Differences Between English And US M&A Risk Allocation

Law360, New York (March 06, 2014, 3:38 PM ET) -- As the mergers and acquisitions markets in Asia continue to mature, U.S. and European multinationals involved in such markets are more frequently experiencing the clash in approaches to M&A risk allocation that Asia-based lawyers and financial advisers have seen for some time.

As a general matter, stock sale and purchase agreements negotiated by English-trained lawyers under English or Hong Kong law tend to place greater risk on purchasers than is typical in sale and purchase agreements between U.S.-based parties negotiated by U.S.-trained lawyers. While these differences can give rise to some lively negotiations, they make depth and diversity of experience in cross-border M&A all the more important for deal makers and their advisers.

Due Diligence and the Data Room

Most U.S. buyers in privately negotiated acquisitions view due diligence as a process purely for the benefit of the buyer, to assist the buyer in gaining familiarity with the target business, assessing risks, effectively negotiating definitive documentation and arriving at an appropriate target valuation. Due diligence and the contents of the data room (be it physical or virtual) are not intended to qualify representations and warranties of the seller or provide the seller with a defense for a breach of representation and warranty.

Historically, the approach in English law-governed transactions or deals between European-based parties has been quite different: Sellers often insist that their liability for breach of "warranty"[1] be limited to the extent the matter was disclosed or "fairly disclosed" in the data room. These days, to ensure that all parties agree on what was disclosed, a CD-ROM containing the full contents of the data room generally is initialed by the parties and attached as part of the sale and purchase agreement or other definitive documentation.

"Fair" Disclosure. The meaning of "disclosed" or "fairly disclosed" for this purpose often is heavily negotiated. For example, a matter may be treated as being "fairly disclosed" and capable of limiting the seller's liability under the warranties only to the extent that "information has been provided in sufficient detail to enable the purchaser, [having regard to its skills and experience in similar transactions and the advice of its financial and legal advisers,] to identify and make a reasonably informed assessment of the nature and scope of the fact, matter or circumstance so disclosed."

To the extent matters are "fairly disclosed" therein, the data room will operate as a supplement to the specific disclosures and exceptions contained in the disclosure letter delivered to the buyer contemporaneously with the sale and purchase agreement.

Additional Warranty Limitations. It also is not uncommon in English and European M&A for the warranties of the seller to be limited by additional matters, which would be very unusual in a typical sale and purchase agreement in the United States.

For example, it is common for the warranties to be given subject to matters contained in the financial statements and other public filings or public records of the target. Furthermore, in sell-side auctions, where it is reasonably common in Europe for the seller's accounting and other advisers to prepare "vendor due diligence reports," which are shown to buyers, warranties are often qualified as to matters "fairly disclosed" in the vendor due diligence reports.

Although not as common, some English law transaction documents also qualify warranties by matters "reasonably apparent from a physical inspection of the properties of the target," thereby forcing the buyer to actively and carefully inspect the target properties.

While matters disclosed in public filings with the U.S. Securities and Exchange Commission (including filed financial statements) are reasonably common qualifications in U.S. sale and purchase agreements, such other qualifications are extremely rare in the U.S. M&A context. Additionally, for both liability reasons and the fact that most U.S.-based purchasers would place very little weight on a due diligence report prepared by a seller's advisers, vendor due diligence reports are uncommon in the United States.

Bring-Down and MAC Conditions

English Law. In public acquisitions in the U.K., Hong Kong, Singapore and many other English common law-based jurisdictions, a bidder's financial adviser (or other financing sources) is required to provide a statement in the public documents, including in the initial transaction announcement, confirming the availability of the cash funds required to complete the transaction.

The cash confirmations generally are not permitted to be conditioned on substantive matters, including that no material adverse change occurs in the target business prior to closing. For all practical purposes, the cash confirmation serves as an unconditional assurance that the bid will not fail because of withdrawal or unavailability of financing. If a financial adviser acts irresponsibly in providing a cash confirmation, it can be subject to regulatory censure and potentially be required to provide the funding itself.

While the cash confirmation process is applicable only in the public acquisition context, in privately negotiated acquisitions under English law, perhaps as a result of the unconditional cash confirmation practice in public transactions, a material adverse change (MAC) condition is less common than in transactions between U.S. parties.

Furthermore, European sellers often will take the view that, so long as they operate the applicable target's business in the ordinary course between signing and closing, the risk of changes in the business that are beyond the seller's reasonable control should fall squarely on the buyer — and should not allow the buyer to terminate the agreement and refuse to close.

While not always successful, it is common for English lawyers to argue strenuously that the warranties should not be brought down at closing, and that the buyer should rely solely on the warranties as of signing and the preclosing covenants.

U.S. Law. The U.S. experience is very different. While financing conditions are not common, in public transactions, MAC conditions (at least for nonmacroeconomic, market-based or industrywide events) are common and generally will track the MAC condition in the related financing commitments as closely as possible. Accordingly, if the financing sources terminate their commitments because of a material adverse change in the business, the purchaser will be able to terminate the agreement without liability.

U.S. purchasers and their legal counsel in privately negotiated acquisitions invariably expect a bring-down certificate repeating the representations and warranties at closing (in addition to preclosing covenants). In some transactions, the seller even is required

to provide representations and warranties at the time of signing "as of signing and as of closing," though in such cases, the seller often will successfully argue for the ability to update the disclosure schedules for matters occurring between signing and closing.

Such updates will have the effect of qualifying the seller's representations and warranties for post-closing liability purposes, though will be disregarded for purposes of the buyer's "bring-down" condition and so its termination rights.

Post-Closing Recovery and Indemnification

U.S. Approach. U.S.-based purchasers in private M&A transactions almost always insist on indemnification by sellers for breaches of representation and warranty. Indemnification generally covers all losses, damages, costs and expenses (including legal and investigatory costs) arising from a breach of representation and warranty and, in some cases, covenants under the sale and purchase agreement.

Various limitations may be negotiated to the right to indemnification (including caps, baskets and survival periods) and, in some cases, the ability to recover indirect losses may be limited or excluded, and obligations to mitigate may be imposed. However, the usual approach is for a general indemnification provision to be included.

English Approach. In a typical English law-governed sale and purchase agreement, indemnification for breach of warranty (or provision for payment of damages "on a full indemnification basis") is less common. More often, sellers insist that purchasers rely on their rights to sue for breach of warranty under a contract damages claim.

The right to damages under contract law (whether English, Hong Kong or New York law) generally will not give rise to the same level of recovery as a typical, broadly drafted indemnification provision. This is because contract damages will be subject to common law limitations, such as a requirement for foreseeability of losses, the breach being the proximate cause of the loss, and a duty to mitigate losses.

Even where there is no right to indemnification, caps, baskets and warranty claims periods will still generally be negotiated to limit the breach of warranty claim. In many English law-governed share sale and purchase agreements, indemnification rights often are included only for specific known matters (such as losses from a known litigation or liability) and for unpaid taxes relating to the preclosing period.

Furthermore, in a typical English law-governed sale and purchase agreement, seller's counsel often insist on an "anti-sandbagging" provision (i.e., an express bar to recovery for breach of warranty to the extent that the buyer had actual knowledge of the circumstances giving rise to the breach of warranty at the time of signing of the sale and purchase agreement). This approach finds some support in certain judicial statements in English case law.

However, to most U.S. buyers, such a provision is unacceptable. The idea that the seller should be excused from compensating the purchaser for a breach of a representation and warranty (including a failure to disclose matters in the disclosure schedule) because the buyer exercised due diligence and discovered facts that, while known to the buyer, may not have been taken into account in the agreed valuation, is seen as unfair in the U.S. M&A context. More common to U.S. purchasers is an express statement that the representations and warranties are not limited in any way by the investigation or knowledge of the purchaser.

While the foregoing examples are, to some extent, generalizations, and deal documents will of course differ depending on the negotiating power and circumstances of the parties, clients involved in negotiated cross-border M&A transactions should be mindful that counterparties (and their legal counsel and financial advisers) may have very different views on acceptable approaches to risk allocation.

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[1] Under English law, a representation is a precontractual statement of fact on which the recipient was intended, and entitled, to rely and which induced it to enter into a contract. A false representation may give rise to a claim in tort with a remedy of rescission, under which the contract can be canceled and the parties restored to their original positions. A warranty, however, is a contractual promise, which if breached, gives rise to a claim for damages designed to put the innocent party into the position in which it would have been had the warranty been true. Most sellers under English law share purchase agreements will intentionally refrain from using the term "representation" to limit the buyer's ability to bring tortious, rather than contractual, claims, in particular, to rescind the contract. New York law generally does not recognize such a distinction and, in any event, most New York law-governed sale and purchase agreements will expressly exclude tortious remedies.

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