LEWIS SILKIN

UK M&A: A Guide for US Buyers'

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An introduction for US-based buyers

We continue to see a lot of mid-market M&A activity in the UK driven by US-based buyers, including both corporate buyers and financial investors. Unsurprisingly, a lot of that activity is focused on sectors such as technology, creative and high-value manufacturing businesses.

Whilst the M&A process and deal practice in the US and UK have many similarities, there are some important differences which a US-based buyer should take into account at an early stage in any transaction. We sometimes see US-based clients fighting an uphill battle in relation to deal terms on UK deals when they have omitted to negotiate what they regard as market-standard terms in the letter of intent on the assumption that what is usual in the US is also standard in the UK.

Every deal will clearly have its own dynamics, and in particular will depend on whether the transaction follows a formal auction process which will typically result in more seller-friendly terms. Nonetheless, it's possible to draw out some common differences in deal practice.

- **Split signing and completion**: UK practice is more heavily weighted towards simultaneous signing and closing. A UK seller is unlikely to agree to a split deal structure unless an interval is absolutely necessary for regulatory reasons such competition law/anti-trust approvals or other regulatory consents, or perhaps if there is a very significant customer whose consent is required. A UK seller will expect any buyer to have financing in place at signing.
- **Conditions to completion**: where this is a split structure, the conditions to completion are likely to be more limited in a UK SPA than in a typical US SPA, giving less room for a buyer to get out of the deal after signing. For example, if the interval between signing and completion is at the buyer's insistence or results from circumstances relating to the buyer, the seller may not be prepared to repeat or "bring down" the full set of commercial warranties as a condition to completion. Business risk between signing and completion may therefore fall on the buyer to a greater extent than may be usual in the US. Similarly, covenants restricting the seller's conduct of the business during that period may be looser in the UK than in the US, whilst UK MAC clauses are usually more tightly drafted so as to limit any get-out for a buyer.
- **Completion accounts versus locked box**: although completion accounts remain very common on UK deals, locked box mechanisms are more common in the UK than in the US especially where the transaction results from an auction process. The perceived wisdom is that completion accounts are more seller-favourable than locked box deals, although buyers also sometimes prefer locked box deals because it reduces the likelihood of post-closing disputes arising. Locked box deals are likely to require more exhaustive financial and tax due diligence because of the absence of a post-completion true-up.
- **Basis of warranties**: the warranties are typically given in US deal practice on an indemnity basis, with the extent of the loss which is recoverable governed by detailed provisions in the SPA.UK deal practice is invariably for the warranties to be given on a common law contractual basis, with the amount of any loss which the buyer may recover being based on the diminution in value of the shares or assets purchased as a result of the breach of warranty. That will typically result in a more seller-friendly position, both in terms of the quantum the buyer may recover and also in greater difficulty for a buyer in quantifying loss in any settlement negotiations. The exceptions to this general rule in the UK are tax matters and also any specific indemnities in respect of issues identified in due diligence, which are closer to the US approach to indemnification.
- **Caps on liability**: the other side of the coin here is that overall caps on claims may well be more generous to buyers in the UK. It's usual for the overall cap on claims in mid-market deals to be somewhere between 50% and 100% of deal value, and therefore higher than the cap in similarly-sized US deals. A reduced cap can be a valuable

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bargaining chip for US buyers to offer UK sellers in return for concessions on other deal points. De minimis and deductible/tipping baskets are broadly similar in UK and US deals.

- **Escrow accounts**: escrow accounts are fairly common on UK deals, but not to the same extent as on US deals and therefore should be agreed in the letter of intent to avoid difficult discussions later in the process. There is no direct linkage in UK practice between caps on claims and the amount held in escrow. It's worth remembering that UK law firms are no longer permitted to hold escrow accounts, so any escrow funds will have to be held by third-party agents who will charge for their services.
- **Disclosure**: the concept of disclosure being made to qualify the warranties, and therefore protect sellers, is very similar in the UK and the US.UK practice, especially on auction deals, is more likely to permit general disclosure of data rooms and vendor due diligence reports.
- **Buyer's knowledge**: whether a buyer may bring a warranty claim despite being aware of the underlying issue (a "pro-sandbagging clause" in US terminology) depends from state to state in the US. Under English law, there is considerable uncertainty regarding the efficacy of a pro-sandbagging clause as the caselaw is not settled. However, even if an English court would uphold a pro-sandbagging clause in principle it seems likely that any damages a buyer would recover would be significantly reduced (perhaps even down to a nominal amount) to reflect the fact that there has been no real loss of bargain.

Lewis Silkin regularly works with US financial and corporate buyers on M&A deals across a wide range of sectors on UK domestic and cross-border transactions. We'd be delighted to discuss any questions you may have regarding UK deal practice at an early stage in any discussions you may be having in relation to possible UK acquisitions.

Read the next in the series:

- Risk allocation as between the parties and conditions to closing.
- Pricing mechanisms, including the use of locked box structures as an alternative to closing accounts.
- The scope of warranties and the legal basis of warranties and indemnification.
- Disclosure and buyer's knowledge (anti-sandbagging) provisions.
- Common issues - a round-up of other deal points, including anti-trust and national security clearances, restrictive covenants, funds flow closing opinions and the execution of documents.

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Risk Allocation

In our second article in the US/UK M&A series, we explore deal certainty, the different appetite for risk and measures that are used to apportion risk between the parties.

Choice of English law

There is a widely held perception that UK style and English law governed M&A transactions are broadly seller friendly, while US style and governed M&A transactions are more buyer friendly. Although there is some truth in this, in practice this is generally driven by the negotiating strength of the parties and different market practice rather than the choice of governing law.

In practice, UK sellers are often unwilling to expose themselves to an unfamiliar US judicial system which is perceived to be more litigious than the UK and where the costs associated with fighting any claim are likely to be higher. US buyers should be aware that, as with most US states, English law is based primarily on common law, developed by judges sitting in courts, and creates binding precedent for future cases. Choosing English law to govern an M&A transaction provides an element of certainty for the parties as it provides access to the English courts and that large body of judicial precedent as well as the consistency and fairness of the English courts. In terms of negotiating the document, the use of English law as opposed to the law of Delaware or New York (for example) is unlikely to have any significant impact on the terms save perhaps in relation to the duration of non-compete covenants and potentially around the buyer's ability to bring claims post-closing even when it was aware of the underlying issue where English law may be less favourable to buyers.

Conditionality and risk allocation

In a UK style M&A transaction there is usually greater certainty; market practice favours simultaneous signing and completion of the SPA perhaps to a greater extent than is the case in the US. Generally, UK style M&A transactions are subject to a very limited range of closing conditions; these are usually limited to obtaining necessary regulatory or anti-trust approvals, any other regulatory clearances and consents that are necessary and obtaining shareholder approval for the transaction itself (if required). Conditions which are solely for the buyer's benefit – such as financing conditions – are not usually accepted. In addition, reverse termination or reverse break-up fees are quite rare.

In the UK, if there is an interval between signing and closing to accommodate the buyer, a UK seller may be less willing than a US seller to accept a "no material adverse change" condition or any other condition which requires the full set of commercial warranties to be accurate at completion or any financing condition. Where MAC clauses are agreed to, UK convention is for these to be tightly drafted and keenly negotiated to limit any get out for the buyer as much as possible; the opposite is arguably true in the US, where the clauses are broader and drafted for the buyer's benefit. In addition, UK deals often rely heavily on covenants that require the target business to be operated on a normal and consistent basis in the period up to completion.

Because conditions are used in a limited way in UK style transactions, there is generally less room for a buyer to manoeuvre to get out of the deal after the SPA has been signed, so there is more certainty for the parties involved in the transaction. UK practice also means that business risk between signing and closing falls on the buyer more heavily than in a US style M&A transaction.

In contrast, in the US, a gap between signing and completion is more common. Market practice regards this as time for the buyer on leveraged deals to put its acquisition finance in place, and US buyers are familiar with the ability to walk away from a transaction in this interim period in the event of a material adverse change. The obligation of the buyer to consummate the transaction in a US style transaction is customarily subject to numerous closing conditions

including: (i) receipt of necessary competition/anti-trust conditions; (ii) receipt of other necessary regulatory approvals; (iii) confirmation that the warranties and representations remain accurate; (iv) compliance with all relevant covenants as at closing (subject to a materiality standard); (v) that no material adverse change has occurred with respect to the target company; and (vi) sometimes a finance condition. These provisions are weighted heavily in favour of the buyer; its ability to walk away from the transaction after signing the transaction documents and before closing mean that there is less certainty for the parties involved in the transaction.

Specifically, in relation to financing, UK sellers (especially in auction situations) usually require a buyer to proceed on a "certain funds" basis. This concept is familiar to the UK market as it is driven by the public M&A regime; in practice it means that the buyer must be able to demonstrate the availability of financing before the transaction documents are signed (rather than rely on a finance condition contained within the SPA). In some cases, especially if the buyer's home jurisdiction imposes capital controls on the flow of its funds out of the jurisdiction, a buyer may be required to deposit, or put a percentage of, the purchase price in an escrow account at signing of the SPA. These funds act as security for the transaction proceeding and usually structured such that the buyer would forfeit them if they failed to complete the transaction.

Warranty and Indemnity insurance ("W&I") is increasingly common in both UK and US transactions – it is advisable to consider whether it is appropriate early in the transaction process, and if so, what level of coverage is required. Coverage in the US is often more comprehensive, with fewer general exclusions and the ability to recover for breach of warranty on an indemnity basis, meaning that policies there are often significantly more expensive than the UK W&I policies.

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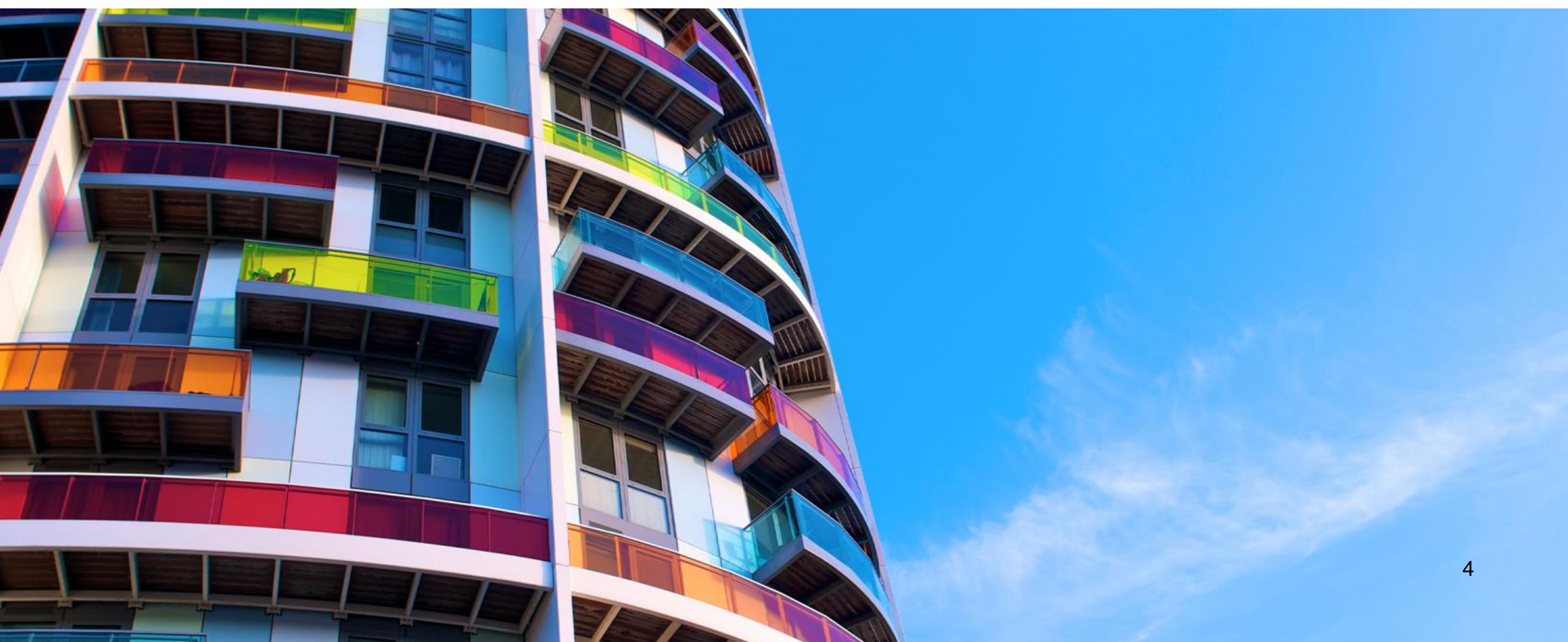

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Price Adjustment Mechanisms - The Locked Box

Price adjustment mechanisms are common in both UK and US style M&A transaction documents to determine the final price that the buyer pays. However, the manner in which the price adjustment is achieved varies. In the US, a closing accounts mechanism is generally used, and although these have remain common in the UK, in recent years we have seen increasing use of “locked box” mechanisms in UK style share purchase agreements governed by English law.

In this article we will examine what’s different in the locked box mechanism and identify some of the key concepts that buyers should understand.

How do traditional price adjustments work?

Traditionally, a share purchase agreement (**SPA**) provides for the purchase price to be varied by reference to some metric, most often the working capital and net debt of the target as at completion. Following completion, the buyer and its accountants draw up a set of closing accounts which are used to calculate the working capital and net debt, with a pound for pound (or dollar for dollar) adjustment to the purchase price to the extent that the actual numbers are different to the target numbers agreed by the parties prior to signing the SPA. Under this mechanism the extent of any price adjustment will not be known until sometime after completion when the closing accounts have been finalised in accordance with detailed provisions set out in the SPA. The approach means that economic risk passes to the buyer at completion and is designed to ensure that the buyer only pays for the actual level of assets and liabilities of the target that the seller delivers on completion.

What is the locked box mechanism?

A locked box mechanism is an alternative pricing mechanism to completion accounts. The main objective of the “locked box” mechanism to provide certainty on the price at the point at which the SPA is signed.

The mechanism is often used in auction situations because it offers the advantage of price certainty for the seller in that it eliminates the requirement for a post-completion price adjustments and so reduces the time and resources that are often dedicated to a more lengthy closing accounts process. In turn, the potential for disputes in relation to the preparation of closing accounts is also eliminated because the locked box accounts are agreed by the parties before the SPA is signed. Agreeing which accounts to use and understanding how they are prepared is therefore crucial for a buyer. The mechanism also allows for as clean a break as possible and affords sellers with the ability to distribute the full proceeds of sale without any requirement for a retention to cover post-completion adjustments. These features, particularly the certainty of price, mean that the mechanism has become increasingly widespread in ‘plain vanilla’ M&A transactions in the UK.

How does the locked box work?

Under the locked box mechanism, the purchase price is established by the parties by reference to a set of agreed historic accounts or a historic balance sheet (this may be the last set of audited financial statements, but sometimes a set of accounts prepared specifically for the purpose) – these are referred to as the “**locked box accounts**” or “**locked box balance sheet**”. These locked box accounts fix the equity price in respect of the cash, debt and working capital actually present at the date of the locked box accounts; this is the equity price that is written into the SPA, and it is not adjusted further following completion.

From the date of the locked box accounts ("**locked box date**") the target company is considered to be run for the benefit of the buyer, and no value (or "**leakage**") is allowed to leave the business – the box is therefore 'locked'. This is a key feature of the 'locked box' mechanism; economic risk in the target passes to the buyer at the locked box date (as opposed to at completion – as with closing accounts).

The term "leakage" is used to refer to any extraction of value from the target by the seller. Any such leakage would mean (if unadjusted), the buyer receiving less value than they have paid for. The SPA will usually contain protection in the form of a 'no leakage' pound-for-pound indemnity. This indemnity protects the buyer during the period from the locked box date to completion from cash and assets being transferred (or 'leaked') from the target company to the sellers or for their benefit.

In practice the seller confirms, by giving warranties in the SPA, that there has been no leakage from the business in the period from the locked box date up to the date on which the SPA is signed. Then, following signing of the SPA, the seller provides covenants that there will be no leakage (other than "**permitted leakage**") in the period down to completion, and usually also agrees to some form of restriction in its conduct of the business down to completion (for example, requiring consent of the buyer before agreeing large long-term contracts, purchasing large fixed assets etc). The SPA will also contain detailed definitions of both leakage and permitted leakage. These terms are a key area of negotiation as they constitute the buyer's principal protection against the seller stripping value from the target and provide the contractual basis on which the seller will be able to make ordinary course payments (the permitted leakage) between the locked box date and completion.

The final element of the locked box mechanism is how to deal with movements in value in the balance sheet due to trading between the date of the locked box accounts (i.e. the moment that the buyer is treated as becoming the owner) and the date of completion (i.e. the date on which the acquisition price is paid to the seller). The seller may still be managing the business to generate profit during this period and is likely to have capital tied up in the business until completion; consequently, sellers often expect to be compensated for this by an upward adjustment to the consideration – this is often referred to as the 'value accrual'.

In practice the cash flow generated by the company in the period between the locked box date and completion is often taken as the basis for determining the 'value accrual'. An alternative approach is an interest-based value accrual applied to the equity value using an agreed rate of return to the seller for the period up to the completion date; this is sometimes referred to as the "ticking fee". The rationale for this is that the buyer otherwise has benefit of the profit for the period without having the cost of servicing the acquisition costs.

What are the key issues for buyers?

The accounts: the locked box accounts must accurately reflect the configuration and resulting working capital and debt of the business in the form in which the target will be delivered to the buyer. Ideally the target should be stand-alone in terms of having separate accounting records – the locked box approach is more complex if this is not the case. From the buyer's perspective, audited accounts will provide it with some further comfort that a third party (the auditor) has reviewed and given an opinion on the quality of those accounts, and as noted above, appropriate warranties will also be negotiated and included in the SPA.

Locked box date: the date of the locked box accounts should not be too close to the completion date – this will allow the seller to prepare for it, and the buyer to fully review the locked box accounts before the SPA is signed. Equally, for the buyer, it is advisable that the locked box accounts are not too historic, as this increases the risk to the buyer of leakage having occurred and the risk of actual profits differing significantly from the value accrual. Ideally there should be few (if any) transactions as possible between the target and the seller group after the date of the locked box accounts.

Financial due diligence: the buyer will need to conduct additional financial due diligence on the locked box accounts to ensure that it and its advisers are comfortable about the basis of their preparation and accuracy. The extent and importance of this due diligence exercise should not be underestimated by the buyer as there is little room for

negotiation once the SPA has been signed. In addition, the buyer is likely to want comfort on the ring fencing and accuracy of recording of profits, losses and capture of cash in the period from the locked box date to closing.

Extent of contractual protections: as noted above, the buyer is reliant on contractual protection in the SPA during the period from the locked box date down to closing; accordingly, the extent of the covenants and warranties as well as the definitions of leakage and permitted leakage are important areas for negotiation.

Typically, leakage is defined to cover any transfer of value from the target to the seller (or its connected parties) between the locked box date and completion. This may include items such as: dividends and distributions; returns of capital; transaction expenses; payments to directors; deal related bonuses and other non-ordinary course intra-group payments. Permitted leakage will depend on the nature of the target business, but usually includes: intra-group payments in the ordinary course of business and on arms' length terms; identified items agreed between the parties and factored into the purchase price (e.g. dividend strip/monitoring fee); payments provided for in the locked box accounts (and therefore priced); and payment of salaries in the ordinary course of business.

The level of undertakings from the seller in relation to the conduct of the business in the period from the locked box date down to completion are also an important element of the buyer's protection; the buyer and its advisers should ensure that a comprehensive package of undertakings and covenants are included in the SPA.

Summary

The key differences between completion accounts and the locked box mechanism.

Completion Accounts	Locked Box
Price determined based on the completion accounts.	Price based on agreed locked box accounts as of the locked box date (in essence by adding cash and deducting debt and similar items in those accounts from the headline price to result in the equity price).
Economic interest passes to the buyer at completion.	Economic interest passes to the buyer on the locked box date.
Cashflow generated prior to completion can usually be distributed to the seller and any closing cash is factored into the completion accounts and price adjustment.	Cashflow generated after locked box date cannot be distributed to the seller and is solely for the benefit of the target business and ultimately the buyer.
Adjustments at completion based on estimated balance sheet at the completion date, with a true-up post completion based on the actual closing balance sheet and a dispute resolution mechanism.	No adjustment at completion other than for 'leakage', and sometimes an adjustment for a 'ticking fee' on the purchase price to provide some value to the seller for foregoing the right to cashflow from the locked box date until completion.

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The pros and cons of the 'locked box'

For:	Against:
• Certainty; the equity price is fixed	• May result in a value shift in favour of the buyer if the target's performance improved between the locked box date and completion, or conversely to the seller if the business underperforms during the period
• Increased control over the process for seller	• Difficult on carve out transactions where the target has no stand-alone accounts, and risk of leakage may be greater
• Simplifies and expedites negotiations on transaction economics	• Locked box accounts need to be robustly prepared to enable the buyer to price the deal and ring fence/protect assets to completion
• Ensures as clean a break as possible (avoids expense and time associated with the completion accounts process and the potential for associated disputes)	• Greater reliance on financial due diligence of the target before the SPA is signed. Not recommended in situations where the buyer is unable to conduct extensive due diligence
• Clean exit for sellers, especially attractive to PE sellers and also in auction situations	• Buyer protection is limited to leakage provisions and warranties, as no post-completion verification/price adjustment
• Ensures as clean a break as possible (avoids expense and time associated with the completion accounts process and the potential for associated disputes)	• Need to debate items such as debt and working capital earlier; potentially with less knowledge
• Streamlines 'plain vanilla' deals where there is no room for significant leakage	

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US/UK M&A: Warranties

In this article we examine the different approaches to giving warranties in US and UK share purchase agreements (SPA) including the terms and scope of the warranties, who gives them, the basis of recovery under the warranties, the basis of the sellers' liability and other protections available to buyers.

What are warranties?

Warranties are a common feature of share purchase agreements on both sides of the Atlantic. The warranties are statements of fact in respect of the target company or business which, if untrue, will give the buyer the right to claim for loss. However, the risk allocation under the warranties differs; a US style SPA tends to favour the buyer, whereas a UK style SPA tends to favour the seller.

Does the scope of the warranties vary between the US and UK?

US style SPAs typically contain extensive representations and warranties from the seller; sometimes these include a broad (and sometimes unqualified) warranty as to the absence of undisclosed liabilities; this is less common in UK style SPAs where, although the warranties are broad, they are not usually as detailed or extensive as those in US style SPAs.

Do all sellers give the same warranties?

Customarily in the US each seller provides the same 'business' representations and warranties and the same 'fundamental' representations and warranties with respect to its title (or ownership) of the target shares and its ability to complete the SPA. A similar approach is common in the UK, unless the seller is a private equity or venture capital fund where it has become customary for such sellers to give only the 'fundamental' warranties and for the business warranties to be given by the management team of the target and therefore to be liable for breaches of warranty post-completion. This also has an impact on the transaction documentation, in a trade sale the fundamental and business warranties are set out in the SPA, but where the seller is a private equity or venture capital fund the fundamental warranties are usually set out in the SPA and the business warranties may be set out in separate management warranty deed between the target management and the buyer.

Representations - what difference does one word make?

It is also customary for US style SPAs to include language that the "Seller represents and warrants that…"; this language does not affect the remedies available to the buyer for any breach of the warranties – generally both are given on an indemnity basis, with no right of recission arising from breach.

However, in the UK the choice of language matters; using the word "represents" is heavily resisted by sellers – and this usually succeeds. Deleting the word "represents" is considered to minimise the risk of the buyer being able to bring a tortious claim (i.e. non-contractual claim) for damages for misrepresentation under the Misrepresentation Act 1967, and so it removes the possibility that the buyer will attempt to rescind the SPA under the provisions of that Act. In a UK style SPA, a well-advised seller will also seek to exclude the remedies for tortious claims and recission by including an express provision in the SPA to that effect; rather than arguing that those rights are excluded because the warranty statements are characterised only as "warranties" and not "warranties and representations".

It is also worth noting that the measure of damages under English differs for contractual and tortious claims. The contractual measure of damages for breach of warranty in an M&A context equates to the difference between the actual value of the target being purchased and its value had the warranty been true; the aim is to put the buyer in the

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position as if the contract had been performed. This contrasts with the position in tort, where damages aim to put the buyer in the position that it would have been in had the tort not been committed, and the damages are the difference between the price paid for the target shares and the actual value of the target.

Is the basis of recovery under the warranties the same in the US and UK?

A key difference between US and UK style SPAs is the basis for recovering any loss for a breach of warranty. In the UK, as noted above, the buyer's ability to recover will depend on how the breach of warranty has affected the overall value of the target company's shares, potentially including loss of profits. Therefore, it may be more difficult for a buyer recover all its costs in the event of a breach of warranty. In the UK there is also likely to be a duty on the buyer to mitigate (or minimise) its loss. Any indemnity cover in a UK style SPA will generally be for specific categories of claims or known liabilities such as tax, material litigation or known environmental issues, it is unusual for the warranties to be given on an indemnity basis. This contrasts with the position in the US, where customarily the buyer is indemnified for breach of warranties, meaning that the buyer can recover its losses for breach of warranty on a dollar-for-dollar basis.

Is the sellers' liability limited?

Both UK and US style SPAs include detailed limitations on the sellers' liability for breach of warranty. UK deals often feature a higher overall cap than the US. In the US, liability for warranty claims is often capped at 100% of the purchase price for a breach of 'fundamental' warranty (those relating to title and capacity) and between 10% and 20% of the purchase price for a breach of the other business warranties. The approach in the UK has traditionally been more generous to the buyer and for this cap to be set between 50% and 100% of the consideration, with 100% common on smaller transactions. It is also common practice to include a 'basket'; this is the level of damages that must be reached before the buyer is able to bring a claim for breach of warranty. The 'basket' may be a deductible basket where only a claim for the amount exceeding the level of the basket can be brought; or more commonly it may be a 'tipping basket' where once the threshold has been reached, the full amount of the claim can be brought. UK SPAs also typically include a 'de minimis' or 'mini basket' level; any claims below this level will be disregarded and will not count towards the basket.

Recourse for warranty claims:

Warranty and indemnity insurance ("**W&I**") (or representation and warranty insurance in the US) has become increasingly popular in both the UK and the US, primarily driven by private equity houses looking for as clean a break as possible on exit. W&I insurance provides cover for losses discovered post-completion and aims to provide cover for any liability arising from a breach of warranty or liability under the tax covenant (or both) in each case where the matter giving rise to the claim has not been fairly disclosed or was not known to the insured. Both buy side and sell side policies are available; although buy side policies are the most common and means that the buyer can sue the insurer directly. In the US W&I cover is often more comprehensive with fewer general exclusions and usually provides the ability to recover for breach of any warranty on an indemnity basis – this also means that US W&I cover is more expensive than UK policies (although this will depend on the risk profile and specifics of the transaction). The precise nature of the exclusions in a W&I policy will also depend on the transaction, but it is relatively common in both markets for policies to exclude matters including unfunded pension liabilities, forward-looking statements, and non-financial relief. Historically, policies have typically excluded known tax liabilities; however, in the UK tax liability insurance may now be available – this is a relatively new product.

Finally, it is worth noting that it in the US it remains common for a portion of the consideration to deposited into an escrow account; arguably, this provides better protection for a buyer, as it has a source of accessible funds if there is a breach of warranty which are not subject to the exclusions imposed under W&I policies. Administratively an escrow is also an easier process to manage as the buyer must only seek release of funds from the escrow agent rather than bring a claim under a W&I insurance policy where the buyer's recoverable loss is likely to be less than the actual loss. Escrow accounts are not uncommon in UK transactions, but they are not used as frequently as the US, and as such it is advisable to agree them at the outset of the transaction in the letter of intent. Additionally, in the UK escrow

accounts are most commonly used to address specific risks that have been identified, this contrasts with the position in the US where escrows/retentions are commonly used as a source to fund warranty claims.

What are the key issues for US buyers?

Scope of the warranties: extensive warranties will be included in both UK and US style SPAs (although they may be more extensive and detailed in US style SPAs). It is also unusual in the UK style SPA to find a warranty that none of the representations, warranties and disclosures contain any untrue or misleading statements and do not omit any material fact; in the UK a well-advised seller would consider such a warranty to too broad and subjective.

Risk allocation: risk allocation under the warranties tends to be more seller friendly under a UK-style SPA. For example, where the seller is a financial seller there is a tendency for fundamental warranties to be given by the seller.

Basis of recovery for breach of warranty differs: In the US warranties are given on an indemnity basis, this is unusual in the UK. In a UK SPA warranties usually protect against the unknown and indemnities allocate risk in respect of a known liability such as tax.

Escrow/retention: are not used as routinely as in the US; where they are used in UK style SPAs the seller's potential liability will often extend beyond the escrow terms and amount.

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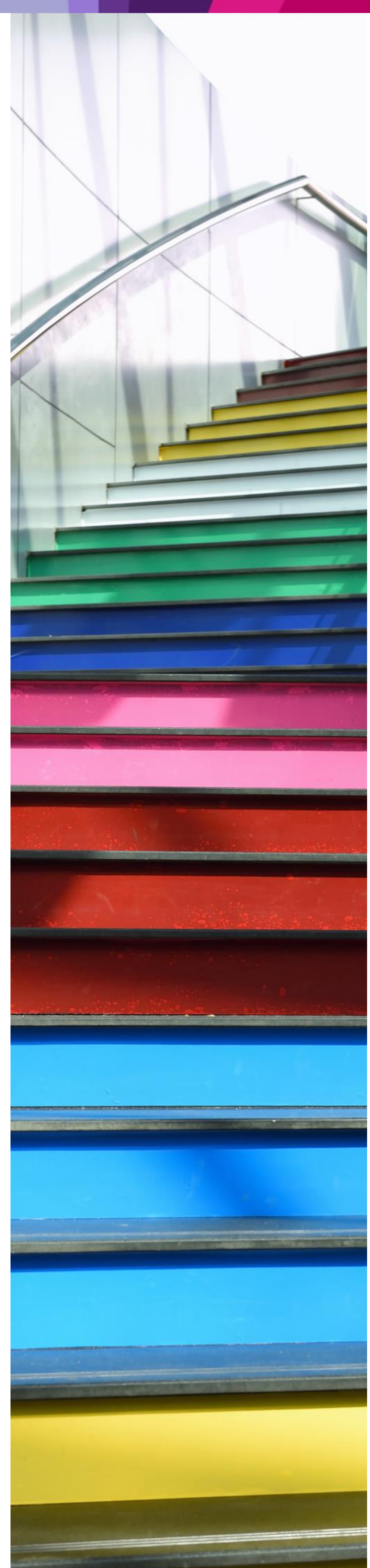

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Disclosure

The disclosure exercise against the warranties contained in the share purchase agreement (SPA) is a common element of an M&A transaction on both sides of the Atlantic Ocean. In this article we will identify some of the different approaches taken in relation to disclosure in the UK and the US.

Specific and general disclosures

In both the UK and the US it is common for the warranties in the SPA to be qualified. In the UK this is done through disclosures set out in a separate disclosure letter, and in the US by disclosures set out in the disclosure schedules to the SPA itself. In the US, the disclosures are usually specific, and it is unusual for a disclosure to be general and qualify all the warranties – generally this is allowed only where the disclosure has clear relevance to another warranty. General disclosures of the contents of all (or portions of) the data room are often resisted.

This contrasts with the position in the UK where statements and information disclosed in the separate disclosure letter serve as exceptions to the applicable warranties. The disclosure letter customarily includes a series of general disclosures. This is usually information that is available in public registers; these general disclosures qualify all of the warranties in the SPA. In addition, it is also common practice for general disclosure of information and documents which were provided to the buyer during the due diligence exercise to be allowed – this is usually done by general disclosure of the contents of the data room. In addition, the disclosure letter is accompanied by a separate disclosure bundle – this is a large collection of documents (which, as noted, may extend to the entire contents of the data room); the entire contents of the disclosure bundle are deemed disclosed against all of the warranties. It is worth noting that in addition to the general disclosures contained in the disclosure letter, specific disclosures against individual warranties in the SPA are also allowed.

Buyer's knowledge/pro-sandbagging

It is common in US style SPAs for there to be a negotiation around 'pro sandbagging' and 'anti sandbagging' provisions. A 'pro sandbagging' clause allows the buyer to bring a claim for a breach of warranty in the SPA notwithstanding that they buyer had prior knowledge of that breach, and it is not uncommon in the US to see such provisions in the SPA, to avoid inadvertently bringing items in the data room into the disclosure schedule through the 'back door'. An 'anti sandbagging' clause prevents the buyer from bringing a claim if it knew about a matter before signing or completion. Sometimes a US style SPA is silent on this, and the issue will then be governed by the relevant state law regarding breach of contract claims. In many US states, the absence of a 'pro sandbagging' clause would mean that a buyer would find it difficult to bring a successful claim for a breach of warranty of which it was aware before signing or completion.

In the UK, clauses relating to the buyer's knowledge ('anti sandbagging' clauses) are often negotiated and are effective; these provisions are often negotiated alongside the issue of data room disclosure. A well-advised seller will usually seek to restrict a buyer's ability to claim for a breach of warranty where the buyer is aware of and has knowledge (whether actual or implied) of the matter resulting in the breach. These provisions typically limit the group of people who are deemed to have knowledge to the buyer's key deal team (the buyer will seek to limit this group and to exclude being attributed with the knowledge of its outside advisers). In addition, UK style SPAs may include a statement that anything contained in the data room is deemed to be known by the buyer. As a result, the parties usually also agree to a contractual standard of disclosure, and that to be effective disclosure must be 'fair'. There is a significant body of case law surrounding this, and it is widely understood that for disclosure to be 'fair' matters must be disclosed with sufficient detail to enable a buyer to identify the nature and scope of the matter so disclosed.

‘Pro sandbagging’ clauses are much less common in the UK, and there is uncertainty regarding their efficacy. English case law suggests that a party generally does not have a right to recover for a breach of warranty of the other party to the extent that the non-breaching party had knowledge of such breach prior to completion. In such cases, the buyer is deemed not to have relied on the accuracy of the warranty, or to have no or de minimis damages, and as such the buyer is presumed to have valued the shares on the basis of its knowledge that the warranty was untrue. Therefore, in the UK it is more common for a buyer to seek recourse for known material issues either by including a specific indemnity in the SPA or by seeking a reduction in the purchase price in respect of the relevant issue.

What are the key issues for US buyers?

Method of disclosure: the disclosures are set out in a separate disclosure letter, and accompanied by a disclosure bundle rather than in schedules to the SPA itself.

General disclosures: unlike the US, general disclosures against the warranties are common practice in the UK.

Buyer’s knowledge: in the UK the enforceability of pro-sandbagging clauses is debateable. It is more common to see anti sandbagging clauses, which are often negotiated alongside general disclosure of the contents of the data room and provisions which attribute the buyer’s knowledge to a specified group of people (usually they key deal team).

We recommend that you read this article alongside our other M&A US/UK articles on warranties and deal certainty.

Lewis Silkin regularly works with US financial and corporate buyers on M&A deals across a wide range of sectors on UK domestic and cross-border transactions. We’d be delighted to discuss any questions you may have regarding UK deal practice at an early stage in any discussions you may be having in relation to possible UK acquisitions.

Read the next in this series here.

LEWIS SILKIN

Miscellaneous/common issues

In our final instalment of our US/UK M&A series we will explore some of the common issues in the M&A process and deal practice in the US and UK.

Title warranties and covenants

Both US and UK SPAs often include a specific warranty relating to the ownership of the shares in the target. In the US, no title covenants are implied, and there is no concept of ‘full title guarantee’ in relation to the shares. In the US (and sometimes in the UK) it is also common for the SPA to contain a specific provision that the shares will be sold free and clear from any claims, liens and other encumbrances and that the seller has the full power and authority to do so. In addition, in the UK, shares are sold with either ‘full title guarantee’ or ‘limited title guarantee’. Full title guarantee is the most common and implies statutory covenants for title that the seller (i) has the right to sell the shares; (ii) will do all that it reasonably can to give the title they purport to sell (at their own cost) to the buyer; and (iii) sells the shares free from all charges, encumbrances and adverse rights other than any charges, encumbrances or adverse rights that the seller doesn’t know or could not reasonably be expected to know about.

Anti-trust and national security clearance

If merger or foreign investment controls are relevant to the transaction, they will need to be factored into the timetable at an early stage and appropriate provisions included in the share purchase agreement. The UK operates a voluntary notification regime for the purpose of anti-trust clearances – although notification to the regulator (the Competition and Markets Authority) is recommended if the relevant thresholds are met, this contrasts with the mandatory regime in the US once the relevant thresholds are met under the Hart-Scott-Rodino regime.

In addition, the UK has recently introduced the National Security and Investment Act 2021 (“**NSI Act**”). The new sets out a new, standalone regime enabling the UK Government to scrutinise and intervene in acquisitions and investments to protect national security in the UK. The regime applies to acquirers or investors from any country. Certain types of transactions in 17 key sectors are be subject to mandatory notification to a new Investment Security Unity within the Department of Business, Energy and Industrial Strategy. Failure to notify acquisitions that fall within the new regime could result in severe penalties including both civil and criminal sanctions, and if a notifiable transaction is completed without approval, it is void (of no legal effect).

The US regime under the Committee on Foreign Investment (“**CFIUS**”) contains a mandatory notification requirement where a foreign person ‘gains control’ over a US business; the definition of control is wide, so it potentially captures investments irrespective of the percentage of shares or voting interest being acquired. But, if the foreign person involved in the transaction is a national of Australia, Canada or the UK they are an ‘excepted investor’ and the mandatory filing is unnecessary. In addition, if there is a concern that a contemplated transaction may give rise to national security risks due to the nature of the business involved, the parties to the transaction often choose to notify CFIUS in advance to gain clearance in advance and obtain a ‘safe harbour’ letter.

Restrictive covenants

It is common practice in both the UK and the US for the SPA to contain restrictive covenants including non-compete, non-solicitation and no-hire. However, there is a difference in practice in terms of the duration of these covenants, in the UK, three years is generally considered the maximum period that the courts are likely to accept, and it is not unusual for shorter periods to be agreed. However, in the US, the non-compete covenant is often expressed to last for between three and five years, and occasionally even longer.

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Transfer taxes

In the UK, share purchase transactions trigger a transfer tax in the form of stamp duty, this is (subject to limited exceptions) payable by the buyer at the rate of 0.5% of the purchase price of the shares. This is accepted market practice, and it would be unusual for the buyer to negotiate for the seller to pay some (or all) of this transfer tax. This contrasts with the position in the US where most share (or stock) transfers do not trigger a transfer tax. However, if a transfer tax is triggered in the US, the parties to the transaction often negotiate whether the tax is payable by the seller, the buyer or is shared between them.

Signature of documents

In the UK, it may be necessary to sign certain of the documents as a deed. In the UK, documents can be signed as simple agreements or as deeds; deeds are a particular form of document which must follow strict signing formalities, which may include the necessity for the signature to be witnessed. In addition, the statutory limitation period for simple agreements is six years, whereas, for a deed this increases to 12 years. The US does not make this distinction in terms of signing formalities or the applicable limitation periods.

Closing opinions and certificates of good standing

In the US, it is common practice to obtain legal opinions at completion, confirming that the relevant party to the acquisition agreement is duly constituted and has capacity to enter into the transaction documents and that the transaction will be valid, binding and enforceable.

In addition, in the US it is also customary to obtain a certificate of good standing at completion. The contents of the certificate of good standing varies from state to state, and it usually confirms the legal name, existence and status of the company. In some states, the certificate of good standing also contains certain tax information, if this is not the case, it is usually possible to run tax searches.

In the UK it is not customary to provide a closing legal opinion, and similarly, certificates of good standing are not usually obtained. A certificate of good standing for a UK company does contain any tax information and it is not possible to conduct separate tax searches.

Funds flow

In the US, the use of paying agents to manage funds flow for completion of acquisitions is common practice. This is relatively unusual in the UK, and funds flow is usually handled between the legal advisers involved on the transaction – usually through their client accounts using undertakings. This practice in the UK means that the funds flow is often more straight forward than the US, as it removes the necessity for lender pay-off letters and setting up multiple electronic payment instructions.

Terminology

Finally, some of the terminology used in the UK and US differs, so we have listed below some common differences:

UK	USA
articles of association	bylaws
company	corporation
completion	closing
completion accounts	closing statements
deliver	furnish
disclosure letter	disclosure schedules
escrow	retention

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UK	USA
ordinary share	common stock
share	stock
shareholder	stockholder
warrant	representation and warranty

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For more information, get in touch with our team:

Geraint Tilsley
Partner

+44 (0)20 7074 8034
geraint.tilsley@lewissilkin.com

Sam Pennington
Partner

+44 (0)20 7074 8113
sam.pennington@lewissilkin.com

Find out more

twitter.com/lewissilkin

linkedin.com/company/lewis-silkin

lewissilkin.com