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THE ROLE OF ESCROW/HOLDBACKS IN M&A TRANSACTIONS

AWARDS:

Pozzuolo Rodden Pozzuolo, P.C. are pleased to announce that Joseph R. Pozzuolo, Esquire has been nominated for the following two awards this past month: 1.) The Legal Elite Award 2023 courtesy of New World Report which employs an entirely impartial panel of veteran academic leaders with international academic and training experience and well versed in research, fact checking and mediation; and, 2.) 2022 AV Preeminent Top Attorney by the American Registry.

THE ROLE OF ESCROWS/HOLDBACKS IN M&A TRANSACTIONS

When purchasing a business, one major concern is whether the buyer is receiving what was promised. As with any transaction while it is important to perform due diligence and thoroughly "kick the tires" on the business, not all sellers are equally honest,

forthcoming, competent, cooperative or even aware of their issues, and it is not practical for a buyer to examine every last detail of a business prior to closing. As a result, the same way a used car salesman may put sawdust in the engine so it runs great for the test drive, the seller may paint a pretty picture before closing only to leave a buyer to find the seller's hidden mess, disorder and/or turmoil after closing. This newsletter will discuss the importance of using representations, warranties, and various holdback/escrow provisions at closing to help protect a buyer in a M&A transaction.

In addition to a buyer's due diligence, it is necessary that a seller make certain formal representations and warranties to hold the seller accountable for breaches or violations that become known or evident post-closing, issues the seller was not forthcoming with, or issues that arise in due diligence. Representations are statements about the business which the seller will affirm to buyer about the quality and veracity of the business. Warranties are made by a seller to stand by those representations to make the buyer whole if anything is amiss. Then they are enforced by indemnification provisions where if a buyer faces a liability, a loss, or damages as a result of a breach of a representation and warranty, the seller will indemnify the buyer. These help to ferret out issues that otherwise would not come to light prior to closing and force the seller to stand by its word.

However, the issue is representations and warranties are great as long as there is someone to stand by them in terms of reputation and fiscal strength. The less trustworthy the seller, the higher the legal fees to uphold representations and warranties and the more likely there will be a future breach. Further, if there is an indemnification against the seller for one million dollars for a buyer's out of pocket loss, if the seller has no assets, the indemnification is meaningless as there are no assets to indemnify the buyer. The indemnitor (i.e. the seller) needs to have enough assets available to pay the buyer to make the indemnification have any meaning. This is not always practical as the sales proceeds may largely pay off debt, the seller may have moved assets around so they are inaccessible to the buyer, or the seller may simply have spent the proceeds and there is nothing left for the buyer to collect.

This is where holdback/escrow provisions come into play. Holding a portion of the purchase price on the side helps ensure that there are some/enough funds to make the buyer whole. Ideally, the seller wants nothing held back whereas the buyer will want as much held back as possible for as long as possible to protect itself. If there is a pending issue or liability, the buyer will usually want at least 1.5x to 2x of the amount involved held aside pending final resolution to ensure any damages and interest relating to the issue can also be covered. Sometimes agreements will have a blanket amount of 10% to 20% of the sales price, with a floor basket and maximum cap, or have payments over multiple installments where delayed payments can be used to cover any unforeseen breaches, especially in larger and more suspect deals. This ensures the buyer will have at least a base amount of protection even if the seller squanders all other funds.

There are a number of ways to holdback funds and which provision is used depends on the nature of the transaction and the relative bargaining power of the parties. The difference between a holdback and an escrow is in a holdback a buyer merely holds back a portion of the purchase price whereas for an escrow a third party escrow agent is retained to

hold the funds held aside. Further, other ways to hold funds back are the use of future employment/independent contractor contracts or installment sales with provisions that the future payments may be subject to the indemnification provisions in the agreement of sale. These future payment contracts also double as an alternative source of partial financing for the M&A transaction.

Holdbacks are generally favored if the amount is small, the cost of an escrow agent is steep, or if the buyer has a higher relative bargaining power. This is because it is simple and direct for buyer. The buyer simply holds 10% to 15% of the purchase price back without getting a third party escrow agent involved. If the business is clean, the seller gets paid. If it is not, then the buyer can withhold payment without any litigation. However, sellers will generally prefer an escrow agent as if the buyer is holding the funds it can decide not to comply in bad faith requiring the seller to bring a lawsuit to enforce payment. This becomes an issue especially when the buyer becomes sour if the profitability of the business suffers after closing not at the fault of the seller. The buyer may hold onto funds in bad faith as a money grab for the lackluster profits or the buyer might have even spent the funds to meet other debt obligations. Further, the cost of litigation may give the buyer bargaining power to bully the seller into accepting a lower payment. Holdbacks are more often used in smaller M&As or in holdback amounts which are immaterial relative to the overall purchase price.

Escrows are favored where the amount is larger, there is general distrust between the parties, and/or where the cost of an escrow agent is immaterial versus the escrowed amount. The positive side to an escrow is it helps ensure fair treatment where the seller does not have to worry about the buyer not paying the balance of the purchase price. Usually escrow funds are released at the joint direction of both parties, the expiration of a time period (i.e.1, 2 or 3 years), or a court order requiring the escrow agent to pay the funds to either party. This means either the parties agree or in the event of a dispute, a payment has been reviewed and ordered by a court. The downside to escrow agreements is the potential cost of an escrow agent and the potential cost and delay of litigation as it is rare for an escrow agent to release funds if there is a controversy absent a court order. Therefore, escrow funds normally are used for larger deals where the cost of administering the escrow becomes immaterial relative to the purchase price.

A bona-fide alternative is a trend to use representation and warranties insurance in M&A transactions for approximately 10 % of the purchase price. The seller, normally the buyer or both parties will purchase a 3 year insurance policy to protect the buyer against losses due to the seller's breach of certain of its representations in the M&A agreement. The typical premium is 2% to 3% of the coverage limits, thus, for example, if 10% of the purchase price and coverage amount is $20,000,000 the premium would be $400,000 to $600,000. As is typical with all insurance policies, there will be a deductible amount and standard exclusions.

In summary, the buyer should take steps to verify that the assets bargained for are the assets received. This may require various levels of due diligence, representations and warranties, indemnification, holdback/escrow provisions and reps and warranties insurance to help protect the buyer for issues that may arise after closing, but no two deals are ever

exactly the same. Therefore, it is necessary to take a step back, understand and comprehend the M&A agreement, and determine what warranty protection is necessary given the size of the transaction, the relationship of the parties, the nature of the business, and the nature of the potential risks involved, as well as what is the appropriate level and type of buyer protections. This largely varies from deal to deal and requires the services of an experienced M&A attorney.