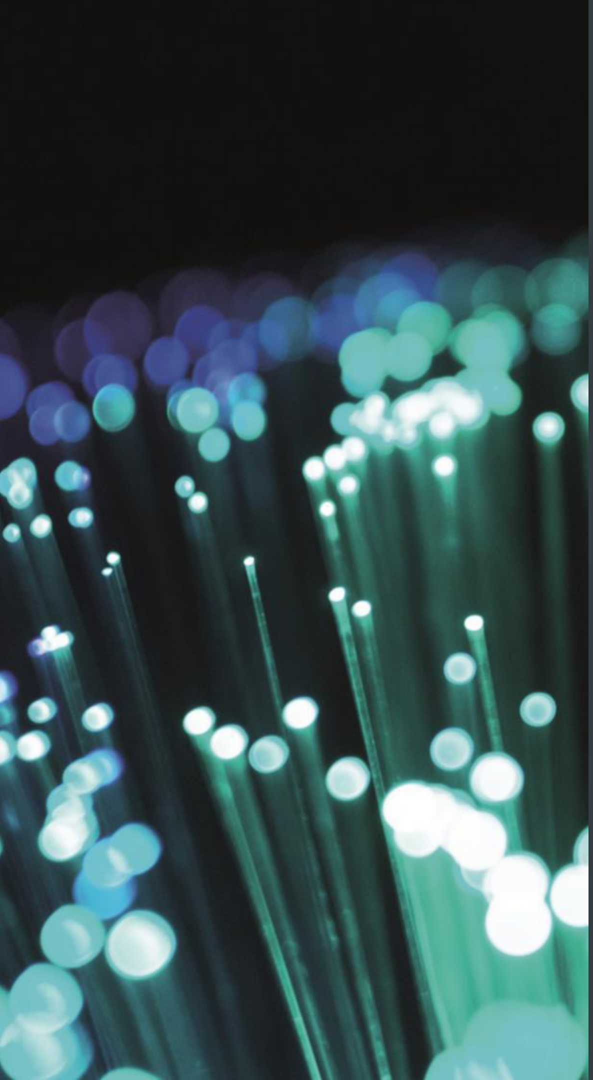
Bird & Bird & Trends & Risk in M&A Transactions

September 2018



Foreword

We have seen a very active M&A market in the last 12 months. There is increasingly more common ground in much of the legal documentation, with the focus being on the terms that matter the most to buyers and sellers, particularly terms that go to risk apportionment and price adjustment. We continue to see an increase in the use of warranty & indemnity insurance in the UK and internationally.

For this report we spoke in depth with our London Corporate Team to assess the key trends and legal issues the group are seeing on both acquisitions and disposals. Where necessary, to provide a wider picture we have referenced a larger report, 'A smarter way to get deals done – International survey' produced by Grant Thornton UK LLP.

Neil Blundell

Head of London Corporate

Limitations on liability

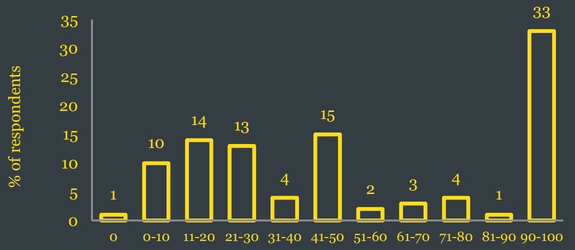
Financial caps on liability

Overall caps on liability

Most M&A agreements provide for the seller's overall financial liability for warranty claims to be capped at an agreed level.

In the UK it is still common for the financial cap to be between 90-100% of the purchase price on smaller transactions. However, there is an increasing trend to buyers accepting a lower limit on the higher value deals.

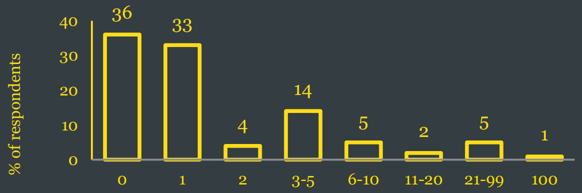
Liability caps remain higher for European transactions as compared to US transactions. The mean average cap for European deals is 58% of the purchase price while the mean average for US deals is 28% *(Grant Thornton, A smarter way to get deals done, November 2017).*



% of consideration on which overall warranty caps based
(Grant Thornton, A smarter way to get deals done, November 2017)

De minimis and basket thresholds

It is still more common than not for M&A agreements to provide that individual claims below a specified value will be disregarded altogether (a de minimis threshold). 73% of respondents reported seeing a de minimis threshold of 2% of the purchase price or less *(Grant Thornton, A smarter way to get deals done, November 2017).*

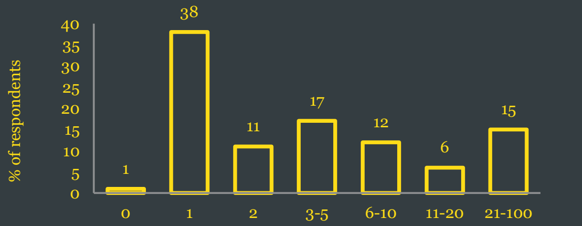


% of consideration on which de minimis thresholds based
(Grant Thornton, A smarter way to get deals done, November 2017)

Similarly, it is still also common for M&A agreements to contain a further financial threshold that must be exceeded either individually or on an aggregate basis before the seller will be liable for any warranty claims (a basket threshold). 50% of respondents reported seeing a basket threshold of 3% of the purchase price or less *(Grant Thornton, A smarter way to get deals done, November 2017).*

Practical Tip

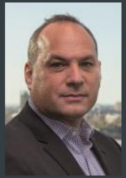
UK market practice is often cited as being 1% and 0.1 % respectively for basket and de minimis thresholds.



% of consideration on which overall basket/threshold caps based
(Grant Thornton, A smarter way to get deals done, November 2017)

Disclosure

While the approach to disclosure will depend on the specific circumstances of a deal, we are seeing a significant trend over the last 12 months in buyers accepting general disclosure of the transaction data room, subject to a standard of 'fair disclosure', which is typically set out in the M&A agreement.



Struan Penwarden

Head of Venture Capital

Disclosure in breach of confidentiality

Legal update: Kason Kek-Gardner Ltd v Process Components Ltd [2017] Court of Appeal

- An IP licence entered into between Kason and Process Components contained:
  - a confidentiality clause which included the terms of the licence; and
  - a separate provision which made any breach of the confidentiality terms a non-remedial material breach giving rise to a right to terminate.
- In connection with a subsequent sale of Kason, the licence agreement was disclosed to the buyer, a potential competitor of Process Components. On becoming aware of this, Process Components terminated the licence, claiming Kason had breached the confidentiality clause.
- Kason argued that disclosure of the contract was permitted under an implied term.
- The Court of Appeal disagreed that such a term could be implied in these circumstances and gave effect to the terms of the licence which allowed termination by Process Components.

Practical tips:

- Most commercial contracts include confidentiality clauses. Disclosure is a risk both to the prospective buyer and the target company. The risk of disclosing every material contract should be evaluated prior to disclosure – consider whether any contracts should be withheld until a certain point in the transaction or if third party consent to the disclosure should be sought.
- Listed buyers and sellers will need to take particular care where the information regarding the potential sale may constitute inside information and so it may not be possible to approach contractual counter-parties for consent without breach.
- Consider the drafting of commercial contracts and the ability of the counter-party to terminate for breach – is confidentiality a material term?

Time periods

It is common in most M&A transactions to have time limits on the buyer's ability to bring claims, usually with separate limits for tax and non-tax claims. In the absence of agreement to the contrary, the normal period during which a claim will be actionable is 6 years if the M&A agreement is signed under hand, or 12 years if it is executed as a deed.

We are typically still seeing:

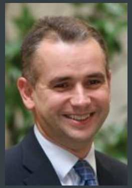
- between 12 – 24 months after completion for general warranty claims; and
- between 4 – 7 years after completion for tax warranties and the tax covenant

though buyers are increasingly under pressure to accept shorter time periods, particularly with the increased use of W&I insurance.

Practical tip:

- W&I insurance is often used as a means to negotiate limitations outside of the M&A agreement. Irrespective of the time periods under the M&A agreement, a W&I insurance policy is able to extend the time period out to 2 years for general warranties (potentially up to 3) and up to 7 years for tax warranties, the tax covenant and fundamental warranties.

Whilst two years for general warranties and seven for tax used to be the norm, we are seeing a much greater variation. Sellers are expecting a shorter period for general warranties (often as low as a single audit period), whilst for IP rich targets, purchasers are wanting a longer period for IP warranties, compromising on the period offered for tax, and accepting a four year period for both.



Simon Allport
Corporate Partner

Warranty & indemnity insurance

We are seeing a significant increase in the use of W&I insurance on M&A transactions - 72% of our London Corporate fee earners reported seeing a rise in the use over the last five years.

The benefits of W&I insurance include:

- allowing sellers to have immediate access to sale proceeds and a reduced period of risk (if any) - in some deals the seller's cap on liability has been reduced to £1 with the insurance policy effectively paying for any claims that arise;
- giving the buyer a satisfactory level of recourse through an insurance policy with financially-rated insurers – this may be particularly attractive where the sellers are individuals; and
- on transactions where the sellers are joining the buyer's management team, W&I insurance can be particularly helpful in resolving warranty disputes which might otherwise poison the relationship between the parties.

Aside from transaction-specific exclusions, policies will typically exclude the following matters:

- known matters – i.e. matters about which the buyer's deal team have actual knowledge;
- forward looking warranties;
- transfer pricing/secondary tax/loss of tax assets on the basis that insurers are often unable to obtain sufficient clarity on these matters to be able to provide cover;
- pension underfunding; and
- sufficiency warranties – trust the business being acquired has all the assets it needs
- losses related to sanctioned people or countries, anti-bribery, criminal fines or penalties or punitive damages.

For an additional premium, policies can be enhanced - for example, to "scrape" knowledge qualifiers from warranties or to disregard the disclosure of the due diligence/ data room for the purpose of claims under the policy.

Over the last 12 months, we have seen a significant reduction in the base premium rates charged for M&A insurance which coincides with the general increase in use, and number of providers, of such policies during this period.

Matt Bonass
Corporate Partner
Co-Head of Energy & Utilities group

Warranty & indemnity insurance – case study

Background

- A corporate acquirer wishes to expand its business by acquiring a technology company through an M&A transaction.
- As is common in the technology sector, the target's principal shareholders are financial investors who require a clean exit and accordingly are not willing to offer substantive warranty coverage.
- The target's minority shareholders consist of individual members of management and key employees who are to be retained in the business post-completion. Those shareholders are unlikely to have sufficient assets to meet any future warranty claim. Furthermore, raising a warranty claim against management is not attractive where they are to remain involved in running the business post-completion.
- The buyer instructs a W&I broker to obtain quotes and indications of coverage. The buyer selects its preferred insurer and negotiates the terms of the policy with the insurer.
- The W&I policy is typically taken out by the buyer, but is often ultimately paid for by the sellers through a deduction from the purchase price.

What to consider as a buyer

1 The sellers will want the terms of the W&I policy to match their liability under the SPA as closely as possible, so as to minimise or even eliminate the extent of their uninsured liability.

2 Insurers will usually offer terms on the assumption that the buyer will have undertaken a detailed, thorough due diligence process involving external advisers in all jurisdictions where the business has material operations and/or experience – the W&I policy is not, therefore, a substitute to the usual due diligence process. Gaps in due diligence coverage may lead to gaps in W&I coverage.

3 Most W&I policies assume general disclosure of buyer due diligence materials and the data room. If a buyer wishes to take a policy without that general disclosure, it will need to take that into account at the outset when it selects a preferred insurer. Not all insurers will be willing to underwrite a policy without that general disclosure and those that will are likely to charge a premium and require additional underwriting.

4 The W&I policy is likely to exclude known issues uncovered during due diligence, such as ongoing litigation. As such, the use of specific indemnities or specific escrow arrangements sitting outside the W&I policy may be necessary.

5 The W&I policy will contain standard exclusions, such as an exclusion of liability relating to environmental contamination. Where this is a concern (for example in the context of industrial transactions), the buyer should consider mitigating their risk through detailed environmental due diligence, specific indemnity arrangements sitting outside the W&I policy and/or by taking out separate specialist insurance. Specialist environmental insurance is available where appropriate.

6 Many insurers now offer a "synthetic tax indemnity" – i.e. an indemnity given directly from the insurer to the insured under the policy if the seller does not give a tax indemnity, however, tax disclosure and due diligence will still be required.

Purchase price adjustments

Purchase price adjustments

Completion accounts vs locked box accounts

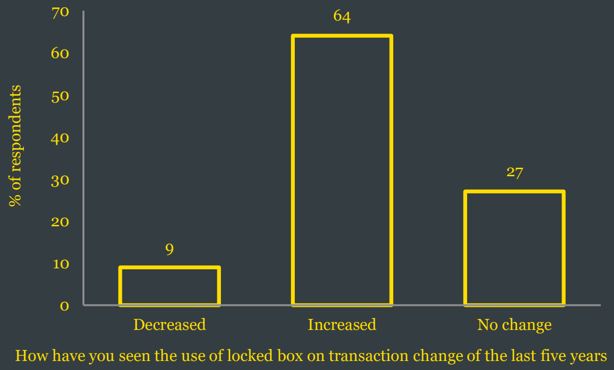
It is very common for an M&A agreement to include a price adjustment mechanism – our London Corporate fee earners reported that 78% of transactions in the last 12 months have involved some form of adjustment.

A completion accounts adjustment involves the final purchase price being calculated after the deal has been completed by reference to a set of accounts which are drawn up to the completion date. It is typical for the buyer to draw up the completion accounts within a specified period of completion.

A locked box mechanism involves accounts being prepared to a date before completion – the locked box date. Any payments out of the Company after the locked box date will be subject to "leakage" provisions in the M&A agreement.

On the whole, we are still seeing more M&A deals using a completion accounts adjustment mechanism, however, we have seen a significant increase in the use of a locked box mechanism recently which seems to track what others are seeing in the market, particularly on mid-market M&A deals.

Helen Gavin-Brown
Corporate Partner



(Grant Thornton, A smarter way to get deals done, November 2017)

Purchase price adjustments

Earn-out

An earn-out is a mechanism which involves at least part of the purchase price being calculated by reference to the post-completion performance of the target company.

Earn-outs are increasingly popular – a mean average of 42% of recent deals included an earn-out (36% private equity, 55% other corporate) (*Grant Thornton, A smarter way to get deals done, November 2017*) – though locked box and completion accounts mechanism are more common in the UK.

Reasons given included:

- where the management team is being retained to incentivise them;
- to bridge the gap between the buyer's and seller's perception of the value of the business and future performance; and
- where the buyer is operating in a new market or business.

The earn-out structure will depend on the specific circumstances of the deal though 76% of respondents to the Grant Thornton International SPA Survey November 2017 reported that the earn-outs were EBITDA based

Practical tip:

- Earn-out provisions commonly take time to negotiate and commonly give rise to claims under the M&A agreement - it is therefore important that they are drafted to be clear and workable.
- Agree the benchmark for calculating the earn-out at the outset – will this be measured on the target company's pre or post-tax profits, EBITDA, revenue or earnings or a non-financial metric?
- If acting for the seller consider including restrictions on the buyer taking any actions during the earn-out period that could have an adverse effect on the earn-out and an obligation on the buyer to continue to operate the target company's business in the ordinary course during the earn-out period.
- If acting for the buyer ensure that the earn-out restrictions can be complied with and do not cut across the buyer's operational plans for the target company post-closing.

"The need to retain and continue to motivate certain key sellers involved in a target business post completion is a common issue in certain sectors where a lot of the value in the business being acquired is in its people. An earn-out structure can be a useful tool in ensuring such sellers stay with the business following completion and are incentivised to maximise the profitability and performance of the business during this period. We have recently seen certain buyers taking a broader view on what earn-out targets are set with payments sometimes linked in whole or in part to non-financial measures such as successful integration of the target into the buyer's business"

Simon Fielder
Corporate Partner

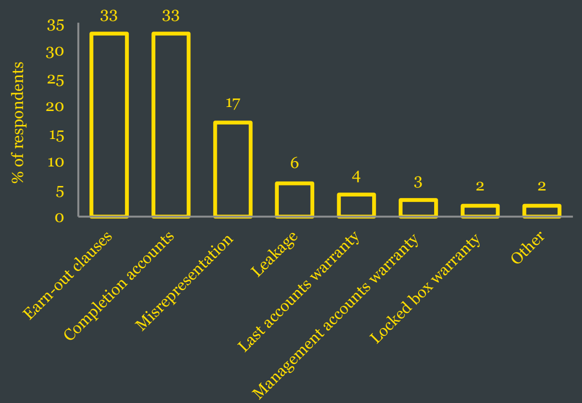
Bringing claims under an M&A agreement

Claims

Where do claims commonly arise?

A mean average of 14% of M&A agreements resulted in a warranty claim, regardless of whether it was settled or otherwise disposed of pre-completion (Grant Thornton, A smarter way to get deals done, Nov 2017).

For our London Corporate fee earners, the most disputed areas of M&A agreements post-closing relate to completion account and earn-out provisions, which tracks what is being seen recently in the market:



Most disputes areas of SPA post-deal

(Grant Thornton, A smarter way to get deals done, November 2017)

Practical tips:

- Immediately following completion buyers should take note of key warranty claim requirements and deadlines under the M&A agreement:
  - diarise the deadlines for warranty claims/claims under the tax covenant and include a diary entry for several months prior to those deadlines for consideration of potential claims. Deadlines are usually hard deadlines.
  - query - do claims need to be notified by the buyer as soon as it becomes aware of them?
- Monitor potential for claims:
  - bear in mind the common areas for dispute.
  - ensure relevant personnel urgently notify issues with the target company to those familiar with the protections in the M&A agreement.
  - if an expert analysis is required (for example, accounts, environmental), arrange quickly and be mindful of deadlines for making claims.
- Team meetings: post-closing team meetings should discuss potential warranty claims – ensure that relevant personnel are familiar with the relevant warranties in the M&A agreement.
- Review audited accounts of the target company: information in the target accounts produced after completion may give rise to potential warranty claims – the accounts should therefore be reviewed carefully by finance personnel familiar with the relevant warranties in the M&A agreement.

Bringing a claim

Recent case law has shown the importance of complying with the procedural requirements for making warranty claims in the M&A agreement

Teoco UK Limited v Aircom Jersey 4 Limited and anor [2018] Court of Appeal

- The M&A agreement purported to exclude liability on Aircom's part for any breach of warranty unless "*the Purchaser has given notice to the Seller of such Claim setting our reasonable details of the Claim (including the grounds on which it is based and the Purchaser's good faith estimate of the amount of the Claim…)*".
- Teoco sent two letters to the sellers notifying possible claims but those letters did not specify which specific warranty (or warranties) was alleged to have been breached.
- The High Court agreed to strike out Teoco's claim on the basis that:
  - a reasonable recipient of the two letters would not have understood them to have been giving notice of a warranty claim; and
  - in any event, neither letter set out the grounds of the claim.
- The Court of Appeal agreed with the High Court's decision.

Practical tips:

- If drafting a notice of claim, it is important to review the terms of the M&A agreement. Even if the substance of a claim is contained within a notice, if the form is not compliant with the terms of the agreement, the claim is at risk of being struck out.
- A notice of a claim should:
  - include as much detail of the facts or circumstances giving rise to the claim; and
  - specify each provision under the agreement under which the claimant is bringing its claim.

Zayo Group International Ltd v Ainger and others [2017]

- Zayo acquired a company from the defendant managers and later claimed that deficient accounts were prepared by the defendants resulting in a breach of the relevant warranties in the M&A agreement.
- The M&A agreement provided that, to bring a warranty claim, notice must be served on each of the defendants at the addresses specified in the agreement within a particular period. On the last day of that period, Zayo attempted to serve each of the defendants with a notice of claim. It managed to serve six of the seven defendants by the cut-off time but failed to serve one defendant.
- The court dismissed Zayo's claim on the basis that service of the notices was defective. The court held that the natural commercial interpretation of the notice provision was that a failure to notify all of the defendants meant that none of the defendants had any liability.

Practical tips:

- Pay careful attention to the notification clauses in the M&A agreement and make sure they are clear and workable. Where multiple parties are involved, the notice should be effective as against each party served.
- Claimant's should follow the notice requirements of the M&A agreement strictly, even if this means sending notices to an address which is no longer occupied.
- If using a third party (e.g. a courier) to deliver notices, give clear instructions as to what they should do if the intended recipient is no longer at that address.

Bird & Bird & 2017 International M&A

Technology & Communications

1 Elisa Corporation: Elisa is Finland's leading telecommunications ICT and online service company.

We advised Elisa on:

- the acquisition from Santa Monica Networks Group OÜ of its Estonian and Finnish managed services and data.

Value: €32 million
Location: Finland, Estonia, Latvia, Lithuania

- the acquisition of AS Starman, the number one pay TV provider and number two fixed broadband provider in Estonia.

Value: €151 million
Location: UK and Finland

2 arm: arm is one of the largest technology companies in the UK whose semiconductor products reach 80% of the global population.

We advised arm on:

- the acquisition of Mistbase in Sweden. Mistbase is a digital wireless communication provider for IoT devices.

Value: £31 million
Location: Sweden

- the acquisition of Simulity Labs in the UK/Ireland/S. Africa/India. Simulity provides operating software and server systems for SIM cards and embedded SIMs ('eSIMs').

Value: £11.7 million
Location: Denmark, India, South Africa, Ireland, United Kingdom

3 Capgemini SA: Capgemini is a global leader in consultancy, technology and outsourcing services.

We advised on the sale of IBX Business Network in Europe, India and the US to Tradeshift, creating the world's largest business commerce platform.

Value: confidential
Location: Sweden, Germany, France, Romania, US, Norway, Denmark

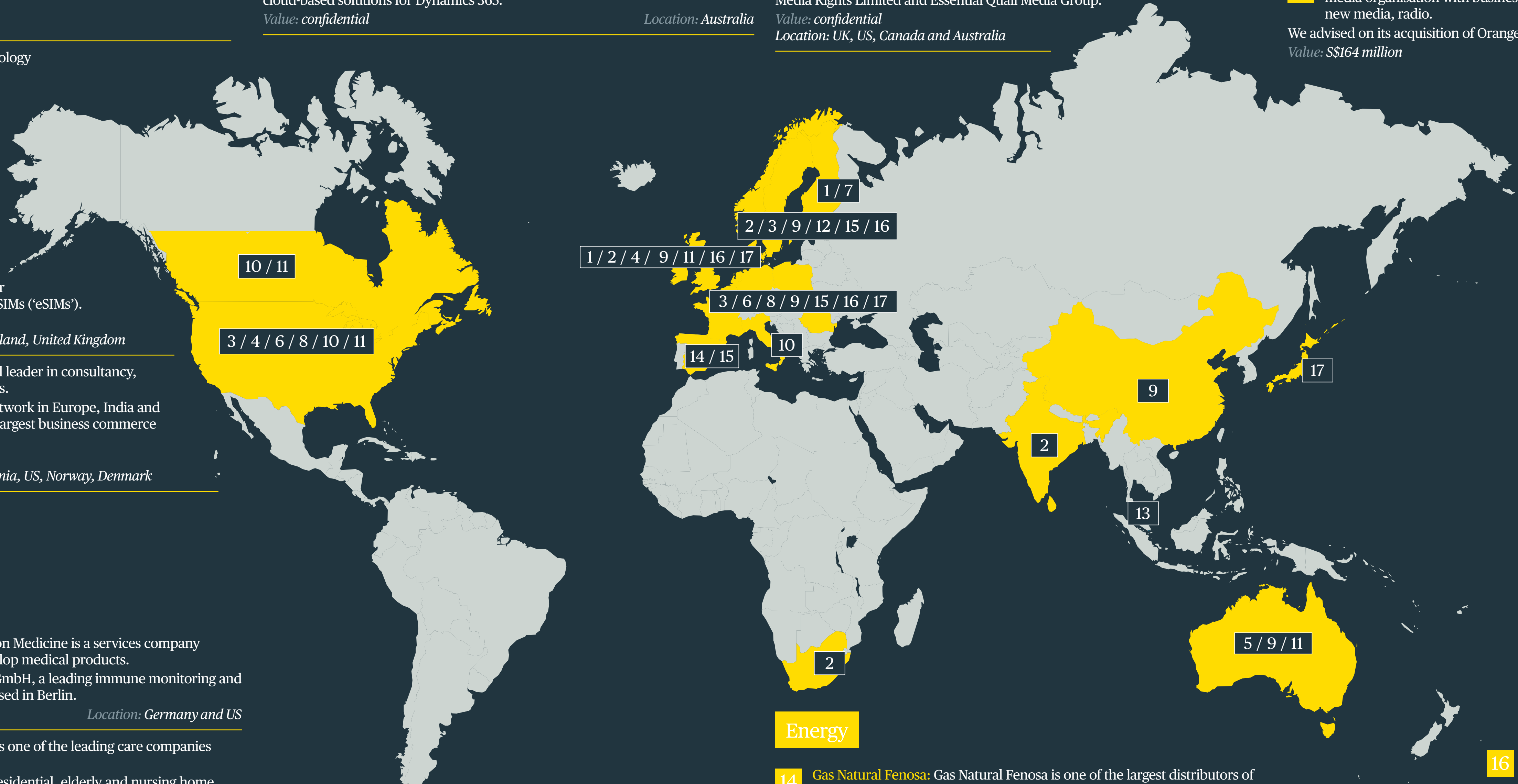
4 RhythmOne plc: RhythmOne (formerly blinkx) is a digital advertising company traded on the London Stock Exchange AIM market.

We advised on its acquisition of YuMe Inc., a New York listed company, which provides digital video brand advertising.

Value: $185 million *Location: UK and US*

5 DXC Technology: DXC is the world's leading end-to-end IT services company. We advised on the on its acquisition of Sable37, a leading Microsoft Dynamics 365 Value Added Reseller and global independent software vendor of cloud-based solutions for Dynamics 365.

Value: confidential *Location: Australia*



Lifesciences & Healthcare

6 Precisison Medicine Group: Precision Medicine is a services company helping life science innovators develop medical products.

We advised on its acquisition of Epiontis GmbH, a leading immune monitoring and epigenetic technology service provider based in Berlin.

Value: confidential *Location: Germany and US*

7 Esperi Care Group Oy: Esperi Care is one of the leading care companies in Finland.

We advised on a series of acquisitions of residential, elderly and nursing home care facilities in Finland:

- Kainuun Hoivatalo Oy
- Viiankoti Ltd
- Hoivia Ltd
- Palvelukoti Rantakartano Oy

Value: confidential *Location: Finland*

8 Flexion Therapeutics: Flexion is a specialist pharmaceutical company focused on the development and communciation of novel non-opioid pain therapies.

We advised on its acquisition of Hamburg-based gene therapy specialist GeneQuine Biotherapeutics' knee osteoarthritis programme.

Value: $64million *Location: Germany & US*

9 Widex: Widex produces hearing aids which are sold in more than 100 countries around the world.

We advised Widex on its merger with Sivantos creating the world's third largest hearing aid manufacturer.

Value: $8billion
Jurisdictions: Denmark, Germany, UK, France, Poland, China and Australia

Media

10 Hootsuite Inc.: Hootsuite is the most widely used social media management platform headquartered in Canada.

We advised on its acquisition of AdEspresso, a SaaS solution for Facebook and Instagram advertising.

Value: confidential *Location: Italy, US and Canada*

11 Kew Media: Kew Media, listed on the Toronto Stock Exchange, is a leading content company that produces multi-genre content worldwide.

We advised on its acquisition of Content Media Corporation Plc, TBC Media Rights Limited and Essential Quail Media Group.

Value: confidential
Location: UK, US, Canada and Australia

12 Dentsu Aegis: Dentsu Aegis is a global media group, made up of 10 global network brands, specialising in Media, Digital and creative Communications.

We advised on its acquisition of Outfox Intelligence, a certified partner to Google and Optimizely, one of the world's largest retailers of the data analysis tool Google Analytics 360.

Value: confidential *Location: Sweden*

13 Singapore Press Holdings Limited: Singapore Press Holdings is Asia's leading media organisation with businesses in with businesses in print, Internet and new media, radio.

We advised on its acquisition of Orange Valley Healthcare Pte Ltd.

Value: S$164 million *Location: Singapore*

Energy

14 Gas Natural Fenosa: Gas Natural Fenosa is one of the largest distributors of natural gas in Spain, Italy, and Latin America.

We advised on the sale of 20% of its natural gas distribution and transmission business in Spain to a consortium comprising Allianz and Canadian pension board CPPIB.

Value: €1.5 billion *Location: Spain*

15 Cerberus Capital Management: Cerberus is a private investment firm, managing over $30 billion, based in New York City with affiliate and advisory offices across the United States, Europe and Asia. We advised on its acquisition of a solar portfolio, involving the bid and simultaneous acquisition of a loan portfolio of the HSH Nordbank (HSH) and an associated debtor structure from Kaiserwetter.

Value: €200 million
Location: Germany, Spain, Denmark, Netherlands, Poland, Belgium, Luxembourg

16 Abbey renewables: Abbey renewables is a development and investment company in the renewable energy, logistics and produce sectors.

We advised on the sale of 14 wind farms across England and Scotland. The wind farms were acquired by the investment arm of Aviva.

Value: £44 million *Location: UK and Sweden*

17 Sojitz Corporation: Sojitz Corporation is one of the largest trading companies in Japan, its chemical division produces and sells more than one million tons of methanol in the Asia region annually, which is mostly used for the production of paints, plastics, adhesives and medicines. We advised on its acquisition of all shares in Solvadis Holding S.à r.l.

Value: confidential
Location: Germany, Luxemburg, Belgium, Poland, Japan, England

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