Holdback Escrows: Security Against the Unpredictable

Escrow accounts for indemnification become relevant as businesses develop an appetite for M&A growth.

As the economy rebounds and more companies are taking an optimistic view of their future growth, the conditions are ripe for merger and acquisition (M&A) transactions among public and private companies alike. And with the appetite for buying and selling, especially in such volatile economic times, comes a need to protect vigilantly against risk for acquirers and their shareholders.

The "holdback" escrow is the preferred way to mitigate risk while facilitating a smooth transaction when whole companies or company assets change hands. In a holdback escrow, the company selling assets places a portion of the transaction cost into an escrow account, where the funds remain until certain conditions are met. The escrow acts as security against unforeseen purchase price adjustments or indemnification claims.

PROTECTING AGAINST RISKS IN A HEALTHY M&A MARKET

After a relatively quiet three quarters, Q4 of 2009 saw a 49 percent increase in the number of M&A transactions compared to the same period in 2008. Taking their cue from this spike, market experts say they expect M&A to soar in 2010, giving IPOs a run for their money as attractive exit strategies.

This sudden resurgence in M&A activity during the past year has elevated escrow to a critical ingredient in a company's portfolio of financial services. According to *Westlaw Business Currents*, parties in the notable M&A deals of late 2009 set aside an average of 10 percent of the purchase price in escrow, for periods of 12 to 18 months (generally until the expiration of the deal's representations and warranties (R&Ws)).

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"Any company that has been through an M&A transaction knows that once the ball starts rolling, things move fast," says Bryan Brittingham, senior operations manager for Global Deposit Operations at SVB Financial Group. "It's important to have your ducks in a row, including having a reliable and reputable source for transferring and reserving a portion of the funds to prevent risk and help the transaction reach completion without delays."

With an escrow account, a company sends a percentage of the transaction cost to the bank that provides the escrow service. As with a standby letter of credit, escrow ensures fair payment between parties. However, the time and terms of the movement of funds remain flexible.

When setting up a holdback escrow, the parties execute an agreement, which guarantees funds will remain safely and securely in escrow and governs the terms by which they can be released. Once the buyer confirms that certain conditions have been met, the bank dispenses the amount held in escrow to the seller or its stockholders.

FINDING THE RIGHT PARTNER FOR THE JOB

Because escrow is inextricably linked to the legalities and financials of an M&A transaction, establishing an escrow can quickly become a quagmire of complex details and miscommunications. In situations where buyers and sellers are sprinting to meet a deadline amidst tough negotiations and dozens of involved parties, it is important to work with an escrow service provider that can stay flexible and resourceful.

Take as an example a deal in which SVB Financial Group client Energy Investor Funds (EIF) agreed to sell an asset held in one of its funds to an Australian company. Since EIF was liquidating the fund, it needed to reserve a portion of the sale price in escrow in case any claims were made by the Australian buyer against the fund's R&Ws.

"With the time differences, the need for a multicurrency escrow account, and so many attorneys and parties involved, the situation quickly grew complicated," says Brittingham. "EIF had initially tried a different route, so by the time they came to us, they were up against a tight deadline."

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The SVB team acted as a liaison between parties' attorneys through all highly complex document negotiations, including Know Your Client (KYC) forms, to deliver an escrow account in Australian currency in time to allow a year-end close to the deal.

In another situation, VC firm Balderton Capital needed to purchase shares in a French company worth approximately 3.5 million euros, involving the use of an escrow account to hold the purchase price — a transaction that had to be completed in about two weeks. The firm had already begun the process with another escrow service provider, so Balderton delivered an agreement already largely negotiated by all parties.

Though SVB prefers to get involved from the beginning of a deal to draft an agreement that fully protects the involved parties, they wanted to help Balderton with its urgent need. A coordinated effort by representatives from across SVB —including Escrow Services, Global Treasury, SVB Global, and Legal — enabled Balderton to receive a EUR escrow account in record-breaking time.

"Reaching out to your existing banking partner for escrow services first can be a way to ensure your transaction is handled with priority treatment, and executed skillfully and quickly," says Brittingham.

LEARN MORE ABOUT SVB ESCROW SERVICES

Call your bank relationship advisor or visit www.svb.com to learn more about different types of escrow services, including escrow accounts that support M&A transactions.

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