We've talked about reps and warrantees and indemnification. What happens if you breach any of them? Now we're going to talk about escrow, which is the part of the consideration that is usually used to address any breaches and the reps and warrantees.

Clint: Let's start with the concept of escrow. What is escrow?

Brad: An escrow, which is also sometimes referred to as a holdback, is the amount of the consideration that is held back or put in escrow for a period of time to satisfy any breaches of reps and warrantees. A typical amount of escrow for a deal is somewhere between 10-20% and the escrow is typically held in escrow for somewhere between a year and two years. So that's the range. Sometimes you'll see things outside that range, but that's the normal range.

So if you sell the company for $100 million in cash, you are really only getting $80 million up front if there is a 20% escrow and $20 million of it is going to sit in the escrow account earning some interest, but usually not very much, until the point at which the escrow timeframe is satisfied. Let's say in this case you go for a higher escrow amount, 20% but a shorter timeframe, a year. After a year, if there are no claims against the escrow, you get your $20 million paid out as well.

Clint: What would be some typical claims that might be made against escrow?

Brad: One example thing that oftentimes ends up in the escrow account would be any sort of legal disclosure. So disclosure that you have rights to, all of your intellectual property, rights, a knowledge rep that you don't have any legal issues what's disclosed in the disclosure statement. Another one would be licensing of software, that you've licensed all of your software correctly.

If, after the deal closes, something comes up to the buyer that you haven't done these things, again, anything that can be in the reps and warrantees, their first recourse is to go against the escrow. Interestingly, in a lot of cases, as the seller, you may still be involved in the company and the buyer so you can help mitigate some of these things. Let's say it's a licensing agreement that is actually just not quite right but you have the history of why it's not quite right and you can work with the buyer to work through it.

In other cases, if the founders or the people in the company aren't part of the acquire, it's often more contentious because there is nobody still in the buyer that really cares about anything around that particular issue other than satisfying the payment of it.

Clint: How common are claims against escrow?

Brad: It varies a lot. I would say that deals tend to fall into one of two categories. They are either totally clean and there are no issues or they are a mess. It's hard to predict, actually, on the front end, which they are going to be because a lot of times, for the ones that are a mess, the issues that come up after the deal closes are a surprise. Most sellers will represent that there are no issues and that the buyer shouldn't worry about it. Most buyers try hard to define what those issues could be, put them in the reps and warrantees and use the escrow to satisfy it.

I'd say in our experience as investors, we get paid out 100% or very close to 100% on the vast majority of escrows that we're involved in. Every now and then, there's something that comes out that has a meaningful impact on the amount that we get paid out. There are plenty of stories, though, of acquisitions where the seller had a lot issues post-close. There is a lot of contention and the amount of the escrow that actually got paid out was very small.

Clint: So in the case where you had a company bought for $85 million, was that escrow held by a third party? You said that company actually ended up tanking and so you don't have to worry about that escrow going away if company doesn't succeed, right?

Brad: The escrow is almost always held by a third party, but not always. There is this construct of a holdback where the seller creates a holdback of the amount. In the situation I described earlier, we had, I believe about a 10% escrow. I remember after a year, the buyer, who was now struggling financially, made a claim against half the escrow, about $4 million of the escrow. The claim was completely arbitrary and specious. They made the claim because they figured, "Well, here's a chance to get some of the money back from the escrow."

We fought. It took us about six months and we got 100% of that money because their claim was invalid. So there is a process that you go through which can either involve mediation or litigation. In our case, we had a mediation clause and they threatened litigation. Ultimately, I think, the CEO of the company (again, a public company) realized that what they were asserting was invalid and they paid out the escrow.

It can be very difficult especially a year or two later when things haven't necessarily gone as planned. It's not quite that same comfortable conversations as the day before the acquisition closes when even though you've been negotiating hard, everybody is super excited about getting things done.