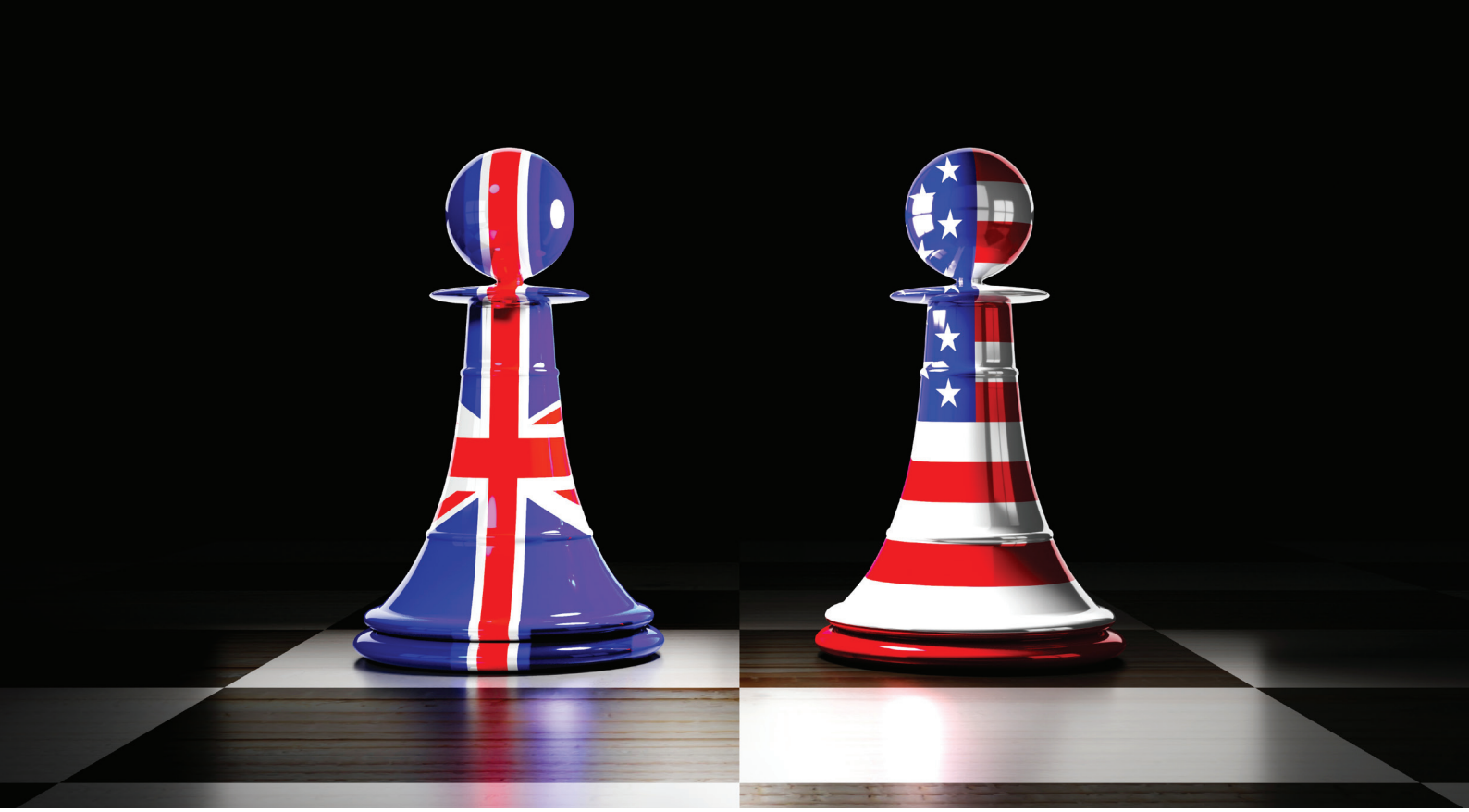

UK AND US M&A DOCUMENTATION
DIVIDED BY A COMMON LANGUAGE

Andrew Hart, Theo Jones, Lara Rush and Isabella Oughtred of BCLP explore the approaches to M&A transactions in the UK and the US by comparing key elements of the deal process and documents.

Despite a generally subdued mergers and acquisitions (M&A) landscape in the UK throughout 2023, inward M&A activity, that is, foreign entities acquiring UK companies, remained strong. According to data published by the UK's Office for National Statistics, this activity was worth £8.6 billion in Q4 2023, marking a 62% increase from the preceding quarter (*www.ons.gov.uk/businessindustryandtrade/changestobusiness/mergersandacquisitions/bulletins/mergersandacquisitionsinvolvingukcompanies/octobertodecember2023*).

The US specifically maintains one of the most substantial investment relationships with the UK on a global scale (*www.trade.gov/knowledge-product/united-kingdom-market-overview*). Due to the recent strength of the US dollar, coupled with what are perceived to be more conservative valuations of UK assets, the UK remains an attractive marketplace for US acquirers and investors.

However, a clear divide continues to exist between the approach of the UK and the US. In the US, buyers generally expect better protections from sellers, including more extensive conditions to completion, broader warranty coverage and a greater ability to walk away from a transaction if issues are detected or underlying market fundamentals change during the period between exchange and completion.

It is important to understand where practices between the two jurisdictions differ materially in order to give context to positions taken by the parties, which may otherwise be considered to be off-market. Otherwise, expectations around pricing, deal certainty and risk apportionment will be mismatched and negotiations may well become protracted. This article explores the approaches to M&A transactions in the UK and US by comparing key elements of the deal process and documents.

PRELIMINARY ARRANGEMENTS

Preliminary arrangements set the tone of an M&A transaction and, other than a few key divergences, the UK and US approaches are similar.

In both jurisdictions, the parties typically enter into a form of non-disclosure agreement (NDA) early in the transaction. In the UK, NDAs generally create restrictions on the use of disclosed information for a period of one to two years. A similar period applies to US NDAs, save that a distinction is made for trade secrets which, under US law, may

be protected for an indefinite time period, although the period of time within which to make a claim is typically three years from the date of misappropriation of the information. Other NDA core principles and carve outs are largely consistent across both jurisdictions and depend on the parties' respective leverage and the perceived complexity and likely timing for completing the buyer's due diligence process and negotiating the underlying transaction documents. Periods of around eight weeks are fairly typical in both jurisdictions. However, particularly in auction sale processes, sellers are understandably reluctant to grant exclusivity and any agreed period tends to be much shorter, even as little as a week, and is granted only at the final stage of the sale process (*see feature article "Auction stations: the UK's bidding battleground", www.practicallaw.com/w-033-3326*).

In both jurisdictions, heads of terms, commonly referred to as letters of intent, term sheets or memoranda of understanding in the US, which stipulate the key agreed commercial terms of a proposed transaction, are generally not intended to be legally binding. The exceptions to this are the terms that cover governing law and jurisdiction, exclusivity, and confidentiality. In addition, it is not uncommon in the US to include reasonable access to information and personnel as a binding term so that a buyer may conduct its due diligence. In both jurisdictions there is no general duty to negotiate in good faith; however, in the US, an express requirement may be included, whereas in the UK an agreement to negotiate in good faith is not enforceable.

The choice of which governing law will govern the main transaction documents is usually stipulated in the heads of terms. Although both jurisdictions are considered fair and efficient, parties might choose one over the other because of where a party is listed (if applicable), tax considerations that are specific to the parties or target, or the country of incorporation of the target. In the US, where each state has its own set of laws, alongside the applicable federal laws, the choice often falls on Delaware or New York law due to their well-established legal precedents in handling M&A transactions. Conversely, in the UK, the law of England and Wales (as opposed to Scotland or Northern Ireland) is typically chosen for complex transactions, due to its comprehensive legal framework and international reputation.

Choice of price structure

UK	US
• Locked box and completion accounts are both used, although there are some sector norms; for example, completion accounts are generally used on corporate real estate deals. • The locked box method is generally preferred by sellers because of the price certainty that it gives them at completion. Private equity sellers, in particular, are often focused on a clean exit and quick distribution of the purchase price funds. • In auction sales, specifying a mandatory locked box structure also allows the seller to simplify the comparison of multiple bids.	• Completion accounts method is standard. • The amount of target net working capital is a key point of negotiation. • Parties often negotiate for floors, ceilings and collars around the completion accounts mechanism to prevent large swings in the purchase price through the adjustment mechanism. • There is an increase in deals having no expected post-completion adjustment as the reference numbers for the completion accounts are filled in at completion, rather than against a normalised peg number. This is especially true in private equity deals where it is important to avoid post-completion disputes with continuing management team members and rollover investors. This is closer to a locked box mechanism.

PURCHASE PRICE

Standard practice in the US is that the final purchase price is determined by reference to completion accounts, more commonly referred to as closing accounts in the US. A provisional price is paid at completion based on pre-completion estimates of the amount of cash, debt, working capital (as compared to normalised working capital) and transaction expenses in the business.

Completion accounts that reflect the actual position at completion are then drawn up after completion and agreed by the parties, with any areas of dispute being determined by an independent expert under a dispute resolution mechanism stipulated in the transaction documents. Completion accounts are considered to give the most accurate indication of the actual financial condition of the target at completion, but they do require the buyer and seller to spend time determining the completion accounts after completion and may require one of the parties to make a true-up payment (that is, the difference between the pre-completion estimates and the actual completion accounts).

This can leave the door open for a party, typically the buyer, to attempt to manipulate the price through the application of the accounting policies that were agreed in the purchase agreement. Some parties perceive that holding the pen on the first draft of the completion accounts provides an advantage, although, in practice, the party that continues to employ the finance team with oversight of the target business up to the date of completion is often best placed to prepare them.

Completion accounts are also common in the UK but, as an alternative, the final purchase price is instead often determined by reference to a set of accounts prepared and made up to a date that is before the date of exchange (or "signing" in the US), referred to as locked box accounts.

From the date of the locked box accounts to the date of completion, the economic risk and reward of the target business is effectively deemed to have transferred to the buyer, with the seller covenanting that there will be no "leakage" of value to its shareholders, such as distributions or other payments or arrangements that benefit the seller or its associates. There are certain items of permitted leakage, which generally include arm's-length bona fide commercial arrangements in the normal course of trading

or those that have already been priced into the deal.

In a locked box deal, the seller may seek to be compensated for the fact that profits of the business from the locked box date will pass to the buyer at completion by including a fixed daily "ticker". This is a daily earnings amount and/or notional interest, the aggregate of which is added to the purchase price paid at completion (*see box "Choice of price structure"*).

DEAL CERTAINTY

In both jurisdictions, the process to complete a transaction will be quicker and transaction documents shorter if the deal can exchange and complete simultaneously, although this may be a practical impossibility where, for example, a regulatory or competition approval or material third-party consent is required (*see Briefing "Seeking closure: how to minimise deal disruption", www.practicallaw.com/w-022-5357*).

In these scenarios, legally binding contracts are signed, with legal completion of the transfer of the target to the buyer occurring once the relevant conditions precedent have been satisfied. However, in the US, a buyer typically has more flexibility to walk away from a deal if there is a material deterioration in the business of the target in the period between signing and completion (*see box "Practical considerations between exchange and completion"*).

Practical considerations between exchange and completion

UK	US
• Conditions to completion typically only include requirements to procure the required regulatory or competition law approvals. • Inclusion of other third-party consents such as consent from the target's contractual counterparties will be resisted by sellers and are only likely to be included if they are fundamental to the target business and it is impracticable to obtain consent before exchange. • While warranties may be repeated at completion, termination rights for material breach will be resisted by sellers. • Broad "no material adverse change" conditions are not generally accepted.	• The seller will have to repeat all representations and warranties at completion, subject to a negotiated materiality standard. The seller typically has a right to terminate if the materiality standard is reached. • The absence of a "material adverse change" is a standard condition to completion (in addition to any required regulatory or antitrust approvals). • Express references in the transaction documents to the termination fees that will apply if either side does not complete the transaction are a common feature of delayed completion transactions. A buyer's right to walk away from the deal and avoid the termination fee is generally conditioned on a seller's inability to meet completion conditions or the raising of legal or regulatory challenges to the transaction, such as antitrust challenges or significant shareholder litigation.

REPRESENTATIONS AND WARRANTIES

In the US, representations and warranties are essentially synonymous and are typically given together by the seller in the transaction documents on an indemnity basis. US transaction documents may also include "line-item" indemnities for known risks, creating a clearer path to recovery than would often be the case under more generic representations and warranties.

The position in the UK is quite different. There are considerable differences between warranties, being the contractual promises in the transaction documents, and representations, being the statements that induce a party to enter into the transaction documents, not least as regards potential remedies for breach.

A breach of warranty gives rise to a right to claim damages that are generally calculated as the difference between the value of the target as warranted (the warranty true value) and the actual value of target (the warranty false value). Whereas a misrepresentation entitles a party to claim damages based on the difference between the price that it paid and the actual value of the target and may give rise to a right to rescind the agreement, that is, to effectively terminate and undo the transaction.

Typically, the transaction documents exclude claims for misrepresentation, other than in the case of fraud, so as to limit the buyer's remedies to the warranties in the transaction documents and to exclude any right of recission. Any rights to terminate the transaction are instead specified in the transaction document.

In addition, indemnities would typically only be given where they have been specifically negotiated in relation to:

- Existing liabilities within the target that are identified through the buyer's due diligence process and in respect of which a post-completion warranty claim would not be possible as a result of disclosure.
- Pre-completion tax liabilities.

The drafting approach is also different. In the US, representations and warranties are drafted on a more generic basis for each relevant category, such as disputes, employees, real estate and the like, with "sweeper" warranties in certain areas, such as no undisclosed liabilities, being common. In UK transaction documents, warranties are drafted much less generically, so the schedule of warranties is typically longer as they seek to address potential issues specifically, but the overall coverage may be narrower.

Finally, the US and the UK take differing approaches to what are known as "pro-sandbagging" clauses. A pro-sandbagging clause permits a buyer to claim a breach of warranty despite it having knowledge of the matters that give rise to the breach.

In the UK, it is unclear whether the English courts would allow a buyer to claim damages relating to a breach of which it had prior knowledge. To avoid any doubt, sellers will typically push for the inclusion of an "anti-sandbagging" clause in the transaction documents. In the US, some state courts

Comparing W&I and R&W insurance

Prepared by Mark Ettershank (Head of W&I and Transactional Insurance) and Meghan Moody (Technical Associate) from the M&A, Litigation and Tax Insurance Solutions practice of international insurance broker, Gallagher, for a comparison of key terms and current market practice in warranty and indemnity (W&I) and representation and warranty (R&W) insurance policies.

	W&I insurance	R&W insurance
Loss mechanism	A W&I insurance policy follows the loss position agreed under the sale and purchase agreement (SPA), typically this will be on a damages basis for a UK SPA. If required, insurers can typically offer synthetic indemnity basis of loss coverage in return for an additional premium (AP) of 10% to 20%.	As standard, R&W insurance policies cover loss on an indemnity basis following the typical position agreed under a US SPA.
Disclosure of the virtual data room (VDR)	A W&I insurance policy typically provides that the contents of the VDR are generally disclosed against the warranties, following what is typically agreed under a UK SPA. If required, some insurers may be able to offer enhanced coverage by agreeing to disapply this SPA disclosure mechanism for policy purposes in return for an AP of 5% to 20% and confirmation that the contents of the VDR have been subject to a due diligence (DD) review.	As standard, R&W insurance policies do not disclose the contents of the VDR against the representations and warranties, following the typical position agreed under a US SPA.
Disclosure of DD reports	W&I insurance policies will typically contain a mechanism whereby the contents of the DD reports are deemed to be disclosed against coverage on the basis that this information will form part of the insured's knowledge. Most insurers in the market are able to remove this requirement in return for an AP (typically nil to 10%), along with a policy no-claims declaration (NCD) provided by the insured confirming that its deal team members have read and understood the contents of the DD reports.	As standard, R&W insurance policies do not generally disclose the contents of the DD reports, but insurers usually require that the insured confirms its deal team members have read and understood the contents of the DD reports when providing an NCD.
Materiality scrape	Given the nature of a UK SPA, "materiality scrapes" are typically not offered as standard under a W&I insurance policy (a "materiality scrape" means that, when determining whether a breach or a loss has occurred, any materiality qualifiers in the representations and warranties are disregarded or "scraped"). However, UK insurers are usually able to "scrape" any general or certain individual materiality qualifiers contained under a UK SPA for policy coverage purposes in return for an AP of 5% to 15%.	As standard, R&W insurance policies will look to follow any materiality scrapes that are typically agreed under a US SPA for the purpose of determining a breach or a loss*. (** However, if the US SPA does not contain a materiality scrape mechanism, then insurers are usually able to offer a synthetic scrape in return for no AP but subject to underwriting.*)

have upheld pro-sandbagging clauses and, in certain states, such as Delaware, courts have held that a buyer's prior knowledge does not preclude it from making a claim where the purchase agreement is silent on the issue. The underlying principle being that the buyer is entitled to the "benefit of its bargain" and to rely on the representations and warranties without having to second-guess the seller or be accused by the seller of failing to uncover matters of which the buyer arguably had notice before completion.

Governing law becomes key to the negotiations in this area, as some US states provide that silence on sandbagging means that it is allowed, whereas other states provide that silence on sandbagging means that it is not allowed.

Insurance

Warranty and indemnity (W&I) insurance has become a common feature in UK and US

Comparing W&I and R&W insurance (continued)

	W&I insurance	R&W insurance
Knowledge scrape	It is common under a UK SPA for warranties to be subject to an awareness qualification on a general or individual warranty basis. Underwriters typically agree to scrape such awareness qualifiers in return for an AP (typically between 5% to 15%), but may reinsert or maintain individual warranty qualifiers where it would be customary to do so; for example, in respect of any warranties that speak to the actions of a third party on an absolute basis.	In the US, knowledge scrapes are not usually relevant given the broad nature of representations and warranties typically contained under a US SPA; that is, they do not usually contain awareness qualifiers.
Warranty spreadsheet	W&I insurance policies usually include a spreadsheet that sets out which warranties under the SPA the insurer is able to cover, not able to cover, or which will need to be amended in order to provide partial cover; for example, where the warranty(s) is deemed to be too broad in nature or speaks to matters which have not been diligenced from the underwriter's perspective.	As standard, R&W insurance policies do not typically contain a warranty spreadsheet. However, an insurer will look to specifically exclude any uninsurable representations and warranties (in full or in part) from the definition of "loss" or "breach" under the policy.
Policy de minimis	UK underwriters typically set a policy de minimis (minimum value of a claim) of 0.01%+ of the target's enterprise value (EV). However, the policy de minimis will be subject to any materiality thresholds applied across the DD work streams on the basis that the insurer will not want to cover any matters that have not been covered by the DD.	As standard, R&W insurance policies do not usually include a small claims threshold, mirroring the position typically agreed under a US SPA. However, if any materiality thresholds have been applied to DD, then an underwriter may look to include a policy de minimis.
Insurance premium	Premiums levels in the UK are currently very competitive, with pricing ranging between 0.4% to 1.2%, for a 10% to 20% of EV policy limit.* (* *Noting that transactions involving an operational business will attract higher premium rates compared to those relating to a non-operational business.*)	Premium levels in the US are also very competitive but given the broader level of coverage offered as standard, R&W insurance is certainly more expensive compared to W&I insurance, with rates currently between 1.8% to 3% for a 10% to 20% policy limit.
Policy retention/ excess	Depending on the nature of the target business, W&I insurance typically includes a policy retention/excess threshold that needs to be eroded before the policy will pay out in respect of any insured claim. In the UK, for transactions involving an operational business, policy retention/excess thresholds are typically set between 0.25% to 0.3% of EV, with some insurers offering a "tipping to nil" or nil option in return for an AP. Non-operational businesses, on the other hand, tend not to have a policy excess given their lower risk profile.	In the US, R&W insurance retention/excess thresholds are generally set higher given their broader coverage, with thresholds set at around 0.6% of EV (dropping to between 0.5% to 0.25% of EV after 12 to 18 months) for operational businesses. Where the business is non-operational in nature, the retention/excess threshold will usually be set 25% to 30% lower than the above levels. In addition to the above, some insurers may agree to allow uninsured claims to erode the policy retention/excess (in full or in part) for certain transactions.

M&A transactions over the past few years. In the US, it is known as representation and warranty (R&W) insurance. Both insurance products operate in a similar fashion, but there are some key and important differences from a pricing and coverage perspective, which are primarily due to the manner in which risk is apportioned in US and UK M&A transactions (*see box "Comparing W&I and R&W insurance"*).

ESCROW AND RETENTION

While the use of R&W insurance in the US has significantly changed market practice, it is still common for the seller to agree to an escrow or a holdback of funds as a source of recovery against indemnity claims and negative purchase price adjustments. As a rule of thumb, the duration of indemnity escrows typically follows the survival period of non-fundamental representations and warranties, that is, generally one to three years. The escrowed amount will vary based

on identified potential risks, the overall cap on the seller's liability (which is typically lower in the US than the UK), the type of business, the identity of the seller and the seller's solvency.

Conversely, in the UK, it is less common for a seller to agree to such a construct, in the absence of any specifically identified due diligence issues, and buyers are required to justify and specifically negotiate any retention or escrow arrangements to which the purchase price will be subject.

DISCLOSURE

As noted above, US transaction documents typically contain a set of broadly drafted representations and warranties in the main purchase agreement, which also includes schedules giving the seller the opportunity to specifically disclose items that qualify the representations or warranties.

Disclosure in the UK is typically dealt with in a separate document known as the disclosure letter, which is broadly split into two sections:

- Specific disclosures, which are known issues that are flagged against specific warranties, similar to the disclosure schedule process in the US.
- General disclosures, which include, for example, the contents of transaction documents, public filings at certain registries, replies to diligence enquiries and the contents of the data room.

The general disclosures and, in particular, the references to all documents contained in the data room are often a source of some concern for US buyers transacting in the UK as, on the face of it, they could severely limit warranty coverage. However, all of these general disclosures are subject to the principle that any disclosure must be fair, the benchmark for which is typically negotiated and defined in the transaction documents and sets the bar on the manner in which information needs to have been presented to the buyer for it to be regarded as "disclosed" for the purposes of qualifying a warranty.

A prudent seller would therefore not rely on general disclosures in the data room as providing protection from warranty claims but run an extensive exercise with relevant members of senior management to determine any matters that should be included as a specific disclosure in the disclosure letter.

DISPUTE RESOLUTION

In a UK purchase agreement, either litigation or arbitration may be specified as a method of dispute resolution, although litigation is more common. If arbitration is chosen, the purchase agreement should make clear which rules apply; this will often be the rules of the London Court of International Arbitration. These rules dictate, among other things, the allocation of expenses, the seat of arbitration and the number of arbitrators who will be appointed to the panel. Where matters proceed to litigation, the disclosure stage is narrower than in the US, with parties only obliged to disclose documents that are relevant and not privileged.

Litigation is the preferred method of resolution in the US as arbitration is perceived by some as not having the same predictable procedural guarantees. Where arbitration is nevertheless chosen, purchase agreements may adopt the rules of the American Arbitration Association, the costs in relation to which are either for the loser to bear or shared between the parties. The disclosure process is also broader in the US, with irrelevant documents often disclosed.

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This opens up the potential for an extensive disclosure exercise to be undertaken and much higher costs.

POST-COMPLETION RESTRICTIONS

Inclusion of post-completion covenants that protect the buyer's interests in the target business typically comprise non-solicitation, non-compete, confidentiality and non-disparagement provisions. These are common in both the UK and the US. The key difference, however, relates to the time periods that are potentially enforceable in respect of these covenants.

Non-compete covenants are void under English law for being a restraint of trade unless they are necessary to protect the goodwill and confidential information being purchased by the buyer. They can also create competition law issues if their scope is deemed to be broader than what is required to protect the buyer's legitimate business interests. As such, buyers need to balance the length and breadth of the restriction sought with the likelihood of enforceability. Restricted periods of up to two to three years are common, although buyers in some sectors, such as human capital businesses like broking, may argue that a longer period is justified. Consideration should also be given to ensure that the business activities covered and geographical scope of the restriction are as targeted and relevant as possible.

Three- to five-year non-compete covenants are typically enforceable in most US states provided that they are narrowly tailored to the business being sold.

In addition to non-compete covenants, restrictions relating to non-solicitation of employees, suppliers and clients are also common in both the UK and the US.

SEEING BOTH SIDES

An uptick in M&A transactions seems likely in the UK and the US in 2024. While there are some similarities in market practices in these countries, it is important to be aware of the differences that exist, as these drive the M&A process and specific documents. Governing law, and with that the jurisdictional M&A issues that apply, are often determined right at the outset of the deal without both parties necessarily appreciating the impact that this may have on the negotiation process that will follow. Tactically, one jurisdiction may materially favour one party more than the other, so it is important to give due consideration to the differences before the choice of law is agreed. Once the determination has been made, with one party potentially agreeing to transact on terms that are less familiar to them, an understanding from both sides of the types of provision that their counterparty may be more used to seeing will better set the context for the negotiating positions that are taken and ultimately lead to a more efficient negotiation process with better outcomes for both sides.

Andrew Hart is a partner, Theo Jones is lead knowledge counsel, Lara Rush is a senior associate, and Isabella Oughtred is a trainee solicitor, at BCLP.

