Cross-Border M&A: Being a Successful U.S. Buyer in Europe

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Introduction

- Investment by U.S. companies and PE funds in Europe remains strong
- U.S. tax reform, a strong U.S. dollar and companies and funds with plenty of cash for investment are strong drivers
- A key change occurring within the European M&A market has been the increase in non-European buyers. Each of the 10 largest European PE deals in 2018 involved at least one non-European buyer, with 9 out of 10 involving a North American investor
- During 2018, non-European investors participated in 710 European deals worth €157.5bn
- In this presentation, we will discuss some of the key things to consider when planning and executing a private company transaction in Europe and highlight some of the key differences with U.S. transactions

Overview

- In broad terms, there is some alignment between the U.S. and European jurisdictions. For example:
    - Process (e.g., LOI, diligence and documentation)
    - Deal structures (e.g., stock, assets or merger)
    - Deal protections (e.g., reps and warranties)
- Key drivers for a flatter deal world:
    - Use of the English language in documents
    - Use of English-language jurisdictions for resolving disputes
    - Technology
    - Globalisation of banks and professional service firms

Deal Planning – Political and Regulatory Considerations

- At the planning stage, it is important to assess any potential key political and regulatory issues
- European politics is in a state of some flux – Brexit, rise of issue-driven parties and coalition governments
- Increasingly, countries are adopting or proposing to adopt national security laws that give governments the ability to block transactions
- Important to determine whether any anti-trust/merger control filings are necessary

Deal Planning – National Security Approvals

- EU countries are increasingly adopting or strengthening CFIUS-like rules
- 14 EU member states have in place mechanisms for the screening of acquisitions or investments by foreign persons
- Several member states have recently strengthened such rules (e.g., France and Germany) and others, notably the UK, are in the process of adopting new rules
- Although these differ in design and scope, they share the same goal of preserving national security and are typically focused on particular industry sectors deemed important to the national interest
- The EU Commission last week issued a new EU regulation which will come into force in 18 months time establishing a framework for the screening of FDI within the EU
- This new regulation will not impose an additional EU approval into any screening process but will set certain requirements for member states who wish to maintain or adopt such processes and create a co-operation mechanism through which member states will be able to share information and raise concerns

Deal Planning – Merger Control Approvals

- EU and national merger control approvals should always be considered
- EU merger control rules apply to all EU member states + Iceland, Liechtenstein and Norway
- If certain jurisdictional thresholds are met, then the EU will have exclusive jurisdiction and no national merger control filings are necessary under the “one-stop shop” principle
- If the EU does not have jurisdiction then need to consider whether national merger control filings are required
- Substantive analysis is only normally relevant if jurisdictional thresholds are satisfied
- Some national jurisdictional thresholds are VERY low for certain transactions
- “Hell or high water” clauses are increasingly common, as are break fees linked to merger control approvals

Deal Planning – Legal System

- Type of legal system
  - European countries are typically either civil law or common law countries
  - Use of the notary
- Most jurisdictions permit, like the U.S., freedom to contract, with the principal of ‘caveat emptor’
- However:
  - Some jurisdictions will imply a positive obligation to negotiate in good faith
  - Specific laws often catch people out (e.g., employment, tax and pensions)

Deal Planning – Practice Differences

- A U.S. buyer will have certain expectations about what a deal will look like (e.g., protections it may enjoy)
- Whilst protections can be the same (e.g., reps and warranties), they may be different:
  - European deals are often more seller-friendly than U.S. deals
  - Disclosure is sometimes treated differently from the U.S.
  - Indemnification is also different from the U.S.
- Negotiating culture can require a different approach

Deal Planning – Deal Structures

- As in the U.S., typical acquisition structures for private companies are:
  - Acquire shares (i.e., stock);
  - Acquire assets; or
  - Effect a merger
- Not all jurisdictions have the concept of merger
- EU rules exist to facilitate cross-border mergers
- Takeovers of publicly listed companies will likely be subject to specific and separate rules not discussed here

Due Diligence

- Helpful that most deals now have a ‘virtual data room’
- If competitors are participating in the sale process, then there may be also a ‘clean room’ (i.e., physical data room for some information)
- GDPR may require the seller to hold back some information (e.g., on employees) until a deal is close to execution
- Site visits can have a dual purpose in allowing the buyer to have a greater familiarity not just with the target but also the jurisdiction
- Requests for diligence information may require sensitive handling due to cultural perception around requests for detailed information
- Increasingly on European auctions, vendor due diligence reports will be prepared, with the successful buyer being able to rely on such reports

Deal Terms – Purchase Price

- Working Capital Adjustments in the U.S.:
  - In the U.S., the buyer typically buys the target on a cash-free, debt-free basis with an agreed upon level of WC
  - Closing accounts would then be produced (typically within 2-3 months of closing) showing the actual working capital and cash/debt position of the target at closing, with an adjustment to the price if the actual amounts are different from the position estimated at closing

Deal Terms – Purchase Price

- Locked Box Mechanic in Europe:
  - Locked-box mechanics are the common stable of European M&A. The price is set by reference to an agreed upon balance sheet which is dated prior to signing (typically last audited accounts or most recent management accounts)
  - The price paid for the shares at closing is essentially calculated by adding cash and deducting debt and debt like items as shown on that balance sheet from the headline price
  - The seller will confirm in the SPA that it not received any value or benefit from the target (referred to as ‘leakage’) in the period between the balance sheet date and closing and will give the buyer the benefit of an indemnity for any such leakage that has occurred during this time
  - This mechanism gives the seller price certainty (as the price is essentially fixed). It also ensures as clean a break as possible, and in the case of private equity, should allow the full proceeds to be distributed upon closing

Deal Terms – Conditionality

- U.S. deals where there is a gap between signing and closing will typically include a MAC condition and a requirement that the reps and warranties are “brought down” at closing. This may also be the time when the buyer will arrange acquisition financing, if required
- Seller’s in European deals require greater deal certainty and limited conditionality:
  - MAC clauses and warranty bring-downs are much less common
  - Seller’s will also often require a buyer to proceed on a ‘certain funds’ basis. In practice, this means the buyer must be able to demonstrate committed financing upon signing of the SPA

Deal Terms – Indemnification

- A key difference between U.S. and European deals relates to indemnification for breaches of representation and warranties
- Damages for breach of warranty in a U.S. deal are usually calculated on an indemnity basis against the full amount required to rectify the defect (subject to any applicable deductible)
- By contrast, European deals often do not calculate damages on an indemnity basis, other than for specifically agreed circumstances. The buyer is therefore required to prove that it has suffered a quantifiable loss (in a share acquisition, a diminution in the value of the shares) as a result of the breach and must mitigate its loss
- 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 issue (analogous to the types of carve-outs you would see in a U.S. deal under a U.S. RWI (W&I) policy)

Deal Terms – Reps and Warranties

- In a U.S. stock deal, it is standard for each seller to make the same “fundamental” representations with respect to its ownership of target shares and its ability to complete the deal and for the sellers/target company to provide “operational representations” with respect to the target company
- In Europe, the operational warranties would normally be provided by the sellers, except where a private equity fund is one of the sellers
- A PE seller typically would only be prepared to give limited “fundamental” warranties. Instead, any other owners (e.g., management) would likely give all of the “operational” warranties related to the target company and therefore be liable for any breaches of those warranties. A seller may also look for these reps to be made on a “knowledge qualified basis”
- Increasingly, buyers of businesses that are owned by PE are using warranty and indemnity insurance to ensure that full “operational” warranties can be obtained with appropriate financial protection
- Escrows of 5% – 15% are not uncommon, but the use of W&I can make an escrow harder to justify

Deal Terms – Disclosure

- Typical U.S. market practice is for disclosures against warranties to be specific, linked to particular warranties and set out in detailed disclosure schedules to the agreement. Broad and general disclosures would be unusual
- A European sale agreement will normally allow the seller to submit a disclosure letter against the warranties on signing containing both general and specific disclosures
- The seller will often also be permitted to make a general disclosure of the contents of the entire data room of due diligence documents
- This general data room disclosure will be tempered somewhat by: (i) an agreed standard of disclosure; and/or (ii) local legal concepts of "fair disclosure"

Warranty and Indemnity Insurance

- A key feature of the current deal environment, particularly on exits by PE houses but increasingly on corporate sales
- Typical European policies will provide cover from 10% – 40% of the enterprise value with a premium of between 1.2% and 1.8% of the sum insured (i.e., coverage amount)
- Insurers will require a deductible. Historically 1% of EV, but 0.5% increasingly becoming the norm
- Insurers sometimes prepared to provide cover even where the seller’s liability is negligible

Specific Issues – Employees

- European countries do not have employment at will
- Typically, employees can only be dismissed if there is a justifiable economic or legal reason (e.g., breach of contract)
- Union and collective bargaining arrangements will be important to consider
- Some jurisdictions (e.g., France) have onerous employee consultation requirements that apply in an M&A context
- European asset deals will ordinarily be subject to the ‘TUPE’ rules (i.e., automatic transfer)
- Data privacy adds particular complexity

Specific Issues – Tax and Restrictive Covenants

- Tax
  - Many jurisdictions have stamp or other transfer tax payable upon the transfers of shares. These taxes can also sometime apply to the transfers of other assets (notably property) and are usually the responsibility of the buyer
  - Check how money can efficiently be repatriated
  - Typically the seller will provide a tax indemnity for unforeseen taxes of the target that relates to the pre-closing period
- Restrictive Covenants
  - A buyer will normally expect a seller to give certain restrictive covenants (e.g., non-competition, non-solicitation and no-hire)
  - Different European jurisdictions have different rules regarding the scope of such restrictions, in particular length

Execution/Closing

- Check local execution formalities (e.g., whether a notary is required)
- ‘Virtual’ execution can be problematic in some jurisdictions
- Consider payment flows required at closing. Moving money cross-border requires prior planning (e.g., bank AML/KYC checks and time zone issues)
- If payment is to be made in a local currency, then consider exchange rate implications
- Payment issues will likely be more complex if third-party finance is involved
- If multiple jurisdictions are involved, depending on deal structure, consider whether a separate closing should take place for non-material jurisdictions
- Closing an asset deal is likely to involve greater local formalities
- Ensure local advice is taken, in particular when lien releases are involved

Post-Closing

- Consider applicable local corporate filing requirements
  - Changes to the directors and officers
  - Change of ownership
  - Change of name
- Requirements of company name changes, signage, letterhead, etc.
- Requirements for changes to the directors and officers (e.g., check if there is a residency requirement)
- Payment of transfer taxes (if applicable)

Questions?

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Thank you!

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