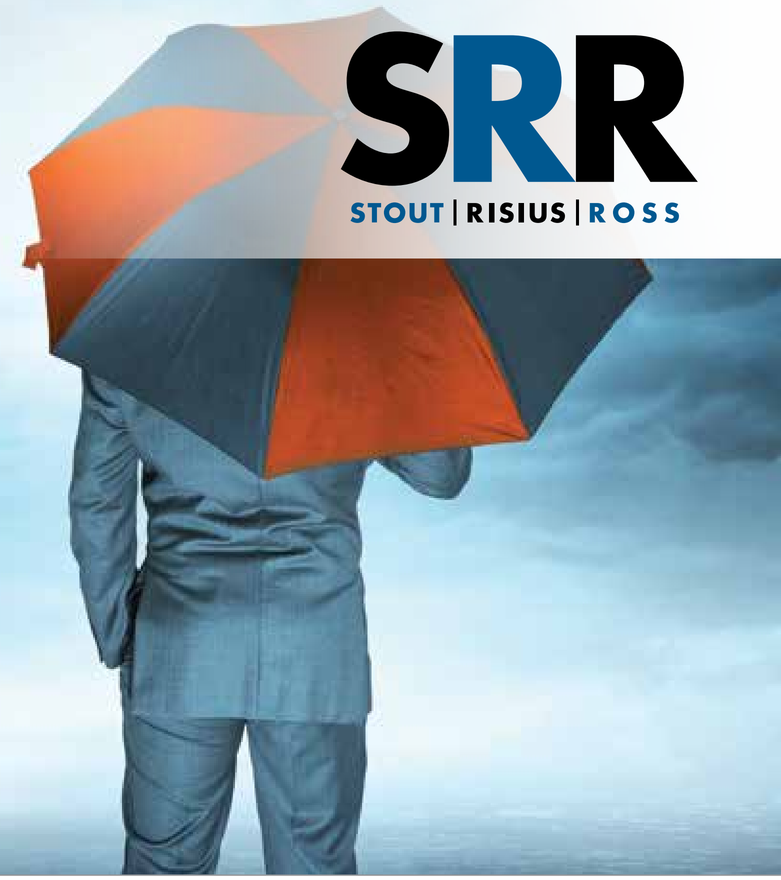

Didn't Get What You Paid For?

Addressing a Breach of Representations and Warranties

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(Part 1 of 2)

As the U.S. and global economies continue a trend of gradual growth, the outlook for increasing merger and acquisition ("M&A") activity appears positive. According to the *KPMG 2013 M&A Outlook Survey*, "companies continue to hold record levels of cash on hand, interest rates are at historic lows, debt on favorable terms is readily available, and the U.S. stock market has rebounded."[1] Each of these factors indicates a strong potential for increased M&A activity in the remainder of 2013 and beyond. As of the midpoint of the year, worldwide transaction volume was down; however, transaction volume in the United States actually increased more than 25%.[2]

Consistent with recent years, middle-market deals are expected to comprise a majority of the deal volume (based on total number of deals), with 79 percent of survey respondents expecting their deals to be valued at $250 million or less.[3] The financial statements and underlying records of middle-market companies are commonly subjected to less regulatory and/or market scrutiny than those of a publicly traded company. As a result, acquisitions involving middle-market companies can be more susceptible to post-acquisition disputes, including disputes relating to breaches of representations and warranties.

Representations and Warranties Defined

Representations and warranties in an M&A transaction are statements of fact made to the counterparty in the transaction to allocate risk between the parties. Typically, representations and warranties are made by both the buyer and seller. However, representations and warranties made by the seller to the buyer are typically greater in number and more detailed, as most facts pertinent to the transaction relate to the target company.[4] From a buyer's perspective, representations and warranties from the seller are designed to accomplish the following primary objectives:[5]

- To assist the buyer in fully understanding the business it is purchasing
- To allow the buyer to abort the transaction if it finds the seller's representations and warranties are materially inaccurate prior to closing
- To allow the buyer to recover damages if the seller makes inaccurate or false representations

1 KPMG 2013 M&A Outlook Survey.
2 "Merger Activity Was Down but not Out in First Half," *DealB%k, NYtimes.com*, July 1, 2013.
3 KPMG 2013 M&A Outlook Survey.
4 Buyer representations typically relate to representations in the value of stock in the event consideration from the buyer is in its own stock. Buyer representations also commonly relate to its ability to pay and/or obtain financing.
5 Litigation Services Handbook, Fifth Edition.

Some examples of common representations and warranties made by the seller include:

- Financial statements are accurate and have been prepared in accordance with relevant accounting guidance (GAAP[6], IFRS, etc.)
- Descriptions of departures from relevant accounting guidance—for example, if the target company recognizes revenue utilizing a methodology that is not GAAP compliant
- Financial statements have been prepared consistently with historical company practice
- All contingent liabilities have been disclosed to the buyer
- Seller is in compliance with all applicable laws and regulations—for example environmental, labor, and ERISA laws
- Seller has complied with and is in good standing with all contractual obligations
- Seller has informed buyer of all actual litigation and potentially material future claims that exist

Potential Impacts of a Breach of Representations and Warranties

When assessing the impact of a breach of representations and warranties, it is important to understand the methodology used to calculate the transaction purchase price. While a full discussion of how transaction purchase prices are determined is outside the scope of this article, a brief discussion is warranted as the implied damages associated with a breach of representations and warranties can potentially exceed the amount of the breach itself and occasionally even the purchase price.

One way in which purchase prices in a transaction are often determined and measured is predicated on a multiple of a financial metric, such as Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA") or net income. For example, based on analysis of transactions for a similarly situated company, the value of the company may be determined to be a multiple of 5 times EBITDA (if EBITDA = $2,000,000, then 5 x $2,000,000 = $10,000,000).

Let's assume the seller is found to have breached a representation stating that the financial statements were free of misstatement, and the buyer relied on said financial statements which included an overstatement of revenues, resulting in an EBITDA overstatement of $50,000. It may be appropriate to adjust the purchase price by applying the multiple to the overstatement (5 x $50,000 = $250,000 adjustment to the purchase price).

However, this view is often too simplistic, as the impact of a breach of representations and warranties could be more substantive, and a one-for-one measurement between the alleged breach and the purchase price may not be appropriate. Utilizing the prior example, assume the same original purchase price of $10,000,000, but the revenue overstatement decreased EBITDA by $1,000,000. Had the overstatement been known at the time of the transaction, the buyer may have arrived at a lower multiple rather than a multiple of 5. Assuming the revised multiple is 4, the purchase price would have been the corrected EBITDA of $1,000,000 times the revised multiple, or $4,000,000, resulting in an adjustment to the purchase price of $6,000,000.

These are simplified examples, however they effectively illustrate that the potential economic impact of a breach of a representation and warranty may far exceed the actual breach. The key question to assess in quantifying damages after determining the amount of the breach is what would the buyer have done if it had known about the issue at or around the date of closing?

Examples of Potential Breaches of Representations and Warranties

Breaches of representations and warranties can occur in a number of areas, both financial and non-financial. Some examples include unknown or undisclosed departures from accounting guidance, tax issues and liabilities, capitalization, intellectual property, compliance with the law in many different areas, employment (including ERISA), and material contracts with both customers and vendors.

This section focuses on the potential *financial* breaches. However, the non-financial breaches are ultimately measured in financial terms. It should also be noted that the due diligence process may or may not have alerted the buyer to certain of these issues, thereby minimizing the potential that they are not addressed in the purchase agreement and reach the breach stage.

Financial Examples

Undisclosed departures from GAAP (or other relevant accounting guidance): Many amounts and disclosures in a company's financial statements contain estimates. While these estimates are required to be GAAP compliant, they are more susceptible to intentional or unintentional departures/misstatements. Financial statement accounts that typically include estimates include, but are not limited to, the following:

- Reserves for uncollectable or doubtful accounts receivable
- Reserves for obsolete or slow moving inventory
- Prepaid assets

[6] Generally accepted accounting principles or GAAP refer to conventions, rules, and procedures that define approved accounting practices at a particular time. These principles are issued by the Financial Accounting Standards Board for use by accountants in preparing financial statements. Apart from guidelines, GAAP also provides detailed practices and procedures. Generally accepted principles are derived from a variety of sources, including promulgations of the Financial Accounting Standards Board and its predecessor, the Accounting Principles Board, and the American Institute of Certified Public Accountants. (Source: USLegal.com).

- Accrued liabilities
- Warranty reserves/expenses

Assume a company historically recorded a reserve for uncollectable or doubtful accounts of 15% of its accounts receivable balance using a reasonable methodology based on historical actual write-offs. At the time the company began considering acquisition offers, the reserve was lowered to 7% of the accounts receivable balance without any change in historical actual write-offs to justify the reduction. Subsequent to the acquisition close, the buyer experiences actual write-offs more consistent with the 15% historically recorded by the company resulting in a lower return on investment than anticipated.

Another example is inventory sitting untouched in the back of the warehouse. The seller may indicate it is sellable inventory, and if limited due diligence is performed, the buyer may accept that as fact. This inventory may not be sellable and has never been written off or reserved, leading the buyer to overpay. Further, if the underlying debt of the company was guaranteed by its assets, or if the debt that was secured for this transaction is guaranteed in a similar fashion, additional issues and exposure may arise for the buyer with lenders.

Vendor and Customer Contracts: While due diligence typically includes an evaluation of vendor and customer contracts at a certain materiality threshold, problems with vendors and customers still arise as a breach of representation and warranty. Often, these issues surround the following:

- Potential undisclosed pricing changes under current or renewing contracts, especially when the contracts are significant and/or material to the company
- Undocumented rebates received or given
- Fictitious vendors or customers under the materiality threshold
- Accounts receivable: overstatement due to accounts being under the materiality threshold during due diligence or the seller using a churning process
- Accounts payable: understatement due to accounts being under the materiality threshold during due diligence

Undisclosed Liabilities: Undisclosed liabilities remain a concern for the buyer. Often the seller is aware of certain liabilities that the buyer should know about, yet does not inform them, leaving the buyer to enter into a very unknown and challenging situation. This may include, but is not limited to the following:

- Undisclosed lawsuits
- Undisclosed potential litigation, recall or warranty claims
- Other undisclosed material liabilities, such as loan guarantees, indebtedness, and environmental and labor liabilities
- Possible government intervention/investigation

A good example is pending or potential litigation. Assume the seller has been informed by a few of its larger customers that one of its products is defective and the customers insist not only on replacement products at no cost, but also for indemnification from any potential liabilities from its downstream customers. This is not disclosed to the buyer, and nearly 12 months after deal close, this information is uncovered. This could be a substantial undisclosed liability that would enable the buyer to make a claim for breaches of representations and warranties. From a damages perspective, depending on the measurement of potential exposure, it is possible the buyer could conclude it would never have entered into the transaction.

Intentional Misstatement: Intentional misstatement occurs when the seller deliberately misrepresents its financial statements and condition. It is not uncommon for this to be uncovered until well after the buyer controls the company. There can be many different ways in which a company may misstate its financial results without being detected during due diligence. This includes, but is not limited to:

- Kickbacks, collusion and other fraudulent schemes
- Improper accruals
- Capital leases classified as operating leases
- Falsified documents utilized to secure debt
- Overstatement of asset and/or collateral values, including inventory, accounts receivable or long-term assets

For instance, let's assume the seller has a kickback arrangement with its largest customer. The customer pays more than market price for the goods, the sale of which is routed through a third-party sales entity that is owned by a relative of the customer. The customer, seller and third-party sales entity split the excess profits from the overpriced goods via commissions from the sale. If such a scheme is uncovered after the deal close, the company's financial results are overstated, as sales and profits prior to the transaction are greater than they should have been and the potential exists that the customer may cease doing business with the company.

Conclusion (Part 1)

In many instances, financial statements and underlying records of middle-market companies may not be viewed with as much scrutiny as they are not necessarily regulated or publicly traded. With middle-market transactions continuing to be more prevalent, there is an increased potential for post-acquisition disputes, including breaches of representations and warranties. There are a variety of financial and non-financial areas that can give rise to such a claim, including the financial-based examples discussed in this article. In quantifying damages, the proper measurement is to assess what the buyer would have done had it known about the issues underlying the breaches of representations and warranties at or around the date of transaction close.

In Part 2 of this article in the next edition of the SRR Journal, non-financial examples of potential breaches of representations and warranties will be discussed, along with the role of due diligence and data rooms in these types of disputes. Part 2 will also cover sandbagging provisions, the structure of agreements for successful claims, and possible alternative insurance options.

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