Spanish M&A standards

Acknowledgement

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Introduction

We are pleased to present this study on Spanish M&A standards. The study is the result of a joint initiative by the IE Business School and the global law firm Hogan Lovells.

Both institutions share a passion for innovation in the legal domain: its lecturing, research and practice.

This passion led us to undertake this study - the first of its kind in Spain - on the legal standards of Spanish M&A agreements.

A team made up of Hogan Lovells' Corporate lawyers and IE Business School researchers has rigorously gathered and processed the data provided by 43 leading corporates and private equity funds, with the aim of analysing the terms of private M&A contracts negotiated in Spain.

We hope the study helps you answer a question frequently raised in the course of M&A negotiations: "Is this clause market practice in Spain?"

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Why a study on Spanish M&A standards?

Spain is a civil law jurisdiction where Share Purchase Agreements (SPAs) are governed by the principle of freedom of contract as there are no laws or regulations specific to them. This, together with the adoption of the anglo-saxon contractual practice, which has shaped M&A globally, has resulted in Spanish SPAs dealing in detail with every aspect of the transfer of the target company as well as with its potential pitfalls.

Unlike other countries, mainly the United States, where research on the actual contents of M&A agreements has become increasingly widespread in recent years, in Spain only a few court decisions provide some clues as to what these agreements consist of and how they operate in practice.

In this context, we realised there was a need to carry out an empirical analysis of Spanish M&A agreements.

In order to overcome the absence of publicly available SPAs, we decided to approach leading Spanish corporates and private equity funds operating in Spain to ask them about their practices in private M&A deals. A heartfelt thank you to all of them for their time and for sharing their experiences with us.

Key conclusions

The main conclusions of the study are as follows:

- **Payment of the purchase price:** In 80% of transactions the price is paid at closing. If payment is deferred, the buyer provides security, usually in the form of an escrow account.
- **Purchase price adjustment:** More than 50% of the deals contain a price adjustment mechanism. Net debt is the preferred parameter for purchase price adjustments.
- **Locked box:** Corporates tend not to use this mechanism. It is, however, widespread among private equity funds, which use it in two out of three transactions.
- **Earn-outs:** This mechanism is used often. Its time period is generally set between two to three years.
- **MAC clauses:** 40% of transactions contain MAC ("Material Adverse Change") clauses but they are rarely enforced.
- **Interim period:** It is common practice to limit the seller's management powers during this period.
- **Representations and warranties:** In 85% of the deals, representations and warranties are "repeated" at closing.
- **Damages:** In most cases, damages refer solely to damages actually suffered, excluding indirect damages or loss of profit.
- **Limitation period:** For damages other than tax, an 18 month limitation period to claim is most popular.
- **Baskets:** The standard is 0.5% of the purchase price. In over 80% of the cases, the basket did not exceed 1% of the purchase price. 60% of the deals contained "first-dollar" recovery.
- **Liability caps:** In 23% of the transactions the cap was the purchase price. In most cases, however, caps range between 10% - 50% of the purchase price.
- **Security for warranty claims:** In four out of five transactions, the seller provided some kind of security. The use of escrow accounts and first-demand bank guarantees was particularly prominent.
- **Non-compete clause:** Nearly 70% of transactions include covenants not to compete. The average duration is between one - two years.
- **Dispute resolution:** Private equity funds prefer arbitration while corporates do not express a clear preference. Standard arbitration is before an arbitration tribunal with three arbitrators.
- **Drag-along:** They are universally used by private equity funds to protect exits.
- **Management team incentives:** Exit ratchets are the preferred formula to incentivise management teams.

1. Purchase price

Purchase price clauses are at the heart of SPAs. They are usually complex as they typically contain adjustments (upwards and downwards), earn-outs dependent on the future performance of the target and, in some cases, deferred payments.

1.1 Payment

The purchase price is paid primarily in cash at closing (see 2.4 below). Only in one out of five transactions was payment deferred.

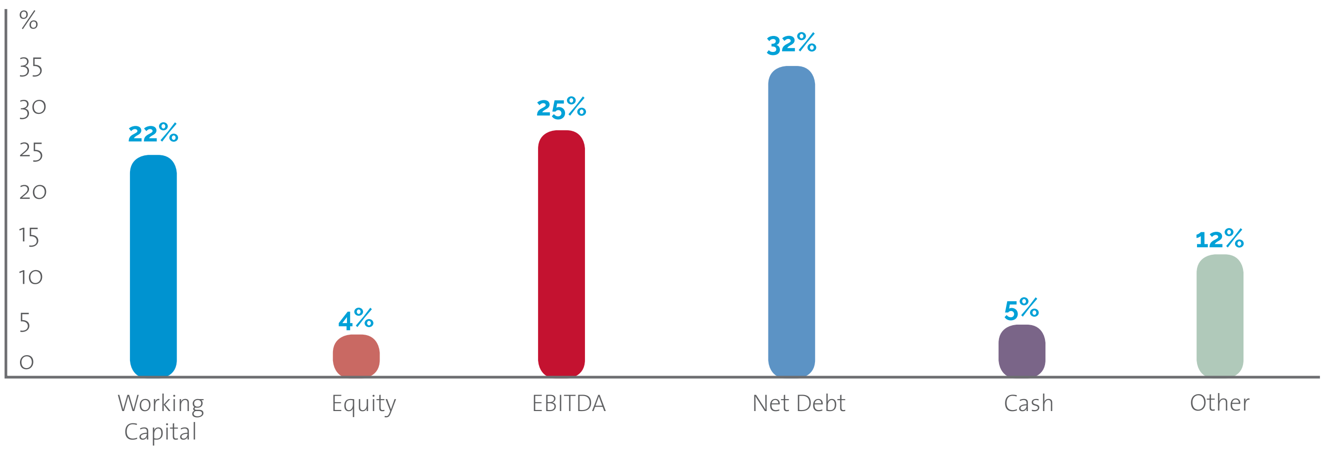
In cases where payment is deferred, the buyer invariably provides security. Securities most commonly used are escrow accounts and parent company guarantees, followed by first-demand bank guarantees.

1.2 Purchase price adjustment

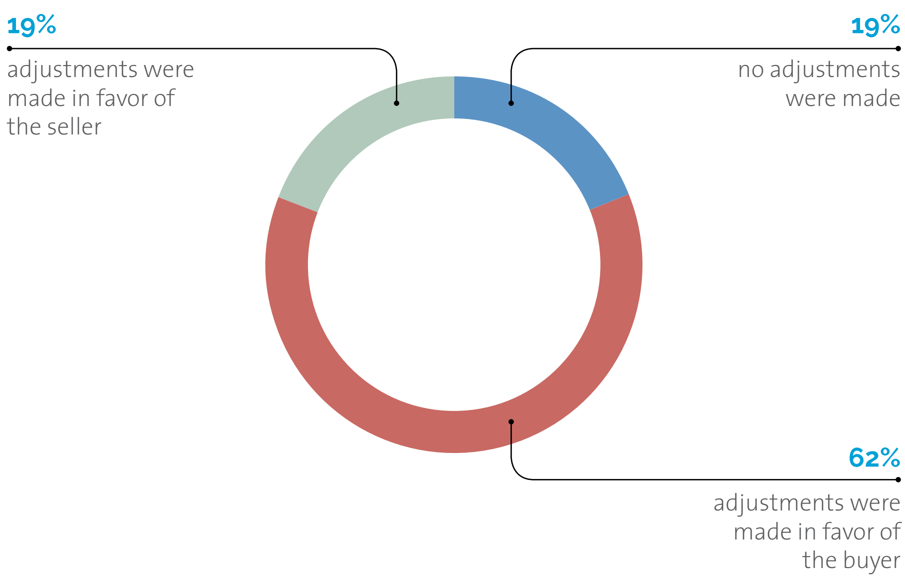
More than 50% of transactions provide for some kind of price adjustment mechanism, in contrast with the US, where 85% of deals contain a purchase price adjustment clause.

Price adjustment mechanisms require parties to agree on reference financial statements for the purposes of determining the adjustment. The date of these the financial statements usually coincides with the closing date. The buyer is normally responsible for preparing such financial statements on the basis of previously agreed accounting principles.

Unlike other European countries - where working capital adjustments are used in more than 40% of transactions - or the US - where almost every single deal contains a working capital adjustment -, in Spain the reference value mostly used for price adjustment purposes is net debt, followed by EBITDA.



Only in one out of five transactions in which a price adjustment mechanism had been provided for did such adjustment not have any impact on the final price. The main beneficiaries of price adjustments were the buyers (three times as much as the sellers).

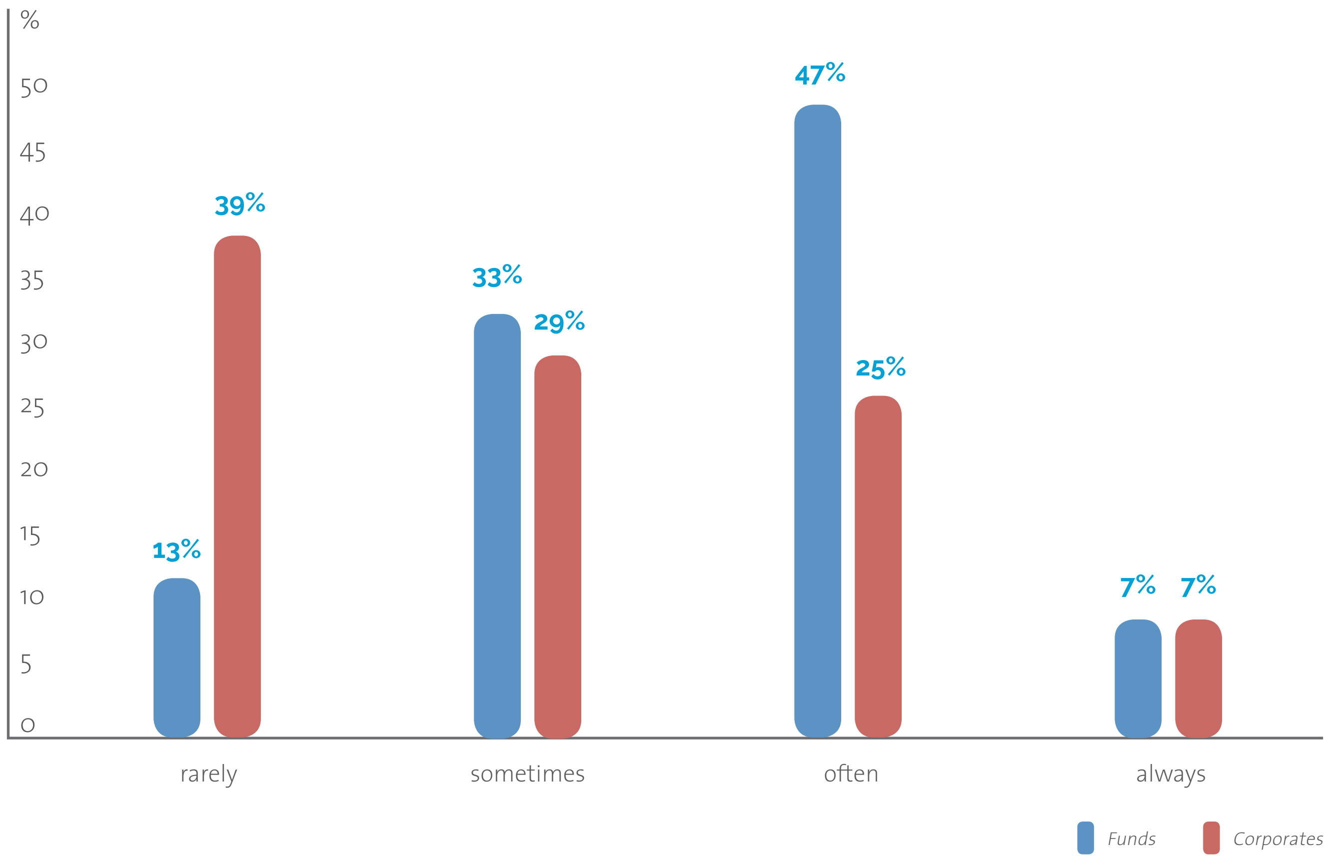


1.3 Locked-box

The locked box is a mechanism whereby the price is fixed at the time of signing the SPA, using as a reference the financial statements of the target business at a given date prior to signing (the locked-box date). The business risk of the target is transferred to the buyer from the locked box date. Until closing, the seller undertakes to refrain from performing certain actions (leakages), such as distributions of dividends and transactions other than at arm's length, aimed at extracting cash from the target. In the event of leakages, the purchase price will be reduced.

The locked-box mechanism can be used as an alternative to the traditional price adjustment (see 1.2 above) once the buyer has gained comfort regarding the financials of the target.

Locked box is moderately popular; only one in three respondents claimed to use it either always or often. Nevertheless, corporates and private equity funds use it to varying degrees.

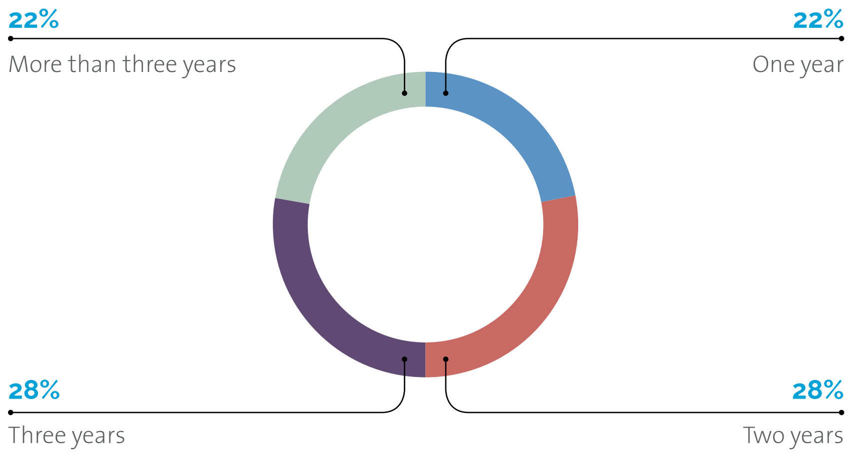


In two out of three transactions carried out by corporates, locked-box was not used. By contrast, private equity funds used it in two out of three of their deals. The reason behind this may be that private equity funds prefer to invest in companies with stable and predictable cash flows (for instance car parks, motorways, energy production plants), which are very well suited for a locked-box mechanism.

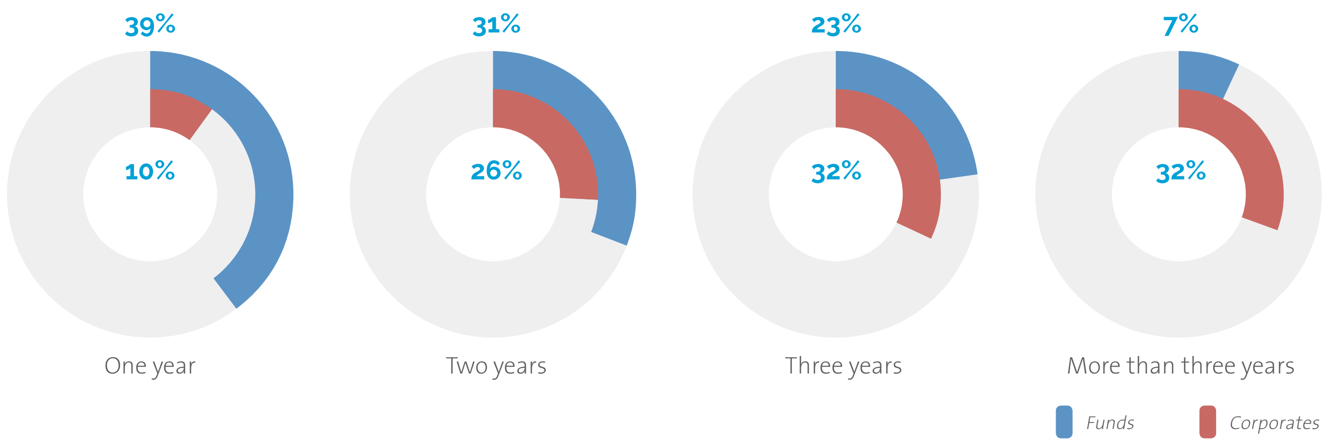
1.4 Earn-out

When a seller remains in the target business after closing as a member of the management team or as a way to bridge a valuation gap, it is quite common to make part of the purchase price dependent on the performance of the business after closing (earn-out). As a result, the buyer and the seller share the benefits as well as the risks of the target's business following the acquisition.

The earn-out is widespread in Spain (60% of the transactions) and the earn-out period is usually set at between two and three years.



In analysing the data above separately for corporates and private equity funds, there are dramatic differences between the two groups as far as timing of earn-outs is concerned.



Thus, while private equity funds set the duration of the earn-out period at two years or less in 70% of transactions, more than 60% of earn-out periods used by companies last at least three years. Corporates preference to focus in the medium term is confirmed by the fact that in nine out of ten of their transactions the length of earn-outs exceeds one year.

The main reason for such a difference is that private equity funds place greater emphasis on maximising business performance immediately after closing, whereas corporates favour a longer term approach.

2. Between signing and closing: the interim period

2.1 Conditions to closing

60% of Spanish transactions provide for a period between signing and the closing, as compared to 80% in the US. This interim period is intended to allow for the conditions to closing (whether mandatory or voluntary, as provided by the parties) to be satisfied.

Where required by applicable law the most common condition to closing is the approval of the transaction by the antitrust authorities. Two out of three transactions encompass the buyer's right to withdraw from a deal in the event conditions Imposed by the competent authorities (usually divestments) are considered unacceptable by the buyer.

It is worth noting that the number of voluntary conditions to closing allowing the buyer to walk away from the transaction was low.

The period for the fulfilment of the conditions precedent ranges from 3 - 6 months.

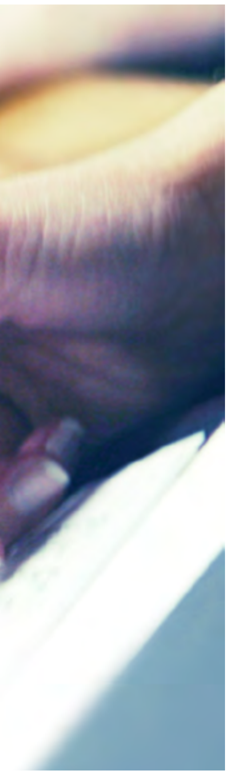
2.2 MAC clause

MAC clauses are a risk allocation mechanism which entitles a buyer to withdraw from the deal when an event entailing material negative consequences for the target business occurs between signing and closing.

MAC clauses are included in 40% of transactions. Although this somewhat exceeds the European average, it is a far cry from the levels in the United States, where MAC clauses are used across the board.

The wording of these clauses is heavily negotiated and sometimes it includes the quantification of the economic impact that the events covered by the MAC clause have on the target's business.

In 10% of the deals, the MAC clause was enforced. It never happened in any of the deals executed by private equity funds.



2.3 Management in the interim period

The wide majority of SPAs include limitations on the management powers of the seller during the interim period. It is important to bear in mind that such limitations may not, under any circumstances, give the buyer control over the target's business before closing, in accordance with applicable antitrust regulations.

In order for the buyer to oversee the management of the target's business during the interim period, three systems are used, none of which prevails over the others: (i) the definition of "ordinary course of business" to which the seller must conform; (ii) the setting of financial thresholds and buyer's approval to go beyond them; or (iii) a list of prohibited decisions.

Only in 30% of deals was a monitoring committee comprising buyer and seller representatives set up to oversee management during the interim period.

2.4 Closing

When conditions to closing have been met, the parties appear before a Spanish notary to close the transaction. Electronic signatures, virtual closings and counterpart contracts are not used due to the formal requirements imposed by Spanish law.

A specific penalty is provided for in more than half of the transactions to the party failing to appear at closing, without prejudice to the right of the other party to enforce the agreement and claim damages.

3. Seller's liability

A critical aspect in SPAs is to determine the seller's liability regime *vis-à-vis* the buyer whereby buyer may claim against the seller for damages resulting from breaches and, in particular, from the inaccuracy of representations and warranties (R&Ws) in relation to the assets, liabilities and, in general, the business of target. It is worth noting that under Spanish law no distinction is made between "representations" and "warranties".

The purpose of the R&Ws is to protect the buyer when signing the SPA. In 85% of cases, R&Ws are "repeated" at closing. The "repetition" or bring-down condition to closing entails in most cases, the right of the buyer to seek remediation if any R&W given at signing was inaccurate at closing.

The rationale for including in a SPA a comprehensive set of rules governing seller's liability in a SPA is to exclude the application of the law, which may contain different rules and principles.

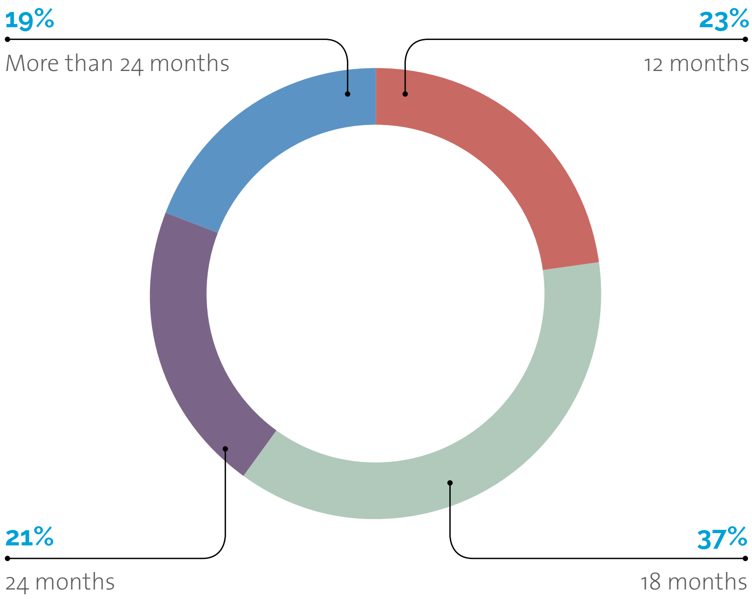
3.1 Recoverable damages

Damages indemnified by the seller occasionally include indirect damages or loss of profit. Therefore, in most cases, indemnification is contractually limited to direct damages actually suffered.

3.2 Limitation period

For tax-related damages (including social security contributions), the period to claim coincides with that of the statute of limitations, with only one in five transactions departing from that period.

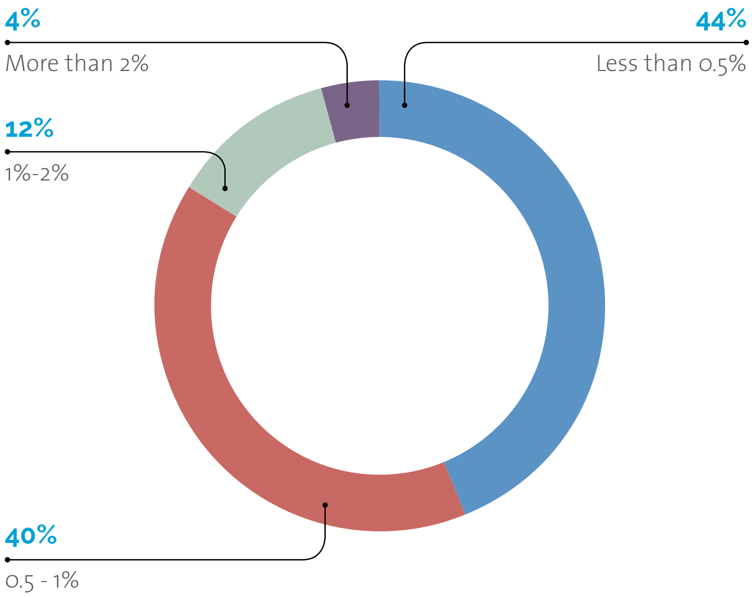
For damages other than those mentioned above, there is no generally accepted period to claim. However, the most common is 18 months, even though in four out of ten transactions longer terms were agreed.



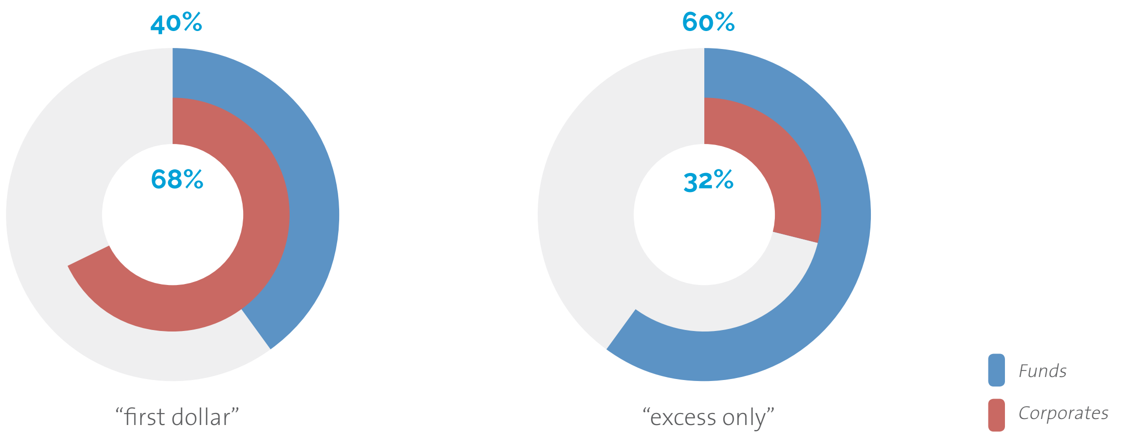
3.3 Baskets

It is commonplace for parties to set a series of thresholds (baskets) so that the buyer will only be able to make a claim when the aggregate of individual claims exceeds such baskets.

In more than 80% of transactions, baskets do not exceed 1% of the purchase price. The preferred basket is 0.5%, which occurs in 45% of cases.



If the amount of the basket is exceeded, the buyer is entitled to claim the full amount from the first dollar (i.e. "first dollar") in about 60% of transactions. First dollar is more popular among corporates. By comparison, the US continues to favour the recovery of just the excess of the claim over the basket (i.e. "excess only").

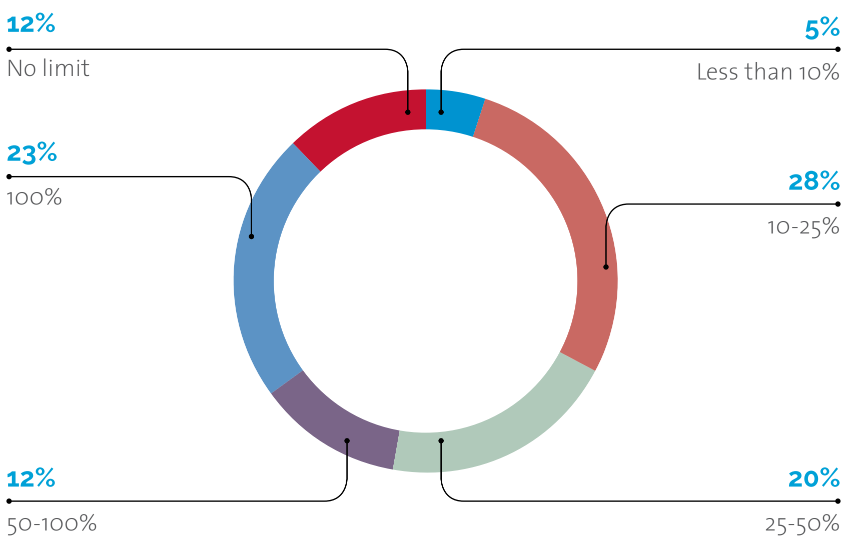


3.4 Liability caps

Limiting the maximum liability of the seller is widely accepted. This is based on the general understanding that it would be unreasonable for sellers to assume liability in excess of the purchase price. Therefore, negotiation focuses not so much on the principle but on the amount of the liability cap.

In a significant number of transactions (12%), no liability cap was established. Surprising as this may be, we must not forget that there may be reasons for it. By way of example, if the seller only represents to own the shares being transferred, the buyer will be hard-pressed to accept any limit whatsoever.

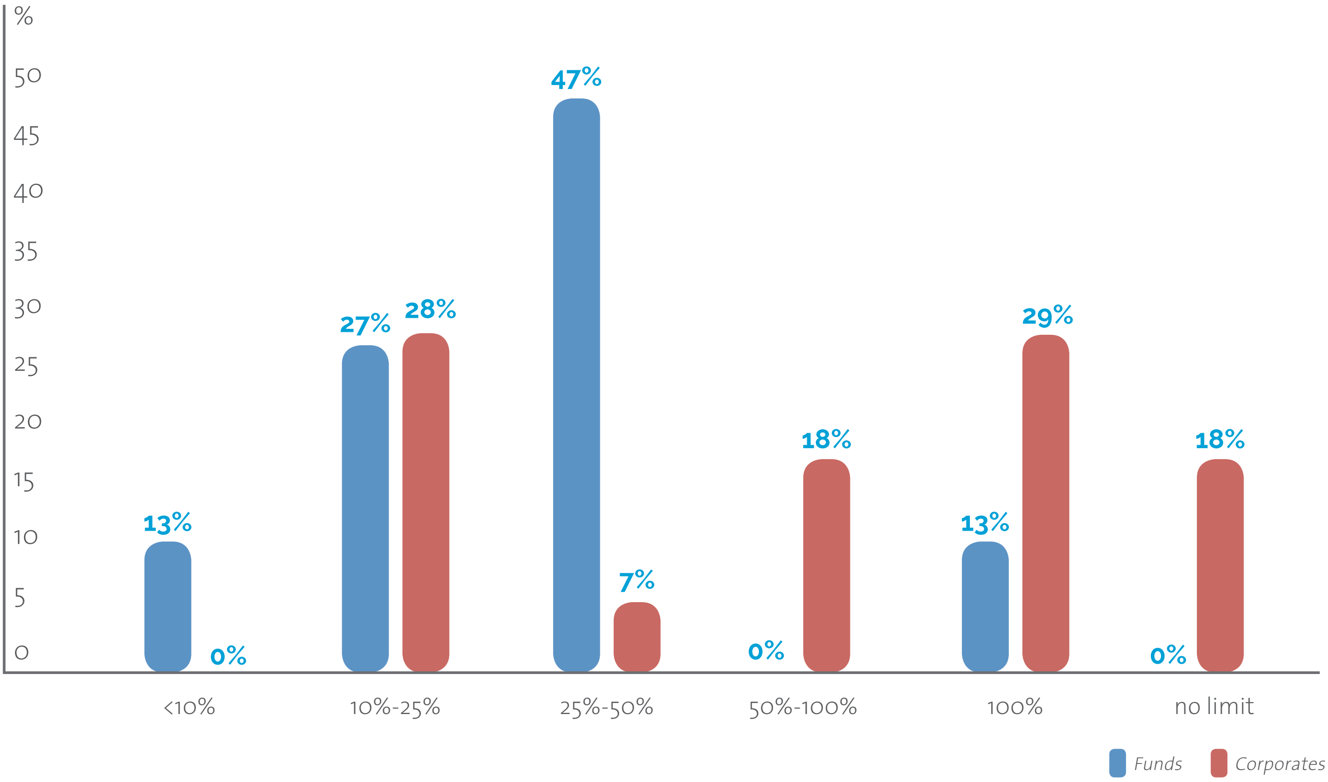
Although in 23% of the deals the cap is the purchase price, in most cases caps range from 10% to 50%.



Private equity funds tend to agree a liability cap of 25% to 50% and only occasionally opt for it to coincide with the purchase price.

Transactions in which the cap exceeds half of the purchase price or where it is simply not stated are almost exclusively associated with corporates.

Despite the above, both corporates and private equity funds establish that, in relation to certain matters, caps do not apply.



These results, which are similar to those recorded in other European countries, are in stark contrast to those in the US, where 87% of the deals contain liability caps of up to 25% of the purchase price.

3.5 Security for warranty claims

In four out of five transactions, the seller provides for some kind of security to guarantee the seller's indemnification for R&Ws and other obligations under the SPA. Escrow accounts, with banks acting as escrow agents, are the most commonly used type of security, followed by first-demand bank guarantees.

R&Ws insurance has not been used much but it is becoming increasingly common, particularly in transactions involving private equity funds.

3.6 Disclosure

There is no clear trend as to the impact on the seller's liability of the knowledge the buyer may have acquired in the course of the due diligence.

However, this may not be entirely correct if we analyse the modus operandi of corporates and private equity funds separately. For private equity funds, the data available for due diligence is for information purposes and only the disclosure schedules in the SPA contain exceptions to the R&Ws (60% of deals). On the other hand, in 60% of transactions by corporates, the entire documentation which was made available to the buyer, in a physical or electronic data room operates as a general disclosure to the R&Ws.

Regardless of the position, in two out of three transactions, the data room in electronic format (CD or similar) was attached to the SPA.

Financial and legal due diligence reports commissioned by the seller (vendor due diligence) are not uncommon in auction sales.

3.7 Seller's best knowledge

The R&Ws are sometimes qualified "to the best of the sellers' knowledge". What does this mean?

Approximately 50% of the agreements define it as follows:

- In general terms, knowledge that a seller should have prevails over actual knowledge.
- Knowledge which managers and/or directors have or should have because of their positions is considered more relevant than that of the seller.

Corporates employ a broader range of definitions of "best knowledge" than private equity funds.

4. Restrictive covenants

4.1 Non-compete

Approximately 70% of transactions include covenants prohibiting the seller from competing with the target.

The average duration of this covenant is one to two years.

The parties usually agree on specific penalties in cases of breach of this covenant since actual damages may be difficult to prove. The amount is agreed taking into consideration the size of the transaction.

4.2 Non-solicitation of employees

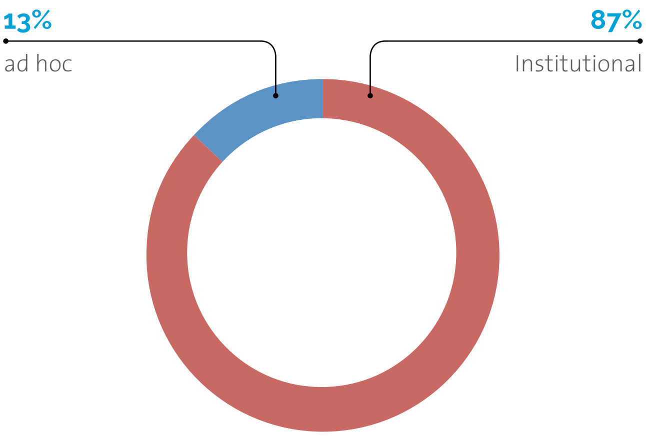
Clauses preventing the seller from soliciting the target's employees are widely used, especially by private equity funds. Their typical duration is one to two years. Only in 16% of the deals was such prohibition extended beyond two years.

5. Dispute resolution

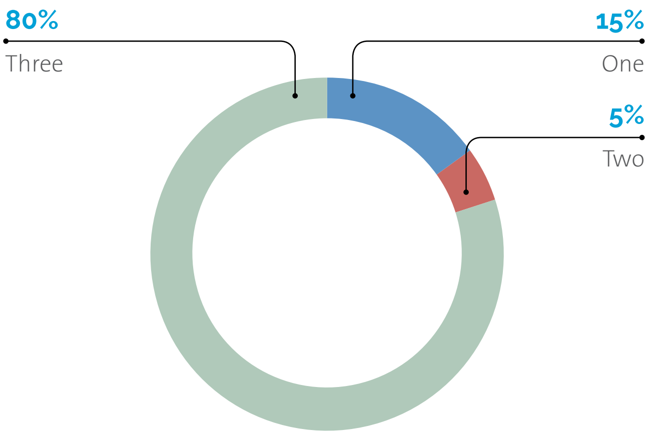
Private equity funds prefer utilising arbitration to resolve their disputes (in 80% of transactions). Conversely, corporates appear a little less enthusiastic about arbitration and tend, in equal measure, to settle matters arising from their SPAs before the courts or an arbitration tribunal.

Parties normally submit disputes to an arbitration tribunal consisting of three arbitrators.

TYPE OF ARBITRATION

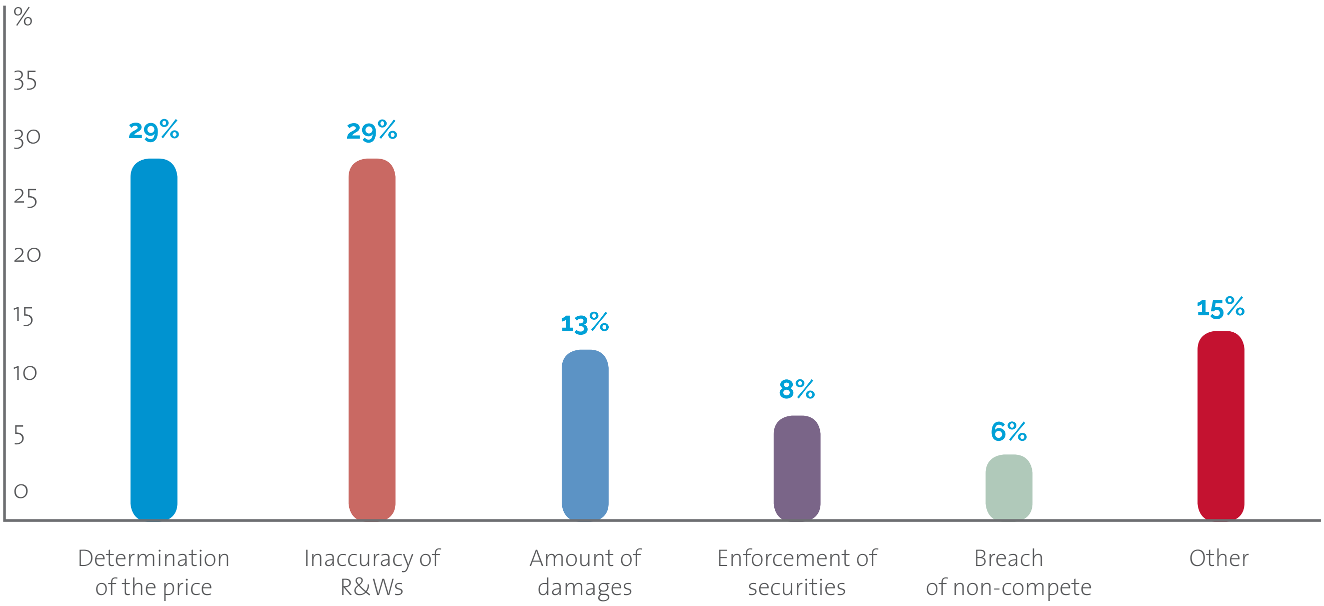


NUMBER OF ARBITRATORS



The grounds for seeking third-party aid are as follows:

- Determination of the purchase price (earn-out, price adjustments, etc.).
- Inaccuracy of an R&Ws.
- Amount of damages.
- Enforcement of securities provided by the seller/buyer.
- Breach of the non-compete covenant.

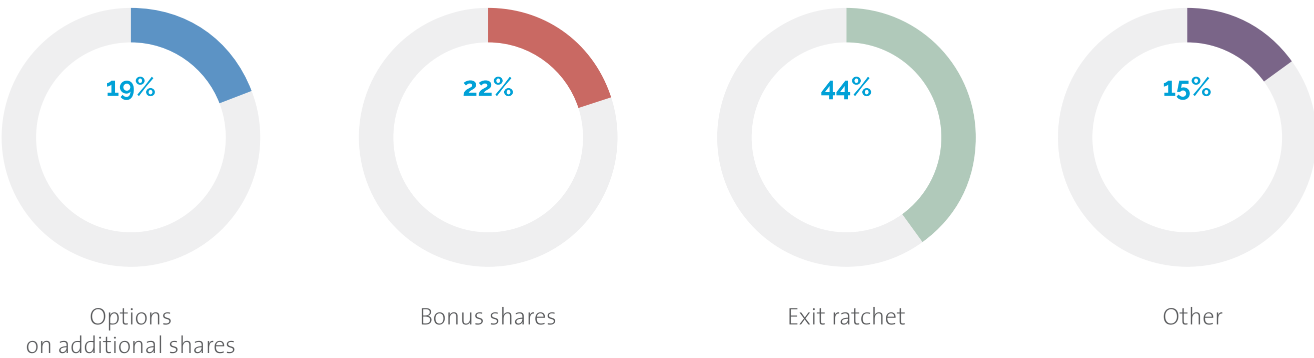


6. Some specifics to Private Equity Funds

For private equity funds, the success of their investment depends on the performance of the management team, so management incentives are normally provided for. On the other hand, when they decide to exit, they must do so seamlessly. How do SPAs address these issues?

6.1 Incentives to management teams

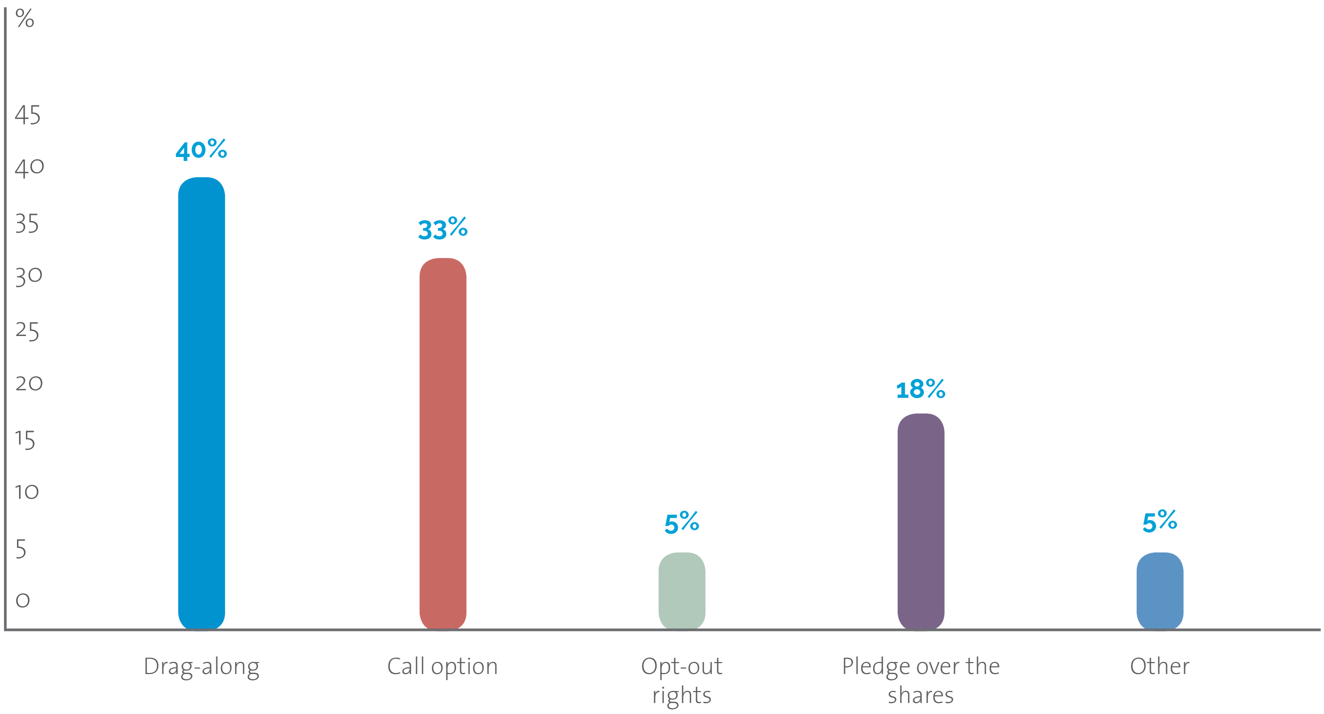
Ratchets are typically used by private equity funds to incentivise management teams of portfolio companies. Generally speaking, its purpose is to increase the equity stake of the managers of the acquired company provided that certain targets (profitability, exit price, etc.) are met. In the case of the so-called “exit ratchet”, if targets are met, when the managers sell their stake in the company, the price received for their shares will be proportionately higher than the one they would have received for their actual percentage of equity stake in the company.



Private equity funds also incentivise managers by giving them bonus shares and options to purchase additional shares.

6.2 Drag-along rights

Drag-along rights, whereby minority shareholders may be forced to sell their stake in the target when the private equity fund decides to exit, are prevalent. It is also highly common for the managers to grant call option rights in favour of the private equity fund.



As a security for such drag-along rights, it is commonplace for managers to pledge their shares and, to a lesser extent, vest the company with opt-out rights.

Methodology

The study is based on the answers of 43 Spanish leading companies and private equity funds to a questionnaire of close-ended questions in order to render the task of the respondents easier while eliminating any bias of subjectivity. In some instances, questionnaires have been followed by interviews.

Although "every SPA is unique", the assessment of the answers has enabled us to take a peek into the contractual practices of the respondents.

The study provides information on the content of more than 200 SPAs executed from 2013 to 2014 by:

- 12 IBEX35 companies;
- 7 listed companies not included in IBEX35;
- 9 corporate groups;
- 9 Spanish private equity funds; and
- 6 international private equity funds operating in Spain.

Data on the US market were obtained from the "2013 Private Target M&A Deal Points Study" prepared by the Market Trends Subcommittee of the Mergers and Acquisitions Committee of the American Bar Association's (ABA), Business Law Section.

Further details on the methodology and additional information can be found in Francisco Marcos, "Los contratos de compraventa de empresas en España 2013-2014" AJ8-228 in the website of IE Business School **(www.ie.edu/es/business-school)** under Claustro e Investigación > Centros Especializados.

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