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M&A PRACTICE IN THE UK AND THE US: A COMPARISON (AND SOME OBSERVATIONS ON THE IMPACT OF COVID-19)

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Introduction

- This presentation compares and contrasts UK and US market practice (and some points of law) as they relate to the negotiation of an SPA
- The propositions which the presentation demonstrates:
  - for a UK seller of a UK business, where there is a choice, English market practice is more favourable
  - for a UK seller, an English law SPA can also be advantageous when selling a US business and may be a good option, subject to deal execution reservations
  - on the other hand, for a US buyer of a UK business, where there is a choice, a US law SPA is generally more favourable
  - generally, market practice is a more powerful driver in the arbitrage than differences in substantive law
- Before we turn to the traditional theme of this presentation, we'd like to make some observations about the impact of the COVID-19 pandemic

US & UK M&A: The Impact of COVID-19

- As regards current M&A deal activity in both the UK and US:
  - We have seen large cap, financial sponsor-led, processes we have been involved in fail or be suspended as a direct result of the pandemic. This seems to have been happening regardless of the sector and is in part a result of an abrupt reversal of the favorable conditions prevailing in the debt financing market;
  - We have been seeing a number of deals which were already progressing when the crisis hit the continue and in some cases close;
  - Securities markets volatility is hampering M&A by our listed company clients;
  - The degree of disruption varies across sectors, mirroring the variations in sector returns in the public equity markets since February: at one end of the scale lies energy (hit by the double whammy of the OPEC crisis), banks and consumer services. At the other end of the scale are pharma, biotech and life sciences.
- There are broadly speaking, two types of challenge which the pandemic is creating: (1) logistical ones resulting from government policy on social distancing, remote working etc. and (2) new transaction risks resulting directly or indirectly from the pandemic.

US & UK M&A and COVID-19: Logistical Challenges

- In both the US and the UK, executing deals electronically has long been a feature of market practice.
  - In the UK the move to remote working, government policy on social distancing and the widespread temporary closure to staff and the public of office and administration buildings poses challenges:
    - UK Companies House and HMRC (for payment of stamp duty);
    - access to the target companies' corporate registers at closing.
  - Other considerations that require carefully navigation include:
    - Notarization requirements
    - Delivery of original collateral instruments and stock certificates
- Electronic execution of documents is in most cases of relevance to M&A deals valid, provided certain formalities are respected:
  - There is an EU wide legal framework for electronic signatures (which continues to apply during the Brexit transitional period) – Regulation EU No 910/2014;
  - The EU Regulation is supplemented in the UK by the JWP Practice note of 2016 and a UK Law Commission report of 2019;
  - Video witnessing of documents is understood not to be possible – the witness must be physically present at the time of signature.
- Management presentations can be done electronically, but site visits?

UK M&A and COVID-19: New Transaction Risks

- We will talk later on about two potential areas of concern: the impact of the pandemic on MAC clauses and warranty and indemnity insurance policies
- In the UK, two areas in which the government has announced measures may also have an impact:
- Insolvency law
  - On 28 March the UK Business Secretary Alok Sharma announced new insolvency measures to help businesses hit by the coronavirus crisis;
  - The change in law is to apply from 1 March for an initial period of three months;
  - To provide relief to struggling companies in financial distress, there is a de facto moratorium on creditor actions, including winding up petitions (a widely used enforcement option for creditors) – impact of end of moratorium?;
  - Suspension of civil offence of wrongful trading by directors: but what about other potential director liabilities?
- Emergency government financial relief for companies

  Transaction risks for an acquirer - impact of:
  - change of control on target satisfaction of eligibility conditions;
  - expiry/withdrawal of the relief programs.

The future of US & UK M&A : Potential Impact of the COVID-19 Pandemic

- Will the dominance of locked box mechanisms continue to prevail?
- The UK government has announced that companies are being automatically and immediately granted a three month extension to file their financial statements (over 10,000 companies have already applied for the extension): the availability of recent audited financials is invariably a *sine qua non* of an M&A deal;
- Working capital provisions on traditional enterprise value, debt free/cash free deals: in the current environment, how do you determine and agree on a "normative working capital" value?
- Longer term: Control of foreign investments: Has the tide of an open economy turned: a CFIUS regime in the UK? Are we heading for an increased politicization of cross border M&A?

Pricing Mechanisms

- Locked box versus completion accounts:
  - locked box mechanisms are not a common feature of US market practice (but the use of them is growing)
  - in the US the seller is often required to deposit a portion of the purchase price in escrow as security for post-closing true up payments; this isn't common on UK deals
- Market practice rather than the law is the driver
- The advantages of locked box mechanisms are principally on the sell side:
  - control of the preparation of the locked box accounts
  - facilitates bid comparisons
  - avoids the potential for dispute over value, via post-closing true up procedures
  - provides a greater degree of control for the seller over the price (the only adjustments to the agreed equity value are in respect of matters - leakage - which the seller controls)
  - provides certainty of timing on the date of transfer of economic risk (i.e. at the locked box accounts date)
  - the time limit for post-closing buyer claims for leakage is short (typically 3 – 12 months)
- But a locked box is not always the right approach for, or available to, the seller (e.g. where current trading is improving; or inadequate robustness of available financial statements; or a pre-sale restructuring, post locked box accounts date, is needed)

Execution Risk: Market Practice on Conditions Precedent and Seller Warranty Bring Down (1)

- There are some significant differences in market practice on CPs and warranty bring down to closing
- CPs in a typical data room draft SPA under English law: Antitrust and other essential regulatory approvals only
- **12** additional "customary" CPs in one US private equity bidder mark-up (it was a US business):
  - all seller warranties to be true and correct at closing
  - seller compliance with all its covenants
  - no MAC having occurred
  - completion of a "marketing period" to obtain financing
  - no court orders restraining closing
  - delivery of good standing certificates, etc…

(The bidder didn't win the deal)

Execution Risk: Market Practice on Conditions Precedent and Seller Warranty Bring Down (2)

- On UK deals, the use of locked box mechanisms has contributed to the acceptance of the transfer of risk from the seller to the buyer at signing, so that:
  - CPs are generally limited to those required by law (e.g. antitrust)
  - it's not uncommon on UK deals for "fundamental" warranties to be brought down to closing, but not the full set of seller warranties
  - MAC clauses are much less common in UK SPAs
- But in US law and practice the buyer may not have it all its own way, even with a MAC clause.
  - Although historically Delaware courts have been reluctant to find that a MAC has occurred in the absence of significant and durable damage to the business, in *Fresenius*, a 2018 case, however, the Chancery Court cited "dramatic, unexpected and company-specific downturn" following signing allowed the buyer to terminate the acquisition on the basis of a MAC. The Chancery Court did, however, eschew creating a standard test for whether a drop in profits or earnings is a MAC.
  - MAC clauses and the COVID-19 pandemic

Execution Risk: SPA Buyer Financing Conditions Where Buyer is a Financial Sponsor (1)

- The typical US approach:
  - a so-called "SunGard" financing condition in favour of the buyer:
    - the buyer provides debt financing commitment letters with conditions to draw down close to that of the SPA CPs
    - the buyer represents what the terms of the financing will be and covenants to raise financing on those terms and to enforce its rights against the committed debt provider
    - the buyer is given a minimum "marketing period" during which it (or its lead lender) can seek to place or syndicate its financing before being required to close, or (if it fails to do so) pay a reverse termination fee
    - the lender's commitment is also often conditional on having the right to syndicate
    - the marketing period doesn't usually start until the seller has provided a financial information package for use in the marketing to potential lenders
    - the seller often also assumes "reasonably cooperation" obligations, to facilitate the financing, including participating in road shows or other lender and investor meetings

Execution Risk: SPA Buyer Financing Conditions Where Buyer is a Financial Sponsor (2)

- The typical UK approach provides more certainty to the seller:
  - the buyer typically contracts on a "certain funds" basis, with no financing condition and the risk of a financing failure is allocated to the buyer
  - the parties may agree a reverse termination fee, but often the buyer will simply be in breach of contract for failure to close
  - the seller will often also seek direct contractual commitments from the buyer's equity providers

CLE Code

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Seller Warranties (1)

- A common feature of both US and UK SPAs: unless the process is highly competitive, warranty protections and limitations on seller liability for breach are heavily negotiated in practice on both sides of the Atlantic
- The scope of the warranties tends to be substantially the same, the extent of materiality and seller's knowledge qualifiers being generally a function of the parties' relative bargaining power on the particular deal
- Having said that, the risk allocation under the warranties tends to favour the buyer in US SPAs and the seller in UK SPAs. For example:
  - where the seller is a financial sponsor: in the UK, often fundamental warranties only are given; in the US, financial sponsor sellers more commonly provide warranties, with their liability capped at a part of the purchase price placed in escrow or the proceeds of a warranty insurance policy
  - US SPAs also often include a broad and unqualified warranty as to the absence of undisclosed liabilities (or as to the absence of unprovisioned liabilities required to be reflected on a GAAP balance sheet); this is much less common in UK SPAs

Seller Warranties (2)

- Before leaving the subject of warranties, some commonly encountered legalese: the difference between "warranties" and "representations":
  - in the US these terms are typically combined (e.g. "Sellers hereby represent and warrant that" etc.) and the use of one word or the other doesn't affect the remedies available to the buyer for breach
  - under English law, the choice of word matters: Sellers seek to avoid the use of the word "representation" (and generally in practice succeed). This is to prevent the buyer being able to make a tortious (i.e. non contractual) claim under the Misrepresentation Act 1967 (the remedies under the 1967 Act include rescission)

Seller Warranties: Seller Disclosure and Buyer Knowledge (1)

- In both the US and the UK, seller warranties are usually qualified by disclosures made in a disclosure letter (in the UK) or disclosure schedules (in the US)
- In a US SPA the parties will often agree that the disclosure qualifies the warranties if its relevance is "readily" or "reasonably" apparent
- On a UK deal a comparable standard is customarily agreed upon – the disclosure has to be "fair" to have exoneratory effect
- On a US deal, the disclosure typically doesn't qualify all the warranties, unless there is clear relevance to another warranty. It's more common on a UK deal for a disclosure to be agreed to qualify all the warranties, not just a specific warranty against which it is made
- Also on a UK deal (particularly one resulting from an auction process) it is common for the contents of the data room to be deemed disclosed. This is a lot less common in the US

Seller Warranties: Seller Disclosure and Buyer Knowledge (2)

- Buyer knowledge:
  - in the US:
    - there is often a negotiation around "pro-sandbagging" and "anti-sandbagging" clauses
    - these clauses result from the US courts typically requiring that the buyer satisfies a "reasonable reliance" (on the warranty) test, as a condition of its right to recover
    - pro-sandbagging: The buyer can bring a claim even if it knew about the matter before signing or closing
    - anti-sandbagging: The buyer is barred from bringing a claim if it knew about the matter before signing or closing
    - often US SPAs are silent on the point, and the issue is then governed by state law regarding breach of contract claims; in the absence of a pro-sandbagging clause, in many states in the US the buyer would be challenged to bring a successful claim for a breach of warranty of which it was aware before signing or closing

Seller Warranties: Seller Disclosure and Buyer Knowledge (3)

- Buyer knowledge:
  - in the UK
    - anti-sandbagging clauses are often negotiated and are effective (they are often negotiated together with the issue of data room disclosure)
    - pro-sandbagging clauses: These clauses are a lot less common, but on this point English law is probably not more favourable to the buyer than the equivalent law on pro-sandbagging clauses in the US: Infiniteland & Anor v Artisan Contracting (Court of Appeal, 2005): if a buyer has knowledge of a fact which would constitute a breach of warranty, it may make a claim, but the court may award only nominal damages
    - Known, material liabilities identified in due diligence are often the subject of specific indemnities

Remedies for Breach of Seller Warranties: Limits on Seller Liability (1)

- Remedies for breach:
  - in the US:
    - generally the buyer is entitled to indemnification for breach of warranties;
    - the buyer may negotiate "materiality scrapes" (all materiality and MAC qualifications applying to the warranty are to be disregarded for purposes of determining breach or recoverable loss, or both)
  - in the UK:
    - express contractual indemnification for breach of seller warranties is less common (except for specific identified liabilities (e.g. environmental remediation) or tax);
    - The buyer's remedy is usually limited to a contractual claim for damages, based on the reduction in value of target company's shares resulting from the breach;
    - losses are generally recoverable to the extent they were "reasonably foreseeable" when the SPA was entered into
- Recoverable losses: in both the US and the UK, exclusions for special, indirect, consequential losses or claims based on value multiples are commonly negotiated

Remedies for Breach of Seller Warranties: Limits on Seller Liability (2)

- Financial limits:
  - liability caps, deductibles or tipping baskets (i.e. thresholds) and de minimis amounts are standard in both the US and the UK;
  - historically seller liability caps were buyer friendly in the US but there seems to be convergence in recent years, under the influence of PE involvement in the M&A market and the competition for good companies, which is driving down caps to distinguish bids;
  - market practice on de minimis and deductible or tipping basket thresholds seems to be broadly comparable (in the US de minimis levels not closely correlated to transaction value)
- Warranty survival periods:
  - not generally an area for arbitrage between the US and the UK; in the UK, tax and fundamental warranties are typically up to six years, plus the current year (coterminous with the UK tax prescription period) and other warranties one to two years; practice in the US is broadly comparable

Seller Warranties – The Impact of Warranty Insurance

- Warranty insurance (representation and warranty insurance in the US) has become increasingly popular in both the US and the UK in recent years, driven by financial sponsors looking for a "clean break" on exits
- In both the US and the UK, the dominant trend is for recourse to buy side policies
- Typical policy exclusions in both markets include unfunded pension liabilities, forward looking statements and claims for non-financial relief. Policies also typically exclude known tax liabilities and transfer pricing risk. What about COVID-19?
- Survival periods in both markets can be longer than the negotiated SPA survival periods
- Premiums and deductibles are reported to be generally higher in the US

Conclusion: There Might Be a Choice, so What's the Right Answer for the Client?

- The client needs advice which is:
  - objective and disinterested; and
  - takes account of deal execution risk and the realities of the process (the identity of the bidders and their advisors; the execution costs of "double heading" UK and US advisors; and issues arising/time lost because of "losses in translation"…)
- The bottom line for a UK sell-side client:
  - if selling a UK business, push back hard if your US bidders push for US law/market practice;
  - if selling a US business: an English law governed and UK style SPA might work and could be to the client's advantage
- The bottom line for a US buy-side client:
  - be prepared to take some deep breaths and abandon some of the deal protections you are accustomed to, if the seller insists on English law and UK market practice. Your common assumptions on deal points and risk allocation aren't shared

Biography

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Stephen Walters counsels clients on public and private mergers and acquisitions, joint ventures, private equity and other equity financing transactions, corporate governance, and general corporate advisory matters. Stephen also handles financial services matters for a number of financial institution clients. He has experience of advising clients in a range of sectors including energy, technology, life sciences and financial services. Dual qualified in England and France, he advises clients on transactions in the UK and France and has also advised on transactions in the United States and a number of emerging markets

Corporate clients he has advised on M&A transactions include: BlackBerry; CRH plc; Chevron Corporation; Lazard; LyondellBasell Industries; OM Asset Management plc; Royal DSM NV; Smiths Group plc; SoLocal SA and Telefónica SA

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With experience in US domestic and cross-border mergers, acquisitions, and dispositions, Andrew Milano advises enterprises on joint ventures, commercial contracts, and general corporate and compliance matters. Andrew regularly advises clients in acquisition and divestment deals involving a range of assets, from container terminals, power generation facilities, and regulated water and wastewater plants to enterprises in the international energy services sector.

Andrew recently participated in a Morgan Lewis team representing a global materials technology enterprise that divested a number of assets in the United States and Mexico. He was also on a team advising a US communication and events company on its acquisition of a domestic trade show organizer.

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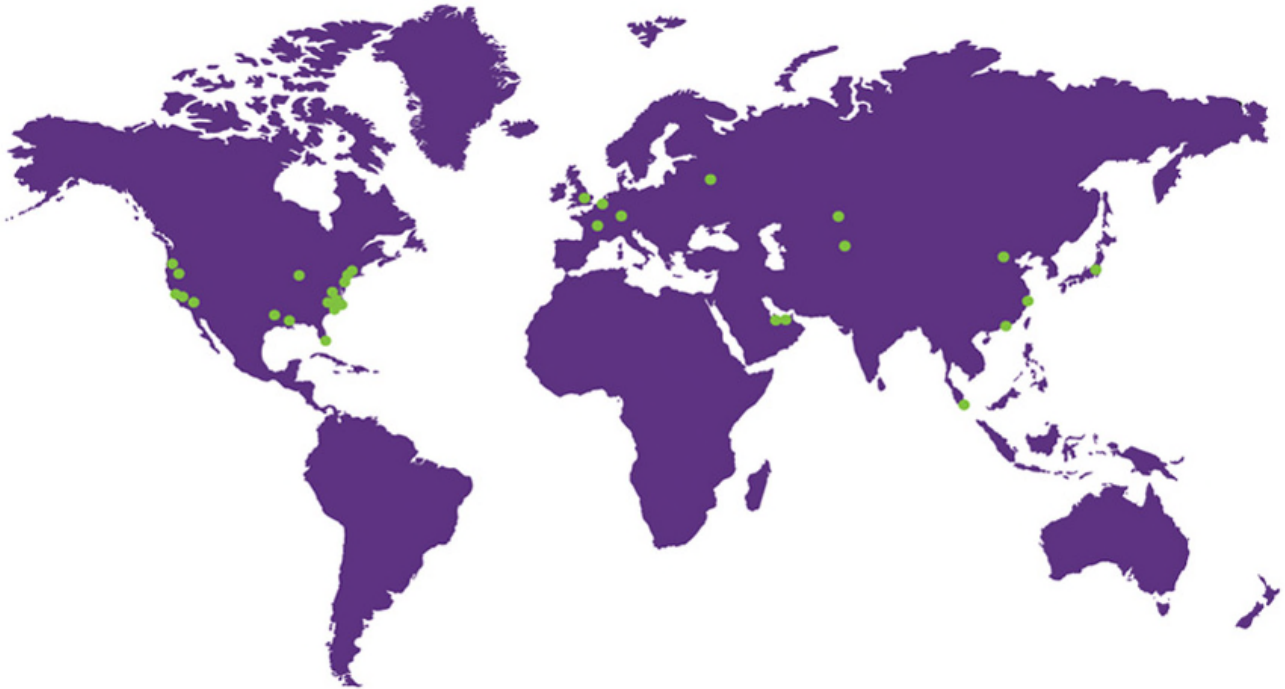

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