

Importance of the Representations and Warranties in Private Equity Transactions

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Two of the most important responsibilities undertaken by a lawyer drafting a business agreement in a private equity transaction (PET) are to protect the client against risks and to secure those advantages that are reasonable and appropriate. Having a client receive both "representations and warranties" (R&W) will generally help you fulfil these responsibilities.

From the seller's perspective, the seller's R&W should be as minimal as the buyer is willing to accept. Of course, it is imperative as well that the information is correct to avoid any post-sale liability vis-à-vis the buyer. From the buyer's perspective, of course, the more substantive R&W that the seller is willing to make, the better.

In general terms, however, the approach and importance given to the R&W in PETs is distinctive from transactions by non institutional investors:

- In order to minimise their risks, private equity houses (PEHs) usually require extensive R&Ws from the sellers when investing in/acquiring a company. Conversely, when divesting interests, a PEH will seek to minimise the R&W on the grounds that the day-to-day management was not performed by the Sponsor. Consequently, the R&W in a PET where a PEH acts as a buyer are extensive, while in those where it acts as a seller, the R&W tend to be fewer.
- Recently, competitive bid processes conducted by the seller and its advisors rather than the purchaser are becoming increasingly common, partly because the presence of PEHs has broadened possibilities to find a purchaser. It is standard practice in competitive bid processes for the seller's advisors to prepare the draft agreement for the successful bidder. Obviously, such a draft will contain a substantially reduced R&W when compared to those normally prepared by a potential acquiror, and any additions to the R&W provided in the agreement are chosen carefully by each bidder, since they may lead to another less demanding bidder being successful in the acquisition process.

The importance of the R&W will also vary with the structure chosen for the transaction. There are two main scenarios: the purchase and sale of shares and the purchase and sale of assets of a business.

In the first scenario, the Spanish Civil Code only protects the buyer for hidden defects in the shares but not in the assets owned by the target company. This is especially critical in the cases where the shares of a Target Company are purchased wholly or in a meaningful percentage, since the absence of protection against hidden defects will imply that the new acquiror will have to suffer any loss of value arising from any existing contingency in the acquired company with an almost non-existent possibility to claim from the seller. Due Diligence thus becomes essential.

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Such transactions require a list of R&W as wide and complete as the buyer is capable to negotiate with the seller, in order to cover all possible responsibilities of the buyer after the transaction is closed. The R&W should therefore cover, among others issues (i) ownership of assets and absence of liens; (ii) compliance with laws and absence of breaches that may lead to claims by the authorities; (iii) the accuracy of financial statements; (iv) the existence of insurance cover; (v) validity and sufficiency of licences and authorisations to run the business, etc.

On the purchase or sale of assets, the buyer is granted more protection under the Spanish Civil Code, since the defects will arise directly on the acquired assets, as well as from eviction, even if the parties did not include any specific provision in this regard in the agreement.

In addition, acquiring assets under Spanish Law will not imply that the seller's liabilities are also transferred, although in general terms the sellers tend to transfer a certain business unit as a whole, thus requesting the acquiror to face the liabilities related to the assets being acquired. Consequently, R&W in this type of transactions are generally similar in scope to those given in company acquisitions.

Finally, in order to ensure the effectiveness of the R&W, it is convenient and very common in PETs for a part of the purchase price to be held on escrow or, as an alternative, guaranteed by a finance entity.
