THE GUIDE TO MERGERS AND ACQUISITIONS

SECOND EDITION

Editors
Paola Lozano and Daniel Hernández

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The Guide to Mergers and Acquisitions

Second Edition

Editors

Paola Lozano and Daniel Hernández

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Publisher's Note

Latin Lawyer and LACCA are delighted to publish this second edition of *The Guide to Mergers and Acquisitions*.

Edited by Paola Lozano and Daniel Hernández of Skadden, Arps, Slate, Meagher & Flom LLP, this guide brings together the knowledge and experience of leading experts from a variety of disciplines and provides guidance that will benefit all practitioners.

We are delighted to have worked with so many leading individuals to produce *The Guide to Mergers and Acquisitions.* If you find it useful, you may also like the other books in the Latin Lawyer series, including *The Guide to Infrastructure and Energy Investment* and *The Guide to Corporate Crisis Management*, as well as our jurisdictional references and our new tool providing overviews of regulators in Latin America.

My thanks to the editors for their vision and energy in pursuing this project and to my colleagues in production for achieving such a polished work.

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Part IV

Select Topics Critical to Dealmaking

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CHAPTER 13

Preliminary Legal Documents in M&A Transactions

Pablo Mijares and Patricio Trad[1]

Term sheets, letters of intent and memorandums of understanding

It is very common to use preliminary legal documents in M&A transactions in Latin America, such as term sheets, letters of intent or memorandums of understanding, as they are useful for parties to quickly and inexpensively set out the commercial terms of a transaction.

In most civil law jurisdictions, there is no specific legal framework around term sheets, letters of intent or memorandums of understanding, and from a practical perspective there are virtually no differences between these figures. We will refer to all these types of documents as 'term sheets' for purposes of this chapter. The unregulated nature of these documents presents challenges that have been addressed by the market participants in different and creative ways.

From a Mexican law perspective (which is not dissimilar to other civil law jurisdictions), one of the above-mentioned challenges is the fact that the law establishes that, for a purchase agreement to be effective, in general terms, the parties need only agree on the good and its price. Subject to certain formalities, and under a simple but formalistic approach, a term sheet executed by the parties could, therefore, be deemed as a valid purchase agreement by a Mexican court. This is often addressed by clearly establishing that the document serves merely as a preliminary understanding of the parties on potential material terms of the agreement but should not constitute a binding agreement itself. Another frequently used alternative or additional level of protection is to establish specific

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1 Pablo Mijares is a founding partner and Patricio Trad is a partner at Mijares, Angoitia, Cortés y Fuentes.

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conditions to which, in any event, the potential transaction will be subject, such as completion of due diligence, execution of definitive agreements, antitrust or other regulatory approvals or the obtention of waivers from third parties. The above-mentioned is also the main setback for using term sheets in the United States. As noted by Lou R Kling and Eileen Nugent Simon, term sheets are usually clearly marked as being non-binding because 'the most serious disadvantage of entering into a letter of intent [is] the risk that such document may be construed as binding upon the parties, leading to liability in damages if the transaction is not consumated'.[2]

In any event, and subject to the parties agreeing on the non-binding effect of the term sheet, in Mexico, term sheets have proved to be really effective in terms of transaction efficiencies, and are more frequently used by the more seasoned market participants, such as private equity funds and companies that are active in M&A transactions. A well-designed and sufficiently detailed term sheet can save months of negotiations as well as the deterioration of the relationships among the parties. An argument could be made that these efficiencies could also be attributed to the fact that, as previously mentioned, seasoned participants are the more frequent users, but in any case, a solid term sheet will pave the way for a smooth transaction.

Further, a term sheet may also save significant time and money for the parties, as the negotiation and execution of definitive agreements regularly involves each of the parties engaging legal, financial and tax advisers as well as due diligence by the buyer, among other aspects that may add to a substantial bill and no deal. Agreeing on a term sheet reduces the chances of a party being surprised on a major term of the deal further along the process.[3]

A well-designed term sheet will, at the least, include the following basic elements:

- the general economic terms of the deal, if the price will be fixed, variable, subject to adjustment or if any seller's financing will be granted;
- basic indemnity terms, including its amount, duration, guarantees or escrow;
- conditions to which the transaction will be subject to, including regulatory approvals;
- basic representations and warranties expected from seller;
- general covenants, including non-compete and non-solicitation provisions;

2 Lou R Kling and Eileen Nugent Simon, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions* (Corporate Securities) (1992).

3 Patrick A Gaughan, *Mergers, Acquisitions, and Corporate Restructurings* – 5th ed (2011).

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- exclusivity provisions that prevent the seller to engage in negotiations regarding the asset;
- binding or non-binding effects, as well as any penalties for the defaulting party;
- choice of law and forum selection; and
- if applicable, the specific post-closing rights of the partners in the shareholders' agreement or the vehicle's by-laws.

As a general rule, the elements that will be further developed in the definitive agreements should be kept as concise as possible at the term sheet level, such as economic terms, indemnities and covenants, whereas provisions pertaining to the term sheet should be sufficiently detailed and leave as little room to interpretation as possible, such as exclusivity, binding effects and jurisdiction, as such provisions may in fact determine the extent to which a court of law grant relief or recourse to the parties.

Given that the term sheet is the first document that outlines the deal, it is, by its very nature, flexible. However, the parties should find the right balance between the time spent on negotiating the term sheet and when it is time to turn into the definitive agreements.

As previously mentioned, the term sheet should clearly establish some basic commercial aspects that are the basic premises of a potential mutually satisfactory transaction; however, as tempting as it may be to fall into the negotiation of the detailed aspects and wording which would be subject of the definitive agreements, that impulse should be avoided as it may defeat the purpose of the term sheet.

Non-binding effect versus specific binding provisions

Whenever parties start negotiating a term sheet, one of the biggest questions is if such preliminary documents would create binding obligations to consummate the deal or economic penalties to either party if they decided at a later stage they do not want to enter into definitive agreements or close on the deal.

There is a common misconception that such preliminary documents are always non-binding in nature. Regardless of the title of the document, term sheets, letters of intents or memorandum of understanding can in fact be binding, non-binding or partially binding and partially non-binding; it all depends on the intent of the parties and the wording of the document. Simply describing a document as a term sheet, letter of intent or memorandum of understanding is not enough to prevent it from being legally enforceable. If such document is sufficiently certain and all the other essential elements necessary for a valid contract are present, it may be enforceable, especially in civil law jurisdictions.

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It is common practice to include language to expressly state that the terms and conditions included in the document are only indicative in nature and for discussion purposes only, and that the transaction is subject to, among others, due diligence process, final negotiation, signing of definitive agreements and regulatory approvals.

A specific reference to which provisions, if any, are in fact meant to be binding is advisable.

Customary terms and conditions that tend to be binding on the parties from the term sheet stage include expenses, confidentiality, exclusivity and escrow deposits.

A well-drafted preliminary document will clearly set forth which clauses are binding and which are non-binding and set the tone for the negotiation of the definitive agreements to be drafted at a later stage. Almost inevitably, a document of this type will create rights and obligations to the parties, and therefore parties need to be sure that the term sheet properly reflects their understanding of the arrangements.

Given the nature of term sheets as a first step towards a definitive transaction, it is common to find clauses that require the parties to use their 'best efforts', 'reasonable best efforts', 'commercially reasonable efforts' or similar formulations towards achieving a specific milestone or result. In Mexico, as in other civil law jurisdictions, there is no legal definition to what may or may not constitute a 'best effort', 'reasonable best effort', 'commercially reasonable effort' or similar formulation, which results in a significant challenge to litigate a breach of this sort. Therefore, if the term sheet is governed by the laws of Mexico or another civil law Latin American jurisdiction, this language could be construed as the parties simply agreeing on doing something in good faith. Therefore, the parties should be made clearly aware that such covenant may be difficult to enforce under local law.

Non-disclosure and confidentiality agreements

Given that the term sheet is the first document that will be executed among the parties as part of a deal, documents include the confidentiality or non-disclosure provisions that the parties will be bound to throughout the negotiation and execution of the deal. These provisions, in addition to protecting the existence of the potential deal from leaking to the public, should also address the measures and restrictions on the use of the information that the potential buyer and its advisers will have access to as part of the due diligence process of the target. Generally, the receiving party should only be allowed to use the information for purposes of evaluating the proposed transaction, and not for any other purpose.

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However, it has become also common to find stand-alone non-disclosure agreements (NDAs) aside of any term sheet that the parties may negotiate, in part following common law practices. This is advisable particularly when the parties expect the negotiation of the preliminary documents to take weeks rather than days, during which the information would not yet be contractually protected absent a stand-alone NDA. Also, confidentiality provisions and agreements tend to be more standardised throughout the market and should require less time until the parties are willing to be bound by their terms.

Owing to the fact that the harm caused from the breach of a confidentiality agreement may be hard to estimate, in addition to the damages and lost profits that a party may seek from the defaulting party, it is advisable that specific performance and equitable relief provisions are included in such agreements or clauses to allow the parties to contain any leaks as quickly as possible through injunctions, without limiting their ability from claiming compensation.

The definition of what constitutes 'confidential information' is highly negotiated. Counsel to the disclosing party will aim for a broad definition, generally covering (1) any information disclosed by or on behalf of its client, in any form (whether written, oral or otherwise) and irrespective of the information being specifically marked as confidential or not, (2) certain specific key elements, such as intellectual property, know-how, trade secrets, and customer and supplier lists, (3) the existence of the negotiations and status thereof, and the existence and terms of any preliminary agreements (including the NDA), and (4) any materials or notes prepared on the basis of or containing any 'confidential information', among others. Under Mexican law, there are no specific limitations as to what may be deemed as confidential information. On the contrary, Mexican law assumes that the disclosure of certain information (mainly certain intellectual property and information deriving from an employment relationship or other appointments) causes damage to the disclosing party and thus the law affords such information status of confidential information.

The term of the confidentiality duties is also a point of frequent discussion among the parties. While the disclosing party often requests confidentiality to run indefinitely, a term between one and three years is common. The disclosing party should make sure it has the right to demand return or destruction of any confidential information by the receiving party at any time (in particular upon termination of the NDA), typically subject to customary retention of records by the receiving party, as required by law or ordinary course electronic data back-up retention policies. The restrictions on the use of any retained information sometimes survive the termination of the NDA.

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In addition to aiming to narrow the definition of confidential information and reduce the term of the NDA, counsel to the receiving party should make sure that specific customary carve-outs to what may be deemed as confidential information are included, such as information that has been made public through no fault of the receiving party, information in possession of the receiving party that was delivered by a third party without breach of a confidentiality duty, and information required to be disclosed under law or government or judicial order. In connection with the latter, the disclosing party should insist that the receiving party is allowed to disclose only the information that is necessary to comply with the relevant legal duty or order and is required to seek assurances that the information will be kept confidential. In any event, under Mexican law, the disclosure required by law or judicial orders is not deemed as a breach of a non-disclosure obligation, although the receiving authority has a legal duty to handle such information as confidential. It is not uncommon to find competitors entering into transactions among themselves in the Latin American M&A market. The exchange of information among such participants poses significant business and legal risks for each party, including from an antitrust perspective, given that significant sensitive information may be transferred among the parties during the course of due diligence efforts. A key factor will be to accommodate to the specific actions that the local regulator demands or will be expecting to see, which may be specific in terms of form and substance. For example, although the Mexican Antitrust Commission has in place specific guidelines that the parties must follow for these cases, there have been other practices that have been successfully implemented in the market. The first step is for the disclosing party to identify its sensitive information. In a second stage, the parties should analyse the ways in which such information may be delivered to the receiving party, in a useful format, without revealing the sensitive aspects. For example, certain financial and business information may be delivered in aggregated form, instead of providing separate information for each channel, product, supplier or customer. Finally, all the other sensitive information should be placed in a clean room to which only the receiving party's external advisers have access and they will have specific NDA agreements in place allowing them to disclose such information to their client only in a way that maintains the sensitive aspects confidential. Entering into specific clean team agreements is sometimes mandatory and often advisable.

It is also not uncommon for NDAs to include non-solicitation provisions with respect to certain employees of the targeted business. A prospective buyer will often have access to key employees of the target. Therefore, the disclosing party might be concerned that the buyer may attempt to poach such employees if a transaction is not consummated, especially if such prospective buyer is a

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competitor. Common exceptions to such provisions include hiring as a result of unsolicited request for employment by an employee or as a result of a general solicitation (including advertisement) that is not directed specifically to any employees covered by the non-solicitation provision.

Exclusivity agreements

Although entering into a separate exclusivity agreement is feasible and is an alternative available to the relevant parties in M&A transactions in Mexico and generally throughout Latin America, it is common practice for exclusivity provisions in connection with M&A transactions to be built in directly into other preliminary agreements of the transaction, such as, depending on the structure of the transaction, the term-sheet, letter of intent, memorandum of understanding or the NDA. In most cases, the exclusivity clauses and provisions included in the preliminary agreements are expressly made to be binding and are enforceable with respect to the parties thereto.

Through an exclusivity agreement or an exclusivity clause included in a preliminary agreement, which is also commonly referred to as a no-shop clause or no-solicitation clause, the potential buyer will generally look to obtain assurance from the seller that there are no existing contractual arrangements or undertakings with any other third party in connection with the acquisition (or similar transaction) of the target company, as well as assurance that the seller is not engaged in ongoing negotiations or discussions with any other potential buyers in connection with the acquisition (or similar transaction) of the target company.

A strong and effective exclusivity agreement or exclusivity clause will typically establish certain commitments of the parties thereto, which will be enforceable during the agreed upon exclusivity periods set forth thereunder, and that typically include (1) the commitment of the parties to deal exclusively with each other for the purpose of drafting and negotiating the definitive agreements for the relevant transaction, and (2) the commitment of the seller and the target company to avoid soliciting or negotiating any offer or proposal from, or engaging in any discussions or negotiations with, or providing any information to, any third party (other than the buyer or its affiliates, shareholders, partners, officers, employees, directors, agents, advisers and representatives) in connection with any inquiries or proposals for acquiring the target company, its assets or its business or any other transaction that is similar, inconsistent, competitive or conflicting with the relevant transaction with the potential buyer. Moreover, it is common practice for exclusivity agreements and exclusivity clauses included in preliminary agreements to establish that, if the seller or the target company receives any unsolicited offers or proposals for the acquisition (or similar transaction) of the target company

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from any third party, the seller and the target company will have the obligation to advise that third party that it is engaged in exclusive discussions with the potential buyer, and that it is precluded from proceeding with any such third party. If the target to a transaction is publicly traded, especially in a common law jurisdiction, additional provisions may need to be inserted as exceptions to the commitment to the particular transaction, including as a result of the requirements that board members satisfy their fiduciary duties, by, among other things, seeking to maximise shareholder value when a company is in play, as well as other legal provisions relating to tender offers.

The exclusivity periods agreed upon by the parties to M&A transactions and set forth in the corresponding exclusivity agreements or exclusivity clause of preliminary agreements will typically range from one to six months. Although the exclusivity periods may vary depending on the jurisdiction and specific characteristics of the transaction and the target company, its assets or business, the range mentioned above is a good rule of thumb for transactions of this type. Often, the parties will agree that such exclusivity period be consistent with the period granted to the potential buyer for purposes of performing the due diligence process of the target company and, in some cases, it may even be longer.

While negotiating the exclusivity period in an exclusivity agreement or exclusivity clause in a preliminary agreement, the potential buyer will typically want to negotiate for a longer exclusivity period, while the seller will want a shorter period. It is also common practice for the parties to the exclusivity agreement or to the preliminary agreement including such exclusivity clause, to establish the ability to extend such exclusivity period upon mutual agreement of such parties.

Moreover, solid exclusivity agreements or exclusivity clauses afford important benefits and are overly convenient from the perspective of the potential buyer due to the leverage afforded to such buyer, considering that the seller will be prevented from searching or soliciting alternative transactions with more favourable terms throughout the exclusivity period. Failure to limit or prevent the ability of the seller to search or solicit an alternative transaction by means of exclusivity provisions could trigger a bidding war for the target company if there are various interested parties, which could ultimately result in a higher transaction price for the potential buyer.

From the perspective of the seller of the target company, that seller should look to avoid an exclusivity agreement or exclusivity clause establishing a long exclusivity period.

Avoiding a long exclusivity period is especially important from the perspective of the seller if there is a risk that the potential buyer will walk away from the transaction upon completion of the due diligence process.

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Owing to the binding nature of exclusivity agreements and the exclusivity clauses included in preliminary agreements for M&A transactions, if any party breaches the exclusivity provisions, the breaching party will be liable to the non-breaching party. In many cases, the breaching party, in addition to any remedies afforded under the applicable law, will typically have the obligation to reimburse reasonable and documented business expenses incurred by the non-breaching party in connection with the negotiation of the transaction, generally including fees and expenses of professional advisers. In certain occasions, depending on leverage and jurisdiction, other liquidated damages in the form of a termination fee may be discussed.

Cost-sharing agreements

M&A transactions may involve, in addition to commercial, financial and legal stream works, several challenges from both accounting and tax perspectives when cost-sharing components need to be addressed by the transaction parties.

In those cases, the parties executing M&A transactions should agree on general terms that will govern their cost sharing allocations before closing the transaction (including on structuring, formation of legal vehicles, filing fees, among others), which should be negotiated, to the extent possible, at an early stage and also be included in the relevant term sheet, letter of intent or memorandum of understanding mentioned above.

In M&A transactions with cost-sharing components, it is advisable for the transaction parties to enter into a cost-sharing agreement (CSA) or, otherwise, include cost sharing clauses in the relevant agreement, whether it is a stock purchase agreement, an asset purchase agreement, or any other type of agreement.

An independent CSA is an agreement entered among business enterprises to share the risks and costs involved in developing, producing or transferring assets, rights or services, and to determine how the interest will be allocated among the transaction parties, as well as how the costs will be shared among them, creating direct economic benefits for such parties.

CSAs are usually used to develop, produce or acquire assets or rights, and to execute specific services. This type of contract is characteristic with an exposure to overall risks that can be shared within two or more companies that otherwise would not have invested any resources on their own.

One of the main characteristics of a CSA is that relevant assets are owned by an enterprise, but the costs and risks of development, and the right to exploit those assets is shared with a cost share participant, usually an affiliate or a subsidiary of such company.

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Different types of CSAs can be executed in M&A transactions. The CSAs and cost-sharing clauses more commonly used in Mexico and in other Latin American countries concern the development of intangible assets. CSAs and cost-sharing clauses are common in transactions regarding the development of industrial and intellectual property rights such as software, patents, utility models among other intangible assets.

Also, enterprises usually enter CSAs when there is a common need from which the transaction parties can mutually benefit. However, it is important to take into consideration that when two enterprises are related parties or are affiliates of the same corporate organisation, the arm's-length principle should apply. That principle states that the proportionate share over all the party's contributions must be consistent with the proportionate share of all the expected benefits to be received by the transaction parties under such CSA.

In addition, CSAs are similar to joint venture agreements. However, the difference between a CSA and a joint venture agreement lies in the fact that CSAs are used only for developing, producing, or transferring rights or assets, or for executing specific services, and for sharing the costs and risks derived therefrom among the parties, while regular joint venture agreements are used for earning income as a result of the contribution of two or more enterprises.

In some countries, CSAs are described as a form of joint venture agreements. However, one of the advantages of CSA compared to variable royalty agreements such as joint ventures is that CSAs may provide to taxpayers with unique opportunities to receive economic compensations from tax authorities that impose limitations on royalty payments. Another advantage is that the parties to a CSA contribute their own resources (whether human, financial or both) and their know-how for the development of an asset (normally intangible assets) or the execution of a specific service, and the ownership of the results are shared among the parties. This means that each party has the right to exploit the results without paying any royalties to any other party for such exploitation.

Such exploitation rights are recognised by the Organisation for Economic Co-operation and Development (OECD), of which Mexico is a member. In that regard, the OECD has recently released new guidelines regarding CSAs, as well as the cost sharing and price transferring derived from the execution of such type of contracts (the Guidelines).

The purpose of the Guidelines is to ensure, among others, consistency in the valuation and pricing of assets and services, whether such assets and services are associated with a CSA, as well as to ensure a common framework regarding the

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characteristics of a CSA, the risks involved in the transaction, the assets being transferred or the services being rendered, and the documentation requirements of the CSA.

Owing to its nature and characteristics, CSAs and cost-sharing clauses included in the relevant agreements represent a competitive and advantageous mechanism when entering M&A transactions, whereby cost-sharing and price-transferring components need to be addressed by the transaction parties.

Recent changes – preliminary agreements during 2020–2021

In light of market uncertainties and volatility created by the covid-19 pandemic, we have seen that parties in M&A transactions are negotiating more detailed term sheets, letters of intent and MOUs. This ensures that the parties have a good business understanding of the transaction, and mitigates the risk of not closing due to covid-19-related issues or market disruptions in general.

We have seen a significant increase in the granularity of topics included in term sheets due to valuation uncertainties – such as contingent purchase price formulas and requests for more detailed financial diligence. The effects of the covid-19 pandemic are considered to be the result of material adverse change. Also, parties have been more willing to agree to binding preliminary agreements. All of these changes have resulted in a longer negotiation process of preliminary agreements, but have helped parties feel more confident that transactions will close on the agreed terms.

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APPENDIX 1

About the Authors

Pablo Mijares
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Pablo is one of the founding partners of Mijares, Angoitia, Cortés y Fuentes. He has extensive experience in mergers, acquisitions and private equity transactions, as well as in public and private bidding processes.

He regularly advises buyers, sellers and investors in complex mergers, acquisitions and joint ventures, shareholders' conflicts and strategic planning of specific projects. He has for many years advised on real estate transactions for hospitality, commercial and residential projects.

He has extensive experience in cross-border and international transactions, which constitute most of his practice, representing Mexican and foreign entities. He has actively participated in various acquisitions and joint ventures involving insurers, banking businesses, as well as in the sale of high-value assets owned or controlled by governmental agencies.

Pablo is constantly ranked in legal industry publications as one of the best M&A lawyers in Mexico.

Patricio Trad
Mijares, Angoitia, Cortés y Fuentes

Patricio appears in the main list of capital markets leaders, considered as a corporate finance all-rounder with broad experience in corporate transactions and structured finance matters.

He is also a relevant practitioner in M&A and energy practice areas. He has experience in mergers and acquisitions, buyouts, joint ventures and divestitures, securities regulation, corporate and structured finance, infrastructure, energy and general corporate law.

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He regularly advises issuers in diverse local and cross-border tender offers, acquisitions, buyouts, and joint ventures advising both buyers and sellers, also institutional investors and private equity investors in different industries, including regulated industries and public companies.

In addition, he has collaborated in a variety of debt and equity issuances in the Mexican market and routinely advises diverse Mexican and foreign banks in lending transactions to Mexican companies and regulatory matters.

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Published by Latin Lawyer and LACCA, edited by Paola Lozano and Daniel Hernández of Skadden, Arps, Slate, Meagher & Flom LLP, *The Guide to Mergers and Acquisitions* provides guidance that will benefit all practitioners acting in Latin American mergers and acquisitions.

M&A activity in Latin America has grown significantly in recent decades, and deals are increasingly complex. This guide draws on the expertise of highly sophisticated practitioners to provide an overview of the main elements of deal-making in a region shaped by its cyclical economies and often volatile political landscape. Its aim is to be a valuable resource for business people, investors and their advisers as they embark on an M&A transaction.

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