ALLOCATING RISK IN THE SALE OF A BUSINESS

*By David C. Longinotti**

Allocating risk in an asset sale transaction is the single most important deal point other than price. The interests of the seller and buyer are always opposed on this issue: the seller wants to walk away free and clear with its profits, and the buyer wants to assure recourse for undisclosed liabilities and misrepresentations. The following is a brief discussion of this risk allocation issue and the legal techniques used to address it.

• **Liability Caps**. There will be no cap on liability at all unless one is expressly negotiated into the purchase agreement. A sophisticated buyer, then, will require the seller to assume all pre-closing liabilities without limit, but will make no mention of a cap in the purchase agreement. The buyer will also seek an indemnity from the seller for pre-closing operating liabilities and breaches of representations and warranties made in the purchase agreement. Many less sophisticated sellers will accept this proposal especially if the indemnification is bilateral – i.e., if the buyer provides an indemnification for post-closing liabilities to the seller. But other sellers will seek to impose a cap on liability and resist the proposed indemnification requirement. There is a great debate as to what the market is for liability cap arrangements, but in the end resolution of this issue comes down to negotiating leverage. Just as an example, in the past year or so we have negotiated caps ranging from seller's net proceeds from the sale, to 20% of the net proceeds, to 2% of the net proceeds, to a flat amount like 1 million dollars, to no recourse at all.

• **Pre-Closing Third Party Liabilities.** Most reasonable parties can agree that there should be no cap on liabilities arising from the seller's operation of a facility prior to closing, including wrongful death claims. Practically speaking, the seller is in the best position to bear these risks because the seller should have business insurance for most types of pre-closing operating risks. Assuming this insurance is in place, what the seller is really exposed to is uninsured risks including the gross negligence and willful misconduct of seller's employees. We typically counsel our selling clients to obtain tail coverage for their insurance for a period of time after closing to provide additional protection. All this being said, we have been in negotiations where sellers have sought an absolute cap, even against these pre-closing third party claims, whether or not there is insurance available to protect its interests.

• **Claw-Backs.** A claw-back is the right of a buyer to make claims against the seller for breaches of representations and warranties in the purchase agreement. The sophisticated seller will insist that the buyer rely on its own investigation of the business being acquired and also insist on a waiver or release of claims or a monetary cap of its liability. The sophisticated seller will also limit the duration of its representations and warranties, insist on express disclaimers of liability, and will require the buyer to covenant as to its sophistication and the thoroughness of its due diligence investigation.

• **Holdbacks.** Claw-backs can be structured using any number of techniques, including holdbacks, thresholds and deductibles. A holdback is a portion of the sales proceeds that is retained by the seller or more typically placed into escrow for a period of time after closing. The holdback amount acts as security to fund any claim of loss by the buyer for a breach of representation and warranty under the purchase agreements. A holdback is most appropriate when there is a specific claim or potential loss that the parties have identified and the holdback is set aside to provide for that contingency. But on occasion a seller may agree to a more general holdback especially if it limits the seller's risk – i.e., the held back amount serves as a cap.

• **Thresholds**. Apart from setting the monetary cap, there are certain other ways to allocate risk, including the negotiation of liability thresholds. A threshold is an amount of loss below which a buyer may not make a claim. So for instance, assuming a $100,000 threshold per occurrence is negotiated, a buyer would have no recourse against the seller for a loss that is determined to be $99,000. If the loss is determined to be $101,000, the seller would be fully responsible from the first dollar.

(Continued on page 15.)

(Allocating Risk, continued from page 6.)

• **Deductibles.** A deductible is the same as the deductible on your car insurance policy; it is a portion of any claim that a buyer will be required to pay on a first dollar basis. The key issue in negotiating thresholds and deductibles apart from price is whether they will apply on a per occurrence or aggregate basis.

• **Reps and Warranties Insurance.** Finally, it is important for the sophisticated buyer to consider reps and warranties insurance. This is insurance that provides a buyer with coverage against losses arising from a seller's breach of a representation or warranty in the purchase agreement. A seller may offer reps and warranties insurance to a buyer in exchange for a full or significant cap on liability. This insurance is expensive and there is typically a large deductible associated with it. Accordingly, it is typically utilized only in complex large scale transactions. The parties will need to negotiate through issues that arise in obtaining this insurance. The insurer will need to conduct its own pre-closing due diligence to assess risk, and there are a number of issues in the policy itself that a buyer should take an active role in negotiating, including term and assignability.

**David C. Longinotti is a partner in the Business Section at Hanson Bridgett Marcus Vlahos & Rudy LLP and is the leader of its Real Estate Practice Group. David is an experienced and effective transactional lawyer and an inventive problem solver. He offers particular expertise in complex real estate secured transactions and related debt and equity financing arrangements. David's recent credits include the acquisition of a portfolio of over thirty senior care facilities, the consolidation of fourteen real estate investment partnerships and the reorganization of two divisions of a publicly traded company.*