Managing risk exposure in acquisitions

Buying an owner-managed business can give rise to particular challenges. However, with careful planning, those challenges can be addressed so as to respect the legacy of the management sellers while protecting the purchaser's interests. Leon Ferera and Mathis Bredimus of law firm Jones Day explain how parties can manage the delicate balance between mitigating risk and preserving the relationship between the purchaser and any management sellers who are to be retained in the target business after closing.

Catering for the seller profile

The acquisition of an owner-managed business can involve tricky questions of buy-side risk management, especially if individual sellers are to be retained after completion as part of the target company's management.

The buyer will normally require the sellers to provide warranties and indemnities in the purchase agreement. However, it may have a limited appetite, or ability, to enforce them.

This may be due to the need to maintain a good working relationship with the sellers (at least for a period after the sale) and benefit from their expertise and know-how, or because the sellers might not have the financial wherewithal to satisfy any claim.

There are various ways of addressing these issues, but each will require some planning and thought at an early stage of the transaction.

Deferred payment with set-off right

One way for a buyer to preserve its ability to enforce a warranty or indemnity claim is to withhold part of the purchase price, with a set-off right for the buyer in the event of a claim.

The purchase agreement will frequently provide that the buyer's set-off right arises only once the claim has been finally determined in its favour by a court.

Key areas for negotiation on deferred payments include the amount and duration of the retention and whether the funds are retained by the purchaser or held by a third party escrow agent, and the circumstances in which a party should have the right unilaterally to instruct the escrow agent to pay out funds.

Parties can agree to structure a deferred payment as an earn-out which requires the buyer to pay an additional amount after closing if performance targets are achieved or certain events occur. Among other benefits, this can further align the sellers' and buyers' interests for a period after closing.

However, both parties should bear in mind certain considerations, such as the complexity of drafting objective milestones for payment, the burden of monitoring post-closing performance, the potential for manipulation of metrics, and the possible impact of extrinsic factors.

For sellers, a deferred payment and set-off mechanism has the advantage that, if their liability under the purchase agreement is limited to the amount of the deferred payment, they know the full extent of their exposure.

Yet there is a drawback: even if no claims arise, sellers will experience a delay in receiving payment of the full purchase price.

W&I insurance

One option which has become commonplace is warranty and indemnity (W&I) insurance. This can provide recourse for a buyer without directly implicating the sellers, thereby helping to preserve – at least to some extent – their relationship after closing.

However, both parties will need to consider certain potential drawbacks. These include deductible and coverage exclusions or limitations (for matters which may include known problems, pension deficits, pollution, product liability, asset condition, sanctions and fraud).

Another potential disadvantage is the cost of obtaining W&I insurance, especially for smaller acquisitions.

Security over the sellers' assets

One further option would be for the buyer to take security over some of the sellers' assets (such as a bank account, real property or other investments) to secure any potential claims under the purchase agreement.

This approach is rare for several reasons. For one thing, any such arrangement will be legally complex. Also, sellers may understandably be reluctant to pledge their assets. Moreover, it may not help to preserve good relations between the buyer and any management sellers who are retained in the target business.

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