Updates
May 20, 2020
Giving Value to Representations and Indemnifications in Distressed Transactions

Indemnification obligations are used to allocate risk between a buyer and a seller in nearly all mergers and acquisitions transactions. In an acquisition of a distressed company or its assets, however, the seller may not be creditworthy (i.e., able to stand behind its indemnification obligations after closing). Still, in a distressed sale, certain techniques can be used to give value to such indemnification obligations and provide additional assurance to the buyer that it is protected against post-closing losses.

Escrows, Holdbacks, and Setoff Rights:

- **Escrow:** Buyers in M&A transactions often require a portion of the purchase price in a transaction to be deposited into an escrow account and held by a third-party escrow agent (typically, a bank). The terms and conditions of an escrow arrangement are set out in a separate escrow agreement that is negotiated among the buyer, the seller, and the escrow holder. The escrow serves as a source of recovery for the buyer for indemnification claims, and unused amounts are released to the seller according to the escrow agreement. While escrow agreements often provide for release to automatically occur after a certain period of time, a buyer in a distressed M&A transaction may demand that the escrow agreement permit such release only with buyer's consent.
- **Holdbacks:** As an alternative to an escrow with a third party, a buyer can hold back a portion of the purchase price in a transaction, to be released upon passage of time and/or certain conditions being met. While sellers typically prefer the relative safety and certainty of a third party holding an escrow to a buyer holdback, a buyer in a distressed M&A transaction may have more leverage to require a holdback and retain greater control over the funds.
- **Setoff Rights:** If a buyer in a distressed M&A transaction owes the seller amounts after the closing under the acquisition agreement (e.g., earnout or installment payments) or other contracts (e.g., seller notes, equity agreements, license agreements, or commercial agreements), the buyer may demand in the acquisition agreement the right to setoff any of its claims against the amounts owed by the seller to the buyer, reducing the obligation of the buyer to the seller by such amount. This approach can be an effective mechanism to give value to indemnification obligations, even if the seller requires that the buyer not exercise such right until a court or arbitrator makes a final determination of such seller's liability.

Equity Holder Guarantees or Indemnities: When the creditworthiness of a seller is a concern, a buyer can negotiate separate guaranties or indemnities with the sellers' equity holders or other affiliates. Typically, these are governed by separate agreements pursuant to which such equity holders or other affiliates agree to pay, or cause the seller to pay, amounts to the buyer as a result of seller's breach of representations, warranties, or covenants made in connection with the sale. Often, in sales of distressed companies or assets, the seller does not have significant assets, may not have the financial resources to back up an indemnification obligation, or may not still be in existence at the time that the claim is made. A guarantee can be another source of assets standing behind the seller's indemnification obligations.

Letters of Credit: Letters of credit are issued by a bank for the benefit of a beneficiary at the request of an applicant. A letter of credit can be used to support an indemnification obligation in a distressed M&A transaction by requiring the seller to provide a letter of credit at closing that the buyer can draw on if seller fails to make payment of an indemnification claim. If the buyer has a claim under a letter of credit, the buyer may seek recovery directly from the issuing bank rather than from the seller. Buyers may prefer a letter of credit issued by a creditworthy bank to other remedies because (1) the buyer will not have to worry about the ability of the bank to make the required payment, and (2) the buyer will not have to initiate legal proceedings against the seller if the seller cannot or does not make the required post-closing payment(s).

Representation and Warranty Insurance: Representation and warranty insurance (RWI) can help shift a significant portion of the risk away from the buyer and seller to a third party, i.e., an insurance company. Under a RWI policy, the insurer provides coverage to the buyer for indemnification claims for breaches of seller's representations and warranties, so the buyer does not have to recover directly from the seller. Typically, RWI policies can be obtained for a cost of approximately 3% of the coverage amount (typically between 10% and 20% of the target business enterprise value) and are subject to a deductible of between 1% and 2% of enterprise value. The allocation of this deductible (also referred to as "retention") can be negotiated between buyer and seller. RWI has recently increasingly been utilized in distressed M&A transactions, including insuring Section 363 asset sales and covering fraudulent conveyance risk.

Security Interests in Assets or Income Stream: A buyer in a distressed M&A transaction may also ensure satisfaction of a seller's indemnification obligations by perfecting a security interest in a seller's assets or income or, in some cases, the assets or income of one of its affiliates. If such seller does not pay its obligations, the secured buyer can undertake a process to take control of the assets itemized in the lien documents. As an additional measure of security, the buyer may require that income received by the seller be placed in a lockbox that is controlled by the buyer and the contents of which are subject to a security interest in favor of the buyer. In using this mechanism, however, a buyer should take measures to claim a first-priority security interest, because, if there are other creditors of the seller with higher priority security interests, the seller's secured assets may be used to satisfy the obligations to those parties and depleted before the buyer's claims are satisfied.

Transfer of Additional Assets: From time to time, there is a situation in which a seller has assets in excess of those the buyer wants that can be included in the sold assets in order to provide additional value to the buyer. If the seller is not creditworthy and the buyer is uncomfortable with the credit risk, a buyer can take sell or otherwise use these additional assets to offset a loss suffered as a result of a breach of a representation, warranty, or covenant.

Attorneys in our Economic Opportunity & Recovery Team are available to discuss further guidance or information on transactions involving distressed businesses or assets.

Explore more in

Bankruptcy & Restructuring Mergers & Acquisitions Real Estate & Land Use

Related insights

Update

HHS Proposal To Strengthen HIPAA Security Rule

Update

California Court of Appeal Casts Doubt on Legality of Municipality’s Voter ID Law