WINSTON & STRAWN LLP

CLIENT ALERT

M&A Across the Atlantic: What A United States Buyer Should Expect in the United Kingdom

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Introduction

In 2014, according to reports, M&A activity reached pre-crisis levels with more than $2.4 trillion of completed deals in the United States and Europe alone. Deal conditions in 2015 remain strong: both buyers and sellers have continued confidence in the economy, interest rates are at historic lows, and both strategic and private equity buyers have historically high levels of cash reserves and commitments. Reports indicate that US buyers, including private equity funds with no overseas offices, are actively looking outside the United States for new investments due to increasingly competitive conditions at home.

What should a buyer from the United States expect when it crosses the Atlantic to purchase a business in the United Kingdom? This briefing will explore some significant differences in market deal terms that a US buyer should be prepared to consider when it seeks to buy the stock of a private company in the United Kingdom, with additional focus on what to expect when the business is being sold by a UK private equity fund.[1]

Purchase Price Adjustments

Typically, in US private stock deals, the buyer buys the target on a “cash-free, debt-free” basis with an agreed-upon level of working capital and with the seller’s transaction expenses having been paid fully by the seller. These balance sheet amounts are often re-measured post-closing and can lead to later purchase price adjustments. In the United Kingdom, however, there is an increasing prevalence by sellers (particularly private equity or private equity-backed sellers) to use what is known as a “locked box” purchase price approach. Under this approach, an equity price will be calculated using an historic set of accounts in respect of which the buyer will have no ability to adjust after closing. The buyer will then rely on contractual protection to ensure that “leakage” from the “locked box” (basically no material cash or assets “out” and no material liabilities “in”) between the reference date of the historic accounts and completion (which is the closing in the United States). See the recent Winston & Strawn briefing, The Locked Box Mechanism, for further details.

Bring Down of the Warranties; No Material Adverse Change

In both the United Kingdom and the United States, it is not uncommon for warranties to be repeated or "brought down" at closing. However, unlike in the United States, sellers in the United Kingdom will seek to resist that principle if there is any gap between signing and closing or, as a fallback position, to argue for repetition of only those warranties over which they have direct control. In addition, it remains unusual in the United Kingdom for the accuracy of all warranties at closing to be a condition of closing in the way it is in the United States such that a buyer would have the right to terminate the deal as a result of a material breach of the warranties given at signing and, in some cases, repeated at closing. Similarly, while it would be more customary for there to be a "no material adverse change" closing condition (or "MAC out") in a US deal, this provision is less common in the United Kingdom and, if included, would generally be more narrowly drafted than in the United States.

The Warrantor Who Provides the Warranties

In a US 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 target company to provide "operational representations" with respect to the target company. If the sellers provide "operational representations," those representations would typically be provided by all sellers. In the United Kingdom, the operational warranties would normally be provided by the sellers except where a private equity fund is one of the sellers. A UK private equity fund seller typically would only be prepared to give limited "fundamental" warranties. Instead, any other owners who are not private equity fund sellers who are receiving, directly or indirectly, sale proceeds (for example, members of management) would likely give all of the "operational" warranties related to the target company and therefore be liable for any breaches of those warranties (and only for amounts not to exceed the portion of the sale proceeds paid to such warrantors which, in a deal with a private equity seller, is often only a small percentage of the overall proceeds to all sellers). Increasingly, buyers of businesses that are owned by private equity are using warranty and indemnity insurance to ensure that full "operational" warranties can be obtained with appropriate financial protection.

Indemnification

A key difference between US and UK deals relates to indemnification for breaches of representation and warranties. Damages for breach of warranty in a US deal are usually calculated on an indemnity basis against the full amount required to rectify the defect (subject to any applicable deductible), with no need to demonstrate a link between the breach and the value of the target company, though principles of remoteness, causation and (usually) mitigation will apply.

By contrast, most UK deals do not usually 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 issues.

Disclosure

Typical US 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 UK sale agreement will normally allow the seller to submit a disclosure letter against the warranties on signing. This letter will contain both general and specific disclosures. Although it is potentially risky for the buyer, the seller will sometimes 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 the concept of "fair disclosure" under English case law—where a buyer is only deemed to have known that an item in the data room served as an exception to a warranty if the information contained in the data room would enable a buyer to make reasonably informed assessments of the circumstances giving rise to a breach of warranty.

Tax

In the United States, tax liabilities and benefits are typically split between pre-closing tax liabilities and benefits, which are the sole responsibility or benefit of the seller, and post-closing tax liabilities and benefits, which are the responsibility or benefit of the buyer. Since most deals close during the fiscal year (rather than the last day of the fiscal year), the parties agree on the manner in which tax returns will be handled during the “straddle period” between the last fiscal year end and the closing date.

In the United Kingdom, it is not possible to agree with the UK tax authority on the manner in which the tax liabilities of a UK company will be handled as of the date of sale of that company, and tax liabilities and benefits typically “go” with the target—and therefore the buyer—unless the seller wants to try to retain group reliefs/the benefit of tax allowances. This fact is usually factored into the purchase price. As a result, a buyer would typically only obtain a specific pre-closing tax indemnity document in relation to tax which is out of the ordinary course of business, unknown or not provided for in the financial statements. Thus, the manner in which the parties approach pre-closing tax liabilities and benefits in the context of a UK deal will be partly dependent upon how the purchase price has been calculated.

Most US stock deals do not trigger a transfer tax, but in the event one is triggered, the parties often negotiate whether transfer taxes would be borne by the buyer or the seller or would be shared. A UK stock deal will trigger a transfer tax, in the form of a stamp duty, payable by the buyer in an amount equal to 0.5% of the purchase price, and it would not be customary to negotiate for any portion of that tax to be paid by the seller.

Restrictive Covenants

A US stock deal will generally have restrictive covenants, such as non-competition, non-solicitation and no-hire covenants, customarily lasting from one to five years (and sometimes even longer). UK purchase agreements will typically contain these types of restrictive covenants but with a shorter time period. Three years is generally considered to be the maximum time period that a UK court is likely to accept (and it would not be unusual for shorter periods to be agreed between the parties under the purchase contract), but each situation will be treated differently as there is no definitive time period provided in English law.

Conclusion

More US buyers are seeking deals in the United Kingdom due to the increasingly optimistic economic outlook across the Atlantic, higher prices at home and a favorable exchange rate. Although UK and US practice is aligned on some issues, significant differences do remain. Awareness of these issues is particularly important in the context of an auction process where commercial and time pressures may require a faster decision-making and negotiation process than would otherwise be the case. Also, with UK practice tending to result in more favorable contractual terms for a seller than a buyer in comparison with US practice, understanding the differences from the outset of a deal will inevitably assist a buyer to not only minimize risk but also act in a way that can be seen as being consistent with the local deal environment.

Summary of Key Differences

M&A DEAL TERM	MORE CUSTOMARY U.S. PRACTICE	MORE CUSTOMARY UK PRACTICE

M&A DEAL TERM	MORE CUSTOMARY U.S. PRACTICE	MORE CUSTOMARY UK PRACTICE
Purchase Price Adjustment	Post-closing working capital adjustment.	Working capital adjustment or "locked box."
Bring down of warranties/MAC	Warranties to be "brought down" at closing with a MAC closing condition in addition.	Less likely.
Warrantors and Warranties	Target company provides full "operational" warranties typically backed by the Sellers (directly as warrantors for those same warranties or indirectly through an indemnification for a breach of the target company's warranties).	Sellers provide all warranties, save that a private equity seller will usually refuse to give "operational warranties" (directly or indirectly).
Indemnification	Buyer usually able to recover full amount of loss suffered due to a breach of warranty (subject to any applicable deductible).	Damages are typically not calculated on an indemnity basis. Rather, buyer will have a breach of contract claim and must prove it has suffered a quantifiable loss (e.g. diminution in value of the shares it has acquired).
Disclosure	Disclosure must be specific, linked to particular warranties and set out in the disclosure schedule.	Disclosures must be "fair" and set out in the disclosure letter. General disclosures (e.g. of entire data room) may be permitted.
Restrictive covenants	Up to five years.	No more than three years.
Tax	Pre-closing tax liabilities are the responsibility of seller; post-closing tax liabilities are the responsibility of the target company (effectively buyer).	Pre-closing tax liabilities remain with the target company (effectively buyer). Usual practice is for the buyer to obtain a specific tax indemnity for unknown tax liabilities.

M&A DEAL TERM	MORE CUSTOMARY U.S. PRACTICE	MORE CUSTOMARY UK PRACTICE
Transfer Tax	Buyer and seller negotiate the handling of transfer taxes, if any.	Buyer pays transfer tax (0.5% of the purchase price).

1 - In the United Kingdom, unlike the United States, there is no concept of legal merger between two UK companies. The majority of private company acquisitions are therefore either done by way of acquisition of the shares of the target company or of the assets of the target company.

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