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English Law on China's Belt & Road

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Using English Law for China's Belt & Road Initiative
- and the Competitive Challenge from Chinese Law
as an Alternative

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Foreward from the authors

Welcome to our guide to using English law for China's Belt & Road initiative - and the competitive challenge from Chinese law as an alternative. We think that this guide is highly topical given the fast-moving economic changes going on in China at the moment and the increased impetus towards China-led outward-bound deal activity and investment, centred around the Belt & Road initiative, in contrast to the preceding economic period when the focus was mainly around in-bound investment into China.

The guide is ambitious in its reach, covering the background to the Belt & Road initiative and what it hopes to achieve, examining in detail the typical deal structures used on transactions under the initiative and also looking at the many choices of governing law and jurisdictions for dispute resolution. As will be seen, there is no 'one-size-fits-all' solution and the position will vary from project to project. It is also quickly apparent that each transaction will in fact involve large volumes of legal documentation with a wide range of different governing laws and jurisdictions, weaved together (often imperfectly) into the overall framework of the project.

We consider in detail the use of English law in Belt & Road transactions and why it perhaps unexpectedly so often remains the primary choice of governing law for the main documentation, even where no English parties are involved. We look in detail at the three primary transaction documents, namely the sale and purchase agreement (or SPA), the shareholders' agreement and the financing agreement. In each case we analyse in detail the complexities and nuances of these documents, including covering the points to negotiate and the pitfalls and traps for an unwary party. As part of this we also look at some detailed and important concepts, including warranties and indemnities, disclosures, limitations of liability and also the points to watch out for on boilerplate clauses.

We go on to consider the use of Chinese law as an alternative to English law for Belt & Road transactions and what the future might hold. We also consider where issues can arise when different governing laws and jurisdiction clauses are, by necessity, being used together on projects and where the overlaps and gaps may lie in wait for the unwary investor.

In this guide, most capitalised terms are defined in the glossary at the end and where relevant the glossary then cross-refers to the detailed section on that particular term in the guide. For those short on time, an abbreviated speed-read version of this guide is also available.

Our guide would not have been possible without the hard work and much appreciated efforts of all of our fellow colleagues at our firm. In particular we would like to express our warm thanks to our colleagues Patrick Daley, Jennifer Ince, Theo Jones, James Marshall and Edward Stewart for all their hard work in helping us to research and prepare this guide.

The contents of this publication are for reference purposes only and are current as at the date of its publication. They do not constitute legal advice and should not be relied upon as such. Specific legal advice about your specific circumstances should always be sought separately prior to taking any action based on this publication.

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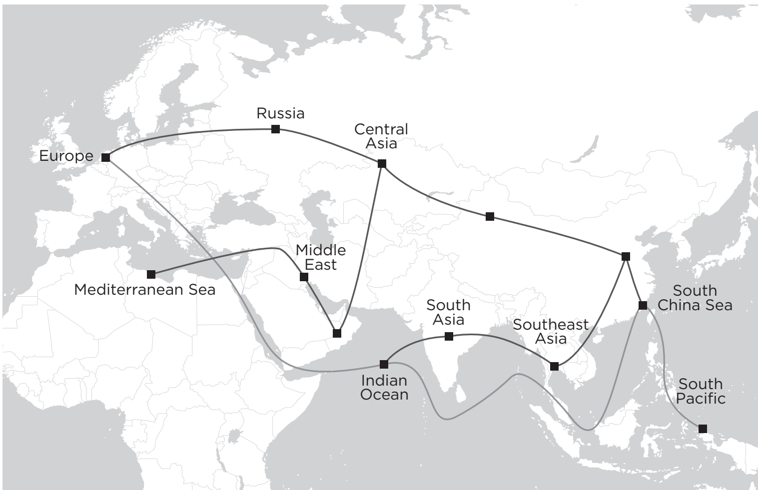
SECTION A: INTRODUCTION

1 WHAT IS CHINA'S BELT & ROAD INITIATIVE?

China's Belt & Road initiative is a development strategy and framework that focuses on connectivity and cooperation amongst countries, primarily between the People's Republic of China (PRC) and the rest of Eurasia, but also reaching into Oceania and Africa. It is also referred to as The New Silk Road or One Belt, One Road (OBOR).

During President Xi Jinping's visit to Central Asia and Southeast Asia in September and October 2013, he first mentioned the Silk Road Economic Belt and the 21st Century Maritime Silk Road (collectively, the Belt & Road initiative) in his speech at Nazarbayev University, Kazakhstan in 2013. At the 10th China-ASEAN Expo in September 2013, PRC Premier Li Keqiang further emphasised the need to build the Maritime Silk Road focusing on ASEAN.



2 A VISION FOR THE 21ST CENTURY

2.1 General background

The Belt and Road initiative underscores China's strategic desire to take on a bigger role in global affairs, to enhance economic and political ties, to improve infrastructure and supply chains and to export excess manufacturing and production capacity. It is sometimes compared to the ancient Silk Road trade routes established during the Han dynasty of ancient China.

In March 2015, *Vision and Actions on Jointly Building Silk Road Economic Belt and 21st Century Maritime Silk Road* (the B&R Guideline) was jointly issued by the PRC National Development and Reform Commission, Ministry of Foreign Affairs, and Ministry of Commerce with the authorisation of the PRC State Council to promote the implementation of the Belt & Road initiative, specifying, amongst other things, the principles, framework, cooperative areas and cooperative mechanisms under the Belt & Road initiative.

2.2 Covered routes and economic corridors

The B&R Guideline outlined five routes under the Belt & Road initiative.

The Silk Road Economic Belt aims to:

- link China to Europe through Central Asia and Russia;
- connect China with the Persian Gulf and Mediterranean Sea through Central Asia;
- bring together China and Southeast Asia, South Asia and the Indian Ocean.

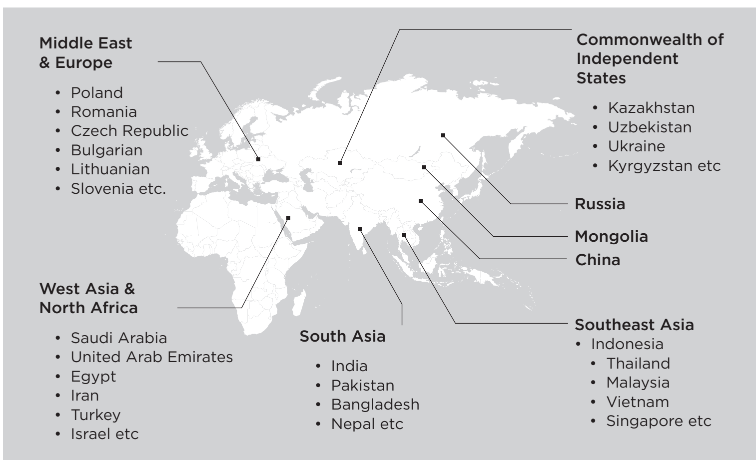
In the meantime, the 21st Century Maritime Silk Road focuses on using Chinese coastal ports to:

- link China with Europe through the South China Sea and Indian Ocean; and

- connect China with the South Pacific Ocean through the South China Sea.

- The Belt & Road initiative aims to promote the connectivity of Asia, Europe and Africa. It covers six international economic cooperation corridors, namely, the Eurasian Land Bridge, China-Mongolia-Russia, China-Central Asia-West Asia, China-Indochina Peninsula, China-Pakistan, and Bangladesh-China-India-Myanmar and envisages cooperation amongst the relevant countries in terms of policy coordination, facilities connectivity, unimpeded trade, financial integration and people-to-people bonds.

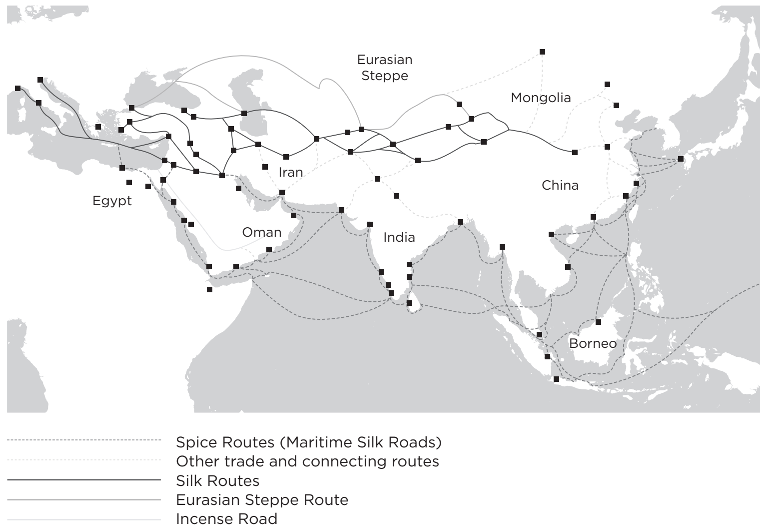
COUNTRIES ACROSS BELT & ROAD ROUTES (MORE THAN 60)



2.3 Compared with the ancient Silk Road

The ancient Silk Road, deriving its name from the trade of Chinese silk, consisted of a series of trade routes established during the Han dynasty (206BC – 220AD) starting in China's East and ending at the Mediterranean Sea, connecting ancient China with the Roman Empire and establishing the trade and cultural relationships between China, India, Persia, Arabia, Greece and Rome. It reached its peak during the Tang dynasty (608-907AD) and played a significant role in the development of ancient Chinese civilisation. Trade decreased as political powers along the route became more fragmented after the fall of the Mongol Empire, finally ending in around 1453 with the rise of the Ottoman Empire.

ANCIENT SILK ROAD



The Belt & Road initiative seeks to recreate the overland ancient Silk Road that connected China with Europe via Central Asia. However, it is even more ambitious in its proposed reach. It is estimated the Belt & Road initiative covers more than sixty countries (around one-third of countries in the world) and affects more than 4.4 billion people (around two-thirds of the world's total population), with an aggregate GDP of USD 2.1 trillion (around one-third of the world's total GDP).

2.4 Recent developments

Since the Belt & Road initiative was first announced in 2013, numerous bilateral arrangements have been entered into between China and countries along the Belt & Road routes. According to China's Ministry of Commerce, direct investment by Chinese enterprises in countries and regions along the Belt & Road routes amounted to USD 14.8 billion in 2015, up 18.2 percent compared with 2014, and the total contract value in 2015 rose 7.4 percent to USD 92.6 billion. In addition, the following major financial institutions have been established with the purpose of providing financing support to projects under the Belt & Road initiative:

2.4.1 Silk Road Infrastructure Fund (Silk Fund)

The USD 40 billion Silk Fund was launched in February 2014 to invest in infrastructure projects under the Belt & Road initiative. It was founded by China's State Administration of Foreign Exchange, China Investment Corporation, Export-Import Bank of China and China Development Bank and is intended to be managed like a sovereign fund.

2.4.2 Asian Infrastructure Investment Bank (AIIB)

AIIB is a new multilateral development bank established in October 2014 with 57 prospective founding members and a registered capital of USD 100 billion. On 16 January 2015, AIIB declared itself open

for business with all 57 founding members having signed the Articles of Association and 48 having ratified them. On 25-26 June 2016, AIIB held its first annual meeting of the Board of Governors in Beijing and announced the approval of the establishment of the AIIB Project Preparation Special Fund and approval of loans with a total amount of USD 509 million to finance four projects in Indonesia, Bangladesh, Pakistan, and Tajikistan.

2.4.3 New Development Bank (NDB)

NDB is a BRICS multilateral development bank established on 15 July 2014 by Brazil, Russia, India, China and South Africa with an initial capital of USD 50 billion.

2.4.4 Mining Industry Development Fund (MID Fund)

The CNY 10 billion MID Fund was launched on 10 June 2015 and founded by Eagle Investment Group Limited and seeks to finance mineral resources, infrastructure facilities and industries related to the Belt & Road initiative.

2.4.5 Silk Road Gold Fund (Gold Fund)

The USD 16 billion Gold Fund was launched in May 2015 and led by the Shanghai Gold Exchange with the cooperation of Shandong Gold Group and Shanxi Gold Group. It aims to facilitate gold purchases for the central banks of Belt & Road countries so as to increase their holdings of the precious metal.

SECTION B: LEGAL FRAMEWORK OF BELT & ROAD TRANSACTIONS

1 THE DIFFERENT LAYERS OF A BELT & ROAD TRANSACTION

The deal structure of most Belt & Road transactions can, on a very basic level, be broken down into four layers, namely:

1.1 **Group company level** – this is effectively the group headquarters level for each of the main participants and where any parent/group level financing will be obtained.

1.2 **Intermediate holding company level** – this refers to the preferred intermediate holding company structures for the respective shareholders for the particular transaction. Typically these will include a choice of *off-shore* companies in order to maximise tax efficiencies and to compartmentalise or ring-fence profits and liabilities. Debt financing is often also introduced at this level.

It should be noted that the use of off-shore companies is under ever increasing international scrutiny over suspicions of tax evasion, but nonetheless many remain lawful, legitimate and flexible choices for cross-border transactions and need to be carefully assessed on a case-by-case basis, albeit with even greater attention being paid to the regulatory and reputational issues surrounding them in today's business environment.

1.3 **Joint venture company level –** this is the level at which the joint venture or joint cooperation between different shareholders will be formed, typically documented in a Shareholders' Agreement relating to a joint venture company. Again, the use of off-shore companies is widespread and the same considerations will apply. Most project-level finance, particularly limited-recourse finance, will be provided at this level. In addition there will probably also be a plethora of project-related

agreements such as government contracts and Concession Agreements, EPC (engineering, procurement and construction) contracts, O&M (operation and maintenance) contracts and off-take arrangements, depending on the nature of the project in question.

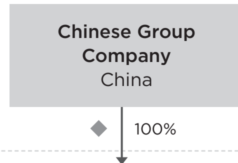
1.4 **Project operation level –** this is the *in-country* level where the operations and business are actually carried out and the assets and real estate are physically located. In the case of cross-border operations (such as international railway projects and energy pipelines) there will be local level issues to consider in more than one country and probably multiple local corporate entities to run them. For practical reasons it is usually preferable for the operational companies to be incorporated locally. Local suppliers usually prefer to deal with local companies and often only local companies can obtain essential permissions such as work permits and construction licences.

Usually the corporate entities at this level will be wholly-owned subsidiaries of the joint venture company, subject to any local law restrictions requiring direct local share ownership. Alternative corporate structures such as representative offices or branches are usually not practical in anything but the short term, due to local restrictions over the types of activities that they are able to carry out. Each deal will need to be assessed on a case-by-case basis.

Section B: Legal Framework of Belt & Road Transactions

CHINESE OUTBOUND INVESTMENT CHART OVERVIEW

Level 1: Group Level



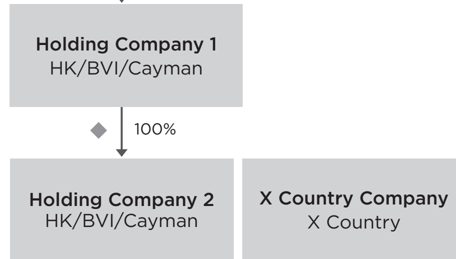
Documents:

- ■ Loan Agreements – Chinese Creditors (Bilateral/Syndicated Facility Agreements)
- ▲ Loan Agreements – International Creditors – (Bilateral/Syndicated Facility Agreements)
- ■ Security Agreements – Chinese Creditors (Pledge/Guarantee Agreements, Trust Deeds)
- ▲ Security Agreements – International Creditors (Pledge/Guarantee Agreements, Trust Deeds)
- ■ Bond Offering Documents issued in China
- ▲ Bond Offering Documents issued in International Market

Documents for equity financing through Chinese company:

- ▲ Framework Agreement
- ■ Capital Increase Agreement
- ■ Share Sale and Purchase Agreement
- ■ Joint Venture Contracts
- ■ Articles of Association
- ■ Ancillary Agreements

Level 2: Holding Company Level



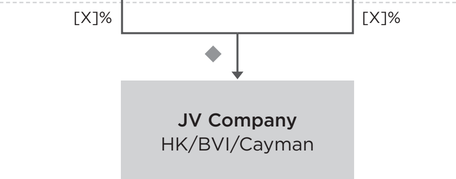
Documents:

- ● Loan Agreements
- ● Security Agreements

Documents for equity financing through overseas SPV:

- ● Framework Agreement
- ● Capital Increase Agreement
- ● Share Sale and Purchase Agreement
- ● Joint Venture Contracts
- ● Articles of Association
- ● Ancillary Agreements

Level 3: JV Company Level



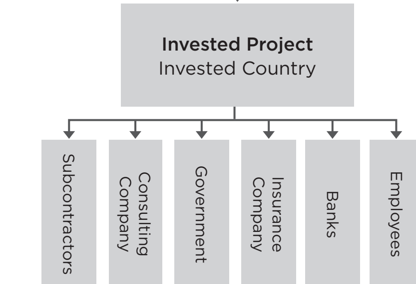
Documents:

- ● Shareholders' Agreement

Documents for a transaction regarding JV Company:

- ● Framework Agreement
- ● Share Sale and Purchase Agreement
- ● Ancillary Agreements

Level 4: Project Operation Level



Documents:

- ▲ Financing Agreements (Loan/Security Agreements)
- ▲ Insurance/Consultancy Agreements
- ▲ Technology and/or IP Transfer Agreements
- ▲ Materials/Equipment Purchase Agreements
- ▲ Subcontracting Agreements
- ★ PPP Framework Agreement/Concession Agreement
- ★ Land/Property Lease Agreements
- ★ Local land permissions and consents to design, construct and operate
- ★ Employment Agreements
- ★ Agreements with local suppliers

Key: ■ PRC Law ● HK/English/New York Law ▲ PRC/HK/English/New York Law ★ Invested Country Law ◆ Double Tax Treaty

At a commercial level there will be many different areas of risk for the various parties to consider and to try to apportion and mitigate as best as possible within the framework of the legal documents. These will include:

- **Political risk** - political support, expropriation/nationalisation, cancellation of concession, import/export restrictions, Taxation.
- **Country commercial risk** - currency inconvertibility, currency controls, foreign exchange risk, devaluation, inflation, interest rates.
- **Country legal risk** - changes in law, law enforcement risk.
- **Development risk** - bidding, planning delay, approval.
- **Construction/completion risk** - delay, cost overrun, under-performance issues, technology issues, completion, Force Majeure, loss/damage to the works, liability risk.
- **Operating risk** - demand, supply, technical issues, Force Majeure, loss/damage to facilities, liability issues.

2 CHOICES OF GOVERNING LAW

2.1 Multiple choice

A question that often arises in the context of Belt & Road transactions is what is the best choice of Governing Law for the contracts and Jurisdiction for Dispute Resolution. In fact, there is no one answer to this question, because in reality each layer of structuring and transaction documentation will have its own Governing Law and Jurisdiction clause.

For example, each corporate entity at each level will have its own constitutional documents governed by its respective laws of incorporation, together with its own local company law requirements. At the joint venture company level, the Shareholders' Agreement and

associated arrangements will be governed by a suitably neutral law acceptable to all parties and compatible with the nature and location of the project. Often this will be English law, although Hong Kong law, Singapore law and New York law are also popular choices.

In the case of Facility Agreements, most lenders will require a neutral or lender-friendly choice of Governing Law which will be easy to enforce. Again, English law is a popular option. In addition, security instruments over shares and assets will usually need to be governed by the laws of the Jurisdiction in which the relevant company is incorporated or the asset located, so as to make enforcement as practical as possible.

In the case of capital raisings on public markets, a whole range of Governing Law and Jurisdiction issues will arise, depending on the location of the issuer, the location of the public markets in question and also the location of the investors/subscribers.

At the project operational level, most of the documentation and arrangements will need to be governed by the laws of the country in which the assets are situated and the business is being operated. This extends to issues such as employment contracts, visas and work permits, planning and construction, environmental issues, health and safety, rights to title and transfer of real estate, local Taxation, etc.

2.2 Concession Agreements

Concession Agreements are contracts between a government and a company, or between an owner and an operator, that gives the right to operate a specific business or asset within the government's territory or under the owner's control, subject to agreed terms and conditions. In the context of a public-private partnership (PPP) they can relate to assets and businesses such as mining rights, public utilities, transport hubs and toll roads. The operator under the Concession Agreement will be given an agreed amount of time to

manage the concession and exclusivity in respect of the business or asset. Often the operator will be required to first finance and construct the asset in question, then operate it for a period (to recoup its investment and make its return) before then transferring the asset to the government at the end of the period (a BOT or Build-Operate-Transfer contract).

Concession Agreements are likely to feature frequently in future Belt & Road transactions. The Governing Law of the Concession Agreement is likely to be the laws of the host country in which the asset or business is located. Normally disputes under the agreement are resolved by the Jurisdiction of the host country.

2.3 Double Tax Treaties

Double Tax Treaties are conventions between two countries that aim to eliminate the double Taxation of income or gains arising in one territory and paid to residents of another territory. They work by dividing the Tax rights each country claims by its domestic laws over the same income and gains. Such treaties are highly relevant to Belt & Road transactions because, where present, they enable the participants to lawfully structure their projects in a more Tax-efficient manner.

China has around one hundred Double Tax Treaties in place, including with most countries in Europe and Asia, Russia and all the CIS countries (Commonwealth of Independent States, being the former members of the Soviet Union), Israel, UAE, USA, Canada and several countries in Africa.

In the case of Double Tax Treaties with China, in addition to the important principal of the Tax-payer not being subject to double Tax on the same income or gains, the benefits usually include reduced dividends Tax on profit repatriation overseas, reduced withholding Taxes and fair treatment on transfer pricing.

It should be said that Tax rules are complicated and beyond the scope of this guide and specific advice should always be taken.

2.4 Bilateral Investment Treaties

In addition there may be Bilateral Investment Treaties (BITs) in place between China and Belt and Road transaction countries. A Bilateral Investment Treaty is a trade pact or agreement establishing the terms and conditions for private investment by nationals and companies of one state in another state. It effectively sets up guidelines for foreign investment in each other's countries, including national treatment, fair and equitable treatment, protection from expropriation and performance requirements for investments, and access to neutral dispute settlement.

Where an investor's rights are infringed, BITs give it the right to submit an investment dispute with the host government directly to International Arbitration primarily under the rules of the International Centre for Settlement of Investment Disputes (ICSID). Disputes under BITs will be governed by the terms of the relevant treaty and international law, and not necessarily by the law specified in contracts related to the underlying investment. Arbitral awards can be enforced in any of the one hundred and fifty-six countries that are signatories to the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the New York Convention).

China has Bilateral Investment Treaties in force with over one hundred countries, including the UK, France, Germany, Italy, Israel, Australia, New Zealand, India, Singapore, Indonesia, Myanmar, Japan, South Korea, Russia, Kazakhstan, Kyrgyzstan, Mongolia, Ukraine, South Africa and UAE. Talks are also in progress between China and the USA.

2.5 Multilateral treaties

Another thing to watch for in this area is the future development of multilateral investment treaties and free trade agreements between China and other countries in the Belt & Road initiative and how this might impact on the rights and obligations of the parties in transactions. China has already identified three strategic blocks, in Africa, Lusophone (Portuguese-speaking) countries and Latin America and is actively promoting the creation and development of multilateral organisations designed to promote trade and investment between the participating countries.

2.6 Sovereign immunity

The principles of sovereign immunity should also be borne in mind. The laws on sovereign immunity are complicated and will vary from country to country and local advice should always be taken. Broadly speaking, sovereign immunity, sometimes referred to as state or crown immunity, is a legal doctrine by which the sovereign or state cannot commit a legal wrong and is immune from civil suit or criminal prosecution. It is based on the principle that the Courts of one state may not exercise Jurisdiction over another state.

It operates on two levels:

- immunity from suit; and
- immunity from execution and enforcement.

Immunity from suit will prevent a Court or Arbitral Tribunal from considering claims against that party. Immunity from execution and enforcement will prevent a national Court from recognising a foreign judgment or arbitral award against the immune party and from making and executing orders against it.

The traditional rule in most Jurisdictions was an absolute one: states could not be sued in a foreign Court. As states became increasingly involved in acts of a commercial nature (often through agencies, organs or State-Owned Enterprises (SOEs)) most countries developed a doctrine of restricted immunity: drawing a distinction between public or state activities, in respect of which state immunity applies, and private or commercial activities in respect of which it does not. However, not all countries have adopted the doctrine of restricted immunity. For example, Russia and China (including Hong Kong) continue to apply the traditional rule of absolute immunity.

Care therefore needs to be taken when dealing with foreign states and those which may claim to be acting under the control of a state, including SOEs and Sovereign Wealth Funds. In the context of China, a SOE which enjoys independent management and freedom from interference of the PRC government, has ownership of assets and has the capacity to assume civil liabilities usually does not enjoy immunity as a matter of PRC law and may be sued in the PRC Courts and, in principle, be subject to the Jurisdiction of an Arbitral Tribunal.

However, the PRC government, as well as any foreign sovereign state, enjoys absolute immunity before the Courts of Hong Kong, and a waiver of sovereign immunity must be presented to a Hong Kong Court at the time the Court is asked to exercise Jurisdiction over the dispute. Therefore, any contractual waiver or Arbitration clause made before the dispute arises will not be recognised by the Hong Kong Court as an effective waiver of immunity.

Also, in many countries execution is only possible against state assets used for commercial purposes. State assets likely to be protected by state immunity include property of a state's central bank or other monetary authority, property of a diplomatic mission, military or cultural property of the state and the collection of taxes or public payments.

3 THE DIFFERENCE BETWEEN GOVERNING LAW AND JURISDICTION

3.1 Definitions

Governing Law, also referred to as substantive law or applicable law, is the law that applies when interpreting the agreement and in determining any disputes regarding it.

Jurisdiction provisions deal with the physical location of where a dispute will be heard, the type of institution (Court or Arbitration Tribunal) that will hear the dispute and which procedural law is used in any hearing.

3.2 Governing Law

Generally speaking, if the parties have not expressly chosen a particular Governing Law, the contract will be governed by the law of the country with which the contract is most closely connected. This will usually be the place of business of the performing party or the place of performance of the contract. However, for any significant agreement the parties will invariably expressly specify what the Governing Law is.

The choice of a Governing Law is likely to bind the parties even if it later transpires that another law would be more favourable for one party. It is therefore important to consider Governing Law clauses very carefully before entering into the agreement. Generally, the parties' express choice of law will be respected. Examples of exceptions in the contractual context are Jurisdiction-specific and may include employee relations, consumer contracts and real estate transactions.

In the European Union member states including England, in some circumstances, parties can now also choose that the Governing Law applicable to their contact also applies to any non-contractual obligations (such as a claim in tort for pre-contractual Misrepresentation).

3.3 Jurisdiction

It is always important to consider the enforceability of any judgment when considering the Jurisdiction clause. If the assets of the potential defendant are located in a different country to the Jurisdiction being considered, any judgment would need to be easily utilised and enforced in that other country in order for the judgment to be of value.

Court judgments are enforced in a foreign Jurisdiction either where there is a treaty providing for such enforcement, or on the basis of the international law principles of reciprocity and comity. If a judgment would not be easily recognised and enforced, it may be appropriate to consider using Arbitration, because enforcement of an Arbitration award via the New York Convention may be more straightforward.

Position in England

In the case of England, English Courts will assume Jurisdiction even if the parties have contractually agreed on a foreign Jurisdiction in situations where:

- the choice of Jurisdiction is non-exclusive and the claim has a connection with England which gives the Court Jurisdiction;
- the defendant participates in the English proceedings other than to contest the Jurisdiction;
- exclusive Jurisdiction is granted to the English Courts either under specific EC regulations (namely the Brussels Regulation or under the Lugano Convention). For example, where the dispute relates to real property which is situated in England; or
- the common law rules of Jurisdiction apply and England is the most appropriate forum for the claim.

3.4 Consistency

Usually, the parties aim to achieve consistency between the Governing Law and the Jurisdiction provisions in their Agreements. In most cases, the parties are likely to want the non-contractual and contractual Governing Laws to be the same and the Governing Law to be the law of the chosen Jurisdiction.

3.5 Reasons for a Jurisdiction clause

Including a Jurisdiction clause is important because:

- it grants Jurisdiction to the Court of chosen country;
- it can exclude the Jurisdiction of other Courts;
- it aims to avoid an expensive and time-consuming Jurisdictional battle; and
- it is likely to impact on the procedure and outcome of any dispute.

3.6 Dispute Resolution out-of-Court

There are many different types of private Dispute Resolution which may be more appropriate than Court litigation.

Agreeing to resolve disputes out-of-Court also allows the parties to control the process, the timetable and the costs involved. The main types of alternative Dispute Resolution are:

- Arbitration.
- Expert determination.
- Mediation.

- Early neutral evaluation.

3.7 Arbitration

3.7.1 Background

Arbitration is one of the most popular choices for Dispute Resolution for international transactions.

Under English law, parties can agree in the contract to refer matters in dispute to Arbitration, where an independent third party gives a binding ruling. The parties are free to select the arbitrator, the venue and agree the procedural rules to be applied. They can also specify precisely which matters, or which type of matter, is to be referred to Arbitration and which is to be referred to Court.

Arbitration hearings are usually held in private, which may be of particular value to companies with reputational concerns. Another advantage of Arbitration is that the parties can select people with specialist knowledge (perhaps of a technical nature or in a particular industry sector) as arbitrators. This will usually enable the dispute to be determined more efficiently and cost-effectively. However, it may be difficult to predict the precise nature of the dispute at the time the agreement is entered into. Even an Arbitration clause with very limited scope (for example limited to share valuation disputes) may appear at first glance as being obviously suited to an accountant arbitrator. In the event, however, the dispute may concern an issue of construction of an agreement for which a lawyer may in fact be the better choice as arbitrator.

Even within the contract, an Arbitration agreement is a contract in itself and the usual contractual principles apply. If a disputed issue falls outside of the Arbitration agreement, the arbitrator has no Jurisdiction to rule on the issue.

The parties may choose a sole arbitrator or a panel of arbitrators. Whilst appointing a sole arbitrator has the advantage of being less expensive and perhaps more time efficient, a panel of arbitrators can offer a wider spread of expertise and disciplines. A further consideration to bear in mind is that if the venue or seat for the Arbitration is in a country other than the country of Governing Law of the dispute, there may be an advantage in specifying that the chairman of the Arbitration Tribunal shall be a lawyer qualified in that Governing Law Jurisdiction.

However, Arbitration may not always be suitable for the parties or the particular agreement. For example, where the claim is straightforward, it may take longer to resolve the issue through Arbitration than through litigation. Courts usually also have the power to compel reluctant third parties to join the proceedings, attend hearings or give evidence if necessary. An arbitrator does not have these powers. Parties must also pay their portion of the Arbitrator costs in advance and will only be reimbursed if the Arbitrator makes a costs award in its favour.

3.7.2 International Arbitration

The rules of the International Chamber of Commerce and the London Court of International Arbitration (LCIA) are widely used in international transactions governed by English law. In addition to setting the procedural rules of the hearing, the secretariat offer administrative assistance and framework guidance to the parties, and can also appoint arbitrators if the parties cannot reach agreement.

The International Chamber of Commerce is often a first choice in international agreements because of its wide international reputation and the fact that it is *tried and tested*. Arbitration under the International Chamber of Commerce rules can be more expensive than other forms of institutional Arbitration as its fees are calculated by reference to the value of the claims subject to the proceedings. There can also be some additional delay in the early stages while the terms of the Arbitration are being formulated.

The London Court of International Arbitration has an excellent international reputation, particularly for London-based Arbitration. It has built a reputation of operating efficiently and has fixed fees regardless of the value of the claim. Other popular choices of Arbitration include the Hong Kong and Singapore International Arbitration Centres and the Arbitration Institute of the Stockholm Chamber of Commerce.

It is a significant advantage of Arbitration that the New York Convention provides for enforcement of Arbitration Tribunal awards in more than one hundred and fifteen other countries. However, the New York Convention contains a reciprocity reservation which permits a country to decline to enforce an award made in a state that is not a party to the Convention. PRC has made the reciprocity reservation and it is therefore prudent to ensure that the proposed venue of the Arbitration is a signatory.

3.8 Expert Determination

Expert determination clauses are often included in Sale and Purchase Agreements and Shareholders' Agreements.

Expert determination is a process in which a third party is appointed to act as an expert rather than in a judicial or arbitral capacity. The parties can specify in the contract the background or institutional membership the expert is required to have. It is most appropriate in disputes over valuation or purely technical matters. Generally, an expert's decision can only be challenged where there has been a material departure from the parties' instructions. There is no right of appeal against an expert's decision.

An expert's decision cannot generally be enforced without further Court action. In England, an expert's determination can be enforced by a summary Court judgment as the refusal to comply with the decision is a breach of contract. However, the availability of a summary procedure in other Jurisdictions varies in relation to the enforcement of an expert's

decision without the cooperation of both parties. Internationally, it may therefore be difficult to enforce an expert's decision without the commencement of a new action. In this respect expert's decision contrast unfavourably with Court judgments, to which the various reciprocal enforcement treaties apply, and with Arbitration awards, to which the New York Convention applies.

3.9 Mediation

Mediation is the facilitation of negotiations between parties by a neutral third party who has no decision-making power. The neutral party facilitates the parties in voluntarily reaching their own settlement by structuring the negotiation, maintaining channels of communication, articulating each party's needs, identifying the issues and, if requested (although this is rare), making recommendations on disputed issues. The mediator does not adjudicate on the matters in dispute.

The process is voluntary, without prejudice and confidential. None of the information disclosed can be used in subsequent proceedings unless the parties otherwise agree. One of the great advantages of mediation is that it enables the parties to settle their dispute on terms which could not be ordered by a Court. Mediation is not commonly used for M&A and financing transactions but is widely used in commercial and construction contracts.

3.10 Early Neutral Evaluation

Early neutral evaluation (sometimes also known as judicial appraisal) is a process where a neutral third party, usually someone with a legal background, reviews the evidence submitted by each party and provides a preliminary, without prejudice, view on the merits of the claim. The opinion is non-binding and is intended to give the parties an indication of how a Court or Arbitration Tribunal would regard the dispute if the matter proceeded.

Early neutral evaluation can be used on a stand-alone basis or in combination with another type of alternative Dispute Resolution. The idea is that neutral evaluation will facilitate direct negotiations as, faced with an independent assessment of the merits, parties are likely to be more inclined to settle early.

4 DISPUTE RESOLUTION AND CHOICE OF LAW ON BELT & ROAD DEALS

4.1 The position in China

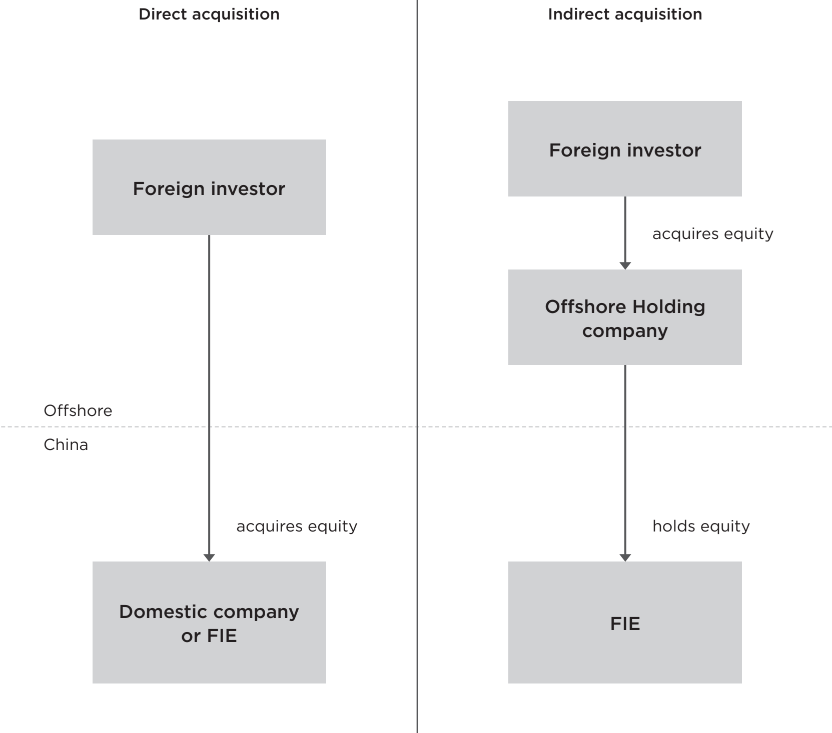
When considering Governing Law and Jurisdiction choices in Belt & Road transactions, it is first useful to look at the rules and norms for transactions in China. This gives some context to the knowledge and experience that many larger Chinese companies and banks will have acquired when dealing with foreign counterparties in China (and hence how these Chinese companies and banks might approach transactions outside of China in the future).

In China, inward-bound investment by foreign investors is heavily regulated. Chinese government control over foreign investment is gradually relaxing, but the regulatory approval, registration, and filing procedures in respect of foreign investment remain complicated and time consuming. Depending on the industries that such foreign investment is aimed at, it normally takes from two weeks to three months to finish all the regulatory procedures. Before the Chinese government cancelled the requirement to make filings at the Ministry of Commerce in respect of foreign investment in real estate, such filing procedures could take up to six months to complete.

Broadly speaking, foreign investors investing into China have two main ways to structure their investment: either direct or indirect.

DEAL STRUCTURES FOR INWARD-BOUND CHINA DEALS

DIRECT ACQUISITION V.S. INDIRECT ACQUISITION



4.2 Direct investment into China

When transacting in China, different rules on Dispute Resolution apply depending on whether or not there is a foreign element. For this purpose, generally speaking, an agreement has a foreign element if:

- one of the parties is a foreign natural person, legal person, entity or a person with no nationality;
- the habitual residence of one of the parties is located outside the territory of the PRC;
- the subject matter is located outside the territory of the PRC; or
- the legal facts that lead to creation, alteration or cancellation of contractual relationships occur outside the territory of the PRC.

If the China-related agreement involves a foreign element, the parties can choose to have disputes resolved through either a PRC Court or Arbitration Tribunal or a foreign Court or Arbitration Tribunal. However, if the China-related agreement does not involve a foreign element, the parties are only allowed to choose a PRC Court or Arbitration tribunal as the Dispute Resolution forum.

Similarly, the parties are only allowed to choose PRC law as the Governing Law of a China-related agreement if it does not have foreign element. On the other hand, if a China-related agreement involves foreign element, the parties can choose either PRC law or foreign law as the Governing Law of such agreement, with certain exceptions where the Governing Law must always be PRC law. For example, pursuant to the PRC law, the following categories of contracts within China can only use PRC law as the Governing Law:

- Sino-foreign equity/cooperative joint venture contracts in China;

- Sino-foreign contracts on joint development of natural resources in China;
- equity transfer agreements in connection with Sino-foreign Equity Joint Ventures (EJVs), Sino-foreign Contractual Joint Ventures (CJVs) and Wholly Foreign Owned Enterprises (WFOEs);
- contracts in respect of the operation of EJVs or CJVs by foreign investors;
- contracts regarding foreign investors' direct acquisition of equity of a domestic enterprise with no foreign shareholders (Domestic Enterprise);
- contracts in connection with foreign investors' subscription of increased capital of a Domestic Enterprise; and
- contracts in relation to foreign investors' acquisition of assets of a Domestic Enterprise.

4.3 Indirect deal structures for inward-bound China deals

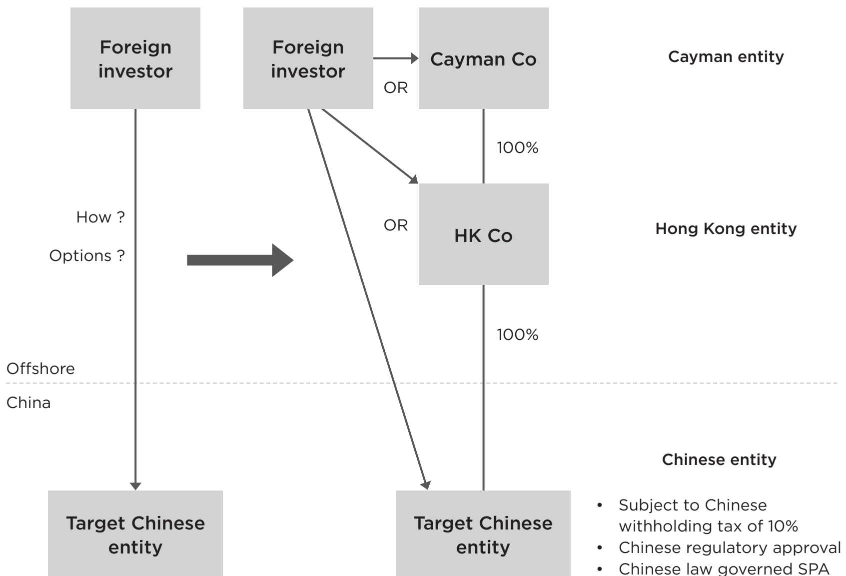
In addition to direct investment/acquisition structures, foreign investors into China often consider alternative indirect options when planning to acquire a PRC target company. This might be for different reasons, including the relatively strict regulatory controls in China and/or a preference for a foreign Governing Law and Jurisdiction. Tax efficiencies might also be sought.

This indirect structure works via the foreign investor acquiring the shares of a PRC target company's overseas holding company (where one exists or has been set up in contemplation of the transaction), which is usually incorporated in Hong Kong or alternatively an *off-shore* venue such as the Cayman Islands, BVI or Marshall Islands. Whilst many procedures such as anti-trust/anti-competition laws will still apply, such an indirect acquisition does not need to go through complicated Chinese regulatory approval procedures.

Since the transaction will be conducted outside of China, the parties are usually free to choose the Governing Law and Jurisdiction clauses for the relevant transaction documents, subject to the requirements of local offshore law. In practice English law, Hong Kong law and New York law are the most popular choices.

DEAL STRUCTURES FOR INWARD-BOUND CHINA DEALS

DIRECT ACQUISITION V.S. INDIRECT ACQUISITION



4.4 Conclusions

As can already be seen in practice in the market, it is clear that the larger Chinese companies and banks are already accustomed to using foreign laws on cross-border transactions and are also familiar with the concept of mandatory local laws, that they realise these are sometimes unavoidable but also know how these might on occasion be structured around. In practice most of the larger Chinese companies and banks also employ English speaking staff with experience of studying and working abroad and many of them will have had extensive experience of transactions under different laws. Using a foreign law such as English law will therefore not be an unexpected concept or obstacle for them.

In practice, English law is mostly being used for the principal agreements on Belt & Road transactions and the reasons for this are examined in detail in the next sections. Having said that, Chinese law continues to develop and to incorporate international concepts. We examine at the end of this guide how much of a competitive challenge this will present to English law in the future.

4.5 Dispute Resolution choices on Belt & Road deals

At the moment, China-related transactions use a variety of Arbitration options and it is likely that these will also be popular choices for Belt & Road transactions. The main ones are:

- China International Economic and Trade Arbitration Commission (located in Beijing);
- Shanghai International Economic and Trade Arbitration Commission / Shanghai International Arbitration Centre;
- South China International Economic and Trade Arbitration Commission / Shenzhen Court of International Arbitration;

- Hong Kong International Arbitration Centre;
- Singapore International Arbitration Centre;
- London Court of International Arbitration; and
- International Chamber of Commerce.

Arbitration awards issued by the Chinese Arbitration Tribunals mentioned above can be enforced in the Chinese Courts. As China is a signatory country of the New York Convention, Arbitration awards issued by foreign Arbitration Tribunals such as the ones listed above can also be enforced in the Chinese Courts.

4.6 Hong Kong International Arbitration Centre

In addition, the enforcement of Arbitration awards issued by the Hong Kong International Arbitration Centre (HKIAC) can be enforced by the Chinese Courts pursuant to a special document issued by the Supreme Court of China *(Arrangements of the Supreme People's Court on the Mutual Enforcement of Arbitral Awards between the Mainland and the Hong Kong Special Administrative Region)*. Due to the close connection between Hong Kong and Mainland China, in practice the enforcement by Chinese Courts of an Arbitration award issued by HKIAC may be more convenient when compared to the enforcement of awards issued by other international Arbitration Tribunals.

However, when choosing Arbitration Tribunals, the parties should also consider, amongst other things, the costs (such as cost of travel and translation) in respect of the Arbitration process and the number of competent arbitrators that are familiar with the Governing Law of the transaction documents.

4.7 Enforcement of Hong Kong Court Judgments in Mainland China

It is worth noting that judgments of Hong Kong Courts can be recognised and enforced in Mainland China pursuant to a similar document issued by the Supreme People's Court of China *(Arrangements of the Supreme People's Court between Mainland China and the Hong Kong Special Administrative Region on Reciprocal Recognition and Enforcement of the Decisions of Civil and Commercial Cases under Consensual Jurisdiction)*. However, according to such document, the Hong Kong Court judgments can be recognised and enforced only if the parties in the dispute have expressly agreed in writing that the Hong Kong Courts are to have exclusive Jurisdiction to hear the case. Without such express agreement, it might be difficult for Hong Kong Court judgments to be enforced in Mainland China.

SECTION C: THE USE OF ENGLISH LAW

1 WHY ENGLISH LAW?

1.1 Background

English law is widely used in international transactions (often in conjunction with local laws) across a variety of jurisdictions, including on many deals in the Middle East, Africa, China, Russia and the CIS. In some cases this is for historical reasons, in others for practical reasons, or sometimes both.

English law has historical ties to former parts of the British Empire, including Hong Kong, Singapore, Canada, Cyprus, India, Australia and New Zealand and the legal systems of those countries today are still in part based on English law.

Both historically and currently, a number of major banks and financial institutions are head-quartered in London and so have logically insisted on English law when issuing financing documents. Financing documentation under English law is well developed and the interpretation and practice relating to this area of law is clear and well established.

The English language is, of course, also generally recognised as the main language of international business globally and is the predominant language of the internet.

In addition, English law has fully developed jurisprudence and a universally well respected judicial system, an independent and trustworthy judiciary that is high calibre, dependable and one which possesses high integrity. The judicial system is reasonably efficient and comparatively cheap, at least as regards the costs of Court proceedings themselves.

1.2 Common law system

English law is a common law system, based on a combination of legislation and case precedent. English law is not set out in a single civil code. This approach has enabled English law to be flexible, adaptable and practical when dealing with the developing needs of commerce, as technology, evolving markets and new techniques all continue to revolutionise the ways in which we do business.

The principles of English law are clear and well established. Within broad parameters, businesses and their advisers have the legal freedom and flexibility to agree to whatever terms they want on their transactions. The laws and rules themselves are less prescriptive when interpreting the intentions and actions of the parties and instead the courts will interpret what the parties have written in the contract. This makes it relatively straight-forward for businesses to transact and to understand clearly what their rights and obligations are under the contract, just by reading what is written in it. This is particularly helpful where one or more of the parties do not have English as their first language.

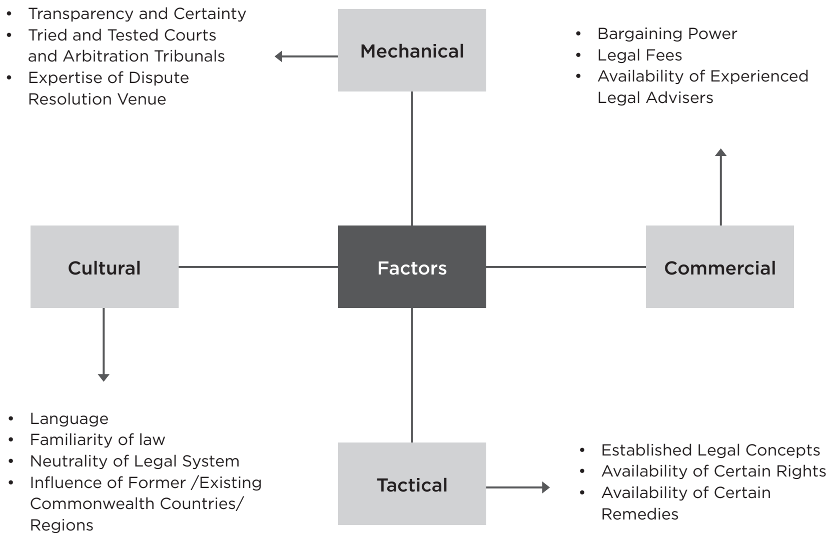
English judges and arbitrators have a strong reputation for reaching fair, balanced and unbiased judgments and rulings with (on the whole) clear and predictable outcomes.

1.3 The competition

English law has close completion from other legal systems, including Hong Kong, Singapore and New York laws. The respective merits of each system can be debated *ad infinitum* and of course there is usually no right or wrong answer; each transaction should be approached on a case-by-case basis. With regards to Belt & Road transactions, the indications so far are that English law is being widely used for the principle transaction documentation. In those cases where a different Governing Law is being used, many of the concepts described in this guide in relation to

English law will equally apply, particularly in the case of Hong Kong and Singapore laws or where the issue is one of contractual negotiation as opposed to purely legal construction. However, they are not identical systems of course and local advice should always be taken.

VIRTUES OF ENGLISH LAW



2 INTERPRETATION OF CONTRACTS UNDER ENGLISH LAW

2.1 Clear and understandable provisions

The key point to bear in mind when preparing and negotiating legal agreements under English law is that the provisions need to be clear, straightforward and understandable.

This is so that the parties to them can easily understand their rights and obligations, particularly if they (or other people in their organisation) are re-reading the agreement several months or even years after the transaction has been signed and completed. It is also essential that a Court or Arbitration Tribunal will be able to properly understand and interpret the agreement and the respective rights and obligations of the parties if there is a dispute.

In this respect, the style of drafting English law agreements varies greatly from the more arcane, legalistic style of US legal drafting. That is not to say that one system is better than another. It is just that US legal drafting has developed to reflect US law and the interpretations and precedents of US Courts. US style template agreements should therefore be avoided as a starting point where the agreement is to be governed by English law.

2.2 Modern rules of interpretation

English Courts will apply modern rules of interpretation when reviewing agreements. Essentially they will interpret a provision in the agreement as having the meaning which would be conveyed to a reasonable person having all the background knowledge that would have been reasonably available to the parties at the time the agreement was made.

However, they are not supposed to take into consideration the previous negotiations of the parties, or what they *meant* to say in the agreement but did not. These matters would only be relevant to other legal remedies (such as rectification, which is outside of the scope of this guide).

In practice, the Courts will usually apply a *common sense* interpretation. Courts tend to take a dim view of attempts by one party to twist or misinterpret wording in an agreement to its unfair advantage. Under English law, any ambiguity in a clause is construed against the party seeking to rely on it (the so-called *contra proferentem* rule).

2.3 Clear approach to drafting is recommended

Some useful tips when preparing and negotiating English law agreements include the following:

- Use clear and concise wording - the agreement should be clear and concise, so that it can be easily read and understood. Verbose and arcane legal expressions should be avoided.
- Use defined terms to help avoid repetition and potentially conflicting provisions. Terminology should also be consistent to avoid areas of doubt or dispute.
- Headings, paragraphs and punctuation should all be used where appropriate.
- When referring to legislation or regulations, make it clear whether that includes any amendments in the future or not.
- Words of the same kind - when listing examples belonging to the same class and using *"including…"*, make sure that this list is *"without limitation"*. Otherwise the list will be interpreted restrictively and anything not specifically listed could be excluded (the so called *ejusdem generis* rule).
- Avoid repetition and hyperbole - these only lead to confusion and potential for dispute and/or mischievous interpretations.

- Worked examples of mathematical formulae are often useful and can be scheduled in the agreement. It is not unheard of for the financial experts to revisit and amend the formulae, after producing the worked examples and then realising that the formulae themselves do not work, or potentially lead to unintended results.

- Describing dates - under English law, *until* a specified date will include that date. *From* or *after* a specified date will exclude that date. Use of the word *inclusive* will include both dates. Other points to look out for include:

  - avoid *"by"* - it is better to use *"on or before"*

  - avoid *"from"* - it is better to use *"from and including"* or *"from but excluding"*

  - avoid *"until"* - it is better to use *"to and including"* or *"to but excluding"*

  - avoid *"between"* - it is better to state whether the period is inclusive or exclusive of the first and last days.

2.4 Subjective terms

Subjective terms in English law contracts should be avoided where possible. Where they are necessary, they should be defined or clarified. Subjective terms can include some or all of the following:

- Reasonable Endeavours and Best Endeavours. The precise application of these terms is open to debate subject to evolving precedents. A term such as *best efforts* should be avoided, since it is a US legal concept and has no precise legal meaning under English law. Reasonable Endeavours and Best Endeavours are considered in more detail in *Section J: Boilerplate Provisions (paragraph 30)*.

- Opinions should be reasonably held (*"in the opinion of the Buyer acting reasonably"*). Ideally they should be made more objective, such as *"in the opinion of a reasonable buyer"*, to avoid disputes regarding the opinion of the specific Buyer (or other party) involved in the transaction.

- Materiality - the concept of *material* and *materiality* is subjective and open to debate unless clearly defined.

- Quantitative expressions such as *major, substantial, significant* and so on should be defined where appropriate to do so.

- Other expressions such as *full, proper, careful, fundamental* and so on should also be defined where appropriate to do so.

SECTION D: SHAREHOLDERS' AGREEMENTS

1 BACKGROUND

The Shareholders' Agreement is a contract between some or all of the shareholders (the Shareholders) and often the Company that they collectively own. It generally deals with management, funding of the Company and any relations between the parties (including additional rights and obligations of the Shareholders) as well as some of the methods for their enforcement. The agreement generally requires new Shareholders to enter into a Deed of Adherence to be bound by the terms of the original Shareholders' Agreement.

2 LEGAL NATURE

The Shareholders' Agreement is not usually publicly registered and thus remains confidential. The Company itself cannot contract out of its statutory duties or limit its statutory powers and so some of the rights and obligations dealing with Veto Rights (such as the issue of new shares) may need to be made between the Shareholders alone and not the Company.

If a Shareholder breaches the Shareholders' Agreement, the remedy is taken against the Shareholder itself, not against the Company. An aggrieved Shareholder has contractual remedies such as damages or an injunction, together with any specific procedures on Default set out in the agreement.

The Shareholders' Agreement can be structured differently depending on the parties' shareholdings. Minority Shareholders in a Company may need additional protections and Veto Rights, while in a Company with a 50:50 split in shareholdings and/or Board voting, the Deadlock provisions will usually be of vital importance.

Alternatives to a Shareholders' Agreement are voting trusts and irrevocable undertakings to exercise voting rights to support a particular major transaction.

3 LOCAL LAWS

As always, it is essential to also take local law advice, particularly where the provisions of the Shareholders' Agreement overlap or conflict with the provisions of the Company's constitutional documents (Articles of Association, charters, etc.) and/or with local company law.

4 COMMON PROVISIONS CONTAINED IN SHAREHOLDERS' AGREEMENTS

Under English law (with certain limited exceptions), parties are legally free to agree whatever commercial terms they decide. The Shareholders' Agreement will include provisions dealing with some or all of the following matters:-

- The Board of Directors of the Company.
- The governing bodies of any subsidiaries.
- Conduct of the Company's affairs.
- Share rights, including rights to vote, rights to capital and rights to dividends.
- Share transfers, including permitted transfers, share Lock-ins and pre-emption rights of first refusal on a transfer of shares.
- Provision of financial information, including Management Accounts and annual Audited Accounts.
- Finance and working capital.

- Any Guarantees to be given by the Shareholders.
- Services to be provided by the Shareholders.
- Loans to be provided to the Shareholders.
- Any appropriate Warranties and Indemnities.
- Reserved Matters (also referred to as Veto Rights or consent matters).
- Any Restrictive Covenants.
- The policy on dividends and distributions.
- The procedure on Deadlock and Dispute Resolution.
- Default and its consequences.
- Step-in or Swamping Rights.
- Tag Along and Drag Along rights.
- Put and Call Options.
- Good Leaver / Bad Leaver provisions.
- Share Ratchets.
- Termination provisions.
- Boilerplate provisions. *See Section J: Boilerplate Provisions* for more details on this.

  Depending on the location of the Company, often many of these provisions (such as Board of Directors, share rights, Leaver Provisions

and Tag Along and Drag Along) will also be included into the Company's Articles of Association. By being provided for in both, they confer contractual remedies and statutory remedies on the Shareholders, under the Shareholders' Agreement and Articles or Association respectively.

5 BOARD OF DIRECTORS

The Shareholders' Agreement will set out the composition of the Board of Directors and the procedure for holding meetings of the Board of Directors and making relevant decisions. The key points often include:-

5.1 **Number of Directors**, who will appoint them (including the finance director and the managing director), their term of office and how they will be removed.

5.2 **Board meetings** – where will they take place and how often? How will meetings be called and what are the formalities for circulating an agenda, tabling matters to be discussed at the meeting and then circulating agreed minutes of the meeting afterwards? Often there will also be Tax considerations when these arrangements are set up, depending on the location of the Company.

5.3 **Entrenched rights to appoint** – will a Shareholder have entrenched rights to appoint, remove and replace its own Directors?

5.4 **Voting** – how voting will be conducted and will any Directors have weighted voting, effectively allowing them to block a vote, or to push through certain decisions?

In respect of key decisions (sometimes called consent matters, Reserved Matters or supermajority matters), these will often be subject to separate Veto Rights. Further details on this are set out later below.

5.5 **Chairman** – who will appoint the Chairman and will the Chairman have a casting vote in the event of a Deadlocked decision at Board level?

5.6 **Quorum** – how many Directors must attend meetings of the Board for a Quorum to be present, so that the meeting can take place? Also, if a Quorum is not present, will the meeting be adjourned and then at the adjourned meeting will the Quorum be any Director who attends? Or alternatively will a failure to achieve a Quorum result in a Deadlock or Default?

5.7 **Fees** – will the Directors be entitled to charge fees to the Company for their services and, if so, how will these be calculated?

6 MANAGEMENT OF SUBSIDIARIES

The Shareholders' Agreement will also usually deal with the management of the subsidiaries of the Company and the composition of their governing bodies.

7 CONDUCT OF THE COMPANY'S AFFAIRS

The Shareholders' Agreement will usually contain provisions dealing with the conduct of the Company's affairs and the overall management of its business. These tend not to be controversial and will include matters such as:-

7.1 **Meetings** – ensuring that regular meetings of the Shareholders and the Board of Directors are held, together with meetings of the Boards of any subsidiaries.

7.2 **Minutes** – ensuring that minutes of the meetings are promptly circulated after each meeting.

7.3 **Business** – ensuring that the business of the Company and its group consists exclusively of the agreed business and ensuring that this is only conducted through the Company and its group, on sound commercial principles.

7.4 **Auditors** – ensuring that the Auditors are appointed.

7.5 **Bankers** – ensuring that the Company has bankers, bank accounts and suitable bank mandates in the names of the appointed Directors and officers.

7.6 **Registered office** – maintaining a registered office.

7.7 **Statutory records** – maintaining all statutory books and records.

7.8 **Compliance** with the Company's constitutional documents.

7.9 **Insurances** – maintaining adequate policies of insurance, including Directors' and Officers' (D&O) Insurance.

7.10 The Shareholders will usually also agree to use their respective voting rights and other powers of control in relation to the Company to ensure compliance with the above matters and generally to comply with the terms of the Shareholders' Agreement.

8 SHARE RIGHTS

The Shareholders' Agreement will often include details on the share rights of the parties, including the numbers of shares they are subscribing for and the rights attaching to those shares. Usually the details of the rights attaching to shares will also need to be set out in the Articles of Association or Charter.

The key rights relating to shares usually include:-

8.1 **Classes** – whether the shares are all one class of shares, or alternatively whether they are ordered into different classes (such as preference shares or deferred shares).

8.2 **Voting** – whether the shares have the right to vote and if so, whether it is one vote per share, or a weighted voting mechanism.

8.3 **Veto Rights** - as with Board meetings, certain specified key decisions are likely to be subject to separate Veto Rights.

8.4 **Quorum** – whether there is any requirement for a particular number or class of Shareholders to be present at a Shareholders' meeting, in order for that meeting to take place. Also, details of what happens if a Quorum is not present. Sometimes the meeting is adjourned and at the adjourned meeting the Quorum is just one Shareholder present. Alternatively, the failure to achieve a Quorum could trigger a Deadlock or Default.

8.5 **Dividends** – details of the dividend rights attaching to each share and the order of any payment amongst different classes of shares.

8.6 **Returns of capital** – the rights that each class of shares has on a return of capital. Sometimes this is structured as a waterfall or priority of returns, which is where different classes of shares receive different entitlements.

8.7 **Share Ratchets** to incentivise and reward performance – more detail on this is set out later on.

8.8 **Pre-emption on new issues of shares** – details of whether the Shareholders have a pre-emption right to participate in new issues of shares. Typically Shareholders would be given a right of first refusal at the same price as any new issue, so they can maintain the same proportion of shares as they currently hold.

8.9 **Anti-dilution protections** – sometimes Shareholders will be given additional protections against a dilution of their shareholdings. This may be a Veto Right over new issues of shares, or potentially the right to subscribe for new shares at their nominal value (i.e. possibly less than the new issue price) to maintain their percentage holding.

8.10 **Lien** – in some Jurisdictions, the Company will have a *lien* (effectively a charge) over the shares of any Shareholder that owes money to the Company. In some cases this lien can be altered, extended or even removed.

8.11 **Step-in** or **Swamping Rights** in the event of a Default – more details on this are set out later on.

9 PREFERENTIAL SHARE RIGHTS

9.1 Share rights may be structured so as to give one or more classes of shares preferential treatment in respect of economic matters such as dividends, returns of capital or other rights of participation. These are usually referred to as preference shares and can be voting or non-voting. The specific rights of priority are agreed between the parties, subject to any legal requirements (such as sufficient profits being available to make preferred dividend payments).

9.2 Share arrangements with differing rights of priority and participation for different classes of shares are very common for private equity deals, development capital investments and many joint ventures. Often they will involve several layers of different classes of shares, each with different rights, and are a key part of the financial structuring of the Company.

The rights themselves will need to comply with the relevant corporate law rules of the Jurisdiction of the Company in question.

10 SHARE TRANSFERS

The Shareholders' Agreement will usually set out the rules and restrictions on transferring shares. Typically these will include some or all of the following:-

10.1 Permitted transfers to identified groups of permitted third parties, such

as other group companies and (in the case of individual Shareholders) family members and family trusts.

10.2 Transfer-back provisions in the event that a permitted transferee ceases to be permitted (for example, if a subsidiary of a Shareholder leaves its group). This is an important provision in order to avoid a so-called envelope scheme, where in order to avoid the share transfer restrictions and pre-emption rights in the Shareholders' Agreement, shares are transferred to a permitted transferee (usually an SPV) and the ownership of that transferee SPV can then itself be sold freely to a third party purchaser.

10.3 Deed of Adherence from any new Shareholders (such as permitted transferees), agreeing to be bound by the terms of the Shareholders' Agreement as if they were a party to it.

10.4 Lock-in periods during which no shares can be transferred, other than to permitted transferees.

10.5 Pre-emption rights or rights of first refusal (ROFR) in favour of the other Shareholders in circumstances where shares can be proposed for transfer to third party purchasers who are not permitted transferees. Typically the non-transferring Shareholders will be given an agreed period in which to decide whether to buy the shares proposed for transfer, at the proposed price. Failing this the transferring Shareholder is then free to sell these to a third party within an agreed period, provided it is not a prohibited transfer.

10.6 Prohibited transfers, such as to competitors or to next of kin/insolvency practitioners on the death or bankruptcy of an individual Shareholder.

10.7 Good Leaver and Bad Leaver provisions dealing with the compulsory transfer of shares by an employee or Director if they leave their employment or directorship. Leaver Provisions are covered in more detail later below.

10.8 Drag Along and Tag Along rights – more details on these are set out later on below.

10.9 Put and Call Options – again, more details on these are set out below.

11 POINTS TO CONSIDER ON SHARE TRANSFERS

There are a number of points to consider on any transfer of shares, many of which are often overlooked:-

11.1 **Consents** – are any consents required, for example under a Shareholders' Agreement, an irrevocable voting undertaking, a Lock-in provision in a SPA or in the Articles of Association or Charter? It is also necessary to consider any Facility Agreements and share pledges.

11.2 **Regulatory issues** – are any regulatory issues involved, such as merger clearances? For example, prior clearance may be required even in respect of indirect Changes of Control, for example where it is the shares of an offshore holding Company and not the underlying subsidiary which are being transferred.

11.3 **Pre-emption rights** – are there any pre-emption rights or other rights of first refusal in favour of other Shareholders, for example in a Shareholders' Agreement or the Articles of Association? Have these been disapplied or waived?

11.4 **Mandatory offers** – does the transfer trigger a requirement to make a mandatory offer for the other shares of the Company, either at law or by regulation (such as under a Takeover Code) or by virtue of a Tag Along right?

11.5 **Formalities of transfer** – what are the formalities of transfer? Usually a meeting of the Board of Directors will be required to approve the transfer. Do the Directors have the power to refuse the transfer in certain circumstances, for example if it is a transfer to a competitor?

11.6 **Tax** – are there any Tax issues relating to the transfer, such as capital gains? Also, are any transfer Taxes due?

11.7 **Costs** – are there any costs associated with the transfer and who bears these? For example, a notary fee which is calculated by reference to the value of the shares being transferred.

11.8 **Co-operation with the transfer** – is the co-operation of the other Shareholders required and, if so, are there suitable contractual obligations in the Shareholders' Agreement? This is particularly important if there is a compulsory transfer, such as under a Drag Along, Call Option or Leaver Provisions.

12 DEED OF ADHERENCE

A Deed of Adherence is often used to transfer to the transferee the rights and obligations under the Shareholders' Agreement. This is particularly important where there are restrictions on share transfers or other provisions dealing with compulsory transfers of shares.

If the substance of the agreement is very particular to the original parties, the transfer of shares may be accompanied by an amended and restated Shareholders' Agreement (in addition or in place of the Deed of Adherence) whereby the parties going forward agree to be bound by a revised version of the original agreement.

13 VALUATION OF SHARES

13.1 Background

In some circumstances, share transfers will be subject to an independent valuation mechanism in the Shareholders' Agreement. This will usually be the case where a compulsory transfer of shares is required (such as under the Leaver Provisions, Drag Along, Put and Call Options or the Deadlock and Default provisions).

Pre-emption provisions sometimes also include the right for the non-transferring Shareholders to require an independent share valuation, if they believe that the price proposed by the transferring Shareholder is too high. Once the valuation is received, if it is materially less than the original proposed price then the transferring Shareholder usually has the right to withdraw its shares from sale. Typically it would not then be able to propose another transfer of those shares for an agreed period (usually the following 6-12 months). If the transferring Shareholder does not withdraw, then the other Shareholders can buy at the revised valuation price. If they choose not to buy, then the transferring Shareholder is free to sell to a third party within an agreed period.

13.2 Expert determination

Where a share valuation may be required, the Shareholders' Agreement will set out the mechanism for establishing the valuation of the shares in question. Usually this will be agreed between the Shareholders and, if they cannot agree within a set period, will then be referred to an independent expert such as an independent firm of accountants.

The Shareholders' Agreement will usually set out a suggested timetable for the valuation and details of how the costs of the expert will be met. It will also need to state that the decision of the expert is final and binding on the parties (in the absence of manifest error or fraud). The expert will usually just give a single figure as its determination for the valuation, without workings or justification. This is to try to avoid the potential for dispute or even being sued itself for alleged negligence.

13.3 Fair Value

The agreement will often state that the expert should reach a determination of the Fair Value of the shares, sometimes also referred to as a fair market value or open market value. There is no strict legal definition of what this means, but it is generally regarded as being the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm's length transaction.

There are several principles of valuation and many different methodologies to calculate this. This is very much the realm of accountants and financial experts and not usually something that lawyers are qualified to advise on. Some Shareholders' Agreements will not include any detail on the principles and methodologies, preferring to leave this to the valuation experts. Other agreements might have substantial schedules of workings and formulae prepared by the parties and their financial and accounting advisers.

In most Shareholders' Agreements, it is usual to state the following assumptions in respect of the valuation:-

- That the Fair Value shall be determined on the basis of the value of the Company as a going concern.
- That it is assumed that there is a willing Buyer and a willing Seller.
- That adjustments shall not (or, alternatively, shall) be made to take into account that the shares constitute a particular proportion of the overall share capital (i.e. majority or minority).

14 PROVISION OF FINANCIAL INFORMATION

14.1 The Shareholders' Agreement will usually set out the rights of the Shareholders to financial information (in addition to any rights they will have at law). These usually include provisions dealing with:-

- Preparation of an agreed annual budget and a (typically 3-5 year) business plan.
- Preparation and circulation of unaudited Management Accounts on a monthly or quarterly basis. These will usually include a profit and loss account, balance sheet and cash flow statement, plus a comparison against the annual budget and a cash flow forecast for the balance of the period covered by the budget.

- Preparation and circulation of the Audited Accounts.
- Reasonable access to the books, records and accounts.
- Such other information as the Shareholders may reasonably request.

14.2 Otherwise, under English law, the rights of the Shareholders to information are very limited and the Directors will be obliged to keep the Company's information confidential.

15 FINANCE AND WORKING CAPITAL

15.1 Background

The Shareholders' Agreement will usually set out how the Company and its business and operations are to be funded. This will usually be by an injection of equity and/or Shareholder loans by the Shareholders at Completion, together with agreed terms in respect of further funding or follow-on funding.

There may also be an agreed schedule of further tranches of investment, or a firm and binding commitment to make specified further investments when called on to do so. This is usually the case where the parties have identified in their business plan, budget and cash flow forecasts that such funding is likely to be required.

The terms of follow-on funding vary greatly from agreement to agreement. Typically they will be quite general and effectively a non-binding *agreement to agree* on something in the future, perhaps with a referral to the Deadlock mechanism if the Shareholders cannot agree.

In other instances the further funding provisions can be very detailed and, for example, provide detailed mechanics for the adjustment of the parties' shareholdings if one of the Shareholders fails to meet its required further funding commitments.

15.2 Equity vs. debt

Usually Shareholders will provide funding as a combination of equity and debt, with the majority of the funding often being made by way of Shareholder loans (possibly documented as a debt instrument such as loan notes or loan stock).

This is usually done because interest payments on Shareholder debt are usually easier to extract than dividends on equity shareholdings (since in most Jurisdictions, profits of the Company available for distribution are required in order to declare dividends). To the extent it is available, the Shareholders can also then take security for their loans, thus placing themselves ahead of unsecured creditors in most situations.

Of course, the Shareholders' ability to do all this may be limited by the terms of any Facility Agreement to which the Company is a party. There will also usually be an Intercreditor Agreement between the Shareholders, the Company and its bank, setting out the order of repayment and perhaps prohibiting dividends or interest payments until the bank is repaid in full.

However, Shareholders also need to be alert to the Tax consequences of Shareholder loans and in particular the ability (or otherwise) to deduct any interest payments on the loans from profits due to Thin Capitalisation rules and other similar doctrines.

15.3 Shareholder Guarantees

Shareholders may also be required to give Guarantees or security for the Company's obligations, for example to trade suppliers and other creditors or under banking facilities. Again this needs to be set out, together with any charging arrangements for this.

15.4 Procedure on departure

The Shareholders' Agreement will usually also set out what happens to any financing arrangements when a Shareholder disposes of its shares and ceases to be a Shareholder.

Depending on the reasons for it ceasing to be a Shareholder, typically its loan capital would be repaid (and replaced by a loan by any new Shareholder) and the Company and/or the other Shareholders would procure the release of any Guarantees it has given on behalf of the Company. Alternatively they may need to counter-indemnify the departing Shareholder pending release of those Guarantees. However, in circumstances where a Shareholder has committed a Default or is a Bad Leaver, these provisions might be disapplied.

16 SERVICES TO BE PROVIDED BY THE SHAREHOLDERS

16.1 Background

The Shareholders' Agreement will often set out the services to be provided by the Shareholders and the bases on which these are provided (including any expected standards or levels of service and their frequency, whether the services are to be charged and if so at what rates, how they will be invoiced and so on).

These may be relatively straightforward items such as Company secretarial services, payroll functions and administrative support, all charged at intra-group rates. However, it may also include more complex arrangements such as licences of IPRs, the use of branding and trade names, employee secondment arrangements, the shared use of premises, goods and services supply arrangements and so on. For more complicated arrangements it is typical to document these in separate ancillary agreements, which are then referred to in the Shareholders' Agreement.

16.2 Points to consider

There are a few important points that will need to be considered in relation to such services and/or ancillary agreements, including:-

- **Enforcement** – how will the Company's rights to receive the services be properly enforced? If the Shareholder providing the services can control the Board of Directors, or if they can create a Deadlock or use a Veto Right to prevent the Company from protecting its rights, then this could be a problem.

  One possible solution is to disenfranchise the relevant Shareholders from their voting rights (including at Board level) in such circumstances in respect of any enforcement action.

- **Cross-default** – does a breach by a Shareholder of the terms of an ancillary agreement create a Default under the Shareholders' Agreement?

- **Termination** – what happens to the services on termination of the Shareholders' Agreement, or if one party ceases to be a Shareholder? If the services are set out in separate ancillary agreements then these agreements may also need to be terminated.

- **Transitional arrangements** – if the services are terminated, are any transitional arrangements required, to deal with matters such as the return of confidential information, the removal of brand names from signs, websites and office stationery and so on?

17 WARRANTIES AND INDEMNITIES

The Shareholders' Agreement may also include Warranties and Indemnities from one Shareholder to another, for example where a new Shareholder is taking a stake in an existing Company and relying on assurances made to it by the existing Shareholder(s). Details on these matters are set out in *Section G: Warranties and Indemnities*.

18 SHAREHOLDER CONSENTS AND VETO RIGHTS

18.1 Background

The Shareholders' Agreement will often contain consents or Veto Rights in favour of one or more Shareholders. This is particularly important to protect minority Shareholders, where one or more parties controls a majority of the votes at Board and/or Shareholder level.

The consents or Veto Rights will relate to a list of agreed Reserved Matters, which cannot be undertaken in respect of the Company (or its subsidiaries, or their respective businesses) without such consents first being given by the relevant Shareholders.

18.2 Reserved Matters

These Reserved Matters will often include:-

- Material changes to the business.
- Approval of the business plan and annual budget.
- Appointments and changes to the management team.
- Major acquisitions or disposals.
- Making changes to the constitution of the Company.
- Issuing shares, share options or loan stock.
- Making changes to the share or loan capital structure.
- Major capital expenditures.
- The terms of third party finance, including granting security.

- Material trading matters, such as entering into or terminating Material Contracts, taking on leases or licences in respect of real estate.
- Conducting litigation proceedings.
- Agreements or arrangements with associates or connected parties.
- (Unless required by law) winding-up the Company.
- Ensuring that none of these matters occur in relation to any subsidiaries without the requisite consents first being obtained.

These Reserved Matters will often be similar to those Veto Rights demanded by a Buyer in an SPA to give it protections in the period between signing and Completion. Details of those matters, together with the usual negotiating points relating to them, are set out in *Section E: Share Sale and Purchase Agreements (paragraph 13)*.

The Reserved Matters have different roles to play, depending on the context. A minority Shareholder generally has limited rights at law: without the minority protections, it will have little influence over how the business is conducted and whether further shares are issued to new Shareholders that potentially dilute its holding. On the other hand, a 50:50 Joint Venture may at law effectively require agreement by both parties (or their representatives) on every issue. In that context, a key purpose of the Reserved Matters is to reserve certain matters to the Shareholders, rather than the Directors (as the Shareholders can act in their own interests, whereas the Directors are required to act in the interests of the Company).

18.3 Minority Shareholder protections at law

Shareholders in English companies have differing legal rights and protections depending on the size of their shareholding.

However, any Shareholder may bring a claim for *unfair prejudice* if the affairs of the Company are being conducted in a way that is unfair to it. Unfair treatment may occur if the majority Shareholder acts in a manner contrary to what the parties agreed upon (which could be by words or conduct) and the minority Shareholder has a legitimate expectation for the majority Shareholder's compliance with such words or conduct.

In cases where the unfair treatment is proved, the minority Shareholder is protected by law, even if there are no express protections in a Shareholders' Agreement or the Articles of Association. However, the minority Shareholder effectively cannot bring a claim if the majority Shareholder offers to buy out the minority Shareholder's shares at a reasonable Fair Value (as that is what a Court is likely to order if unfair treatment is proved).

Local law advice should be sought for the relevant Jurisdiction of the Company.

19 RESTRICTIVE COVENANTS

Restrictive Covenants are also often included in the Shareholders' Agreement. More detail on Restrictive Covenants is set out in *Section E: Share Sale and Purchase Agreements (paragraph 15)*.

20 DIVIDENDS AND DISTRIBUTIONS

The Shareholders' Agreement will usually set out the Company's policy on dividends and any restrictions on these. Declaration of dividends will often be made subject to the reasonable working capital requirements of the Company and its group, as determined by the Board of Directors from time to time.

Payment of dividends is also likely to be subject to the terms of any Intercreditor Agreement with the Company's Lenders.

21 DEADLOCK AND DISPUTE RESOLUTION

21.1 Background

The Shareholders' Agreement will usually set out the procedure to be followed in the event that the Shareholders have reached a Deadlock. These provisions may apply to all potential disagreements or just those relating to major decisions affecting the business. As many Deadlock resolution procedures ultimately lead to some sort of buy-out mechanism, they tend to favour the party who is best able to raise the funding for a buy-out. It is common to try to prohibit artificial Deadlock – but there is always a risk that the Deadlock provisions may be manipulated by one party as a means to buy out another.

There are different ways of defining what constitutes a Deadlock. For example, these may include some or all of the following:-

- Where a matter relating to the affairs of the Company or its business has been considered by the Board or Shareholders and no resolution was passed because of an equal number of votes for and against.

- Where a matter has not been considered at all, because an insufficient Quorum was present in order to form a Board or Shareholders' meeting when it was called, and at a second attempt to hold the meeting.

- Where the Company has not achieved a sale or IPO in accordance with an agreed exit strategy.

- Where a matter has not been approved because one Shareholder has exercised its Veto Rights in order to block the approval.

In some Shareholders' Agreements, the exercise of Veto Rights will not be considered a Deadlock situation at all and instead just a control and limitation on the agreed direction of the business. In cases where one Shareholder has a sufficient majority of the votes at Board and

Shareholder level, a Deadlock is unlikely to arise at all (except perhaps in relation to an exercise of Veto Rights by the minority Shareholder) since the majority Shareholder may be able to vote through any approvals it requires.

21.2 Procedure on Deadlock

In the event of a Deadlock, there are a number of different ways of dealing with this. Typically there will be a cooling-off period, during which nothing can happen, in order to give the Shareholders time to take advice and consider a sensible negotiated outcome. Sometimes the Shareholders will be required to circulate to each other a written summary of their views, to try and narrow the issues and reach a compromise.

This is sometimes accompanied by a Gin and Tonic clause in the Shareholders' Agreement, where the senior management of the respective Shareholders are required to meet (presumably over a gin and tonic!) to discuss the issues and try to reach a sensible outcome. Such a provision may be useful in focusing the minds of any executive managers of a corporate Shareholder, who will not want to escalate the matter to the senior people in their organisation without good reason.

Where these steps do not lead to a satisfactory compromise, one alternative in the Shareholders' Agreement is to refer the matter to Dispute Resolution.

21.3 Dispute Resolution

Details on the different types of Dispute Resolution are set out in *Section B: Legal Framework of Belt & Road Transactions (paragraph 3)*. The main options are:-

- Court litigation

- Arbitration
- Mediation
- Expert determination
- Early neutral evaluation

21.4 Competitive bids for the shares

Alternatively, the Shareholders' Agreement may set out an auction procedure, where the parties make bids for each other's shares and the highest bid wins. This procedure may also be applied where a non-binding form of Dispute Resolution (such as mediation) has failed.

There are several different variations available for the auction procedure. The main ones are known by the following names:-

- **Texas Shoot Out** – when all Shareholders are interested in buying each other out, each Shareholder submits a sealed bid and whoever makes the highest bid buys out the remaining Shareholders' shares at that price. This is the most popular form of bidding mechanism on Deadlock in Shareholders' Agreements.

- **Russian Roulette** – similar to Texas Shoot Out, but in this case one Shareholder names the price and the other Shareholders then decide if it is a Buyer or a Seller at that price. Set the price too low and you risk being bought out on the cheap; set the price too high and you risk paying too much for the other Shareholders' shares.

- **Dutch Auction** – a type of auction where the auctioneer begins with a high asking price which is lowered until one party is willing to accept the auctioneer's price, or a pre-determined reserve price (the Seller's minimum acceptable price) is reached. The starting price will be very high (higher than the Seller genuinely expects to get) and is lowered

in increments until someone bids. Dutch Auctions are less usual in Shareholders' Agreements.

21.5 Put and Call Options

Alternatively, a failure to resolve a Deadlock could lead to one Shareholder being granted a Put Option in respect of its shares, or a Call Option over the shares of the other Shareholders (or both). However, as this mechanism favours one of the parties it is more common in the context of Defaults *(see paragraph 25 below)*.

21.6 Sale or Liquidation

If all else fails to work, the Shareholders' Agreement can provide that the Company will be put up for sale (with the Shareholders undertaking to co-operate with the sale) or alternatively put into liquidation proceedings and wound up, with the assets being sold and proceeds being returned to Shareholders (again, with the Shareholders' undertaking to co-operate with this).

21.7 Enforcement

The Shareholders' Agreement will usually have a Power of Attorney provision in the event that a Shareholder refuses to co-operate with the Deadlock provisions in breach of its contractual obligations. This will usually be relevant where the outcome of the Deadlock procedure is that one Shareholder is required to sell and transfer its shares to the others.

The provision will appoint a buying Shareholder or its representative as the attorney of the (forced) selling Shareholder, in order to deal with practical matters such as transfer of the shares on an unencumbered basis and with full title, giving Indemnities for missing share certificates, payment of the purchase price into trust (if it is not readily accepted by the forced selling Shareholder) and giving a valid receipt for payment of the price.

If there is no Power of Attorney provision in the Shareholders' Agreement, then a buying Shareholder can apply to Court for an order for specific performance to effect the transfer. However, the use of Power of Attorney provisions and the concept of specific performance may be problematic depending on the location of the Company in question and the local laws applicable to such matters and local advice should always be sought.

22 DEFAULT

22.1 Background

The Shareholders' Agreement will usually set out the rights and obligations of the Shareholders if one of them commits a Default. These are a matter for negotiation and may include some or all of the following events:-

- Breach of the Shareholders' Agreement.
- Breach of an ancillary agreement, perhaps including the SPA or an employment contract or Service Agreement. This is often called cross-Default.
- Bankruptcy, insolvency and related events.
- Possibly, failure to attend Board or Shareholders' meetings.
- Possibly, a Change of Control in the ownership structure, voting rights or other powers of control of a Shareholder.

22.2 Negotiating points

The Shareholders need to be very careful when negotiating the terms of Default provisions, since they often do not know whether in the future it is they who will be the innocent party, or the defaulting Shareholder.

Usually the following points will arise:-

- **Materiality** – breaches normally need to be sufficiently material.

- **Cure periods** – the provisions will sometimes include a grace period to allow the defaulting Shareholder to cure its own breach. This will usually say that it only applies where the Default is capable of being cured. In some cases, the defaulting Shareholder will only be given one chance to cure (so that it cannot keep defaulting and then curing).

- **Insolvency matters** will usually need to be sufficiently serious. Litigation-type events in the ordinary course of trading which do not seriously impact on the Shareholders' solvency position are likely to be excluded.

- **Change of Control** – this can be a dangerous area for the parties, particularly in today's uncertain economic climate where even once rock-solid international companies and banks have been forced to enter into debt-for-equity swap arrangements, severely dilute their Shareholder base with new share issues or even sell out ownership control altogether.

  In cases where Change of Control is a trigger for a Default, this will usually still include a procedure for one Shareholder to request advanced consent from the other Shareholders and may also state that such consent cannot be unreasonably withheld or delayed. There may also be agreed carve-outs for solvent reconstructions and group reorganisations, where the ultimate ownership structure of the Shareholder remains unchanged.

- **Cross-default** under ancillary agreements can be a difficult area to negotiate. For example in the case of the Sale and Purchase Agreement, it may be relatively easy for the Buyer to argue that there has been a breach of Warranty and then use this in order to trigger the Default mechanism. In the case of a Service Agreement or employment agreement, an individual employee will see this as conceptually separate from and unconnected to their equity investment in the Company and will not want to link the two.

- Failure to attend Board or Shareholders' meetings is often regarded as a Deadlock issue and not a Default.

22.3 Procedure on Default

Where one Shareholder is in Default, it is usual for the innocent non-defaulting Shareholders to then have the option to decide whether or not to trigger the Default procedure. There may be instances where they decide not to do this for commercial reasons. This right is usually subject to a reasonable agreed time limit, so that one Shareholder cannot then threaten to trigger the Default mechanism at any time, even years after the Default has occurred.

The mechanics of Default clauses vary from deal to deal and there is no market standard. Usually it will involve the rights of the non-defaulting Shareholders to buy out the shares of the defaulting Shareholder and/or to force the defaulting Shareholder to buy their shares. This can be structured along the lines of Put and Call Options or a Drag Along.

There will usually be provisions dealing with the calculation of the price for the shares in question, usually by reference to a Fair Value. Issues of Fair Value and share valuations are considered earlier in this Section *(paragraph 13)*.

Where the defaulting Shareholder is forced to sell its shares, it is usual for the Shareholders' Agreement to apply a discount to the determined value of its shares, effectively as a punishment for the Default and also to deter Shareholders from defaulting, or from engineering a Default in order to liquidate their shareholding in the Company and achieve an early exit. There is no market standard for this, but a 10%-30% discount seems to be a popular range.

The parties should always consider the prohibition under English law on Penalties, which could potentially apply here. Having said that, Courts are usually reluctant to interfere in agreed Default mechanisms in

Shareholders' Agreements, where there is a commercial business bargain between sophisticated parties and with the benefit of legal advice.

As with Deadlock, the Shareholders' Agreement will usually have a Power of Attorney provision, to be used in the event that the defaulting Shareholder refuses to co-operate with the Default provisions in breach of its contractual obligations.

22.4 Other remedies

The shares of the defaulting Shareholder will often be disenfranchised from voting once the Default procedure has been invoked and its nominated Directors may also be disenfranchised from voting or required to resign from office.

It should also be noted that in addition to the Default procedures in the Shareholders' Agreement, the non-defaulting Shareholder will usually also have its rights to claim for breach of contract and seek damages for its loss in the usual manner.

23 STEP-IN RIGHTS

23.1 Background

The parties will sometimes agree to Step-in Rights or Swamping Rights. These are a contractual mechanism (usually also contained in the Articles of Association) which allows one party to *step in* and take voting control at meetings of the Board of Directors and/or at general meetings of Shareholders.

The events which allow one party to step in and take control are subject to negotiation. Typically these include where the Company is (or is likely to become) in default under its Facility Agreement, or where a Shareholder is in breach of the Shareholders' Agreement.

Usually the Step-in period will only last whilst the breach is ongoing and in order to give the party who is stepping in the opportunity to rectify the problems and to put in place measures to ensure that the breach does not reoccur. In the case of financial defaults, this may include the ability to raise fresh loan finance and grant new security, or to issue share capital on a non pre-emptive basis, thus diluting the shareholding of the defaulting Shareholder.

As with Deadlock and Default, the Shareholders' Agreement will usually have a Power of Attorney provision to enable the Shareholder who is stepping-in to effectively enforce its rights.

23.2 Trigger events

Some examples of Step-in triggers may include:-

- The Company being in Default (or likely to become in Default) under its Facility Agreement.

- Interest on investor loan stock not being paid.

- Insufficient profits available to pay dividends on preferential shares.

- Insolvency-type events, including those which have not yet occurred but are reasonably likely to occur in the near future (the logic here being that, by the time the events have actually occurred, it is already too late to take effective action).

- Material breach by a Shareholder under the Shareholders' Agreement.

- Material breach by a Shareholder under another transaction document (such as the Sale and Purchase Agreement).

- In the case of an individual Shareholder who is employed by the Company, material breach under their Service Agreement or contract of employment.

- More controversially – failure to hit agreed financial targets.

23.3 Negotiating points

Step-in Rights are common on private equity deals where a private equity institution is providing most of the financial investment and a management team of individuals is running the Company. They are however rare on most corporate joint ventures between Shareholders with more or less equal bargaining power.

Where Step-in Rights are included, the party giving the rights should consider adding some or all of the following parts:-

- Any breaches are sufficiently material.
- A cure period to remedy breaches is included.
- Any financial triggers give sufficient flexibility to cope with usual business cycles and give credit for over-performance in previous financial periods.
- The Step-in Rights stop once the breach has been cured.
- There are appropriate limits on the powers of the Shareholder who is stepping-in, so that other Shareholders are not unfairly prejudiced.
- There is a right to participate in any issues of shares, even if it is just a right to catch up after an emergency funding round. This would normally need to be at the same price per share as the emergency funding round.
- As mentioned above in relation to Default, care needs to be taken when agreeing that a cross-Default under another transaction document will also trigger a step-in.

24 DRAG ALONG AND TAG ALONG

24.1 Drag Along

A Drag Along right allows a Shareholder of the Company (usually a majority Shareholder, or institutional investor, or Shareholders together holding say 75% of the shares) to force the remaining Shareholders to accept an offer from a third party to purchase the whole Company, where the majority Shareholder has accepted that offer, on the same terms. The other (usually minority) Shareholders are then *dragged along* and forced to sell their shares at the same time and at the same price per share.

The idea is to give liquidity and an exit route to the majority Shareholder(s)/institutional investor for its investment, on the assumption that most Buyers will want to acquire 100% of the Company and not be left with a (potentially uncooperative or even hostile) minority Shareholder group. It is sometimes known as a squeeze-out provision.

24.2 Priority order of payment

In some cases, whilst the Drag Along *offer* will usually be structured at the same price per share for all Shareholders, under the Shareholders' Agreement the *proceeds of the sale itself* might then be allocated amongst the Shareholders in accordance with their respective share rights under any preferential share rights, waterfall provisions or other similar provisions in the agreement (or in the Articles of Association) dealing with the return of capital to Shareholders and the priority order of repayment.

Depending on the level of the overall offer price, this may mean that in effect the dragged Shareholders receives little or no value for their shares. Such provisions are of course controversial and are usually only agreed to in private equity and venture capital deals, as a way for the institutional investor to claw back some of its original investment where the business has failed to perform.

24.3 Practicalities

In reality the majority Shareholder will often need to rely on the co-operation and goodwill of the minority Shareholders in order to organise a sale to a third party. This is particularly true where the minority Shareholders are also the management team and are running the business and operations day-to-day. Their support and co-operation will be required to help collate information for Due Diligence and the Data Room, to help respond to enquiries from prospective Buyers and their advisers, to provide access to records, premises and key employees, to review Warranties and help collate the Disclosure Letter and Disclosure Bundle and so on.

They will also be needed to help communicate with key clients, customers and suppliers, to help obtain any Change of Control consents and to manage the expectations of employees. In some cases they will also be needed to give Warranties themselves on operational and trading matters, since they are likely to have a better understanding of the Target and the business being sold than a majority Shareholder who is a passive institutional investor.

24.4 Additional rights

For this and other reasons, the Shareholder with the right to Drag Along will also need to consider whether it needs additional supporting rights in the Shareholders' Agreement, for example:-

- A further assurance undertaking from the other Shareholder(s), agreeing to co-operate with the Drag Along sale, including with the Due Diligence process of the third party Buyer and the sale process generally.
- A Power of Attorney in favour of the Shareholder who has triggered the Drag Along, enabling it to execute any necessary share transfers on behalf of the dragged Shareholder and sign Indemnities for missing share certificates.

- Undertakings or Warranties from the dragged Shareholder that its shares will be sold with full title guarantee and free from all encumbrances.

- Disenfranchising the votes of the Shareholder who is being dragged along.

- Provisions dealing with payment of the purchase price into trust (if the dragged Shareholder refuses to co-operate) and the provision of a valid receipt for the payment.

- Possibly, undertakings from the Shareholders to give substantive Warranties and Indemnities in favour of the third party Buyer on operational and trading matters. This provision is often heavily negotiated.

In most cases, these rights are never fully triggered and instead the Shareholders will come to a mutual agreement. However, their inclusion in the Shareholders' Agreement is a very useful bargaining tool for one party to bring the other to the negotiating table.

24.5 Drag Along protections

The Shareholder(s) who may be dragged along will usually try to negotiate contractual protections in the Shareholders' Agreement, such as:-

- The Drag Along offer must originate from a genuine third party, unconnected to the majority Shareholder and acting on arm's length commercial terms.

- The Drag Along offer may also need to match or exceed a minimum agreed price.

- There may also be a minimum time period after Completion before the Drag Along right can be triggered.

- The minority Shareholder(s) may also be given a limited time period (a matching right period) in which to match the offer and buy the majority Shareholder's shares itself.

  If so, this matching right may be at the *same price*, or also on the *same terms and conditions* (so that the minority Shareholder also gets the benefit of any Warranties and covenants that the selling majority Shareholder was proposing to give in favour of the third party Buyer as well).

  The Shareholder(s) who can be dragged along will want its matching right period to be long enough for it to be able to raise the necessary finance in the market from banks and/or equity investors. In reality this Shareholder is likely to have known about the proposed sale process for some time before it receives any formal Drag Along notice, since its consent and co-operation is likely to be required to release confidential documents to prospective Buyers and generally to help facilitate the sale process.

  The Shareholder with the right to Drag Along will not want the matching right period to be too long, or this will deter prospective Buyers from incurring the time and cost of carrying out their Due Diligence and then negotiating the deal and preparing legal documentation, knowing that the minority Shareholder(s) may still exercise its right to match anyway. For this reason, the preferred bidder will often be given a Break Fee if the matching right is successfully exercised.

- The Drag Along provisions sometimes also state that the price must be in cash only, payable in full at completion of the transfer of the shares (so precluding, for example, any non-cash Consideration (such as shares or loan notes), deferred Consideration or an Earn-Out).

- The Shareholder triggering the Drag Along should be required to make full disclosure of the price being paid for its shares (including any side deals, consultancy arrangements and so on) so that the dragged Shareholder(s) can ensure it is also getting the same price per share.

- Disenfranchisement of voting rights should only take place if the dragged Shareholder(s) breaches its obligations under the Drag Along.

- Certain categories of third party Buyers (such as competitors) may be prohibited.

24.6 Tag Along

A Tag Along provision is a corresponding right that entitles certain (usually minority) Shareholders to participate in a sale by the other (usually majority) Shareholders at the same time and at the same price per share. The minority Shareholder(s) then *tags along* with the majority Shareholder's sale. If the Tag Along procedures are not followed by the third party Buyer, then its attempt to buy any of the shares is not valid and will not be registered.

Tag Along rights need to ensure that:-

- The Shareholder(s) with the right to Tag Along is given a sufficient window of time to decide whether or not to Tag Along.

- It is given full disclosure of the price per share being paid (including any side deals).

- It will usually be the case that the Shareholder(s) also has a pre-emption right, so instead of tagging along, it may instead decide to buy the selling Shareholders' shares itself.

25 PUT AND CALL OPTIONS

25.1 Put Option

A Put Option is a right or option conferred on one Shareholder to require the other Shareholder(s) compulsorily to purchase its shares. In other words, it can *put* its shares on the other Shareholder(s). If the

Put Option holder (i.e. the current holder of the shares) exercises its *put* right, then the other Shareholder(s) is contractually obliged to acquire the shares on the terms set out in the Shareholders' Agreement.

The agreement will contain all the terms of the Put Option, such as the price payable for the shares and the conditions and circumstances under which it can be exercised. Those circumstances may include where there is a Default.

The Shareholder with the benefit of the Put Option should also consider carefully the consequences of the other Shareholder(s) refusing to make payment and complete the purchase of the shares. In such circumstances a Power of Attorney will not help and the only remedy will be to sue for breach of contract or trigger a provision under the Default procedures.

25.2 Call Option

A Call Option works in the same way but in reverse: in this instance it is the Call Option holder who has the right to acquire the shares of the other Shareholder(s) i.e. to *call* for the shares of the other Shareholder(s). As with Deadlock and Default, the Call Option agreement may provide that if the Shareholder(s) refuses to transfer its shares, then the Call Option holder has an irrevocable Power of Attorney to sign the transfer on behalf of the grantor and to deal with the formalities of Completion.

In both cases, the Put or Call Option is a right that the Put Option holder or the Call Option holder possesses. There is no obligation to exercise the option and no obligation to transfer the shares arises unless and until the option is exercised. It is essential to stipulate how the price for the Call and Put Options will be determined and this should be set out in the agreement. Sometimes this will be an agreed fixed price, whereas on other occasions it will be calculated by reference to an agreed formula (such as a multiple of earnings or profits) or subject to an independent valuation procedure.

26 GOOD/BAD LEAVER PROVISIONS

26.1 Background

Leaver Provisions are a contractual mechanism covering employees who are also Shareholders in a Company. Under these provisions, when an employee leaves the employment of the Company, he/she is required compulsorily to transfer his/her shares back to the Company (or as the Company directs – for example, to a new incoming employee).

Leaver Provisions are usually used for senior management employees and Directors who have been given shares at a discount to market value, in order to incentivise and reward them in the business. These provisions are often included in the Articles of Association or constitutional documents of the Company (particularly for Tax reasons), but can also be structured into a Shareholders' Agreement or even a side letter.

Good and Bad Leaver Provisions are widely used on private equity investments, when an institutional Shareholder wants to incentivise key management to stay with the business and perform well and wants to discourage them from leaving. They are also used on joint ventures with owner-managers and on management buy-ins and buy-outs.

26.2 Good and Bad Leavers

Usually the Leaver Provisions will distinguish between Good Leavers and Bad Leavers. Typically a Good Leaver would be someone who has died, retired on retirement age or resigned due to genuine bad health. A Bad Leaver would include someone dismissed for gross misconduct or dishonesty.

There is no standard definition of Good and Bad Leaver and the parties are free to agree to whatever definitions they like. In recent years, the market practice has also been to link *bad* behaviour to a breach of the

Restrictive Covenants, so that a departing employee who was initially *good* can be converted to *bad* if they then subsequently breach their Restrictive Covenants. If they have already been paid for their shares, then the Company will seek to recover the over-payment as a debt (on the basis that they were given a Good Leaver value, when in fact they should have only received a Bad Leaver value).

Good Leavers tend to receive Fair Value for their shares, whereas the price paid to Bad Leavers tends to be heavily discounted (often just nominal value, or Fair Value, if lower). As with Default provisions, the Shareholders' Agreement will set out how the value is calculated and, similarly, the parties also need to be mindful that any discount must not be a Penalty.

26.3 Intermediate leaver

There is often a third category of intermediate leaver, for example, if someone resigns after an agreed period of service, or if their employment is terminated for redundancy reasons. There tends to be a lot of negotiation over the scope and definition of this third category, particularly in relation to termination of employment for performance reasons and the price that the departing employee then receives for his/her shares. Often the Shareholders' Agreement will include a vesting schedule, which over a period of time increases the percentage value (against market value) that the employee will receive, to reflect long service and built-up value.

26.4 Enforcement

As with Call Options and Drag Along rights, an irrevocable Power of Attorney from the employee Shareholder in favour of the Company (or its officers) is often used in order to secure the obligations of the employee Shareholder and ensure that the compulsory transfer takes place.

26.5 Negotiating points

Sometimes employees will also negotiate for outright ownership vesting provisions, so that they can keep an agreed proportion of their shares even after they have departed, with the proportion depending on their prior years of service at the point they leave and also whether they are a *good, intermediate* or *bad* leaver. Often the vested shares would be disenfranchised from voting whilst the ex-employee continues to hold them.

Summary of possible Good/Bad Leaver positions		
Good Leaver	**Intermediate Leaver**	**Bad Leaver**
Death	Resignation after an agreed minimum period	Resignation prior to an agreed minimum period
Serious/ permanent illness	Serious / permanent illness of spouse	Dismissal for fraud or dishonesty
Retirement at retirement age	Dismissal on grounds of poor performance	Dismissal for gross misconduct
	Redundancy	Breach of Restrictive Covenants

27 SHARE RATCHETS

27.1 Background

Share Ratchets are a contractual mechanism contained in the Shareholders' Agreement or Articles of Association. Under the ratchet, the number of a Shareholder's shares and/or the amount of Consideration sale proceeds that it receives on an exit (such as a sale or IPO) is increased

or decreased (*ratcheted* up or down) according to an agreed performance formula.

The formula is agreed by negotiation between the parties and can be linked to the personal performance of the Shareholder if they are an individual. Alternatively they can be based on the overall performance of the Company, or on the returns received by an investor.

Ratchets are less popular than they used to be and there are a number of Tax issues to consider for the Shareholders and the Company, depending on the Jurisdictions involved. However, ratchets are still sometimes used on private equity investments and management buy-outs.

27.2 IRR

A typical Share Ratchet would give senior management Shareholders an additional share/Consideration entitlement if the investor's IRR (internal rate of return on its investment from dividends, interest, management charges and Consideration sale proceeds) exceeds an agreed target amount. Sometimes ratchets are calculated pro rata to actual performance against targets. In other cases this can be stepped increases, with gateways between steps. Ceilings or caps on the ratchet amount are usual.

Example of a stepped ratchet

% of agreed target achieved	Additional % of shares/proceeds
<100%	0
>100%-105%	0.5%
>105%-110%	2%
>110%	3%

28 TERMINATION AND EXIT

28.1 Exit strategy

The Shareholders' Agreement may include details of the Shareholders' intended exit strategy for the Company, such as an eventual sale or IPO. Such provisions are likely to be a statement of general aims and an *agreement to agree*, rather than anything legally binding on the Shareholders.

However, the agreement could go into great detail about the obligations of the Shareholders to help market the Company for an exit and may also then trigger the Drag Along rights or Put and Call Options if an exit is not achieved within the agreed time frame.

28.2 Termination

The Shareholders' Agreement will also usually set out the circumstances in which the agreement will automatically terminate. These may include:-

- On the expiry of an agreed fixed term after which (if the Shareholders cannot agree on an exit strategy or extension of the term) the Deadlock mechanism is triggered or the Company is liquidated.
- If the Company commences compulsory winding up procedures.
- If there is only one owner of shares in the Company.
- Reduction of the number of shares owned by one of the Shareholders below an agreed threshold.

In such circumstances the agreement will usually deal with any unwinding arrangements for the services provided by the Shareholders

and also require the Company's name to be changed if it includes the corporate or brand name of one of the Shareholders or their group. It will also state which of the provisions of the agreement will remain in force after the termination, such as confidentiality undertakings and (possibly) Restrictive Covenants.

SECTION E: SHARE SALE AND PURCHASE AGREEMENTS (SPAS)

1 BACKGROUND

The structure of a typical Share Sale and Purchase Agreement (SPA) is usually as follows:

- Parties to the agreement.
- Definitions and interpretation provisions.
- Agreement for sale and purchase.
- Consideration provisions relating to calculation and payment of the purchase price.
- Conditions Precedent to Completion occurring.
- Conduct pending Completion undertakings.
- Termination rights prior to Completion.
- Completion mechanics (in US-style agreements Completion is referred to as Closing).
- Retentions and Escrow Accounts.
- Restrictive Covenants.
- Warranties and Indemnities.
- Limitations on the Sellers' liability - these are often contained in a

separate schedule to the agreement. More detail on limitations on liability is set out in *Section H: Limitations of Liability*.

- Boilerplate provisions covering matters such as confidentiality and announcements, rights of Set-off, Joint and Several Liability, Default interest, Gross up, entire agreement provisions, Third Party Rights and so on. More detail on Boilerplate provisions is set out in *Section J: Boilerplate Provisions*.

- Governing Law and Dispute Resolution. More detail on this is set out in *Section B: Legal Framework on Belt & Road Transactions (paragraph 3)*.

- Schedules to the agreement - typically including a schedule of the specific Warranties, a schedule of Tax Indemnities and other schedules on matters such as the real estate properties, Material Contracts, Intellectual Property Rights, a list of key employees.

2 IDENTITY OF THE SELLERS

The first point to check on the SPA is who the Sellers are and whether they have sufficient financial resources to meet their obligations under the agreement, including if there is a breach of Warranties or a claim under the Indemnities.

If the Sellers are Special Purpose Vehicles (SPVs) with no other assets, there is a very real danger that the sale proceeds will be stripped out shortly after Completion and the Buyer will be left trying to pursue its claims against empty shell companies. Similarly, where the Sellers are individuals, they may dissipate their assets (or even disappear).

Careful consideration also needs to be given as to how easy it will be to enforce any judgments against the Sellers, depending on where they (and their assets) are based.

Where there are concerns about the financial covenant strength of the

Sellers, this will need to be dealt with by a retention from the purchase price payable at Completion, a parent Guarantee or bank Guarantee, some collateral security or some other suitable means. Trustee Sellers may be required to give undertakings not to distribute the proceeds of sale to the beneficiaries of the trust for an agreed period.

We have assumed here that all the Sellers give the Warranties. In cases where not all of the Sellers give Warranties, it is usual to have a separate definition of the Warrantors, being those persons who are giving Warranties.

Cases where Sellers will not necessarily give a full set of Warranties include receivership sales, sales by personal representatives of a deceased shareholder, sales by trustees, and sales by private equity funds and institutional investors.

3 IDENTITY OF THE BUYER

The Sellers will also need to ascertain the identity of the Buyer and whether it has sufficient financial resources to meet its obligations. The main obligation of the Buyer is usually to pay the purchase price.

If the price is payable in full on Completion, then effectively the Sellers will not pass title to what they are selling until they have been paid. However, up to that point the Sellers run the risk that they are negotiating with a Buyer that may not be able to get its finances/funding arranged so that it can complete the deal. This is potentially a serious risk for the Sellers, as they may incur significant costs negotiating with a Buyer that cannot complete – and may also lose out on the opportunity of closing a deal with another potential purchaser. Accordingly, it is common for Sellers to require proof of funding, especially in an Auction Sale, where it will be a key criterion of any bid.

If there is a delay between signing of contracts and Completion or some of the price payable is deferred, then there are additional risks.

Where there is a time gap between signing of contracts and Completion, the Sellers will not want a situation where the Buyer is a newly created SPV with no assets. Otherwise the Buyer effectively has an option to purchase and can breach its obligation to buy, knowing that the Sellers are unlikely to waste time and effort suing an SPV with no assets. For this reason, SPV Buyers are usually supported by a suitable Buyer's parent Guarantee or bank Guarantee, or are required to pay a deposit.

If part of the price is payable after Completion then, again, the Sellers will want to ensure that the Buyer will be in a position to satisfy this. Otherwise, the Sellers run the risk of having transferred title to what they are selling but never being paid in full.

4 GUARANTORS

4.1 Background

As mentioned above, sometimes it will be necessary for a Guarantor to provide a Guarantee in support of a party to the deal. This Guarantor can be a parent or other group company, or it can be a bank or some other third party. A Guarantee is an undertaking given by a third party that, if the primary obligor does not pay or perform, the Guarantor will pay and perform in place of the primary obligor.

Unlike an Indemnity, a Guarantee under English law creates a secondary obligation to support the primary obligation of the Sellers and is contingent on the Sellers' obligations (whereas an Indemnity creates an independent, primary obligation). In practice, a large number of Guarantee provisions also include an Indemnity.

4.2 Key points

The key points on Guarantees (using a Seller's Guarantee as an example) include:

4.2.1 Ensuring that there is adequate Consideration being given for entry into the Guarantee (so that it will be enforceable). Alternatively it can be executed as a Deed under English law.

4.2.2 Is it just a payment Guarantee, indemnifying the Buyer for failure by the Sellers to pay? Or is it also a performance Guarantee, undertaking to perform the obligations of the Sellers if they fail to? Usually it should be both.

4.2.3 Joint and Several Liability in the case of more than one Guarantor.

4.2.4 Ensuring that obligations of the Guarantor are not affected or released by matters such as:

- A variation to the main agreement.
- Any other agreement entered into between the parties.
- Any time or indulgence given to any of the Sellers.
- Any of the Sellers becoming insolvent or bankrupt.
- Any of the Sellers undergoing a reconstruction or reorganisation.
- The unenforceability or invalidity of any provision against the Sellers.

4.2.5 The Guarantor is usually required to defer its rights against the Sellers (to indemnification, Set-off and subrogation (the right to stand in the place of the creditor)) until the guaranteed party has been completely repaid.

4.2.6 In the case of loan obligations, Lenders will often require the right to appropriate, in other words to reserve money received from the Guarantor in a suspense account, whilst it continues to seek payment from the third party Borrower.

4.2.7 Often the Guarantor will want an express provision to state that its obligation can never be greater than the Sellers' original obligations under the guaranteed contract (although this is the default position under English law anyway).

4.2.8 Often Guarantees will be subject to an agreed time period, but usually the term of the Guarantee will simply follow that of the underlying obligations.

4.2.9 The party taking the benefit of the Guarantee (in this case the Buyer) will want to check that the Guarantor has the capacity and authority to give the Guarantee (although note that this is not much of an issue for an English company, given sections 39/40 of the Companies Act 2006) and that it is being given for the commercial benefit of the Guarantor. This is usually done by inspecting the constitutional documents, signing authorities and Board minutes of the Guarantor and/or the parent company of the Guarantor. Commercial benefit should not be hard to demonstrate if the Guarantor is the parent company of the relevant party. It will also not be a concern (apart from insolvency issues) if the parent company of the Guarantor has approved the Guarantee.

4.2.10 Individuals who are acting as Guarantors may seek lower caps on their personal liability, particularly where extensive Warranties and Indemnities are being given.

4.3 Alternatives

If a Guarantor is not available or is not commercially acceptable, then the Sellers could consider the following alternatives in order to support their obligations in the SPA:

- Letter of credit - a letter from a bank, agreeing to make payment on demand on presentation of certain specified documents.

- Standby letter of credit - similar to a letter of credit; popular in the US

and has the advantage of being transferrable, so that an unconnected third party can take the benefit of the letter and present it to the bank for payment.

- *On demand* Guarantees and performance bonds - more typical on tenders and projects.

- Alternatively, a retention may give some comfort.

5 AGREEMENT FOR SALE

The SPA will often state that the Sellers sell their shares *with full title guarantee*. Under English law, this implies the following terms into the contract:

- That they have the right to sell the shares.

- That the sale is free of all charges and encumbrances and from all other rights exercisable by third parties (other than those which the Sellers do not and could not reasonably be expected to know about).

- That the Sellers will (at their own cost) do all that they reasonably can to give the Buyer title to the shares, although note that most agreements have a further assurance clause anyway.

Unencumbered title to what is being acquired is naturally regarded by Buyers as critically important - attempts to limit the comfort given on these issues (with Disclosures or other limitations on liability) are resisted by Buyers wherever possible. Indeed, most clients will tend to be more focused on price and the terms, and just assume that they are getting good title.

Accordingly, the SPA generally also includes an express covenant that there are no encumbrances (whether or not the Sellers know about them). In fact, often all the implied covenants are covered (as well or

instead) by express provisions in the SPA (and so the 'full title guarantee' wording may not be used).

6 CONSIDERATION AND ADJUSTMENTS

There are a number of different ways to structure the Consideration (purchase price) and the position agreed between the parties will need to be set out in the SPA.

Usually the Consideration will be paid as money, Consideration Shares and/or loan notes, or as a combination of these. More complicated alternatives are also possible, such as an asset swap or the provision of services, although careful advice will need to be taken in such cases and Tax and company law issues are likely to arise.

The main mechanisms for determining the timing of payment and any adjustments to the Consideration include:

- Completion Accounts.
- Locked Box.
- Deferred Consideration (including Earn-Outs).
- Retention or Escrow Accounts.

7 COMPLETION ACCOUNTS

7.1 Background

Completion Accounts are used as a means of determining the price to be paid for the Target and to protect the Buyer against any adverse change in the financial position of the Target since the last Audited Accounts.

Typically, where Completion Accounts are used to fix the Consideration,

on Completion of the SPA the Buyer will pay an amount on account of the Consideration, often by reference to an estimated figure agreed by the parties.

Accounts of the Target drawn up as at the date of Completion (and so known as Completion Accounts or Closing Accounts) are then prepared following Completion. The Consideration is calculated on the basis of the Completion Accounts in accordance with the terms of the SPA.

The Buyer will try to ensure that any payment on account is less than the price to be finally determined. The Sellers will usually want to receive Consideration payments as soon as possible, with interest from the date of Completion, without Set-off and (in addition to a payment on account) may request that a sum be paid into an Escrow Account as security for the final payment of the Consideration.

7.2 Form of the Completion Accounts

The form of the Completion Accounts will depend on whether the price is to be varied by reference to the assets and/or profits of the Target or some component of them. Accordingly, a balance sheet and/or a profit and loss account may be required. If that is the case, it is usual for fixed values to be apportioned to certain items (such as real estate) so that in practice the parties are only assessing constantly changing items such as creditors and debtors, stock and work-in-progress.

7.3 Debt Free, Cash Free

However, Completion Accounts are most commonly used on Debt Free, Cash Free deals, to simply calculate the amount of Net Debt and Working Capital. Buyers are usually asked to make an offer for the Target on a Debt Free, Cash Free basis. This is the price the Buyer would pay if the Target had no debt and no cash – and it makes it easy for the Seller to compare competing bids if all bids are required to be made on this basis.

Adjustments are then usually made in the SPA to reflect that, as a matter of legal fact, cash and debt will actually be acquired by the Buyer when it buys the Target (to the extent that this is not stripped out by the Sellers on or prior to Completion).

The SPA will usually state that on Completion the Buyer will pay the agreed fixed price for the shares of the Target, less an estimate of the debt and plus an estimate of the cash. The actual debt and cash positions will then be finalised post-Completion in an indebtedness statement (usually as part of the Completion Accounts) and there will then be a balancing payment to, or from, the Buyer. This is in contrast to the position with Locked Box - more detail on this is set out below.

Whatever form the accounts take, both the accounting bases on which the Completion Accounts are to be prepared and also the adjustments, if any, that should be made to them need to be clearly set out in the SPA and will almost certainly require the involvement of each party's accountants or in-house financing/accounts team.

7.4 Who prepares them?

The SPA should provide whether the first draft of the Completion Accounts is to be prepared on behalf of the Sellers or the Buyer.

Although the party who initially prepares the accounts often incurs the greater cost, there is likely to be an advantage in taking control of the process, as the preparation of the accounts is likely to involve a degree of judgement and evaluation (for example, the recovery of book debts) which it can exercise in its favour (and which it can be hard for the other party to challenge successfully).

It is important to agree specific policies – for example, that all debts over a certain date will be discounted by an agreed percentage, or considered bad. Also, the Seller may no longer have the capability to easily prepare them, as the relevant employees may have transferred to the Buyer. This is

a reason why the Buyer generally prepares the first draft.

If the Sellers are to prepare the accounts, they should ensure that they will have access to financial records and personnel who will have come under the control of the Buyer from Completion.

7.5 Timetable

The SPA should provide for a timetable within which the Completion Accounts are to be prepared and agreed or, in the absence of agreement, determined by independent accountants. In practice, it is useful to set a time period for each of the individual steps involved in the preparation and review of the accounts.

7.6 Final and binding nature

If a dispute is referred to independent accountants, it is usual to provide that their determination is final and binding upon the parties. The SPA should set out the detail of the parties' rights to make representations to the independent accountants and their obligations to make working papers and records available to them.

It should be noted that whatever the provisions stated in the SPA, the independent accountants will want to negotiate terms of engagement acceptable to them.

7.7 Manipulations

The Buyer should seek to ensure that any price adjustment mechanism cannot be manipulated so as to artificially increase the price. This could occur, for instance, if the Sellers were paid extra for any cash in the Target (e.g. on a Debt Free, Cash Free deal), but there was no working capital adjustment (as the Sellers could then simply increase the effective price they were paid by collecting creditors more quickly or not buying stock). So, the first point for the Buyer is to ensure that, so far as possible, the

mechanism cannot be manipulated. Secondly, it can look to ensure by way of Warranty (or undertaking, if there is a delay between signing and Completion) that the business has (since the date of the last accounting information) and will be (from signing) carried on in the ordinary and normal course and that no transaction or other act will be done or omitted to be done with a view to artificially increasing the price payable by the Buyer.

7.8 Possible areas of dispute in relation to Completion Accounts

Most disputes in relation to Completion Accounts arise in relation to what accounting policy is to apply.

The SPA will generally provide that as regards any matter to be dealt with the first applicable policy will apply out of the following:

- a policy expressly stated in the SPA; and
- if no such express policy applies, the policy adopted for the same sort of matter in the last accounts; and
- if the matter was not dealt with in the last accounts, a policy provided for by Relevant Accounting Standards.

However, without further clarification and drafting this leaves plenty of scope for complication and uncertainty, for example:

- What if the policy adopted in the last accounts was wrongly adopted/applied?
- What if the policy adopted in the last accounts no longer complies with current accounting standards?
- What are the 'Relevant Accounting Standards'? What if they change

between the date of the agreement and the date the completion accounts are prepared?

- What about the areas of discretion when applying the policies?

8 LOCKED BOX

8.1 Overview

Locked Box is an alternative to Completion Accounts. In a Locked Box deal the price payable for the Target is determined by reference to a historical balance sheet or set of accounts (the Locked Box Accounts). The Buyer's principal comfort on price will come from financial Due Diligence. However, the Locked Box Accounts should also be Warranted.

From the date of the Locked Box Accounts, the Target business is *"locked up"* and the Sellers must operate the Target business in the ordinary course and undertake not to extract cash/value from the Target (the no Leakage covenant). The commercial principle is that, from the date of the Locked Box Accounts, the risk and reward of the operation of the business lie with the Buyer.

The Locked Box mechanism generally favours the Sellers, because of the price certainty it gives to them. However, many Buyers have grown accustomed to its use and may also perceive advantages (principally, the time/cost saving of not having Completion Accounts) notwithstanding the additional risks involved.

8.2 Example

- The Target is valued at USD 100m on a Debt Free, Cash Free basis.

- The Locked Box Accounts show that Target has Net Debt (i.e. debt less surplus cash) of USD 20m.

- Then the price payable to the Sellers will be USD 80m, regardless of the results of actual trading for the period from the date of the Locked Box Accounts until Completion.

- Any changes in Net Debt between the date of the Locked Box Accounts and Completion will lie with the Buyer (subject to various contractual protections – mainly the no Leakage covenant and any pre-completion undertakings).

8.3 No Leakage Covenant

The Sellers will warrant that there has been no *leakage* from the date of the Locked Box Accounts. Where there is to be delay between signing and Completion, the Sellers will also undertake that there will be no *leakage* until the date of Completion.

Leakage refers to the extraction of cash/value by the Sellers (or connected persons) and is typically defined to include:

- Dividends and distributions.

- Other payments made, or assets transferred, to the Sellers or a connected person (other than *ordinary course* payments).

- Liabilities assumed, indemnified or incurred by the Target for the benefit of the Sellers or any connected person.

- Costs or expenses assumed by the Target in connection with its sale.

- The waiver by the Target of any amount owed to it by the Sellers or any of their connected persons.

- Agreements for any of the above to occur.

The no-Leakage covenant is not intended to prohibit payments made in

the ordinary course of business. Payments to the Sellers or connected persons under existing trading arrangements will ordinarily need to be expressly excluded from the definition of Leakage.

This is generally best dealt with in the SPA in a separate definition of *Permitted Leakage*.

8.4 Permitted Leakage

8.4.1 Permitted Leakage is something that would constitute Leakage from the Locked Box, but for the fact that it is expressly permitted.

Whether or not there is a separate definition of Permitted Leakage depends on how Leakage itself is defined and the circumstances of the deal - is there anything that needs to be carved out?

Any permitted Leakage that is not *ordinary course* (for example, a pre-sale dividend or buy-back of shares) is a matter for negotiation and will need to be factored into the pricing of the deal.

8.5 Claims for breach

Generally, it is standard for negotiated wording to include:

- An Indemnity for Leakage.
- An exclusion of claims relating to Leakage from the limitation provisions relating to other claims (thresholds and so on).
- An obligation on the Sellers to notify the Buyer of any Leakage.

The SPA will generally provide that the general limitations of liability on claims in the SPA will not apply.

However, it is likely to provide that any claims have to be made within a relatively short period (e.g. 12 months).

8.6 Interest mechanism or daily earnings amount

It is relatively common (at least in Sellers' market) for the price payable to the Sellers to be increased by a notional interest or daily earnings amount. This somewhat cuts across the concept of the box being locked (and the principle that the risk and reward of trading from the date of the Locked Box Accounts lie with the Buyer). However, the reasons given for it are as follows:

- the price the Sellers receive on Completion is a sum set by reference to a historical date (rather than a current value) so the Sellers look to receive interest on that sum from the valuation date to compensate them for delayed receipt; and

- if the Target is likely to generate surplus cash after the valuation date (i.e. cash in excess of Target's working capital requirements), the Sellers will naturally look to make the Buyer pay for it.

8.7 Advantages and disadvantages of Locked Box

- Price certainty for the Sellers.

- Easier for the Sellers to compare bids.

- Avoids the time and cost of having Completion Accounts prepared and agreed/determined (which is often problematic). Therefore the transaction is concluded faster and cheaper, which may be advantageous for both parties.

- An advantage for the Seller is that the Buyer loses the opportunity to adjust the price downwards (by means of the Completion Accounts policies and the way that they are applied).

- As mentioned above, the Locked Box mechanism generally favours the Sellers and historically the mechanism is used more frequently in a Sellers' market.
- A disadvantage for the Buyer is that the Buyer loses the opportunity to adjust the price downwards (by means of the Completion Accounts policies and the way that they are applied).
- May lead to more Warranty claims by the Buyer at a later stage.
- The procedure is not always well understood by all parties.
- Information quality issues - the Buyer needs a good set of accounts in order to agree pricing.

9 DEFERRED CONSIDERATION

9.1 Background

Deferred Consideration is essentially any Consideration which is not paid at Completion. It can include balancing payments under Completion Accounts, Earn-Outs or just deferred tranche payments by the Buyer.

Note that payments into Retention Accounts are not, strictly speaking, Deferred Consideration.

9.2 Deferred tranches

Where the Buyer agrees to make deferred tranches of payments to the Sellers after Completion, the key points to consider include:

- **Timing** - what is the agreed timing for the payments? Is time of the essence? A Seller may want express time of the essence provisions, where

performance by a certain date (and/or time) is important to it. An explanation of what is meant by time of the essence can be found in *Section J: Boilerplate Provisions (paragraph 20)*.

- **Conditions** - are the payments conditional on anything? Sometimes these will be linked to future performance (such as an Earn-Out). Alternatively they may be linked to the performance of matters after Completion (Conditions Subsequent) such as obtaining a third party consent, transferring an asset or implementing a transitional arrangement.

  There is no requirement under English law for the deferred Consideration to be subject to conditions.

- **Set-off rights** - does the Buyer have rights of Set-off, enabling it to deduct the amount of any claims it may have (for example under the Warranties and Indemnities) against the deferred Consideration? If not, then from the Sellers' perspective this needs to be clearly stated. Such rights of Set-off are unpopular with Sellers, because it makes it much easier for a Buyer to refuse to make payment, without it first having to incur the expense and time (and risk) of establishing a Warranty or Indemnity claim in Court.

- **Security** - do the Sellers have any security for the Buyer's obligation to make the payments of the deferred Consideration? What happens for example, if the Buyer becomes insolvent, or reorganises itself so that it no longer has the financial ability to make the payments?

9.3 Earn-Outs

Earn-Outs are a contingent price mechanism which compare future economic performance against agreed targets (such as revenue or profits) and then calculate the deferred payments according to whether or not these targets are met.

They are often used where the Target business has a limited track record and/or where some or all of the Sellers retain some interest in the Target, either via an on-going shareholding or where they continue to have an executive role (perhaps on a transitional basis) as senior employees and/or Directors. This continued involvement may be the case if, for example, the business is in the services sector and the Buyer needs the business reputation and goodwill of the Sellers as individuals to help smoothly transition the business and key client relationships into the Buyer's group. In such a case, an Earn-Out mechanism may be a good way to incentivise the Sellers to do this and also to protect the Buyer from paying too much for the Target up front at Completion.

The actual details of Earn-Out provisions vary widely from contract to contract. Some usual points for negotiation and discussion include the following:

- **Agreed targets** - the parties will need to specify the financial targets that need to be achieved and also whether these are proportionate, so that for example, if 85% of the target is achieved, will 85% of the Earn-Out payment be due?

- **Duration** - as with other forms of deferred Consideration, the parties will need to agree on the period of the Earn-Out and also on the timing of any payments.

- **Definitions of *profit* and *revenues*** - as with Completion Accounts, the parties will need to carefully agree on what is meant by profit and revenue and this will need specialist financial and accounting input. The specific accounting principles and practices to be used ought to be stated, ideally together with some useful worked examples of possible future scenarios. Generally, revenue-based Earn-Outs are very rare as parties are naturally more interested in profitability than turnover.

- **Adjustments** - the parties will also negotiate detailed specific adjustments to the Earn-Out calculation. For example, the Sellers will not want to be

penalised for the cost of any long-term investments in matters such as research and development and so will ask for these to be added back. The Buyer will want to exclude the financial benefit of any synergies obtained from the Target now being part of its group (such as lower borrowing costs, better terms of settlement with suppliers, lower insurance costs and so on), although accounting for this and documenting it accurately in the SPA is very difficult.

- **Capped amounts** - the Buyer will often seek an overall cap on the amount of the Earn-Out payment. This may not be necessary where the Earn-Out is based on particular targeted figures, but it will still give the Buyer peace of mind and may also be required for the Buyer's own internal controls and consents (for example under Board or shareholder approvals or a consent right in a Shareholders' Agreement or Facility Agreement to which the Buyer is a party). It may also be necessary or desirable for regulatory reasons in the case of a publicly listed Buyer. Depending on the Jurisdiction, a cap may give rise to additional transfer Taxes.

- **Credit for over-performance** - the Sellers will sometimes ask for credit to be given for over-performance against financial targets in good years.

- **Controls** - the SPA will normally also include provisions (expressed as negative covenants) to prevent one party from manipulating the trading business in order to produce anomalous or unsustainable short-term results which will affect the Earn-Out payment. These are likely to include provisions relating to the management of the business during the Earn-Out period and vetoes or add-backs/adjustments over items such as capital expenditure, Directors' remuneration and intra-group trading arrangements.

- **Set-off** - as with other forms of deferred Consideration, the parties will need to consider whether the Buyer has rights of Set-off against any Earn-Out payments.

- **Security** - likewise, the parties will need to consider whether the Sellers should have any security for the potential Earn-Out payments.

- **Who produces the relevant accounts?** - as with Completion Accounts, the SPA will need to set out the procedure for producing the relevant accounts on which the Earn-Out will be calculated, how this figure is provided to the other party and the mechanism for dealing with any disagreements. Almost invariably the Buyer will produce the accounts, since as the new owner, it will have all the data.

- **Disputes** – again, as with Completion Accounts, there will be a mechanism dealing with disputes. Since these are likely to be financial in nature, a referral to a firm of independent accountants is almost always the most appropriate route.

- **Tax issues** - the Tax treatment of the Earn-Out will need to be considered by both the Sellers and the Buyer, and specific legal advice should be sought.

10 CONSIDERATION SHARES

Where the Buyer issues Consideration Shares to the Sellers as part (or all) of the purchase price, the following matters will also need to be considered:

- **Regulatory issues** - the parties will need to consider whether there are any regulatory issues connected with the proposed issue of shares (such as the requirement to produce a prospectus or to obtain a share valuation). A formal announcement may also be required. Care will also need to be taken to ensure that the issue of shares does not inadvertently trigger any requirements to make a mandatory take-over offer.

- **Tax issues** - there will usually be Tax issues associated with issuing and receiving the shares and these should be analysed in each case.

- **Authorities and consents** - the Buyer will require authority (including any shareholder and Board approvals) to issue the shares, together with disapplication of any rights of pre-emption (where relevant). Consents may also need to be obtained under Articles of Association, any Shareholders' Agreements, Facility Agreements or under applicable legislation, such as antitrust law, etc.

- **Conditionality** - the SPA may need to be made conditional on the Buyer obtaining the necessary approvals and consents.

- **Listing condition** - if the Buyer's shares are listed on a regulated stock exchange, the Sellers will also want to have their Consideration Shares listed and the relevant formalities to do this will need to be complied with.

- **Number of shares** - the parties will need to agree on the number of shares to be issued and how this is determined. This may be a fixed number on signing of contracts, or alternatively in the case of listed shares it may be a number determined at a later date by reference to the market price at Completion.

- **Value attributed to the shares** - the parties will need to consider the value attributed to the shares, since this will be relevant for Tax purposes and also potentially in respect of Warranty claims. The financial caps on Warranty claims are usually linked to the amount of Consideration received by the Sellers and so the value of the Consideration Shares will potentially affect this figure. In the case of listed shares, the parties will also need to agree whether the financial caps increase and decrease as the market value of the Consideration Shares fluctuates post-Completion.

- **Satisfaction of Warranty and Indemnity claims** - the parties will sometimes agree that Warranty and Indemnity claims should first be satisfied by returning the Consideration Shares. Again, the value of the shares will need to be ascertained in order to do this.

- **Due Diligence on the Buyer** - the Sellers may need to undertake their own Due Diligence on the Buyer, to ensure that they are happy with the valuation attributed to the Consideration Shares. Where the shares are not publicly listed, the Sellers may want to negotiate minority protections and Veto Rights in order to protect their investment.

- **Warranties and Indemnities on the Buyer** - likewise, the Sellers may also find it necessary to seek Warranties and Indemnities from the Buyer.

- **Lock-in** - the Buyer will usually seek to restrict the Sellers from selling or otherwise disposing of their Consideration Shares for an agreed period following Completion. In the case of listed shares, there will need to be agreed carve-outs for matters such as recommended takeover offers but it is worth noting Lock-ins are difficult to enforce in this context. Even where a breach is discovered, it is often difficult for the Buyer to prove that it has suffered loss.

- **Orderly market** - the Buyer's broker may also require that, after the Lock-in period has expired, any shares are only sold in the market through that broker and on such reasonable terms as the broker requires. The Sellers will want a carve-out to this if the price and settlement terms being offered by the broker are materially less favourable than those they can obtain elsewhere in the market.

11 RETENTION/ESCROW ACCOUNTS

11.1 Background

Retentions are amounts that are held back from the purchase price payable at Completion, usually as security for performance of the obligations of the Sellers under a post-Completion undertaking or a Condition Subsequent, or to meet claims for breach of the Warranties and under the Indemnities.

Typically money retained would be placed in a Retention Account (often also known as an Escrow Account) which is jointly controlled by the Sellers and the Buyer (or their respective lawyers), or by an independent escrow agent, and can only be released in accordance with joint instructions given under the provisions of the SPA. If there is a dispute and the parties cannot agree, then the money stays in the account and the matter is referred to Court or Arbitration.

11.2 Key points for setting up Retention Accounts

The key points for setting up Retention Accounts include:

- Who will hold the money? Will this be the lawyers of one of the parties (under a joint legally-binding instruction letter from the Buyer and the Sellers), or an independent third party escrow agent? What is the duration of the retention/escrow?
- In what circumstances can payments be made from the account?
- Who receives the interest on the account?
- How are bank charges and escrow agent's fees dealt with?

11.3 Main negotiating points in the Sale and Purchase Agreement

The main negotiating points on Retention Accounts include the following:

- **What claims does it cover?** - can the Retention Account be used to satisfy all claims (including for example, a claim under the Completion Accounts, a claim for breach of Restrictive Covenant or Warranty and Indemnity claims) or certain claims only?
- **Duration** – ideally, the Buyer will want the money to continue to be held in the Retention Account for as long as the Sellers may have liability

under the obligations that are being secured by the Retention Account. The Sellers may well want a shorter period. Accordingly, depending on the nature of the obligations, a staged release of the money is a common compromise.

- **Claims** - if there is a claim, the Buyer will want the amount of its claim and also an amount of money sufficient to cover its costs in respect of such claim to remain frozen in the Retention Account until the dispute is settled or decided in Court or by Arbitration. The Sellers will not want the Buyer to bring spurious claims in order to keep the money held in retention. A compromise here is sometimes to seek the opinion of an experienced counsel on the likelihood of the Buyer's claim succeeding. The Sellers' preferred approach would be that if the counsel rates the chances of success as more than 50%, then the money is not remitted to the Sellers when due but continues to be held in the Retention Account until the dispute is settled or decided in Court or by Arbitration. The Buyer would prefer counsel only needing to opine that the Buyer has reasonable grounds for the claim, as otherwise it is effectively having to prove that it would win at trial.

11.4 Practical considerations

From a practical perspective, the parties should bear in mind that Retention Accounts will take time to set up. The terms and charging arrangements will need to be agreed and documented with the escrow agent and KYC (Know Your Client) procedures may need to be carried out for bank accounts.

12 CONDITIONS TO BE SATISFIED BEFORE COMPLETION

12.1 Background

In many cases the SPA will have simultaneous signing and Completion, in other words Completion of the agreement will take place immediately after it has been signed.

However, in other cases this will not be possible, because one or more key items (such as obtaining a consent) needs to be dealt with before the SPA can complete. In theory the parties could simply delay the signing until the outstanding item has been dealt with. However in practice, the parties will want legal certainty that the transaction will go ahead and that one party will not change its mind and back out, or try to renegotiate a key term at the last minute. Also, the Sellers are unlikely to want to take material steps such as a pre-sale dividend or reorganisation without sufficient certainty that a deal will proceed.

For this reason, the parties will often agree in the SPA to a delay between signing and Completion, with Conditions Precedent to be satisfied prior to Completion.

12.2 Conditions Precedent

Conditions Precedent (commonly known as CPs) are clauses which typically provide that the obligation to buy/sell under the SPA will only come into force if and when agreed conditions are met or are waived. Alternatively, where the SPA deals with multiple Targets, CPs can apply to the acquisition of the individual Targets.

These conditions might include obtaining anti-monopoly merger approvals, bank consent, Change of Control approvals from key customers and suppliers, or consents to assign other key contracts that are otherwise non-assignable.

Under English law, within reason the parties can agree to whatever CPs they like. These conditions do not need to be within the control of the parties provided they are clear and can be objectively assessed. Each party will be concerned to ensure that CPs requested by the other do not effectively turn the agreement into an option to buy/sell in favour of the other party only. Generally, CPs are kept to a minimum and are inserted as a result of mandatory legal requirements, for example merger control clearances in certain Jurisdictions, or shareholder approval to a stock

exchange regulated takeover, or approval from another key third party (such as a key customer of a joint venture partner of the Target).

The SPA will typically include provisions dealing with the legal obligations of the parties pending satisfaction of all the conditions and the efforts to which they must go in order to achieve satisfaction of the CPs themselves. These obligations are legally binding even if the CPs are not met.

12.3 Long stop date

The SPA needs to include a long stop date, in other words a cut-off date, after which it will terminate if the CPs have not been satisfied (without prejudice to any accrued rights, if for example one party has deliberately failed to satisfy a CP in breach of its obligations).

This long stop date can always be extended by agreement between the parties and often the SPA will expressly state this. An express statement is not strictly necessary under English law, but is generally helpful – so that any extension does not require the formality associated with varying the contract.

There is no market standard for the length of time for long stop dates. Usually the parties will want these to be as short as possible, in order to avoid delays and the risk of something happening which may lead to a breach or even termination of the deal. In practice, they are usually for at least one month (to deal with the relevant CPs to be satisfied) and can be 2-3 months in length. Longer periods are possible, particularly in a market where Buyers remain cautious and prefer to have potential areas of risk dealt with up-front and before they have completed and paid over the money. However, this runs the risk, from the Sellers' point of view, of turning the agreement into an option and is generally resisted.

12.4 Examples of Conditions Precedent

Some examples of CPs include:

- Shareholder approval – where this is a regulatory requirement of the deal itself or an aspect of it, e.g. the ability of the Buyer to issue Consideration Shares.
- Anti-trust/competition law clearances.
- Change of Control consents in respect of key contracts.
- Bank consent in respect of existing financing arrangements and sometimes also security releases (although these releases are normally dealt with on Completion as a Closing item).
- The consent of any relevant regulator for businesses subject to specific regulation (such as banks and insurance companies).
- Other third party consents, such as landlord's consent in respect of key premises or a release of security over specific assets.
- The release of a Guarantee to a third party (although this is usually dealt with at Completion, as a Closing item).
- Setting up a Retention/Escrow Account for the retention of part of the purchase price payable at Completion (although again, this is usually dealt with as a Closing item).
- If relevant to an individual Seller - Tax clearances.
- On occasion, the Buyer will seek a funding Condition Precedent, making Completion of the deal condition on it having the necessary funding in place. Clearly such a condition is unpopular with Sellers and is usually resisted.

- Corporate approvals - in respect of both the Buyer and the Sellers, Board approval is usually expected before signing, but where shareholder level approval is required (typically, if it is a regulatory requirement of the deal itself or an aspect of it, e.g. the ability of the Buyer to issue Consideration Shares) it may be accepted as a CP.

12.5 Corporate approvals as a Condition Precedent

Board approval is usually not accepted as a CP, since one party will not want the other to effectively have the ability to back out of the deal by deliberately not satisfying this.

For the same reason, if shareholder approval is included as a CP, it is usually supported by a Break Fee arrangement if the CP is not satisfied, and/or by irrevocable voting undertakings to vote in favour and to give the relevant approval.

12.6 Satisfaction and waiver of CPs

The SPA will need to state not only what the CP is but also what steps the Buyer and/or Sellers need to take to fulfil it - otherwise the CPs just become an unenforceable *wish list* of things that the parties would like to happen. This will depend on which party requires the CP and what powers it or the other party has to fulfil the CP. In some cases the CP will need to be satisfied by both parties together – for example, by both parties providing information required in connection with an approval to be sought from a regulatory authority, with one party having the responsibility of actually making the relevant filings and submissions.

12.7 Reasonable Endeavours

Sometimes the SPA requires that one or both parties use their respective Reasonable Endeavours or another endeavours requirement (such as Best Endeavours or All Reasonable Endeavours). However, what is actually required by an obligation like this will depend on the circumstances, is

unlikely to be clear at the outset and may be more (or less) onerous than a party expects. Accordingly, these terms should be used with caution and it will often be preferable to specify exhaustively the steps a party has to take instead, or perhaps to set out steps that the endeavours obligation will and will not include. The meaning of the various endeavours obligations is considered in *Section J: Boilerplate Provisions (paragraph 30)*.

In particular, care needs to be taken with matters outside of the control of a party (for example, obtaining anti-monopoly clearances). In such situations the party responsible can only give an undertaking to do certain things (e.g. make filings and submissions, etc.) or, perhaps, to use Reasonable Endeavours to procure satisfaction. In the case of items such as anti-monopoly clearances, the SPA is likely to include a detailed list of the steps and obligations to be taken by both parties in co-operation with each other.

12.8 Rights of waiver

The SPA will also usually give one party the right to waive particular CPs, where it is the party that insisted on them in the first place (for example, to obtain a specific Change of Control consent to a Material Contract). However, for some CPs which will affect both parties (such as anti-monopoly clearances) the SPA may provide that the consent of both parties is required in order to waive this CP.

13 CONDUCT PENDING COMPLETION

13.1 Background

Where there is a delay between signing and Completion, the SPA should set out the rights and responsibilities of the parties in relation to events occurring or coming to light during the intervening period. The two main issues to consider are the Buyer's rights under the Warranties and the obligations of the Sellers regarding the conduct of the business between signing and Completion.

The way in which this is resolved is often influenced by the reason for the delay between signing and Completion, with the party effectively responsible for the delay bearing the greater risk.

The Buyer will be concerned to have Veto Rights or controls over the conduct of the business in the period up to Completion and the undertaking of various corporate actions such as the payment of dividends. Typically, a number of protections in favour of the Buyer are negotiated – mainly consisting of things that the Sellers undertake will not be done without the Buyer's prior approval.

13.2 Typical undertakings/Buyer's Veto Rights

Typical undertakings by the Seller applying between signing and Completion in relation to the Target (and including its subsidiaries):

- **Share capital** - no changes to share capital; no granting of share options.
- **Loan capital** - no changes to loan capital; no granting of options or similar instruments in respect of loans.
- **Constitution** - no amendments to the Articles of Association/Charter of the Target.
- **Dividends** - not to pay any dividends or other distributions (unless specifically envisaged and agreed).
- **Acquiring or disposing of assets** - not buying or selling assets in excess of an agreed threshold (or aggregate threshold).
- **Book debts** - not assigning or disposing of book debts.
- **Business disposals** - not disposing or agreeing to dispose of any material part of the business or any subsidiary.

- **Borrowings** - not borrowing money or taking on new finance commitments; not to make any loans.
- **Security** - not granting or agreeing to grant security, including mortgages, charges, debentures.
- **Guarantees and Indemnities** - not giving or agreeing to give Guarantees or Indemnities.
- **Leasing and hire purchase** - not to enter into any agreements or arrangements for leasing, hire purchase, payment on deferred terms or similar arrangements.
- **Contracts** - not to enter into contracts or commitments other than in the usual course of trading; not to amend or terminate any Material Contract.
- **Capital expenditure** - not to incur capital expenditure in excess of agreed amounts.
- **Unusual or abnormal contracts** - not to enter into unusual or abnormal contracts or commitments.
- **Real estate** - not to grant or take leases, licences, etc. in respect of real estate, or to dispose of real estate.
- **Employees** - not to make any changes to terms and conditions of employment (including salaries, bonuses, benefits, etc.); not to make any promises (even non-binding) to make such changes; not to hire new employees or consultants (other than replacements); not to terminate the employment of any employees (other than on terms that justify summary dismissal).
- **Litigation and disputes** - not to institute, settle or agree to settle any legal proceedings.

- **Insurance** - not to let any insurance policies lapse or do anything which would cause them to be void or voidable.

- **Liabilities with connected persons** - not to incur liabilities or obligations between the Target and the Sellers and/or their associates/ connected persons.

- **Warranties** - not to do anything which may cause a breach of the Warranties.

13.3 Other rights of the Buyer pending Completion

The Buyer will also usually request other rights in the period between signing of contracts and Completion, such as:

- Rights of access to the records and books of account of the Target and its group (including the right to make copies).

- Rights of access to the premises and properties.

- Rights of access to the employees.

- Such other information regarding the business, assets and affairs of the Target group as the Buyer may request.

The Buyer may also seek to impose positive obligations on the Sellers for this period, such as to continue running the business in the normal and ordinary course.

13.4 Negotiating points

Typically the Sellers might seek to negotiate exceptions/exclusions to the Buyer's Veto Rights along the following lines:

- **Compliance with laws** - the Sellers will seek an exception for doing or omitting to do anything for the purpose of complying with applicable laws and regulations.

- **Existing contracts** - the Sellers will seek an exception for actions in connection with the performance of contracts or arrangements entered into prior to the SPA. The Buyer will seek to narrow this exception to only those contracts which have been disclosed to it and/or contracts entered into in the ordinary course of business.

- **Materiality** - the Sellers will seek to ensure that any restrictions are limited to material matters only, so that they cannot accidentally breach the SPA for trivial matters. Usually this is dealt with by the Buyer agreeing to threshold amounts for items such as capital expenditure, below which the Sellers can continue to do business.

- **Day-to-day ordinary course trading** - sometimes the Sellers will seek a general exception for ordinary course trading matters. This is usually unpopular with the Buyer, since it is very wide and subjective and therefore open to dispute. As a compromise, the parties will often instead agree to threshold amounts for items such as capital expenditure, below which the Sellers can continue to do business. The Sellers will also sometimes want to carve-out debt collection in the ordinary course in accordance with the Target's usual terms of business and payment.

- **Agreed drawings under existing debt facilities** - if there are restrictions on drawing against existing debt facilities, the Sellers will sometimes require the right to draw against existing debt facilities for day-to-day business, up to agreed limits.

- **Termination of employees** - the Sellers sometimes seek the freedom to terminate the employment of any employee for good cause (for example, in cases of dishonesty or gross misconduct).

- **Litigation** - the Sellers may want some flexibility to conduct litigation proceedings, particularly where the Target is the defendant and needs to protect its rights and/or comply with strict Court deadlines.

- **Warranties** - the Sellers will usually try to avoid including a restriction on *"not doing or allowing anything which may cause a breach of the Warranties"*, on the basis that this will effectively amount to a repetition of the Warranties by the Sellers up to and including Completion. Even where it is commercially agreed that the Warranties will be repeated, the Sellers will argue that this should be dealt with in the Warranties section of the SPA, so that it can be tied into the relevant sections of the agreement on matters such as Disclosures and limitations of liability. The issues surrounding repetition of Warranties are considered in *Section G: Warranties and Indemnities (paragraph 6)*.

- **Agreed pre-sale dividends** - the Sellers sometimes want specific carve-outs for any agreed pre-sale dividends.

- **Agreed pre-sale restructurings** - the Sellers will also want specific carve-outs for any agreed pre-sale restructurings.

- **Implementation of the SPA** - the Sellers will sometimes seek a general carve-out for matters required *"to effect the transactions contemplated by this agreement"*, although the Buyer will usually insist on more identified, specific items.

- **Reasonableness** - the Sellers will sometimes try to impose an overall requirement on the Buyer to act reasonably and not to unreasonably withhold or delay its consent. Sometimes they will even include a mechanism where they notify the Buyer of a decision and the Buyer is deemed to consent unless it objects in writing (with valid reasons) within an agreed period. The Buyer is likely to strongly object to such provisions, since it seriously dilutes its protections over the Target and its business.

- **Rights of access** - the Sellers will normally agree to give the Buyer rights of access prior to Completion, provided that the requests are reasonable and they are given a reasonable period to respond. They will also want to ensure that inspections are made during normal office working hours and that any copies of records are logged and kept confidential.

- **Reasonable Endeavours** - in many cases the Sellers will argue that they cannot give an absolute undertaking to do (or not to do) something, since it is outside of their control and they are reliant on third parties. In such cases they will often suggest as a compromise to use their Reasonable Endeavours. What is meant by Reasonable Endeavours is considered in more detail in *Section J: Boilerplate Provisions (paragraph 30).*

14 RIGHT TO TERMINATE

14.1 Background

The Buyer may want the right to terminate the SPA prior to Completion in various different circumstances.

14.2 Examples of termination trigger events

Examples of termination trigger events, allowing the Buyer to terminate the SPA prior to Completion, include the following (clearly in each case they will be heavily negotiated with the Sellers):

- A failure to satisfy those Conditions Precedent to be fulfilled by the Sellers (unless these are waived by the Buyer).

- A breach by the Sellers of the provisions relating to conduct pending Completion.

- A material breach of the Warranties or other terms of the Share Purchase Agreement.

- Material Adverse Change in the financial condition of the Target and/or its business.
- Material Adverse Change in economic conditions generally (not just restricted to the Target and/or its business).
- Any Force Majeure events (to the extent that they are not already covered by the Material Adverse Change provisions).

14.3 What is meant by Material Adverse Change?

There is no statutory definition of Material Adverse Change (MAC) under English law and so, for clarity, the parties generally define what they mean by this in the SPA – although the party with the right to terminate (generally the Buyer) will usually look to do so non-exhaustively.

Often the parties will agree to a specific definition of what is material in relation to the Target and its business by reference to profits and/or revenue figures. For example, this might be:

- A diminution (reduction) of 5% or more in net profits.
- A diminution of 5% or more in revenues.
- A diminution of 5% or more in the value of net assets.

In each case it is necessary to benchmark these figures against an agreed set of financial figures (such as the last set of Audited Accounts, or some other agreed set of more recent Management Accounts). It is also necessary to include a Dispute Resolution mechanism for determining whether such a reduction has actually occurred (such as referring the matter to an independent firm of accountants).

14.4 What is meant by Force Majeure?

Force Majeure is best described as an event or effect that cannot be reasonably anticipated or controlled by the parties and which leads to the impossibility of performance of the parties' obligations. There is no statutory definition of *Force Majeure* under English law and so it is necessary for the parties to define what they mean by this in the agreement.

In the context of SPAs it is often not separately listed as a termination event, but is instead effectively included within the trigger events giving rise to a Material Adverse Change. The definition will usually be heavily negotiated and may include some or all of the following:

Force Majeure
• Acts of God, explosion, flood, lightning, fire or accident.
• War, hostilities (whether war is declared or not), invasion or acts of foreign enemies.
• Revolution, acts of terrorism, military or usurped power or civil war.
• Riot, civil commotion or disorder.
• Adverse measures of any kind on the part of any governmental authority.
• Strikes, lock-outs or other industrial actions or trade disputes of whatever nature.
• Material defaults of suppliers or sub-contractors.

14.5 Consequences of termination and negotiating points

In the event of a termination of the SPA by the Buyer prior to Completion, the Buyer will want the right to also sue for damages and/or an indemnity for its costs.

The Sellers may try to remove the right to terminate altogether. However, this is only likely to be acceptable if the Buyer is wholly responsible for the delay.

Alternatively, they may try to restrict the right to terminate this as much as possible, e.g. by:

- including tests of materiality (with defined thresholds); and
- including a reasonable grace period to cure breaches.

It may also try to insist that, if the Buyer decides to terminate, it loses its right to sue for damages. However, in practice, the parties are likely to distinguish between those events where the Sellers may be responsible (and therefore potentially liable for damages/costs) such as breach of conduct pending Completion obligations and those events where the Sellers are unlikely to be responsible (such as Force Majeure).

15 RESTRICTIVE COVENANTS

15.1 Background

Restrictive Covenants are contractual promises not to enter into competition or similar undertakings which are given to protect the goodwill of the company or business sold. Typically they would prevent the Sellers from competing with the Target business being sold, maintaining the confidentiality of the company or business and non-poaching undertakings in relation to key staff, suppliers and customers.

Often the most effective remedy for breach of covenant is to seek a Court injunction, to prevent a continuing or threatened breach. This will then be followed by a financial claim for damages. However, it should be noted that injunctions may be difficult to enforce in local courts and local legal advice should always be sought.

Restrictive Covenants under English law are subject to the doctrine of restraint of trade. The basic principle is that they are not enforceable unless they both:

- Protect a legitimate proprietary interest.
- Go no further than is reasonably necessary to protect such an interest.

15.2 Key points to consider

When preparing and negotiating Restrictive Covenants, the key points for the Buyer to consider are:

- For how long do the current trade secrets and confidential information need to remain confidential?
- How long should it protect relationships with key clients/customers, suppliers and employees after the business has been sold?
- Which areas of the business are key?
- Which geographical locations need to be protected?

15.3 Key categories of Restrictive Covenant

Key categories of Restrictive Covenant	
Non-solicitation of employees and officers	Non-solicitation of employees and Directors (i.e. approaching, hiring). Needs to be senior/key people. The restriction must be limited in time.
Non-solicitation of clients/customers and suppliers	Non-solicitation of key clients / customers and suppliers (i.e. approaching). Needs to be a legitimate protection of trade connections and so should be limited to current/recent customers and/or suppliers. The restriction must be limited in time.
Non-dealing	Non-dealing with key clients/customers and suppliers (i.e. where they approach the Sellers). Easier to prove than non-solicitation. Again, should be limited to current/recent customers and/or suppliers. The restriction must be limited in time.
Non-competition	Not competing with the business. Of course, the above two covenants (to the extent that they relate to customers) are a form of focused non-compete. This provision tends to be a more general covenant not to undertake the same or a similar business.

	The restriction must also be limited in geographical scope which must reflect the geographical scope of the business.
Confidentiality	Agreement to keep confidential any information of a confidential nature. Often restrictions of this nature are dealt with in a separate confidentiality clause elsewhere in the agreement. The restriction may be limited in time. But it may instead be expressed to cease to apply to information as and when that information eases to be confidential (other than because of a breach by the Seller).
Representing yourself as connected with business	Not to represent yourself as still being connected with the business after Completion. This restriction is not usually time limited.
Use of trade names used by the business	Not to use certain trade names used by the business or anything confusingly similar after Completion. This restriction is not usually time limited.
Statements	Not to make negative or adverse public statements regarding the parties, the Target and its business or the transaction. This often overlaps with the announcements restriction – but may be expressly dealt with in any event.

	This is particularly important where there is bad feeling on a deal (or where bad feeling may later arise, for example if there is then a Warranty claim or a dispute over the Completion Accounts). It is also important where a Buyer feels that it may be overpaying for the Target (perhaps for strategic reasons), or the Sellers feel that they may be selling for too low a price (perhaps in a distressed situation). In each case they will not want to be embarrassed by negative press coverage and unwanted comments from the other party. This restriction is not usually time limited.

15.4 Duration

There is no set period for Restrictive Covenants under English common law and the view is that they should be for no longer than is reasonable as a legitimate protection. Three years from Completion is often considered to be the absolute maximum period, although in most cases a reasonable period on the specific facts of the transaction (and the wording of the actual covenant) will be much less.

In the case of transactions subject to UK and/or EU competition law, the maximum justifiable periods for non-compete and non-solicitation covenants are:

- Three years (where know-how and goodwill is transferred); or
- Two years (where only goodwill is transferred),

provided that the scope is limited to what is necessary. In particular, the geographical scope must be limited to the areas in which the Seller has offered the products or services before the transfer. The geographic scope

may only include areas of planned expansion if investment has already been made into the planned expansion.

The rules relating to UK and/or EU anti-competition law are complex and beyond the scope of this guide, but it should be noted that they can apply not just to EU-based parties and/or Target companies, but also to relevant trade arrangements affecting the UK or EU. The Governing Law of the SPA is also not relevant when applying these restrictions.

Conversely, on a transaction with no UK/EU element, these rules may not apply, even where the SPA is governed by English law. However, care needs to be taken in case the trading arrangements of part of the Target group include UK/EU activities which could inadvertently be caught by the restrictions. Local law anti-competition regulations should also be taken into account.

The Buyer will always want the Restrictive Covenants to run for as long as possible. However, this needs to be balanced against the risk of a Court ruling that the restriction is too long and so therefore unenforceable altogether. In such circumstances the Court does not have the power to simply reduce the period to one that would be enforceable.

15.5 The *blue pencil* rule

When looking at Restrictive Covenants, Courts may apply a blue pencil rule, whereby parts of provisions which are unenforceable may be struck out to leave behind only those parts that are enforceable. However, they will only do so where it accords with public policy and where what remains requires no further modification.

The Courts will not rewrite the parties' contract – for example by replacing an unenforceable covenant with one that has a lesser restriction. For this reason, Restrictive Covenants are sometimes drafted in the alternative and/or in very long form, so that, for example, each territory is separately listed for each covenant.

However, agreements will often also expressly state that if any part is deemed void or unenforceable, then that part is deemed to be deleted and replaced with a lesser, enforceable restriction. Recent case law suggests that these provisions may have no effect and add nothing to what the Courts would in any event do or not do under the blue pencil test.

15.6 Restrictive Covenants from a Buyer

Sometimes the Buyer will be asked by the Sellers to give Restrictive Covenants itself, for example in relation to a retained part of the Sellers' business which they are not selling and wish to protect.

To be enforceable, they will need to be directly related to and necessary for the implementation of the agreement - and in practice are likely to be narrower than any similar provisions for the benefit of the Buyer. The general view is that such Restrictive Covenants should not usually be given and will not be enforceable against the Buyer, since they are not a legitimate protection of the business. Depending on their nature and the subject matter, they may also be in breach of any applicable anti-trust or anti-monopoly legislation.

15.7 Local law position on Restrictive Covenants

Notwithstanding the position agreed in the SPA, local law advice should also be sought to check whether the Restrictive Covenants in question will be recognised and enforced in the Jurisdiction in question.

If not, then this would then leave the Buyer with trying to claim damages for breach of contract and to enforce this against assets of the Sellers outside of the local Jurisdiction in question, or to try to Set-off the claim against a Retention Account or some deferred Consideration.

In the case of employment arrangements, local laws must usually be applied to any contract of employment including any Restrictive Covenants.

SECTION F: FINANCE AGREEMENTS

1 BACKGROUND

The term *finance agreements* includes the main loan agreement or Facility Agreement and also a potentially wide range of other finance and finance-related documents including Guarantees and Intercreditor Agreements, together with security documents such as mortgages, debentures, pledges, charges and liens. The actual documentation involved will vary, depending on the identity of the parties, the nature of the loan, the security package and where any secured assets are located.

The Facility Agreement is the main lending agreement under which a Lender is prepared to make a loan Facility available to a Borrower. In the UK, many Facility Agreements are based on standard forms produced by the Loan Market Association (LMA). Those agreements have become standard in most markets where syndicated facilities are used and increasingly also for bilateral facilities. The LMA's stated aim is to promote *a more harmonised approach to loan documentation, making for more efficient primary and secondary loan markets*. The LMA and the Association of Corporate Treasurers have each also prepared helpful guides to the LMA standard form documents.

In Asia, the Asia Pacific Loan Market Association (APLMA) works with the LMA and others to help closely integrate the Asian loan markets into an increasingly globalised loan market.

The structure of a typical Facility Agreement is usually as follows:

- Parties to the agreement.
- Details of the Facility and its purpose.

- Conditions of utilisation.
- Utilisation.
- Repayment.
- Prepayment and cancellation.
- Interest.
- Fees and costs.
- Guarantee and Indemnity.
- Warranties and Representations.
- Undertakings and Covenants.
- Financial Covenants.
- Events of Default.
- Assignment/transfer by the Lender.
- Role of the Administrative Parties.
- Various administrative and Boilerplate provisions, including standard Indemnities from the Borrower in favour of the Finance Parties.
- Governing Law and Jurisdiction.

In addition there will usually be a large amount of underlying security documentation to secure the obligations of the Borrower under the loan against the shares, assets and real estate of its group.

2 PARTIES TO THE AGREEMENT

As would be expected, the Borrower and the Lender are the main parties to the Facility Agreement. Lenders are usually commercial banks but can be other financial institutions. A non-bank's ability to lend will be determined by whether they have the necessary regulatory authorisations.

In addition, depending on the identity of the Borrower, there may also be a Guarantor (for example a parent company of the Borrower) to Guarantee the obligations of the Borrower under the Facility Agreement.

There may also be more than one Lender, in which case it is usual to also include an Agent to act on behalf of all the Finance Parties (being collectively the Lenders, the Arranger, Security Trustee and the Agent). The Arranger is the entity which has arranged the loan and will normally expect to receive a fee from the Borrower for this. The Security Trustee is the entity that holds the benefit of the security on behalf of the Finance Parties. The roles of the Agent, Arranger and Security Trustee are considered later below. One entity can be the Lender, the Agent, the Arranger and the Security Trustee or the roles can be combined in various configurations.

Where there is more than one Lender, the Facility Agreement will also contain additional provisions dealing with matters such as majority decisions and pro-rata sharing of payments from the Borrower so as to ensure equality of treatment between Lenders in a syndicate. Lenders are often listed in a schedule to the agreement.

3 DETAILS OF THE FACILITY AND PURPOSE

The agreement will set out the details of the Facility, including the amount being borrowed and lent and in which currency and the basic framework of the loan (term loan, revolving, etc.) and also the purpose of the Facility and what the Borrower can utilise it for.

4 CONDITIONS OF UTILISATION

4.1 Conditions Precedent

Conditions Precedent (CPs) in finance deals are conditions which a Lender requires a Borrower to fulfill before all or part of a loan is lent to the Borrower. Most CPs are aimed at ensuring that the Borrower has the capacity and authorisation necessary to enter into the Facility Agreement.

The Facility Agreement will be structured so as to become binding whether or not the CPs have been satisfied and the Commitment Fee and any Arrangement Fee will be payable regardless. Otherwise, the Borrower might purposely fail to satisfy a condition if it finds cheaper funds elsewhere. However, the Borrower should not be able to drawdown under the agreement unless and until the CPs are satisfied. The Lender will, nevertheless, be able to begin monitoring the Borrower, and the Borrower will not be able to terminate the agreement without paying a Break Fee.

The Borrower will usually be given a time limit to satisfy the CPs, in order to prevent the Lender being subject to an indefinite contingent commitment. The list of CPs can be extensive, especially in project finance deals.

4.2 Common Conditions Precedent

Common CPs include providing the following documents and information:

- the current constitutional documents (memorandum and Articles of Association, Charter, etc.) of the Borrower and any company giving Guarantees or security;

- a Board resolution approving the terms and conditions of the Facility Agreement and authorising signatories;

- a list of names of authorised signatories, together with a specimen of their signatures;
- Legal Opinions from the Lender's lawyers, confirming the validity of the agreement and effectiveness of any security;
- a comfort letter from the Borrower's parent;
- insurance policies, including any *keyman* insurance;
- certificates of title for any property;
- executed security documents, together with any documents of title (e.g. share certificates) which those documents require;
- Management Accounts;
- payment instructions notifying the Lender where loan monies should be paid (particularly important for complicated facilities with multiple Borrowers);
- any consents or licences that are necessary for the purposes of the loan; and
- an agreement for process agents to be appointed by a Borrower which is domiciled abroad.

Since Borrowers may not want to provide originals of documents, certified copies are usually considered sufficient, i.e. a copy of the original which has been signed, usually by a Director or secretary of the Borrower, as a true copy of the original at a given date. However, certified copies would not suffice for certain items, such as share certificates, where the originals will be required as part of the security package.

4.3 Others

Non-documentary CPs might include the satisfaction of certain requirements, such as obtaining a listing on a stock exchange or successfully concluding some litigation.

Where the Borrower is incorporated or domiciled outside of the country in which the loan is being made, or any part of the agreement or any ancillary document may be performed outside of that country, CPs should be settled having regard for the requirements of other relevant Jurisdictions.

4.4 Continuing Conditions Precedent

Sometimes, certain conditions need to be satisfied for the loan Facility to continue to be made available, after the documentation has been signed, such as winning a particular licence or contract.

Borrowers need to take care that they are not unduly disadvantaged by CPs. A company that is listing on a stock exchange might need to show that the loan Facilities are unconditional. In addition, a Borrower might be at risk if any of the CPs are reliant on the behaviour or conduct of third parties.

4.5 Subsequent Conditions Precedent

There may also be subsequent CPs that must be met for every drawdown/utilisation, principally:

- certain Representations and Warranties are true both on the date of the drawdown request and on the date of the drawdown itself; and
- no Event of Default has occurred and is continuing.

The Borrower will usually confirm these conditions are met in a written

utilisation request. Certain registrations in connection with the grant of security are also conditions subsequent.

5 UTILISATION

5.1 Terminology

The term *utilisation* refers to the drawdown of monies by the Borrower under the Facility Agreement. In the past, it was commonly referred to as *drawdown* and that term is still in use, although utilisation is the accepted LMA term.

5.2 Utilisation notice

No money will change hands until a utilisation notice is issued by the Borrower requesting the money. Even then, the money will only be advanced if the Borrower is in compliance with various CPs, is complying with certain Warranties and Representations and there is no Event of Default outstanding or which would result from the utilisation.

The utilisation clause states how and when the Borrower can receive money under the loan. Utilisation may be allowed on a set day or during a certain period of time, known as the utilisation period. The Borrower may want different amounts of money at different times (in tranches) if, for example, it is funding a construction project. The overall length of time when money will be available is known as the *commitment period*.

5.3 Large loans

In the case of large loans, Lenders usually obtain the funds for the loan by borrowing themselves in the interbank loan market, rather than using money deposited with them. In such cases, they will require notice of a utilisation a certain number of business days prior to any proposed utilisation date. In some cases (though rarely) telephone notice may be permitted, but should still be confirmed in writing.

The Borrower will want the maximum flexibility both as to the amount it can draw on each occasion and as to the advance periods.

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5.4 Revocation of utilisation request

Although utilisation requests are generally expressed to be irrevocable, a Borrower may wish to be able to revoke without penalty and without triggering any indemnity:

- if any change in circumstances occurs (e.g. increased costs, illegality, market disruption);
- (in the case of multi-currency loans) if an alternative currency is not available;
- where the Borrower would be obliged to Gross up payments in relation to that advance; or
- where the Lenders or the Agent would become subject to Tax and the Borrower would be obliged to indemnify this under the Tax Gross up clause.

6 REPAYMENT

6.1 Repayment

The Facility will need to specify the dates and amounts when payments are to be made. If the loan is amortising, then payments made on the interest payment date will include an interest amount and an amount of capital that is being repaid. In a bullet loan, only the interest will be repaid during the term of the loan. All capital will be repaid on the final payment date.

In the case of a term loan, any amount repaid cannot then be re-borrowed. However, in a revolving loan amounts may always, in theory, be repaid and then re-borrowed up to an agreed minimum amount outstanding at any given time.

6.2 Mandatory repayment

In certain circumstances the Borrower might be obliged to prepay or cancel the Facility, for example, in the case of illegality, where it becomes illegal for a Lender to lend to the Borrower due to a change in law prohibiting it from lending, but being obliged to do so under the agreement. This usually arises in the context of government-level sanctions programmes being introduced against a shareholder, company or country.

Borrowers may seek to include a qualified obligation on the Lender (where possible) to switch its lending office if the illegality arises and also a grace period to repay. They may also seek to ensure that the test of illegality is objective and not simply left to the determination of the Agent or the Lender. Borrowers may also try to negotiate that if it becomes unlawful for a Lender to lend, the Borrower may instead replace the Lender.

6.3 Change of Control

Lenders often insist on a Change of Control provision, whereby the Borrower is obliged to repay the loan early if there is a Change of Control of the Borrower (unless the Lender has consented in advance in writing).

The rationale for this is that the Lender's credit assessment is unable to take into account a Change of Control and its (potentially significant) impact on the Lender's credit assessment. Lenders will point out that a repayment obligation is preferable to it being classed as an Event of Default, where the potential for the Change of Control to then trigger cross-defaults in other agreements increases.

The Borrower might object to a Change of Control clause on the grounds that:

- it cannot control the identity of its shareholders, and still less know who is acting in concert with them; thus it should not be penalised for matters beyond its control;

- the Lenders do not need this protection, since they have sufficient control over the Borrower, by means of the Financial Covenants, Negative Pledge and restrictions on disposals and so on, for the identity of the controlling shareholder not to matter;

- the Directors may not be able to satisfy themselves that it is in the best interests of the Borrower to agree to this provision; and

- linked to this, the provision may be viewed as a *poison pill* which will put off or delay any potential takeover of the Borrower company in the future, on the discovery that a Change of Control provision exists which may terminate loan Facilities and, if an Event of Default, could also then trigger cross-default provisions in other agreements.

If the provision is agreed to, the Borrower will attempt to negotiate a reasonably long notice period, such as three months, to allow time for

reorganisation. An alternative is to allow each individual Lender the right to cancel its own commitment in the event of a Change of Control of the Borrower.

7 PREPAYMENT AND CANCELLATION

7.1 Cancellation

If the Borrower realises it will not need to utilise some of the money under the Facility, it may be able to cancel part of the undrawn Facility and avoid some of the commitment fee that it has to pay on this (although it may still have to pay a cancellation fee). Sometimes the Borrower will also be able to negotiate the right to cancel any undrawn commitment where a Lender is in default itself (for example, because it has failed to lend) and to separately arrange for that undrawn commitment to be assumed by another Lender.

7.2 Prepayment

The Borrower will usually also want the ability to repay early (prepay) any monies which have been utilised (for example if it is able to refinance at cheaper rates or if it has surplus profits available). However, the Lender will probably want prepayment to occur only at a time when an interest period for the tranche is being prepaid, to prevent it incurring breakage costs on its own interbank borrowing. In the case of a fixed rate loan, the Lender may not be able to obtain the expected rate if it re-lends. It may also incur administration costs. The Lender will want a Break Costs clause to allow it to cover these amounts.

7.3 Order of application

The Lender will usually insist that prepayments satisfy repayment obligations in reverse order. Otherwise, the cancellation of near term payments might mean that it loses control of its ability to monitor the Borrower's financial health.

Borrowers may wish to resist this as it shortens the agreed term of the loan (i.e. the term on which the margin is based). Borrowers should try to obtain the Lenders' agreement that a prepayment reduces repayment instalments in their chronological order of maturity, or that it reduces repayment instalments pro rata.

7.4 Preference

If a corporate Borrower is insolvent when making a prepayment, there is a risk that the prepayment might be a preference under the relevant insolvency laws. In that case, the Lender could be required to pay back any such *preferred* prepayment to the insolvent company. There could also be a problem if the Borrower becomes insolvent within a short period of making the payment. Local advice should be taken in each case.

8 INTEREST

8.1 Interest rate

As mentioned above, when a Lender makes a loan, it usually funds the amount by borrowing itself in the interbank loan market. It then sets the interest rate to be charged to the Borrower by adding its margin (i.e. the amount of profit, after deducting internal costs, on that particular loan) to its own cost of borrowing. This margin or profit is sometimes known as the *spread*. In addition, it may also need to add other mandatory costs, such as the amount that the Lender is required to pay to the regulatory authorities in relation to the loan. The extent to which these are chargeable to the Borrower and the method for calculating mandatory costs is a matter for commercial agreement between the parties.

For a typical loan in the UK, the interest rate is therefore usually made up of three components:

- LIBOR (being the Lenders' own cost of funds);

- the Lender's own margin (i.e. profit); and
- any mandatory costs.

8.2 LIBOR

LIBOR stands for *London Interbank Offered Rate*. It is the rate at which the Lender can expect to obtain funds in the interbank loan market. The market operates by establishing rates for one-month, three-month and six-month loans. Under a floating rate loan, the Lender will set the floating rate for the next one, three or six month period.

Even under a fixed rate loan, the Lender will still obtain its funds in the floating rate market. It will then include in the interest rate charged to the Borrower, an amount to reflect the cost to it of converting to fixed rate (either a *risk* amount or an amount to cover any hedging it undertakes to lay off the risk).

8.3 Default interest

The Lender will also charge default interest on overdue amounts. Default interest is considered in more detail in *Section J: Boilerplate Provisions (paragraph 11)*.

8.4 Changes to the calculation of interest

The Facility Agreement will include provisions to deal with substitute bases for calculating the interest on the loan if an unexpected event occurs, such as the absence of a quoted interbank rate and/or market disruption. Market disruption provisions protect Lenders if the funding market is disrupted, enabling Lenders to select other funding sources in the event of non-availability of interbank deposits to fund the loan.

8.5 PIK interest

An alternative to conventional interest is PIK interest. PIK stands for *payment-in-kind* or *paid-in-kind*. PIK interest or PIK debt is a type of junior debt on which the Borrower (or issuer) pays no cash interest (or yield) until the principal amount is repaid (or redeemed). PIK debt can be structured in a variety of ways, including as a subordinated loan, a deep discount bond, loan notes or an issue of bonds in the public debt markets. Depending on how the PIK debt is structured, on each interest payment date the accrued interest is either added to the principal and is paid when the debt matures or is satisfied by the issue of further loan notes or bonds.

Private PIK debt is arranged and underwritten by senior banks and mezzanine houses and then syndicated to institutional investors (such as hedge funds) with appetite for higher risk and higher yielding instruments. Public PIK debt is structured as a capital markets bond issue (and can be viewed as being like a no-cash pay structurally subordinated high yield bond).

The PIK debt will be redeemed after all the senior and other junior debt has been repaid and is usually subordinated to all other forms of acquisition finance.

Given that PIK debt is a high risk investment, the holders may also require warrants over shares to enhance their returns.

9 FEES AND COSTS

The Borrower will be required to pay any incidental/out-of-pocket expenses associated with the loan. These include costs of administration, negotiation and preparation of the documentation, amendment of documents, registration requirements, stamp duty and other costs associated with maintaining and enforcing the Lender's rights under the loan.

There will also be fees for the different functions being performed by the Lender or its Agent, including a commitment fee, the Agent's, Security Trustee's and Arranger's fees, and sometimes a prepayment or cancellation fee.

Details of fees are usually included in a separate *fee letter*, which will not be available to all parties for reasons of confidentiality. However, the Agent should ensure that the Facility Agreement specifically refers to fees payable, to avoid the suggestion that the fee is a secret profit, in breach of the Agent's fiduciary duties. If an agreement imposes additional fees in the event of a Borrower's default, these should be structured so that they cannot be attacked as a Penalty. Penalties are considered in more detail in *Section J: Boilerplate Provision (Paragraph 8)*.

The Lender will also try to include provisions allowing it to increase costs in order to pass on to the Borrower any additional costs resulting from a change in law or regulation. This provision tends to be negotiated by a Borrower to include sensible parameters and a test of materiality.

10 GUARANTEE AND INDEMNITY

As mentioned above, depending on the identity of the Borrower and its own financial position, the Lender may also require one or more entities in the Borrower's group, such as a parent company with substantial assets, to also give a Guarantee and Indemnity in respect of the Borrower's obligations. This is usually included into the Facility Agreement but could instead be structured as a stand-alone document, for instance to assist with the arrangements for signing where the Guarantor is in a different physical location to the Borrower.

Issues relating to Guarantees are considered in *Section E: Share Sale and Purchase Agreements (paragraph 4)*.

11 WARRANTIES AND REPRESENTATIONS

The Borrower will be required to give Warranties and Representations to the Finance Parties on signing of the Facility Agreement and on each subsequent utilisation date and interest payment date. The differences between Warranties and Representations under English law are considered in *Section G: Warranties and Indemnities*.

The Warranties and Representations will usually cover matters such as:

- the status of the Borrower, its power and authority to enter into the relevant agreements, the valid and binding nature of its obligations and the absence of conflict with other obligations;
- the absence of any Events of Default;
- confirmations in relation to financial statements;
- confirmations in relation to business and financial conditions and no material adverse changes;
- confirmations in relation to no litigation or legal proceedings; and
- where an Information Memorandum or other similar material has been provided, confirmation that the information is accurate and not misleading and nothing material has been omitted.

12 UNDERTAKINGS AND COVENANTS

12.1 Introduction

For larger loans, it is usual to impose a number of obligations on the Borrower and restrictions on its activities. These obligations and restrictions are broadly divided into positive and negative Covenants.

As the names suggest, positive Covenants put the Borrower under an obligation to do something, while negative Covenants oblige the Borrower to refrain from certain actions.

12.2 Positive Covenants

These typically include requirements to:

- notify the Lender of any default or potential default under a loan;
- maintain all relevant insurances and licences;
- provide information and assistance to the Arranger in arranging the syndication (although the Borrower will probably want to limit its obligation under this Covenant).

There will also be positive Covenants to provide types of information such as:

- **financial information** – Audited Accounts, Management Accounts, projected forecasts, auditors' certificates and any other relevant information within the Borrower's control;
- **legal proceedings** - details of any litigation or legal proceedings that have been brought against the Borrower;
- **shareholder information** - copies of any information that the Borrower provides to its shareholders; and
- **compliance information** – such as compliance with laws, compliance certificates and Know Your Customer (KYC) information.

12.3 Negative Covenants

The main negative Covenants are:

- **a Negative Pledge** - this prevents a Borrower from creating security over its assets in favour of a third party;
- **a *pari passu* clause** – which ensures that the Lender's right to repayment is not subordinated to that of unsecured creditors. This is required because some Jurisdictions allow certain creditors to rank ahead of others;
- **covenants preventing disposal of assets**;
- **covenants restricting lending** - since allowing a Borrower to lend money carries the risk that the money might not be repaid to the Borrower;
- **covenants restricting dividends and share buy backs** - since these would involve the payment out of money that should only be available to shareholders once other obligations have been paid;
- **covenants restricting the appointment of Auditors** - without the Lender's consent, since the Lender might want the Borrower to appoint suitable Auditors who would spot any potential problems.

12.4 What is the purpose of a Negative Pledge?

A Negative Pledge which prevents a Borrower from creating security over its assets in favour of a third party is relevant where the Lender is unsecured or only has a floating and not fixed charge over those assets. In such case the Lender is at risk of the Borrower creating security in favour of another creditor which would position that other creditor ahead of the unsecured Lender or floating charge holder on the Borrower's insolvency. The Lender should also be concerned about transactions the Borrower might enter into in respect of its assets which would give third parties a better claim to those assets than the Lender, such as finance leases, sale

and leasebacks and factoring arrangements (sometimes known as *quasi security*).

The Negative Pledge clause seeks to protect against these circumstances. If a creditor takes a security in breach of a Negative Pledge and has actual knowledge of the Negative Pledge, then in the UK the creditor should be subject to any security the Lender has. The Borrower is likely to want to negotiate carve-outs that will allow it to carry on its business, such as security under equipment leasing, liens arising out of common law, cash collateralisation necessary as part of business arrangements, and retention of title clauses.

13 FINANCIAL COVENANTS

13.1 Introduction

In addition to general Covenants, in considering a credit proposal, a Lender is likely to use several tests of a Borrower's financial strength, so as to measure its ability to carry on and develop its business and repay the loan with interest. It is common for a Lender then to translate the principal tests into minimum financial criteria, by expressing them as financial undertakings or Financial Covenants.

For example, the Lender will normally consider:

- the Borrower's balance sheet strength, including the ratio of debt-to-equity;
- various ratios of assets to liabilities;
- whether the Borrower's earnings are sufficiently greater than its obligations to pay interest and other expenses; and
- whether the Borrower will have adequate cash resources to meet its obligations as they fall due.

Although initially many Borrowers resisted giving financial undertakings, claiming that they constituted an unreasonable interference in their affairs, such undertakings are now common in commercial lending transactions, both secured and unsecured.

13.2 Arguments in favour

The principal arguments in favour of including Financial Covenants are that:

- a Lender entering into a commitment for the medium or long term is legitimately entitled to accelerate repayment of the loan where the financial position of the Borrower deteriorates and the risk increases beyond agreed parameters;
- they introduce greater clarity and certainty than other monitoring or default arrangements, for example a Material Adverse Change clause, which can in turn reduce the likelihood of the Lender having to act on a more imprecise and controversial clause;
- they introduce financial discipline and keep a check on any over-ambitious plans of the Borrower;
- they provide a framework within which the Lender can give advice to the Borrower if problems arise and can consider remedial action; and
- where a Borrower is seen to operate comfortably within its financial undertakings, this fact can of itself maintain the confidence of the Lender in the Borrower and may thereby enable the Borrower to avoid undue interference by the Lender.

However, the financial statements against which such undertakings are measured will inevitably not be up-to-date. In particular, audited financial statements will often relate to the position months before they are delivered to the Lender. Furthermore, the accounting standards on

which they are compiled and the treatment of individual items, may vary considerably. Book values of assets may not in fact be realisable especially on a forced sale or break-up basis.

13.3 What are the main areas that may be measured?

The main areas that are measured are:

- **general risk** - what is the amount of earnings and/or net worth against which the loan is made? Generally, Lenders expect risk to decrease over the life of the Facility as the business grows (i.e. they would require the Borrower to reduce its debts through making repayments);

- **profitability** - can the Borrower's group generate sufficient profits to cover its interest payments and other finance charges? This can be regarded as a medium term measure of business performance;

- **cash-flow** - does the Borrower have the ability to fund all payments due under its debt arrangements (both principal, interest and other finance charges (e.g. fees)) and other normal business expenditure? The cash-flow test is required in addition to the profitability test as profit and cash are not the same thing. Accounting profit may include non-cash items (e.g. such as revaluations) and will not take account of all outgoings so that there could be accounting profit but still a shortage of cash in the business; and

- **liquidity** - does the Borrower have the ability to pay its debts as they fall due, i.e. is there sufficient cash and other liquid assets to meet monthly bills? This is a short-term measure of business performance.

13.4 Investment grade vs leveraged

A distinction is usually made between investment grade transactions and leveraged transactions. In some investment grade transactions there will be no Financial Covenants (although this is increasingly rare for all but

the top rated companies) and in others there will be limited Financial Covenants. For Borrowers near the investment grade/non-investment grade border (e.g. companies in areas which are perceived as higher risk) and in certain other transactions, more detailed Financial Covenants will be included.

In an investment grade transaction, the Lender may be relying purely on the published Audited Accounts for information. This will mean that such information will only be available yearly and half yearly and that the Financial Covenants will be much simpler than those for a leveraged transaction. The definitions required for the Financial Covenants will be drafted by reference to specific lines in the published Audited Accounts.

However, in a leveraged transaction the information provided will be much more detailed and will usually be provided quarterly or monthly. In such circumstances the financial definitions will be much more detailed as the whole point of them is to vary the accounting treatment. It is therefore important that any such variations are set out in full.

In reality a line cannot always be drawn so neatly between investment grade and leveraged transactions and in reality what may be required is to produce is a set of Financial Covenants and definitions falling somewhere between the two.

14 EVENTS OF DEFAULT

14.1 Introduction

The Facility Agreement will contain Events of Default which will entitle the Lender to accelerate or call in the loan, in other words to demand early repayment as well as to cancel obligations to lend further advances. Typical Events of Default include:

- **non-payment of principal or interest** and any other amounts due under the other transaction documents - the Borrower will want a short grace period for payment before a default is triggered;

- **breach of Covenant** – the Borrower will want to add a materiality test to these;
- **insolvency** (e.g. liquidation or voluntary arrangement) affecting the Borrower or a Guarantor;
- **enforcement of security held by others**;
- **failure to pay other indebtedness on its due date** – the Borrower will try to include a materiality test here, as well as reference to grace periods applicable to other the debt and a provision that early repayment of the other debt would not be a cross-default unless due to a default by the Borrower. Otherwise another loan becoming repayable early (e.g. because of illegality affecting another Lender) may trigger this default, even though the Borrower is not at fault. It may also seek to exclude from the cross-default any debt which is being contested in good faith;
- **Warranties and Representations incorrect** - The Borrower will try to widen the materiality test so that the incorrectness of a Warranty or Representation must materially and adversely affect the Lender's interests;
- **breach of Financial Covenants** (e.g. non-compliance with required ratios); and
- **Material Adverse Change (MAC)** clauses are possible but less frequent in Facility Agreements and Lenders tend to instead rely on the Financial Covenants, which are less subjective and so easier to interpret and rely on.

14.2 Change of Control

As mentioned above, a Change of Control event is usually structured as a trigger requiring early repayment (i.e. a straight mechanical event with no suggestion of fault) rather than an Event of Default. However, this is a matter for negotiation.

14.3 On-demand

As an alternative to detailed Events of Default, a simpler format can be achieved by providing for the Facility to be accelerated at any time on-demand by the Lender. The Borrower will of course resist this, because it gives it no control over circumstances in which it may have to repay. Besides forcing the Borrower to find funds elsewhere in a hurry, a demand for early repayment may trigger cross-default provisions in the Borrower's other loan or facility documentation.

On-demand should therefore only be agreed as a last resort by the Borrower in most cases.

15 ASSIGNMENT/TRANSFER BY THE LENDER

A Lender will want a right to assign or transfer its rights and obligations under the Facility Agreement to another bank or financial institution and potentially also to a trust, fund or other entity which is regularly engaged in or established for the purpose of making, purchasing or investing in loans, securities or other financial assets.

This second group of potential transferees tends to be negotiable with the Borrower. Lenders have been very keen to allow for transfer to non-bank Lenders, due to concerns that market liquidity will be adversely affected by consolidation in the banking sector. Another factor has been the growing trend amongst banks towards more active loan portfolio management, and the use of securitisation vehicles as Lenders.

Borrowers will need to consider carefully how the inclusion of non-banks would impact on them and also whether there would be any negative Tax consequences in the way that they remit their interest payments.

There are a variety of ways that a Lender can transfer and sell its loan commitment, including a legal assignment of its rights (but not obligations) or a novation of both its rights and obligations (the most

common option). Other alternatives include an equitable assignment, a funded participation (where in return for the participant paying the Lender an amount equal to all or part of the principal amount of the loan made by the Lender, the Lender agrees to pay to the participant all or the relevant share of principal and interest received by the existing Lender from the Borrower in respect of that amount) and a risk participation (where the risk participant agrees, for a fee, to put the Lender in funds in certain circumstances, typically on any payment default by the Borrower).

Lenders will usually prohibit the Borrower and/or its affiliates/associates from acquiring any part of the loan commitments themselves.

16 ROLE OF THE ADMINISTRATIVE PARTIES

16.1 Arranger

On syndicated loans, the Arranger is the bank which has been awarded the mandate by the Borrower to arrange the loan. Very large or prominent loans may have more than one Arranger in which case one may be in charge of documentation and one (the *bookrunner*) for managing the primary syndication of the loan.

An Arranger:

- assists the Borrower in preparing an Information Memorandum for potential participants;
- solicits expressions of interest from Lenders;
- negotiates the terms of the Facility Agreement; and
- verifies the CPs.

These duties tend not to be set up in detail in the Facility Agreement; they attract a large fee and the details are put into a confidential fee letter. Arrangers are, however, generally party to the Facility Agreement in order to benefit from Indemnities from the Borrower and any exceptions regarding liability and to participate as a Lender.

16.2 Agent

For convenience a bank is appointed as Agent for the syndicate of Lenders. It is often the same bank that acted as Arranger and may also act as Security Trustee.

The Agent's powers and duties are set out in the Facility Agreement; they are largely administrative and bring with them a relatively low fee. The Agent acts as a conduit for information and payments amongst the Lenders and between the Lenders and the Borrower (and, where relevant, the Guarantor).

The Agent's functions are:

- maintaining contact with the Borrower and representing the views of the syndicate of Lenders;
- monitoring the compliance of the Borrower with certain terms of the Facility;
- to receive notices from the Borrower; and
- to act as paying agent - the Borrower makes all payments of interest and repayments of principal and any other payments required under the Facility Agreement to the Agent. The Agent passes these monies back to the Lenders to whom they are due. Similarly the Lenders advance funds to the Borrower through the Agent.

16.3 Security Trustee

On syndicated loans it is common to have a Security Trustee holding the security over the Borrower's assets on trust for the syndicate Lenders. This is easier and cheaper than granting security separately to all Lenders and allows for a change of Lender without the need for new security and consequent worries about loss of priority. The duties imposed upon the Security Trustee are typically more extensive than those imposed on an Agent.

SECTION G: WARRANTIES AND INDEMNITIES

1 REPRESENTATIONS AND WARRANTIES

One of the key terms that most Buyers will require under an SPA, and most investors will require under a Shareholders' Agreement are Warranties, as protection against unknown issues and to underpin the assumptions on which it is valuing the Target/Company and its business.

In business circles the term *Reps and Warranties* is often used. In English law they are two separate and distinct concepts, each with their own rights and remedies.

2 REPRESENTATIONS

Representations under English law are statements by one party which induce another party to enter into a contract. Broadly speaking, if the statement relied on is untrue or incorrect (that is, there has been a Misrepresentation) and the other party relies on it then, at law, it may be entitled to rescind the contract, effectively unwinding it, and/or to claim damages. The aim of the damages in this case is to put the innocent party in the position it would have been in had the false statement not been made, in other words, as if it had not entered into the contract.

In the SPA, the Buyer may also seek a right to terminate (rather than rescind) so that it can claim rights and remedies available under the contract (e.g. under an indemnity for costs). The Sellers, on the other hand, will try to exclude liability for any representations (other than any that are fraudulent) – and instead limit the Buyer to claims under the SPA, itself, for instance for breach of the Warranties.

3 WARRANTIES

Warranties are contractual statements set out in the SPA or Shareholders' Agreement which, if breached, will entitle the innocent party to claim damages (but not generally to rescind or terminate the contract). The aim of these damages is different from those that may be awarded for Misrepresentation. Generally, the contractual measure of damages aims to put the innocent party in the position it would have been in had the breach not occurred (i.e. had the statement been true).

The purpose of Warranties in a SPA is:

3.1 To ensure full Disclosure of matters that may be relevant to the Buyer when considering whether to acquire the Target and what price to pay.

3.2 To apportion risk by imposing liability on the Sellers, often even where the Sellers had no knowledge of the matter or thing that causes the breach. In principle, the Buyer sets its price on the basis that all the Warranties are true. If some of them turn out to be inaccurate in certain respects, a claim under the Warranties provides a means of adjusting the price, post Completion, as appropriate. However, claims may be hard to make and enforce for a number of reasons:

- limitations of liability in favour of the Sellers;
- having to prove breach and loss; and
- enforcing recovery – i.e. making sure the Sellers actually pay.

So they are a price adjustment mechanism of last resort.

Warranties (sometimes expressed also to be Representations, in an attempt to increase the various remedies available for breach - see further below in paragraph 4.4) are sought by the Buyer in order to provide

reassurance from the Sellers on factual matters or future promises concerning the status of the Target and its business, assets, liabilities and financial position.

English law offers a lot of flexibility when negotiating the scope of Warranties. A Warranty can relate to any event or possible future event whether or not that event is within the control of a party to the agreement. However, they tend to be limited to statements of existing fact (and sometimes current belief), as the Sellers are of course keen to ensure that they only make statements they are certain (or can take steps to ensure) are true.

For both Warranties and Representations, damages are only awarded for loss that results from the breach and which the law recognises as recoverable. Furthermore, the amount that a claimant can recover may be reduced if it did not take reasonable steps to mitigate its loss.

4 EXAMPLE OF DIFFERENT MEASURES OF DAMAGES

4.1 Damages for breach of Warranty *look forward*

The damages that can be claimed for breach of Warranty can be roughly calculated as follows:

- start with the actual value and look forward to what the value would be if the Warranty had been true;
- damages are equal to the additional amount that the target would have been worth if the Warranty were true (i.e. take the *value if Warranty true* and subtract the *actual value*).

4.2 Damages for Misrepresentation *look backwards*

The damages that can be claimed for Misrepresentation can be roughly calculated as follows:

- start with the actual value and look back to see what the buyer paid;
- damages are broadly equal to the amount by which the price paid is greater than the actual value (i.e. take the *price paid* and subtract the *actual value*).

4.3 Which damages will be the largest?

Whether the Buyer is able to claim more by way of contractual damages (pursuant to a claim for breach of Warranty) or tortious damages (pursuant to a claim for Misrepresentation) will depend upon whether the Buyer paid more or less than the value of target.

In general, if the Buyer has overpaid, damages for Misrepresentation will be larger than those for breach of Warranty.

If the Buyer made a good bargain, it is the other way around and damages for breach of contract will be larger than damages for Misrepresentation.

A simplified example of the different measure of damages for a breach of a Warranty and a Misrepresentation is as follows. The Buyer purchases shares in a company which purportedly owns its own plant and machinery. After Completion it then discovers that, despite assurances from the Sellers, it does not.

Market value of the Company, had the Warranty/ Representation been true	$120 million
Price paid	$100 million
Market value of the company with the breach of the Warranty/Misrepresentation	$80 million

The tables below show (in simple terms) the different amounts in damages that the Buyer could expect to receive, depending on whether or not it has a claim for breach of Warranty or a claim for Misrepresentation.

Broadly speaking, where a Buyer has made a good bargain, in other words where it has paid less than the market value would have been if the statement had in fact been true, it will usually be better off pursuing a Warranty claim.

Warranty (good bargain)	
Market value without breach:	$ 120 m
Market value with breach:	$ 80 m
Damages	**$ 40 m**

Representation (good bargain)	
Price paid:	$ 100 m
Market value with breach:	$ 80 m
Damages	**$ 20 m**

However, in cases of a bad bargain (where the Buyer has overpaid, even if the statement had been true) a claim for Misrepresentation may be its preferred option if this is available.

In the second example the Buyer purchases the Company but overpays for it.

Market value per share had the Warranty/Representation been true: $120 million.

Price paid: $150 million.

Market value of the Company with the breach of Warranty/ Misrepresentation: $80 million.

Warranty (good bargain)	
Market value without breach:	$ 120 m
Market value with breach:	$ 80 m
Damages	**$ 40 m**

Representation (good bargain)	
Price paid:	$ 150 m
Market value with breach:	$ 80 m
Damages	**$ 70 m**

4.4 Warrant and represent?

Buyers will often try to require Sellers to both *warrant and represent*. Sellers will normally resist this, on the basis that the Buyer's only remedies should be under the Warranties. At the very least they will want, to the extent permitted by law, to expressly remove the Buyer's right to rescind (in effect, to unwind) the SPA, particularly once Completion has taken place and to limit the Buyer's right to claim that the Representations that are repeated in the SPA are false.

In any event, the *warrant and represent* wording above is unlikely by itself to be enough to turn Warranties into Representations. Very clear and consistent drafting – e.g. regarding limitations of liability – are likely to be required.

In the case of Facility Agreements, a Lender will usually require both Warranties and Representations to be given in the agreement and this is much more of a market standard for lending documents.

4.5 Warranties from the Buyer

The Sellers will also seek Warranties from the Buyer in certain circumstances, such as:

- Basic Warranties on the Buyer's capacity and ability to enter into the transaction, that it has the necessary corporate approvals, authorisations and any other required consents and that the transaction will be legally binding on it. However, the Sellers should query the value of these in many cases, as if they are not true they will be contained in an agreement that may not be enforceable (e.g. if capacity is an issue). If these fundamental matters are a concern, a Legal Opinion should be obtained.

- The Buyer may be required to warrant that it has the necessary funding in place to finance the transaction and pay the Consideration when due. In cases where the Buyer's financial covenant strength is unknown or the Buyer is an SPV, this would normally be supported by documentary evidence, such as a comfort letter from a bank or even a Guarantee.

- In cases where the Buyer is satisfying some or all of the Consideration with Consideration Shares, more substantive Warranties on the Buyer and its business, trading and operations may well be required.

5 SPECIFIC WARRANTIES

Typically, Warranties by the Sellers will cover the following statements:

5.1 Accounts and accounting matters

- Accuracy and fairness of the Audited Accounts and Management Accounts; confirmation of policies used regarding matters that may be key to the deal; adequacy of provisions made regarding certain matters.

- Consistency in the manner of their preparation when compared with historical accounts of the Target (so that the Buyer knows it is comparing like with like).

5.2 Corporate and constitutional matters

- Accuracy of the constitutional documents that have been provided to the Buyer.

- Accuracy of details of share capital and options and subsidiaries, branches and associates (all of which are commonly set out in a separate schedule to the agreement).

- Accuracy of the statutory books and records, Board minutes and shareholder resolutions, statutory filings, possession of title documents and other original documents.

5.3 Finance matters

- Details of bank accounts, bank and other borrowings, finance commitments, loans and debts with associates, Guarantees, security, dividends and other distributions, liabilities, working capital, creditors and government grants.

5.4 Trading matters

- Details of Material Contracts, changes since the last Audited Accounts, connected party transactions, Change of Control, the effect of the sale on key relationships with customers and suppliers; joint ventures and partnerships, agency agreements.

- Details of all the licences, permits and consents used by the Target group.

- Confirmation that they are all valid and subsisting, can be renewed without undue effort or expenditure and that no others are required (but not currently held) by the business.

- Confirmation of compliance with regulations relating to the collection, management and protection of data.

- Confirmation of no defective products or service liabilities.

5.5 Employment

- Details of employees and terms of employment, bonus schemes, pensions, life and health benefits, changes in remuneration, termination rights and 'golden parachutes', trade unions, workplace and collective agreements, working time regulations and redundancies.

5.6 Assets

- Sufficiency and ownership of assets.

- Adequacy of stock and work-in-progress.

- Maintenance of assets

5.7 Intellectual Property Rights and Information Technology

- This will typically include details on ownership, registrations and protections, licences, infringements and third party claims, use of business and trading names.

- Details of IT systems and hardware, websites, email addresses, software and databases, ownership, licensing and maintenance, escrow arrangements, sales, marketing and distribution agreements, disruption and faults, infringements and third party rights.

5.8 Competition and anti-trust

- Compliance with relevant permissions and clearances.

- No anti-competitive agreements, cartel agreements and arrangements restricting freedom of trade.

5.9 Insurances

- Details of existing insurance policies, any claims and possibly confirmations that future policy renewals will not be problematic or involve significant additional expense. (The extent and relevance of these Warranties will depend upon whether the Target will have any right to claim under the policies after it has been acquired by the Buyer – often they are part of group policies maintained by the Seller that will end on Completion).

5.10 Compliance with laws and regulations

- This will typically include general details on compliance by the Target group. This potentially catches a number of different areas which may also be specifically warranted elsewhere (e.g. aspects of the employment, real estate, accounting, Taxation and data protection Warranties, etc. are likely to cover compliance).

- Details on any current or pending investigations of the Target group or its business (including Tax investigations).

5.11 Litigation and disputes

- Confirmation of no existing or pending disputes and no knowledge of facts or circumstances likely to give rise to disputes.

5.12 Insolvency, bankruptcy and winding-up matters

- Confirmation of no current, pending or threatened insolvency and related matters.

5.13 Real estate

- Details of title and ownership, registration, encumbrances and security, Third Party Rights, planning/zoning matters, legal obligations, adverse orders and compulsory purchase, the condition of the properties and valuation, insurance, leases and tenancies.

5.14 Environmental matters

- Details of environmental hazards, risk activities, permits and use, and reports commissioned.

5.15 Taxation

- Details of administration of Tax matters, Tax computations and filings, outstanding Tax liabilities, use of Tax reliefs, allowances and Tax planning schemes, Tax disputes with authorities, employer-related Taxes and social payments, share incentive plans, corporate income and capital Taxes, sales Taxes, transfer Taxes, debts, interest and loan relationships, finance leases, group treatments and reliefs, depreciatory transactions and value shifting, base costs, intangible assets, foreign income, non-resident companies and branches, customs and excise.

5.16 Reports

- Where reports have been commissioned (for example, a Vendor Due Diligence Report), the Buyer will sometimes ask the Sellers to warrant the accuracy of the reports.

5.17 Information disclosed to the Buyer

- This is a *sweeper* Warranty, confirming the accuracy and completeness of all information disclosed to the Buyer and confirming that there is nothing else material in relation to the Target group or its business which has not been fully disclosed. This Warranty is nearly always resisted by Sellers on the basis that it is for the Buyer to seek the specific assurances that it requires: the Disclosure Letter should not potentially increase the Sellers' liability – nor is it the Sellers' job to guess what is important to the Buyer.

6 REPETITION OF WARRANTIES

6.1 Background

Where there is a delay between signing and Completion, the Buyer will usually insist on a repetition of the Warranties by the Sellers at Completion.

This should be acceptable for basic matters such as ownership of the shares, ability to freely transfer them on an unencumbered basis and so on. However, in the case of substantive Warranties relating to trading and other matters, the position becomes more problematic.

6.2 Negotiating positions and compromises

- The Sellers' ideal position is to have no repetition of the Warranties on Completion.

- The Buyer's ideal position is to have all the Warranties repeated. Essentially it is a question of who bears the risk between signing and Completion. This is likely to be determined by general bargaining strength, who is responsible for there being a delay and by the market practice for the sector.

Possible compromises include:

6.2.1 The Sellers can agree to only repeat those Warranties which relate to matters within their control. This is a difficult approach to accurately document and it is not popular with Buyers. Arguably, there are very few matters completely within their control – and those matters may not represent the key risks affecting the business and against which the Buyer most wants protection.

6.2.2 The Sellers can agree to repeat the Warranties, with the Buyer being given a right to terminate and walk away from the transaction if there are breaches of Warranty for matters arising after signing the SPA (possibly with a right to then sue for damages, depending on whether or not the breach is caused by the Sellers). However, if the Buyer decides to go ahead and complete the transaction, then it loses its right to sue for damages for the breach.

6.2.3 This compromise area is often heavily negotiated and there are several different variations, including an assessment of whether the breach is due to the fault of the Sellers (or, alternatively, something outside of their control) and whether the matter is sufficiently material to entitle the Buyer to terminate. In this context, materiality is often defined as being established where matters have arisen which would in aggregate give rise to the Buyer being able to claim damages in excess of a specified amount.

6.2.4 The Sellers can agree to repeat the Warranties, but only if they have the right to provide a second (updated) Disclosure Letter to the Buyer against the repeated Warranties. This is potentially dangerous for a Buyer, since the Disclosures will then prevent it from bringing a claim against the Warranties, as repeated, in respect of new matters that are disclosed. Thus the repetition of the Warranties arguably becomes predominantly informational for the Buyer. But, of course, to the extent that there are other breaches of the repeated Warranties – which relate to matters not disclosed – the Buyer will still have the right to make a claim for damages. Also, it will in any event usually insist on a termination right

where the matters revealed by the second Disclosure Letter are material.

6.2.5 It should be noted that the second (updated) Disclosure Letter should only be allowed to be disclosed against the repeated Warranties. It should not be allowed to make effective Disclosures against those Warranties already given by the Sellers on signing of the SPA. If those Warranties were not accurate when they were given, the Buyer's rights should be unaffected by any second Disclosure Letter.

6.3 Alternatives

An alternative to repeating the Warranties is to include a Condition Precedent or a pre-Completion undertaking that they must remain true and accurate at Completion (or perhaps, true and accurate in all material respects). This effectively gives the Buyer a potential termination right if something has changed and this is no longer the case. The Sellers need to take care to ensure that they are not undertaking to procure that such a CP will be satisfied. Otherwise they effectively end up repeating the Warranties, but potentially without the protections of a Warranty limitation schedule and Disclosures.

6.4 Context

6.4.1 Whatever is agreed needs to be considered in the context of other protections that there may be under the SPA, such as:

- Covenants (e.g. regarding fundamental matters such as title to the shares) and Indemnities that are not affected by Disclosures (but the agreement must be checked carefully to ensure that this is the case).

- Rights to terminate for Material Adverse Change (MAC).

- Rights to terminate for a breach of the conduct of business undertakings, which may include an obligation to procure that the Warranties (usually within the Sellers' control) are not breached.

- Completion Accounts (if there are any - and note, of course, that a Locked Box deal will not afford any protection to the Buyer in the way that Completion Accounts do).

7 ASSIGNMENT OF WARRANTIES

7.1.1 Background

The Buyer will sometimes seek the right to assign the benefit of the Warranties to a third party, who can then directly enforce them against the Sellers as if it were named in the SPA as the Buyer.

Usually the Buyer will want this right for the following reasons:

- **Intra-group reorganisations** - the Buyer may be planning to reorganise the Target and its business after Completion and may want to ensure that the benefit of the Warranties sits with the correct company in its group structure, which may not have been formed or even contemplated at the time the SPA is entered into.

- **Requirement under the Facility Agreement** - the Buyer may be required by its bank to charge or assign the benefit of the Warranties to the bank as part of the security arrangements under its Facility Agreement. This may be pursuant to the Buyer's acquisition finance arrangements in order to fund the purchase of the Target, or it may come up after Completion as part of a refinancing.

- **Subsequent purchaser of the Target** - the Buyer may subsequently sell the Target to a new purchaser, in which case it may be helpful to be able to assign the benefit of the Warranties to it. If the Buyer is able to offer an assignment of the existing Warranties, then it potentially adds value (and thus enhances the price). It also potentially means that the Buyer will need to give less extensive Warranties itself. However, in practice, recovery under assigned Warranties is likely to be problematic (see further below).

7.2 Sellers' position

The Sellers will usually accept the Buyer's right to assign the benefit of the Warranties intra-group. However, they will normally insist that, if the transferee company then leaves the Buyer's group, the benefit should immediately be assigned back to the Buyer (or another company in its group) or else the Warranties cease to apply. In each case, some thought needs to be given as to what should trigger the requirement to reassign the assigned rights. For example, is it the transferee ceasing to be a member of the same group structure as the Buyer and/or is it the transferee ceasing to be a member of the same group as the Buyer's ultimate parent at the date of the SPA?

In the case of assignment to the bank, the Sellers will normally have to accept this where the Buyer is relying on acquisition finance, since without it the Buyer's bank will refuse to lend and the Buyer cannot fund the acquisition.

However, the Sellers will normally not want the Buyer to be able to assign the benefit of the Warranties to third parties (such as a subsequent purchaser of the Target), since they will not want to be potentially liable to an unknown third party, with whom they have no history or relationship.

In each case where the right of assignment is accepted, the Sellers will generally want to include an express statement that they cannot incur any greater liability than they would have had if the assignment had not taken place (even though this is the position in English law in any event).

7.3 Problems with assigning the benefit of the Warranties

The Buyer should be alert to the fact that there are problems associated with assigning the benefit of the Warranties.

An assignee/transferee (of the Warranties and the Target) can only recover its own losses to the extent that they do not exceed (and are of the same nature as) losses that the original Buyer would have suffered had it not sold the Target and assigned the SPA. The analysis can be complicated. As an alternative to assigning the benefit of the Warranties, the Buyer may want to consider one of the following:

- Including a provision to ensure that the original Seller is deemed to have repeated the Warranties in favour of the assignee/transferee (and the assignee is deemed to have paid the Consideration). This is unlikely to be commercially acceptable to the original Seller.

- Providing that the Warranties are intended to be enforceable by any future transferee of the share/business and assets being purchased. Again, this is unlikely to be commercially acceptable to the original Seller.

- If the identity of a potential assignee/transferee within the Buyer's group is not known at the date of the SPA, have the SPA entered into by the Buyer for itself and all group companies and provide that the Warranties are given to all the group companies.

- The Buyer could give Warranties to the transferee in the same or similar terms as the original Warranties it received from the Sellers. If these repeated Warranties are then breached the original Buyer would of course be liable to the transferee, but may be able to pursue the original Sellers if the Warranties given by such Sellers were also breached (at the time they were given). However, this approach should be adopted with caution. For example, there is a risk that the original Sellers may argue that any loss suffered by the Buyer arises on account of the Warranties it has provided on its on-sale and is too remote.

8 WARRANTY AND INDEMNITY INSURANCE

8.1 Introduction

Warranty and Indemnity insurance (WII) is an insurance product which covers loss arising from breach of a Warranty or Indemnity. WII can be taken out, either by the Sellers or by the Buyer (often referred to as *sell-side* and *buy-side* WII respectively). Sell-side WII often also covers the costs of defending claims.

A WII policy taken out by the Sellers effectively sits behind what would happen in the event the Buyer makes a claim against the Sellers (and they are liable to the Buyer):

- the Seller must promptly inform the insurer of any claim it receives;
- the insurer will exercise conduct/control over the claim and its defence; and
- the WII insurance pays out (subject to the policy terms) in respect of any amount agreed or determined to be payable.

A WII policy taken out by the Buyer usually works rather differently. The transaction documents are drafted in the normal way, except that the liability of the Sellers is limited - typically to $1 so that the Sellers effectively have no liability. Instead, the Buyer makes a claim against the insurance.

8.2 Reasons WII is taken out

There are a number of reasons why WII may be taken out:

- the Sellers want a clean exit so that they can make a full and immediate distribution of the sale proceeds to their interested parties/shareholders, etc. They would not be able to do that if part of the Consideration is

tied up in a Retention Account or otherwise needs to be set aside to meet potential liabilities under Warranties.

- The Buyer wants financial security, rather than being exposed to the prospect of a Seller being unable to meet its liabilities under claims.

- Bridging the gap between the cap the Sellers want on their liability and the cover the Buyer requires.

- Protecting a relationship - if the Buyer is to have ongoing trading arrangements with the Sellers, it may be preferable not to have to claim against them.

8.3 Limitations

Warranty and Indemnity insurance is a very useful mechanism but its limitations - and how it may impact a deal - need to be understood:

- Taking out the insurance takes time and the insurer's lawyers will need to carefully review the SPA and the Disclosure Letter.

- A proper negotiation of the Warranties and Disclosure exercise will still be required (because confirmations will be required by the insurer – and the policy will not usually cover known issues).

- The policy will not cover loss from a bad bargain or as a consequence of the operation of a price adjustment provision and certain Warranties will be excluded, such as forward-looking Warranties and environmental Warranties.

9 INDEMNITIES

9.1 Background

Indemnities are contractual promises to compensate for loss (including costs, expenses and other liabilities) arising from an identified occurrence or event and tend to be used where there is a known or potential liability, the risk of which is to be borne by the party giving the Indemnity, such as unpaid Tax, a potential environmental claim, or a specific issue arising from Due Diligence. In the case of Tax matters on M&A transactions, the Tax Indemnities will typically be contained in a separate Tax Deed of covenant.

Indemnities from a Borrower to the Finance Parties are common in a Facility Agreement.

9.2 Advantages of using an Indemnity instead of a Warranty

There are several reasons why it is preferable for the Buyer to seek an Indemnity instead of (or in addition to) a Warranty:

9.2.1 It is harder to prove loss under a Warranty – an indemnity is a promise to pay *dollar for dollar* the amount of any cost or claim arising from the subject matter of the indemnity. For a breach of Warranty, the Buyer has to show that the market value of the Target is less than it would have been had the Warranty been true. Establishing loss on this basis can be difficult since the exact amount of the loss, if any, can be hard to ascertain and subject to limitations, for example:

- ***rules of remoteness*** which limit recoverable losses to matters:

  (i) <u>arising naturally</u> from the breach; or

  (ii) being in the <u>reasonable contemplation</u> of both parties at the time the contract was made.

However, in the case of Indemnities, the test of remoteness does not usually apply (unless the claim is essentially a claim for contractual damages) and it is therefore easier for the Buyer to recover its losses in full.

9.2.2 **Recovery of costs** - an Indemnity can be expressed to also include the Buyer's costs and expenses (such as legal expenses). These may not be recoverable (or not recoverable in full) in the event of a Warranty claim, even where the Buyer is successful in Court.

9.2.3 **Indemnities not affected by knowledge** - in contrast to Warranties, usually the Indemnities will not be affected by the knowledge of the Buyer, or by matters disclosed in the Disclosure Letter. This is of particular importance where the Indemnity is in place to protect the Buyer against a known risk.

9.2.4 **No duty to mitigate** - again in contrast to Warranties, in general there is no duty on the Buyer to mitigate or take steps to reduce its losses or stop future losses when relying on an Indemnity.

9.3 Specific Indemnities

Specific Indemnities vary from transaction to transaction and there is no one market standard. Usually Indemnities will be appropriate for clearly identified risks.

Some examples of specific Indemnities include:

- **A specific issue arising from Due Diligence** - this might be a potentially material issue such as outstanding litigation or a breach of regulatory rules. Alternatively it might be something straightforward such as a missing document or certificate, where the Sellers are certain that the risk is low and are happy to give the Buyer comfort on this with an Indemnity.

- **Environmental issues** - Buyers are often wary of environmental problems and, depending on the nature of the business, may seek a wide Indemnity for these issues.

- **Pre-Completion reorganisations** - the Buyer will usually request an Indemnity for any pre-Completion reorganisations carried out by the Sellers. The exception to this may be where the Buyer has itself requested the reorganisation, perhaps to help facilitate its acquisition and financing arrangements.

- **Breach of Warranty** - some Buyers, particularly US Buyers, will often seek to treat the Warranties *on an Indemnity basis*. The Buyer's objective here is to avoid having to show loss on a contractual basis – and to avoid other restrictions arising on what it may recover on account of remoteness, mitigation and so on, once a breach of Warranty has been established.

- **Tax schemes** - Tax schemes put in place by the Sellers in order to avoid or reduce Tax liabilities are often met with scepticism by a Buyer, particularly if they are aggressive or untested. Often an Indemnity will be demanded by the Buyer.

- **Tax issues** are often addressed with Tax Indemnities.

9.4 Tax Deed of Indemnity

It is usually considered important for the Buyer to obtain a Tax Indemnity in respect of pre-Completion Tax risks. In effect the Indemnity will cover unexpected Tax liabilities – as generally it covers all Tax liabilities relating to pre-Completion matters, save to the extent provided for in the Audited Accounts or any Completion Accounts.

Whilst this broad principle is almost always accepted, there is room for disagreement and negotiation as to precisely which Taxes and which

events and triggers of liability are covered, how Tax reliefs are used and how claims are conducted with the Tax authorities.

In some cases the Tax Indemnities will be contained in a separate Tax Deed of Indemnity (sometimes called a Tax Deed). There is no legal reason for this to be a separate document to the main SPA, but logistically it can be more convenient, since it allows the Tax specialists and Tax advisers to negotiate this separately, in parallel to the negotiations on the SPA. Also, it is given as a *Deed* to allow claims to be made under it for a longer period, compared to claims under the rest of the agreement.

In the UK, for reasons of Tax efficiency the Tax Indemnities are given to the Buyer and not the Target, even though it is the Target (and its group) who will have incurred the Tax liability to be indemnified.

However, in some Jurisdictions the Tax authorities do not make a distinction between Indemnity payments made to the Buyer from those Indemnity payments made directly to the Target and so it might be possible to structure the Indemnity either way.

Even in cases where the Buyer obtains a full Tax Indemnity, it is still advisable for it to seek Tax Warranties, even though these will overlap. This is for two main reasons:

- **Information seeking** - the Tax Warranties and the Sellers' Disclosures against them in the Disclosure Letter will give the Buyer advance notice of any issues. This will cut down on the cost and management time involved in identifying and dealing with any unexpected problems or disputes with the Tax authorities after Completion.

- **Warning about future issues** - the Tax Warranties and Disclosures may also give the Buyer advance warning of any potential issues that may arise after Completion, if it plans to integrate the Target's business into its group or to conduct a post-Completion reorganisation which may otherwise have unexpected Tax effects.

SECTION H: LIMITATIONS OF LIABILITY

1 BACKGROUND

It is usual for the Sellers to try to limit their liability in respect of the SPA. This is particularly the case for the Warranties, but can also apply to other areas of the agreement, such as Indemnities, post-Completion undertakings and so on.

Many of the limitations will also be applicable to Warranties given under a Shareholders' Agreement. By contrast, limitations on liability in a Facility Agreement are rarer given the relative negotiating strengths of a Lender versus a Borrower and the usual market practice for such agreements, although there is still room to negotiate on certain points.

Limitations of liability in an SPA will typically include provisions in respect of matters such as:

- Materiality.
- Knowledge of the Sellers.
- The time periods for making claims.
- Thresholds and caps on liability.
- Proportionate liability amongst the Sellers.
- Credit for improvements or unexpected windfalls.
- Actions of the Buyer.

- Procedures for notification of claims.
- Conduct of claims.
- Recovery from third parties.
- Assignment of the benefit of the Warranties.
- Consequential loss and loss of profit.
- The period of ownership of the Sellers.
- Contingent liabilities.
- Changes in law and regulation.
- A Change of Control of the Buyer.
- Mitigation provisions.
- No double recovery.
- Ring-fencing of the Warranties.
- The Buyer's knowledge.

2 MATERIALITY

Sellers will often try to restrict some or even all of the Warranties by reference to materiality (often with negotiations over what is meant by material).

Although it is common to include such a qualifier within individual Warranties, the Buyer should do so with some caution because:

2.1 The wording may well operate as a *double margin of error* for the Sellers, so that if the Buyer agrees to include a threshold for individual claims or for making recovery from the Sellers (as is normal), the Buyer will need to prove that <u>both</u> the threshold has been exceeded <u>and</u> that the materiality qualifier of the Warranty itself has been met (e.g. that the relevant matter constitutes a *material breach* or a *breach of a material term* or is a *breach having a material impact on the business* – whatever the terms of that qualifier are); and

2.2 The exact meaning of the word material is unclear and unless it is defined in the SPA, it would ultimately need to be decided in Court or by Arbitration.

Consequently, the Buyer is likely to resist a general qualifier of materiality affecting all the Warranties (e.g. along the lines of the inclusion of words to the effect that the Warranties are true in all *material* respects). Also, if it accepts the qualifier at all, it is likely to seek to define the effect of the qualifier so that it does not operate as a double margin of error. This may be achieved by providing that where any Warranty is subject to a materiality qualifier, that qualifier shall be deemed to be satisfied if the amount claimed (disregarding the qualifier) exceeds the *de minimis* threshold for claims.

3 KNOWLEDGE OF THE SELLERS

3.1 The Sellers will often try to restrict certain Warranties by reference to their knowledge. This is done by stating so *far as the Sellers are aware* or *to the best of their knowledge, information and belief.*

3.2 There are often also negotiations over what is meant by knowledge, whether that includes imputed knowledge of employees and third parties, whether knowledge should include facts that the Sellers do not actually know, but would have known on making reasonable enquiries.

In broad terms knowledge falls into three categories:

- *actual* knowledge can be described as knowledge which a person has;
- *imputed* or *implied* knowledge is knowledge which a person is deemed to have by reason of it being knowledge of that person's agent; and
- *constructive* knowledge is knowledge which a person ought to have (but does not).

In respect of Warranties qualified by knowledge, individual Sellers will usually want to limit these to matters within their own individual actual knowledge (or perhaps within their knowledge as a group of individuals, having made enquiries of each other).

3.3 In the case of corporate Sellers, the Sellers will often want to limit this to the actual knowledge of the Directors (and perhaps certain other key personnel in connection with the transaction) and the actual knowledge they gain from enquiring of other specified individuals. The key point is this does not fix the Sellers with the knowledge held by those individuals if the individuals in question do not divulge that knowledge (whether deliberately or not) to the Sellers. If the Sellers were to be fixed with that knowledge, they could be liable for a breach of Warranty where they had made enquiries of the relevant individuals but had not been given the relevant information.

3.4 A Buyer is likely to argue that it should not be bearing the risk of non-disclosure by an individual to the Sellers and that the Sellers should be carrying that risk. The Sellers, however, will argue that they are making enquiries of the relevant individuals and can do no more in the event that they do not divulge information to them. The outcome of this negotiation will depend on the transaction in question and the negotiating strength of the respective parties.

4 PERIODS FOR MAKING CLAIMS

The standard limitation period for bringing claims for breach of contract under English law is 6 years from the date the cause of action arises (e.g. the date the Warranties are given in the case of a breach of Warranty; or the date that a matter arises that is the subject of a claim under an Indemnity). In the case of contracts executed as Deeds, the limitation period is 12 years. These periods can be reduced by agreement between the parties. On a typical deal, the parties will usually agree to a limitation period of 1-3 years for non-Tax Warranty claims.

Local laws may also have their own limitation periods which in some cases might override or conflict with the position agreed in the SPA. For this reason, local legal advice should also be sought.

5 THRESHOLDS AND LIABILITY CAPS

5.1 Typically, Sellers will ask for:

- an individual *de minimis* claims threshold, which sets a minimum level of claim below which a claim does not count; and/or

- a basket or bucket claims threshold, which sets the amount that claims exceeding the *de minimis* have to reach (alone or in aggregate), before any claim can be pursued. Buyers typically look to ensure that the threshold acts as a *tipping basket* (i.e. once the threshold is met, the Buyer can recover the full amount of its claims, not just the *excess only*).

5.2 The Sellers will also seek an aggregate financial cap, which restricts the maximum amount that is recoverable for all claims. The Buyer will usually look to set this at the amount of the Consideration it pays the Sellers and to be able to recover its costs on top. The Sellers will usually want any such cap to include costs and may look to set it at a fraction of the Consideration (perhaps between 20% to 50%, particularly on

an Auction Sale, if bargaining strength allows). Also, if only limited Warranty cover is given, then that is a reason for justifying a lower cap (e.g. where much of the value of the transaction relates to a particular property or asset – in respect of which the Sellers give no Warranty – perhaps because it has been agreed that the Buyer must rely on its own investigation/assessments).

In any event, any gap in cover can be addressed by warranty and indemnity insurance, if required (See *Section G: Warranties and Indemnities (paragraph 8)*).

6 PROPORTIONATE LIABILITY

Where there are multiple Sellers, it is sometimes appropriate to ask for several liability and a proportional sharing of liability between the Sellers by reference to the percentage of sale proceeds each receives or its responsibility as regards the relevant matter.

Joint and Several Liability is considered in *Section J: Boilerplate Provisions (paragraph 7)* but it is worth noting here that if the Sellers give the Warranties severally that does not mean that, by default, each Seller is only liable up to the amount of the Consideration it receives or (where the Warranties are qualified by awareness) only in respect of matters of which it is aware.

7 CREDIT FOR IMPROVEMENTS

7.1 The Sellers may ask for credit for improvements. This is the ability to Set-off (against any liability arising under the Warranties) any improvements which exist in the Target group in excess of the warranted position.

So for example, if a bad debt provision proved to be unnecessary, then (subject to how benefit is defined) there could be a benefit to the Buyer and that benefit would have to be taken into account when determining the amount of a claim under the Warranties.

7.2 Whether this is at all appropriate will depend upon how the price has been set. It is most likely to be appropriate to the extent that there are Completion Accounts and the relevant matter would have increased the price payable. Even then, however, the Buyer may have factored in some upside to the price (i.e. it may have thought that the Sellers' provisions were greater than necessary). It may be unwilling to pass on to the Sellers any benefits that accrue to it (perhaps because of its efforts, e.g. it collects debts better than the Sellers).

In other circumstances, the fact that, for example, a debt previously considered to be bad is in fact recovered would have had no real impact on the price. The Buyer will argue that it should have no impact on what it can recover under the Warranties.

7.3 Accordingly, this provision often does not make it into the final (or sometimes even first) draft of the SPA. If it is included, the meaning of benefit is likely to be closely defined, for example to include drafting around:

- overprovisions made in the Completion Accounts;
- the extent of the amount by which an asset of the Target has been understated in the Completion Accounts; and
- the extent of the amount by which the liabilities of the Target have been overstated in the Completion Accounts.

7.4 However, the Buyer will want to make this drafting even tighter, as it will not want the Completion Accounts to effectively be able to keep being re-opened by the Seller. Neither will it want endless arguments as to what the proper values for liabilities and assets are in the light of information that becomes apparent after Completion.

8 ACTIONS OF THE BUYER

8.1 The Sellers will often seek to limit their liability in respect of liability caused (or increased by) voluntary acts or omissions of the Buyer and its group, or of the Target after Completion (once it is owned the Buyer). As regards most Warranties, it is unlikely that acts or omissions after Completion could give rise to a liability – because the Warranties only need to be true on the date they are given (i.e. the date of the agreement and, perhaps, Completion). A liability under the Warranties may be increased by acts or omissions afterwards – but what the Buyer can recover will generally be subject to it taking reasonable steps to mitigate its loss in any event.

8.2 Accordingly, this limitation will sometimes be accepted by the Buyer, provided there are express carve-outs for matters such as:

- Acts or omissions in the normal course of trading, or for the protection of the goodwill of the Buyer's group, or (after Completion) the Target. Subject to any mitigation issues, the Buyer is entitled to continue the business in the normal course and protect the goodwill associated with it, as any responsible owner of the business would do. This carve-out might be resisted by the Sellers.

- Acts carried out to avoid breach of subsisting binding obligations or to comply with legal or regulatory requirements.

- Acts carried out to comply with accounting standards. The Sellers will normally accept legal requirements here, but will not accept any other liability arising from changing the accounting policies or adopting the Buyer's group accounting standards.

- Acts or omissions which are substantially a consequence of a breach by the Sellers.

9 NOTIFICATION OF CLAIMS

The Sellers will usually require the Buyer to promptly notify them of any potential Warranty claims and to provide details of the claim.

The Buyer needs to be very careful that any such requirements are reasonable ones that it will be able to comply with, e.g. as to the details required and the time period for the notification. It should also include a provision that failure to strictly comply with the notification requirements will not invalidate the notice or prevent the Buyer from bringing a claim, provided it is still within the overall agreed time period for making claims (although the amount it may recover may be reduced by any breach).

10 CONDUCT OF CLAIMS

10.1 The Sellers will sometimes seek provisions allowing them to take conduct of claims, where third parties are bringing a claim which could in turn lead to a Warranty claim. This is usually structured as follows:

- **Settlements/admissions** - the Sellers may ask that the Buyer does not settle any claims with third parties which could lead to a claim under the relevant Warranty without the Sellers' prior consent.

- **Co-operation** - the Sellers may ask the Buyer to provide reasonable co-operation (including access to records, premises and staff of the Target) when analysing any third party claim which may in turn lead to a claim under the relevant Warranty.

- **Conduct of third party claims** - the Sellers may ask the Buyer to let them have conduct of claims opposite third parties (including the right to conduct litigation in the name of the Target).

10.2 The Buyer may accept such provisions, provided the Sellers agree to indemnify it against any costs and expenses associated with the conduct of claim, together with adequate security for costs.

However, in some cases the Buyer will be reluctant to agree to this, since it may lead to business disruption and damage to the Buyer's and Target's business name, reputation and goodwill, particularly if the third parties involved in the claim include customers or suppliers.

10.3 A potential compromise position here is for the Buyer to consult with the Sellers prior to conducting or settling relevant disputes with third parties and to take such reasonable steps as they may request, provided always that such steps to do not adversely affect the goodwill of the Target or the Buyer.

11 RECOVERY FROM THIRD PARTIES

11.1 The Sellers will sometimes ask that the Buyer seeks recovery from third parties in respect of matters which give rise to a Warranty claim. Such third parties could include insurers, debtors, suppliers and even, in some instances, employees. This might be resisted by the Buyer. It would naturally prefer to claim against the Sellers than against third parties with a potentially continuing relationship with the Target. However, subject to the Sellers settling the claim in full, Buyers typically agree to account to the Sellers to the extent that amounts are actually recovered from third parties (to the extent that such recovery, net of costs, would otherwise amount to double recovery – and to the extent that no other claims are outstanding).

11.2 In some cases the Sellers will also ask to take conduct of claims against third parties where the Target has a potential right of recovery itself. The Buyer will normally resist such a demand, but where it is negotiated the usual points on conduct of claims provisions will equally apply here.

12 CONSEQUENTIAL LOSS AND LOSS OF PROFIT

12.1 English law has some well-established rules for determining the damages awarded for breach of contract. Generally speaking, a party can claim for both direct loss, which flows naturally from the breach, and also consequential (or indirect) loss, which does not flow directly from the breach but which arises in special circumstances which are known or foreseeable at the time of entering into the contract.

Accordingly, it is possible under English law for a party to claim damages for loss of profit – and such loss may be *direct loss* or *consequential loss*, depending on the circumstances. Indeed, loss of profit may be the main loss flowing from a breach that a Buyer wants to claim.

12.2 The parties can contractually agree to limit recoverable loss by excluding consequential loss or loss of profit. Whilst the potential effect of these is very different of course, both are often resisted by the Buyer and, in particular, loss of profit – as this may be the main type of loss the Buyer suffers. For example, if manufacturing equipment is defective, the Buyer will want to recover not just the cost of repairing or replacing it, but also all the revenue it loses whilst the equipment is un-operational.

12.3 It is also open to the parties to agree to a Liquidated Damages clause if a particular Warranty (or other provision of the SPA) is breached. This needs to be a genuine pre-estimate of the Buyer's loss in the case of breach. Otherwise it is likely to deemed a Penalty clause and so unenforceable altogether. In practice, it is rare for the parties to seek to agree to such a clause.

13 PERIOD OF OWNERSHIP

13.1 The Sellers will sometimes argue that they should only be responsible for matters arising during their period of ownership (and not for any earlier period when they did not own the Target). From a Buyer's perspective,

it will take the view that it is paying a full price for the Target (if it is) and so the Sellers should take full risk and give a full set of Warranties; otherwise, any increase in exposure is likely to be factored into the price it pays.

13.2 This limitation of liability was frequently demanded by institutional Sellers during a booming market, in competitive Auction Sales. In the current market it is much less likely that the Buyer will accept it, although if the Sellers are able to offer the Buyer an effective assignment of the Warranties given to them when they originally acquired the Target, then this may still be accepted (but see *Section G: Warranties and Indemnities (paragraph 7*) above for information on the potential pitfalls of doing this).

14 CONTINGENT LIABILITIES

14.1 The Sellers sometimes request a limitation on claims to the extent that it relates to a liability that is contingent and not yet actual.

A contingent liability may still give rise to actual costs and liabilities even before it becomes actual (and even if it never becomes actual). For example, a contingent liability may need to be provided for on the balance sheet if it is sufficiently probable and can be estimated – and any such provision could cause the Target to breach net asset tests in its banking covenants or other requirements of a third party regulator. Even if it just has to be noted, its existence may loom large (depending on what it is) and affect investor/customer confidence.

Accordingly, Buyers will often resist this limitation and tell the Sellers to rely on the English law requirements regarding proving loss (i.e. if there is no loss flowing from a contingent liability, the Buyer will not be able to recover in any event, and if there is a loss, why should the Buyer not be able to recover that?).

14.2 However, in practice Buyers do sometimes accept this limitation, provided it is expressly stated that the time limits for bringing a claim are effectively frozen whilst the parties wait to see whether the contingent liability becomes actual. This is a separate point, but an important one, if the first point - not to allow claims to be made while a liability is contingent - is conceded.

15 CHANGES IN LAW AND REGULATION

The Sellers will usually insist that they are not liable for any changes in law or regulation after Completion (or, sometimes, after signing).

16 CHANGE OF CONTROL OF THE BUYER

Occasionally the Sellers will argue that the Warranties should fall away if there is a Change of Control of the Buyer, on the basis that they are then effectively dealing with an unknown third party with whom they have no history or relationship.

It is rare for the Buyer to agree to such a limitation, unless the Buyer is seeking to deter a subsequent takeover of it, in which case it may regard this as a welcome *poison pill*. However, in agreeing to such a term, the Directors of the Buyer should have regard to the best interests of their company.

17 RING-FENCING

17.1 Sellers will sometimes include in the SPA a clause known as a ring-fencing or boxing clause. Its effect is to ring-fence the Warranties relating to particular matters so that the Sellers are only liable in respect of, say, real estate, under the specific real estate Warranties.

17.2 Provisions like this are quite common in Auction Sales. Without them, Sellers are exposed to potential liability under general Warranties

regarding matters such as compliance with laws and absence of disputes in relation to matters such as employment, environmental and IPRs – despite the fact that they have negotiated separate, more limited Warranty cover regarding compliance and disputes for those matters (and under which the Buyer would not have a claim).

17.3 In practice the point is sometimes accepted, but Buyers are naturally nervous about doing so and (if they cannot resist the point) may look to protect their position by:

- limiting it to certain Warranties only (e.g. by providing that compliance claims in relation to employment matters can only be made under the employment compliance Warranties and not under the general compliance Warranty);
- reserving the right to claim for any matter under the accounts Warranties; and/or
- ensuring that the Warranties it has regarding each matter (e.g. employment) are comprehensive and that no reliance needs to be placed on any other Warranties.

18 MITIGATION

18.1 The amount that the Buyer can recover for breach of Warranty may be reduced if it has not taken reasonable steps to mitigate its loss, as the Seller can raise a defence that the Buyer has not taken such reasonable steps. It is not strictly a duty, but is commonly referred to as the *duty to mitigate*.

18.2 The Sellers will sometimes still look to include a clause expressly relating to mitigation. This is not unreasonable, so long as its purpose and effect is simply to make it clear that the obligations of the Buyer expressly stated under the agreement (to take reasonable steps to resist claims) are not the full extent of the mitigation that may effectively be required of it

by law. However, such provisions sometimes look to go further, along the lines of requiring the Buyer to use All Reasonable Endeavours to mitigate and minimise its losses. As such, they may require more of the Buyer and place a greater restriction on its rights under the Warranties. To the extent that they do, they should normally be resisted by the Buyer.

19 DOUBLE RECOVERY

19.1 The Sellers will normally want to expressly state that the Buyer *cannot recover twice for the same loss*. For example, a litigation claim may give rise to a claim under the litigation Warranties and could also give rise to separate claims under the accounts Warranties and trading Warranties. As it is reasonable that the Buyer should of course only be able to recover the same loss once (and this is the case under English law in any event), the Buyer should have no problem agreeing to this.

19.2 However, Buyers should be very wary of the Sellers trying to achieve more than this. A provision that states that the Buyer *cannot recover or claim twice in relation to the same circumstances* is not the same thing. It may well be construed to mean that, having claimed for certain items of loss in relation to a breach, it was then unable to subsequently claim other items of loss in relation to the subject matter of that breach.

20 BUYER'S KNOWLEDGE

20.1 Whether acting for the Sellers or the Buyer, it is important to understand the law relating to the effectiveness of clauses which purport to permit the Buyer to bring a claim for breach of Warranty even if the Buyer had knowledge of the facts and circumstances giving rise to the breach.

A Buyer's starting position in negotiating the Warranties and Disclosure against those Warranties will often be that the Warranties are only qualified by matters disclosed in the Disclosure Letter, irrespective of the Buyer's own knowledge at Completion.

20.2 The current position appears to be as follows (but is based in part on English law cases that did not go to a full hearing of the issues):

- even if the SPA includes a general provision allowing the Buyer to make a claim notwithstanding its knowledge, the Buyer may still be precluded from making a claim in respect of a matter that it was aware of before it entered into the SPA (although a clear and specific reservation of rights in relation to a particular matter should be effective);
- if the SPA is silent, the position is unclear, but is presumed to be as above – i.e. the Buyer may well be precluded from making a claim; and
- if the SPA limits the Buyer's rights to make a claim in respect of matters of which it is aware, those limits will be enforceable against the Buyer.

The Sellers will sometimes seek a reverse Warranty from the Buyer, confirming that the Buyer:

- is not currently formulating a claim; and/or
- is not aware of circumstances that would entitle it to bring a claim (sometimes called a *no sand-bagging* provision).

20.3 The potential effect of these two limbs is quite different. The Buyer is usually happy to confirm that it is not currently formulating a claim. The Buyer is more likely to want to renegotiate price now, rather than enter into the agreement with a view to making a Warranty claim – not least because of all the limitations applying to claims, the time, cost and effort involved in making a claim and the uncertainty as regards what effect its knowledge of the matter will have on its right to recover.

20.4 However, the Buyer should usually be wary of confirming that it is not aware of circumstances that would entitle it to bring a claim. The full potential effect and ramifications of the matters disclosed to the Buyer, or of which it is otherwise aware, may not be fully apparent to it at this

stage. Of course, if the matter ever came to be determined by a Court or Arbitration Tribunal, what the Buyer was and was not aware of may be hard to prove. And, depending on the drafting of this provision, there will again be arguments as to what (and who) is included within the scope of the Buyer's knowledge.

SECTION I: DISCLOUSRE LETTER AND DISCLOSURES

1 INTRODUCTION

To the Sellers, the preparation of the Disclosure Letter is as important as negotiation over the wording of the Warranties and the limitation schedule. This is because the Warranties are qualified (and so the liability of the Sellers under the Warranties is reduced) by the matters disclosed. In effect each Warranty is a statement to the effect that the information warranted is true apart from the matters described in the Disclosure Letter. The SPA should make it clear that the Disclosure Letter qualifies the Warranties.

2 DISCLOSURE LETTER

The Disclosure Letter will normally be divided into two sections, namely general Disclosures and specific Disclosures.

In the Sellers' first draft of the Disclosure Letter, they will often try to make the following general Disclosures to the Buyer:

- All matters contained in the Data Room.
- All matters contained in an agreed Bundle of Disclosure Documents.
- All matters contained in the previous correspondence between the parties and their advisers.
- All matters contained in the last Audited Accounts. Possibly also in earlier sets of accounts and also the Management Accounts.

- All information which can be obtained from relevant searches at relevant Company Registries and any relevant Register for each of the real estate properties of the Target.
- All matters which would be apparent from a physical inspection of the real estate properties of the Target.
- All matters contained in the statutory books of the Target group.
- All matters contained in the Vendor Due Diligence Reports.
- All matters contained in the Due Diligence reports prepared by the Buyer's advisers.
- All matters which are on public record or in the public domain.
- All matters which the Buyer ought reasonably to be aware of as affecting similar businesses to those of the Target.

3 NEGOTIATING THE GENERAL DISCLOSURES

Depending on the circumstances, the Buyer may reject a number of these general Disclosures, on the basis that they are too wide and need to be made more specific. In many cases it will require the Sellers to make specific Disclosures if they have particular concerns.

The Buyer is likely to also reject any vague wording such as *matters referred to* in the relevant general Disclosure document, limiting the effectiveness of the disclosure to information *contained* in the document and *fairly* disclosed *(see paragraph 8 below)*.

A general Disclosure of the contents of the Data Room can be a contentious issue and this is considered in *paragraph 5* below.

4 SPECIFIC DISCLOSURES

The second part of the Disclosure Letter will contain the Sellers' specific Disclosures against the Warranties. These will be listed against each Warranty to which they may be relevant.

Arguably, it is in the interests of both parties to ensure that the Specific Disclosures are full and clear, in order to avoid any future disputes. Usually the Buyer will seek clarifications and more information after it receives the first draft. It will want to understand the true effect of matters disclosed. At the same time, the SPA will generally set out requirements for any disclosure to be effective and the Sellers will want to make sure that these requirements are satisfied *(see paragraph 8 below)*.

Despite the extensive Due Diligence exercise that will have been carried out by the Buyer by this stage, it is still not uncommon on transactions for the Buyer to learn new information about the Target for the first time when it receives the Sellers' first draft of the specific Disclosures. Even at this late stage in the transaction, depending on the nature of the new information, the Buyer should be prepared to react to this new information by seeking an appropriate provision in the SPA (such as an Indemnity, a reduction of the Consideration, or an increase in the amount to be withheld and paid into the Retention Account at Completion).

5 DISCLOSURE OF THE DATA ROOM

5.1 Data Room

In order to avoid subsequent arguments as to what information has been disclosed, all documents disclosing information should be collated in to an agreed Bundle, referred to as the Disclosure Bundle.

The Sellers will frequently set up a Data Room at the beginning of a transaction, containing a large amount of information to which the

Buyer is given access. Whether or not that takes place, the Sellers will usually be asked to provide a large amount of information to the Buyer and its advisers in response to its Due Diligence enquiries. In theory, the process of replying to Due Diligence enquiries is separate from the Disclosure process and the Sellers should start preparing the Disclosure Bundle from scratch, disclosing only those documents required to qualify the Warranties. However, that is not how the process usually works in practice.

In practice, the Sellers will take the Data Room files, or the copy files of information provided to the Buyer during Due Diligence, and make those the basis of the Disclosure Bundle. The Sellers will then add to the Disclosure Bundle as the form of the Warranties is finalised and additional documents and information are required to qualify the Warranties. This is the most advantageous position for the Sellers as, in conjunction with the general Disclosures, it ensures that all the information provided to the Buyer is treated as disclosed.

5.2 Buyer's position

A Buyer will usually try to resist general Disclosure of the Due Diligence information or Data Room files in that way. A US Buyer will, in particular, object strongly to Disclosure in that form. The US practice is for very specific Disclosures to be made against each Warranty to which they apply and for those qualifications to be included in schedules to the SPA itself. In a US transaction, no general Disclosure is accepted and each document must be specifically cross-referenced to each Warranty to which it relates.

One possible compromise position could be to agree to treat only certain documents (or only relevant parts of those documents) in the Due Diligence information or Data Room files as disclosed against certain Warranties (e.g. employment information would be disclosed against the employment Warranties only).

Ultimately, the question of general Disclosure of the Data Room will be a matter for commercial negotiation between the parties.

6 DISCLOSURE OF STATUTORY BOOKS

The Sellers might seek to disclose copies of the statutory books. A Buyer will usually resist general Disclosure of all of the statutory books on the basis that:

- If a matter recorded in the books contravenes a Warranty, that matter should be specifically disclosed.
- The statutory registers should be up-to-date and complete. A defect in the statutory books is not something which will usually be acceptable to the Buyer and the Buyer will not usually accept the Disclosure of any such defect. The defect should normally be remedied prior to Completion.
- The statutory records include the minutes or minute books of the meetings of the Board of Directors, and the Buyer will usually resist deemed general Disclosure of information contained in those records.

If a general Disclosure of the statutory books is accepted by the Buyer, the corporate records must be reviewed in detail. If the companies are old, a compromise would be to limit such Disclosure to entries in the recent past (for example, the previous two years). A Buyer is advised to specify exactly which statutory registers are to be disclosed and reviewed (for example, the register of members, register of Directors, register of charges), and to exclude the minute books.

7 WARRANTING THE DISCLOSURE LETTER

A Buyer's first draft of the SPA will sometimes include a Warranty asking the Sellers to confirm the accuracy of the Disclosure Letter.

The purpose of the Disclosure Letter is to detail exceptions to the Warranties, not to give the Buyer further Warranties. If matters arise in Disclosure that effectively increase the Warranty cover that the Buyer needs (i.e. if it needs to have a right of action if the Disclosure is not true), then a further Warranty should be added. However, this is unlikely to be agreed to by the Sellers.

Also, a Warranty of this kind may be seen as a back door way of obtaining a Warranty from unwary Sellers of a matter which might not otherwise be warranted. For example, express Warranties relating to Management Accounts or profit forecasts are usually strenuously resisted, but if copies are in the Disclosure Bundle they may be caught by a Warranty in relation to the accuracy of the Disclosure Letter and Bundle.

The Disclosure Letter is also likely to contain a number of general Disclosures which deem various documents and information to be disclosed. From the Sellers' perspective, it is extremely dangerous to warrant the accuracy (even if qualified by knowledge and materiality) of matters which are deemed to be disclosed. Sellers should resist a Warranty of this kind and argue that if the Disclosure Letter is inaccurate, it is unlikely to amount to an effective Disclosure against the Warranties.

The better approach is for the Buyer to ensure that the Warranties specifically address all matters which arose in its Due Diligence process. Where confirmations were given as part of the Due Diligence process, the Buyer should make sure that those confirmations are reflected as Warranties in the SPA. In that way, matters on which the Buyer is relying are addressed up-front in the Warranties, not by a back door method in the Disclosure Letter.

8 FAIR DISCLOSURE

Often, negotiations over Disclosures will include a discussion as to whether they are fair or not – with only fair Disclosures being effective to qualify the Warranties. Recent English Court cases suggest that the adequacy of a Disclosure will be judged against any test that the parties agree. It has therefore become quite standard practice for the parties to include in the SPA a definition of what is meant by fairly disclosed. An example of this might be:

- *A matter shall be regarded as having been fairly disclosed in the Disclosure Letter only to the extent that accurate information about that matter is contained in the Disclosure Letter in sufficient detail to enable the Buyer properly to identify the nature and scope of that matter and the Warranties which are to be qualified by it.*

The Sellers should also consider the scope of the general Disclosures carefully and make sure they extend to all matters and documents which the Sellers have in mind. If there is any doubt, then they should refer to the matter or document specifically.

Buyers will also sometimes seek full Disclosure. Such a term is subjective and potentially unclear and it will always be open to dispute whether the Disclosure is *full* or not. For this reason, the concept of *full Disclosure* should usually be refused by the Sellers, unless the SPA then goes on to explain with sufficient clarity what is meant by this.

SECTION J: BOILERPLATE CLAUSES

1 SOME "STANDARD" BOILERPLATE PROVISIONS EXPLAINED

English law governed agreements such as SPAs, Shareholders' Agreements and Facility Agreements will also contain a large number of so called standard provisions or Boilerplate provisions. Most of these provisions deal with specific points or case precedent that have developed under English law over the years. Some are genuinely standard, neutral provisions, whereas others need to be carefully reviewed and amended if necessary.

2 BACKGROUND/RECITALS

Recitals that set out the background to the transaction are common. Whilst the agreement will often specify that they have no legal effect, setting out the basics of the transaction may be especially helpful in future reviews of the agreement after Completion. If the agreement is silent as to their effect, they will and they may be used by a Court or Arbitration Tribunal when it construes what a provision in the agreement means.

3 COMMENCEMENT DATE

Generally the agreement has a date added at the very top of it and takes effect from that date. That date should be no earlier than the date that the agreement has been signed by all the parties (as under the laws of many Jurisdictions, contracts must not be backdated or this may potentially constitute fraud).

An express commencement date is necessary if the date on which the agreement comes into effect, or its obligations commence, is different to

the date when the agreement is signed by the parties. If the parties do not expressly provide for a commencement date, an agreement will take effect immediately when it is signed or the date of the last signature, if the parties signed on different dates.

4 DEFINITIONS AND INTERPRETATION

This is where the defined terms used throughout the main body of the agreement are contained. Some standard interpretation guidelines are also stated in order to avoid any dispute on the basis of grammar or semantics. Many simply repeat the position at law and are there for convenience.

Ideally, defined terms should be listed in alphabetical order and at the start of the agreement (or in a schedule at the end) for ease of reference, rather than dotted around the agreement where they may be hard to find.

5 ANNOUNCEMENTS

Parties to a transaction will often be concerned to control the announcement of information about the transaction. An official announcement regarding the transaction may be required if a public listed company or a regulated company is involved in the transaction.

An announcements clause aims to ensure that a transaction is publicised in an appropriate form, and in an agreed manner, by preventing each party from making a public announcement about the transaction without the prior written consent of the other party.

If the parties have already agreed to issue an announcement in respect of the transaction, they will usually set out the agreed wording, for example in a schedule to the main agreement or as an agreed form document.

6 CONFIDENTIALITY

As mentioned above, the parties to a transaction are likely to wish to control what is being made public about the transaction. While a duty of confidentiality may arise under English law principles anyway, it is preferable to rely on express contractual provisions.

A confidentiality clause is designed to regulate what information the parties may release and what information is confidential. This duty of confidentiality is separate to the Confidentiality Agreement which will, in all likelihood, have been signed prior to the commencement of negotiations on an M&A transaction or the Buyer's Due Diligence process and which may terminate on Completion.

7 JOINT AND SEVERAL LIABILITY

Where two or more parties to a contract are giving a promise or assuming a liability in respect of the same thing, the issue of Joint and Several Liability often comes up. In the context of SPAs, this is often relevant where there are two or more Sellers each giving Warranties.

The meaning of different types of liability	
Joint and Several Liability	The Buyer can enforce its rights against any or all of the Sellers and can pursue each for the full amount of the claim. It is up to the Sellers to agree amongst themselves on their respective proportions of liability to each other. A Seller who pays more than its proportion of liability then has a right of contribution against the others, which gives it a right to claim back from the other Sellers amounts corresponding to their liability.
Several Liability	Each Seller is treated as having assumed liability solely for its own performance. However, as regards the giving of the Warranties, this simply means that each Seller separately gives the Warranties and, again, the Buyer can enforce its rights against any or all of them and can pursue each for the full amount of the claim (although the Buyer will not be able to recover its loss twice and the Sellers may have a right of contribution against each other). Accordingly, if the intention is to limit the liability of each Seller to an agreed proportion (e.g. one-third) of any claim, and to limit each Seller's overall liability to the Consideration that it receives, the agreement will need to provide this expressly.

Joint Liability	Relatively rare situation. Similar to Joint and Several Liability, but legal proceedings must usually be issued against all the Sellers. Also, in the case of individuals, if one Seller dies or becomes bankrupt, his estate is released from liability.

8 COSTS AND BREAK FEES

The agreement will usually contain provisions dealing with costs and how these are allocated amongst the parties.

In general each party is responsible for its own costs and expenses in an SPA or Shareholders' Agreement and the Buyer is responsible for any Taxes payable on the transfer of the shares. In a Facility Agreement it is usual for the Borrower to pay the Lender's reasonable fees.

In addition, in an M&A transaction the Buyer will want to be sure that transaction costs (such as for the preparation of the Data Room and any Vendor Due Diligence Reports) are not being borne by the Target (or, to the extent that they are, that the practice is lawful and the costs are fairly reflected in the price it will be paying for the Target). This is generally dealt with in the first instance by way of a Warranty – to flush out details of any costs being borne by the Target.

The SPA may also contain provisions dealing with Break Fees. The term Break Fees is used to describe arrangements between a prospective Buyer and the Sellers or the Target under which one party agrees to pay a certain sum to the other party upon the occurrence of a specified event which prevents the Completion of the transaction. A Break

Fee, sometimes also called an inducement fee, is intended to ensure that professional and advisory costs incurred by one party during negotiations or the Due Diligence process are borne, in whole or at least in part, by the other party if the transaction does not complete. Break Fees may also focus the parties' minds on completing the transaction successfully. The circumstances in which Break Fees may be paid will be a matter for negotiation and will usually depend on which party is at fault.

Break Fees in favour of the Finance Parties are also common in Facility Agreements.

Care must be taken to ensure that Break Fee arrangements are not prohibited by the laws and regulations to which the parties and/or the agreement may be subject. Under English law, a Break Fee must not be a Penalty on the paying party as Penalty provisions are void and unenforceable under English law. Broadly, a clause will be a Penalty if it provides that – in the event of a breach – a sum is payable (or an entitlement or property is forfeited) which is not a genuine pre-estimate of the loss arising from the breach and which is excessive and without commercial justification. This is an evolving area of case law in recent times but for now caution is advised.

9 SET-OFF

There are many circumstances in which a party may want to exercise a right of Set-off, for example a Buyer may want to do this against a deferred purchase price payment obligation in order to satisfy a claim for breach of Warranty.

Set-off means, in essence, deduction. Where a creditor claims a debt and the debtor has a cross-claim against the creditor, a right of Set-off enables the debtor to reduce or extinguish the creditor's claim by deducting the amount of the cross-claim. Under English law, the

default position is that Set-off can be made of amounts that are due and owing under the same or a closely related transaction.

A Buyer will often look to extend its rights of Set-off, for example so that it can withhold/deduct disputed amounts (as without such a provision, the withholding/deduction of any amount, which does not comprise a debt which is due to the other, would potentially be a breach of contract by the party that withholds). A Seller will generally try to exclude all rights of Set-off. Rights of Set-out in favour of the Finance Parties are common in Facility Agreements.

10 WITHHOLDING TAX AND *GROSSING UP*

10.1 Withholding

Usually, payments are Taxed in the hands of the recipient of the payment (for example, capital gains). However, in certain circumstances it is not the recipient who has to account for the Tax due on the payment but the party making the payment. The Tax charged in such a role-reversal is called withholding Tax, since the payer is withholding part of the payment to pay Tax.

Therefore, the term *withholding Tax* does not refer to a discrete Tax as is sometimes thought. Instead, it refers to the payer's obligation to withhold a certain part of the payment it intends to make. A common example of this is the income Tax employers deduct from their employees' salaries.

An obligation to withhold Tax is often also imposed on the payer where the recipient of the payment is resident abroad. Depending on any Double Tax Treaties, the rate of withholding Tax could be significant.

A Buyer may seek to include a provision that the purchase price is to be paid net of any withholding Tax. This means that, should it transpire

that the Buyer is obliged to withhold Tax, any amounts in respect of Tax come out of the agreed purchase price.

Sellers will usually resist such a provision. Essentially, this is a question of risk allocation and the parties will need to agree who is to bear the cost of any withholding Tax in the event that any becomes due. The example below illustrates the effect of such a provision on both parties.

Example of a withholding provision

The parties agree on a purchase price of $100m.
The Buyer has to withhold Tax at a rate of 20%.

	SPA does not contain a withholding provision	**SPA contains a withholding provision**
Buyer's cost	**$100m** (of which $20m is paid to the Tax authority)	**$125m** (of which $25m is paid to the Tax authority)
Sellers' receipt	**$80m**	**$100m**

10.2 Gross up

In some circumstances, one party will also ask for a *Gross up* for Tax, so that it receives the full amount of any payment, including an additional amount to compensate it for any Tax that it is required to pay on this amount. Typically a Buyer will request this in relation to any payments to it by the Sellers under the Warranties and Indemnities.

No-withholdings and gross-up provisions in favour of Lenders are common in Facility Agreements.

11 DEFAULT INTEREST

Where there are payment obligations under the SPA after Completion (for example, some deferred Consideration or an Indemnity payment) the parties should consider including a Default interest clause. Such clauses are also usually included as standard in favour of a Lender in Facility Agreements.

Care needs to be taken to make sure that this does not constitute a Penalty, which is prohibited under English law. In the context of late payment interest, the Penalty issue becomes more relevant where the interest rate is extravagant or excessive in relation to the loss suffered. Default interest rates should therefore not be punitive, but reflect the reasonable loss suffered by the innocent party as a result of the Default.

Note that interest may give rise to withholding Tax.

12 FURTHER ASSURANCE

A further assurance clause seeks to cover any deficiencies in the agreement which may not be noticed when it is signed and which, if unremedied, would change the way the agreement was intended to work. However, generally it does not operate to correct mistakes.

For example, if a business transfer agreement purporting to transfer the Sellers' entire business to the Buyer does not pass title to a particular asset, the further assurance clause can be invoked by the Buyer after Completion in order to perfect title. Under its terms the Buyer can require the Sellers to execute an additional document of transfer and do such other things as may be required to transfer the relevant asset. However, if the agreement sets out an exhaustive list of all the assets to be transferred, then the Buyer would not generally be able to invoke a further assurance clause to require the Sellers to transfer further assets.

13 GOOD FAITH

Unlike some legal systems, English law does not impose a general duty of Good Faith on the parties.

However, where parties expressly state in the agreement that they are required to act in Good Faith, the Courts will give force to such provisions. Also, the English courts may sometimes imply a duty of Good Faith, especially if the contract is a *relational* one (such as joint venture agreement).

Honesty is the core requirement of the duty of Good Faith. What else is required is very much specific to the context of the agreement and may include:

- observing generally accepted standards of commercial dealing; and
- sharing information relevant to the performance of the contract.

This is an evolving area of case law in recent times but for now caution is advised when including such a provision.

14 RIGHTS, VARIATIONS & WAIVERS

14.1 Variations clauses

A variations clause is intended to ensure that a degree of formality is required for any variations to the agreement. The requirement for written variations is designed to exclude the possibility of informal, and perhaps inadvertent, oral variations.

As it is a question of fact as to whether the parties have agreed to vary the agreement, it is sometimes claimed that such clauses carry little or no legal weight. If both parties vary the contract by their subsequent

conduct and at a later stage one of the parties looks to a variations clause to invalidate the variation, there will be a clear conflict between these two actions. Therefore, it is arguable in such a case that two contracts may exist - the original one, which the parties agreed could not be varied; and a new agreement representing the variation. Clearly each case will depend on its specific facts.

14.2 No-waiver clauses

A so-called no-waiver clause is often included in an agreement to try to ensure that any failure to enforce contractual rights (either deliberately or by oversight) does not result in any waiver of those rights or remedies for their breach. Usually, they are used to prevent waiver of the right to terminate the agreement, although it is in this context that they may prove ineffective, as it is often difficult to draw any distinction between a variation and a waiver. In many cases, a variation by conduct is, in essence, no different from a waiver. For this reason, variation and no-waiver clauses are often combined into one variation and waiver clause.

The value of a no-waiver clause lies largely in the commercial influence it holds with the contracting parties. In certain circumstances, it may be ineffective if challenged in Court. However, it may be of help to support the assertion that a party had elected not to abandon a right (although to do so, case law indicates that there must be a clear and unequivocal communication).

15 NO MERGER

No merger clauses deal with a technical point under English law. Under the *doctrine of merger*, it can be argued in some circumstances that subsequent documents that actually effect a transaction also replace the agreement pursuant to which they have been entered into. Consequently, on that basis, rights and obligations under an SPA (including key rights and obligations such as Warranties and

Indemnities, Restrictive Covenants and so on) could cease on the date of the transfer document. No merger clauses are therefore intended to clarify the parties' intention that the doctrine of merger should not apply to the agreement, although this would be the case on a common-sense interpretation.

16 CUMULATIVE RIGHTS

The rights and remedies provided in an agreement are usually expressed to be cumulative and not exclusive of any other rights or remedies.

The purpose of such a clause is to make an express statement of the parties' intention that the rights and remedies set out in the agreement are in addition to their rights provided by the law in general and not a substitution for them. The more comprehensive an agreement is, the more likely the Courts will hold that the parties have set out all the terms which they intended to govern their relationship, to the exclusion of all other possible rights or remedies. Therefore, a cumulative rights clause should be included if the parties want to preserve the rights and remedies available to them under general law.

In other cases, it may well be that the parties do want to specify sole or exclusive remedies and if that is the case, the agreement should make it clear that those rights are the parties' only rights in relation to that matter.

17 THIRD PARTY RIGHTS

Although contrary provisions can be included in a contract, English law sometimes allows third parties which are not parties to a contract to enforce provisions in the contract which are beneficial to them. These are often referred to as Third Party Rights clauses. The third parties do not need to be specifically named, but they do need to be an intended beneficiary of the rights in question (and not just incidental).

An example of this in SPAs is where the Sellers agree with a Buyer not to bring claims against its (now former) employees and Directors – and the parties agree that those persons may (perhaps subject to the permission of the Sellers) directly enforce that benefit.

18 WAIVER OF CLAIMS

The Sellers in an SPA will often be asked to waive any claims they may have against the Directors, officers and employees of the Target at Completion. This can be done in the SPA, or in a separate Deed of waiver delivered at Completion.

The rationale for such a provision is to prevent the Sellers from bringing such claims after Completion, once the Buyer owns the Target. This might arise if, for example, the Buyer brings a Warranty claim against the Sellers and the Sellers then respond by saying that they were relying on information received from a particular Director or employee of the Target when negotiating the Warranty in question and making any relevant Disclosures against it.

Clearly such a claim by the Sellers would be disruptive to the ongoing business of Target and of great personal concern to the Director or employee involved; for these reasons the waiver is usually sought by the Buyer. The Sellers will often seek a carve-out in the case of fraud, which is acceptable and would be the case at law anyway.

Sometimes the waiver provision will also seek to protect auditors and professional advisers, although there is less logic for this and such references are usually deleted.

19 INVALIDITY

An invalidity clause seeks to ensure that, in the event that part of the agreement is held unenforceable, the remaining clauses are unaffected.

As mentioned in *Section E: Share Sale and Purchase Agreements (paragraph 15)*, Courts may apply a blue pencil rule, whereby parts of provisions which are unenforceable may be struck out to leave behind only those parts that are enforceable. However, they will only do so where it accords with public policy and where what remains requires no further modification. The Courts will not rewrite the parties' contract – for example by replacing an unenforceable covenant with one that has a lesser restriction.

Sometimes agreements will also expressly state that if any part is deemed void or unenforceable, then that part is deemed to be deleted and replaced with a lesser, enforceable restriction. As mentioned in *Section E: Share Sale and Purchase Agreements (paragraph 15)*, recent case law suggests that these provisions may have no effect and add nothing
to what the Courts would in any event do or not do under the blue pencil test.

20 TIME OF THE ESSENCE

If time is of the essence, then a failure to perform on time may entitle the other party to the contract to terminate it without notice. Time is not of the essence under English law, unless it is expressly made so.

Care should be taken where this is done, to make sure that it does not put a party in risk of breach of an otherwise relatively unimportant provision. Time of the essence provisions are not usually used in SPAs or Shareholders' Agreements and should be used with caution in finance documents.

21 COUNTERPARTS

It is usual for agreements to include a Counterparts clause.

Parties will often execute documents in Counterparts so that there exists either:

- multiple duplicate originals all executed by all parties; or
- a number of 'copies' each executed by only one party (so that each party has executed at least one copy).

In either case, each duplicate or the counterpart copies together constitute an original. This is useful as each party may then possess an original. Additionally, signing in Counterparts is common practice where the parties cannot all be physically present at the signing meeting (as in large, especially multi-Jurisdictional transactions with multiple parties), or where there is no physical signing meeting.

It is not necessary to include a Counterparts clause for the agreement to be valid. However, including a Counterparts clause may help prevent a party claiming that the agreement is not binding because there is not one original signed by all parties. It also avoids uncertainty about when the agreement takes effect.

Where a physical Completion meeting with *wet ink* signatures is not taking place, care should be taken to ensure that a recognised signing protocol is in place in advance. Swapping pre-signed signature pages into agreements that are not yet finalised is not recommended and can lead to issues later on in the event of a dispute.

22 LANGUAGE

A prevailing language clause is used if the agreement is prepared in more than one language, or is likely to be translated into another language. This avoids doubt about which version is to prevail if the agreement is the subject of litigation or Arbitration proceedings and

the different language versions of the same agreement are contradictory. Local language translations of key transactional documents will normally be required for submission to notaries, Tax authorities and so on.

In some countries the local language is specified by law as the prevailing language for agreements subject to the law of that country. If English is the prevailing language, the agreement is also likely to specify that any notices given pursuant to the agreement should also be in English.

It is not unusual on cross-border M&A deals for some of the original supporting documents to be in a different language, for example parts of the Disclosure Bundle or particular schedules to the SPA or Shareholders' Agreement. It may be prohibitively expensive and time-consuming to have these translated at the time the transaction is being implemented, particularly if both parties have native speakers who are comfortable with the documents in question. However, the parties should bear in mind that these documents may need to be translated by experts at a later date in the event of a dispute.

23 NOTICES

At some point in the future, it is likely that communications will need to be sent by one party to the other under the terms of the agreement. Notices clauses are included to facilitate this process by specifying the parties' details, addresses and acceptable methods of delivery. Usually, notices clauses will also set out when a communication will be deemed to have been received.

Notices clauses generally set out the only means by which notices may be served and non-compliance with the notices clause will mean that other communications are ineffective. This is therefore a very important part of the Boilerplate provisions. Case law shows that English Courts are likely to require notice provisions to be strictly complied with. However, if the provision is not clear, it may be construed as simply being permissive

- i.e. setting out means by which notices may be served, but allowing for service in other ways. This is generally not advisable as it may lead to uncertainty as to when a notice is received (which could be very important, e.g. in the case of deadlines for making claims).

The agreement will sometimes also require the appointment of an Agent for the Service of Process, so that a party does not need the Court's permission in order to serve Court proceedings on a party based outside of the relevant Jurisdiction of the agreement.

24 ENTIRE AGREEMENT

24.1 Background

In the case of M&A transactions, this is one of the most important Boilerplate provisions. Entire agreement clauses serve two main purposes:

- to confirm that the SPA is the whole agreement (*whole agreement* wording); and
- to exclude liability for pre-contractual statements (*no Representation / reliance / remedy* wording).

24.2 Whole agreement wording

Whole agreement wording confirms that the agreement between the parties is confined to the SPA and any other documents referred to in that agreement. Its purpose is to rule out any claim based on a *collateral Warranty* or *collateral contract*, in other words, a provision that sits outside of (and is collateral to) the main agreement.

However, whole agreement wording will not in itself prevent a party from claiming:

- that it was induced to enter into the SPA by means of a pre-contractual Representation; and/or

- for remedies in tort for a pre-contractual Representation repeated in the SPA.

24.3 No Representation/reliance/remedy wording

It is therefore common for the Sellers to also include a statement in the agreement that there are no Representations given outside of the SPA and/or a confirmation from the Buyer that it has not relied on any pre-contractual Representations and/or that it has no remedy in respect of them and is instead relying solely on the express terms set out in the agreement.

Without such a provision, the Buyer may be able to claim that:

- it has in fact relied on statements made to it during the negotiations, which were not reflected in the agreement; and

- therefore a collateral Warranty or pre-contractual Misrepresentation exists, which gives rise to a liability of the Sellers.

24.4 Carve-out for fraud

Often, the whole agreement clauses include an express statement that the parties do not seek to exclude liability for fraud. Such an exclusion would be void under English law anyway and it is often argued that if the entire agreement clause tried to exclude such liability, the whole clause could be struck out, although more recent case law suggests that the mere failure to carve-out fraud will not in itself lead to the whole provision failing. However, best practice remains to expressly state that any restrictions or limitations on liability do not apply in the case of fraud.

Where fraud is proven, the fraudulent party will not be able to rely on any limitation or exclusion clauses, including the entire agreement clause.

Individual Sellers will often want to expressly state that this only applies in the case of *their own individual fraud*, so that they do not lose their limitations protections in the case of fraud by third parties or even by their fellow Sellers. This is permissible and is a matter for negotiation.

25 CURRENCY CONVERSION

Currency conversion clauses are included to give certainty as to the rates at which amounts in different currencies are converted. This can be important, for example, when the parties need to determine whether a certain financial threshold under the agreement has been reached where different currencies are used. The provisions of such a clause will need to identify the currency rate and the timing of such conversion.

26 NO PARTNERSHIP

A Shareholders' Agreement will often state that it does not give rise to a partnership between the parties. This may sound unusual, since at a commercial level this is normally exactly what the parties would like to achieve. However, the purpose of the clause is to seek to avoid the venture being deemed a *legal partnership*. Depending on the rules of the relevant Jurisdiction, being deemed a legal partnership may have different legal and Tax consequences for the Shareholders and may also expose them to unlimited personal liability.

27 TAX LOSSES AND CONSORTIUM RELIEF

Depending on the relevant Jurisdictions of the Company and the Shareholders, the Shareholders' Agreement may include Tax specific provisions relating to consortium relief and the surrender of Tax losses.

28 CONFLICTING AGREEMENTS

It is usual to include a provision in the Shareholders' Agreement that, as between the Shareholders, the terms of the agreement will prevail over the Articles of Association of the Company. This will need to be made subject to any overriding local law requirements for the Company and usually the Company will not be able to unlawfully restrict its own statutory powers.

29 INDEMNITY IN FAVOUR OF DIRECTORS

Where the laws of the relevant Jurisdiction of the Company permit, Indemnities from the Company in favour of existing and former Directors and officers are sometimes included in the Shareholders' Agreement (or, more likely, the Articles of Association). These usually relate to liabilities to third parties and for costs of defence proceedings (subject to an obligation to repay if the defence is not successful).

30 REASONABLE ENDEAVOURS AND BEST ENDEAVOURS

English law contracts frequently use the concepts of Reasonable Endeavours, Best Endeavours and All Reasonable Endeavours to describe the efforts to which a party must go in order to ensure that something outside of its direct control will occur. Their purpose is to soften absolute obligations. These terms are not defined in legislation and have instead developed via case law. However, they continue to develop and what they require in any given situation will depend upon the circumstances and is an issue of *construction/interpretation* of the contract, not of extrapolating from other cases.

A brief summary of the different concepts is set out below.

Reasonable, Best and All Reasonable Endeavours	
Reasonable Endeavours	This requires a party to take reasonable steps to achieve an objective, taking into account its own commercial considerations. This may only require it to follow just one course of action that is reasonable in the circumstances.
Best Endeavours	This is the strictest of the three. Although it is not an absolute obligation, it requires a party to take all the steps within its power that a reasonable person, acting in its own interests, would take to achieve an objective, even if that involves expending money, commercial sacrifice and/or suffering a loss. However, it does not require a party to act in a way that would be financially ruinous to it.
All Reasonable Endeavours	Once considered a half-way point between Reasonable Endeavours and Best Endeavours, it has recently been held to be *approaching* best endeavours in what it requires. It probably requires a party to exhaust all (or certainly numerous) reasonable courses of action that may be available to achieve an objective. It may require a party to incur expenditure; however, the extent to which it may require a party to sacrifice its own commercial interests is unclear.

31 FORMALITIES RELATING TO DEEDS

English law recognises a special form of legal instrument known as a Deed. Deeds are subject to particular rules on execution and delivery and are required for certain English law contracts, such as in relation to a transfer of land.

In the case of contracts executed as Deeds, the standard limitation period for bringing claims for breach of contract is 12 years (as opposed to 6 years from the date the cause of action arises in the case of contracts signed underhand and not executed as Deeds), unless expressly varied by the parties.

For English companies, valid execution of Deeds requires:-

- the signatures of two officers (two Directors, or a Director and the secretary); or
- for the Company seal to be affixed in the presence of two officers; or
- the signature of one Director in the presence of an independent witness, who must then attest the signature in their capacity as witness.

For individuals, they must normally sign in the presence of an independent witness, who must then attest the signature in their capacity as witness.

In the case of non-English companies where their local law does not recognise the concept of a Deed, the general view is that they should just sign the Deed as they would a normal contract.

Unlike ordinary contracts under English law, Deeds do not require an element of Consideration to be binding. However, the equitable remedy of specific performance is only available where Consideration is given and so for this reason stand-alone Put and Call Options (i.e. those not

contained within a Shareholders' Agreement) will often expressly include the requirement to make a token payment (of say $1) in return for the grant of the option (in cases where it is not entirely clear that some other form of Consideration is being given as part of the overall deal).

It is important to note that a Power of Attorney under English law needs to be granted under a Deed. As mentioned earlier above, Powers of Attorney are often included in the Shareholders' Agreement in order to deal with the enforcement of various rights and so it is important to ensure that where the agreement includes a Power of Attorney, it is properly executed as a Deed.

SECTION K: THE COMPETITIVE CHALLENGE FROM CHINESE LAW AS AN ALTERNATIVE

1 BACKGROUND

One obvious question in relation to the Belt & Road initiative is whether over time, Chinese participants will begin to insist on using Chinese law to govern the principal investment documentation. There is some logic behind this, since in many cases it will be the Chinese companies and banks providing the bulk of the financing and so they will often hold the balance of power in negotiations.

In order to address this question, it is first worth assessing the current legal framework in China and how suitable it might be for outward-bound Belt & Road transactions. One interesting market development which is noted further below is the introduction by legal practitioners of English law concepts into Chinese law governed agreements.

2 CHINESE LAW

2.1 General introduction

The development of modern PRC law commenced after the establishment of the PRC government in 1949. The government refers to China's legal system as 'a socialist legal system having Chinese characteristics', but China's legal system is essentially a civil law system, consisting of statutes, administrative rules and regulations. It is influenced by European (particularly that of Germany) and Japanese civil law systems. Unlike common law systems such as those in England & Wales and the USA which incorporate case law as binding precedent, China's legal system does not give case law precedent legal effect and lower courts do not need to follow the decisions of higher courts.

However, lower courts are required to follow the judicial interpretations issued by the Supreme Court of China when adjudicating cases.

Hong Kong and Macau still maintain traditional legal systems which are different from Mainland China pursuant to the *One Country Two Systems Policy*. Hong Kong uses a common law system inherited from England, whilst Macau retains a system based on Portuguese civil law. The laws of Taiwan are also mainly based on a civil law system, which is codified into six codes, from the constitution to administrative laws. For the purposes of this guide in the following sections we focus only on Mainland China and do not cover the laws of Taiwan, Hong Kong or Macau.

3 SOURCES OF PRC LAW

PRC law derives from the following three sources:

- statutory law;
- judicial interpretation; and
- international treaties.

3.1 Statutory law

The PRC statutory law consists of laws in relation to constitution, civil and commercial, administrative, economic, social, and criminal matters and laws in relation to lawsuit and non-lawsuit procedures.

For instance, China has enacted in respect of the civil laws, amongst others, the following laws: General Principles of Civil Law, Contract Law, Guarantee Law, Auction Law, Trademark Law, Patent Law, Copyright Law, Marriage Law, Inheritance Law, and Adoption Law. In respect of commercial laws, the laws promulgated by Chinese legislative bodies include but are not limited to Company Law, Partnership Law, Securities Law, Insurance Law, Commercial Banking Law and Trust Law.

In respect of laws concerning lawsuit and non-lawsuit procedures, amongst others, the following laws have been enacted: Civil Procedures Law, Criminal Procedures Law, Administrative Procedures Law and Arbitration Law.

It would be difficult to list out all the laws currently in force in China, but generally speaking, PRC statutory law derives from the following four levels of laws: state laws, state administrative regulations, local statutes and state and local rules.

3.1.1 State laws

State laws include laws promulgated by PRC National People's Congress (the NPC) and its Standing Committee. The NPC enacts and amends basic laws in relation to criminal offences, civil affairs, state institutions and other matters. The Standing Committee enacts and amends all laws except for basic laws that should be enacted by the NPC and, in addition, the Standing Committee may also partially supplement and revise laws enacted by the NPC when the NPC is not in session, provided that the changes do not contradict with the basic principles of such laws.

The NPC Standing Committee also has the power to interpret a state law if the specific meaning of a provision needs to be further defined or new developments make it necessary to define the basis on which to apply to the law after its enactment. Such legal interpretation adopted by the NPC Standing Committee has the same legal effect as the laws enacted by it.

3.1.2 State administrative regulations

The PRC State Council (the State Council) issues state administrative regulations based on the Constitution and other laws enacted by the NPC and its Standing Committee.

3.1.3 Local statutes

Subject to the particular conditions and practical needs of the relevant administrative regions, the Peoples' Congresses of provinces, autonomous regions and municipalities directly under the supervision of PRC Central Government and the Standing Committees of such legislative bodies may enact local statutes. Such local statutes shall not contravene the Constitution or other state laws and administrative regulations enacted at the state level.

Similarly, subject to the specific conditions and practical needs of the relevant larger cities, their Peoples' Congresses and Standing Committees may enact local statutes and submit them to the Standing Committees of the Peoples' Congresses of the relevant provinces or autonomous regions for approval before they take effect. Such local statutes shall not contravene the Constitution, other laws and administrative regulations or local statutes passed by the relevant provinces or autonomous regions where such larger cities are located.

In addition, the Peoples' Congresses of national autonomous areas may formulate local statutes concerning autonomy and local needs in consideration of their own local political, economic and cultural circumstances, which shall take effect after they have been approved by the NPC Standing Committee. However, the local statutes enacted by the autonomous prefectures or counties will only take effect after they are approved by the Standing Committees of the People's Congresses of the provinces, autonomous regions, and municipalities directly under the Central Government.

3.1.4 State and local rules

The ministries and commissions of the State Council, the People's Bank of China, the State Audit Administration as well as the other organs endowed with administrative functions directly under the State Council may, in accordance with the laws as well as the administrative regulations,

decisions and orders of the State Council and within the limits of their power, formulate state rules. In addition, the people's governments of the provinces, autonomous regions, municipalities directly under the Central Government and the comparatively larger cities may, in accordance with laws and administrative regulations and the local regulations of their respective province, autonomous regions or municipalities, formulate local rules.

Laws promulgated by different legislative bodies do not have the same legal force. The Constitution has supreme legal force, followed by state laws which prevail over state administrative regulations, local statutes and state and local rules. State administrative regulations have greater force than local statutes and state and local rules. State rules and local rules have the same legal force.

3.2 Judicial interpretation

The Supreme People's Court of China is empowered to issue judicial interpretations as guidelines to the lower Courts. Such judicial interpretations have legal effect and constitute part of PRC law.

However, there is no definite answer as to whether such judicial interpretations shall prevail over the statutory law or alternatively have lesser legal effect than statutory law when there are inconsistencies between the two and this ambiguity creates great uncertainty in the enforcement of law in China. In practice, lower Courts tend to follow the judicial interpretations in their rulings.

3.3 International treaties

Although the PRC Constitution and the PRC Legislative Law have not specified that international treaties duly entered into by China are part of PRC law, there are some individual laws (such as the General Principles of Civil Law) which confirm that the provisions of international treaties, other than the provisions which are the subject of reservation made by

China, will prevail over the provisions of the respective laws if there are any inconsistencies, thereby making international treaties part of PRC law.

4 ENGLISH LAW CONCEPTS APPEARING IN CHINESE LAW-GOVERNED DOCUMENTS

4.1 Incorporation of English law concepts

Despite mainly bearing the characteristics of a civil law system, especially a German-influenced civil law system, PRC law is a mixed legal system and traces of English law concepts can be found in PRC law. In addition, as the volume of inward-bound and outward-bound investment in relation to Chinese companies has rapidly increased as China's influence has expanded both politically and economically in the past three decades, more and more China-related agreements have been drafted with English law concepts in mind.

For instance, in an inward-bound China deal where a foreign investor acquires the equity in a PRC domestic company and establishes a Sino-foreign joint venture company, PRC law requires that the relevant transaction documents be governed by PRC law. However, in practice and to facilitate the negotiation process and realise the commercial intentions of the parties, the lawyers acting for the parties will very often draft the SPA and the joint venture contract (Shareholders' Agreement) based on English law templates. This is because English law concepts are well-established and expected by international parties and it is a logical starting point.

Pursuant to PRC general principles of civil law and PRC contract law, as long as the provisions of the agreements do not contradict any mandatory rules under PRC law, the contractual arrangements between the parties should be deemed valid (with certain exceptions). Most of the English law concepts discussed earlier in this guide will appear from time to time and in various forms in PRC law governed agreements.

This is in direct contrast to the position in Jurisdictions such as Russia, where prior to its own civil code reforms, the inclusion of English law concepts into Russian law governed agreements would at best have been invalid and, where needed, might also have led to the notary public refusing to notarise the document in question.

4.2 Uncertainty risk

However, the approach of incorporating English law concepts into PRC law governed agreements, whilst making it easier for the drafting and negotiation process of the transaction agreements, may cause problems when it comes to the enforcement of such agreements in the PRC Courts if a dispute arises.

First, if agreements with English law concepts are not carefully phrased and structured so as not to violate the mandatory rules under PRC law, it might be impossible to enforce them. For instance, if the English law concept of Put and Call Options is incorporated, without necessary adjustments, into a PRC law governed joint venture contract which involves a target Company that conducts business in a restricted foreign investment industry that has a cap on the equity ratio for foreign investors, then the trigger of the Put or Call Option right may breach the cap and so be unenforceable.

In addition, the judges in PRC Courts, unlike the legal counsels who initially drafted and/or participated in the negotiations of such agreements and who most likely have been educated in common law countries, may not be familiar with the English law concepts built into such agreements. The interpretation of the relevant provisions of the agreements is therefore subject to judicial uncertainties. Since case law is not part of PRC law and there are no binding precedents to follow by the lower Courts, different Courts may reach different conclusions in respect of the interpretation of a particular English law concept.

SECTION L: SUMMARY CONCLUSIONS

For now the use of Chinese law for the principal documents on Belt & Road transactions remains limited and English law remains the dominant influence, followed by other similar common law systems such as Hong Kong and New York law. The principles of English law are clear and well-established and this gives parties confidence when transacting. English law is flexible and can be adapted to the commercial needs of the parties, with largely predictable outcomes in the event of disputes. The ability to use it with international Arbitration is hugely beneficial and convenient on cross-border transactions. In the case of transactions with Chinese counterparties, English law is regarded as a suitably neutral choice.

That is not to say that English law offers the perfect solution. Far from it. As explained earlier, Belt & Road transactions will by necessity involve a complex web of different Governing Laws and Jurisdictions and this will always be less than perfect in the event of a problem or dispute, because it throws up the potential for overlapping or even conflicting points at different levels or under different laws. Lawyers drafting the legal documents will contemplate this and try to address it as best they can, but it will never be a perfect outcome where, say, the finance is being provided in one country but the security is sitting in another; or where a party is based in one country and the counterparty in another. The issue becomes even more complex where (as is often the case) different key transaction documents are between different parties – for example, the Facility Agreement is between the bank and the project Company, but the Shareholders' Agreement is between the Company and its Shareholders, whilst the Concession Agreement is between the project Company and a government body. There is no easy solution to this and no one-size-fits-all framework for Belt & Road transactions.

Time will tell whether the trend towards using English law will change. Instinctively one would expect there to be a greater demand amongst Chinese

companies and banks for PRC law, particularly on those projects where they are providing the financing and/or hold the upper hand in negotiations. Logically, they will be more familiar and comfortable with PRC law and Chinese language documents, will have easier access to Chinese lawyers and will be more comfortable settling disputes in China. However, the converse will of course be true in the case of non-Chinese counterparties. For them the language barrier is a high one and Chinese law firms are not yet truly global in the same way that English and US law firms have become. Also, many non-Chinese counterparties will not be familiar with or fully understand the Chinese legal system and (fairly or not) may not trust its Courts and Arbitration Tribunals to always reach an unbiased outcome which does not favour the Chinese party.

For now, most Chinese parties seem comfortable using English or a similar foreign law for Belt & Road transactions. Where the question of using PRC law is sometimes raised, this is usually as a tool in negotiations and is traded for some other concession on the deal.

Another final consideration is the so-called *bankability* of projects that require not just Chinese financing but also (or instead) financing from non-Chinese banks. This might include where the financing is being provide by an international syndicate of banks or will be syndicated after Completion. All banks will require the project to be *bankable*, loosely meaning that it makes sense for them economically and has been legally structured in a manner which is regarded as market standard and will protect the bank's money, reputation and other commercial interests and allow it to enforce its rights in the event that there is a default. In the context of Belt & Road transactions, most Western and Japanese banks are likely to insist on the comprehensive provisions and protections of English law to help achieve this.

Much of course will also depend on how quickly PRC law can continue to develop and adapt to the challenges and opportunities being created by the Belt & Road initiative and how quickly non-Chinese parties can become accustomed to and be comfortable with PRC law and Dispute Resolution

options in China. Given the massive proposed scale and reach of Belt & Road, anything and everything is possible and we eagerly wait and watch to see what the future might hold.

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GLOSSARY

Cross-references in this glossary are to Sections and paragraph numbers

Agent	In the context of a *Facility Agreement*, the bank appointed as agent for the syndicate of *Lenders*. See *Section F.16.*
AIIB	Asian Infrastructure Investment Bank.
All Reasonable Endeavours	A requirement under English law, once considered a half-way point between *Reasonable Endeavours* and *Best Endeavours*. It has recently been held to be "approaching" *Best Endeavours* in what it requires. It probably requires a party to exhaust all (or certainly numerous) reasonable courses of action that may be available to achieve an objective. It may require a party to incur expenditure; however, the extent to which it may require a party to sacrifice its own commercial interests is unclear. See *Section J.30.* See also *Reasonable Endeavours and Best Endeavours.*
Anti-embarrassment	A contractual provision in a *Sale and Purchase Agreement* entitling the *Sellers* to additional *Consideration* if the *Buyer* resells the *Target* at a significant gain within a short period of time after *Completion*.

Arbitration	An alternative *Dispute Resolution* method where an *Arbitration Tribunal h*ears and decides the dispute. See *Section B.3.*
Arbitration Tribunal	A tribunal of arbitrators which has the power to hear and decide matters which the disputing parties referred to *Arbitration*. See *Section B.3.*
Arranger	In the context of a *Facility Agreement*, the bank which has been awarded the mandate by the *Borrower* to arrange the loan. See *Section F.16.*
Articles of Association	The articles of association of a company contain the powers of the company and govern the relationship between the shareholders and the company. Sometimes referred to as the *Charter*.
Auditors	Auditing accountants who review a company's annual accounts and make a declaration to shareholders as to the accuracy of those accounts.
Audited Accounts	Accounts prepared to an audited standard, reviewed and confirmed by a company's *Auditors*.
Auction Sale	A sale process by which an asset or a company is offered for sale in a competitive bidding situation.
Bad Leaver	See *Leaver Provisions*.

Best Endeavours	A requirement under English law for a party to take reasonable steps to achieve an objective, taking into account its own commercial considerations. Although it is not an absolute obligation, it requires a party to take all the steps within its power that a reasonable person, acting in its own interests, would take to achieve an objective, even if that involves expending money, commercial sacrifice and/or suffering a loss. However, it does not require a party to act in a way that would be financially ruinous to it. See *Section J.30.* See also *Reasonable Endeavours* and *All Reasonable Endeavours*.
Bilateral Investment Treaties (BITs)	A trade pact or agreement establishing the terms and conditions for private investment by nationals and companies of one state in another state. See *Section B.2.*
Board of Directors or **Board**	The governing body of a company, elected by the company's members/shareholders to establish the company's policy, appoint officers and make major business decisions.
Boilerplate	Standard provisions in a contract dealing with administrative and other matters. See *Section J*.
Borrower	The person or entity taking a loan from a *Lender* under a loan agreement or *Facility Agreement*. See *Section F.2.*
BOT contract	Build-Operate-Transfer contract.

Break Fees	A contractual payment made by one party to the other party upon the occurrence of a specified event. *See Section J.8.*
Buyer	A company or an individual who is willing to pay a certain price for a certain asset or company.
Call Option	The right of one party to acquire the shares or assets of another party in certain circumstances. See *Section D.25.*
Chairman	A *Director* with responsibility for overseeing meetings of the *Board of Directors*.
Change of Control	A change of the ownership, control and/or voting rights of a company.
Charter	See *Articles of Association*.
Closing	See *Completion*.
Completion	The final stage of a transaction, where the necessary formalities to close the deal are performed and ownership of the *Target* is transferred from the *Sellers* to the *Buyer*. Sometimes referred to as *Closing*.
Completion Accounts or Closing Accounts	A contractual mechanism in a *Sale and Purchase Agreement* whereby accounts of the *Target* and its business are drawn up as at *Completion* and the purchase price is adjusted if the actual position at *Completion* (for example in relation to net assets) is different from the values assumed in setting the price. See *Section E.7.*

Concession Agreements	Contracts between a company and a government, or between an owner and an operator, that gives the right to operate a specific business or asset within the government's territory or under the owner's control, subject to agreed terms and conditions. See *Section B.2.*
Conditions Precedent (CPs)	In the context of an M&A deal, those clauses which provide that certain parts of the *Sale and Purchase Agreement* will only come into force if and when agreed conditions are met or are waived. Usually these are conditions to *Completion*. See *Section E.12.* In the context of a *Facility Agreement*, those clauses which provide that the *Facility* will only be available for draw-down/utilisation once agreed conditions are met or are waived. See *Section F.4.*
Conditions Subsequent	Conditions that have to be met post-*Completion*. An obligation subject to Conditions Subsequent will bind the parties and in some very limited circumstances may give one or both parties the right of termination in the event the Conditions have not been satisfied.
Confidentiality Agreement	An agreement that binds one or more parties with confidentiality undertakings to hold all confidential information received on a confidential basis.

Consideration	The purchase price payable by the *Buyer* to the *Sellers* in respect of the *Target*. See *Section E.6. and E.9.*
Consideration Shares	Shares of the *Buyer* (or its group) issued to the *Sellers* in part or full payment of the *Consideration*. See *Section E.10.*
Counterparts	Multiple original copies of a document, each executed by only one party (so that each party has executed at least one copy). See *Section J.21.*
Court	A governmental institution with the authority to adjudicate legal disputes and carry out the administration of justice in civil, criminal and administrative matters.
Covenants	In the context of a *Facility Agreement*, the positive and negative covenants given by the Borrower to the Lender in relation to the running of its business during the term of the Facility. See *Section F.12.* In the context of an M&A deal, see also *Veto Rights*.
Data Room	A room, whether electronic or physical, containing information on the *Target*. See *Section I.5*.
Deadlock	A situation where the *Board* or shareholders of a company do not agree on a matter and the *Shareholders' Agreement* provides a mechanism to bring the stalemate to an end (e.g. by resolution, determination or buy-out). See *Section D.21.*

Debt Free, Cash Free	In the context of an M&A deal, this relates to an offer made by the *Buyer* for the *Target* at a price which does not take into account the financing debt or cash position of the *Target*. See *Section E.7.*
Deed	A special type of legal instrument under English law by which an interest, right or property passes or is confirmed, or an obligation binding on some person is created or confirmed. See *Section J.31.*
Deed of Adherence	A *Deed* which is entered into by one or more new shareholders in order to make them become parties to an existing *Shareholders' Agreement*. See *Section D.12.*
Default	In the context of a *Shareholders' Agreement* these are specific events relating to one shareholder (such as its failure to perform its obligations, insolvency or *Change of Control*) which entitle the non-defaulting shareholder to exercise certain rights (such as a *Call Option* and/or a *Put Option*). See *Section D.22.* In the context of a finance deal, see also *Events of Default.*
Director	A member of the *Board of Directors*.
Directors' and Officers' (D&O) Insurance	Insurance for the benefit of the *Directors*.
Disclosure Letter	A letter from the *Sellers* (or *Warrantors*) to the *Buyer*, setting out *Disclosures* against the *Warranties*. See *Section I.*

Disclosure(s)	The general and specific matters disclosed in the *Disclosure Letter* which constitute exceptions and qualifications to the *Warranties*. See *Section I*.
Disclosure Bundle	The agreed bundle of documents to be annexed to the *Disclosure Letter*. See *Section I*.
Dispute Resolution	The method of resolving a dispute between the parties to an agreement. See *Section B.3*.
Double Tax Treaty	A reciprocal agreement between two countries not to apply *Tax* twice to the income earned by an entity/person in one country and repatriated to the other. See *Section B.2*.
Drag Along	A contractual right that allows one or more shareholders (usually the majority shareholder(s) or an institutional investor) to force the remaining shareholders to accept an offer from a third party to purchase the whole company, where the majority shareholder(s) have accepted that offer, on the same terms. See *Section D.24*.
Due Diligence (DD)	The process of investigating a potential investment in, or acquisition of, the *Target*.
Dutch Auction	An auction bidding process, sometimes used for Deadlock resolution in a *Shareholders' Agreement*. See *Section D.21*.
Earn-Out	A contingent price mechanism in a *Sale and Purchase Agreement* which determines the amount of any deferred payments which may become due to the *Sellers* by reference to the actual future economic performance of the business (e.g. revenue or profits). See *Section E.9*.

EPC contract	Engineering, procurement and construction contract.
Escrow Account	See *Retention Account*.
Events of Default	In the context of a *Facility Agreement*, the events which will entitle the *Lender* to call or accelerate early repayment of the loan. *Section F.14*. In the context of a *Shareholders' Agreement* see also *Default*.
Exchange	The legal process where the parties formally agree to enter into the transaction and actually sign contracts. Sometimes referred to as signing.
Exclusivity Agreement	An agreement or contractual provision designed to protect a prospective *Buyer* from rival bidders, by preventing the *Sellers* from entering into negotiations or actively soliciting a rival bid during a specified period of time.
Fair Value	The amount for which an asset (such as shares) could be exchanged in an arm's length transaction between unrelated, willing parties who are reasonably well-informed. See *Section D.13*.
Facility	The loan facility being made available under a *Facility Agreement*. See *Section F*.
Facility Agreement	An agreement or letter in which a *Lender* sets out the terms and conditions (including the *Conditions Precedent*) on which it is prepared to make a loan *Facility* available to a *Borrower*. See *Section F*.

Finance Parties	The *Lenders*, *Agent*, *Arranger and Security Trustee* under a *Facility Agreement*.
Financial Covenants	In the context of a *Facility Agreement*, those *Covenants* given by the *Borrower* to the *Lender* which relate to the on-going testing of the financial health of the business. See *Section F.13*.
Force Majeure	An event or effect that cannot be reasonably anticipated or controlled by the parties which leads to the impossibility of performance of the parties' obligations. See *Section E.14*.
Gin and Tonic	A method of resolving a *Deadlock* by referring the matter in dispute to more senior representatives of the parties. See *Section D.21*.
Good Faith	An open and honest manner in which one party deals with another which may be required by contract or, in certain Jurisdictions, by law. See *Section J.13*.
Good Leaver	See *Leaver Provisions*.
Governing Law	The law which applies when interpreting what the provisions of a contract mean and in determining disputes. See *Section B.3*.
Gross(ing) up	A process to calculate the gross amount of a payment, before withholdings or *Tax*. See *Section J.10*.
Guarantee	An undertaking given by a third party (*Guarantor*) that, if a party does not pay or perform, the *Guarantor* will pay and perform in its place. See *Section E.4. in relation to M&A deals* and in the context of a finance deal *Section F .2*.

Guarantor — The party giving a *Guarantee*. See *Section E.4. in relation to M&A deals* and in the context of a finance deal *Section F .2*.

Heads of Agreement — See *Heads of Terms*.

Heads of Terms — A document setting out the main terms agreed in principal between the parties in the early stages of a transaction.

Hive Down — An internal reorganisation of a company whereby certain assets and liabilities are transferred to a new company.

Hold Harmless Letter — A contract between two parties, for example the *Auditors* and a *Buyer*, confirming that one party will be "held harmless" and indemnified by the other in relation to the release of confidential papers or reports.

Indemnity — A binding promise by one party to hold another party harmless in relation to a particular liability or event (so that it pays to that other party a sum equal to any cost or loss it incurs as a result). See *Section G.9*.

Information Memorandum — In the context of an M&A deal, a selling document which gives bidders a reasonable amount of information about the *Target* in order to elicit meaningful bids.

In the context of a finance deal, an explanatory document from a *Borrower* to elicit potential interest from *Lenders*.

Intellectual Property Rights (IPRs)	Intangible rights protecting the products of human intellect, such as patents, trademarks and copyright.
Intercreditor Agreement	A contract (often executed as a *Deed*) which regulates the respective rights and ranking of two or more funders (often both debt and equity) in a financing.
Initial Public Offering (IPO)	Initial issue of securities by a particular entity on a recognised exchange.
Joint and Several Liability	Where an obligation is owed by two or more parties and any one of them can be required to perform it in full or they can be jointly required to perform it. See *Section J.7*.
Jurisdiction	In the context of a dispute, the country whose *Courts* will determine any dispute or the terms of agreement by the parties to refer any dispute to an Arbitration Tribunal. Also, in the case of persons and legal entities, the administrative laws and location to which that person or entity is subject. See *Section B.3*.
Leakage	In the context of *Locked Box*, prohibited extractions of cash or value from the *Target* by or on behalf of the *Sellers* prior to *Completion*. See *Section E.8*.
Leaver Provisions	Provisions used to require an employee who is also a shareholder of the company to transfer his/her shares back to the company if he leaves in certain circumstances. See *Section D.26*.

Legal Opinion — An opinion from lawyers issued in letter form expressing legal conclusions or legal analysis of a transaction or matter, to be relied on by the addressee of the opinion.

Lender(s) — The person or entity making a loan *Facility* available to a *Borrower*. These are usually commercial banks but can be other financial institutions. See *Section F.2*.

Liquidated Damages — Under English law, a fixed or determined sum agreed to be payable on breach of contract which is a genuine pre-estimate of the loss likely to be incurred. See also *Penalty*.

Letter of Intent (LOI) — See *Heads of Terms*.

LIBOR — The London Interbank Offered Rate. It is the rate at which the *Lender* can expect to obtain funds in the inter-bank market. See *Section F.8*.

LMA — The Loan Market Association. *Section F.1*.

Lock-in — A period during which no shares can be transferred, other than to permitted transferees. See *Section D.10 and D.11*.

Locked Box — A contractual mechanism in a *Sale and Purchase Agreement* where the price payable for the *Target* is determined by reference to a historical balance sheet or set of accounts. An alternative to *Completion Accounts*. See *Section E.8*.

Locked Box Accounts — The agreed set of accounts to which the *Locked Box* relates. See *Section E.8*.

Management Accounts	Unaudited internal accounts produced on a monthly or quarterly basis, usually including a profit and loss account, balance sheet and cash flow statement.
Material Adverse Change (MAC)	A clause in an agreement which aims to give the *Buyer* the right to walk away from the acquisition before *Closing*, if events occur that are detrimental to the *Target*. See *Section E.14*.
Material Contract	A contract which is of a significant financial or strategic value to a company.
Memorandum of Understanding (MOU)	See *Heads of Terms*.
Misrepresentation	A false representation made by one party to another in the course of negotiating a contract, which induces the other party to enter into the contract. See *Section G*.
M&A	Mergers and acquisitions.
Negative Pledge	A *Covenant* from a *Borrower* to a *Lender* in a *Facility Agreement* not to create security over its assets in favour of a third party. Relevant where the *Lender* is unsecured or only has a floating and not fixed charge over those assets. See *Section F.12*).
Net Asset Value	The value of a company's assets less the value of its liabilities.
Net Debt	Total debt minus cash and cash equivalents.

New York Convention	1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.
Non-Disclosure Agreement (NDA)	See *Confidentiality Agreement*.
O&M contract	Operation and maintenance contract.
Penalty	A clause in a contract that calls for a sum to be paid or other detriment suffered by a party in the event of a breach, which is utterly excessive and the primary purpose of which is to deter breach, rather than compensate for loss (unlike *Liquidated Damages*). See *Section J.8*.
Permitted Leakage	In the context of *Locked Box*, expressly permitted extractions of cash or value from the *Target* by the *Sellers* prior to *Completion*. See *Section E.8*.
Power of Attorney (PoA)	A written authorisation to represent or to act on other's behalf (which must be given by way of a *Deed* under English law).
PPP (or **P3** or **3P**)	Public/Private Partnership.
Put Option	The right of one party to require another party to buy its shares or assets in certain circumstances. See *Section D.25*.
PRC	The People's Republic of China.
Quorum	The minimum number of *Directors* or shareholders required for a valid meeting of *Directors* or shareholders (as appropriate) to take place.

Reasonable Endeavours	A requirement under English law for a party to take reasonable steps to achieve an objective, taking into account its own commercial considerations. See also *All Reasonable Endeavours* and *Best Endeavours*. See *Section J.30*.
Red Flag Report	A short form of a *Vendor Due Diligence Report*, prepared on behalf of the *Sellers* to provide high level guidance to the *Buyer* when it is carrying out its own *Due Diligence*.
Reliance Letter	In the context of an M&A transaction, a letter from the provider of a *Vendor Due Diligence Report* in favour of the *Buyer*, allowing it to rely on the report.
Representation	A statement by a party which induces the other party to enter into the contract. See *Section G.2*.
Reserved Matters	See *Veto Rights*.
Restrictive Covenants	Contractual provisions not to enter into competition or similar undertakings given to protect goodwill. See *Section E.15*.
Retention Account	An account set up to hold retained amounts from the *Consideration* often as security for potential claims or whilst *Completion Accounts* are being determined and usually administered by an escrow agent. See *Section E.11*.

Russian Roulette — An auction bidding process, sometimes used for *Deadlock* resolution in a *Shareholders' Agreement* for a joint venture whereby one party (A) offers to buy the stake of the other party (B) at a certain price – and B must either sell its stake to A, or buy A's stake, at that price. See *Section D.21*.

Sale and Purchase Agreement (SPA) — A contract between the *Buyer* and the *Seller* for the sale and purchase of the *Target*. See *Section E*.

Security Trustee — On syndicated loans and certain other loans, the entity holding the security over the *Borrower's* assets on trust for the syndicate *Lenders*. See *Section F .16*.

Seller(s) — The seller(s) of the *Target*.

Service Agreement — A contract of employment between a company and an employee.

Set-off — A right to deduct the amount of a claim against another party from an amount owed to that party. See *Section J.9.*

SHA — See *Shareholders' Agreement*.

Share Ratchet — A contractual mechanism contained in a *Shareholders' Agreement* or *Articles of Association* under which the number of a shareholder's shares and/or the amount of *Consideration* sale proceeds that they receive on an exit (sale or *IPO*) is increased or decreased (ratcheted up or down) according to an agreed performance formula. See *Section D.27*.

Shareholders' Agreement (SHA)	A contract between some or all of the shareholders and often the company, which generally deals with management, funding of the company and any relations between the parties including additional rights and obligations of shareholders as well as the methods for their enforcement. See *Section D*.
SOEs	State-Owned Enterprises.
SPA	See *Sale and Purchase Agreement*.
Special Purpose Vehicle (SPV)	A company created specifically for certain objectives of the deal in question, often to avoid financial risks or legal complexities associated with some *Jurisdictions* and/or to ring-fence assets and/or liabilities.
Step-in Rights	A contractual mechanism contained in a *Shareholders' Agreement* or *Articles of Association* which allows one party to "step in" and take control of the voting at *Board* and/or shareholder level in certain circumstances. See *Section D.23*.
Swamping Rights	See *Step-in Rights*.
Tag Along	A contractual right that entitles one shareholder to participate in a sale by the other shareholders at the same time and at the same price per share. See *Section D.24*.
Target	A company (and, where relevant, its subsidiaries) that is the subject of a sale and purchase between a *Buyer* and *Seller(s)*.

Tax or **Taxation**	A financial charge imposed by a state or local government body on a taxpayer, including income and capital gains taxes, corporate taxes, sales taxes, transfer taxes, employer-related taxes, social taxes and so on.
Tax Deed	A *Deed* that provides for *Tax Indemnities* in respect of pre-*Completion* Tax risks. See *Section G.9*.
Term Sheet	See *Heads of Terms*.
Texas Shoot Out	An auction bidding process, sometimes used for *Deadlock* resolution in a *Shareholders' Agreement* for a joint venture whereby one party (A) offers to buy the stake of the other party (B) at a certain price – and B must either sell its stake to A at that price or offer to buy A's stake at a higher price (and if B's offer is not accepted by A, each party submits a sealed bid). See *Section D.21*.
Thin Capitalisation	*Tax* anti-avoidance rules determining how much of the interest paid on corporate debt is deductible for *Tax* purposes.
Third Party Rights	The right of a third party to enforce a benefit given to it in a contract to which it is not a party. See *Section J.17*.
Transitional Services Agreement	A contract between the *Sellers* and the *Target* and/or the *Buyer* relating to the provision of ongoing services from the *Sellers* (or their group) to the *Target* and/or the *Buyer* for an agreed period after *Completion*.

Ultra Vires activities	Activities that are beyond the legal capacity of the entity undertaking them.
UNCITRAL	United Nations Commission on International Trade Law.
VAT	Value added *Tax*.
Vendor Due Diligence Report	A *Due Diligence* report prepared by the advisers to the *Sellers* and to be addressed to the *Buyer* at *Completion*.
Veto Rights	A contractual power to prevent certain matters being undertaken in relation to a company or its group without the prior consent of the holder of the veto rights. See *Section D.18.* and *Section E.13*. In the context of a finance deal, see also Covenants.
Warrantors	In the context of an M&A deal, those persons (often the *Sellers*) who are giving *Warranties* to the *Buyer* in respect of the *Target* and its business. In the context of a finance deal, the *Borrower* when it is giving *Representations* and *Warranties* to the *Lender* under the *Facility Agreement*.
Warranty and Warranties	A contractual statement by a party that a particular state of affair exists and breach of which entitles the innocent party to claim damages. See *Section G.3*.

Warranty and Indemnity Insurance (WII)	An insurance against liability under *Warranties* (and sometimes also *Indemnities*). See *Section G.8.*

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