
Cross-border M&A: Comparing U.K. and U.S. Private M&A Transactions

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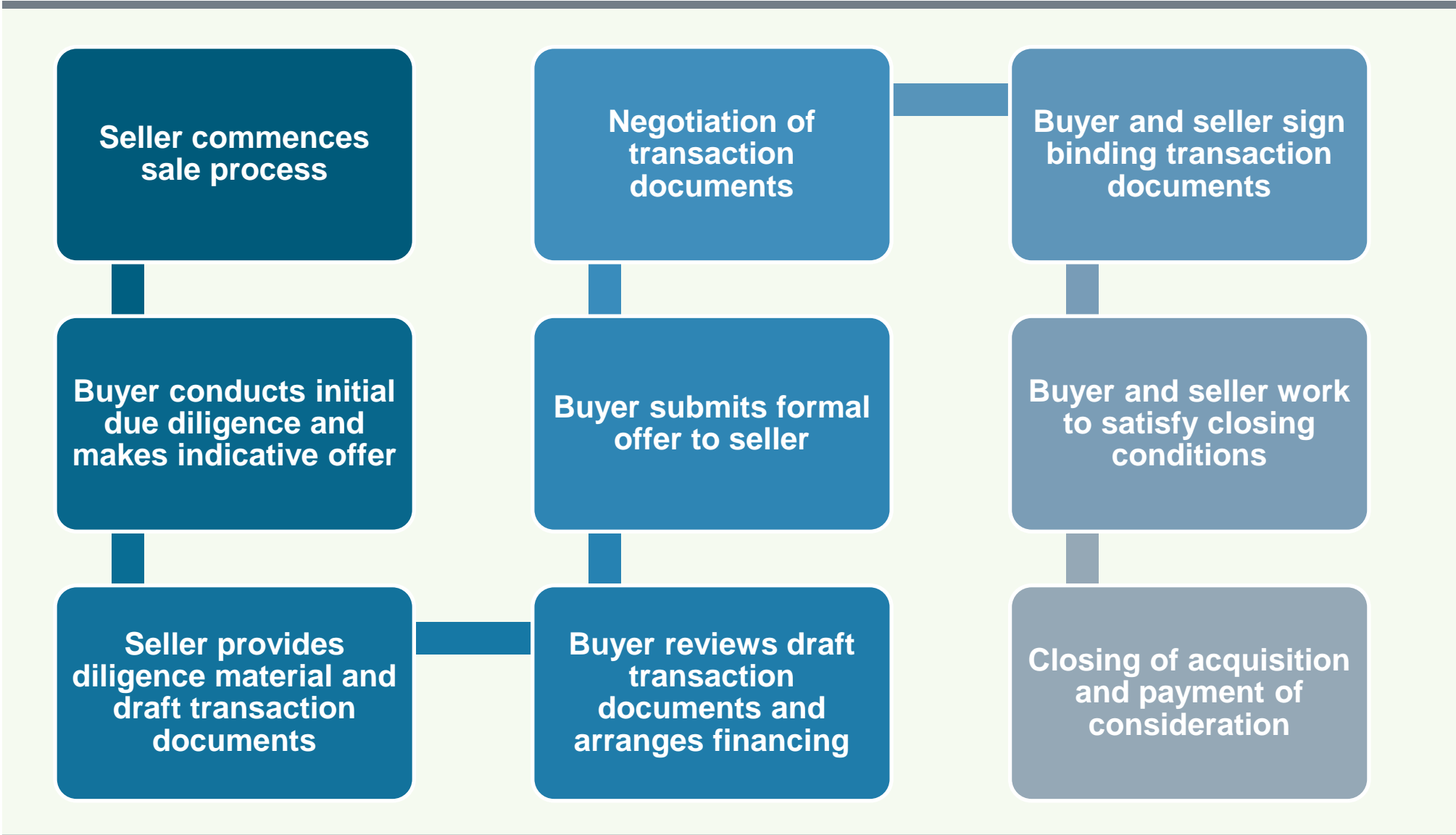


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Topics for discussion

- Sales process, diligence and key transaction documents
- Conditionality and deal certainty
- Pricing mechanisms, including closing accounts and the use of the locked box mechanism
- Recourse against a seller and limiting a seller's liability, including the use of rep and warranty insurance
- Post-closing covenants

A typical sales process?



Key transaction documents

■ Preliminary documents

- Letter of Intent
- Bid Process Letter
- Confidentiality Agreement

■ Vendor due diligence

- VDD Reports
- Release and Reliance Letters

■ Principal transaction documents

- Purchase Agreement
- Warranty Deed
- Rep and Warranty Insurance
- Disclosure Letter

■ Ancillary transaction documents

- Escrow Agreement
- Transitional Services Agreement
- Management Employment / Incentive Arrangements
- Shareholder Agreement
- Corporate Authorizations
- Director Resignations
- Powers of Attorney
- Deed of Termination (for Shareholder Agreement)

■ Debt and equity financing documents

General observations on deal terms and structures

- Difficult for anyone to make claim as to “normal” market practice for international transactions – deal terms continue to converge on U.S. vs. U.K./European market norms
- No discernible material changes in market norms over last 12 months – Softening of seller-friendly terms? More diligence? More broken processes?
- Key drivers?
 - Bilateral negotiation vs. auction process
 - Depends on parties involved – financial sponsor as seller/buyer, U.S. listed corporate as buyer, U.K. listed corporate as buyer
- Broader range of private M&A transactions
 - Pre-IPO sale, controlled auctions, carve-outs, reversing into listed companies
 - Driven by financial sponsors looking at alternative exit routes, availability of finance, ability of seller to run a competitive process

Conditionality and termination rights

- Fundamental difference between U.K. and U.S. practice
- Typical conditions?
 - Financing (cf. practice of U.K. certain funds)
 - Legality/regulatory/anti-trust
 - Shareholder consent
 - Accuracy of warranties
 - Compliance with pre-closing covenants
 - MAC
 - Deal specific conditions (key contracts, employees)
- Condition vs. termination right
- Break/termination fees

Pricing mechanism – closing accounts vs. locked box

| | Purchase Price Adjustment <i>(based on closing accounts)</i> | Locked Box Mechanism <i>(based on historical accounts)</i> |
|-------------------------|---|--|
| Rationale | <ul style="list-style-type: none"> Price agreed on basis of actual position at closing | <ul style="list-style-type: none"> Certainty of price at closing Avoids complexity, cost and delay associated with closing accounts |
| Features | <ul style="list-style-type: none"> Estimate closing payment Revised accounts prepared post-completion Agreed price adjusted | <ul style="list-style-type: none"> Fixed price, based on historical accounts Purchaser may pay interest on price since reference date No leakage undertaking, often backed by indemnity from seller |
| Potential Issues | <ul style="list-style-type: none"> Agreeing adjustments (if any) Party preparing revised accounts has advantage Credit risk on payment of adjustments (if no escrow) | <ul style="list-style-type: none"> Agreeing permitted leakage Reliance on historical accounts Warranties on locked box accounts |

Recourse against a seller – warranties and indemnities

- Fundamental difference between U.K. and U.S. practice
- Remember the U.K. legal niceties
 - Difference between representations and warranties
 - Difference between warranty claim and indemnity claim
- Common categorisation of warranties
 - Fundamental (title, capacity)
 - Business
 - Tax
- Tax covenant/indemnity
- Other specific indemnities
 - Environmental matters
 - Litigation

Limiting a seller's liability

- Scope of limitations
- Financial thresholds
 - Cap
 - De minimis
 - Basket
- Time limits
- Disclosure
 - General
 - Specific
- Awareness
- Boxing

| Limitation | U.K. market norm? <i>(illustrative and outside of hot auction)</i> | U.S. market norm? <i>(illustrative and outside of hot auction)</i> |
|--|--|--|
| <i>Scope of limitations</i> | <ul style="list-style-type: none"> ■ All claims other than fundamental warranties and specific indemnities | <ul style="list-style-type: none"> ■ All claims other than fundamental warranties and specific indemnities |
| <i>Cap – aggregate liability</i> | <ul style="list-style-type: none"> ■ 100% price | <ul style="list-style-type: none"> ■ None |
| <i>Cap – liability for warranties</i> | <ul style="list-style-type: none"> ■ 100% price for fundamental warranties ■ Up to 25% price for business warranties | <ul style="list-style-type: none"> ■ 100% price for fundamental warranties ■ 5% to 15% price for business warranties |
| <i>De minimis and basket</i> | <ul style="list-style-type: none"> ■ Up to 0.1% de minimis ■ 1% to 2% basket | <ul style="list-style-type: none"> ■ \$25,000 to \$100,000 de minimis ■ 0.5% to 1.5% basket |
| <i>Time limit – warranty claims</i> | <ul style="list-style-type: none"> ■ 12 to 24 months | <ul style="list-style-type: none"> ■ 12 to 18 months |
| <i>Time limit – tax covenant / specific indemnities</i> | <ul style="list-style-type: none"> ■ 6 or 7 years | <ul style="list-style-type: none"> ■ 6 years |

Rep and warranty insurance – two types of policy

| | Buy-side policy | Sell-side policy |
|--------------------------------|---|---|
| <i>Rationale</i> | <ul style="list-style-type: none"> ▪ Seller unable or unwilling to provide recourse for buyer ▪ Buyer concerned about credit worthiness of seller | <ul style="list-style-type: none"> ▪ Seller wants to back to back risk of a claim |
| <i>Features</i> | <ul style="list-style-type: none"> ▪ Buyer policy covers loss arising from a matter which would be a breach of warranty ▪ Buyer may claim against management/escrow up to warranty cap and simultaneously claim under policy for any excess | <ul style="list-style-type: none"> ▪ If buyer makes a claim, seller will turn to the policy for cover ▪ Seller remains liable to buyer, but insurer will become involved in claims process |
| <i>Potential Issues</i> | <ul style="list-style-type: none"> ▪ Consistency between SPA and policy ▪ Ensure claim against management/escrow treated as deductible under policy ▪ Double up on claims | <ul style="list-style-type: none"> ▪ Scope of SPA and policy coverage should match ▪ Insurer requires excess under policy (kicks in after de minimis and basket under SPA) ▪ Control of claims process |

Rep and warranty insurance – current trends

- Transaction insurance very common, particularly in the U.K.
- Buy-side policies, but process initiated by sell-side
- Choice of insurers, competitive pricing, flexible policies
- Recent trends?
 - Pricing terms and speed of cover still improving
 - Standard package – 1% deductible, 10% business warranties, 100% title warranties
 - Ability to cover tax covenant
 - Common exclusions
 - Zero recourse deals
- Developing history of claims

Post-closing covenants – protecting the buyer's interests

- More limited protection in U.K./Europe than in U.S.
- Standard set of post-closing covenants
 - Non-compete
 - Non-solicitation of customers/suppliers
 - Non-solicitation of employees
- Consider enforceability
 - Scope of activities covered
 - Duration of restriction
 - Relevant territory
- Exceptions to post-closing covenants
- Post-closing information rights and co-operation

Questions and further information

To read *Private M&A* please visit
gtdt.link/pma-a

To find out more about our M&A practice
davispolk.com/practices/corporate/mergers-and-acquisitions/

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