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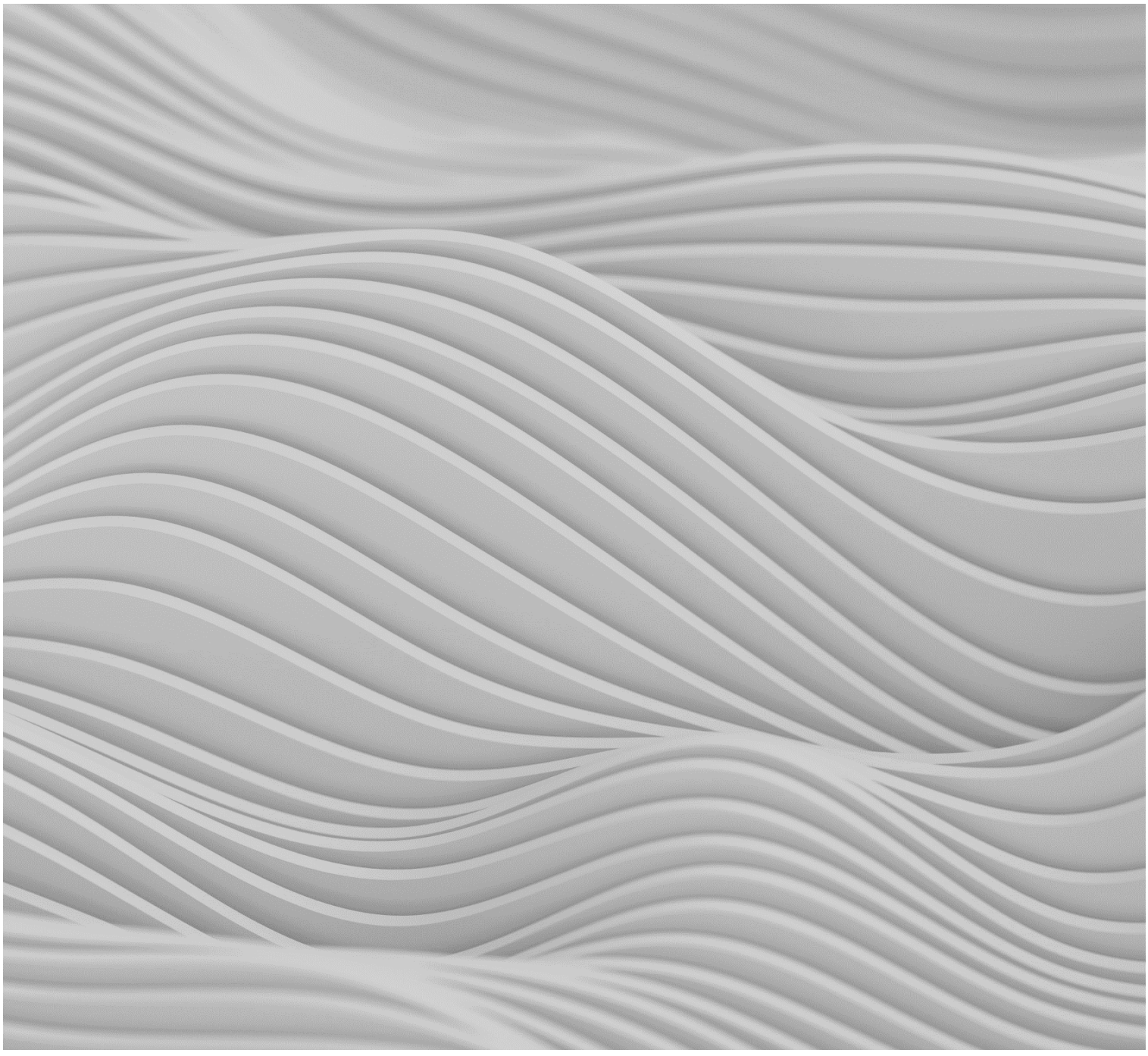
April 2023

10 KEY ISSUES IN M&A LITIGATION

Keys 3, 4, 5 and 6. Representations and warranties, specific indemnities, W&I insurance and the impact of the purchaser's knowledge on the seller's liability



10 KEY ISSUES IN M&A LITIGATION

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, we outline the 10 main disputed issues and some solutions to prevent them through the following "information pills."

The first pill, on breaching preliminary agreements, is available at Key 1. Preliminary agreements. Breach. The second brochure examines keys 2 and 8, which focus on the price and third-party determination of the price. For more information, see Keys 2 and 8. Price and expert determination.

This document looks at four new important aspects: representations and warranties, specific indemnities, W&I insurance and the impact of the purchaser's knowledge on the seller's liability.

In the following session of this cycle, we will continue to address the remaining issues listed at the end of this document.

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 3 years 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 Key 4.

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 anything it may have identified before signing the agreement (generally, through the due diligence), or at least anything it considers important.

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.

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.

Our brochures address the following issues:

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 purchaser'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

For additional information, please contact our *Knowledge and Innovation Group* lawyers or your regular contact person at Cuatrecasas.