Disclosure in M&A Transactions: UK & US Perspectives

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Introduction

Surprisingly, while the disclosure schedule (or disclosure letter) is one of the most significant documents in any M&A transaction, with important consequences for both the buyer and the seller, it is often prepared at the last minute and without a full understanding by the parties of its strategic and lasting importance to the deal. Whether for an asset sale or stock sale, every definitive agreement is going to contain representations of fact from the seller to the buyer regarding key aspects of the business being sold. A buyer will want those representations to cover the broadest possible spectrum of issues in a very specific way. A seller will want to give as few representations as possible, limited to key issues for the particular business being sold, and qualified in such a way that those representations only cover “material” or very important issues from a financial perspective. Negotiating the specific representations in the definitive agreement is time consuming and a high art, which is why the seller may breathe a sigh of relief when the form of the representations has been agreed and the definitive agreement seems to be approaching its final form. In reality, the hard work for the seller has only just begun. Each of those representations, once agreed with various qualifications as to materiality and scope, must be reviewed again and the disclosure schedule or disclosure letter prepared.

Why is Disclosure Important?

For the buyer, the disclosure schedule serves as the last but critical part of the due diligence process and, where the disclosures reveal some new fact or circumstance, it may also give the buyer a chance to renegotiate the price, require the seller to correct some perceived deficiency or, in extreme circumstances, walk away from the deal entirely. In deals with very short fuses (and many distressed deals need to be done virtually overnight to preserve going concern value), the
Disclosure schedule or disclosure letter is the best chance for the buyer to get visibility into key issues.

For the seller, the disclosure schedule, if drafted properly, can be valuable protection against future misrepresentation claims by the buyer.

**Disclosures in U.S. M&A**

Disclosure schedules in U.S. transactions are usually incorporated into the definitive agreement itself as integrated schedules and generally serve two different functions: either as an affirmative disclosure or as a negative disclosure. For the affirmative disclosure, the representations in the definitive agreement may have required the seller to list various things that are important to the business being sold, such as all of its customers who have orders over a certain dollar amount, all of the seller’s inventory as of a certain date, or all the trademarks and other intellectual property owned by the seller.

The negative disclosure function is the opportunity for the seller to limit or qualify the representations made in the definitive agreement so that the representation matches the reality of the seller’s business. This requires different members of the seller’s management team to review the representations relevant to their functional area and confirm the accuracy of the representation. For example, if there is a representation that the seller has all necessary intellectual property rights to operate its business, the management team negotiating the deal may believe that statement to be true. However, the seller’s IT manager might know that the license agreements for the key software packages used in the business have a certain number of licensed users and that the seller is actually over that limit. If those facts are not disclosed and the buyer has to pay for additional licenses, that cost will come back as an indemnity claim against the seller.

Disclosure schedules also need to be kept current with the seller’s ongoing business operations and updated through the date on which they become effective. This is particularly important where there is a gap between the signing of the definitive agreement and the closing of the transaction.

**Disclosures in U.K. M&A**

Although the U.S. concept of an integrated disclosure schedule is becoming more common in U.K. M&A deals, the standard U.K. approach to the disclosure process is for a separate disclosure letter to be delivered by the seller to the buyer. The purpose of the disclosure letter is similar to that of disclosure schedule, however the disclosures tend to be more broadly stated, with the disclosure letter usually consisting of the following matters:

(i) general disclosures - consisting of information relating to the target company which would be available to any buyer searching a publicly available register (e.g., a search carried out by any member of the public at U.K. Companies House, revealing basic corporate filings made by the seller over the years, including details as to the seller’s owners and directors, bylaws, resolutions and any security granted over the seller’s assets). Such general disclosures are “deemed” to be disclosed to the buyer, whether or not the buyer has undertaken such searches; and

(ii) specific disclosures - consisting of matters which negate the scope of the representation being made by the seller in the definitive agreement (similar to the negative disclosures made in the
U.S.). It is also common for a disclosure letter to qualify all of the representations and warranties (but not specific indemnities) in a purchase agreement.

Disclosure letters in the UK often make reference to, and are accompanied by, a “Disclosure Bundle” which contains copies of various documents forming part of the disclosure being made by the seller (e.g., the seller’s financial statements or contracts entered into by the seller containing unusual terms or provisions).

Recent decisions by the U.K. courts support the view that a seller will not be able to defeat an indemnity claim by a buyer (and thereby benefit from the protection of disclosure) unless the seller has made disclosures which are sufficiently precise or “fair.” “Fair disclosure” means the seller has provided the buyer with sufficient details to identify the nature and scope of the matter being disclosed against the particular representation. For example, using the IT software license scenario above, if it is indeed the case that the seller’s total users exceed the number permitted under a licence, it is possible that a court would not consider it “fair” for the seller simply to include in the disclosure bundle a copy of the software license and a listing of the number of software users as this would require the buyer to form its own conclusions about the meaning of those two disclosures. Indeed, to meet the standard of “fair” disclosure, a court might require the seller to go the additional step and specifically disclose the fact that the number of licensed users had been exceeded.

**Does the Buyer's “Knowledge” Limit the Need for Disclosure?**

In the vast majority of M&A deals (whether in the U.S. or the U.K.), a buyer will embark on a fact finding “due diligence” exercise prior to agreeing to acquire a target company or business. During the course of such exercise, the buyer (whether directly, or through its advisors or agents) will obtain “knowledge” of the seller’s business activities and some of the problems or challenges facing the seller. The definitive agreement will need to address whether the buyer will be bound by what it learned (or could have learned) during the due diligence exercise, but a seller should not rely on the buyer being so bound as an excuse to avoid a thorough disclosure exercise. Although the U.K. position remains unclear as to whether a buyer’s knowledge of the facts precludes a buyer from making a claim, the leading case in the U.K. suggests that where a buyer has actual knowledge or imputed knowledge (e.g., knowledge of the buyer’s agent), it may still be able to bring a claim for breach against a seller where this is provided for and permitted in the wording of the definitive agreement itself (subject to the court suspecting that the buyer has acted unfairly). This argues strongly in favour of the seller taking care to disclose fully against all representations notwithstanding the buyer’s due diligence exercise.

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