

## M&amp;A; EXECUTION PROGRAM

PART 07 OF 12 · PART 2: WORKING CAPITAL &amp; CLOSING MECHANICS

# PART 7

## THE PURCHASE AGREEMENT: LEGAL GUARDRAILS

*The SPA or APA is the definitive document that determines the rights, obligations, and risk allocation between buyer and seller. This session covers representations and warranties, baskets, caps, survival periods, and indemnification — the CFO's legal guardrail framework.*

### IN THIS PART

- Representations and warranties architecture
- Fundamental vs. general reps
- Baskets: tipping vs. deductible structures
- Caps and uncapped fundamental breaches
- Survival periods and statutes of limitation
- Indemnification mechanics and sandbagging

### THREE CASE STUDIES

*Each session includes one fully worked case study with detailed calculations, negotiating dynamics, and CFO-level decision frameworks.*

## ■ SESSION 7: REPS, WARRANTIES, AND INDEMNIFICATION

### The SPA: Where Risk Is Allocated, Not Eliminated

The Stock Purchase Agreement (SPA) or Asset Purchase Agreement (APA) is the definitive legal document of an M&A transaction. From the CFO's perspective, the SPA is primarily a risk allocation document. It cannot prevent bad things from happening after closing — it determines who bears the financial cost when they do.

The three primary risk allocation mechanisms in the SPA are: (1) **Representations and Warranties** — statements of fact that, if false, give rise to indemnification claims; (2) **Covenants** — promises to take or refrain from certain actions; and (3) **Indemnification Provisions** — the financial remedy structure if a rep is breached. The CFO must understand all three to properly evaluate deal risk.

### Representations and Warranties: A Tiered Architecture

Rep Category	Examples	Typical Survival Period	Cap?
Fundamental Reps	Title to shares/assets, authorization, capitalization, tax reps, fraud	Indefinite or statute of limitations (6 years)	Usually uncapped — full consideration
General Business Reps	Financial statements, material contracts, employee matters, environmental, IP	12-24 months (most common)	Capped at 10-15% of transaction value
Specialized Reps	ERISA/employee benefits, environmental, regulatory licenses	18-36 months (or regulatory SOL)	May be uncapped for environmental
Knowledge-Qualified Reps	Reps qualified by 'to seller's knowledge' — limits scope	Same as general reps	Same cap; but scope of claim narrowed

## The Basket: The Deductible of M&A; Insurance

No buyer expects to recover from the seller for every minor breach of a representation. The basket (sometimes called a threshold) is the minimum aggregate loss amount that must be reached before indemnification kicks in. There are two types with very different economics.

### ◆ BASKET MECHANICS

#### BASKET MECHANICS — TIPPING vs. DEDUCTIBLE

Transaction value: \$40,000,000

Basket size (1% of transaction): \$400,000

#### TIPPING BASKET (also called 'Dollar-One Basket'):

If aggregate losses EXCEED \$400K threshold,  
seller pays ALL losses starting from dollar one

Example: \$600K in losses → seller pays full \$600K

The basket 'tips' — it is a trigger, not a deductible

#### DEDUCTIBLE BASKET (most common in practice):

If aggregate losses exceed \$400K,  
seller only pays losses ABOVE the \$400K deductible

Example: \$600K in losses → seller pays \$200K

The basket 'deducts' — it is a permanent floor

BUYER PREFERS: Tipping basket (maximum recovery)

SELLER PREFERS: Deductible basket (permanent buffer)

MARKET: Deductible is more common in private deals

MARKET BASKET SIZE: 0.5% - 1.5% of enterprise value

## The Cap: The Policy Limit of M&A; Insurance

The indemnification cap is the maximum total amount the seller can be required to pay for all general rep breaches. For general reps, caps typically range from 10% to 20% of the total consideration. Fundamental reps (title, authority, fraud) are typically uncapped — or capped at 100% of consideration.

### ◆ CAP AND UNCAPPED REPS

#### CAP AND UNCAPPED FUNDAMENTAL REPS — MECHANICS

Transaction EV: \$50,000,000

General Rep Indemnification Cap (15%): \$7,500,000

→ Buyer CANNOT recover more than \$7.5M  
for all general rep breaches combined

Fundamental Rep Cap: UNCAPPED (or 100% = \$50M)

- Title to shares: uncapped
- Capitalization: uncapped
- Fraud: uncapped and survives indefinitely

ENVIRONMENTAL REP (negotiated case-by-case):

Often uncapped or separately capped at 25-50% of EV

Remediation costs can exceed transaction value

REPRESENTATION & WARRANTY INSURANCE (RWI):

- Third-party insurance replaces seller's indemnity
- Buyer buys policy covering general rep breaches
- Premium: 2-4% of coverage limit (significant but clean)
- Allows seller to receive clean exit (no holdback)

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## CASE STUDY 1

### Graystone Environmental Services

*Post-Close Environmental Contamination — Uncapped Fundamental Breach*

## Background

Graystone Environmental Services was acquired for \$35M. Eighteen months post-close, the buyer discovered historic soil contamination from solvent disposal practices dating to the 1980s. The seller had represented that 'to the knowledge of the Company, there are no environmental liabilities.' The remediation cost estimate was \$4.8M. The dispute: was this a general rep (capped at \$5.25M / 15%) or a fundamental breach triggering uncapped liability?

## ◆ GRAYSTONE — ENVIRONMENTAL CLAIM

## GRAYSTONE — ENVIRONMENTAL CLAIM ANALYSIS

Transaction value: \$35,000,000

General rep cap (15%): \$5,250,000

Basket (deductible, 1%): \$350,000

REMEDIATION COST ESTIMATE: \$4,800,000

## BUYER'S THEORY (Fundamental Breach):

Environmental rep was not knowledge-qualified

in SPA (drafting error on seller's side)

Therefore: absolute warranty → fundamental rep

Uncapped; full \$4.8M recovery sought

## SELLER'S DEFENSE:

Environmental rep is listed in general reps section

Subject to general rep cap and basket

Recovery limited to \$4.8M - \$350K = \$4.45M

But capped at general rep cap: \$5.25M > \$4.45M

Full \$4.45M would be payable (within cap)

## ARBITRATION OUTCOME:

Court found environmental rep was general rep

Knowledge qualifier implied by surrounding provisions

Award: \$4,450,000 (net of basket)

Lesson: Always explicitly knowledge-qualify env. reps

or negotiate environmental sub-cap separately

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## CASE STUDY 2

## Pinnacle Tech Holdings

*RWI Insurance — Using R&W; Policy to Replace Seller Indemnity*

## Background

Pinnacle Tech was acquired by a PE fund for \$120M. The sellers (three founders) wanted a clean exit — no holdback, no escrow, full proceeds at closing. The buyer needed protection against rep breaches. The solution: Representation and Warranty Insurance (RWI), which replaced the traditional seller indemnity structure.

## ◆ RWI — REPRESENTATION &amp; WARRANTY INSURANCE

## RWI STRUCTURE — PINNACLE TECH

Transaction value: \$120,000,000

## RWI Policy Terms:

Policy limit (coverage): \$18,000,000

(15% of transaction value — standard)

Retention (buyer's deductible): \$1,200,000

(1% of transaction — paid by buyer first)

Premium rate: 2.8% of coverage limit

**Premium cost: 2.8% × \$18M = \$504,000**

(paid by buyer; deducted from purchase price)

## SELLER BENEFITS:

No escrow or holdback required

Full \$120M received at closing (less adjustments)

Seller indemnity limited to fraud only

Clean exit; no post-close claim exposure

## BUYER BENEFITS:

\$18M of insurance coverage for rep breaches

Cleaner closing process; faster timeline

Claims paid by insurer, not contested with sellers

Retention (\$1.2M) is manageable operational risk

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## CASE STUDY 3

## Clearwater Data Systems

*IP Ownership Dispute — When a Rep Breach Exceeds the Cap*

## Background

Clearwater Data Systems was acquired for \$65M. The seller represented that the company owned all necessary IP, including its core database software. Post-close, a former contractor filed suit claiming ownership of critical components, valued by experts at \$22M. The general rep cap was \$9.75M (15% of \$65M). The buyer faced a \$12.25M gap.

## ◆ IP BREACH EXCEEDING CAP — ANALYSIS

CLEARWATER — IP BREACH EXCEEDING THE CAP

Transaction value: \$65,000,000

General rep cap: \$9,750,000

IP claim value (expert estimate): \$22,000,000

General rep basket (deductible, \$650K): (\$650,000)

Net claim above basket: \$21,350,000

Cap applies: \$9,750,000

UNCOVERED LOSS: \$21.35M - \$9.75M = \$11,600,000

## BUYER'S REMEDIES BEYOND THE CAP:

1. Fraud claim (if seller knew) — uncapped

But 'knowledge of company' qualification makes  
fraud claim difficult to prove

2. Specific performance — not available (already closed)

3. Price adjustment theory — courts split

LESSON: For IP-intensive businesses, negotiate:

- a) Higher IP-specific rep cap (25-30% of EV)
- b) OR IP reps as fundamental (uncapped)
- c) OR RWI with higher coverage limit
- d) IP title opinion from patent counsel pre-close