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COMPARING PRIVATE M&A TRANSACTIONS IN THE U.K. AND U.S.

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INTRODUCTION

Cross-border M&A transactions in the U.K. and U.S. remained prevalent in 2021 and into early 2022 despite the economic uncertainty that exists in today's markets. Many involved in those transactions were forced to confront a simple but important question: which laws and practices should regulate the transaction? The answer to this question has important implications for those involved in future transactions.

From a seller's perspective, an English law-styled and governed share purchase agreement is often preferred as it generally results in the sellers facing less potential exposure. By contrast, a U.S.-styled agreement gives buyers stronger recourse should things go wrong. The ultimate choice often depends on the negotiation strength of the parties, the jurisdiction in which the target is located and the method by which the transaction is being conducted.

In this article, we will look at some of the main differences between custom and practice in U.K. and U.S. M&A transactions.

PRICE ADJUSTMENT STRUCTURES

Two price adjustment structures are typically used in private M&A transactions – closing accounts/working capital adjustments and locked box accounts.

Closing Accounts/Working Capital Adjustments

Under this structure, a set of financial accounts for the target company is prepared post-closing and calculated as of the closing date. An adjustment is then made to the purchase price based on the net assets or working capital position of the target at the closing date (based on a comparison of the actual net assets or working capital to the negotiated estimate or target amount). While this type of price adjustment structure is common in the U.K., it is much more prevalent in the U.S. In U.S. deals, sellers are often required to place a portion of the purchase price in escrow as security for payment of any post-closing price adjustment, something which is relatively uncommon in U.K. transactions.

Locked Box Accounts

In the U.K., many deals – especially in auction scenarios or where there is a private equity (financial sponsor) seller – adopt a locked box accounts structure. Under this structure, the target company is sold at a price calculated by reference to financial statements made up to a date prior to closing known as the *locked box date*. The economic risk in the business passes to the buyer with effect from that date. This means that the buyer bears the risk and is entitled to the benefit of the profits and cash flows from that date. Interest in the form of a 'profit ticker' is often added to the purchase price to compensate the seller for profits accruing between the locked box date and closing date.

To ensure that no value (which belongs to the buyer) leaks out of the target to the sellers between the locked box date and closing, the share purchase agreement usually includes an express prohibition on the return of value to the sellers, including the payment of dividends, bonuses, etc. There is normally some negotiation around this and certain 'permitted leakage' is agreed (such as employment remuneration, director fees and monitoring fees). The prohibition on leakage is typically backed up by a pound-for-pound indemnity.

Locked box mechanisms largely favour the seller as they assist the seller in comparing competing bids, give the seller control over the preparation of the locked box accounts and give the seller more control over the price by avoiding the risk of the downward price adjustments associated with closing accounts. That said, locked box deals might not always be the right approach for the seller, especially where revenues and profits are improving or where there is a lack of robustness associated with the locked box accounts. They also might not work for buyers concerned about the future financial performance of the target – as we saw frequently during the COVID-19 pandemic.

While locked box pricing structures are not a common feature in the U.S. market, partly due to the concern that sellers may be leaving cash on the table, their use is growing. That growth has been spurred in part by the practice of bridging the earnings before interest, taxes, depreciation and amortization (EBITDA)-driven headline price to the equity price at closing, and the use of profit tickers, each of which helps alleviate seller concerns. However, buyer concerns around future prospects may continue to temper that growth.

EXECUTION RISK

In both the U.K. and U.S., closing can be made subject to a number of conditions including regulatory, shareholder and third-party approvals. However, apart from these conditions, U.K. deals don't generally give the buyer a right to pull out of a deal. This contrasts with U.S. deals where the buyer often has several means by which it can get out of a deal.

Financing Conditions

While a seller in the U.K. will generally satisfy itself as to a buyer's financial ability to close a share purchase transaction, closings in the U.K. are rarely subject to any form of financing conditions. The buyer is typically obliged to close on an agreed closing date and failure to do so will give the seller a right to terminate the contract and claim for either a breach of contract or an agreed termination fee.

In the U.S. it is common for buyers to provide sellers with debt financing commitment letters, with conditions to drawdown being very similar to the conditions to closing set out in the share purchase agreement. In tandem with doing that, the buyer usually represents to the seller that it will draw down the financing, will not do anything to terminate or jeopardise the financing, and will not alter its terms without seller consent. This gives the seller more certainty that the buyer will be able to close the transaction in due course.

In several recent U.K. deals, we have seen financing conditions creep in on both the buy side and sell side. The readiness of some of the larger U.K. firms to accept these financing conditions on the buy side – as well as proposing them on the sell side – is perhaps indicative of a changing trend in the U.K. market.

Repetition (Bring-Down) of Warranties

Where there is a gap between signing the purchase agreement and closing, it is common in the U.K. to repeat only fundamental warranties (warranties as to title, capacity and insolvency) at closing. Instead of relying on repeated non-fundamental warranties at closing, the buyer relies on covenants given by the sellers to conduct the business of the target on specific terms between signing and closing.

This position contrasts with U.S. deals where buyers expect warranties to be repeated (or brought-down) in full at closing and to have a right to walk away from the deal if there has been a material adverse change or breach of warranties between signing and closing.

Material Adverse Change

Material adverse change (MAC) clauses are much less common in U.K. share purchase agreements compared to those in the U.S. Where they are included, the threshold at which a MAC is deemed to arise is usually set quite high and can often be difficult to establish. Once triggered, a MAC clause usually gives the buyer the right to terminate the share purchase agreement and walk away from the deal.

WARRANTIES, REPRESENTATIONS AND DISCLOSURES

It is common under both U.S. and U.K. share purchase agreements for the sellers to give warranties to the buyer in respect of the target company. These are statements of fact which, if they turn out to be untrue, entitle the buyer to claim compensatory damages in order to be put back in the position it would have been in had the warranties been true, subject to, among other things, contractual rules of foreseeability and remoteness, and any negotiated limitations.

The scope of the warranties given by the sellers is relatively similar on both sides of the Atlantic, and the language of the warranties is often heavily negotiated.

In the U.K., where the seller is a financial sponsor, it will customarily only give fundamental warranties. This contrasts with the position in the U.S. where financial sponsors normally provide a full set of warranties on the basis that their liability is capped at either a portion of the purchase price (usually placed in escrow) or the proceeds of a warranty insurance policy.

Risk allocation under the warranties tends to favour the buyer more in U.S. share purchase agreements compared to U.K. agreements where buyers often find it difficult to successfully bring warranty claims.

Distinction Between Warranties and Representations

In the U.S. there is no discernible legal difference between warranties and representations. In the U.K. the difference matters as both have different legal meanings. Breach of a warranty only entitles the buyer to contractual damages equal to the loss suffered. By contrast, a breach of a representation also entitles the buyer to make a non-contractual claim for misrepresentation and to seek remedies such as the right to rescind the contract. For this reason, it is almost universally the case that sellers under U.K. share purchase agreements provide warranties only and not representations.

Distinction Between Warranties and Indemnities

In the U.K. the difference between warranties and indemnities is that the buyer is normally able to recover all losses covered by an indemnity, as the contractual principles of remoteness and foreseeability applicable to warranties do not apply. Moreover, while warranties are qualified by disclosures, indemnities are usually not. As such, if a relevant liability crystallises, the buyer is entitled to be made whole irrespective of disclosures, knowledge, remoteness, etc.

Contrary to the position in the U.K., in the U.S. warranties are typically given on a basis where a breach of warranties is covered by indemnity. Having a breach of warranty backed up by an indemnity in this manner makes it easier for the buyer to recover when something goes wrong.

Where specific risks are identified in the target, it is common for a buyer under U.K. share purchase agreements to obtain specific indemnity cover for that risk rather than simply relying on warranty cover. Specific indemnities are common in the U.S. as well, as a promise to indemnify even in the absence of a breach of a representation or warranty.

Warranty Packages

Warranty packages are generally extensive in both jurisdictions, although in the U.S. warranties are often given subject to materiality. While materiality is accepted to a certain extent in the U.K., normal practice is to rely on the de minimis liability thresholds applicable to warranty claims as setting the bar for what is material or not in the context of warranties. These thresholds are set out in the purchase agreement.

Disclosures

In the U.K. warranties are qualified by general disclosures (usually matters of public record, such as filings in the Land Registry or Companies House), and specific disclosures set out in a disclosure letter, which accompanies the share purchase agreement. While warranties under U.S. share purchase agreements are qualified by specific disclosures (set out in a disclosure schedule to the share purchase agreement, rather than in an accompanying letter), they are not usually qualified by general disclosures.

For a disclosure to be effective in qualifying warranties in the U.K., it needs to be fairly disclosed with sufficient detail to enable a buyer to understand the nature and scope of the matter being disclosed. In the U.S., general disclosures (if accepted by the buyer) can appropriately qualify a representation and warranty under a purchase agreement. Once the seller lists an item on a schedule, it is disclosed to the buyer. However, in practice sellers often include as much information as possible on disclosure schedules. While general disclosures are acceptable, recent U.S. case law suggests that the disclosure should be reasonably apparent from the text of the disclosure schedules and it should not be so vague as to be meaningless. Many times, U.S. purchase agreements contain provisions expressly setting forth these interpretation standards.

In U.K. transactions, particularly in auction sales, it has become much more common in recent years for the contents of data rooms as a whole to be deemed disclosed against warranties. The net effect is that liabilities which can be reasonably or fairly identified in the data room are deemed disclosed against the warranties. This practice is less common in the U.S., where the norm remains to make specific and individual disclosures against warranties in the disclosure schedules.

Where disclosures are made under U.K. transactions, it is common for the disclosures to qualify all warranties. By contrast, and while the practice is increasingly being adopted in the U.K., disclosures under U.S. share purchase agreements tend to qualify only those warranties to which their relevance is "readily" or "reasonably" apparent. It is common for the parties to expressly state this standard in the purchase agreement or disclosure schedules.

Buyer's Knowledge

Ordinarily, a buyer under a U.K. share purchase agreement will not generally be able to claim in respect of a breach of warranty where it was aware of the matter giving rise to the breach of warranty prior to the warranty being given. To get around this, buyers typically require indemnities for known liabilities or seek to reduce the purchase price to compensate.

Under U.S. share purchase agreements, buyers are often restricted from claiming for a breach of warranty in respect of matters it was aware of prior to signing (known as 'anti-sandbagging'). However, it's also somewhat common for buyers and sellers to agree that the buyer can bring a claim even where it was aware of the matter giving rise to the claim before signing (known as 'pro-sandbagging') provided of course the matter was not disclosed in the disclosure schedule (although this position has been decreasing in popularity in recent years). Absent having a pro-sandbagging clause, state laws often preclude the buyer from bringing claims for breach of warranty that it was aware of prior to signing or closing.

Damages

Damages for breach of warranty under U.K.-governed share purchase agreements are assessed by the English courts and typically reflect any diminution in the value of the buyer's shares as a result of the breach. Losses are often also only recoverable to the extent they were reasonably foreseeable when the parties signed the share purchase agreement. As warranties are typically given on an indemnity basis under U.S. share purchase agreements, recovery is usually on a dollar-for-dollar basis for any loss suffered by the buyer.

In each case, the amount of damages recoverable may be subject to limitations of liability imposed under the share purchase agreement or law.

Tax indemnity

In addition to having tax warranties under U.K.-governed share purchase agreements, it is normal to have a standalone tax indemnity that enables the buyer to recover the amount of any pre-closing tax liabilities from the seller on a pound-for-pound basis. Similarly, in the U.S., standalone tax indemnities for pre-closing tax liabilities are common.

Mitigation of Loss

In both jurisdictions, the buyer has a common law obligation to mitigate losses deriving from breaches of warranties. In the U.K. no such duty exists in relation to breach of indemnities, although this is sometimes contractually agreed. In the U.S. it is common for the purchase agreement to contain a duty to mitigate damages.

LIMITATION OF A SELLER'S LIABILITY

Financial Limitations

In the U.K. and U.S., liability caps and the exclusion of de minimis claims are commonplace. In both jurisdictions, liability for fundamental warranties is normally fixed at the consideration paid, while liability for general warranty and indemnity claims (including, in the U.K., tax claims) is subject to an overall cap of between 10% and 100% of the consideration, depending on the size of the deal, the bargaining powers of the parties, and the risk profile of the target. Generally, the greater the value of the deal, the lower the percentage liability threshold.

In the U.K. liability for financial sponsor sellers is typically capped at consideration for fundamental warranties, with no liability for non-fundamental warranties. Liability for management sellers who are remaining on as part of a private equity buyout is often limited to amounts recoverable under warranty and indemnity insurance.

Liability can be further regulated in both jurisdictions by limiting the warranty and indemnity claims the buyer can take by reference to the value of such claims. For example, in the U.K. buyers will often be precluded from making warranty claims with a value of less than circa 0.1% of the consideration. In the U.S., including such a feature is less common but not rare, and this amount is often simply a fixed amount (often between, e.g., US$25,000 and US$100,000). Claims that fall below the stated thresholds are generally referred to as *de minimis claims*.

Even where the de minimis claim threshold is surpassed, a buyer will often be precluded from taking a claim unless the amount of all non-de minimis claims exceeds a basket amount. This basket amount is generally between 1% and 2% of the consideration in U.K.-governed share purchase agreements, and 0.5% and 1% of the consideration in U.S. agreements.

Once the basket amount is surpassed, the buyer under a U.K.-governed agreement will ordinarily be entitled to claim for all non-de minimis claims, and not simply the amount by which such claims exceed the basket amount. This feature is typically referred to as a tipping basket. In U.S. agreements, tipping baskets are common as well as “deductibles” where the buyer is only entitled to recover the amount of any excess above the basket amount and not the amount below.

Time Limits

Under U.K. share purchase agreements, a buyer will usually have a period of 12 to 24 months to enforce a general warranty claim, 12 to 36 months for a specific indemnity claim, and 48 to 84 months to enforce a tax claim. In auction situations, those time periods can often be reduced to as low as 12 months across the board. The position in the U.S. is similar to that in the U.K., with the buyer ordinarily being entitled to make claims between 12 to 36 months post-closing, but longer for statutory-based warranties such as tax, employee benefits and environmental, as well as fundamental warranties.

General Limitations

In the U.K., there is a range of general limitations that affect the buyer’s ability to claim under the warranties. In particular, the buyer will be precluded from claiming loss for liabilities to the extent (a) disclosed in the annual accounts or management accounts, (b) such losses have been recovered by the buyer from insurance companies or third parties, or (c) they result from changes to the law or actions of the buyer post-closing. These types of general limitations are less common in the U.S., but can be addressed in the purchase agreement though disclosure exceptions or indemnification provisions.

Warranty and Indemnity (W&I) Insurance

The use of W&I insurance (or representation and warranty insurance, as it's called in the U.S.) is a growing feature of M&A transactions in both the U.K. and U.S. The increased use of such insurance reflects the desire of sellers, especially financial sponsors, to exit an investment without the risk of further warranty or indemnity claims.

While the insurance products are similar in both jurisdictions, there are some differences:

- Coverage under U.S. policies tends to be greater in the U.S. than in the U.K., especially given the ability to recover for breach of warranty on an indemnity basis under U.S. purchase agreements.
- Policy exclusions in both jurisdictions typically include known tax liabilities, transfer pricing risk, underfunded pension liabilities and forward-looking statements.
- U.K. policies typically attract premiums of 1% to 2% of the insured amount, compared to 2% to 4% in the U.S., subject to a minimum premium amount.
- Deductibles also tend to be higher under U.S. policies.

SELLER COVENANTS

Sellers are usually required to provide post-closing covenants including noncompete, nonsolicitation of customers, suppliers and employees, and confidentiality. These covenants are typically between 12 to 36 months in duration in the U.K. In the U.S., noncompete provisions are generally between 12 to 60 months depending on the nature of the transaction and the governing state law, and the nonsolicitation provisions often extend to 60 months as well. In the U.K. financial sponsors will generally not give these covenants (apart from confidentiality).

CONCLUSION

The determination as to the choice of law will often depend on the negotiation positions of the parties. However, it is fair to say that if you are selling a business, whether in the U.K. or U.S., an English-governed share purchase agreement encompassing the related market practice will favour sellers. If you are a buyer, a U.S.-styled agreement will give you greater certainty and protection from risk.

For more information on buying or selling companies, please contact Steven Foristal (St. Louis office).