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Navigating Merger Deals in Economic Uncertainty

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When merger deals fall through, each party looks to regain what they lost, and more so during economic uncertainty. Alykhan Sunderji, former head of Amazon Canada and Amazon Fashion, explains the importance of sellers and buyers performing due diligence and making sure representations and warranties are completely spelled out.

With an uncertain economic landscape, clients are increasingly engaging attorneys to renegotiate—or seek redress—under previously negotiated acquisition agreements. Changing economic conditions can highlight issues that may not have been evident pre-acquisition or that acquirers may not have spent time to diligence.

In many cases, these experiences reflect common pitfalls to be avoided by buyers and their legal counsel. These are the most common concerns identified when working with clients who have buyer's remorse and how to avoid them.

Limited Due Diligence

Moving quickly is important when negotiating and closing a transaction, but not at the expense of sufficient due diligence. Due diligence involves verifying the representations of the seller with available data.

For example, I worked with one client who understood their target's business and operations, but did not conduct due diligence on the underlying customer contracts. Revenue they believed was contractually guaranteed was not, and the buyers failed to secure projects they had baked into their financial model.

This was a miss that could have been avoided with customary due diligence of the target's most important contracts.

Of course, even the most sophisticated investor can make this mistake in an attempt to close quickly and take advantage of strong economic conditions. Elon Musk famously waived due diligence when negotiating the buyout of Twitter.

Insufficient Representations and Warranties

Even where an acquirer conducts limited due diligence, they may be protected by strong representations and warranties provided by the seller. Representations and warranties are promises that a seller makes in the purchase agreement about the current and future state of the assets or business being acquired.

An acquirer should seek representations and warranties concerning those issues that raise the most risk or are tied to the value of the acquisition target.

For example, if a target is appealing because of its IP assets, a buyer should seek strong and targeted representations around the ability of a purchaser to use and exploit those IP assets, including the existence of any restrictive licenses or potential infringement claims.

Similarly, if a target is in a highly regulated sector, the buyer should seek representations around the target's regulatory history and potential regulatory enforcement or other limits on growth.

A buyer should also ensure these promises are incorporated into the purchase agreement, since most purchase agreements will expressly disclaim any statements made outside of it. Verbal promises typically provide cold comfort to the buyer who regrets their purchase.

Practical Limitations on Remedies

Strong representations and warranties are only worth as much as the remedies provided under an acquisition agreement. The purchase agreement should not only provide a clear remedy for breach, but also a practical source of redress.

In many private company sales, indemnities are provided by companies that are merely shells after the sale of their assets.

Buyers can protect themselves by requiring the principals of a seller to personally agree to the indemnification provisions in the agreement. Buyers and sellers should also consider time-bound escrow funds or other hold backs to satisfy any indemnification obligations that arise post-closing.

While these provisions can add complexity to a purchase agreement, they greatly simplify the process by which a buyer can seek redress if a seller has breached their obligations or representations.

Sellers can also benefit from these mechanisms. For example, if a seller provides financing to a buyer, they should consider seeking a personal guaranty under the promissory note as well as clearly defined security for the obligations.

Don’t Forget SBA, Other Requirements

Lenders, including the Small Business Administration, impose their own requirements around purchase agreements, and failing to incorporate them into the purchase agreement can jeopardize or slow down the loan approval process.

In many cases, SBA lenders won’t start formally processing a loan without a signed purchase agreement that meets their requirements.

I regularly work with clients who engaged non-specialized M&A counsel to amend pre-existing agreements that have been rejected. For example, if the transaction involves seller financing, SBA lenders typically require a minimum 5-year term. This is a simple provision, but renegotiating can introduce more complexity.

The risks inherent in buying and selling a business are not new, but they are more likely to arise when economic conditions turn negative or a target is distressed. Each transaction should be structured based on the unique risks it presents to buyers and sellers and within the constraints of the client (both time and budget).

Engaging specialized M&A counsel is a sound way to avoid pitfalls and reduce overall legal costs associated with a buyout transaction.

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