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Common Pitfalls In Cross-Border M&A

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Below, we present some of the most common pitfalls we have encountered during decades of negotiating and closing mergers and acquisitions between U.S. and European or Asian companies. Most of them are surprising outcomes when well-known principles of one jurisdiction are applied in another.

Purchase Price Adjustment vs. "Locked Box"

A critical juncture in every deal is the method of calculating the purchase price of the target company. Europeans are often surprised how precise U.S. companies want to be in this respect. In a typical U.S. deal, the agreement to sell a company is signed first, but the sale of the company consummates only at the closing, which may take place several weeks or even months after the signing (i.e., a sign-and-delayed closing). Since the economic and financial situation of the target company can fluctuate significantly between signing and closing, it is customary U.S. practice to adjust the agreed purchase price to the actual economic value of the target company at the closing. This is often done through a working capital adjustment, where a target working capital number is agreed upon at the signing stage and then the purchase price is adjusted up or down at the closing after comparing the actual target working capital number at the closing with the working capital target (subject usually to a band around the target in which an amount above or below the target would not cause a change in the purchase price).

In contrast, the "locked-box" mechanism is popular in Europe. In its simplest form, the "locked box" means that a deal has a fixed price, which does not compensate a seller for any increase in performance of the target company before the closing date. In a "locked-box" scenario, the purchase price is determined based on a historical balance sheet on a date that precedes the closing date (the "locked-box date"). Until the closing date, the seller has to ensure that no payments out of the ordinary course (the so-called "leakage") occur between the locked-box date and the closing. This can be achieved through contractual provisions, such as representations, warranties and covenants. If the target company performs better than expected, the buyer benefits due to the locked-box price, which does not go up due to increased performance. If the target company performs worse, the seller benefits.

Accordingly, European buyers should expect criticism from U.S. sellers under a locked-box approach, particularly where the target company's performance is on an upward trend. A strict locked-box

approach leads to automatic tension between the buyer and the seller, especially when the closing is delayed. And closings of cross-border deals are often delayed, partly due to other obstacles discussed below. “How much longer do you want us to operate the company for free?” is a typical question from a seller and its counsel, leading often, at least, to an attempt to renegotiate the locked-box price.

U.S. National Security Requirements in Cross-Border Transactions

In times of shifting dynamics in our global economy, parties have learned to anticipate whether national governments and agencies will interfere with or be interested in a transaction. The U.S. version of such a governmental body is the Committee on Foreign Investment in the United States. It reviews transactions by which non-U.S. citizens or foreign governments gain control of an American business, especially when national security matters are at stake, such as critical infrastructure, technology or products. CFIUS is concerned with selling military goods, equipment or technology to countries that present national security concerns to the U.S., and CFIUS’ review has a very wide scope. Under the ultimate authority of the U.S. president, it can prohibit, suspend or impose conditions and restrictions on transactions. For example, last month, President Donald Trump blocked Broadcom from pursuing its hostile takeover of Qualcomm (an American multinational semiconductor and telecommunications equipment company).[1] There is even a further effort to expand the scope of transactions that may be reviewed by CFIUS — which was introduced in Congress as part of the proposed Foreign Investment Risk Review Modernization Act.

The fear that CFIUS might invalidate a transaction between signing and closing, or worse, after the parties have begun implementing the sale of a business and shipping equipment across the Pacific, along with the negative publicity that a CFIUS review may entail, has at times jeopardized deals or even prevented target companies from considering foreign buyers for their business. We have also seen that target companies may expect a potential buyer from certain countries to offer incrementally more than a U.S. buyer to be considered competitive in a bidding process.

Non-U.S. buyers, as well as U.S. target companies, should consider early in the process whether or not a transaction could potentially trigger CFIUS review. The same is, of course, true for the CFIUS equivalents of other countries. U.S. buyers of target companies in Europe, Asia and other jurisdictions should be wary of the fact that the governments of such jurisdictions may prevent a deal from consummating in order to protect their national interests, whether for national security reasons, competitive reasons or otherwise.

Expectations Regarding the Formalities of Executing Documents

It is well-known by most foreign buyers that agreements can be concluded in the U.S. by exchanging PDF files of executed signature pages. In contrast, in many civil law jurisdictions, it is sometimes necessary or common to make appointments with a certified notary public weeks ahead of time to read out loud complete contracts with all of its pages, or to sign or to initial each page of the agreement. In the U.S., closings take place remotely and frequently simply by email without an in-person meeting or even a telephonic closing call.

Even the procedures for correcting mistakes in the signed documents are different in the U.S. versus other countries. Civil law practitioners may cringe that U.S. attorneys casually correct mistakes after a contract has been signed by adding slip-in pages and that corrections are only approved by email, and not by new “wet signatures.”

Then again, one area where foreign parties often underestimate the U.S. formalities is the necessity of board/shareholder (in the case of a corporation) or member/manager (in the case of a limited liability company) approvals to enter into an M&A agreement. This may lead to frustration for some foreign parties that may have negotiated with the CEO or manager of a U.S. company for weeks and months just to find out that — when they believe the documents are final — additional approvals may take extra time.

Yet, another surprise to some is another method of the U.S. system that makes up for some delays: The common practice that M&A attorneys obtain their client's signatures days in advance, and hold the signature pages in escrow until the final version of the contract is agreed upon (and approvals have come in). The attorneys can then speedily exchange signatures and effect the "signing" of the contract. This process of signing in advance and having signature pages held in escrow may be foreign to a non-U.S. buyer.

Cultural Differences and Perceived Weight of Due Diligence

Books could be and have been written about the role cultural differences play in the negotiation of M&A agreements between U.S. and foreign parties. One point we always emphasize, in particular vis-a-vis Asian clients, is that in the U.S., the spoken word, especially during due diligence, appears to have much less weight than, at least in the past, in many Asian cultures. We have seen disappointment and conflict when U.S. sellers did not feel committed to forecasts, profit margins or revenue targets given in management presentations or during due diligence. These Asian buyers have often felt betrayed because they had based their investment decisions in part on oral or written statements made in management presentations by the U.S. target company. In contrast, the U.S. seller may not understand the frustration felt by the Asian buyer when the U.S. seller points at contractual language stating that the M&A agreement supersedes and replaces all prior communications or discussions, or even that the buyer waived reliance on facts (other than fraud or misrepresentation) not included or attached to the contract.

On the other hand, one surprising fact that is positive for non-U.S. buyers is that if there is a pro-sandbagging clause in the M&A agreement, even if a buyer knows of a breach of representation or warranty prior to closing, such buyer could claim damages that result from the breach after the closing.

Enforceability of Noncompete Agreements

Another issue we have encountered in most deals involving Europe is a buyer's desire to prohibit the seller from competing with the business it just bought for two, three, five or more years. It is worth knowing that California has one of the most restrictive laws concerning such noncompetes. California prohibits, among other things, noncompetes enforced against employees of the target company (unless the employees are shareholders of the target company holding a significant percentage of the target company's equity). This comes usually as a surprise to some buyers from other U.S. states or from other countries where such covenants not to compete are enforceable, at least when the employee receives compensation for observing the noncompete.

European buyers sometimes assume, without mentioning, that they can enter into long-term employment agreements with the target company's employees that also include a noncompete. When they learn that such contracts and noncompetes are not enforceable, buyers may have to rethink their strategy and sometimes rethink the entire deal. Again, the earlier in the deal timeline these issues are addressed, the better.

Hidden Employment-Related Liabilities

Foreign buyers acquiring businesses in Europe sometimes do not expect that they are taking over certain employment-related liabilities as a matter of law, regardless of what the M&A agreement says. Examples of these liabilities include private pension fund amounts in Germany or in Italy that accrue or follow the employee. From the buyer's perspective, the amount of these liabilities are usually easy to calculate and, once known, the parties can negotiate whether or not to deduct them from the purchase price. However, even the reserves for such pensions in the financial statements of the target company may not always accurately reflect the full amount of such liabilities. We therefore recommend involving a local accountant or payroll consultant in the diligence early on, because last-minute attempts to renegotiate the purchase price are often not well-received and can sour a deal.

On the other hand, foreign buyers in the U.S. are frequently relieved when they have to consider only accrued paid time off or sick leave as pension liabilities are uncommon in the U.S.

Labor Law Requirements Slowing Deal Consummation in Europe

Similarly, U.S. buyers are frequently surprised when they learn that the labor procedures required to consummate an acquisition in Europe can be as (or more) time-consuming than the entire due diligence exercise on the target company. Depending on a buyer's plan for the target company's employees (i.e., whether the buyer plans to hire all or less than all of the target company's employees), negotiations with labor unions may be required, involving several meetings. In our experience, it can be difficult and a big hurdle to the deal to schedule meetings with labor unions, especially during holiday or vacation season. In fact, we recommend that deal timelines include the notices to the labor unions so that all parties are on notice that the labor union meetings are a gating item to the deal consummation.

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[1] Presidential Order Regarding the Proposed Takeover of Qualcomm Incorporated by Broadcom Limited, issued on March 12, 2018.