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PUBLISHED: NOVEMBER 14, 2024

Legal Insights for Manufacturing: Corporate Transactions

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This article is excerpted from our third-annual *Legal Insights for Manufacturing* report, published in October 2024.

Much like the narrative surrounding the larger economy, dealmaking in the first half of 2024 was a mixed bag of good and bad news. Overall sentiment is improving as first-half deal values in the U.S. and globally edged up, but concerns among dealmakers persist as the second quarter failed to keep pace. Both strategic and financial deal participants have consistently cited valuation as a major hurdle, and to be sure, financial markets have experienced significant volatility, even as they push against all-time highs. In August 2024, the CBOE Volatility Index, or VIX, experienced an unprecedented seesaw, posting its biggest intraday jump in history, followed by its largest six-day decline, highlighting the fragility of markets as they test valuation limits.

The valuation gap between buyers and sellers has also fed on factors not related to the market as a whole. Post-Covid consumer demand and patterns of consumption have been wildly unpredictable, adding a level of complexity to sellers rationalizing large swings in revenue and projecting future corporate earnings. Inflation and rising costs of materials and labor have had a dramatic effect on some companies' historic financials. Finally, technological innovations, such as generative artificial intelligence, are leading to large expenditures for some companies, while at the same time making it difficult to pin down how exactly these rapidly evolving innovations will reconfigure operations. These factors have played a role in creating frothy markets and suppressing manufacturing industry deal values and volumes.

Despite these challenges, deals are still being closed in certain corners of the wider market. Areas of strong deal activity include all-domestic transactions, which accounted for 80 percent of all deals closing from January to April 2024—10 percentage points higher than the historical average. According to

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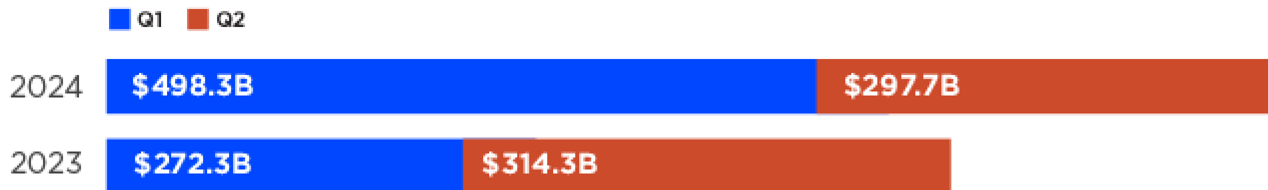
PwC's Industrial Manufacturing: US Deals 2024 Midyear Outlook, this spike in domestic activity reflects measures taken by U.S. companies to address "supply chain management risk driven by geopolitical uncertainty."

U.S. M&A DEAL VALUES, H1 2023 VS. H1 2024



Source: LESG and Axios.

Using Earnouts to Close Valuation Gaps

The PwC report also noted the continuing strength of middle-market and strategic bolt-on transactions in the U.S., segments that also prominently feature private companies where owners are looking to exit. Private company valuations are notoriously difficult and can be a major sticking point in the deal process; however, there are some approaches to managing valuation risk in these instances. The use of earnouts—which tie a portion of the purchase price to some future financial metric—is often seen in private company deal structures and can help close the valuation gap in negotiating deals.

It should be noted that, while the inclusion of earnout provisions can plug the valuation gap during the negotiation phase, it can lead to disputes post-closing when it comes to operating the business and determining whether the earnout measure was achieved. It is not always true that the interests of buyers and sellers remain in alignment after the deal is closed; therefore, purchase agreements should clearly outline the rights and restrictions of the parties that will govern during the earnout period and explicitly account for situations where the objectives of the buyer and seller may fall out of alignment.

Earnouts are complex structures that require sharp attention to detail and an ability to think through complicated macroeconomic and industry-specific data, as well as the structure's tax implications. Both buyer and seller should consider the tax consequences associated with best-case and worst-case scenarios and how those affect the economics of the deal.

The Role of Representations and Warranties Insurance

Another method of hedging transaction risk involves the use of Representations and Warranties Insurance (RWI). For buyers, the obvious utility of RWI is to guard against breaches of representation and warranties without having to pursue the seller or require the seller to tie up a large part of the

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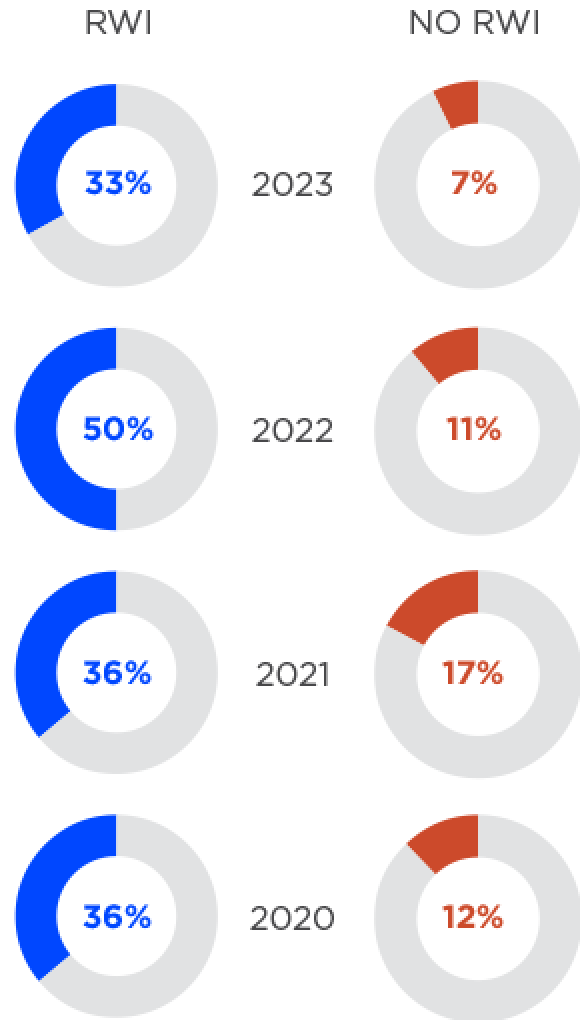
purchase price in an escrow for an extended period of time. RWI policies typically range between 10 to 20 percent of the purchase price, thereby offsetting transaction risk without the need for a large escrow. Furthermore, policies can be customized to cover a desired timeframe with premiums that flex accordingly. The presence of RWI often signals to the seller a buyer's seriousness and attention to detail, making a buyer's proposal more competitive. Another benefit is, when previous owners remain involved with the business post-closing, RWI can prevent a buyer from having to pursue an awkward indemnity claim against the previous owner who is now a part of buyer's organization.

The presence of RWI can limit or eliminate the need to hold funds in escrow for indemnity claims. Sellers prefer clean exits and have therefore displayed a greater preference for bids including RWI. RWI also reduces some pressure on the negotiation of reps and warranties and certain indemnity provisions in a purchase agreement, thereby relieving both buyer and seller of a major pain point in the negotiation process.

All hedges come with certain tradeoffs, and RWI is no different. RWI claims can take as long—and sometimes longer—to resolve as traditional indemnity claims, and they can entail more complexity. According to SRS Acquiom, an M&A consultancy, RWI can also influence deal terms: deals with RWI are more likely than deals without RWI to be structured as "no survival," that is, deals where the seller's representations and warranties do not survive beyond the closing.



Source: Atlantic Global Risk LLC.

While underwriters work with deal participants to craft a policy appropriate to the desired coverage levels and stated risk appetite, there are certain risks that will fall outside the scope of RWI. Among those areas, known issues (known as "deal-specific exclusions") and "actual knowledge" of the buyer's deal team are at the top of the list, meaning RWI policies typically will not cover issues known to the buy side through its diligence or some other means. Additionally,

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purchase price adjustments, transfer pricing issues, asbestos-related claims, and pension withdrawal issues almost always fall outside the scope of coverage.

Once upon a time, RWI was only seen in larger transactions, but more and more, it is found in smaller deals well under $100 million. Given that much of the deal activity in the manufacturing industry has featured smaller, bolt-on acquisitions or middle-market transactions, carriers are working to take advantage of the increased demand by developing insurance products specifically tailored to smaller deal sizes.

These streamlined RWI policies could offer valuable protection, particularly for companies—both strategic acquirers and those with a private equity sponsor— that aggressively use M&A to grow. Even the limited scope of the most standard items included in RWI, like tax-related claims and regulatory compliance issues, can provide deal teams some comfort as they perform diligence in connection with evolving areas of risk, such as supply chain-related areas, labor and employment law, or the way an enterprise operationalizes artificial intelligence.

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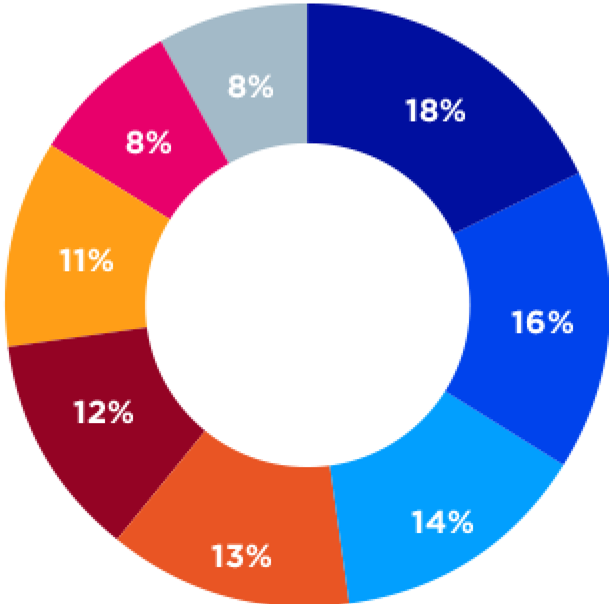
MOST FREQUENT RWI CLAIMS



- TAX
- FINANCIAL STATEMENTS
- LEGAL/REGULATORY COMPLIANCE
- MATERIAL CONTRACTS
- LABOR/EMPLOYMENT MATTERS
- INTELLECTUAL PROPERTY
- LITIGATION
- OTHER

Source: *Atlantic Global Risk LLC.*

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