URÍA MENÉNDEZ

LITIGATION IN THE CONTEXT OF INTERNATIONAL M&A TRANSACTIONS. CASE STUDY

Javier Tortuero

Uría Menéndez, New York

1. INTRODUCTION

The purpose of this paper is to briefly analyze three different cases that either have or could potentially have resulted in litigation. All of these cases have occurred in the context of international M&A transactions.

The cases have been carefully selected for the purposes of discussion. Each of them occurred at different stages of the process of a typical M&A transaction.

The first one took place once a letter of intent (LOI) was executed, but before the parties reached a final agreement in connection with the acquisition of the target business.

The second one, relating to a sale and purchase agreement with a delayed signing and closing, took place once the conditions to which the effectiveness of the transaction was subject were satisfied, but prior to the consummation of the transaction.

Finally, the third one took place once the acquisition was consummated through a voluntary tender offer launched over a listed company.

All three cases present different fact patterns that will help the reader to reflect about the potential outcome of the actions of the players involved in the deals.

For the sake of brevity, only the main facts of each transaction have been summarized in the background section of each case. Furthermore, for confidentiality reasons, the names of the parties and other details of the transactions have been omitted.

2. LETTER OF INTENT

2.1 Background

In this case, the controlling shareholder of a company (who owned a controlling stake of over 80% of the company's equity) intended to sell 100% of the company. To that end, that seller negotiated and executed a LOI with one of the potential buyers. In the LOI, both parties agreed on the object of the transaction (*i.e.*, 100% of the company's equity) and the consideration. Notwithstanding, the closing of the transaction was subject to certain conditions (among others, reaching an agreement regarding the representations and warranties regime). Furthermore, the closing of the transaction should take place before a certain date and the parties agreed to an exclusivity period during which the seller would not negotiate with anyone else without previously notifying the buyer.

The LOI did not contain an express non-binding clause. However, the language of the LOI was consistent with the idea that it was a non-binding agreement ("*the parties have the strong desire*", "*the parties intend to*", "*if the closing does not occur*", etc.)

Even though after signing the LOI the parties negotiated in good faith, the exclusivity period expired without having reached an agreement. The day after the expiration of the exclusivity period the buyer filed a lawsuit requiring the execution of the transaction based on the fact that the LOI was a comprehensive, binding agreement setting forth in detail all of the material terms of the parties agreement regarding the sale of the company.

2.2 Discussion

For completely understanding this case and the legal discussion it entailed, it is important to bear in mind the obligation to exercise rights according to good faith that exists in all common law legal systems[1] and the fact that, however counterintuitive it may seem, under Spanish law share purchase agreements do not need to be in written form to bind parties and create legal, valid and enforceable obligations[2].

In this case, the plaintiff –*i.e.*, the buyer– argued that the LOI was a binding agreement which contained the main terms of the transaction –*i.e.*, object and consideration– and that the outstanding terms were either agreed in the LOI or determined by the parties during the negotiations (either expressly or tacitly) and, therefore, the seller had to sell its stake in the company.

1 The good faith principle obliges the parties in a negotiation to conduct in good faith and to exercise their rights according to it. The consequence of not doing so is that the other party will be entitled to an indemnification.

2 At least from a theoretical perspective, because it is almost impossible to find a non-written SPA.

As for the defendant (the seller), it pleaded that the LOI was nothing more than an agreement to regulate the negotiations, that it did not bind the parties to execute the transaction and that it only obliged to negotiate in good faith but not to sell or buy.

Eventually, the buyer's claim did not succeed but it was only because the court understood that the consideration was not sufficiently determined in the LOI[3]. In other words, what seemed obvious for the seller and its advisors: that the LOI did not constitute an agreement to sell the company but an agreement to negotiate the sale of the company, was not so obvious to the buyer and the court and resulted in a process that prevented the sale of the company for several months.

Two conclusions can be drawn from this case: (a) when negotiating any kind of agreement it is important to decide if you want it to be binding or not and to clearly state it in the agreement and afterwards to behave consistently with what has been agreed[4]; and (b) any dispute among the parties that results in litigation will almost for sure thwart the M&A transaction and prevent the transfer of the asset not only between the parties in the proceedings but also for other potential buyers[5].

3. TERMINATION OF A SALE AND PURCHASE AGREEMENT

3.1 Background

In this case, a private equity was intending to acquire a business based in Spain and in certain Latin American countries. The business was ultimately owned by a Luxembourgian company. The transaction was structured as a share deal involving the acquisition of the shares of the Luxembourgian holding company. The legal team was lead by counsel in Spain and also involved legal counsels in the country of origin of the private equity, Luxembourg (both for the buyer and the seller) and in the Latin American countries where the business was present.

The target was a tech business, which core activity was the development of certain IT systems and algorithms. For obvious reasons, the buyer was interested in verifying the correct

---

3 There were references to a representations and warranties regime that would have had an impact on the consideration agreed in the LOI.

4 There is little point in drafting carefully the LOI for not being binding if in the correspondence exchanged and in the meetings held afterwards the parties consider it and treat it as binding, and *vice versa*.

5 It is almost impossible to sell a company when the ownership of its shares is being discussed in a proceeding.

functioning of those systems and algorithms. At the same time the seller was reluctant to give full access to the buyer to those critical assets in the due diligence phase. Among other reasons, the fact that the private equity intending to acquire the business was the owner of certain other businesses that were competing with the target business in other regions resulted in the parties reaching an agreement to allow an independent third party to conduct the technical due diligence over the IT systems and algorithms. However, the seller required the buyer to provide evidence of its real intentions to acquire the business and of its capability to raise the required funds to pay the purchase price if the due diligence was satisfactory.

As a result, the parties agreed to enter into a sale and purchase agreement (SPA) with a delayed signing and closing and subject to completion of certain conditions precedent. The main condition was the verification by the independent third party of the required characteristics and correct functioning of the IT systems and algorithms. To prove certainty of funds, upon signing the SPA, the buyer deposited 25% of the purchase price (several million euros) in an escrow account opened specifically for these purposes at an international bank.

All the conditions to which the consummation of the transaction was subject were met and the parties agreed in writing on a closing date by exchanging closing notices. However, two days prior to closing, the seller sent a notice to the buyer alleging that the transaction could not close since the way in which the financing and the related security package was structured by the buyer and its financiers could impact the credit rating of the target business, which may also impact the earn-out provisions contemplated in the SPA. In addition, the security package implied taking security over certain of the target business' assets (as it is customary in transactions of this nature), for which purposes the consent of the seller was required under the SPA. The seller claimed the application of this provision of the SPA and refused to give consent to the taking of security, something which obviously led to the cancellation of the closing.

The parties had been working for several months on the transaction and the seller was aware of the security package which, as mentioned, was standard of this kind of transactions. Thus, the buyer was under the view that the seller was raising a pure technical point to abort the transaction.

3.2 Discussion

Upon receipt of the notice from the seller leading to the cancellation of the closing, the buyer and its advisors analyzed the alternatives available to seek remedies from the seller. There were several options available:

(i) Do nothing.

(ii) Negotiate with the seller the termination of the SPA.

(iii) Negotiate with the seller the termination of the SPA and the payment of compensation for the damages suffered.

(iv) File a lawsuit against the seller for acting in bad faith, claiming damages and required either the fulfillment of the SPA or its termination.

In analyzing all these alternatives, the buyer and its advisors took into account the fact that the buyer had deposited several million dollars in escrow.

In this regard, it should be highlighted that the SPA was governed by the laws of the Grand Duchy of Luxembourg. Any disputes under the SPA were subject to the jurisdiction of the courts of the city of Luxembourg. However, the escrow agreement was governed by the laws of the Kingdom of Spain and subject to the jurisdiction of the courts of the city of Madrid (Spain).

After analyzing the different alternatives available, the buyer and its advisors reached the conclusion that, under the circumstances, it would be essential to recover the funds deposited in escrow as soon as possible. Otherwise, being aware that there was a dispute, the escrow bank would retain the funds until there was a court resolution in favor of any of the parties or they reach an agreement and jointly instruct the escrow bank to release the funds. Obtaining a court resolution in favor of any of the parties could take several months or even years.

Regardless the fact that it was more than likely that the buyer would succeed in any claim against the seller, the buyer decided to propose the seller to voluntarily terminate the SPA without any of the parties being liable to the other and to send a joint notice to the escrow bank to release the funds in favor of the buyer. The seller obviously accepted this proposal and the buyer recovered the escrowed funds.

This is an example of a situation where one of the parties has clear chances of obtaining a favorable ruling in the context of a claim against the other but where the fact that litigation could drag for several years affects the decision making process. In this case, the buyer took a practical approach and decided to recover the escrow funds (considering also the fact that it was a private equity house and had raised such funds from its investor base). Thus, even in those instances where it could be obvious that litigation is the clear answer, other facts should be considered before making a decision. The commencement of litigation could have several implications and ramifications. That is why in certain instances it could be better to reach an amicable solution.

4. LITIGATION IN THE CONTEXT OF A VOLUNTARY TENDER OFFER

4.1 Background

One of the world's leading utility companies decided to acquire a renewable energy business in a third country within the European Union. The target business was owned by a listed company which was controlled by a family.

Initially, the buyer acquired a minority stake from the controlling family and entered into a shareholders' agreement. Subsequently, the initial buyer transferred its stake in the target company to one of its subsidiaries that owned and operated the renewable energy business of the group. Such subsidiary was also a listed company, although a majority stake (exceeding 70 % of the share capital) was owned by the parent company of the group. In addition, the subsidiary (which will be referred to as the buyer) was assigned the rights and obligations under the shareholders' agreement.

The shareholders' agreement provided that if the controlling family intended to sell shares exceeding 3% of the target company, then the controlling shareholders should notify the buyer, which will have a preferential right to acquire those shares.

Subsequently, the buyer, which at that time already held 49.9% of the share capital of the target, acquired an additional 2.8% of the shares, reaching a total of 52.7% of the share capital of the target company.

Shortly thereafter, the buyer's parent entered into a number of equity swaps over a total of 9.8% of the target's share capital. Those equity swaps only provided for cash settlement, as opposed to the physical settlement by delivery of the underlying shares. At that point, the original controlling shareholders sold part of their shares to the banks that entered into the swaps, which acquired those shares to hedge their position. It should be highlighted that the parent company requested the opinion of a reputable local law firm before entering into the equity swaps.

Later, while still holding 52.7% of the share capital of the target (*i.e.*, the 49.9% initially acquired plus the 2.8% subsequently bought), the buyer launched a voluntary tender offer for the acquisition of the total ordinary shares in the target that it did not own. For such purposes, it filed the prospectus required with the securities and exchange regulator. Within the approval process of the prospectus, and based on allegations filed by third parties, the regulator informed the buyer that it could have breached the applicable tender offer regulations. In particular, the regulator claimed that the buyer would have breached its obligation to submit a mandatory tender offer for the entirety of the share capital of the target within twenty days of the direct and indirect acquisition, within the previous twelve months, of voting rights for a percentage over 3% of the total voting rights in the target. According to the regulator, the buyer would have allegedly breached such obligation as a result of its parent entering into the equity swaps to which we have referred above.

In response to such allegations, and in addition to filing the corresponding pleadings, the buyer filed two additional legal opinions supporting its position. According to those opinions, it could be concluded that the buyer had not breached the obligation to launch a mandatory tender offer.

Regardless of the allegations made and the supporting documentation filed, the regulator resolved that the buyer had breached such obligation. At the same time that it approved the tender offer prospectus, it imposed a pecuniary fine to the buyer (the minimum fine for such breach – the regulator could have imposed a much greater fine and even suspend the buyer's voting rights in the target) and forced the buyer to include a statement in the tender offer prospectus with a reference to the breach of the tender offer regulations and the fine imposed.

According to the regulator, the breach of the law took place in two phases: (a) upon the immediate and direct acquisition by the buyer of 2.8% of the target's shares and with the indirect acquisition, acting in concert with third parties (the buyer's parents and the banks with which it entered into the equity swaps) of an additional 9.8% and (b) through the inactivation of the voting rights of the underlying swap shares from the total number of the ordinary shares in the target company and due to such inactivation, the increase of the directly acquired percentage of 2.8% into a 3.105% percentage of the total shares with voting rights in the target company (*i.e.*, over the 3% threshold allowed by law).

The buyer included such statement in the prospectus, and also mentioned that it disagreed with the fine imposed and was intending to file an appeal. It is worth noting that the regulator was not able to force the buyer to change the tender offer price (which was lower than the price at which the mandatory tender offer should have been launched).

The tender offer was successful. The banks holding the shares underlying the equity swaps tendered those shares in the context of the offer. The shares owned by other shareholders that were not tendered were acquired by the buyer following a squeeze-out process. Thereafter, the buyer delisted the target company from the stock exchange.

However, a few months later, a number of minority shareholders filed lawsuits against the buyer. These lawsuits were based on the fact that the buyer should have launched a mandatory tender offer at a much higher price. Thus, the plaintiffs were claiming pecuniary damages (for the difference between the tender offer price and the theoretical price at which the mandatory tender offer should have been launched) and moral damages. It is worth noting that most of the plaintiffs tendered their shares in the voluntary tender offer, some of them even sold their shares to the buyer before the tender offer was approved and only one plaintiff transferred its shares to the buyer in the context of the squeeze-out procedure.

The buyer filed an appeal against the fine imposed by the regulator with the competent administrative court. Subsequently, the civil courts started to issue their first instance rulings in favor of the plaintiffs. Later, the appeal filed against the fine imposed by the regulator was dismissed and the fine confirmed.

The buyer filed appeals against the rulings issued by the civil courts and also filed an appeal of cassation against the fine imposed by the regulator. The civil courts of appeal confirmed the first instance rulings and the buyer filed appeals of cassation.

Later, the fine imposed by the regulator was confirmed by the Supreme Court and, based on it, the first instance rulings issued by the civil courts were confirmed on appeal.

The legal proceedings lasted for several years and, while they were pending, interest was accruing on the amounts claimed by the plaintiffs.

The buyer paid the amounts claimed by the plaintiffs (plus interest) in those cases where the appeal of cassation was already resolved and reached extrajudicial agreements with the plaintiffs whose lawsuits were still pending to be resolved (either in second instance or in cassation).

4.2 Discussion

In this case, the buyer and its parent (both listed companies subject to strict corporate governance rules) proceed diligently. Given that they were operating under the laws of a foreign jurisdiction they sought for proper and local legal advice. However, even if the advice received confirmed that the buyer's parent could enter into the cash-settled equity swaps, the regulator imposed the fine on the buyer and this resulted in civil claims from minority shareholders. This exposed the buyer to the payment of several million euros, which indirectly implied an increase in the purchase price for the target's business (aside from the risks associated with being involved in litigation –reputational risks, additional claims, uncertainty of the outcome of the legal proceedings, claims against directors and officers, etc.–).

In the case at hand, it would have been advisable to confirm the advice received from the local lawyers with the regulator.

In hindsight, it would probably have been more cost effective to reach a settlement agreement with the plaintiffs. However, based on a number of circumstances, the buyer decided to engage in litigation. Among these were the following: (a) the listed nature of the buyer and its parent and, thus, being subject to strict corporate governance principles and reporting obligations and (b) the fact that reaching a settlement agreement would have led to new claims. However, even if the buyer would have increased the tender offer price and offered such increase to all the former shareholders of the target company whose shares were acquired, the aggregate consideration for the acquisition of the target business would have been lower than the result of adding the actual consideration paid and the amounts paid to the plaintiffs in the context of the legal proceedings.

5. CONCLUSIONS

From the three cases discussed the following conclusions can be drawn:

- While negotiating an M&A transaction and signing and executing agreements it is important to consider the litigation standpoint. Often times it is important to involve the litigation colleagues at the early stages of the transaction.
- When the transaction involves foreign jurisdictions it is important to get local advice in order to avoid future claims not only from the parties in the transaction (that can be harder to miss) but also for other stakeholders involved or affected (such as shareholders, employees, clients, public authorities, etc.).
- Litigation frequently has a deep impact over M&A transactions and sometimes it is used – or better said, misused– to prevent the sale of an asset or to significantly reduce its value.
- Even if we are completely sure of being right, the decision whether to litigate or not must be taken after a thorough cost-benefit analysis and taking into account that the outcome of the proceedings is uncertain.
- Sometimes the fundamental purpose of litigation in connection with M&A transactions is to show a strong position in order to avoid future claims from other parties but even then all costs (including interests) should be taken into account to decide whether litigation is worthwhile or not.

*   *   *