

REPS, WARRANTIES AND INDEMNITIES IN THE SALE OF A BUSINESS--PART 1

If you are selling your business, or if you are purchasing a business, the most important sections in any purchase agreement are those dealing with the representations, warranties and indemnities of the seller. This newsletter is the first part of a two-part newsletter addressing these sections in a purchase agreement.

Representations and Warranties. The representations and warranties generally form the bulk of a purchase agreement and are integral and vital to the buyer of a business. The representations and warranties serve three main purposes:

1. They aid in disclosing important information about the seller even before the signing of the agreement.
2. The representations and warranties provide the basis for the buyer's right to terminate the acquisition before closing.
3. Finally, and maybe most importantly, the seller's representations and warranties form the basis for the buyer's right to indemnification if there is a breach of any of those representations and warranties after closing. The buyer will want to make sure the shareholders of the seller are personally and jointly and severally liable for the representations and warranties.

Types of Representations and Warranties. The buyer will want to carefully craft each of the representations and warranties to fit the particular business of the seller. The buyer's due diligence of the seller can help in drafting the representations and warranties so that they fit the particular type of business of the seller or fit the specific facts applicable to the seller. In any event, the following is a representative list of representations and warranties that should be included:

-The seller is duly incorporated and in good standing and has the authority to sell the business.

-That the financial statements of seller are true, complete and correct, and fairly present the financial condition of the seller (and, if applicable, were prepared in accordance with GAAP).

-That seller has good and valid title to the assets being sold (or if the transaction is a stock sale, that the sellers are the owners of the stock and that no other persons have any rights to acquire any of the stock).

-That no adverse changes have occurred in the financial condition, business, or prospects of the seller since the latest financial statements.

-That all taxes have been paid and all tax returns have been duly filed and there are no IRS disputes

-If accounts receivable are part of the assets being purchased, that all such accounts receivable are valid accounts and are collectible.

-If equipment or other personal property is being sold, that such personal property is all the personal property currently utilized in seller's business, and that it is currently in good operating condition, subject to normal wear and tear

-That the seller has complied with all applicable laws and has all required permits or licenses for the operation of its business

-That there are no pending or threatened lawsuits, investigations or proceedings, and there is no basis for any such lawsuit investigation or proceeding

-That the seller has the legal right to all of its intellectual property and is not subject to infringement claims

-Representations regarding seller's employees and benefit plans and compliance with all employment and benefit laws

-Seller's compliance with all applicable environmental laws. If any real property is involved in the sale (whether by purchase or lease), that no hazardous materials have been disposed on the property and that such property is free from any hazardous materials, underground storage tanks, or other environmental hazards.

Things the Seller Should Consider. Although the representations and warranties serve as the basis for indemnification, the seller may not be willing to make certain representations if they are not true, and the allocation of risk will need to be dealt with separately for those areas in the indemnification section. Generally, the seller will want to include as many qualifiers as possible in the representations and warranties, such as "to the best of seller's knowledge," or making a particular representation (such as compliance with laws) only "in all material respects" or adding other materiality qualifiers. Adding knowledge qualifiers can limit the buyer's indemnification rights by shifting to the buyer the economic risk of "unknown" facts.

Part 2 of this newsletter will address the seller's indemnification for any breaches of the representations and warranties. We hope this newsletter has been helpful. If you are thinking about selling your business or buying a business, we can provide the experienced mergers and acquisition assistance you need.