UK M&A Deals: What A US Buyer Should Expect

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Introduction

The market for M&A deals is on the rebound after a sluggish 2013, with the first and second quarters of 2014 being some of the most active quarters since the 2008 financial collapse.[1] Deal conditions are favorable: both buyers and sellers have improved confidence in the economy, interest rates are at historic lows, and both strategic and private equity buyers have historically high levels of cash reserves and commitments. Reports indicate that US buyers are actively looking overseas for new investments due to increasingly competitive conditions at home. International M&A deals are up, with outbound US M&A deal volume at the highest year-to-date level on record since 2007 at $1.83 trillion.[2]

What should a buyer from the United States expect when it crosses the Atlantic to purchase a business in the United Kingdom? This article will explore some significant differences in market deal terms that a US buyer should be prepared to consider when it seeks to buy the stock of a private company in the UK, with additional focus on what to expect when the business is being sold by a UK private equity fund.[3]

Purchase Price Adjustments

Typically, in US private stock deals, the buyer buys the target on a "cash-free, debt-free" basis with an agreed-upon level of working capital and with sellers' transactions expenses having been paid fully by seller. As such, the agreed-to purchase price in a US purchase agreement is generally subject to upward and downward adjustments post-closing based on the actual levels of working capital, cash, debt and unpaid sellers' transaction expenses at closing. In the UK, however, while many deals use a similar adjustment mechanism, there is an increasing prevalence by sellers (particularly private equity or private equity-backed sellers) to use what is known as a "locked box" purchase price approach. Under this approach, an equity price will be calculated using an historic set of accounts in respect of which the buyer will have no ability to adjust after closing. The buyer will then rely on contractual protection to ensure that "leakage" from the "locked-box" (basically no material cash or assets "out" and no material liabilities "in") between the reference date of the historic accounts and completion (which is the closing in the US). Absent the purchase agreement prescribing a different remedy, if such leakage takes place, then the buyer would have a right of claim against the sellers for breach of contract.

Representations and Warranties

In the UK, it is common for sellers to resist giving representations as well as warranties and to delete references to "representations" from the purchase agreement. The deletion of the term "representation" is considered, by some UK practitioners, to minimize the risk of a tortious claim for damages under the Misrepresentation Act 1967 and to remove the possibility that the buyer will attempt to rescind the agreement under the provisions of that Act. In reality, the simple categorization of a statement as a warranty (without any further provisions) probably has little bearing on whether the statement is susceptible to being treated as a representation for purposes of that Act.

Accordingly, a well-advised seller in the UK will always seek to exclude the remedies of tortious claims and rescission by express provision to that effect, rather than by arguing that those rights are excluded by virtue of simply characterizing the statement as a "warranty" and not a "representation."

In addition, in the US, purchase agreements will typically contain more extensive and detailed representations and warranties from sellers than the seller warranties contained in a UK contract. And, while a US purchase agreement may contain a "10b-5 representation" that none of the representations, warranties and disclosures in the purchase agreement contain any untrue or misleading

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1. S&P Capital IQ Market Analysis, July 10, 2014.
2. Dealogic M&A Review, First Half 2014, July 2014
3. In the UK, unlike the US, there is no concept of legal merger between to two UK companies. The majority of private company acquisitions are, therefore, either done by way of acquisition of the shares of the target company or of the assets of the target company.

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statement and do not omit any material fact, a seller in a UK purchase agreement would rarely provide that warranty as it would be considered too broad and subjective.

Bring Down of the Warranties; No Material Adverse Change

In the UK and the US, it is not uncommon for warranties to be repeated or "brought down" at closing. However, unlike in the US, sellers in the UK will seek to resist that principle if there is any gap between signing and closing or, as a fallback position, to argue for repetition of only those warranties over which they have direct control. In addition, it remains unusual in the UK for the accuracy of all warranties at closing to be a condition of closing in the way it is in the US such that a buyer would have the right to terminate the deal as a result of a material breach of the warranties given at signing and, in some cases, repeated at closing. Similarly, while it would be more customary for there to be a "no material adverse change" closing condition (or "MAC out") in a US deal, this provision is less common in the UK and, if included, would generally be more narrowly drafted than in the US.

The Warrantor Who Provides the Warranties

In a US stock deal, it is standard for each seller to make the same "operational" representations and warranties related to the target company and the same "fundamental" representations with respect to its ownership of target shares and its ability to complete the deal. In the UK, the same approach would be considered customary except where a private equity fund is one of the sellers. A UK private equity fund seller typically will only be prepared to give limited "fundamental" warranties. Instead, any other owners who are not private equity fund sellers who are receiving, directly or indirectly, sale proceeds (for example, members of management) will likely give all of the "operational" warranties related to the target company and therefore be liable for any breaches of those warranties.

Indemnification; Liability Caps

A key difference between US and UK deals relates to indemnification for breaches of representation and warranties. Indemnification goes hand in hand with the making of representations and warranties in the US; and there are usually extensive provisions in a US purchase agreement setting forth indemnification obligations, procedures for making indemnification claims and limitations on indemnification obligations. Indemnification obligations are often the exclusive post-closing remedy for buyers in a US deal to recover damages from sellers for any breaches of representations and warranties, and, as mentioned above, a buyer generally has recourse against all of the sellers for breaches of the representations and warranties made by them.

In contrast, there is no separate indemnification provision in a typical purchase agreement for a UK deal. If there is indemnity coverage at all, it would be for certain specifically identified categories of claims or known liabilities, such as tax, known material litigation claims, known environmental issues or pension deficits or underfunding issues. In order to obtain damages for any breaches of the warranties, in the absence of indemnification provisions, a buyer would sue the warrantors for breach of contract. It is, however, customary in the UK for the purchase agreement to contain an extensive set of provisions relating to the procedures to be applied when making a breach of warranty claim and limitations on the warrantors obligations.

Caps on the indemnification liability ranging from 5% to 15% of the total purchase price are typical in the US market (with certain exceptions allowing for liability in excess of this cap relating to breaches of fundamental representations, tax representations and covenants and for fraud). This indemnification cap would generally apply to all sellers in the US regardless of whether any seller is a private equity fund or management. And, with several but not joint liability, each seller's individual liability would also typically be capped at 5% to 15% of each seller's individual proceeds. As discussed above, if the UK seller is a private equity fund, it will have given limited fundamental warranties and, thus, the buyer will likely need to look to management warrantors for damages from a breach of almost all of the warranties. Since those management warrantors typically receive a very small percentage of the overall total purchase price, even if the buyer is able to negotiate for a much higher indemnification cap in the UK (e.g., 50% or more of the proceeds given to the management), those proceeds may ultimately be only one or two percent of the overall purchase price. However, in UK transactions where the seller is prepared to give a full set of warranties, a liability of cap of between 50% to 100%

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of the purchase price is often negotiated (generally with the same exceptions for fundamental warranties, covenants and fraud that allow for liability in excess of the cap).

Escrow of Funds

In both the US and the UK, some amount of funds from the purchase price paid to the sellers are often set aside in an escrow account to cover indemnification obligations in a US deal or breach of contract damages in a UK deal. In the US, the escrow account is typically held by a third party escrow agent, whereas the law firms advising the parties in the transaction typically jointly hold the escrowed funds in the UK. In the US and the UK, such funds are generally held in escrow until they are jointly released by the buyer and the sellers (or occasionally by one party, depending on the circumstances) at the end of the survival period of the general representations and warranties, although different lengths of time are often negotiated. One issue that is often the subject of negotiation in the UK is on what basis monies should remain in the escrow account if the buyer has an outstanding claim which had not yet been settled or determined at the end of the escrow period. In such circumstances, a seller will want to ensure that it is protected against a buyer making a vexatious claim simply to ensure monies remain in escrow. One compromise that is often used in the UK to retain funds in escrow beyond the end of the escrow period is for the buyer to have obtained an independent legal opinion from a barrister that the relevant claim is bona-fide.

Disclosure Schedules/Letter; Data Room; Buyer's Knowledge

In the US, statements and information disclosed in disclosure schedules attached to a US purchase agreement serve as exceptions to the applicable representations and warranties. Buyers are deemed to be aware of information contained in the disclosure schedules, and the sellers are customarily not liable for such information, even if it would otherwise be a breach. In order to limit exposure, buyers carefully review the disclosure schedules and resist blanket, vague or overly broad statements, particularly disclosures of all or portions of the electronic due diligence data room (without sufficient specificity as to why those electronic data room items are being referenced and disclosed). Further, in the US, a purchase agreement may be silent with regard to the consequences arising from buyer's knowledge about a seller breach, may contain "anti-sandbagging" language (indicating a buyer cannot recover for damages with respect to a seller breach over which it had knowledge pre-deal) or may contain a "pro-sandbagging" provision (indicating a buyer can recover for damages with respect to a seller breach even if buyer had knowledge of that breach). In order to avoid inadvertently bringing items in the data room into the disclosure schedule through the "back door," it is not uncommon for buyers in the US to negotiate for a pro-sandbagging provision in the purchase agreement.

In the UK, statements and information disclosed in a separate disclosure letter serve as exceptions to the applicable warranties. The disclosure letter typically contains a series of general disclosures (for example, information that appears in public records) that qualify all of the warranties in the purchase agreement, as well as specific disclosures that, while cross-referenced to specific warranties in the purchase agreement, are often treated as effective disclosures in relation to all of the warranties. In the UK, the disclosure letter is typically accompanied by the "disclosure bundle" – a large collection of documents (which can sometimes extend to all of the documents in the data room) of which the entire contents are disclosed against all warranties. As is the case in the US, a UK purchase agreement may be silent with regard to the consequences arising from buyer's knowledge about a seller breach, may contain "anti-sandbagging" language or may contain a "pro-sandbagging" provision (although English case law has cast doubt on ultimately

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how effective such a provision will be). In contrast to the US, a seller will typically argue that the disclosure letter or the purchase agreement should contain a statement that anything contained in the data room is deemed to be "known" by the buyer, and the seller is therefore not liable for anything contained therein. If accepted by the buyer, then this statement will be tempered somewhat by the concept of "fair disclosure" under English case law – where a buyer is only deemed to have known that an item in the data room served as an exception to a warranty if the information contained in the data room would enable a buyer to make reasonably informed assessments of the circumstances giving rise to a breach of warranties. It is increasingly common in the UK for the parties to agree to a contractual standard of "fair disclosure" in the purchase agreement due to current case law not being definitively prescriptive.

Damages

Another difference in US and UK deals is the manner in which damages are calculated and recovered. As stated above, indemnification provisions are typically the exclusive remedy for a buyer to recover post-closing for losses and damages in a US deal resulting from seller's breach of representations and warranties. In the US, damages are frequently calculated based on the full amount required to remedy the defect arising from the breach—typically subject to some deductible or threshold of damages but without reference to any actual loss in the value of the target company as a result of such defect. Often, US purchase agreements provide for which types of damages a buyer is entitled to recover, and it is not unusual for consequential, indirect, special, lost profit, or diminution in value damages to be expressly excluded or, alternatively, for the agreement to be silent with respect to such damages (which, if silent, may result in the inclusion of such damages depending on the state law which governs the purchase agreement). It is common in the US to include a "materiality scrape" in purchase agreements for purposes of calculating damages (and sometimes also for purposes of determining if there has been an actual breach). This means that any materiality qualifiers in a representation or warranty are "scraped" or read out of such representation or warranty for purposes of determining whether there has been damages (or potentially also a breach). Further, the buyer and seller typically negotiate in the indemnification provisions of the agreement whether and to what extent the buyer must mitigate any damages – with some US purchase agreements being silent on buyer's duty to mitigate.

In the UK, unless the parties agree to a different approach, damages for a breach of the purchase agreement will be measured by the difference between the price paid for the shares of the target and the actual value of those shares at closing, given the breach. Additionally, under English law, the buyer has a duty to mitigate its loss in respect of a breach of contract claim. It is also worth noting that in UK litigation, generally speaking, a court will decide that the costs incurred by the parties to the litigation will be borne by the loser. These UK characteristics are thought by some practitioners to be contributing factors to the relatively low instances of warranty claims in the UK relative to the US.

Tax

In the US, tax liabilities and benefits are typically split between pre-closing tax liabilities and benefits, which are the sole responsibility or benefit of the seller, and post-closing tax liabilities and benefits, which are the responsibility or benefit of the buyer. Since most deals close during the fiscal year (rather than the last day of the fiscal year), the parties agree on the manner in which tax returns will be handled during the "straddle period" between the last fiscal year end and the closing date.

In the UK, it is not possible to agree with the UK tax authority on the manner in which the tax liabilities of a UK company will be handled as of the date of sale of that company. In basic terms, the tax system requires an accounting period of the target (usually 12 months) to end, corporation tax returns to then be filed within 12 months of the end of the accounting period with the tax authority, and for the tax authority to then agree or disagree with those tax calculations. In a UK stock sale, tax liabilities and benefits typically "go" with the target—and therefore the buyer—unless the seller wants to try and retain group reliefs/the benefit of tax allowances. This fact is usually factored into the purchase price. As a result, a buyer would typically only obtain a specific pre-closing tax indemnity document in relation to tax which is out of the ordinary course of business, unknown or not provided for in the financial statements. Thus, the manner in which the parties

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approach pre-closing tax liabilities and benefits in the context of a UK deal will be partly dependent upon how the purchase price has been calculated.

Transfer Tax

Most US stock deals do not trigger a transfer tax, but in the event one is triggered, the parties often negotiate whether transfer taxes would be borne by buyer or seller or would be shared. A UK stock deal will trigger a transfer tax, in the form of a stamp duty, payable by the buyer in an amount equal to 0.5% of the purchase price, and it would not be customary to negotiate for any portion of that tax to be paid by seller.

Restrictive Covenants

A US stock deal will generally have restrictive covenants, such as non-competition, non-solicitation and no-hire covenants, customarily lasting from one to five years (and sometimes even longer). UK purchase agreements will typically contain these types of restrictive covenants but with a shorter time period. Three years is generally considered to be the maximum time period that a UK court is likely to accept (and it would not be unusual for shorter periods to be agreed between the parties under the purchase contract), but each situation will be treated differently as there is no definitive time period provided in English law.

Conclusion

In the US and the UK, there are few legally implied terms in a contract for the purchase of a business, and thus, parties are free to agree on what contractual provisions they will include in their purchase agreements. While there are a number of consistencies between US and UK M&A deals, there are a number of material differences. In the current "sellers market" where buyers in both the US and the UK are encountering competitive "auctions" and finding it more difficult to negotiate buyer-favorable terms, US buyers should be aware of the UK market deal terms they will be expected to accept when purchasing a UK target from a UK seller in a "UK-style" deal.

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