Disputes in an M&A context

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By: Henry Quinlan | Richard Hughes | Charlotte Leith

The previous three articles in this series considered issues which commonly give rise to disputes between shareholders and some of the informal and formal steps that can be taken by parties seeking to protect their positions.

This article explores some of the provisions in transaction documentation which, if inadequately or inappropriately addressed, can lead to disputes in an M&A context. Often some of the most heavily negotiated terms of an acquisition agreement, we discuss some of the drafting considerations when dealing with price adjustment mechanisms, earn-out provisions, warranties and limitations and conditions to closing.

Price adjustment mechanisms

Price is almost always the most important term in an acquisition agreement. Sellers will typically seek to fix the price either on the closing date or by reference to a fixed accounting date (a “locked box” mechanism). More frequently (particularly in a buyer’s market), the price will be adjusted to reflect the financial position of the target on the closing date by reference to “completion accounts”. Depending on the nature of the target business, the adjustment will usually seek to determine either (i) the actual net asset position of the target on the closing date; or (ii) the debt/cash position of the target at closing, often combined with a normalized working capital. The completion account mechanism will either lead to a further payment from the purchaser to the seller, or require the seller to reimburse the purchaser for a portion of the consideration paid on the closing date.

The completion accounts are determined by a set of negotiated rules, which are usually found in a schedule to the acquisition agreement. As the completion accounts will be prepared within the weeks following the closing date, the purchaser will usually have control over their preparation. The seller will then have a period to review the completion accounts and identify disputed items (which may ultimately be referred to an expert for determination).

The completion accounts can often give rise to disputes because of their susceptibility to differing accounting interpretations. For this reason, it is important that both the purchaser and seller obtain accounting advice during the negotiation period. Care should be taken in the drafting to clearly define which items should constitute (for example) “debt”, “cash” and “working capital” in the context of the target business. The parties should also agree the basis on which the completion accounts will be prepared (i.e. whether this will be on the basis of the last audited accounts, IFRS, specific policies agreed between the parties or a hierarchical combination of these factors).

Ultimately, market practice is for an independent accounting expert to finally determine any disputes between the parties in relation to completion accounts. However, price adjustment provisions should be clearly drafted to ensure that one party cannot take advantage of any ambiguous provisions.

Earn-out provisions

Earn-out provisions are one of the most hotly negotiated (and ultimately, contested) areas of the acquisition agreement.
These provisions provide for an additional payment to sellers where certain performance objectives are met over a fixed period (post-closing). Earn-outs are typically used where there is a gap between the parties’ views as to the value of the target business and/or to incentivise a seller which is remaining with the target business post-closing.

As the purchaser will have control over the target business during the earn-out period, a well-advised seller will include provisions in the acquisition agreement which protect the earn-out calculation from abuse. These protections will seek to ensure that “ordinary course” operations are maintained, and provide the sellers with an element of control over the target business during the earn-out period by restricting certain actions unless the seller’s consent has been obtained.

Again, accounting input during the drafting process is essential to ensure that earn-out provisions are not open to abuse. For example, the seller will want to avoid a situation whereby the purchaser can increase (ie front-load) costs during the earn-out period as this would be likely to negatively impact the earn-out performance calculation.

As with disputes relating to other price adjustment mechanisms, disputes between parties to an earn-out arrangement are typically finally determined by an independent accountant. However, the risk of disputes can be mitigated if both parties are properly advised during the earn-out negotiation process.

**Warranties and limitations**

Warranties are contractual statements contained in the transaction documents regarding the condition of the target company. These statements have two principal functions: (a) to provide a purchaser with a legal remedy in the event that the statements are found to be incorrect (ie damages for the difference between the price paid and the actual value of the shares) and (b) to encourage the seller to disclose problems with the target company (which might otherwise give rise to a breach of warranty) so that these issues can be dealt with before the acquisition documentation is signed (potentially through a price reduction or indemnity). A significant proportion of post-acquisition disputes relate to claims for breach of warranty.

When negotiating warranties in an acquisition context, a purchaser should bear in mind various protections, including:

- If the purchaser has identified a specific liability of the target company during the course of its due diligence (for example an environmental issue at the target's premises or a claim by a former employee), an indemnity may be an appropriate contractual protection. Indemnities are contractual promises to reimburse the recipient of the indemnity for a particular liability. Indemnities in the context of an acquisition move risk from the target company (and consequently the purchaser) to the seller, as an indemnity allows the purchaser to recover its losses from the seller on a dollar-for-dollar basis. Conversely, a breach of warranty will only give rise to a successful damages claim if the purchaser can show that the breach reduced the actual value of the business acquired in comparison to the price paid.
- Warranties should “follow the money” – ie the seller of the target company will be the warrantor. However, in practice, the seller may be a holding company (incorporated with limited liability), with no operations or assets other than its shares in the target company. For a purchaser, this creates the risk that, even if it does have a strong claim against the seller, its prospects of recovery are limited. In such circumstances, it is common for purchasers to insist upon a guarantee provided by another party (for example the owner of the seller) to provide the purchaser with additional comfort.
- Where there are multiple sellers, an agreement needs to be reached between the sellers and the purchaser as to the extent of each seller’s individual liability. For a purchaser, the favored position is that sellers give their warranties “jointly and severally” so that the purchaser can proceed against any one of the sellers for the full amount of the loss arising from the breach of warranty. This approach is often opposed by sellers, particularly in cases where some sellers have a greater involvement in the business than others.

From a seller's perspective, it will be important to reduce their exposure in the event that a dispute arises from the warranties given. This is primarily achieved through the negotiation of various limitations on liability which typically include (as a minimum):

- Financial caps - liability may be limited in financial terms through the inclusion of a cap on total liability, a minimum amount for individual claims ('de minimis') and/or a minimum limit for aggregate claims (a 'threshold' or 'basket').
- Limitations in time - although the governing law of the transaction documents may impose a statutory period during which a claim can be initiated by the purchaser (under UAE law, 15 years for contractual disputes and under English law, six years where the claim arises under a simple contract or 12 years if the agreement is executed as a deed), in
practice the parties may contractually agree to a shorter liability period. Periods of 18 months to three years are commonly seen for commercial warranties, or the liability period can be tied to an audit cycle to allow sufficient time for any possible liabilities to be determined. Longer or uncapped time periods are often seen for specific warranties, for example those relating to title, the capacity of the seller and tax matters.

- Disclosure - When the acquisition documentation is signed (and potentially at formal completion), a seller will want to provide a disclosure letter containing matters which, provided they meet the negotiated standard of disclosure, will qualify the warranties. Sellers will also seek to disclose the contents of any data room which has been made available to the purchaser and its advisers during the due diligence process. If a data room is very large or badly organised, full disclosure may be resisted by the purchaser.

- Awareness - Sellers will typically seek to limit their exposure under certain warranties so that they are only liable for matters of which they are actually aware when the warranties are given. Though often resisted by the purchaser, sellers will also try to exclude any matters about which the purchaser is aware at the point of signing.

The successful negotiation of a robust set of limitations can reduce a seller's exposure to warranty claims significantly, and protect them from post-acquisition disputes.

**Conditionality**

Whilst it is possible for completion of a transaction to take place on the date that the acquisition agreement is signed, in the Middle East there is almost always a gap between signing and formal closing. This period allows the parties to satisfy certain conditions (such as regulatory approvals or third party consents) once they have obtained comfort that comprehensive transaction documentation has been entered into. During this period, subject to the conditions being satisfied, a purchaser is contractually obliged to purchase the target business and the seller maintains control until formal closing. This delicate position gives rise to a number of complexities which, if not properly dealt with in the acquisition documentation, can quickly lead to disputes between the parties. Some of the key considerations in a transaction where signing and completion are split are:

- Responsibility for conditions - from a seller's perspective, conditions should be as tightly drafted as possible to ensure that closing (and payment of the consideration) can be achieved as quickly and smoothly as possible. Purchasers will want to ensure that any loose ends from the due diligence process are dealt with as conditions to closing - in the period leading up to closing, the seller is highly motivated. A seller will want to avoid agreeing conditions which are very broad and subjective as they would effectively provide the purchaser with the ability to walk away from the transaction. An example would be a condition that the purchaser has completed its due diligence process to its satisfaction.

- Pre-completion conduct - as the seller will still be the owner of the target, the purchaser will want to ensure that the business is operated in the ordinary course of business (in accordance with agreed restrictions on conduct which require the purchaser's prior consent). The purchaser will commonly seek a right to terminate the acquisition agreement in the event that these conduct provisions are breached. Actions for damages may arise if the purchaser only becomes aware of the breach once completion has occurred and it has taken control of the business.

- Material adverse change - a key consideration in the context of the gap between signing and closing relates to which party should bear the risk in the event of "material adverse change" or "MAC". A purchaser will want to have the right to walk away in these circumstances. While the concept of a MAC is often included in the documentation, this is usually subject to a significant materiality threshold. MAC clauses are notoriously difficult to draft and negotiate and, in the unlikely event that a materially adverse circumstance for the target business were to arise, it is likely that the relevant provisions would be prone to disputes given they often involve some degree of subjectivity.

**Conclusion**

In the majority of M&A transactions, the parties reach completion and are never required to revisit the transaction documents in a dispute context. Nevertheless, it is important for parties and advisers to be aware of the drafting pitfalls in the acquisition documentation which can lead to ambiguity or expose a party to transactional uncertainty or, worse, formal claims. The next article in this series will consider the actions that can be taken by a purchaser when it has a potential claim against a seller under the acquisition documentation.

**AUTHORS**