

Methods to allocate tariff-related risks in M&A agreements

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Key takeaways:

- Parties to an M&A transaction should carefully consider the potential risks to the target business of the impact of newly imposed or future tariffs that may affect target businesses.
- There is no one-size-fits-all solution to allocating responsibility for tariff-related risks in M&A transactions.
- Insurers are unlikely to cover losses for breaches of representations and warranties related to tariffs, but it may be possible to minimize this representation and warranty insurance (RWI) coverage gap.

One approach to affording a buyer some protection in the event a tariff is imposed after signing but prior to closing is to include a specific line-item indemnity in the acquisition agreement.

Buyers and sellers that are parties to an M&A transaction should carefully consider whether the risks associated with tariffs that have already been imposed or that may be imposed in the future may significantly impact the revenues and net profits of a target company business. If there will be a significant impact, it would be prudent to address those risks through various provisions of the acquisition agreement.

For example, a buyer may seek an indemnity, tariff-related representations and warranties (or at least to add specific language on tariffs to existing representations and warranties), a closing condition, or even an earnout, a holdback, or a purchase price adjustment if the risk and/or bargaining power is significant enough.

By contrast, a seller may seek to modify the definition of material adverse change (MAC) to expressly exclude the impact of tariffs as an event or circumstance that could

give rise to a MAC that enables the buyer to terminate the transaction. A seller may also attempt to negotiate for greater flexibility in the interim operating covenants in case a new tariff is imposed that would otherwise negatively impact the seller's business.

Indemnities

One approach to affording a buyer some protection in the event a tariff is imposed after signing but prior to closing is to include a specific line-item indemnity in the acquisition agreement. Alternatively, a buyer may choose to incorporate tariff-related language into the more common indemnity for pre-closing taxes.

A third alternative would be to incorporate such language on tariffs into the tax-related or other applicable representations and warranties that would be within the scope of indemnification for breaches of such representations and warranties.

The latter two approaches may possibly be more favorable in the context of a transaction that includes an RWI policy to minimize the likelihood of an exclusion under the policy specifically for a tariff-related indemnity.

Representations and warranties

A buyer may seek either to add specific, tariff-related representations and warranties or alternatively to supplement other more traditional representations and warranties with language addressing tariffs.

For example, a buyer may desire to include tariff-related language in connection with a seller's representations about its customers and suppliers, and its and their respective supply chains, including (a) whether any such relationships have been terminated or modified due to new tariffs, (b) if applicable, whether a seller's inventory has become more difficult to obtain or turn over in a timely fashion, (c) country-of-origin information, (d) current tariff rate, and (e) volume of supply broken down by supplier.

A buyer may also seek to expand more traditional tax representations to include language addressing the impact

of tariffs on the business. Another possibility would be to expressly include tariff-related language in the common representation concerning the absence of changes to prompt more specific disclosure from the seller about announced, recently effective, or proposed tariffs on various products, goods, and services.

In contrast, a seller should take care when preparing its disclosure schedules to consider the impact of tariffs on traditional representations regarding (i) the absence of undisclosed liabilities and (ii) whether the financial statements fairly present the financial condition of the seller's business in light of any recently enacted tariffs. If a seller takes steps to reduce a target company's imports, additional disclosures about acting outside of the ordinary course of business may be warranted.

A buyer and seller will also have to negotiate the procedure for a seller to update its representations and warranties at closing to avoid its representations being inaccurate at such time in case new tariffs that may affect the business become effective during the period between signing the acquisition agreement and the closing of the acquisition.

Another consideration for buyers and sellers with respect to representations and warranties related to tariffs is that most, if not all, insurers providing RWI are unlikely to provide any insurance coverage for breaches of representations specifically relating to tariffs. This is particularly true for transactions where the target company imports goods, but it may also apply in the case of retaliatory tariffs to businesses that export goods to other countries.

RWI policies are expressly intended to cover breaches of historical representations. As a result, M&A parties should push an insurer to limit any tariff-related exclusions to tariffs imposed on or after a specified date in recent proximity to the date of the acquisition agreement.

If an exclusion is unavoidable, the M&A parties should try to limit its scope by removing the words "arising out of and resulting from" or similar phrases to ensure that indirect and tangential consequences of tariffs are not also excluded from coverage under the policy.

It may also be possible to limit the tariff-related exclusion from the policy by narrowing the circumstances under which the exclusion would be triggered to only those involving increases in supplier pricing caused by a tariff.

Closing conditions

As an alternative to seeking to expressly include tariffs in the definition of a MAC (addressed below), a buyer may choose to negotiate for a closing condition based on the imposition of new tariffs between signing and closing.

For example, if there is a key country from which a target company's business obtains a majority of its supply, such as China, the closing condition could include a threshold percentage that the tariff rate cannot exceed as of the date of the closing of the acquisition. If the tariff percentage threshold

is exceeded, the buyer would have the right to terminate the agreement and the transaction.

Alternatively, a closing condition could permit the buyer to terminate the agreement and walk away if, for example, new tariffs were to negatively impact the target company's operations, revenues and/or net income by certain agreed upon benchmarks. However, doing so may be difficult, particularly if there is not an easy way to measure the direct effect of such new tariffs on a business's traditional financial metrics.

Earnouts, holdbacks and purchase price adjustments

Another tool that may be available to a buyer to protect against new tariffs negatively impacting the enterprise value of a target company during the period between signing and closing is to provide for an earnout, a holdback or even a purchase price adjustment.

An earnout or a holdback can be structured to apply upon closing of an acquisition in the case where a tariff has become effective shortly before an acquisition agreement is signed and the impact of such tariff on the financial performance of the business is neither known at signing nor determinable upon consummation of the transaction.

Alternatively, the parties may agree to structure an earnout or a holdback to be triggered in the event that a tariff is proposed to be imposed and/or is to become effective after signing — but before consummating — the acquisition agreement, or otherwise shortly after its consummation.

In either case, the parties will need to negotiate the (a) length of the earnout or holdback period, (b) length of any initial trigger period within which a tariff may become effective after signing and/or consummating the acquisition agreement that would cause the earnout or holdback period to terminate early, and (c) scope of the protections to be afforded to the buyer in terms of the degree to which the tariff must negatively impact the financial performance of the target business to enable the buyer to forego any payment to the seller in respect of the earnout or holdback.

If the risk of a tariff imposed prior to, or proposed to become effective after, signing an acquisition agreement were to materially threaten the enterprise value of a target company, a buyer may attempt to negotiate for a purchase price adjustment to address the disconnect between the purchase price negotiated prior to closing and the price paid at closing without the benefit of the impact of such tariff on the target company's bottom line.

Any such purchase price adjustment would need to include specific provisions concerning (a) how to calculate the negative impact of the tariff on the target company's enterprise value during the post-closing period and (b) the duration of the post-closing period within which the parties agree to consider such negative impact.

Material adverse change definitions

A seller may seek to negotiate with a buyer to expressly exclude tariffs as a basis on which a buyer may claim that there has been an event or circumstance that has had a material adverse effect on the target business that would enable such buyer to terminate the acquisition agreement.

However, some may take the position that even without negotiating for their express exclusion, tariffs are not a basis for a MAC under the standard formulaic definitions of the term — the rationale being that such MAC clauses already exclude changes in laws from those changes that, if they were to have a negative impact on the target business, could form the basis of a MAC.

Sellers should keep in mind that it is rare for a court to find the existence of a MAC that would permit the buyer to walk away from a transaction. Nevertheless, in negotiating the definition of a MAC, it is important to include specific language to minimize the risk of a court interpreting the term to mean something different from what the parties intended.

To this end, the parties may wish to include a specific time frame for analyzing whether a MAC has occurred. Delaware courts have stated that such a time frame should be a “commercially reasonable period”. This is generally interpreted as years, not months.

It is common for the period between signing and closing an acquisition to be months, and so any otherwise carefully drafted language regarding the inclusion or exclusion of

tariffs as a basis for a MAC may be inadvertently undone by a misaligned measurement period.

Interim operating covenants

Sellers should pay particular attention to the relative flexibility afforded them pursuant to the interim operating covenants in an acquisition agreement in the current tariff environment. This consideration likely becomes more significant the longer the period between signing and closing.

Buyers generally loathe the idea that sellers can operate the business during this interim period in any fashion that deviates from the ordinary course of business that sellers engaged in prior to signing the acquisition agreement.

However, when faced with circumstances that may fairly be characterized as out of the ordinary and that may have significant consequences on the financial performance of the business, sellers may feel they have no choice but to deviate from the ordinary course consistent with their past practice to adapt to such out-of-the-ordinary circumstances.

As has been recently seen with COVID-19, sellers may be forced into hard choices when confined by the inflexibility of strict interim operating covenants. A seller would be well-advised to negotiate in the interim operating covenants the flexibility to take certain actions that deviate from the ordinary course of business based on its past course of conduct with respect to tariffs that would otherwise negatively impact such seller’s business.

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