The middle market keeps an eye on growth

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The middle market has been on the rebound, with nearly 4 out of 5 businesses reporting revenue gains in 2021 and 57% of middle-market firms expanding the size of their workforce.

Corporate director Gene Barton recently spoke with Crain's to provide insights into key trends in the marketplace.

CRAIN'S: There have been an increasing number of transactions in which the working capital adjustment has been eliminated. Is this trend sustainable? When is it appropriate and what are the pros and cons?

GENE BARTON: Eighty-seven percent of all merger-and-acquisition transactions over $30 million have working capital adjustments, according to the 2021 American Bar Association's Deal Points Study. Working capital adjustments ensure that the purchaser has sufficient working capital for successful company operations. Still, working capital provisions take an inordinate amount of time to fully negotiate. Moreover, a significant portion of post-closing litigation involves working capital disputes. We have seen an increasing number of situations where the parties have agreed to forgo working capital adjustments altogether.

Buyers need to be careful as the absence of a post-closing adjustment could enable the seller to manipulate the timing of the payment of payables to its advantage. In many circumstances, the elimination of a working capital adjustment isn't appropriate as the parties aren't really in a position to settle on important elements before closing. At a minimum, such an approach will only work when the target has a very consistent working capital profile.

Care should also be taken to put in place other contractual provisions that protect the buyer. In Europe, for example, buyers and sellers often agree upon the so-called lock box mechanism. In this scenario the parties agree to fix the target's balance sheet and close on that basis with any downward variance treated as a reduction in purchase price.

CRAIN'S: How will the tightening economy affect buyers' willingness to accept deals without indemnification and rely strictly on representation and warranty insurance?

GENE BARTON: Representation and warranty insurance is a type of insurance policy purchased in connection with M&A transactions and covers breaches of certain representations and warranties in the purchase agreement. It is designed to provide flexibility by reducing or even eliminating the need for an indemnity escrow. It has now become fairly standard, particularly for private equity-backed sellers. Representing a seller, we almost always advocate for R&W insurance, particularly if the buyer is willing to pay the premiums.

There are some drawbacks for buyers using this approach, as R&W insurance does not cover known breaches, and it may be easier to recover from an escrow fund than it is from an insurance company. On balance, however, the market believes that the benefits of R&W insurance outweigh its costs. Transactions in which the sellers roll some of their equity and stay on in management roles are particularly appropriate for insurance, as it lessens the chance that the new owner will have post-closing conflicts with the management team.

R&W insurance is not a panacea, given increased premiums and some cases the absence of an insurer to offer coverage. In the tightening economy and M&A market, we anticipate private-equity firms will continue to push for R&W insurance while strategists and entrepreneurs become more wary of its costs. If the parties opt for R&W insurance, they need to make sure to fit the policy into the indemnification package of the purchase agreement and to make sure the target gets proper insurance with the correct coverages.

CRAIN'S: What is the market and consideration for noncompetition covenants? How deep into an organization should a buyer go?

GENE BARTON: An essential component of any merger or purchase agreement is getting noncompetition covenants from both the seller and shareholders who are receiving significant value in the transaction. It is fairly well settled that such covenants are enforceable in the context of the sale of a business.

Typically, going into a transaction, the target will have in place noncompetes with its senior management, but these will vary. This can present a significant dilemma to buyers: The people they might most be afraid of competing with may not have in place acceptable noncompetes. Companies that have been built through acquisitions may be particularly vulnerable as key managers from acquired businesses may be able to compete with the buyer. Companies preparing for a transaction should study carefully their existing noncompetes and have in place a strategy for dealing with buyers.

CRAIN'S: Is the "no undisclosed liability representation" really necessary or is it the latest incarnation of the 10(b)-5 rep?

GENE BARTON: The 10(b)–5 rep in acquisition agreements died a slow, painful death in the past 10 years. Representing a seller, it is difficult to accept such a broad representation, particularly in light of all of the other detailed representations contained in the purchase agreement that cover virtually all risks. Now the "no undisclosed liability representation" is taking on the same role as a 10(b)–5 rep, giving the buyer an essentially unbounded representation that all is good with the business. An increasing number of transactions have such a representation, so it is getting more difficult to oppose. With the market tightening, we expect the no undisclosed liability representation to become the norm.

If a seller does agree to such a representation, it should take care to use "ring fencing," which means limiting specialized representation—in cases such as environmental matters, taxes or intellectual property—to the terms set forth in the representation. Otherwise, a buyer can use the no undisclosed liability representation to get around specific limitations.

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