

## Escrows get more consideration in today's M&A environment

**B**aby boomer retirements, the continued credit crunch, and the softening of valuations coupled with many banks taking a more conservative approach to credit, are all factors affecting merger & acquisition (M&A) activity this year. Such conditions are likely to result in an increase in activity in the small to middle market where due diligence is a more complicated process. There is also more of a need for buyers to consider holding back a portion of the purchase price in an escrow account.

The first wave of baby boomers are beginning to reach retirement age and are looking to cash out or monetize their investments. Many of these boomers are owners of privately-held businesses. Since valuations of companies are down, the likelihood of a quick profitable sale by an acquirer has been greatly reduced. Thus, many owners find this climate ideal to sell their ownership interest to strategic buyers who will likely invest in the maintenance and long-term growth of the businesses they have worked so hard to build and, in some cases, retain them as an employee or consultant. This trend is fueling more strategic M&A deals, which are less affected by the credit crunch and state of the economy, and giving private equity firms – typically referred to as financial buyers - more aggressive competition from strategic investors.

Once the decision to sell a company is made, bridging the gap between what the privately-held or middle market business owner believes his/her business is worth and what a buyer is willing to pay is perhaps the most formidable challenge in closing a successful M&A transaction. In particular, stipulating future potential liabilities is one of the most complex parts of the due diligence process. This is especially true for cases involving smaller business owners who may not be sufficiently organized, experienced, or fluent in the diligence process to provide the information necessary for buyers to make an informed decision. Buyers must often rely on comparability to other similar transactions. For instance, representations and warranties need to have a stable baseline; financial information needs to be reliable, useful, and easily manipulated; and long-term liabilities need to be fully understood in comparison to industry norms for preparation of post-closing carve-outs. Many buyers mitigate this uncertainty by setting aside a larger percentage of the purchase price in a third party escrow account to provide for indemnification from future liability. The creation of the escrow account to evidence financial surety is a simple and safe solution for safekeeping cash, stock, pledged collateral, or a combination thereof. It also provides the buyer with additional peace of mind and leverage should the seller breach its representations and warranties.

Determining if it is necessary to establish an escrow account as part of a merger or acquisition is an important part of a buyer's effective due diligence. The aging of the baby boomer population, the shift from financial to strategic acquisitions, and the recent tightening of credit by lenders have all contributed to a surge of M&A activity within the small to middle market. Although there are tremendous opportunities for buyers in this marketplace, there are risks to these types of transactions that can be greatly mitigated through the establishment of third-party escrow accounts.

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