

ROBERT G. HUTCHINS – LEGAL ESSAYS

Selling Private Companies – Part III - Representations and Warranties in Acquisition Contracts

Preliminary Note

In any business acquisition, a threshold issue of considerable importance concerns the extent to which the seller will indemnify the buyer against a loss that does not become apparent until after the contract is signed and may arise from undisclosed or misrepresented facts adversely affecting the target.

It is generally assumed that when a buyer asserts the seller has misrepresented or omitted relevant facts, the ensuing dispute will be governed exclusively by the acquisition contract. That contract is negotiated by parties who deal with each other at fully extended arm's length. The contract reflects the bargaining power and informed judgment of those parties and their advisers. It contains detailed representations about significant ("material") facts concerning the target and its business that are made (or disclaimed) by the seller. It requires that the seller warrant the truth of each representation that is *not* disclaimed. It establishes the buyer's precise remedies if the warranties are "breached" (because the facts are not as represented) and it fixes the time periods within which a suit for redress must be brought. Accordingly, it would seem that one could always rely upon the contract to establish the ground rules for a straightforward resolution of a misrepresentation claim. Was the buyer harmed by the falsity (or omission) of a fact it assumed was true (or absent)? Was the fact material? In the contract, did the seller represent the fact as true or, in the case of an omitted adverse fact, as nonexistent? Did the seller warrant the accuracy of the representation? Did the buyer assert its claim within the time period allowed by the contract? If the answer to any one of these questions is "no," the claim will be denied. When the answer to all of them is "yes" the buyer will recover, or so it is commonly thought.¹

¹ It is worth noting, if only in passing, that binding warranties can also be imposed by seemingly innocuous preliminary documents, to the chagrin of the unwitting sellers who sign or authorize them. Examples are sales brochures, purportedly "non-binding" letters of intent and consents to acquisition reviews or "due diligence" investigations. Further, in an acquisition structured as a stock purchase the buyer may have recourse under federal and state securities laws. The role played by preliminary documents and securities statutes in the allocation of risk between seller and buyer is a complex subject beyond the scope of these comments. For a comprehensive judicial discussion of the issues that *are* addressed here see

Unfortunately, despite the care with which an acquisition contract is usually prepared, there are circumstances in which, even though a breach of warranty may have occurred, the remedies the contract provides will *not* be enforced as written. In this Essay, I examine the legal positions and reciprocal strategies of buyer and seller when those circumstances are present. Since they are present most often when a potential breach is discovered between the contract date and the closing date, that time period provides the context for our inquiry. During that period, it will be recalled, the buyer is completing its "due diligence" investigation and the seller is soliciting formal approval of the acquisition from shareholders and various third parties (lenders, landlords, etc.). Both parties may be awaiting regulatory clearance. The outcome of a misrepresentation claim arising at this critical juncture will be influenced profoundly by how the parties react when the claim (or the possibility of its assertion) comes to their attention.²

The General Rule - The Parties' Contractual Remedies Are Controlling

The typical acquisition contract provides the buyer with two independent sources of protection against the breach of a seller's warranty; a condition to the buyer's duty to close and the buyer's right to bring suit. If the breach is discovered *prior to closing*, the buyer can *abandon* the transaction without liability citing the *condition*. If the breach is discovered only *after the closing*, the condition will have expired automatically, but under the contract the representations and warranties will *survive*. The buyer can *bring suit* for redress at any time *within the survival period*.

If the claim is disputed, the court or arbitrator will determine whether the misrepresented or omitted fact was warranted as true or non-existent and whether the fact was material. If so, the condition or remedy invoked by the buyer will apply. The buyer may abandon the transaction, recover damages, obtain injunctive relief, or utilize a combination of remedies depending upon the precise recourse specified in the contract. Conversely, if the fact was not warranted, or was not material, the seller will prevail. In neither case will the buyer's reliance upon the truth of the representation, or any delay in asserting the claim, be the subject of much debate. The buyer's reliance will be presumed because the contract will have characterized the representation as an important inducement to the buyer and the buyer will have

CBS, Inc. v. Ziff-Davis Publishing Co., 553 N.E.2d. 997. (N.Y. 1990). See also, this Website, Essays, *Letters of Intent in Business Acquisitions - Problems, Risks, and a Mechanical Solution*.

² For a comprehensive discussion of the acquisition process when the target is privately held, see this Website, Essays, *Buying Private Companies, Subsidiaries and Divisions, Parts I, II and III*.

proceeded with the closing. So long as the claim is not time-barred under the contract itself, it will not matter when the buyer asserts it.

The general rule will also apply, and the contract will govern the dispute, if the buyer discovers a misrepresentation prior to closing and *reveals its potential claim to the seller*. The contract will convert the buyer's purchase *obligation* to a purchase *option*. Under the general rule, the buyer can abandon the transaction without liability (assuming the claim is valid) because a condition to closing will not be satisfied (the material truth at closing of the seller's factual representations).

The situation changes, however, when a buyer with knowledge of a probable breach elects to close *without revealing its knowledge to the seller*. There can be legitimate motives for the buyer's silence. The buyer may be uncertain prior to gaining control of the target whether the questioned representation is actually false. The buyer may not be in a position to calculate its damage until it has operated the target. The buyer may simply want time to conduct a cost/benefit analysis of its claim in light of other business considerations. *Whatever the motivation, though, the buyer's silence prior to closing may prevent it from recovering afterward, even though the contract did not require a pre-closing notice of claim, the claim is otherwise timely and the buyer can prove that the warranty was breached.*

Before exploring that turn of events it is important to note that, in the absence of a contractual provision *requiring* immediate disclosure of suspected claims (something few buyers will accept), *the silent buyer has not waived its right to sue*. As a matter of settled law, a binding waiver presupposes an intentional relinquishment of a known right. The relinquishment must clearly be established by a written acknowledgment, or by conduct that is patently inconsistent with assertion of the right. The silent buyer has not signed an acknowledgment. It did nothing to cause or induce the misrepresentation. It intends to reserve its right, not to relinquish it. The buyer has merely assumed, not illogically, that it can rely later upon a contract that provides a buyer's remedy for the very claim that has arisen.

The Exception - Muddled Thinking in the Courts -The Buyer's Dilemma

The buyer's assumption is dangerous. Despite the seemingly clear language of the contract, the buyer may be confounded by a clash between the law of contracts and the law governing actionable wrongs called "torts." The following example will illustrate the applicable legal principles and the buyer's dilemma:

The representation and warranty: Assume the seller has furnished to the buyer the target's audited financial statements for the preceding five fiscal years plus supporting journals and other records. In the acquisition contract, the seller has made a standard factual *representation*: "The financial statements conform to

generally accepted accounting principles consistently applied and they present fairly the financial position and results of operations of (the target) at and as of their respective dates." The seller has *warranted* that the representation was true at the contract date and will also be true at the closing date. The representation and the related warranty are to survive until the third anniversary of the closing date.

The claim: After the contract is signed, but prior to the closing, the buyer discovers what appears to be a material *overstatement* of the target's trailing EBIT in the financial statements. The purchase price is a fixed sum calculated as a multiple of trailing EBIT. Thirty percent of the price will be paid at closing. The balance will be paid in quarterly installments and the contract gives the buyer the right to offset valid warranty claims against them.³

The negotiating risk: Despite the claim, the buyer wants to complete the acquisition, albeit at a lower price. However, the seller has been approached by other qualified bidders. The buyer believes that, if its potential claim is revealed, the seller will offer to permit the buyer to abandon the transaction, but will insist that, if the buyer proceeds, it must pay the stated price without adjustment. The buyer assumes, correctly, that if it closes *on those terms* it *will* have waived its claim because it will have intentionally relinquished a known right. The buyer's tentative strategy, therefore, is to remain silent and assert its claim after the closing by exercising its contractual right of offset. That will shift the cost of initiating litigation to the seller, thus increasing the buyer's leverage. Should the buyer pursue that strategy?

A contract "warranty" is simply a promise to cure or compensate for harm resulting from the falsity of a fact represented as true. Under the law of contracts, if a seller's warranty has been bargained for and purchased by the buyer in an acquisition, it will be enforced. The seller is thus converted from a vendor, obligated only to cause a conveyance of the target's assets or outstanding stock, to an insurer obligated to satisfy claims if the target is not as represented.

The law, however, also recognizes so called "tort" claims based upon conduct described variously as "fraud", "deceit" or "misrepresentation." Such claims do *not* arise from the language of a contract. The innocent purchaser of shoddy goods, worthless stock, or inaccessible swamp land may pursue "tort" remedies even

³ "EBIT" is an acronym for "earnings before interest and taxes." By eliminating interest and taxes from the computation of earnings, financial analysts can compare companies with varying capital structures and borrowing requirements. Variations of the measurement eliminate depreciation (EBID) and interest, taxes, depreciation and amortization (EBITDA). "Trailing EBIT" is EBIT for a specified period of time prior to closing, usually one year.

though the underlying contract may be free of, or may even disclaim, any warranty. The foundation for tort remedies is the claimant's good faith and reasonable reliance upon the truth of the basic facts that induced the purchase; facts that, to the knowledge of the seller, were false. When that reliance cannot be shown, the claim fails.

The problem for buyers in the acquisition context is that courts have mistakenly applied the "tort" rule to claims based upon a contract warranty. They have denied recovery to silent buyers fitting our example on the erroneous ground that, even though the warranty may have been breached, the buyer was not *deceived*. Accordingly, the necessary *reliance* cannot be shown.

Certainly a buyer with knowledge of a breach of warranty cannot claim to have relied upon the warranted *fact* when electing to close (though it probably *assumed* the fact when preparing its bid). That, however, is not the point. The buyer will rarely be certain of *any* fact associated with the target. It is precisely that uncertainty that prompts the buyer to negotiate and pay for the seller's warranty, something the tort claimant has not done. *It is the warranty upon which the contract buyer relies, not the underlying fact.*

Nevertheless, a buyer that conceals its knowledge of a potential breach can encounter very rough sledding. If the buyer admits its knowledge, it may be perceived as asserting an unfair advantage. If it admits only that it was suspicious, the result may be no different. The seller will argue that had it known of the claim in time it might have corrected the misrepresentation somehow (an argument that brushes aside the probability that the seller knew of the misrepresentation all along). In our example, the seller will observe that the financial statements and related records, which the buyer examined in detail, speak for themselves. With the benefit of hindsight, the seller may then argue persuasively that any material overstatement of EBIT would have been apparent to the buyer as soon as the underlying financial records were examined. Since the buyer did not object, it could not possibly have relied upon reported EBIT when it elected to close. There is an inherent psychological appeal to that argument stemming from the notion that the buyer should not have its cake and eat it too.⁴

⁴ If the warranty is limited to facts *actually known* to the seller (a so-called "knowledge qualifier"), the buyer's claim may collapse for failure to prove the knowledge. That result, however, follows from the terms of the contract and owes nothing to tort principles. Likewise, if a falsehood is sufficiently glaring as to be obvious to both parties, the claim may collapse on *that* ground. Under the circumstances, no reasonable person would have supposed the seller meant to warrant against the falsehood. That too is a matter of contract law. The seller inadvertently allowed the warranty to remain in the text, but its

Because of all this, my legal advice to our hypothetical buyer would necessarily be hedged: The buyer may be able to close without revealing its suspicions to the seller and without unacceptable legal risk, if it can demonstrate that the financial statements were ambiguous and that it conducted an adequate pre-closing investigation that failed to remove the ambiguity. The buyer *may* also be helped by a common contractual provision that the seller's warranties are binding notwithstanding the buyer's investigation, but such provisions are *not* dispositive. Until courts can be relied upon to think clearly about the difference between contract and tort claims, buyers will remain silent at their peril. When a potential breach is discovered prior to closing, prompt disclosure is the only *certain* way to preserve a claim.

My advice to the seller under the same circumstances would depend upon two factors: the seller's assessment of the merits of the claim and the presence or absence of other qualified bidders. If the claim is without merit, the seller can stand on the contract and insist that the buyer close. The seller can rely upon its own right to sue if the buyer refuses. If other bidders are present, the seller may be tempted to take the position illustrated by our example, regardless of the merits of the claim. The seller can deny the claim, but accompany the denial with a new offer allowing the buyer, alternatively and in the buyer's discretion, to withdraw from the contract without liability, or to waive the claim and proceed to closing. That position can provide the seller with significant negotiating leverage.

It is probably gratuitous to add that serious disputes reflect genuine differences of opinion, that negotiating strategies are more easily stated than executed and that the parties typically resolve their differences (through an adjustment of the purchase price) in response to the same overriding factor that has motivated them all along; the desire to consummate an important transaction.

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inadvertence was obvious to the buyer. Contract warranties require an *objectively* demonstrated intent to be bound. When that is absent, no warranty is made at all and no tort rule is relevant or necessary to protect the seller.