

# The Sliding Scale of Representations and Warranties — Negotiating Representations and Warranties when Buying or Selling a Business (or Real Property)

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## Brief Description: What is a representation and what is a warranty?

**Representations:** In an acquisition setting, generally a representation is a statement made from one party to the other as to some fact or circumstance which is influential in inducing the closing of the agreement.

For example, “Seller *represents* that the Financial Statements provided to Buyer are accurate and complete in all respects.”

**Warranties:** In an acquisition setting, generally a warranty is a stipulation to a fact or set of facts related to the subject matter of the agreement *and an agreement to make the recipient of the warranty whole if those facts turn out to be untrue.*

For example, “Seller *warrants* that Seller has good and marketable title to the assets and that there are no liens encumbering those assets.”

At law, generally as to breach of contract claims, if a warranty is breached it is presumed to be material while the burden is on the party claiming an inaccurate representation to show that the misrepresentation is material. So, a warranty must be strictly complied with, while materiality may apply to representations when determining whether a representation is inaccurate.

## In Practice, the Distinction Fades in an Acquisition Setting

Notwithstanding the legal differences, in practice the distinction between representations and warranties in a negotiated acquisition does not tend to matter.

First, for right or wrong, the terms are often used together in an acquisition agreement. The following is representative of language commonly used in an acquisition agreement: “*Seller represents and warrants to the Buyer that the following statements are true and correct as of the effective date hereof and will be true and correct as of the Closing Date . . .*” As you can see, representations and warranties are frequently lumped together and difficult or impossible to distinguish in an acquisition setting.

Although “representations” and “warranties” may have different meanings at law, in a negotiated acquisition the differences are normally made irrelevant because the parties negotiate the consequences of an inaccurate representation or breach of warranty and so the remedies for such occurrences are set out in detail in the agreement as the exclusive remedies of a party.

That being said, when referring to these promises, sound smart by saying that if a representation is not true it is “*inaccurate*,” while if a warranty is not true it is “*breached*.”

## **A Hypothetical Sale: The Purchase of South Texas Services by Oleo National**

Sam Seller, from Yancey, Texas, is 48 years old. He has worked in the oil fields his entire life, and quickly moved up the ranks of the several companies he worked for. Sam was always resourceful and in 1999 he started an oil field equipment and services company which is based in Karnes County named “South Texas Services.” South Texas Services is in the “Business” of manufacturing, delivering, installing and servicing frac tanks, pumps and frac fluid distribution systems. Of course, since 2009 business has been booming from Eagle Ford development and South Texas Services has reached \$100MM in revenue. Sam is the sole shareholder of South Texas Services and has received a \$30,000,000.00 offer for the sale of all of the outstanding stock of South Texas Services to a global company which is heavily involved in and has long term plans in the Eagle Ford play. Sam has decided to accept the offer. Sam (“Seller”) has engaged you to represent him in the transaction as Seller’s counsel.

Oleo National, based in Brazil, is a global oil and gas exploration company and operator. Oleo has recently invested billions of dollars in the Eagle Ford play and has a 10-year plan for development in that area. In order to take advantage of efficiencies, it is purchasing several of its service providers in the area. Oleo (“Buyer”) will be purchasing all of the outstanding stock in South Texas Services for \$30,000,000.00. Ignoring obvious conflicts of interest issues, the other-you has been engaged to represent it as Buyer’s counsel.

## **Typical “Positioning” for your Client in the Early Stages of a Negotiation**

**Representing the Seller:** When representing a seller, we frequently tell our clients that our goal is to help them receive as much money as possible, and to make sure they don’t ever have to give any of that money back—or to at least try to ensure they only have to give back as little money as possible.

An initial negotiating position when representing Sam the seller in our hypothetical might look something like this:

*“Oleo, you are a big sophisticated company with expensive tall building lawyers. You’ve been in this industry for 30 years and know the oilfield business. As such a sophisticated buyer, you’ll have to engage in your own due diligence and decide for yourself whether you want to purchase the company, and if so you will have to purchase it in its current condition. Sam the Seller is only going to represent or warrant things to you that you cannot determine or discover on your own through due diligence.”*

**Representing the Buyer:** An initial negotiating position when representing the buyer, Oleo in our hypothetical, might look something like this:

*“The representations and warranties from Seller are going to serve several purposes for my client the Buyer—they are not simply provided by the Seller to backstop my client’s due diligence. Some of those purposes include: (a) assisting my client the Buyer to better understand the business and assets it is purchasing; (b) establishing that certain facts are true and accurate as presented*

*by Seller or discovered by Buyer during the due diligence process; (c) to protect my client the Buyer in allowing it to terminate the agreement in the event the representations are inaccurate or warranties are untrue; and (d) to allow my client the Buyer recourse after closing in the event the representations are inaccurate or the warranties are breached as provided by Seller.*

*Even if my client conducts due diligence, as a buyer they are at a significant disadvantage to Sam in knowing specifics about the business and assets as compared to Sam himself who is in the best position to be knowledgeable about those matters and therefore bear the risk.”*

### **Which Party Controls the Drafting?**

Buyer’s counsel frequently desires to control the initial draft of the purchase agreement. After all, the Buyer is paying the purchase price and will likely want to structure the initial offer. This also allows you as buyer’s counsel to establish the tone as to (a) expectations regarding the sophistication of the agreement, and (b) the measure of representations and warranties you expect from a seller. Just as importantly, the representations and warranties serve as the foundation for an indemnification claim after closing and buyer’s right to terminate the agreement in the event things with the business, assets or real property in question are later determined to not be as they seemed. If this is left to the seller’s counsel, seller’s counsel would likely include no or only minimal representations and warranties and will have “anchored” the negotiation from that “low” place from a buyer’s perspective.

Of course, as seller’s counsel, if the buyer invites you or provides you the opportunity to prepare the initial draft of the acquisition agreement, I highly recommend you take advantage of that opportunity.

### **A Note about the Tenor of this Discussion**

This discussion is not a “pro-seller’s side” discussion. It may seem like this piece concentrates on how to “water down” representations—thereby benefiting the seller in a transaction at the cost of the buyer. That is because if we are commencing with the premise that the buyer will produce the initial purchase agreement and therefore that the representations are fully formed and likely even heavy-handed in favor of the buyer. As such, with the starting point of the drafting hypothetical commencing from a buyer favorable place, the process requires the “winnowing down” of buyer favorable representations. This is the “sliding scale”—each representation may be anywhere on the scale from a “buyer-friendly” to “seller-friendly” representation. This discussion commences with buyer-friendly representations and those representations will naturally slide towards more seller-favorable representations as they are negotiated.

### **Common Representations in a Business or Real Property Acquisition:**

- Title to assets or property
- Authority and capitalization of entity
- Condition of assets or improvements
- Assignable contracts are in full force and effect
- Financial statements are true and correct
- Litigation
- Taxes
- Solvency
- Authority and capitalization of seller
- Litigation
- No environmental matters
- Leases are in full force and effect
- No condemnation

## Examples of Common Representations and Warranties and their Negotiation

### Initial Draft from Buyer

“Contract,” means all contracts, agreements, commitments, or other obligations, whether express or implied, and whether written, oral, or otherwise, of Seller entity.

**Representations and Warranties of Seller:** Except as expressly set forth otherwise herein, Seller represents and warrants to Buyer that as of the Effective Date and through and on the Closing Date the following:

**Contracts:** All Contracts to which Seller is a party are identified on Schedule 1.1 hereto. Except as expressly disclosed in Schedule 1.1, (i) no Contract has been breached or canceled by the other party, and there are no anticipated breaches by any other party of any such Contract, (ii) Seller has performed all the obligations required to be performed by it under the Contracts and is not in default under or in breach of any Contract, and no event or condition has occurred or arisen which with the passage of time or the giving of notice or both would result in a default or breach thereunder, (iii) Seller has no present expectation or intention of not fully performing any obligation pursuant to any Contract, and (iv) each Contract is legal, valid, binding, enforceable and in full force and effect and will continue as such following the consummation of the transactions contemplated hereby.

**Condition of Real Property:** There are no defects in or unrepaired damage to the Property; all mechanical, electrical, plumbing, HVAC, elevator, access, security, fire protection, sanitary sewer, storm drainage and other systems and equipment serving Seller’s Property are in good working order and condition; and the roof of the improvements is in sound condition without leaks or ponding.

All representations and warranties by Seller in this Agreement shall survive the closing of this transaction.

**Draft No. 2: Seller's First Response** (Some tools for limiting representations and warranties: (a) Limiting the time of application; (b) materiality qualifiers; (c) knowledge qualifiers; (d) material adverse effect qualifiers; and (e) limitation on the survival of the representations and warranties)

"Contract," means all contracts, agreements, commitments, or other obligations, whether express or implied, and whether written, oral, or otherwise, of Seller ~~entity~~.

*"Material Contract," means any Contracts (a) which involve any future payment or obligation to perform by Seller in excess of Fifty Thousand and No/100 Dollars (\$50,000) (unless such obligation may be avoided by cancellation or termination by Seller on less than sixty (60) days' notice to the other party), (b) which involve any future payment to Seller in excess of Fifty Thousand and No/100 Dollars (\$50,000), or (c) for which the default thereunder by Seller would have a Material Adverse Effect on the business of Seller.*

*"Material Adverse Effect" means any state of facts, change, development, event, effect, circumstance, condition or occurrence that, individually or in the aggregate would have an adverse effect on the business, properties, assets liabilities, financial condition, or results of operations of Seller or its business and that would prevent or materially impair or delay the ability of Seller to perform its obligations hereunder.*

*"Seller's Knowledge" means only to the actual knowledge, at the time in question, without a duty to investigate, of Sam Local the President of Seller.*

**Representations and Warranties of Seller:** Except as expressly set forth otherwise herein, Seller represents and warrants to Buyer that as of the Effective date ~~and through and on the Closing Date~~ *hereof*, the following:

**Contracts:** All Contracts to which Seller is a party are identified on Schedule 1.1 hereto. Except as ~~expressly~~ disclosed in Schedule 1.1, (i) ~~no contract~~ *No Material Contract* has, *to Seller's Knowledge*, been breached or canceled by the other party, and *to Seller's Knowledge*, there are no anticipated breaches by any other party ~~of~~ *to any such contract* *Material Contract*, (ii) Seller has performed all the obligations required to be performed by it under *the Material Contracts, except to the extent the failure to perform such obligation will not have a Material Adverse Effect on the Business*, and is not in default under or in breach of any *Material Contract*, and no event or condition has occurred or arisen which with the passage of time or the giving of notice or both would result in a default or breach thereunder, (iii) Seller has no present expectation or intention of not fully performing any obligation ~~pursuant to~~ *under any Material Contract*, and (iv) each *Material Contract* is ~~legal, valid, binding, and enforceable~~ and in full force and effect ~~and will continue as such following~~, *except to the consummation of extent the transactions contemplated hereby same is not binding and enforceable and in full force and effect only in part and the same shall not have a Material Adverse Effect on the business.*

**Condition of Real Property:** ~~Intentionally deleted. There are no defects in or unrepaired damage to the Property; all mechanical, electrical, plumbing, HVAC, elevator, access, security, fire protection, sanitary sewer, storm drainage and other systems and equipment serving Seller's Property are in good working order and condition; and the roof of the improvements is in sound condition without leaks or ponding.~~

All representations and warranties by Seller in this Agreement shall survive the closing of this transaction *for six (6) months only*.

**Draft No.3: Buyer's First Response Draft** (As Buyer's counsel, beware of the duty to investigate and inquire, and beware of double materiality qualifiers)

"Contract," means all contracts, agreements, commitments, or other obligations, whether express or implied, and whether written, oral, or otherwise, of Seller.

"Material Contract," means any Contracts (a) which involve any future payment or obligation to perform by Seller in excess of ~~FiftyFive~~ FiftyFive Thousand and No/100 Dollars (\$505,000) (unless such obligation may be avoided by cancellation or termination by Seller on less than sixty (60) days' notice to the other party), (b) which involve any future payment to Seller in excess of ~~TwentyFive~~ TwentyFive Thousand and No/100 Dollars (\$505,000), ~~or (c) for which the default thereunder by Seller would have a Material Adverse Effect on the business of Seller.~~

"Material Adverse Effect" means any state of facts, change, development, event, effect, circumstance, condition or occurrence that, individually or in the aggregate would have an adverse effect on the business, properties, assets liabilities, financial condition, or results of operations of Seller or its business and that would prevent or materially impair or delay the ability of Seller to perform its obligations hereunder; *provided that the parties agree that any such result, consequence, condition or matter having a value or adverse impact in excess of Ten Thousand and No/100 Dollars (\$10,000) shall be deemed to constitute a Material Adverse Effect.*

"Seller's Knowledge" means only to the actual knowledge, at the time in question, ~~without~~ *with an affirmative duty to investigate; (which implies that the relevant parties are qualified to and have engaged in all investigation reasonably necessary to make any relevant representation or warranty),* of Sam Local the President of Seller ~~and John Knowitall the Chief Operating Officer of Seller.~~

**Representations and Warranties of Seller:** Except as expressly set forth otherwise herein, Seller represents and warrants to Buyer that as of the Effective Date ~~hereof~~ *and again on the Closing Date*, the following:

**Contracts:** All Contracts to which Seller is a party are identified on Schedule 1.1 hereto. Except as disclosed in Schedule 1.1, (i) No Material Contract has ~~to Seller's Knowledge~~, been breached or canceled by the other party, and to Seller's Knowledge, there are no anticipated breaches by any other party to any Material Contract, (ii) Seller has performed all the obligations required to be performed by it under the Material Contracts; ~~except to the extent the failure to perform such obligation will not have a Material Adverse Effect on the Business,~~ and is not in default under or in breach of any Material Contract, and no event or condition has occurred or arisen which with the passage of time or the giving of notice or both would result in a default or breach thereunder, (iii) Seller has no present expectation or intention of not fully performing any obligation under any Material Contract, and (iv) each Material Contract is binding and enforceable and in full force and effect, ~~except to the extent the same is not binding and enforceable and in full force and effect only in part and the same shall not have a Material Adverse Effect on the business.~~

~~Condition of Real Property: Intentionally deleted.~~

*Condition of Real Property: To Seller's Knowledge: (a) there are no defects in or unrepaired damage to the Property; (b) all mechanical, electrical, plumbing, HVAC, elevator, access, security, fire protection, sanitary sewer, storm drainage and other systems and equipment serving Seller's Property are in good working order and condition; and (c) the roof of the improvements is in sound condition without leaks or ponding.*

*Except as otherwise provided in Section 10 regarding Indemnification, all representations and warranties by Seller in this Agreement shall survive the closing of this transaction for ~~six (6) months only.~~ a period of eighteen (18) months, as to matters for which Purchaser has not provided written notice to Seller within such period of time, and will survive for three (3) years as to all matters specified in any such written notice to the extent that such matters are not resolved or made the subject of litigation instituted prior to the expiration of such three (3) year period.*

## Draft No.4: Seller's Second Response Draft

“Contract,” means all contracts, agreements, commitments, or other obligations, whether express or implied, and whether written, oral, or otherwise, of Seller.

“Material Contract,” means any Contracts (a) which involve any future payment or obligation to perform by Seller in excess of Five Thousand and No/100 Dollars (\$5,000) (unless such obligation may be avoided by cancellation or termination by Seller on less than sixty (60) days’ notice to the other party), (b) which involve any future payment to Seller in excess of Five Thousand and No/100 Dollars (\$5,000).

“Material Adverse Effect” means any state of facts, change, development, event, effect, circumstance, condition or occurrence that, individually or in the aggregate would have an adverse effect on the business, properties, assets liabilities, financial condition, or results of operations of Seller or its business and that would prevent or materially impair or delay the ability of Seller to perform its obligations hereunder; provided that the parties agree that any such result, consequence, condition or matter having a value or adverse impact in excess of ~~Ten~~*Fifty* Thousand and No1/00 Dollars (~~\$10~~*50*,000) shall be deemed to constitute a Material Adverse Effect.

“Seller’s Knowledge” means only to the actual knowledge, at the time in question, ~~with an affirmative duty to investigate or inquire, (which implies that the relevant parties are qualified to and have engaged in all investigation reasonably necessary to make any relevant representation or warranty);~~ of Sam Seller ~~and~~*the President of the Seller entity*, John Knowitall the Chief Operating Officer of Seller, ~~and Sherry Smith the HR Director of the Seller entity.~~

**Representations and Warranties of Seller:** Except as expressly set forth otherwise herein, Seller represents and warrants to Buyer that as of the Effective date and again on the Closing Date, the following:

**Contracts:** All Contracts to which Seller is a party are identified on Schedule 1.1 hereto. Except as disclosed in Schedule 1.1, (i) No Material Contract has been breached or canceled by the other party, and to Seller’s Knowledge, there are no anticipated breaches by any other party to any Material Contract, (ii) Seller has performed all the obligations required to be performed by it under the Material Contracts and is not in default under or in breach of any Material Contract, and no event or condition has occurred or arisen which with the passage of time or the giving of notice or both would result in a default or breach thereunder, (iii) Seller has no present expectation or intention of not fully performing any obligation under any Material Contract, and (iv) each Material Contract is binding and enforceable and in full force and effect.

**Condition of Real Property:** To Seller’s Knowledge: (a) there are no defects in or unrepaired damage to the Property; (b) all mechanical, electrical, plumbing, HVAC, elevator, access, security, fire protection, sanitary sewer, storm drainage and other systems and equipment serving Seller’s Property are in good working order and condition; and (c) the roof of the improvements is in sound condition without leaks or ponding.

Except as otherwise provided in Section 10 regarding Indemnification, all representations and warranties by Seller in this Agreement shall survive the closing of this transaction for a period of ~~one year (1) eighteen (18) months, as to matters for which Purchaser has not provided written notice to Seller within such period of time, and will survive for three (3) years as to all matters specified in any such written notice to the extent that such matters are not resolved or made the subject of litigation instituted prior to the expiration of such three (3) year period.~~

## How to Further Limit the Effect of Representations and Warranties

(AS IS, WHERE IS Language, “No Reliance” Language, Disclaimer of Reliance on Information from Third Parties, Acknowledgement of Physical Inspection, Waiver of Claims Related to Disclaimed Matters)

### AS IS, WHERE IS Disclaimers

As seller’s counsel in the sale of a business or real property, in striving to limit your client’s exposure to the greatest extent, AS IS, WHERE IS disclaimers are recommended. Such disclaimers have the effect of waiving and disclaiming implied warranties and limiting a seller’s exposure for inaccurate representations or breaches of warranties to only the representations and warranties expressly made and negotiated with great care in the agreement itself. The following reflects a very brief AS IS, WHERE IS disclaimer. In practice, these disclaimers may be a page in length or longer. Note that these provisions should be in bold and/or capital letters so that they are “conspicuous.”

**AS A MATERIAL PART OF THE CONSIDERATION FOR THIS AGREEMENT, SELLER AND BUYER AGREE THAT EXCEPT FOR SELLER’S WRITTEN REPRESENTATIONS AND WARRANTIES EXPRESSLY SET OUT IN THIS AGREEMENT, SELLER IS CONVEYING THE PROPERTY TO BUYER “AS IS” “WHERE IS,” AND WITH ALL FAULTS. THIS PROVISION SHALL SURVIVE CLOSING AND SHALL NOT MERGE THEREIN.**

### No Reliance Disclaimers

It is also recommended that, if representing the seller, as seller’s counsel you attempt to include a “no-reliance” statement which is an acknowledgment by the buyer that it is not relying upon any representations or statements of seller (except as set forth in

the agreement) as to the business or property, and is relying only upon its own examination thereof. The following is an example of a simple “no reliance” disclaimer:

*Other than the representations and warranties expressly set forth herein, Buyer specifically disclaims that it is relying upon or has relied upon any statements, representations or warranties that may have been made by any person, and acknowledges and agrees that the Seller has specifically disclaimed and does hereby specifically disclaim any such other representation or warranty made by any person.*

Further disclaimers and limitations on representations and warranties may be negotiated and included as well, such as:

- Requiring buyer to acknowledge that, unless an express representation was made to that effect, buyer is not relying on any written information or data provided thereto by seller which was prepared by third parties, as seller has made no independent investigation or verification of such information’s accuracy.
- Requiring buyer to acknowledge that prior to closing it will have made its own physical inspection of the relevant assets or property and will satisfy itself as to the condition of the assets or property.
- A statement from buyer that it waives, releases and discharges any claim it might have with respect to any disclaimed matters or the condition of the assets or property or defects related to the assets or property.



## **How to Further Limit the Effect of Representations and Warranties** (Indemnification Thresholds, Indemnification Caps, Fundamental Representations)

### **Indemnification**

The indemnification provisions in a negotiated acquisition are frequently the most heavily negotiated part of the agreement. Indemnification obligations expose the seller to the risk of having to pay or return money to the buyer after the closing if the seller has breached its warranties or made misrepresentations or for a variety of other occurrences, such as breaches of covenants.

As discussed, as seller's counsel, one of your goals is to make sure that your client does not have to give any of the purchase price back—or to at least only return as little as possible. As buyer's counsel however, you want to ensure that seller remains responsible for inaccurate representations and breached warranties, and event the operations of the business or property prior to the closing date.

#### **Thresholds for Indemnification Liability**

To further limit the consequence of my client's representations and warranties, I will frequently include a provision which sets forth that there must be a minimum dollar amount of losses suffered by the buyer before the seller owe any indemnification liability. This is frequently called a "threshold."

In short, the seller is saying "Hey, no one survives a deal like this without getting nicked a little, so just expect that but don't come knocking on my door based on some nominal claim—those little nicks are a cost of doing business."

A simple indemnification threshold provision may read something like this:

*Buyer shall not be entitled to indemnification under this Section unless the losses associated with such indemnifiable claims in aggregate exceeds Fifty Thousand and No/100 Dollars (\$50,000.00) ("Buyer's Indemnification Threshold").*

By way of example, in the Oleo National buy-out of Sam Local, which is a \$30,000,000 transaction, a \$50,000 threshold on indemnification liability may be appropriate, as the purchase price is so significant Sam would be justified in the position that the parties should not be bothering one another over a mere \$50,000.

In the face of such a provision, buyer's counsel will want to ensure that the indemnification obligation "looks back" and includes all such indemnifiable claims up to that amount in the event the threshold is reached (e.g., when the indemnifiable losses accrue to \$50,001, the entire \$50,001 amount is owed and not merely amounts over the threshold of \$50,000). So, as buyer's counsel when presented with such a provision you would likely request the following be added to address what happens when the threshold is reached:

*Once Buyer's Indemnification Threshold is exceeded, the Buyer shall be entitled to indemnification for the entire amount of any such loss without deduction.*

## Caps for Indemnification Liability

To even further limit the consequence of my client's representations and warranties, I frequently include a provision which sets forth that there is a maximum dollar amount for indemnification liability for my client as a seller. This is frequently called a "Cap."

A simple indemnification cap provision may read something like this:

*After the Buyer's Indemnification Threshold has been cumulatively achieved, the aggregate indemnification liability of Seller to the Buyer under this Section shall not exceed Two Million and No/100 Dollars (\$2,000,000.00) (the "Cap").*

By way of example, in the Oleo National buy-out of Sam Local, a cap on indemnification liability may be very appropriate, as the Buyer is such a sophisticated party and so well capitalized that it can bear that kind of financial risk and in fact such risks may already be built in to their financial modeling for such a purchase.

In the face of such a provision, buyer's counsel will want to limit the application of the cap to what may be referred to as "non-fundamental" representations. As buyer's counsel you should insist that there should not be a cap on indemnification liability associated with certain fundamental representations such as, for example, (a) title to the assets, stock or real property being acquired, (b) whether taxes have been paid, (c) authority to enter into the transaction, (d) bankruptcy or solvency of seller, or (e) whether a broker has been engaged.

So, as buyer's counsel you might insist any language related to caps to indemnification liability be modified to include something like the following:

*The indemnification Cap described in the immediately preceding sentence shall not apply to indemnification liability arising under the representations or warranties provided in Sections \_\_\_\_, \_\_\_\_, \_\_\_\_, and \_\_\_\_ ("Fundamental Representations").*

**Let's Get Crazy!**  
**How to Even Further Limit the Effect of Representations and Warranties**  
(Knowledge Matters Disclaimer, Reduction of Liability for Insurable Claims, Reduction of Liability based on Tax Benefit to Seller)

**Knowledge Matters**

As seller's counsel, if your client has significant bargaining power, consider requesting a "Knowledge Matters" type disclaimer, to further limit your client's indemnification exposure. In short, this type of provision provides that if buyer is made aware of an inaccurate representation or breached warranty prior to closing and elects to close on the contemplated purchase nonetheless, all in the face of such inaccurate representation of breached warranty, the seller shall have no liability for such matter. Such a provision may look something like this:

*Notwithstanding anything contained herein to the contrary, neither party shall have any indemnification obligation to the other party pursuant to this Section if the Closing takes place despite such other party having knowledge of any inaccurate representation or breached warranty or breach of any covenant contained in this Agreement by the breaching party as a result of the provision of written notice from the breaching party prior to Closing or otherwise.*

**Reduction of Liability for Insurable Claims**

As seller's counsel, if your client has significant bargaining power, consider requesting a reduction or limitation of indemnification liability provision which provides that the Buyer or each party waives all rights of recovery against the other for indemnification against which the waiving

party is protected by insurance. So, by including such a provision each party is agreeing that it will simply rely on its insurance, to the extent it can, to recover for claims which might otherwise be indemnifiable. In short, the provision will provide that the amount of any indemnification obligation will be reduced by the amount of any proceeds of insurance received by the indemnified party in connection with such claim.

**Tax Benefit Limitation**

As seller's counsel, if your client has significant bargaining power, consider also requesting a reduction or limitation of indemnification liability which is based on taxable benefit received by the indemnified buyer arising from the occurrence giving rise to or payment of any claim.

## **How to Backstop Representation and Warranty Liability Obligations: Escrows, Hold Backs and Guarantees for the Benefit of Buyer**

In buying the assets of a business the seller will have conveyed to the buyer at closing all of its valuable assets. Frequently in buying a parcel of real property the seller is a special purpose entity with one asset—the real estate that was conveyed at closing.

In those cases, after closing the seller entity will have no assets left other than the cash paid as the purchase price which will be quickly distributed to the owners of the seller entity—leaving the seller entity insolvent and unable to perform on its indemnification obligations. So, as Buyer’s counsel, after the closing of an acquisition, how can you help your client ensure the seller parties have the ability to perform on their indemnification obligations?

### **Purchase Price Holdback**

Frequently, when representing a buyer, I request that a portion of the purchase price be “held back” until some time period (sometimes being ninety days to one year) after closing to secure the seller’s indemnification obligations and reserving the right of buyer to offset from such holdback amount any seller indemnification obligations that accrue. A simple holdback provision may look something like the following:

*A portion of the Purchase Price in the amount of ten percent (10%) hereof (the "Holdback Amount") will be reserved by Buyer at closing for a period of one hundred eighty (180) days commencing on the Closing Date (the "Holdback Period") to secure Seller's monetary obligations under the indemnification provisions of this Agreement. Upon the expiration of the Holdback Period, that*

*portion of the Holdback Amount, if any, not used to satisfy Seller's indemnification obligations will be remitted to Seller.*

### **Escrow of Holdback**

As seller’s counsel if agreeing to a holdback provision I prefer an escrow arrangement, whereby the hold back amount is escrowed with a third party and automatically released on the expiration of the holdback period unless there is a dispute. This ensures the buyer doesn’t go and spend the holdback during the holdback period and has the money to release to your seller client at the expiration of the holdback period. Of course, as seller’s counsel I prefer an independent party to hold those funds subject to and escrow agreement as opposed to an interested and adverse party retaining those funds.

### **Requiring a Seller to Retain Cash and not Dissolve**

Again, in the context of an asset purchase and frequently when purchasing real property from a special purpose entity, after closing the seller entity is insolvent after distributing the purchase price to its owners—leaving the entity unable to perform on its indemnification obligations if a claim is triggered. Frequently we’ll request covenants and financial reporting from a seller entity after closing which require the sellers to agree to leave some amount of funds in the bank accounts of the seller entity and no dissolve the seller entity for a certain period after closing--thereby ensuring a capitalized entity against which the buyer can recover if an indemnification obligation is triggered.

## **Guarantees**

Finally, as buyer's counsel, in and effort to ensure your client has the ability to enforce and recover under the indemnification provisions negotiated in the purchase agreement, consider requesting that the owners of the seller entity issue personal guarantees in some amount to guarantee the indemnification obligations under the purchase agreement.

Sellers are normally hesitant to agree to this. As seller's counsel, if our clients will agree to a personal guarantee, I recommend you attempt to negotiate that the guarantee be limited in time and amount, and "ratchet down" or "burn down" over time. For example, in a \$30MMM transaction the buyer you may require a \$5MM guarantee. As seller's counsel I would suggest limiting the guaranty exposure to inaccuracies in Fundamental Representations only, and negotiating that the guaranty burns down to \$1MM after one year and terminates completely after eighteen months.