

# The New Practice (TNP)

## - An Andersen Collaborating Firm



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## “Shine your Eyes” – Are Disclosure Letters in Acquisitions the Real Deal?

Negotiations usually cover the nature and extent of the warranties, the liability arising from breach and the limitations on the liability of the seller. If a warranted promise turns out to be untrue or misleading, the purchaser is likely to make a claim to recover its losses. However, such a claim will fail if the facts which gave rise to the breach were disclosed, hence the need to “Shine your eyes”.

### Disclosure the real deal?

Disclosures could be voluntary, general, specific, or mandatory. It is mandatory when required by statute and accounting standards, while it is voluntary when made on the seller’s volition.

In an acquisition, both the mandatory and voluntary disclosures are needed by the investor to guide its investment decision. In a share sale, the contract often includes a clause that the representations and warranties will apply except as disclosed in a disclosure letter.

General disclosures cover certain matters that appear in public records and of which the purchaser ought to be aware of based on enquiries or searches conducted prior to the agreement to acquire the target.<sup>1</sup> Specific disclosures occur when the seller discloses, in precise terms, factual matters which, if not disclosed, would create a breach of warranty. The specific disclosures are made by reference to the warranties themselves. For example, if there is a warranty within the sale agreement that the target company is not a party to any litigation, the seller would need to disclose full details of any current litigation affecting the company. Also, certain warranties may require specific information to be listed in the disclosure letter such as material contracts, pension schemes, etc.<sup>2</sup> On the other hand, general disclosures such as public information and searches which are quite standard across all acquisitions are deemed to have been disclosed to the purchaser. Examples of general disclosure include a review of the target company’s statutory books, searches at Corporate Affairs Commission, searches on the company’s real property and so on.

It is very important to note that when making disclosures, the seller’s objective is to transfer the risk in respect of the matters disclosed to the purchaser. On the other hand, the purchaser may only want to accept disclosures which are fairly made and with reasonably sufficient details to enable the purchaser to fully understand the implications of the disclosures.

As a seller, you will want to ensure that you limit your potential liability to the barest minimum. Issuing a disclosure letter offers the seller that protection by “flushing out” information about the business and thereby protects the seller from a prospective breach of warranty claim.<sup>3</sup>

For a purchaser, the disclosures supplement the due diligence exercise by giving it a full picture of the business to be acquired. It helps the purchaser to discover any defects in the company’s accounts or any similar problems, prior to the acquisition rather than having to discover them at a later date.<sup>4</sup>

### What the Seller should Shine Eyes on?

The seller must ensure that all important disclosures are made in detail. It is better for the seller to disclose more than is necessary than not to disclose enough information. When all relevant disclosures are made to the purchaser from the kickoff, it can minimize any claims for breach of warranties. Where the seller does not adequately divulge the necessary details, the purchaser may allege that the disclosure was inadequate, thus exposing the seller to a claim for breach of a representation and warranty. When drafting the disclosure letter, the seller should confer with all its operative units to obtain all relevant information. In addition, the seller has a duty to update the disclosure letter with any new findings during the course of negotiations until the transaction is closed out. Relevant documents which further validate the disclosure letter should be enclosed.

### What the Purchaser should Shine Eyes on?

To protect itself and mitigate future challenges that may arise from the disclosure, the purchaser may negotiate for certain concessions with respect to the disclosures made by the seller. Such concessions

may include the option to terminate the agreement, or specific indemnities pertaining to a disclosure item, or a reduction of the sale price. As much as possible, the purchaser should ensure that it thoroughly inspects the documents disclosed by the seller, in addition to the general disclosures made by the seller, and in spite of the seemingly ample information that may have been likely obtained during due diligence.

During negotiations, the purchaser should ask questions in relation to the drafts of the disclosure letter, and documents disclosed, to ensure clarity and an understanding of the documents. The purchaser must understand the consequences of accepting the disclosure letter. It is best for the purchaser to raise issues at the negotiation stage of the deal rather than after completion.

More importantly, the purchasers are advised to ask questions about the disclosures from the seller and review all accompanying documents to fully assess the impact of the disclosures on the transaction and the business.

### Implication of a Disclosure Letter in Acquisitions

As indicated already, the effect of a disclosure letter is that it releases the seller from liability on matters that have been disclosed. However, the purchaser may still be able to claim under a disclosed matter by including indemnities to alleviate the risks embedded in the matter. Disclosure letters are critical in acquisitions as they complement a purchaser’s due diligence and help the seller to limit or qualify warranties and representations provided in the sale contract. The letter, though not a contractual document in itself, has contractual significance and the parties may agree for it to prevail if there are inconsistencies between it and the main agreement. Whilst there is no prescribed format for the letter, it usually contains an introduction, general and specific disclosures, as well as enclosed documents, if necessary.

### Conclusion

The disclosure letter is as important as any other transaction instrument in an acquisition. A well-drafted and negotiated disclosure letter can minimize the time and money spent on acquisitions. Bearing in mind the critical nature of disclosures in acquisitions, it is necessary to seek legal advice before and during negotiations of the terms of the acquisition. The potential liabilities and losses that could flow from a poorly drafted disclosure letter underscores the need for the parties to an acquisition to have expert legal representation throughout the process. Poorly drafted documentation and half-baked advice can result in repayment of some or all of the consideration or the purchaser having no recourse despite being misled as to the true value of the target business.

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<sup>1</sup> <https://www.gabyhardwicke.co.uk/briefing-notes/the-disclosure-letter-explained/>  
<sup>2</sup> <https://www.gabyhardwicke.co.uk/briefing-notes/the-disclosure-letter-explained/>  
<sup>3</sup> <https://www.fig.co.uk/blog/disclosure-in-business-acquisitions-why-is-it-important/>  
<sup>4</sup> <https://www.fig.co.uk/blog/disclosure-in-business-acquisitions-why-is-it-important/>

The Nigerian slang “Shine your eyes”, meaning “wake up, look at what is really happening”, is a must in any acquisition transaction.

Mergers and acquisitions are a regular feature of the commercial eco-system. They are often used as a tool for rescuing companies from financial distress, building stronger businesses, or complying with regulatory recapitalization mandates.

In a typical acquisition agreement, as with most legal contracts, representations and warranties are made by the parties to give each other the confidence required to consummate the transaction. Due diligence, which requires information-gathering, usually about the target company, is mostly done by setting up a data room that will contain details and documents relevant to the target business. The purchasers will sift through the documents in addition to checking publicly available records about the target.

It is often assumed that when a thorough due diligence exercise has been conducted, the investor or purchaser becomes aware of every relevant piece of information about the target company and its business. This assumption is not correct because, more often than not, due diligence does not reveal all the details which may be of interest to the investor or purchaser.

### Representations and Warranties, the Caveat

When agreeing to acquire a business, a purchaser will usually have relied upon various statements of fact and promises made by the seller, known as representations and warranties respectively. To compensate for the lack of statutory protection for a purchaser and to ensure that the purchaser can recover its losses if the basis of the purchase subsequently proves to be incorrect, the main representations and warranties relied on are usually included in the sale and purchase agreement.

In the context of a business acquisition, it is generally accepted that the purchaser will seek and the seller will give warranties. Warranties take the form of promises, assurances or guarantees from the seller as to the condition and state of the target company and in particular, any existing or contingent liabilities, at the time of completion. No matter how thorough the purchaser’s due diligence is, the purchaser cannot expect to find out everything about the company before completing the acquisition. If the purchaser subsequently finds that he has not bought what he thought he was buying, he may be able to bring a claim for damages for breach of warranty.

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