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Buying and Selling a Small Business: Part 3 – Analyzing the Representations and Warranties Provision of the Purchase Agreement

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Introduction and Background

This article continues a review of Purchase Agreements for the sale of small businesses. By way of background, the relevant provisions of such agreements are:

1. Introduction

2. Sale and Closing

3. Representations and Warranties

4. Preclosing Covenants

5. Preclosing Conditions

6. Postclosing Covenants

7. Remedies and Indemnification

8. Miscellaneous

Today's installment will analyze what is generally the third and most robust part of a purchase agreement – The Representations and Warranties. Because of the length of this section (there can be more than thirty representations in a standard agreement) we will take a cursory look at ten common provisions.

Representations can be defined as statements made by one party at the time the contract is entered into, regarding a fact which is influential in bringing about the agreement. Warranties are promises that a statement of fact is true. Or, put another way, representations relate to past or existing facts and warranties relate to future facts. Taken together, they provide a formal description of the business that is for sale. Although there is a difference in the nature of representations as opposed to warranties, this difference "has proven unimportant in acquisition practice"[1]. For simplicity, the remainder of this article will refer to "Representations and Warranties" as simply "representations."

As with all contractual issues, the relative bargaining power of the parties will determine how extensive the representations section actually is. For example, when there are multiple potential buyers, the

[1] See, *ABA Model Agreement*, note 2.

seller may get away with fewer and less stringent representations. Conversely, when the buyer has the upper hand, the seller will need to offer more representations.

Who is Representing and Warranting What?

Both buyers and sellers make representations. However, the seller's representations are of the greatest concern and receive the bulk of attention in the purchase and sale agreement. Buyer representations are generally limited to stating the buyer: (i) is duly organized and in good standing; (ii) has the authority to enter into the agreement; and (iii) has no pending proceeding that may interfere with the consummation of the transaction.

Sellers, however, must provide extensive representations. Because the buyer (in most cases) has not been a part of the company over the years and needs to understand it substantially prior to a purchase, it is of utmost importance from a buyer's perspective to comprehend the representations prior to committing to the purchase. While a certain level of comfort can be achieved through the due diligence of the buyer, it will often need to rely on seller's representations to achieve a full understanding of the risks it is assuming.

Representations are read in conjunction with Disclosure Schedules, which are an appendix to the agreement. Disclosure Schedules enable the seller to delve into the details and exceptions set forth in the representations.

Representations (along with the Disclosure Schedules) serve three primary purposes: First, they are informational – they allow the buyer to understand the state of the business it is buying prior to signing the agreement. Second, they give the seller the opportunity to provide details of issues with the business and allow the buyer to determine whether or not to proceed with the transaction. Finally, if breached, they provide for a damages action under the Remedies and Indemnification section of the agreement.

Various qualifies appear throughout the seller's representations which attempt to limit the seller's liability for the breach of a representation. Generally, the seller will want to limit the representations to facts to which the seller has "knowledge," and not make an absolute statement. Other qualifiers relate to "materiality" and "adverse effect," both of which excuse the seller for omissions of relatively minor facts. The buyer, of course, will fight to have the representations as inclusive as possible. As such, these qualifications can be highly negotiated and are often a source of contention among the parties.

10 Primary Representations

1. Organization and Good Standing. This representation states that the seller is, indeed, what it claims to be and is in good standing with all governmental entities. The most basic of all representations, but necessary in that the buyer wants to know that the business has been and will continue to be operated properly. This representation will also list the states where the seller is qualified to do business so that the buyer will have an idea of where exactly it needs to obtain the same qualifications.

2. Financial Statements. This is the representation that a purchaser will need above all else in this transaction, as it provides a snapshot of the entire state of the business. The representation will state that seller delivered audited financial statements to the buyer that have been prepared in accordance with GAAP and will generally also provide for unaudited financial statements for the most recent period. Due to its importance, this representation is heavily negotiated. While larger businesses can often comply with the audited financial statement requirement, it can be problematic for smaller businesses that do not have the time and funds to have such statements audited.

3. No Undisclosed Liabilities. This representation assures the seller that, other than the liabilities set forth in the agreement that buyer is explicitly purchasing as part of the business, there are no additional liabilities. While the nature of an APA is that the buyer is only purchasing the liabilities explicitly set forth in the agreement, liability may still be imposed on a purchaser pursuant to bulk sale statutes, fraudulent conveyance laws, and possibly environmental and products liability law. The representation is even more important in a stock purchase agreement, as the buyer in that case is purchasing all the liabilities that run with the company and will want full knowledge of these risks. If liabilities are undisclosed, the seller may seek redress through the indemnification provision of the agreement.

4. Taxes. Buyers want to confirm that a seller has filed all tax returns properly and that the seller has paid and withheld taxes appropriately. This representation is necessary because, in the event that seller has not paid its taxes properly, a lien could be placed on the assets just purchased by the buyer.

5. No material Adverse Change. This short representation states that, since the date of the Agreement, there has not been any material adverse change in the business, operations, or other aspect of the company that will materially affect the company. This representation gives the buyer an opportunity to get out of the agreement if such a change has occurred.

6. Legal Proceedings. Seller will be asked to disclose all pending and threatened litigation, even if, in the case of an asset purchase agreement, the buyer will not assume responsibility on the claims. Such disclosure enables the buyer to understand some of the risks associated with the business. While a seller may be reluctant to provide all litigation when it is maintaining responsibility for the claims, a buyer could be drawn in to such litigation pursuant to successor liability. It is therefore in the purchaser's best interest to understand all the litigation and threatened litigation currently existing, regardless of whether it will stay with the company or be retained by the seller.

7. Employment Matters. The buyer will want to know the status of potential strikes or other labor issues and will also want to ensure that the seller has not engaged in employment practices (ie, discrimination, unsafe working conditions) that can leave the company open to future liability.

8. Contracts and Leases. Contracts and leases are valuable assets for a business. As such, the purchaser will want to ensure (i) that the seller has not breached or otherwise violated the agreements and (ii) that the agreements are assignable without undue hardships, such as a penalty or termination of the agreement. If consent to assign is necessary, the buyer will want to know so that they may make preparation to do so.

9. Intellectual Property. While this representation is highly dependent on the type of business at issue, intellectual property can be another substantial asset for some companies. Where applicable, the representation will state facts related to the company's trademarks, trade names, patents, copyrights, trade secrets and other IP issues affecting the business. Due to the nature of intellectual property, the seller will often need to do its own diligence to ensure it is fairly representing all the facts related to this representation. When intellectual property is a significant asset of the seller, the buyer will want to ensure, both through this representation and its due diligence efforts, that the seller validly owns or licenses the intellectual property. In an asset purchase agreement, when the intellectual property is licensed, the buyer will also want to ensure that the license can be assigned.

10. Disclosure. This catch-all provision will generally state that no representation made by the seller in the purchase agreement or any other documents submitted to buyer contains misstatements or omissions of material facts. The seller further represents here that there is no material information about the Seller that has not been disclosed. In effect, this section gives comfort to the buyer that everything it has been provided regarding the business is accurate and there is nothing outstanding that will be a surprise to the buyer in the future.

A Closing Caveat

As stated at the beginning of this article, the representations section is extensive. While the ten representations discussed above are important and will appear in most purchase and sale agreements, there are numerous other representations that are prevalent in such agreements and need to be dealt with in some form in most agreements[2]. The ABA's model asset purchase agreement, as well as other sample agreements may be found online and will provide many other representations commonly found in purchase agreements.

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[2] By way of example, other representations may include: customers and suppliers; inventories; insurance; product warranties; product liability; powers of attorney; and business relationships.