Private M&A

Contributing editors
Will Pearce and John Bick

2019

GETTING THE DEAL THROUGH

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Davis Polk & Wardwell LLP

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Second edition

Getting the Deal Through is delighted to publish the second edition of *Private M&A*, which is available in print, as an e-book and online at www.gettingthedealthrough.com.

Getting the Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique **Getting the Deal Through** format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on Brazil, Costa Rica, Ecuador, Egypt, Indonesia, Malaysia, Myanmar, Philippines, Singapore and Taiwan.

Getting the Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at www.gettingthedealthrough.com.

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Getting the Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, Will Pearce and John Bick of Davis Polk & Wardwell, for their continued assistance with this volume.

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Comparing UK and US acquisition agreements

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Over the years, English law has become popular as a governing law for cross-border private M&A transactions even where the target has little or no connection with the UK. Aside from the perceived neutrality of, backed by the commercial flexibility and certainty of judicial interpretation offered by, an English law contract, one of the reasons for this is the perception that a UK-style agreement and related market practice is seller-friendly. By contrast, a US-style agreement and related market practice is regarded by some as more buyer-friendly. One fundamental reason for this difference is that UK market practice tends to regard economic risk as transferring from the seller to the buyer at the point of signing the acquisition agreement rather than at closing, whereas, in contrast, US market practice tends to regard economic risk as transferring to the purchaser at the point of closing.

Deal certainty and limited conditionality

UK-style acquisition agreements are usually subject to a very limited range of conditions. Normally, a seller (unless it is in a weak negotiating position) would accept those conditions to closing that are only required by applicable law or regulation (eg, mandatory antitrust approvals or, for a UK premium-listed buyer, shareholder approval if the transaction is a Class 1 transaction under the UK Listing Rules). A seller is unlikely to accept a no material adverse change condition, a financing condition or any condition that requires warranties to be accurate or pre-closing covenants complied with at closing. A US seller, in contrast, will sometimes agree to such conditions.

Specifically in relation to the financing of a private M&A transaction, a UK seller will often require a buyer to proceed on a 'certain funds' basis. In practice, this means that the buyer must be able to demonstrate the availability of financing at the point of signing the acquisition agreement, and the seller will not allow the buyer to walk away from the transaction after this time even if its lenders decide not to fund the acquisition. In some cases, especially if the buyer's home jurisdiction imposes capital controls on the flow of its funds out of such jurisdiction, a seller may even require the buyer to pay a deposit or to put a small percentage of the purchase price in an escrow account at the signing of the transaction. Such funds would then be forfeit if the buyer is unable to complete the transaction. In comparison, US market practice tends to regard the gap between signing and closing as a time for a buyer to put its acquisition financing in place, with a seller sometimes willing to accept a material adverse change condition to match the corresponding material adverse change condition in the buyer's financing documents.

Fixing the purchase price

Locked-box mechanics are now a common staple of UK-style private M&A transactions. The purchase price is set by reference to an agreed balance sheet being drawn up, and settled between the parties (referred to as the 'locked-box balance sheet'), as at an agreed date in advance of signing (referred to as the 'locked-box date'), often the previous financial year-end date or the date of the most recently available management accounts. The equity price paid by the buyer at closing is essentially calculated by adding cash and deducting debt and debt-like items represented on that balance sheet from the headline price. The seller will confirm in the acquisition agreement that it has not received any value or benefit from the target (referred to as 'leakage') in the period between the locked-box date and signing, and is then restricted from doing so in the period between signing and closing. To support this protection for the buyer, the seller will provide an indemnity to the buyer for any leakage during this time.

The locked-box mechanism has the advantage of price certainty for the seller in that there is limited scope for any adjustments to the purchase price after closing. It ensures as clean a break as possible and, in the case of a private equity seller, enables the full proceeds of a sale to be distributed upon closing (without any requirement for a retention to cover any post-closing adjustments).

In contrast, while locked boxes are used in the US, it is still more usual for US private M&A transactions to use a closing accounts mechanism. In other words, the buyer would pay a purchase price at closing of the transaction that is calculated based on an estimate of the target's working capital or net assets as at the closing. Closing accounts would then be produced by the buyer in the period post-closing to determine the actual working capital or net assets, with adjustments made to the purchase price to reflect the difference between the actual working capital or net assets and the estimated working capital or net assets. Accordingly, there is a potential for the purchase price paid to the seller at closing to be reduced after closing and for disputes to arise between the parties as to how such adjustments are determined.

Calculating recovery for warranty breach and disclosure against warranties

Again, there may be advantages for a seller to choose English law as the governing law for an acquisition agreement in terms of limiting a buyer's recovery for breach of warranty.

For UK-style transactions, losses for breach of a warranty are compensated by the seller on a 'damages' basis, namely the fall in the value of the shares of the target as a result of the breach of the warranty, with a duty on the part of the buyer to mitigate its losses and a requirement for such losses to be reasonably foreseeable in order for the buyer to bring a claim. For US-style transactions, such losses are compensated on an indemnity basis, namely recovery on a dollar-for-dollar basis, although it is open for the parties to negotiate for a narrower indemnity scope. In general, recovery under an indemnity claim is likely to be higher than under a damages claim. Normally, in the UK context, indemnities will be provided only in relation to a known risk identified from the buyer's due diligence (eg, in relation to losses arising from a specific piece of litigation or environmental liabilities).

For both UK- and US-style transactions, a seller will make various disclosures against its warranties in the acquisition agreement that would prevent a buyer from bringing a warranty claim in relation to such disclosures following the closing of the transaction. Under a UK-style acquisition agreement, the seller's specific disclosures are usually set out in a disclosure letter separate to the acquisition agreement; in the US, such disclosures are set out in a schedule to the acquisition agreement itself. More fundamentally, in addition to specific disclosures, a UK disclosure letter will also contain a list of general disclosures against the warranties – deemed disclosure of the content public searches (eg, available on the UK Companies House website), the entire data room (including any related Q&A tracker document) and any vendor due diligence reports produced by the seller's advisers. In relation to such vendor due diligence reports, the buyer may be able to rely on such reports, particularly if they are financial and tax (rather than commercial) reports produced by a UK accounting firm or a legal report produced by the seller's legal advisers. In the US, however, such general disclosures are less common and typically resisted by a buyer.

Credit support for claims against the seller

As is the case in both UK and US private M&A transactions, a seller will, in general, provide the buyer with title and capacity warranties and a suite of business warranties. In terms of credit support for the seller's liability under these warranties, there has been a shift in recent years away from the use of escrows to warranty and indemnity insurance in UK-style transactions. In large part, this has been fuelled by market practice for UK private equity transactions and the desire of a private equity seller to achieve a clean break and distribute the full proceeds of a sale (without any retention to cover possible warranty claims) to its investors as quickly as possible following closing.

Specifically, private equity sellers in the UK market may often decline to provide any business warranties to a buyer. This leaves the buyer with business warranties from management who often have a smaller stake in the target and receive a smaller percentage of the overall sale proceeds, and therefore are prepared to offer only a lower liability cap in the acquisition agreement for a breach of warranties. In addition, management may well be continuing in their employment with the target after closing of the transaction, making it counter-productive for a buyer to bring a warranty claim against them. From an employee-retention perspective, it also makes keeping a proportion of the management's sale proceeds in escrow a more difficult proposition. To address these issues and bridge the recovery gap, buyers are increasingly using warranty and indemnity insurance to provide real recourse for any breach of warranty and, absent fraud, to avoid having to bring an action against management.

In short, warranty and indemnity insurance provides cover for losses discovered post-closing arising from a breach of warranty or in certain cases under an indemnity. Such insurance aims to offer 'back-to-back' cover for any liability arising from a breach of warranty or for liability under any tax covenant, or both, in each case where the matter giving rise to such claims has not been fairly disclosed or was not known to the insured. Typically, warranty and indemnity insurance policies purchased by the buyer provide cover in a range between 10 to 20 per cent of enterprise value with net premiums between 1 and 2 per cent of the value of the policy. In general, insurers will require the insured to bear an excess of between 0.5 and 1 per cent of the enterprise value at their own risk before the insurance policy attaches; however, increasingly, for a higher premium, insurers are willing to provide insurance cover with no excess.

For US-style deals, in contrast, it is still more common for escrows to be used with private equity and management sellers, in proportion to their respective shareholdings, depositing around 5 to 15 per cent of the equity value in an escrow account to settle claims against the sellers. Arguably, an escrow provides better protection for the buyer as it is a source of actual funds that it can access if there is a breach of warranty. Administratively, it is also an easier process to seek the release of funds from an escrow agent compared with having to bring a claim under a warranty and indemnity insurance policy, not least as such cover is subject to various exclusions (eg, fines and penalties, environmental liabilities and cyber-attack liabilities), and there will always be a degree of mismatch between the loss suffered by a buyer as a result of a breach of warranty and the loss that a buyer can actually recover under such insurance.

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Comparison of English law and US law-governed acquisition agreements

English law-governed acquisition agreement	Key provision	US law-governed acquisition agreement
• General principles: freedom to contract, caveat emptor, no positive duty to negotiate in good faith • Parties sometimes agree high-level letter of intent before SPA • Vendor due diligence (VDD) reports are commonly used (particularly in auction processes) • Distinctive UK-style sale and purchase agreement (SPA), sometimes with separate tax covenants and usually with a separate disclosure letter	Transaction documentation and process	• Similar general principles to UK • Parties sometimes agree more detailed heads of terms (in the form of a term sheet) before the SPA • Use of VDD reports is rare • Distinctive US-style SPA with tax indemnity and disclosure schedule included as part of the agreement
• Payment is generally made at closing, with post-closing adjustments based on closing accounts: may see caps and collars on adjustments • Prevalence of 'locked-box' structure, particularly in auctions and where there is a private equity seller: the structure places increased importance on pre-signing diligence and the scope of permitted leakage	Price mechanisms	• Similar position to UK • While increase in use, 'locked-box' structure is not as common as closing accounts
• Escrow arrangements are sometimes used to give the the buyer comfort on recovery of warranty claims against individuals, or multiple or private equity sellers	Escrow arrangements	• Similar position to UK, but escrow arrangements usually cover closing adjustments as well as other claims under the SPA • Often the first or only source of recourse against a seller
• Closing may be subject to regulatory or shareholder or third-party consent, but rarely subject to a financing condition • If there is a gap between signing and closing, conditions to closing will be limited and a seller is unlikely to agree to a no material adverse change condition (with termination right)	Conditionality and termination rights	• Similar conditions to UK save that financing conditions are more common and low Hart–Scott–Rodino thresholds mean that US deals are often subject to regulatory clearances • If there is a gap between signing and closing, a no material adverse change condition is common and would give rise to a termination right (albeit a material adverse change can be difficult to establish)
• If there is a gap between signing and closing, a seller will generally covenant to carry on the target's business in the ordinary course: a buyer may argue compliance with this covenant should be a condition to closing, but this is usually rejected by a seller	Pre-closing covenants	• Similar position to UK
• Legal distinction between warranties and representations: rescission is available for a breach of representation • Repetition is resisted by a seller: accuracy of warranties is rarely a condition to closing • Warranty package can be extensive (more limited in auction processes or where private equity seller) and a buyer is unlikely to accept materiality qualifiers (as a broad scope of disclosure against the warranties is permitted) • Warranties are given subject to general disclosures (those matters of public record or knowledge) and specific disclosures (set out in a separate disclosure letter) • Parties generally agree that to be effective disclosure must be 'fair' (matters must be fairly disclosed with sufficient detail to enable a buyer to identify the nature and scope of the matter disclosed), reflecting the position established by the English courts • A seller will seek to qualify warranties by reference to all matters disclosed (and may argue the data room should be treated as disclosed against all warranties) • A seller will seek to restrict a buyer's ability to claim for a breach of warranty where it was aware of the matter resulting in the breach	Scope of warranty protection and disclosure against warranties	• No legal distinction between warranties and representations • Repetition is common practice: accuracy of warranties is often a condition to closing • Warranty package is extensive, but warranties are often given subject to a level of materiality • General disclosures against warranties are not common • A seller's disclosure against warranties is limited to particular matters set out in a disclosure schedule to the SPA • A buyer is often not restricted in the SPA from claiming for a breach of warranty where it was aware of the matter resulting in the breach: where the buyer is restricted, the provision is referred to as an 'anti-sandbagging' clause
• Damage for a breach of warranty is generally assessed by the English courts by looking at any reduction in the value of shares acquired as a result of the breach • Warranties are generally not given on an indemnity basis, but it is common for a buyer to ask for specific indemnities to cover specific liabilities that have been identified: these indemnities may be capped in amount or subject to a time limit for claims • If warranties are given as both 'representations and warranties', then a breach may give rise to a right for a buyer to rescind the SPA • Obligation on a buyer to mitigate its losses for a breach of warranty: unless an indemnity provides for it, there is no common law duty to mitigate losses under an indemnity	Liability of a seller	• Warranties are generally given on an indemnity basis, facilitating dollar-for-dollar recovery for any loss suffered by the buyer • Recovery is generally limited to direct loss and out of pocket expenses (with no recovery for indirect or consequential loss or diminution in the value of the shares acquired) • Quantum of recovery is often calculated by discounting any reference to materiality in the body of the warranties (referred to as a 'materiality scrape') • As no legal distinction between warranties and representations, no right to rescind an SPA arises • Similar to UK, with an obligation on a buyer to mitigate its losses

• Period for claims is generally limited to between 12 and 24 months (statute of limitation for tax claims) • Liability of a seller is generally capped at consideration for fundamental breaches (breach of title warranties) and often at less than 25 per cent of consideration for other breaches • Claims are subject to individual (often up to 0.1 per cent of consideration) and overall (often 1 to 2 per cent of consideration) de minimis • Range of other limitations on claims commonly negotiated, including matters disclosed in accounts, sums recovered from insurance or third parties, and loss from changes in law or a buyer's actions • Separate claim periods and thresholds often apply to claims under tax covenant and for breaches of tax warranties	Limitation of a seller's liability	• Period for claims is generally limited to between 12 and 36 months (statute of limitation for tax claims) • Liability of the seller is generally capped at consideration for fundamental breaches (breach of title warranties) and between 10 and 20 per cent of consideration for other breaches • Claims subject to individual de minimis (often US$25,000 to US$100,000) and overall deductible (often 1 to 2 per cent of consideration): 'tipping baskets' are not uncommon • Range of other limitations on claims commonly negotiated, including matters disclosed in accounts, sums recovered from insurance or third parties, and loss from a buyer's actions
• A buyer will request post-closing covenants from a seller to protect its interests in the business it is acquiring: these covenants generally include non-compete, non-solicit of customers, suppliers and employees, and confidentiality • Post-closing covenants will generally be for a period of 12 to 24 months	Post-closing covenants	• Similar position to UK, with post-closing covenants from a seller including non-compete, non-solicit of employees and confidentiality • Post-closing covenants will generally be for a period of two to five years for the non-compete and 12 to 24 months for the non-solicit and other covenants

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