Pre-closing disputes

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1. Introduction

In the context of M&A transactions, a deal is not finalised until the closing is done. The closing is the final step of a given M&A transaction, be it an acquisition or a merger. It is a combination of the signing of an agreement and the completion of conditions precedent of various types. It is the end result of a period during which different actions have been undertaken, such as a final due diligence, and the satisfaction of these conditions – eg, competition law filing, verification of the truthfulness of representations and warranties, or the verification that no material adverse change has happened. This phase's length varies according to business practice, typically from several weeks to six months (but possibly even longer). The whole period before the actual achievement of the M&A transaction by the closing is therefore the 'pre-closing phase', during which parties, sometimes with conflicting interests, can face difficulties and hence disputes, and have recourse to arbitration or other alternative means in order to settle their disputes.

To understand the commercial context in which these types of dispute arise, it is necessary to clarify what the usual steps are during that pre-closing period in order to identify the parties involved, as well as the contractual/non-contractual relationship between them and hence the possible types of claim.

The M&A pre-closing process is normally said to include four distinct phases, the fifth phase being the one immediately preceding, or concurrent to, the closing, including final verifications and fulfilment of conditions. These phases, which have become more standardised in these past few years, are the following:

- *Initial negotiations*. These negotiations and contacts are informal but the buyer will be provided with some information through what is generally called an 'information memorandum' – a sort of summary of the company containing basic data. A confidentiality agreement is occasionally executed between the parties, as well as an exclusivity agreement if these preliminary negotiations appear to be potentially fruitful. Parties are here in a pre-contractual relationship in general.
- *Term sheet, memorandum of understanding or letter of intent.* If the initial negotiations are successful and/or if the seller identifies a buyer with which a deal can be concluded in the end, the first step between the parties would generally be to conclude a 'letter of intent' (LoI), sometimes also called a 'term sheet' or a 'memorandum of understanding' (MoU). The name of this document varies as much as its content, depending on the parties' positions,

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and it is therefore vital to analyse its substance with the utmost caution.[1] Its binding effect will depend on its wording, and hence the parties' intention, but it generally outlines the parties' intention at that given moment. This document is generally very descriptive, defining the subject matter of the deal, the nature of the deal (type of sale or merger, for instance), a price range, the procedure that will be followed and a tentative timetable. Most of these letters of intent have legal consequences; and if a confidentiality agreement or an exclusivity agreement has yet to be concluded, it will generally be executed concurrently or included in the LoI. An LoI can also include a dispute settlement provision.

- *Due diligence.* This is a phase during which the buyer is provided with more information about the target business in order to decide, based on further and precise evidence, whether it wishes to close the deal and eventually state further preconditions for such a deal to close. This buyer's investigation includes exchanges of documents but also intense contact and interviews between the still potential buyer and the target company key persons. This phase sometimes enables the buyer to identify what are called 'conditions precedent', ie, conditions that will have to be fulfilled before the deal is closed (and, in particular, representations and warranties). This phase enables the parties to refine their position, strategy and proposals.
- *Merger or purchase agreement.* If the buyer has found the due diligence to be satisfactory, the next logical step is signing a merger agreement, a purchase agreement for assets, or a share purchase agreement (SPA). This is the contractual concrete expression before implementing the envisaged transaction by the parties, which includes the terms and conditions mentioned above as well as the scope of the transaction and its price (or the formula to determine it). The seller's representations and warranties, and its regime, are normally set out lengthily in such an agreement. We refer to the period after this phase as 'post-signing but pre-closing'.
- *Steps leading to the closing.* Before reaching the closing phase, which is not directly a consequence of the signing in most cases, the conditions precedent have to be fulfilled and it is then, and only then, when all these conditions are met, that the closing happens. These conditions can range from a competition law filing to a verification that no material adverse changes have happened to the business since the outset of the negotiations; they generally also include a verification of the correctness of the representations and warranties. These are the classical examples of such conditions but they can differ depending on the specificities of each individual transaction. Once everything is cleared, the closing happens and the deal is closed. The post-closing phase then begins.

Aside from these steps during the M&A process, the pre-closing phase can also be

1 For a more precise analysis, with an arbitration twist, see H Peter and J-C Liebeskind, "Letters of Intent in the M&A Contest" (2005) *ASA Special Series*, No 24, at p265.

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separated into two phases: pre- and post-signing. As one author has put it, the pre-closing phase is "one of the most hectic phases of a merger and acquisition (M&A) transaction, when the parties are struggling to have all the necessary documents ready and are striving to comply with all the conditions to be met for the closing".[2] Being indeed hectic, it creates fertile grounds for disputes that will, more often than not, end up being settled through the most appropriate alternative dispute resolution mechanism depending on the phase during which these disputes crystallize (see further section 4 below).

The different parties in a pre-closing phase, namely buyer(s) and seller(s), can also encounter various difficulties, depending on with whom such a difficulty arises (see section 2 below) and on the different practical issues facing the parties (see section 3 below). But once the dispute is settled or decided, what are the remedies provided and what practical considerations can be envisaged (see section 5)? We will attempt to tackle all these issues to offer an overview of the situations surrounding pre-closing disputes.

2. Parties to the pre-closing disputes

In an M&A operation, the pre-closing dispute appears in a timeframe during which the final deal or transaction has not yet materialised. The transfer of the shares or assets and payments not having been made, these disputes can classically crystallise among buyer(s) and seller(s) and this is the main focus of the present chapter. In fact, the disputes can be separated as follows:

- conflicts among the buyers;[3]
- conflicts between buyer(s) and seller(s) during the pre-signing/pre-closing phase; and
- conflicts between buyer(s) and seller(s) during the post-signing/pre-closing phase.

Disputes among buyers comprise a category that relates to disputes between consortium partners for an acquisition or a merger. Issues can arise if one of the consortium partners attempts to buy the target company alone or if the consortium partners do not agree on the final decision on whether or not to buy the target company. These disagreements between consortium partners and their consequences can therefore lead to disputes and legal proceedings – mainly arbitral as the parties often include an arbitration clause in their consortium agreement and translate it into either damages, if the parties cannot finalise the deal, or declaratory awards indicating the behaviour that is expected from the consortium partners with regard to their agreement during the pre-closing phase.[4]

Disputes between buyer(s) and seller(s) are the paradigmatic pre-closing disputes. Indeed, they involve the two sides of the M&A transaction, with protagonists from

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2 G von Segesser, "Arbitrating Pre-Closing Dispute in Merger and Acquisition Transactions" (2005) *ASA Special Series*, No 24, at p17.

3 Though rare, conflicts amongst sellers can occur as well; but they are rarely related to the M&A operation *per se* and, rather, to their own contractual relationship.

4 See the unpublished ICC and LCIA cases mentioned in G von Segesser, *op cit*, at pp20–1.

each side having incompatible interests. As stated above, these disputes can be separated into two categories pre-signing/pre-closing and post-signing/pre-closing.

The first type of pre-closing dispute generally arises from letters of intent, bad-faith negotiations, an unfair bidding process by violating an exclusivity agreement, due diligence issues, non-fulfilment of signing conditions, or even violation of confidentiality agreements (if any). The second type of dispute, namely post-signing/pre-closing, often arises from failures by the seller to fulfil pre-closing conditions such as obtaining official permits or the correctness of representations and warranties, material adverse changes, or even the violation of covenants by the targeted seller in its business conduct. Issues relating to the pre-signing phase have been addressed in the previous chapter, so we will therefore analyse in greater detail the second type of dispute, post-signing but pre-closing, in section 3 following.

3. Representative post-signing/pre-closing disputes

As explained in section 1 above, an M&A transaction follows different steps that can each potentially result in a dispute. In fact, the potential for disputes increases as the transaction progresses since the undertakings from the sellers, including covenants and the fulfilment of conditions precedent, increase. In the post-signing phase, but still pre-closing, there is a binding agreement/contract signed by the buyer(s) and seller(s) that can thus result in contractual claims, notwithstanding the fact that there has not yet been any transfer of property of the target business.

The post-signing/pre-closing period is a timeframe during which both parties are in a situation where they should both want to close the deal so as to materialise their efforts of the preceding months. But before a deal is closed, many conditions precedent, which cannot be fulfilled before the signing, have to be met both legally and contractually. And most of the disputes arising at this time relate to the non-fulfilment or non-achievement of these conditions precedent (also called 'closing conditions'), which have a suspensive effect on the execution of the agreement until fulfilled.[5] Four categories of conditions (each further described below) are the most common for generating disputes, being:

- obtaining governmental or regulatory authorisations;
- specific covenants and specific conditions;
- a statement that there are no material adverse changes; and
- the correctness of the representations and warranties.

3.1 Governmental or regulatory authorisations

Governmental or regulatory obligations entail, for example, granting official authorisations to operate the target company, or release of some patents by the official authorities, getting licences to continue the target company's activities without interruption by obtaining, before closing, official permits, or a transfer of concessions from the state authorities. This is notably the case in some regulated markets such as the banking, telecommunication or aeronautics industries, where

5 SH Elsing, "Probleme bei M&A-Schiedsverfahren", in Wilhelm Moll (ed.), *Festschrift für Hans-Jochem Lüer Zum 70 Geburstag*, Verlag CH Beck, Munich, 2008, p518 and following.

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official authorisation, permits or concessions need to be obtained to complete a transaction. Failing to obtain such an authorisation, particularly if one of the parties is not diligent or has not undertaken every action it should have, can lead to disputes.

Another very common regulatory authorisation concerns competition law filings as conditions precedent to the closing. Before obtaining the clearance of the competent competition authorities, a transaction cannot be properly, let alone legally, completed. A merger clearance has to be obtained; indeed, failure to obtain such a clearance where it was a condition precedent to the closing can lead to disputes. In an ICC arbitration, the conditions precedent, including an EU merger clearance from the European Commission, had to be obtained by a given date or else the deal would not occur. Since this clearance was not so obtained, the seller sued the buyer alleging that it did not take all the actions necessary to obtain the clearance and claimed for damages. On its part, the buyer indicated that since the conditions precedent had not been met, the promissory agreement had expired and no closing could occur. Based on the facts of the case, the wording of the agreement and the intent of the parties considered under the applicable law, the arbitral tribunal held that the buyers had adopted a reasonable approach, under the circumstances, and that they were thus not negligent nor did they act wrongfully.[6]

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3.2 Specific covenants and conditions

These specific commitments generally concern financial arrangements that need to be obtained by the buyer to close the deal, namely bank loans, guarantees or a guarantor for a loan, etc. The example that can be given to illustrate the point is a DIS arbitration following a share purchase agreement that contained as a condition precedent for the buyers an obligation to obtain a loan, by an agreed date and with binding commitments from one or several banks, of the amount of the purchase price. If the buyers failed to fulfil this condition precedent, the sellers were entitled to 10 million deutschmarks as compensation for the exclusive negotiations. The buyers were only able to provide a conditional loan agreement from a bank, and the tribunal thus concluded that the sellers were entitled to the amount of penalty envisaged in the agreement due to the buyers' failure to fulfil its contractual obligations as per the purchase agreement.[7] This example illustrates the need for these conditions to be drafted carefully or they can have devastating consequences.

Relevant conditions can also concern obligations for the seller/target company to restructure itself before the deal can be implemented, such as assigning some assets to or from the target, refinancing it or taking out all or part of the available free cash.[8] These internal measures, which can also comprise internal communication obligations with employees, remuneration of the management or payment of dividends, can be suspensive and non-negotiable for the buyer. They can prevent the

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6 Unpublished case reported in K. Sachs, "Schiedsgerichtsverfahren über Unternehmenskaufverträge – unter besonderer Berücksichtigung kartellrechtlicher Aspekte" (2004) *SchiedsVZ*, 123 at 127; and G. von Segesser, *op cit*, at p49.

7 *Id*.

8 H Peter, "M&A Transactions: Process and Possible Disputes" (2005) *ASA Special Series*, No 24, at p5.

transaction from going forward and generate disputes over the responsibility of the seller for having failed to fulfil its obligations.

3.3 No material adverse changes

A material adverse change (MAC) can be defined as "an event, fact or issue which gives rise to a material change in the financial conditions, assets, liabilities or operational results of the company as a whole that is so substantial and adverse as to fundamentally impair the company's value to the buyer".[9]

A 'no MAC' clause is one of the paradigmatic provisions of an M&A transaction, in which the seller undertakes that the target company will not be materially different at closing from what it was during earlier inspections. If this is not the case, the clause generally allows the buyer to rescind the purchase agreement and thereby refuse to close the deal. It can be found as early as in the letter of intent; but it generally finds its way into the purchase agreement itself, as there should not be any MAC during the post-signing/pre-closing phase.

The potential for disputes is very high, particularly on the interpretation of what is a 'material' change and what is an 'adverse' change. To avoid disputes or interpretative debates, it can be envisaged to include thresholds below or above which the change can be qualified as material, but one can never avoid the possibility of contesting the way this threshold is attained, calculated etc. If such a MAC occurs, and if the parties still have the willingness to close the deal, the buyer is likely to request the seller to lower its selling price. The seller will generally not be in a position to refuse, in order to mitigate its losses and close the deal.[10] If no agreement can be found, a damage claim is likely to be filed if the buyer has the impression that the seller did not do everything to prevent such an occurrence or was even part of the material change.

3.4 Representations and warranties

Correctness of the representations and warranties is a source of dispute both pre- and post-closing as discovery of inaccuracies can happen at the latest stage of the M&A transaction, even when the closing has occurred years earlier. A 'representation' is defined as a statement of facts or allegations from the past of the target company in relation to its current status. In other words "A presentation of fact – either by words or by conduct – made to induce someone to act, especially to enter into a contract".[11] However, a warranty generally moves from the present to the future and, being forward looking, it provides an assurance about the future and hence signifies, in the contractual context, a promise or guarantee.[12]

Blending representations and warranties together in an M&A transaction merges past, present and future statements – through these assurances given by the seller(s) to the buyer(s) – within the terms of the agreement. Section 2-313 of the US Uniform

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9 G. von Segesser, *op cit*, at p29.

10 S Abraham, "When M&A Transactions Go Wrong: The Resolution of Disputes Arising out of M&A Transactions" (2010) *Conference Reports – IBA Annual Conference 2010,* 14, at p16.

11 *Black's Law Dictionary* (8th edn), Thomson West, 2004.

12 *Id.*

Commercial Code defines them thus: "Any affirmation of fact or promise made by the seller to the buyer which relates to the goods and becomes part of the basis of the bargain creates an express warranty that the goods shall conform to the affirmation or promise."

These representations and warranties in an M&A agreement thus serve three distinct objectives: obtaining disclosure and undertakings from a seller, being a mechanism for terminating the agreement prior to closing if they are proved to be wrong, and anticipating the buyers' indemnification in case of false representation or a breach of warranty.

Representations and warranties are a general hot topic of M&A negotiations and one of its key elements.They can include such representations as the following:

- No other contracts were concluded but those disclosed to the buyer(s);
- Financial statements are established according to generally accepted accounting principles (GAAP or IFRS, for example);
- No further liabilities exist than on the most up-to-date balance sheet; and
- There is compliance of the target company with the local legislation.

Hence, "[o]ne important source of disputes is vaguely, ambiguously or incompletely drafted representations and warranties, as the buyer may then more easily claim that the seller is liable for breach of contract and/or (negligent) misrepresentation".[13] It should therefore be in the interests of all the protagonists to an M&A transaction to draft the most precise representations and warranties in order to avoid disputes over interpreting their scope and content.

Besides, as these representations and warranties are made before signing the purchase agreement, the price agreed can sometimes be adjusted accordingly, before closing, if some of these representations and warranties appear to be incorrect as a result of, for instance, the non-existence of certain assets or the discovery of hidden liabilities.[14] These price adjustments are the source of many disputes, both before and after closing, and in a case of profound disagreement can even lead to a decision of the buyer(s) not to close the deal. As many disputes are closely linked to the purchase price, they will often stem from requests for adjustment to that price.

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4. Dispute settlement mechanisms

All the potential for disputes that we have mentioned in the previous section in connection with the pre-closing period warrant specific dispute settlement mechanisms; they also require different remedies, depending on the issues at stake and the stage of the process when these disputes arise.

Given the frequency of disputes in M&A transactions, M&A lawyers have tended in recent years to anticipate them from the outset of the negotiations, by paying more attention to the dispute settlement mechanisms that may be best suited to settle their potential dispute and by including dispute resolution clauses in the

13 B Ehle, "Arbitration as a Dispute Resolution Mechanism in Mergers and Acquisitions" (2005) 27 *Comparative Law Yb of Int'l Bus* 287, at p294.

14 W Peter, "Arbitration of Mergers and Acquisitions: Purchase Price Adjustment Disputes", *Arbitration International*, 2003 Issue 4, 491.