DORSEY
always ahead

UK and European M&A of IP Rich Companies

Presented by:

Fabrizio Carpanini, Partner

Alan Farkas, Partner

Gina Cornelio, Partner (Moderator)

UK and European M&A of IP Rich Companies

Fabrizio Carpanini
Partner, London

Gina Cornelio
Partner, Denver
Moderator

Alan Farkas
Partner, London

INTRODUCTION

What we will cover

The Agenda

- The idea is to focus on matters that highlight the key differences between acquisitions of IP rich companies in the US and UK/Continental Europe
- The overall style and substance of the sale and purchase agreement
- Due diligence issues including the use of seller due diligence reports and reliance
- Pricing mechanisms: completion accounts v locked box
- The approach to representations and warranties and indemnity v damages claims
- The disclosure process
- Governing law

OVERVIEW OF THE M&A LANDSCAPE IN THE UK/EUROPE

The overall transaction climate for IP Rich Companies

- The overall transaction climate during 2018 was strong when compared to 2017
- In the UK this was despite the continuing uncertainty over BREXIT
- The strong transactional climate included deals involving IP rich companies across a number of different sectors including healthcare/medical devices, software and consumer/fashion brands
- Deals included:
  - Michael Kors €1.38bn acquisition of fashion label, Versace
  - Canon Europa Healthcare's acquisition of digital xray system manufacturer DelftHold B.V.
  - €40bn merger of two eyewear giants – Essilor and Luxottica

BREXIT Impact

- UK is due to leave the EU at 23:00hrs GMT on 03/29/19
- Following 2 years of negotiation the UK Govt. and EU agreed the terms of Britain's withdrawal from the EU. However, this agreement has faced widespread opposition and has been resoundingly rejected by the UK Parliament
- The Prime Minister is seeking further "assurances" from the EU on several aspects of the withdrawal agreement the most important being the Northern Ireland backstop governing the boarder arrangements between the Republic of Ireland (a member state of the EU) and Northern Ireland (part of the UK)
- An amended withdrawal agreement is to be re-presented to the UK Parliament for approval before 03/12/19
- There is increasing likelihood as a result of the UK Parliament not wishing to leave the UK without a "deal" that BREXIT will be delayed

BREXIT Impact…Cont'd

- IP/Trademarks
  - No requirement to refile or amend existing registrations or existing applications in the UK or EU
  - EU Trademarks filed after BREXIT will not extend to the UK so will need to file UK applications separately to secure protection in the UK
  - BREXIT will not affect UK membership of the European Patent Convention
- Data Transfer
  - UK law will require safeguards to be put in place in relation to any data exported from the UK
  - Likely that the UK will recognise EU member states as countries that provide an adequate level of protection to personal data and that uninterrupted data flows can therefore continue
  - UK Govt. has confirmed that after BREXIT UK will adopt GDPR. Pending adoption it will be necessary to put in place safeguards such as data transfer agreements for data flows between EU and UK
- Personnel
  - Following BREXIT British Citizens will loose there automatic right to live and work in the EU (other than Ireland due to the Common Travel Area) and visa versa
  - Following BREXIT likely that EU Citizens (other than those in the UK at 03/29/19) will be subject to the same imigration rules as non-EU Citizens (for example US Citizens)
  - Not expected that any UK workplace rights will change in the short term following BREXIT

BREXIT Impact…Cont'd

- Taxation
  - Following BREXIT and in the absence of a new trade agreement with the EU, imports and exports of goods between the UK and the EU will be subject to both customs duties and import VAT
  - In relation to exports, the UK Govt. intends that UK VAT registered businesses will be able to continue to zero rates sales of goods to EU businesses
  - Not expected that VAT rules on the supply of services by a UK business to an EU VAT registered business (or visa versa) will change
- Legal Enforceability of Contracts
  - UK Govt. intends to adopt the "2015 Hague Convention" which provides for enforcement in the EU of contracts which include "exclusive jurisdiction" clauses in the courts of a member state. This means that for contracts governed by English Law and subject to the exclusive jurisdiction of the English courts, the English courts will continue to have exclusive jurisdiction of any dispute
  - Where the contract provides for the non-exclusive jurisdiction of the English courts, the enforceability in the EU of a judgement from a UK court will depend upon the domestic rules of the country in which enforcement is sought

TRANSACTION STRUCTURES, DOCUMENTATION AND COMMON PRACTICE

Offer letters – Heads of Terms and signing deposits

- Offer letters
  - Offer letters typically turn into or form the basis for detailed Heads of Terms or Letters of Intent
  - Actively encouraged to flesh out all important issues before delving into the due diligence and detailed negotiations
  - Will cover all of the usual provisions including target details/assets, pricing, conditionality and sometimes set out high level warranty/indemnity requirements, including limitation levels
  - Heads of Terms will be subject to contract but contain certain specific provisions which may be legally binding (see exclusivity arrangements)
- Signing deposits
  - Not typically used in European M&A transactions other than real estate
  - Signing deposits are occasionally encountered where a non-UK/European purchaser is involved and a perceived execution risk eg Chinese purchaser
  - The amount of any signing deposit is for negotiation although the rule of thumb for real estate transactions is 10% of the purchase price

Exclusivity Arrangements

- Typically expected and requested on most M&A transactions particularly in the context of an auction sale process
- The length of the exclusivity period usually driven by the competitiveness of the auction process
- Relatively short exclusivity periods are the norm – 4–6 weeks?
- Implications for breach of exclusivity by the seller? Must avoid penalties but link to actual loss (professional fees?)
- As a purchaser, expect exclusivity to be granted on the basis that the purchaser is required to reconfirm offer terms every so often, as well as continuing exclusivity to be conditional on certain (due diligence?) milestones being achieved

Style and substance – share sale v asset sale deals and pre-sale reorgs

- UK Agreements not dissimilar in substance from US but style of documents does "look and feel" different
- Common terms include: Conditions, Price, Warranties/Indemnities, Restrictive Covenants, Confidentiality
- Most M&A in the UK and Europe is structured by way of a share sale rather than asset sale; exceptions include:
  - Purchaser only wants to acquire specific assets, for example - IP
  - Business saddled with liabilities, for example - litigation or tax
- Business will often carry out pre-sale re-organisations in order to:
  - Deliver "clean/simplified title" to the "crown jewels"
  - Mitigate tax liabilities
  - Enable sharing of assets, for example IP Licensing
  - Allow a company to ring fence part of its business from potential claims

Transitional service arrangements including IP transitional licences for shared IP

- Where part of a group is being sold (share sale) or a business is disposed of (asset sale) the purchaser/seller may require transitional support. This could include:
  - Sharing IP / Premises
  - Accounting/back office support
- The terms of a transitional services agreement would include:
  - Pricing
  - Duration
  - Rights of termination
  - Rights of future development of IP

Conditions – change of control/ anti-trust/tax clearances

- Typical conditions in M&A transactions in the UK and Europe would include:
  - Change of control
  - Anti-trust
  - Tax Clearances
- A Purchaser of a significant IP asset may require a specific condition to cover IP:
  - Delivery of an IP License
  - IP to be unencumbered
- Other terms include:
  - Timing for satisfaction of condition
  - Criteria to prove condition has been satisfied
  - Consequences if condition not satisfied; extension of time, reimbursement of expenses

DUE DILIGENCE

IP issues to look out for in EU/UK deals

- Work Product developed by contractors
- Liabilities for employment inventions
- Registered rights issues
- Jointly owned right
- Licences in/out

The use of seller due diligence (VDD) reports

- Due diligence reports
  - Typical due diligence will center around financials, legal and commercial aspects although very specific areas around such matters as IP and insurance also form part of the purchaser's due diligence exercise
- The use of seller due diligence reports?
  - The last 5-10 years have seen the emergence in the UK and Europe of seller diligence reports originally focused on target financials as a way of eliciting a more considered offer from prospective purchasers
  - Such reports were also designed to speed up the transaction process
  - Seller reports typically used for deals over a certain size ($50million?) where competitive pressure amongst potential purchasers is anticipated
  - IP rich target companies should consider the preparation of an IP report to assist purchasers but also to flesh out, ahead of any sale process, any underlying issues or problems
  - Typical issues faced by the acquirer of IP rich target companies concern such matters as highlighted in slide 16 including a lack of comprehensive data proving the history of development and title

Reliance on VDD Reports

- The private equity sponsor purchaser is likely to be more familiar with the use of VDD reports because of general practice but also their own inclination to use these when selling portfolio companies
- The US purchaser is less familiar and possibly more skeptical about the use of VDD reports
- If VDD reports are prepared under instructions from the seller, what use are they to a purchaser? This question leads to the "reliance" discussion
- The typical arrangement in an auction sale process is for VDD reports to be made available to prospective purchasers as part of the data room. Provided on a "non-reliance" basis
- The chosen purchaser, who invariably is allowed a period of exclusivity to complete the transaction, may request the original author of each report to undertake "top up" due diligence or have its own advisors undertake any additional work
- The successful purchaser will, as part of the sale and purchase agreement obtain "reliance" on the VDD reports. Specific "reliance letters" will be negotiated between legal advisors
- Who pays for the VDD reports?

PURCHASE PRICE ADJUSTMENT/CALCULATION MECHANISMS

An overview of locked box v. completion accounts mechanisms

– Completion Accounts

- The more traditional method of finalising the purchase price for a target company through the sale and purchase agreement is for accounts to be prepared to the date of completion **after** completion has occurred. These accounts are then "negotiated" between purchaser and seller
- The completion accounts approach sometimes, but not always, leads to a further price negotiation. It also opens the discussion concerning how much the purchaser should pay the seller on completion and whether or not part of the anticipated purchase price should be placed into an escrow account?
- Partly for the reasons mentioned above regarding uncertainty at completion over what the purchase price would ultimately be, as well as a desire to ensure that a purchaser undertakes as much of its financial diligence up front and before completion, the emergence of the "locked box" pricing mechanism has been pushed forward in the UK and Continental Europe

An overview of locked box v. completion accounts mechanisms…Cont'd

– Locked box

- Locked box born out of the private equity sponsor seller looking for greater certainty surrounding the purchase price particularly in the context of returning funds to its investors. Use is now prevalent across many deals
- The locked box arrangement is a seller friendly pricing mechanism as, unlike completion accounts, it does not provide any formal structure within the sale and purchase agreement for calculating and verifying the purchase price post completion
- What is a locked box? It consists of a balance sheet drawn up to an agreed "locked box date" which precedes signing of the sale and purchase agreement. The date may be two or three months pre-signing or as long as six to nine months. Clearly, from the purchaser's perspective, it will want the date to be as close to signing as possible
- The locked box mechanism does provide certain protections against the seller extracting "value" pre-completion – no "leakage" provisions
- The seller agrees to pass the economic risk and reward in the business to the purchaser from the locked box date. As seller does not receive the sale proceeds until completion, seller will seek a rate of interest on the agreed equity price or a "daily ticker" to represent the lost profit between the locked box date and completion
- Seller is required to pay purchaser for any unauthorized "leakage" on a pound for pound basis

REPRESENTATIONS AND WARRANTIES

The general approach and scope of reps and warranties

- As in the US a purchaser will expect in non-public M&A to receive comprehensive warranties from the seller. These typically cover:
  - Ownership of shares/assets
  - Compliance with laws
  - Litigation
  - Employees
  - Intellectual Property
- In the case of public deals (and PE) the purchaser will need to rely on its due diligence (including VDD reports (see above))

The general approach and scope of reps and warranties…Cont'd

- A seller will only provide warranties not representations, as representations will extend potential liability beyond contractual damages
- Legal documentation will include limitations on the Seller's liabilities including:
  - Time limits
  - Thresholds (de minimis)/Caps
  - Disclosure

Measure of damages – indemnity v damages

- A breach of warranty will give rise to a successful claim in damages if the purchaser can show that the warranty was breached and has resulted in a reduction in value in the company or business acquired. The onus is on the purchaser to show breach and quantifiable loss
- An indemnity is a promise to reimburse the purchaser in respect of a particular type of liability should it arise. An indemnity shifts the risk of a particular matter to the indemnifying party thereby allowing the indemnified party to recover on a pound for pound basis in respect of that matter

Rep and warranty insurance

- US terminology: representation and warranty insurance – UK terminology: warranty and indemnity insurance
- UK and Continental European transactions have seen a significant rise in the use of rep and warranty insurance. Probably driven by the private equity sponsor seller which, in the UK and Europe, will not typically provide any warranties or indemnities
- Previously a seller would insure its potential liability under the warranties under what are termed "seller policies". Now rarely used given emergence of the "purchaser policy"
- The purchaser policy is often instigated by a seller and its advisors as part of an auction process. As the warranties are settled and negotiations progress, the purchaser and its advisors take on the negotiation and implementation of the insurance policy dealing indirectly with the underwriter through the chosen broker
- The scope of such policies can vary and for an IP rich target, a purchaser may need the comfort of such a policy to deal with specific IPR issues although it is likely that specific, highlighted issues may require a stand alone policy
- Prevalence of underwriters entering the market. Competition has had positive impact on pricing. As a rule of thumb - premium range of 1%-3% of the required coverage.

The disclosure process – disclosure schedules/bundles/disclosure letter

- In the UK (but less so in Continental Europe) it remains very much the tradition to have a separate document listing out those matters that contradict the warranties in the sale and purchase agreement
- This document is known as the disclosure letter – containing both "general" and "specific" disclosures
- "General disclosures" that the purchaser is deemed to be aware of eg Companies Registry filings and various intellectual property registries
- "Specific disclosures", for example litigation
- Wholesale disclosure of the contents of data rooms

UK and European M&A of IP Rich Companies

Questions ?

Fabrizio Carpanini
Partner
Mergers & Acquisitions
London, England
carpanini.fabrizio@dorsey.com
+44 (0)20 7031 3738

Alan Farkas
Partner
Mergers & Acquisitions
London, England
farkas.alan@dorsey.com
+44 (0)20 7031 3782

Gina Cornelio
Partner
Patent
Denver, Colorado
cornelio.gina@dorsey.com
(303) 352-1170