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10 KEY ISSUES IN M&A LITIGATION

Main causes of conflict and recommendations for preventing them

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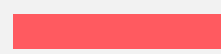

Company acquisitions through the purchase of stock are complex transactions that can lead to disputes between purchasers and sellers. In the absence of agreement, these disputes will be settled before a court or an arbitral tribunal.

Based on our litigation and arbitration experience, this brochure outlines the 10 main disputed issues and some solutions to prevent them.

The first few keys concern substantive issues: breach of preliminary agreements, price determination, lack of veracity or breach of representations and warranties, specific indemnity clauses, the relevance of the buyer's knowledge in contractual liability mechanisms and risk coverage through W&I insurance.

The next keys address procedural issues: contractual claims procedures, third-party determination of contractual aspects, expert evidence in court or arbitration proceedings, submission of the dispute to court or arbitration and whether to provide alternative dispute resolution mechanisms such as mediation.

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Table of contents

Key 1	Preliminary agreements. Breach
Key 2	Price
Key 3	Representations and warranties
Key 4	Specific indemnities
Key 5	W&I insurance: A growing trend
Key 6	The impact of the buyer’s knowledge on the seller’s liability
Key 7	Contractual prior claims procedure
Key 8	Third-party determination of contractual elements
Key 9	Expert evidence
Key 10	Dispute resolution procedures—court or arbitration? Mediation as an alternative

Key 1

Preliminary agreements. Breach

Buyers and sellers enter into preliminary agreements to prepare, negotiate and sign a future contract. In M&A transactions, during this period, the parties usually sign a letter of intent (“LOI,” also called memorandum of understanding, heads of agreement or term sheet), stating their intention to begin or continue negotiations to reach a final purchase agreement.

LOIs can have different content, but the parties typically address the following aspects: the state of their negotiations to date; a statement of their willingness to negotiate the purchase of a company and, if applicable, an obligation to negotiate exclusively for a certain period of time; provisions governing the negotiation process; and confidentiality obligations. It is also common to include a non-binding clause whereby the seller and the buyer state that they are not obliged to enter into the transaction on the terms set out in the letter, while including certain binding clauses (e.g., confidentiality, exclusivity, jurisdiction and applicable law).

The parties may be interested in signing a LOI for diverse reasons, e.g., ensuring exclusivity of the offer for a certain time; establishing confidentiality (and its scope) of the information disclosed during negotiations; setting out the conduct required of the participants in the negotiation and of the directors and officers of the parties; or determining due diligence terms and period.

Regardless of whether they have signed a LOI, Spanish law and the general duty of good faith under our Civil Code impose certain obligations on the buyer and the seller during the negotiation phase. This negotiation phase may result in signing the purchase contract or breaking down of negotiations.

When negotiations break down, the remedies available to the “frustrated” buyer or seller will depend not only on the documents signed and the status of the negotiations but, in particular, on the actions of the parties. All this will determine whether we are dealing with mere preliminary agreements, a pre-contract or even a final contract. These will produce different effects and claims of different scope.

While the consequences of breaking down preliminary negotiations are clear, the line between a preliminary agreement and a contract (or, as the case may be, a pre-contract) in complex negotiations may be blurred. This is a question of fact to be determined by the courts or arbitration on a case-by-case basis, including any compensation.

To avoid undesired consequences for the parties, it is important to have specialized legal advice regarding the letter of intent and the actions of the parties during the negotiation phase:

To define the scope of the obligations undertaken and their consequences.

To claim or defend against potential liability for *culpa in contrahendo* in the negotiation of preliminary agreements**.**

To claim or defend against liability for breach of obligations under the letter of intent such as confidentiality, exclusivity, non-receipt of offers or transfer of information.

Key 2

Price

The price mechanism plays a fundamental role in transactions as complex as company acquisitions. Rather than agreeing on a fixed price, it is most common to regulate a price adjustment based on closing accounts or through a locked box mechanism.

Under price adjustment mechanisms, the price is determined after the closing date, based on the company's financial statements and a calculation of the relevant financial parameter(s) prepared by the buyer (generally, net financial debt and working capital). Therefore, the economic risk is transferred to the buyer on the closing date.

Under locked-box structures, the price is calculated based on the company's most recent balance sheet prior to the date of the contract. The price is not subject to subsequent adjustment, unless there is some type of leakage as defined in the contract. Therefore, the economic risk is transferred to the buyer on the date of the reference financial statements.

Although, traditionally, the most common price mechanism was the adjustment based on closing accounts, both systems now coexist and the option for one or other adjustment is negotiated between the parties.

Another possibility is agreeing to an earn-out, consisting of a variable deferred consideration (usually in combination with a price to be paid on the closing date). It is calculated based on certain contractual parameters, either financial or non-financial. However, the price is usually conditional on the future profits of the target company (most commonly EBITDA).

Whatever the mechanism agreed, the contract should determine the price to the greatest extent possible, linking the remaining part to clear and objective parameters to minimize disputes over its calculation. If the contract provides for expert determination in the event the parties fail to reach an agreement, it is advisable to follow the recommendations set out in key 8.

Furthermore, the seller should ensure it has access to the necessary information to check or determine the amount pending calculation. Also, during the period of accrual of the variable price (as the case may be), the buyer should be required to comply with certain obligations (to do or not to do).

To avoid undesired consequences for the parties, it is important to have specialized legal advice in the negotiation of the purchase agreement and the price clause. In particular, it is especially important to determine the price to the greatest extent possible, linking the remaining part to clear and objective parameters.

Key 3

Representations and warranties

Company purchase agreements usually include a specific liability arrangement. The seller grants representations and warranties (R&W), which include fundamental warranties (R&W relating to the seller's capacity and title to the shares) as well as business warranties (R&W concerning the business of the company whose shares will be acquired) for the period specified in the agreement (usually ranging between 18 months and 24 months from the closing date). The lack of veracity or breach of the R&W will oblige to seller to indemnify the purchaser for any damages it or the company may suffer. Any claims made to this effect must follow the procedure set out in the agreement.

The purchaser must ensure that the R&W include at least all of the aspects that are essential for it as regards the company it intends to purchase. Moreover, if it becomes aware of any significant contingency during the due diligence process, the purchaser must assess whether it would be advisable to specifically regulate the consequences in the agreement to avoid potential disagreements as to the value and meaning of its awareness of the risk and, particularly, whether this was taken into account on setting the price of the agreement.

Regulation of the consequences of known risks is commonly carried out through the seller's indemnity undertakings in case the risks eventually occur (known as "specific indemnities"), as we will see in the following key.

Key 4

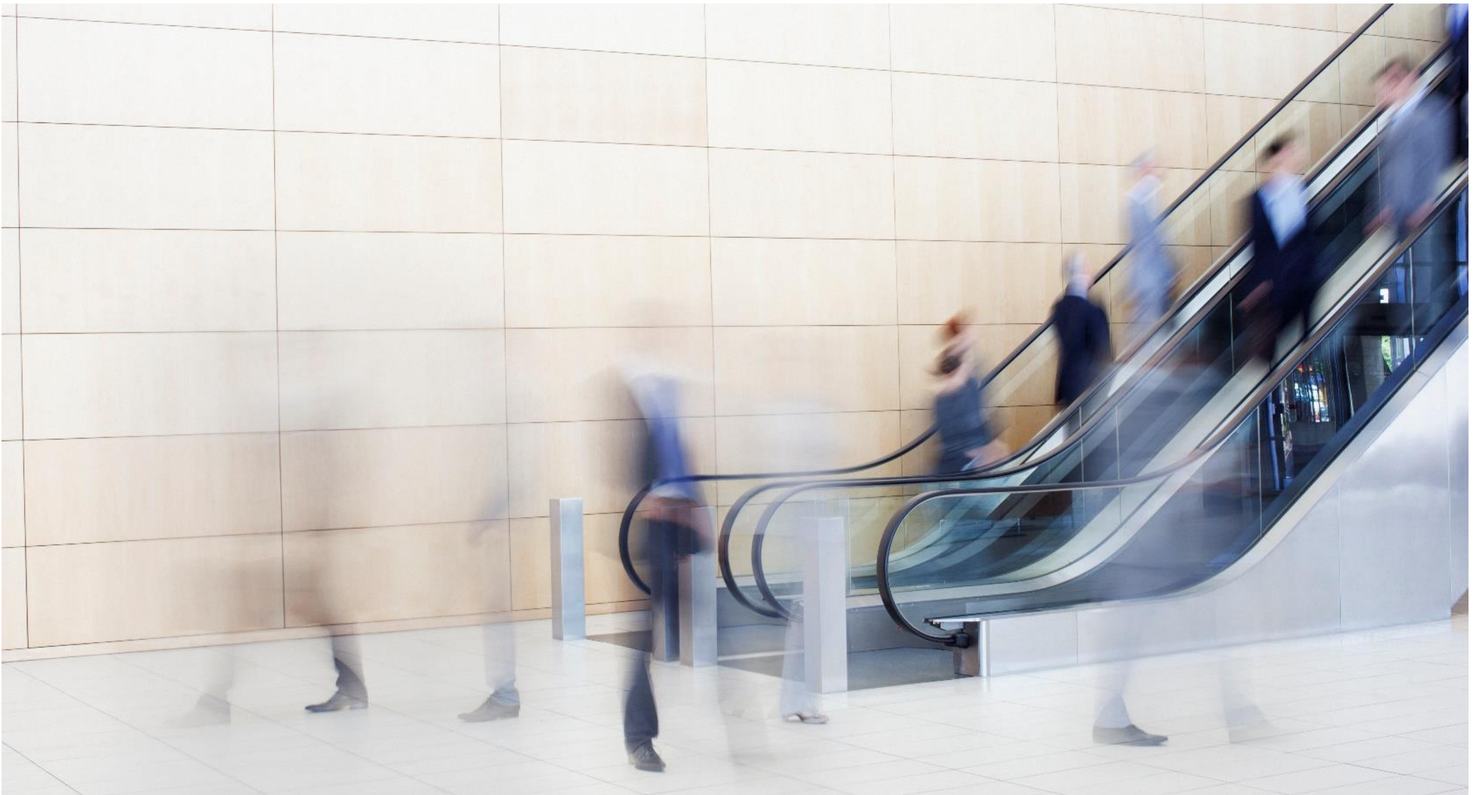
Specific indemnity

Specific indemnity is a compensation instrument available to the seller that differs from the R&W arrangement used for particularly significant contingencies that were already known before signing the company purchase agreement and the purpose of which is to cover the purchaser's risk if the contingencies occur after the transaction is closed.

Therefore, it is used when the purchaser becomes aware—usually when conducting the due diligence—of the existence of a contingency that is likely to cause damages for the purchaser and, instead of changing the price (an option the seller will be very reluctant to accept as it is not an actual, but potential damage) or even backing out of the transaction (an option that is unduly burdensome for both parties), the purchaser agrees with the seller that the latter will assume any negative financial consequences arising from that risk (as they are not usually subject to any quantitative or time constraints).

To claim the coverage provided under a specific indemnity, the purchaser will only be required to prove or justify the damage and the causal link (i.e., that it is the result of the circumstance described in the specific indemnity), and not the breach of a R&W.

Depending on the contingency covered by the specific indemnity of the particular case, it is highly advisable for the purchaser to regulate how the damage will be quantified if it occurs, and to establish the possibility of claiming compensation for damages from when it can be quantified, even if no actual disbursement has been made. Also, it is advisable for the purchaser to include as specific indemnities any contingencies it identifies before signing the agreement (generally, through the due diligence) for which it may wish to file a claim.



Key 5

W&I insurance: A growing trend

The use of R&W insurance policies in M&A transactions (known as R&W insurance or W&I insurance) has risen considerably in recent years, especially in transactions involving private equity funds and in auction processes. This upward trend is partly due to (i) the contracting process having been simplified in time and form; (ii) the greater supply-side competitiveness, leading to lower premiums; and (iii) the trend having been driven by a seller's market.

The market offers different types of coverage, the most common being insurance covering unknown risks. There is insurance that covers known and identified risks and insurance for ongoing disputes, but it is less common and the premiums are very high.

Regardless of whether the policy is taken out by the seller or purchaser (as occurs in practically all cases), it is intended to provide coverage for breach of the seller's R&W in the SPA, and the general principle is that the insured's situation cannot be better than it was before taking out the policy.

There are two types of policy: (i) without recourse to the seller, meaning that the seller has no liability to the purchaser in case of untruthfulness of the R&W (with the exception, normally, of R&W relating to the seller's capacity and title to the shares), and the purchaser's only recourse is to the W&I insurance; and (ii) with recourse to the seller, meaning that the SPA sets liability limits and thresholds. The seller is liable above the

threshold and up to the limit.

It is important to review the entire draft policy carefully before the execution of the SPA or the closing (as the case may be) to ensure consistency between the policy and the SPA, and to determine the seller's liability in the transaction not transferred to the insurer as regards quantitative and time constraints (e.g., it is necessary to analyze the caps and deductibles, the interim period, and the duration of the liability), and for the purposes of the covered item. This last point is important because, in accordance with market practice, R&W policies for unknown risks do not cover the following:

(i) Known risks

(ii) Matters not covered by the due diligence

(iii) Anti-corruption, bribery, money laundering and tax evasion

(iv) Fines and penalties

(v) Price adjustment or locked box mechanisms

(vi) R&W as to future events

(vii) Environmental liabilities

(viii) Transfer pricing and joint and several tax liability for group membership

(ix) Statement of assets

(x) Product liability

(xi) Offsetting of tax loss carryforwards

(xii) Legal reforms

(xiii) Obligations and commitments of the seller on the management of the business during the interim period

To cover this last point and for the insurer to cover any breaches of the R&W at or very near the closing date, a bring-down mechanism can be agreed on. In this case, the seller can provide a bring-down certificate (bring-down disclosure) certifying the accuracy and truthfulness of the R&W on the date of the certificate. If any facts or circumstances known to the seller are identified or occur after the execution of the SPA and cause the R&W to be untrue or inaccurate at the closing date, it may be agreed that those facts or circumstances disclosed in the bring-down certificate will qualify the R&W.

Key 6

The impact of the purchaser's knowledge on the seller's liability

In procedures involving the purchase of a company, the purchaser may become aware of some of the contingencies before acquiring the company, usually during the due diligence process.

Therefore, it has become a common practice to negotiate and regulate the impact of the purchaser's knowledge on the seller's liability if the R&W are breached with regard to the company's situation. If the corresponding clause states that this awareness will not affect the seller's liability, this is known as "pro sandbagging," while if it states that previous awareness will prevent the purchaser from claiming compensation for damages, this is known as "anti sandbagging."

Despite its widespread use in practice, there is no well settled case law of the Supreme Court on the effectiveness of pro sandbagging clauses. This means a case-specific analysis is required, bearing in mind the circumstances of the transaction and the agreements the parties have reached in the SPA.

If the purchaser identifies a risk during the due diligence process and it invokes a pro sandbagging clause to claim compensation for damages from the seller, it may argue in its defense the free will of the parties, the task of allocation and sharing risks in the

transaction under this clause, or that the clause is tantamount to the seller's undertaking of security. The seller may argue that the purchaser's conduct is contrary to contractual good faith, as it constitutes an abuse of rights, or that the purchaser gave its tacit consent to that contingency because it was aware of the risk before signing the agreement and did not request a specific indemnity to cover it.

Without prejudice to a pro sandbagging clause being included in the SPA in the purchaser's interest, if the risk is known and serious, it is highly advisable for the purchaser to negotiate a reduction in the price or to agree on a specific indemnity (particularly when faced with actual, rather than potential damages).

In turn, if anti sandbagging clauses are agreed, it is in the seller's interest to place on record all of the information and documents made available to the purchaser (e.g., the submission before a notary public of a pendrive with all of the due diligence information), thus enabling the seller to prove that the purchaser had access to this information and was aware of the risk.

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To avoid undesired consequences for the parties, it is important to have specialized legal advice in the negotiation of the purchase agreement and the clauses concerning the seller's liability. The following is particularly important:

The purchaser must ensure that the R&W include at least all of the aspects that are essential for it as regards the company it intends to purchase.

If the purchaser becomes aware of any serious risk during the due diligence process, it is highly advisable to negotiate a reduction in the price or to agree on a specific indemnity (particularly when faced with actual, rather than potential damages).

Depending on the contingency covered by the specific indemnity of the particular case, it is highly advisable for the purchaser to (i) regulate how the damage will be quantified if it occurs; and (ii) establish the possibility of claiming compensation for damages from when it can be quantified, even if no actual disbursement has been made.

If a W&I insurance is taken out, the entire draft policy should be carefully reviewed before closing the transaction to ensure consistency between the policy and the SPA, and to determine the seller's liability in the transaction not transferred to the insurer.

If anti sandbagging clauses are agreed, it is in the seller's interest to place on record all of the information and documents made available to the purchaser, thus enabling the seller to prove that the purchaser had access to this information and was aware of the risk.

Key 7

Contractual prior claims procedure

To supplement the seller's liability regime, company purchase agreements usually include the procedure the purchaser must follow prior to bringing a claim before a court or an arbitration tribunal (as determined in the agreement) when it identifies what it considers to be a breach of any representations and warranties.

This prior claims mechanism, which is triggered when the seller is notified of the contingency, usually distinguishes between damages suffered directly by the company and damages resulting from claims the company has received from third parties, detailing the steps that should be taken in each circumstance and the time in which they must be taken. Sometimes a negotiation phase is provided for between the parties during the pre-litigation stage.

The main issue that tends to arise, and that purchasers should take care to avoid, is whether strict compliance with the prior procedure, including all the agreed stages and deadlines, is an essential prerequisite to be able to initiate court or arbitration proceedings.

In this regard, the purchaser will be keener to establish that completing the stages and meeting the deadlines of the prior claims procedure is not a requirement to be able to proceed with the litigation, while the seller is likely to adopt the opposite stance.

It is worth drawing attention to the negotiation phase, as disagreements often arise as to whether a true negotiation has been carried out and, again, whether not carrying it out at all would prevent the purchaser from initiating proceedings. Therefore, the purchaser is advised to set a specific deadline for this phase so that once it has expired, proceedings can be initiated regardless of whether negotiations have taken place.

To avoid undesired consequences for the parties, it is important to seek specialized legal advice in the negotiation of the purchase agreement and the clauses concerning claims for damages. The following is particularly important:

As regards the prior claims procedure specified in the agreement, the purchaser will be keener to establish that completing the stages and meeting the deadlines of that procedure is not a requirement to be able to proceed with the litigation, while the seller is likely to adopt the opposite stance.

If the agreement provides for a pre-litigation negotiation phase between the parties, the purchaser is advised to set a specific deadline so that once it has expired, proceedings can be initiated regardless of whether negotiations have taken place.

Key 8

Third-party determination of contractual elements

Where not all contractual elements are determined at the time of closing, it is common for the parties to appoint a third party for this purpose. In some cases, the third party will determine these elements directly, while in others it will only do so when the parties fail to reach an agreement (e.g., on the price adjustment mechanism).

Experts are often appointed to determine part of the purchase price based on certain parameters, which should be as clear and objective as possible.

The contract should specify the expert's identity to avoid discussions on the appointment. In this regard, it is advisable to include more than one to cover the eventuality that the first candidate cannot take on the assignment for any reason (such as a conflict of interest), but the relevant clause should clearly state the order the experts will be called.

Depending on the circumstances, it may also be advisable to expressly establish the mechanism for contacting the expert, possibly including the letter of engagement as an annex to the contract. The relevant clause may also determine how the expert will receive the information and communicate with the parties—for instance, whether both parties will receive a copy of all the documentation and whether all communications will be addressed to both parties. If the contract establishes a deadline for the expert's opinion, it should also specify the consequences for non-compliance.

Where the parties have so agreed, the decision of the third party will be binding. However, this does not preclude that in certain circumstances such decision may be reviewed in judicial or arbitration proceedings—especially if it departs from the parties' instructions.

To avoid undesired consequences for the parties, it is important to have specialized legal advice in the negotiation of the purchase agreement and the price clause. In particular, when a third party has been appointed to integrate a pending element, it is especially important to take the following precautions:

Specify the expert's identity in the agreement, including more than one in a clear order.

Consider establishing the mechanism for contacting the expert and for providing the information.

Establish the consequences for the expert's failure to comply with the deadlines.

Key 9

Expert evidence

In litigation involving company acquisitions, it is common to use experts to draw up reports that are then submitted to the court or tribunal to prove technical issues supporting the parties' arguments. In general terms, each party will hire its own experts and will submit one or several expert reports, although the court may sometimes appoint an expert, too.

If the dispute is concerning the calculation of a part of the price that has not yet been determined, it will be necessary to consult economists with a background in finance and experience in business appraisals. However, other experts may also be required to assess other aspects. For example, if a dispute arises as to whether the company's assets are in the same condition as the seller has described in the representations and warranties, it will be necessary to seek advice from experts to examine their condition (e.g., architects, if the assets are made up of real estate; insurance actuaries; experts in financial assets, brands, corporate image; among others).

Given the weight of the expert reports to mount a successful defense, it is important to choose the experts carefully and to be in contact with them so that they work alongside the lawyers as soon as their action is needed. Therefore, advising the client on identifying the issues that may require an expert report, on choosing the best experts to compile those reports, and on assisting them and coordinating their work is an essential task to be performed by the lawyers in charge of the matter.

Key 10

Dispute resolution procedures—court or arbitration?
Mediation as an alternative

Disputes involving the acquisition of companies may be settled in courts of law or in arbitration proceedings. Arbitration is particularly advisable when international factors are considered, as it may provide the parties with a neutral forum, enabling them to avoid any controversy concerning jurisdiction. Also, once the award has been served, it is relatively easy to enforce it in different countries.

Moreover, parties often agree to keep the arbitration proceedings confidential. In litigation, on the other hand, the rulings are public and cannot be kept confidential.

Technical complexity is another compelling reason to opt for arbitration, regardless of whether the intention is to have the dispute settled by one or several specialists in the acquisition of companies, or whether the transaction concerns a company operating in a specific sector (e.g., insurance or energy), as it is advisable to rely on specialists in the sector, who will be in a much stronger position to settle the dispute satisfactorily.

In contrast, if the transaction is of little economic significance, or when the contingencies are not expected to be material, it is preferable to initiate ordinary court proceedings, as the high costs of arbitration tend to be discouraging in these cases.

In terms of appeals, ordinary courts of law allow the possibility of lodging them and bringing the case before an appellate court. Although some arbitration regulations allow this possibility, it is uncommon on the market.

In any case, it is worth noting that, generally speaking, first-instance rulings will be subject to provisional enforcement. This means that any payments must be made as soon as the ruling has been handed down, irrespective of whether it can be appealed. Subsequently, if the first-instance decision is overturned, the party that received the money in first instance must return the amount, entailing a risk (for the other party) of it becoming insolvent in the meantime.

However, litigation is frequently unnecessary to settle disputes arising in the context of the acquisition of a company, as many can be settled through a mediation procedure, thus avoiding the costs and delays inherent to court and arbitration proceedings. Mediation is a speedy and efficient solution that allows the parties to retain control over the result of the dispute and to reach, quickly and with total confidentiality, a binding agreement that is enforceable in court.

Mediation also allows the parties to maintain their relationship, without it being damaged by court or arbitration proceedings. Therefore, it is strongly advisable when the sellers continue to have a relationship with the acquired company, and when the transaction is carried out within family businesses.

Under the *Draft law on measures on the procedural efficiency of the public service of justice* (in the process of parliamentary approval in June 2023), it is obligatory to seek an appropriate dispute resolution ("ADR") method as a procedural requirement to be able to initiate proceedings in a civil or commercial court. This means that it will not be possible to bring legal proceedings unless the parties have gone through one of these channels, one of which is mediation. Therefore, if the rule is finally approved in these terms, mediation will offer an added advantage, if the parties have agreed to pursue litigation and are unable to reach an agreement, which is that they will have fulfilled the procedural requirement enabling them to file the corresponding claim.

To avoid undesired consequences for the parties, it is important to seek specialized legal advice in the negotiation of the purchase agreement and the clauses concerning claims for damages. The following is particularly important:

Advising the client on identifying the issues that may require an expert report, on choosing the best experts to compile those reports, and on assisting them and coordinating their work is an essential task to be performed by the lawyers in charge of the matter.

Arbitration is far preferable when (i) international factors are considered; (ii) the parties wish to keep confidential the terms of the agreement or the mere existence of the dispute; or (iii) the case is of particular technical complexity.

In contrast, litigation may be preferable when (i) the transaction is of little economic significance; or (ii) the contingencies are not expected to be material, as the high costs of arbitration tend to be discouraging in these cases.

Mediation, on the other hand, allows the parties to maintain their relationship, without it being damaged by court or arbitration proceedings. It is also a speedy and efficient solution that allows the parties to retain control over the result of the dispute and to reach, quickly and with total confidentiality, a binding agreement that is enforceable in court.

Our Corporate and M&A Disputes practice

Representing clients in the full spectrum of corporate and M&A litigation cases.

Our team of lawyers is highly specialized in corporate disputes, enabling us to offer clients sophisticated and efficient advice, along with innovative solutions. We handle the early stages of disputes in an effort to avoid reaching the litigation stage; however, if litigation is necessary, we guarantee our expertise when preparing for litigation.

After over 20 years in this practice area, we are highly specialized in defending our clients in all types of claims arising from M&A transactions.

In our practice, we combine legal, economic (financial and accounting) and business knowledge to build our defense. In addition, we have extensive experience in international M&A and sales transactions, which involve several legal systems and the coordination of teams based in different countries.

Due to our recognition on the market, we have participated in major corporate disputes of all types.

"Outstanding powerhouse with a top-tier dispute resolution practice." Chambers, 2023

"From the beginning Cuatrecasas understood the case and our needs, implementing a very good litigation strategy." Chambers, 2022

Leading firm in Dispute Resolution and International and Cross-border Disputes

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