South Africa

Negotiated M&A Guide

Corporate and M&A Law Committee

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1. Introduction / Legislative Framework

The M&A legislative framework in South Africa comprises both statute and common law. In private M&A deals, where much is regulated by agreement between the parties, the uncodified common law of contract plays a particularly significant role. As discussed in greater detail below, the three primary means of implementing a private M&A transaction, a sale of business, a sale of shares and a merger, are primarily achieved through contract. Statutory law, which plays a more central role in public deals, is more peripheral in the context of private deals, although obviously still important.

From a statutory perspective, one of the key pieces of legislation is the South African Companies Act, 2008, as amended, which commenced in 2011 (the “Companies Act”). Amongst other things, the Companies Act prescribes (i) shareholder approval for the disposal by a target of a greater part or all of its assets or business, (ii) provides for the acquisition of minority shareholdings when an offeror acquires 90% of the shares in the target (a “Squeeze Out”), (iii) regulates schemes of arrangement (a statutory procedure commonly used to implement acquisitions, although primarily in the context of public deals, and only used in the context of private deals if there are a large number of shareholders involved); (iv) appraisal rights for dissenting minority shareholders to schemes of arrangement, mergers and sales of business (if all or a majority of the business is sold) and (v) provides for a statutory merger procedure where two corporate entities amalgamate into one.

South African mergers and acquisitions are also governed by the Takeover Regulations, which are contained within the body of the Companies Act. Although the Takeover Regulations apply primarily in the case of public transactions, they also apply to private transactions where there has been a transfer of 10% or more of the shares in the private company (other than between related parties) within the last 24 months. The Takeover Regulations apply to so-called “affected transactions”, which includes, among others, those which involve a disposal of the whole or substantially the whole of the business of the company, a merger, a scheme of arrangement, or a transaction which results in a person acquiring 35% or more of the voting rights in a company. Amongst other things, the Takeover Regulations impose strict timetables on transactions; they impose restrictions on frustrating actions and dealing in securities before, during and after the offer period; they introduce independent expert and independent board requirements; and they require a person acquiring 35% or more of the voting rights in a company to make a mandatory bid for the remaining shares in the company. An affected transaction may not be implemented by a regulated company unless the Takeover Regulation Panel (the “Panel”) has issued a compliance certificate, or granted an exemption, in respect of the transaction.

The Listings Requirements of the JSE Limited (the “Listings Requirements”) will also apply if the offeror’s or target’s shares are listed on the Johannesburg Stock Exchange, which is the main licensed exchange in South Africa for the listing of equity and debt securities (the “JSE”).

Another important piece of legislation is the Financial Markets Act, 2012. The Financial Markets Act regulates and controls securities trading, clearing and settlement, and among other things, the prohibition of insider trading and other market related abuses. The South African Competition Act, 1998, (the “Competition Act”) forms an important part of the South African M&A legislative framework. For those transactions which constitute notifiable mergers under the Competition Act, approval of the South African competition authorities is required before the transaction can be implemented. A notifiable merger is one where there is change of control (either legal or de facto control) over a South African company or business and the thresholds (of assets and turnover) set out in the act for mandatory notification; are met. From a threshold perspective, there are two categories of notifiable mergers: intermediate mergers and large mergers – the latter generally involving a more extended approval process, with the approval of South Africa’s highest competition body, the Competition Tribunal. Mergers which fall below the prescribed thresholds for an intermediate merger are considered to be small mergers and are not notifiable, although the competition authorities retain the ability to call upon the parties to a small merger to notify the merger if they believe it may substantially prevent or lessen competition or cannot be justified on public interest grounds.

Another consideration that needs to be taken into account in M&A transactions in South Africa is the system of exchange controls which South Africa has had in place for many years aimed at regulating the flow of capital in and out of the country. These controls (which are set out in the Exchange Control Regulations, 1961) have often played a significant role in the manner in which M&A transactions in South Africa, particularly cross-border transactions, are structured. Amongst other things, approval is required for a South African corporate to acquire a shareholding in an offshore entity, for the sale of South African shares or assets to an offshore entity, or for the use by foreign companies of their shares as acquisition capital for the acquisition of South African entities. It must be noted, however, that these exchange controls have been gradually relaxed in recent years. Amongst other things, the size of the minimum equity stake which South African corporates are required to hold in their foreign investments has been reduced, and allowances have been made for foreign companies to use their non-South African shares as acquisition capital for M&A transactions by means of a secondary listing on the JSE.

One unique consideration in the South African context is the regulatory framework aimed at black economic empowerment ("BEE"), i.e. ensuring the economic empowerment of previously disadvantaged black South Africans. From an M&A perspective one of the key elements of the government's BEE policies has been the targets prescribed in respect of black equity ownership, and most of the major companies in South Africa have concluded transactions in terms of which they have disposed of a significant equity stake (generally up to 25% or 30%, depending on the industry) to black shareholders. It is generally a key commercial imperative for a company to have this significant equity stake held by black shareholders, and in certain cases (such as for the holders of mining or telecommunications licences), it is a legal requirement. The acquirer of the shares in or business of the target will often need to consider how the business's BEE requirements will be met post-transaction.

In particular industries there will also be industry specific legislation which will have an impact on the transaction – for example, in terms of the Mineral and Petroleum Resources Development Act, a change of control of the holder of a mining right requires the approval of the Department of Mineral Resources.

2. Structure of the Transaction

In terms of structuring a private M&A transaction in South Africa, there are three primary options available to the parties – a sale of the shares in the target company from the vendor shareholders to the acquirer, a sale of the target company's business (or a portion thereof) to the acquirer or a merger.

Historically, a sale of shares was the preferred route for implementing a private M&A acquisition, given that it is usually cheaper, simpler and quicker than a purchase of a business. A sale of shares avoids the logistical issues inherent in transferring each individual asset and liability of a business and allows for the business to continue unaffected. In particular, it often avoids the need to procure governmental and/or third party consents which may be required to transfer things like licences, intellectual property or contracts. The only possible area where potential formalities may arise is if there are any change of control provisions in any of the company's contracts, or if a change of control of the holder of a licence requires government approval. A sale of shares also does not necessitate a transfer of employees, as the employees will simply continue with their employment with the target company. Although in terms of the South African Labour Relations Act, 1995, the employees of a business which is sold as a going concern will automatically be transferred as a matter of law to the purchaser, the purchaser will need to ensure that it employs the employees on terms and conditions which are no less favourable than those on which the employees were employed by the seller. If, for example, an employee has certain medical aid and pension fund benefits with the seller, he or she would be entitled to similar or greater benefits from the purchaser.

Since the coming into effect of the Companies Act in 2011, and the introduction into South Africa of the statutory merger provisions which provide for one entity to merge into another or for two or more entities to amalgamate into a new separate entity, the market has seen a slow increase in the number of transactions making use of this statutory procedure. The merger procedure provided for in the Companies Act is, on the face of it, relatively straightforward and flexible. In theory, the merger procedure has an advantage over the sale of business in that it provides for the automatic transfer of property and obligations of the merging parties as well as the dissolution by operation of law of non-surviving entities without the additional costs, formalities and time to transfer the business and need to go through formal liquidation proceedings.

Logistical considerations aside, however, there may be specific benefits for a purchaser in implementing a sale of business. The key advantage of a sale of business, is that the purchaser is able to cherry pick the assets it requires, and only assume known and quantified liabilities. A sale of business also only requires the approval of the shareholders of the selling entity, unlike the merger which requires approval from all merging entities shareholders.

Tax considerations generally play a key role in deciding which structure may be appropriate for a transaction. A sale of business, for example, may result in a potential extra level of taxation for the vendors, given that taxes may be required to be paid, both when the assets are sold and when the proceeds are distributed to shareholders. On the other hand, the acquirer may prefer an acquisition of the business, as he will generally be able to avoid any unforeseen contingent or other tax liabilities which the target may have incurred.

Ultimately the most appropriate structure for the transaction will depend on the facts of the particular transaction.

3. Pre-Agreement

It is not uncommon for parties to enter into heads of agreement prior to concluding a definitive acquisition agreement, particularly in complex negotiations, as a means of determining whether or not the parties are agreed on principal commercial points. Usually, heads of agreement will be short, high-level documents and non-binding. Parties tend to avoid legally binding heads of agreement as they may take as long to negotiate as the definitive acquisition agreement and may end up being of equal length and complexity. Furthermore, an agreement can be void for uncertainty if major terms are left unagreed. In order, therefore, to have a legally binding heads of agreement, it is not only necessary to draft and agree upon the principal terms, such as the assets being sold, the consideration, conditions and other major terms, but it is also necessary to negotiate the detailed wording of the warranties and indemnities, the limitations on the liability of the seller or the directors and what disclosure will form an exception to the warranties. In many cases, lawyers will favour not having heads of agreement at all, given that they often take the parties little further and given that the net result may be merely to delay the preparation and negotiation of the definitive acquisition agreement.

The purchaser will often request exclusivity from the target company, either as a binding provision in an otherwise non-binding letter of intent or in the form of a stand-alone agreement. The typical exclusivity arrangement will block the target company from (i) soliciting offers for the subject business, (ii) sharing information and (iii) engaging in discussions with other potential buyers. A purchaser will generally not want to incur the significant time and expense associated with due diligence and transaction negotiations without exclusivity, and will want to avoid serving as a "stalking horse" for other bidders. However, target companies typically strongly resist granting exclusivity.

In respect of shareholder lock-up agreements, Guideline 1/2013 issued by the Panel in terms of the Takeover Regulations provides that no more than 5 minority shareholders, each holding at least 5% or more of the shares of the target, can be approached. Although, as noted above, the Takeover Regulations apply both to public companies and certain larger private companies, lock-up arrangements are not commonplace in the context of private deals. The only time that one may see lock-up arrangements in the context of a private detail are in situations where a scheme of arrangement is used, which as noted above are only likely to be used in the context of a private deal if there are a large number of shareholders involved. Even in the context of public deals, soft irrevocables are generally given by shareholders, allowing the shareholder the opportunity to back out if a better offer comes along.

A purchaser will generally look to conduct due diligence of the company or business which it is looking to purchase, to ascertain, as far as is possible, the nature and value of the assets and liabilities to be acquired, and confirm possible risks to which the company or business may be exposed. In some cases, such as where the purchaser is a competitor of the business or the seller is anxious for a quick sale and there are a number of interested parties, the seller may deny the purchaser any meaningful due diligence, but otherwise the purchaser will typically be afforded the opportunity to conduct at least some due diligence. The extent of the due diligence which the purchaser is afforded is likely to impact on the extent of the warranties which are given by the seller. Where the purchaser conducts a comprehensive due diligence, the seller is likely to be less willing to give wide ranging warranties. Where, however, the purchaser has not been afforded the opportunity to conduct any meaningful due diligence, the purchaser is likely to demand a full set of warranties and/or indemnities.

4. Acquisition Agreement

The content of the acquisition agreement obviously varies greatly from matter to matter, depending on the particular transaction. Generally speaking, a sale of business agreement is likely to be a more complicated document than a sale of shares or merger agreement, as the assets and liabilities that are being transferred need to be carefully defined, and the mechanisms of transferring the business needs to be set out. A sale of shares and a merger agreement, however, will often have a more comprehensive set of warranties, given that the purchaser of the shares in the company is generally at greater risk than an acquirer of the business, who can pick and choose the liabilities that it would like to assume. Whether the transaction is structured as a sale of shares, a merger or a sale of business, most acquisition agreements will have a number of standard provisions, including clauses dealing with the consideration and manner of payment, conditions precedent to the transaction, pre-transaction and post-transaction covenants, warranties and representations and dispute resolution. These are dealt with in greater detail below.

5. Consideration

Although the consideration for an acquisition normally consists of, or largely includes, cash, it is not uncommon for the consideration to be, or to include as an alternative, shares of the purchaser or, indeed, other forms of property. The new merger provisions contemplate a consideration where shares in the merging companies are converted into shares in the merged entity, but also potentially allows for the shareholders of one or more of the merging entities being paid in cash (which creates the possibility of a merger being used as a Squeeze-Out mechanism) or receiving shares in an entity other than the merged entity (such as, for example, the holding company of the merged entity) as consideration.

The price will normally either be a fixed price, an amount determined with reference to the net asset value of the target (as shown by accounts prepared as at the completion of the transaction) or a figure calculated with reference to the profits of the company, either historical or future.

If a fixed price is agreed with no provision for adjustment by reference to completion date or other accounts, the consideration can be simply stated. It is, however, becoming increasingly common for purchases to be made by reference to the net assets or profits shown by completion date accounts or, at least, for any fixed consideration to be subject to adjustment by reference to them. This provides a purchaser with far greater protection in knowing exactly what it is paying for. Provision is often made for an inventory-taking clause, which regulates how inventory of the business will be accounted for, and how things such as obsolete and damaged inventory will be treated. A price adjustment mechanism is particularly useful in a sale of business where variable assets such as inventory or book debts are being acquired. Amongst other things, it protects the purchaser against the seller managing the assets to be handed over at completion to his advantage. An example would be a scenario where the purchaser is taking over the book debts of the company, but is not acquiring the cash and cash equivalents (given that it makes little sense to pay cash in return for cash). This creates an obvious incentive for the seller to accelerate his debtors' book to increase the cash balance upon completion, to the prejudice of the purchaser and the value of the assets which he pays for. A price adjustment mechanism will help protect the purchaser in this regard, by ensuring that he only pays for what he receives.

The consideration is normally settled in full at completion or, where completion accounts are to be made up, shortly after they are made up, together with interest from the date of completion on any under or over-payment at an agreed rate. Provision can also be made for the consideration to be determined by subsequent events, either realisation on an agreed basis of specific assets or future profitability. Provisions relating the consideration to future profitability ("earn-outs") are most common when there are certain key personnel who are vital for the success of the business. In such cases, if all the key people were to leave, the goodwill would be lost and the target's value much reduced. If the key people are also sellers and they know that all or a large part of the consideration for the sale is related to future profitability, they will be more inclined to stay and work to obtain profitability. Although the principle of an earn-out is simple, the detailed provisions are generally not and are often the subject of extensive negotiation. The sellers will usually require some sort of undertaking from the purchaser that if their consideration is related to future profitability, then the purchaser will not do anything which might adversely affect that profitability. Sellers will generally have to accept the risk of changes from outside events but they will want to restrict internal change and retain substantial management control. The purchaser will therefore typically be constrained in the way that it can deal with the target and its business until the earn-out has expired.

Holdback arrangements, where a portion of the purchase price is held back as security for any claims that the purchaser may have under the agreement, are not uncommon in South African acquisition agreements. Typically, to the extent that the seller agrees to such an arrangement, it will require that the held-back amount is kept in escrow by an independent third party (often a firm of attorneys). The agreement will specify the procedure which must be followed before any amount can be released from the escrow account to either of the parties. Generally, such a clause will provide for a retention period which will mirror the length of the warranty period (as discussed below), and will require that the purchaser not only made a claim against the seller, but (to the extent that the seller has not accepted the validity of such claim) have initiated legal proceedings against the seller prior to the end of the retention period. In such a case, the agreement will typically provide for the money to remain in escrow until the legal proceedings have been settled, although the seller may ask for provision to be made for that portion of the retention amount that is not in dispute to be released from the escrow account.

Another item which sometimes causes debate is the valuation of book debts. Typically, the purchaser will require that adequate provision is made for bad debts in the accounts of the target. Although the seller will generally not object to this, particularly as proper provision is in any event required in accordance with generally accepted accounting principles, it is likely to resist any request to make full provision for all liabilities since this could be very onerous. In some cases, the purchaser may seek to agree that bad debts which have not been recovered after a certain period (such as 90 days) can be ceded back to the seller, at the face value thereof (less any provision in the accounts therefor).

6. Conditions of closing

The conditions of closing to which the acquisition agreement is subject vary from deal to deal. One of the most common conditions is approval from the South African competition authorities. As noted above, a merger which meets the prescribed thresholds must be notified to the South African Competition Commission, and the transaction cannot be implemented until such approval is obtained. Competition approval may take up to sixty business days (in the case of an intermediate merger) and four months (in the case of a large merger), so it is often one of the key factors affecting the timing of a transaction. It also generally means that there may be a long period between the signature date and the closing date, which results in extensive negotiation around issues such as how the business should be managed during the interim period and the extent to which the seller should be liable for a breach of warranties at the closing date as a result of events arising during the interim period.

If a cross-border transaction is involved, approval of the Financial Surveillance Department of the South African Reserve Bank may also be required and this may need to be a suspensive condition to the agreement. Approval may, *inter alia*, be required in advance if a South African entity is seeking to acquire an offshore entity or if an offshore entity is looking to purchase South African assets (such as intellectual property). Approval is also required if warranties are given by a South African entity to an offshore entity before such warranties can be enforced. Strictly speaking, such approval is only required when the purchaser is looking to enforce the seller's warranties, but a purchaser will generally want to get such approval upfront in order to have certainty that the warranties can be enforced. If an offshore entity acquires shares in a South African company, such shares will need to be endorsed "non-resident" by the exchange control authorities. This does not need to be a condition precedent to the transaction; it is generally a straightforward process and may be done post-transaction. If it is not done, it does not affect the validity of the transaction, but until such endorsement is obtained, no dividends can be paid out in respect of such shares, nor can the purchaser repatriate any funds received for the shares should it subsequently sell the shares to a South African purchaser.

In particular industries, where a licence is required to operate the business, the approval of the relevant authorities will generally be required for the transfer of the licence (in the case of a sale of business) or a change of control of the licensee (in the case of a sale of shares or merger), and as such will need to be a condition precedent to the agreement. Industries where such approvals are likely to be required in South Africa, include the mining, telecommunications and banking industries.

In terms of the Companies Act, any sale by a company of all or the greater part of its business or a merger or scheme of arrangement requires a special resolution of the shareholders of the company (being 75% of the disinterested shareholders voting at the meeting called to consider the resolution). This therefore needs to be a condition precedent to any sale of a business which involves all or a majority of the business being transferred or merger or scheme of arrangement. The Companies Act unfortunately does not define what is meant by "the greater part" of the company's business (although it does set out the mechanism and prescribed manner in which to fairly value the disposal of a company that is governed by the Takeover Regulations), so in situations where not all of the business is being sold, consideration needs to be given to whether this constitutes a "greater part" of the business in order to determine whether such approval will be obtained. Often, in situations when it is not completely clear, the parties may in any event make the obtaining of such a resolution a condition precedent in order to be safe.

Because a merger, scheme of arrangement or sale of all or a greater part of a business will trigger appraisal rights for shareholders who vote against the transaction, it is often made a condition precedent that no more than a small specified percentage of shareholders exercise their appraisal rights. Dissenting shareholders who vote against any of the aforementioned transactions may also apply for court review of a transaction, and if more than 15% of shareholders vote against, automatic court review is required (unless the company decides to treat the resolution as a nullity). It may also be made a condition precedent to the transaction that no court review process is initiated or required.

A condition precedent that is often required by the purchaser in sale of business agreements is that approval is obtained for the assignment of certain contracts from the seller to the purchaser. Even where such contracts do not have a strict prohibition on assignment without the consent of the counterparty, a delegation of the seller’s obligations under such contract will, as a matter of South African common law, require the consent of the other party. The purchaser will generally therefore want certainty that such consents will be obtained, although for matters of practicality, this will generally be confined to those contracts which are particularly material to the business. One of the major advantages of implementing a transaction by way of a merger is that assets and liabilities are assumed by the surviving entity by operation of law and therefore, that there is no need to obtain approval for the assignment of contracts, except in limited circumstances where the contract expressly contemplates and restricts a statutory assignment. In the case of a sale of shares, where consent of a counterparty to a material contract is required for a change of control of the entity in which the business is housed, the purchaser will want to make it a condition precedent to the transaction that such consent is obtained.

7. Covenants of the buyer and seller

Pre-transaction covenants

As noted above, competition approval is often required for a transaction, and may result in there being a significant delay between signature and closing. The purchaser will therefore often seek to place limitations on the seller (in the case of a sale of business) or the target company’s (in the case of a sale of shares or merger) ability to do anything which may impact on the value of the business, by seeking undertakings from the seller and/or company that they will not do certain things during the interim period without the purchaser’s approval. This will include entering into major transactions, incurring large liabilities, hiring or firing of employees and/or distributing profits of the business to shareholders. Given that this may have a significant impact on the seller and/or company’s ability to conduct its business, the seller will often resist giving too comprehensive a set of undertakings in this regard, particularly if there are a number of other conditions precedent, and if there is no guarantee that the transaction will go through. To the extent that the seller and/or company agree to such restrictions, they will generally seek to limit their ambit by requiring that it only apply to transactions outside the ordinary course of business, or to matters over a certain specified amount. Care needs to be taken in the case of transactions requiring competition approval that in giving such undertakings, the purchaser does not implicitly acquire negative control over the business, as this may be considered by the competition authorities to be acquisition of *de facto* control prior to the necessary approvals being obtained. The purchaser may therefore need to ask for less comprehensive undertakings from the seller or target company than it would otherwise normally want. The purchaser may, however, protect itself in other ways, by asking for an adjustment of the purchase price post-closing if the seller and/or company’s actions during the interim period have significantly impacted the value of the business, or asking for warranties as at the closing date that certain actions have not been taken during the interim period, which will then allow the purchaser to claim damages and/or terminate the agreement if such warranties have been breached. The purchaser may also ask for one of its representatives to be able to attend board meetings of the target as an observer during the interim period, although the seller may well resist this, particularly if the purchaser is a competitor.

Another pre-closing issue that is often the subject of negotiation in sale of business agreements relates to the provisions of Section 34 of the South African Insolvency Act, 1936, in terms of which any company which seeks to sell its business, or a portion thereof, must publish a notice of the intended disposal in the Government Gazette and four daily newspapers at least 30 days and not more than 60 days before the intended disposal. This requirement is aimed at alerting all creditors of the company to an intended disposal of the company's business or part thereof. Upon publication of the notice, any creditor may demand immediate payment of any liquidated claim which it may have against the company, even if such claim would only become due and payable at some future date. If the notice is not published as prescribed by the section, then for a 6 month period following the disposition, such disposition will be void as against the company's creditors, and, in the event that the company is liquidated during that period, as against the company's liquidator. Thus the creditors of the company may, in respect of any liquidated debt owed to them by the company, claim against the business or assets of the company which has been disposed of to the purchaser. Likewise, if applicable, the liquidator of the company may choose to ignore the transfer of the business and treat any disposed assets as forming part of the company's estate.

It is therefore in the purchaser's interests that such notices are published prior to closing, and the purchaser may seek the requisite undertaking from the seller in this regard. Given the potential disruption that this is likely to cause to the seller's business and the significant impact that this may have on the seller's cashflow, the seller generally resists giving such undertaking, and will instead ask that the parties agree to waive giving such required notices, in return for the seller indemnifying the purchaser for any claims that may be made against it. Provided that the seller is a reputable organisation which is unlikely to have significant unpaid debtors, and which has the wherewithal to make good on its indemnity, the purchaser will often agree to this, particularly in light of the impact that the publication of such notices may have on the timing of the transaction, and the cashflows of the business. To the extent that the seller is selling all or most of its business, however, the purchaser will generally require an indemnity to be given by a parent or sister company of the seller who will be able to make good on such indemnity. To the extent that the purchaser agrees to acquire all of the liabilities of the seller as part of the acquisition of the business, such an indemnity may not be necessary, and the parties may just agree to waive the publication of the notices.

Post-transaction covenants

One of the most common post-transaction covenants that a purchaser may request from a seller is a non-compete undertaking of some sort. Generally, the willingness of the purchaser to acquire the business or target company may depend on the seller giving certain undertakings, such as not to use a similar name in a competing business, perhaps not to compete at all for a particular period, not to solicit any of the employees for a particular period or merely to continue certain trading arrangements. Any provisions of such nature which may restrict the seller's future trading ability need to be considered, however, in the light of the relevant South African law, and in particular South African common law.

Under the South African common law, covenants in restraint of trade are only enforceable to the extent that they are reasonably necessary for the protection of the party's legitimate interests. On the sale of the company or business, the purchaser has a legitimate interest in ensuring that the seller does not derogate from his sale by seeking to retain some of the goodwill which the purchaser would expect to go with the company or business. What is reasonable, however, varies from case to case, and will depend completely on the facts of the particular transaction. The type of restraint that is required will be relevant. An undertaking not to compete under a similar trading name, for example, is likely to pass muster but an undertaking not to compete at all will in all likelihood have to be limited to the business as carried on at completion (and not areas into which it subsequently develops). Other important considerations are the duration and the geographical extent of the restraint. Typically a restraint will be for a period of one to three years after completion, and anything more than five years is likely to be problematic. From a geographical perspective, the starting point will be to limit the restraint to the area in which the business is conducted as at the closing date, although a purchaser may be able to justify a restraint which extends to areas where the business is likely to expand in the near future.

As noted above, as a matter of South African common law, except in the case of a merger in respect of which contracts are assigned by operation of law, even where there is no express prohibition on the assignment of the contract, the delegation of the seller's obligations under such contract will require the consent of the counterparty. Although in respect of material contracts that need to be assigned as part of a sale of business, the obtaining of such consent will often be made a condition precedent to the agreement, this is not necessarily practical for all contracts to which the company is a party. Accordingly, it is usual in a sale of business agreement to include a clause regulating the manner in which those contracts where consent has not been obtained will be dealt with. Typically, the clause will provide that, to the extent possible, the purchaser will perform all the seller's obligations under the contracts as if it were a subcontractor to the seller, and the seller will exercise all its contractual rights for the benefit of the purchaser and will pay to the purchaser all amounts paid to it. It will also provide that to the extent this is not possible, the purchaser and the seller must co-operate to find the best manner to achieve their objective.

Another post-transaction covenant which is typically included in a sale of business agreement is an obligation on the seller to give the purchaser such reasonable access to its books and records as the purchaser may require for the purposes of its tax affairs or for the continued operation and management of the business.

Representations / warranties / indemnification

Much of the negotiation of the acquisition agreement will centre around the representations and warranties. It has become generally accepted that extensive protection is given to purchasers in acquisition agreements, particularly so in the case of a sale of shares where the purchaser is potentially at greater risk.

There are many warranties that are standard to almost any type of acquisition. This would include, amongst other things, warranties regarding the corporate organisation and structure of the company, the books and records of the company, the assets and liabilities of the company, employees and employee benefits, tax, litigation, intellectual property, material contracts, licences and permits and compliance with all applicable laws. There are also warranties which will be specific to the type of company or business being acquired. Thus, for example, if the company being acquired is a mining business, the purchaser would expect specific environmental and regulatory compliance warranties; if the business involves manufacturing, product liability warranties are generally asked for. A warranty that is often seen in South African acquisition agreements is one relating to the black economic empowerment status of the target company. As noted above, black economic empowerment has become an important legal and commercial imperative for companies conducting business in South Africa, and a purchaser will want some comfort that the company or business being acquired has an adequate BEE rating, or, in cases where a certain percentage of black ownership was required in order for the company to obtain the licences necessary for conducting its business (such as in the mining and telecommunication industries), that these criteria were met. As the level of BEE ownership is also something that is taken into account in determining the BEE rating, an acquirer will also often need to have a plan in place to ensure that there is adequate replacement BEE shareholding, particularly if a certain level of BEE ownership is required for the target company to maintain its key licences.

In cases where the purchaser has been allowed to conduct due diligence of the target, sellers will typically seek to argue that the level of warranty protection to which the purchaser should be entitled should be reduced accordingly. Many sellers will start from the position that warranty claims should be excluded where they relate to matters which have been or ought to have been uncovered in the due diligence process. Broadly speaking, there will be an inverse relationship between the extent of the due diligence which the purchaser has been allowed to conduct and the level of warranty cover which that purchaser can expect in the acquisition agreement. Whether or not that inverse relationship is actually reflected in the final document is dependent upon the characteristics of the transaction and the relevant bargaining strengths of the two parties.

Typically, the seller will be afforded the opportunity to provide a disclosure letter, in which it will disclose information in relation to specific warranties where the warranty as stated is not completely accurate or where the seller feels the warranty needs to be qualified. The effect of such a letter is to limit the liability of the seller under the warranties in respect of those disclosures that have been made and accepted by the purchaser. The disclosure letter also gives the purchaser a better idea of possible risks in relation to the target company and in relation to the shares or business being purchased. The contents of such a letter are typically a matter for negotiation. The seller will generally try and make its disclosures as broad as possible to limit its liability. In addition to specific disclosures made against specific warranties, the seller will often also attempt to include various general disclosures, such as providing that all information on record at public registries, including those at the Companies and Intellectual Property Commission, or all information made available to the purchaser in a due diligence investigation will be considered disclosed to the purchaser. The purchaser, on the other hand, will seek to limit the seller's disclosures to the specific disclosures made in the formal disclosure and will also seek to resist disclosures in the disclosure letter which are too broad and which may have the effect of negating the entire warranty to which it is supposed to be an exception.

Where there is a delay between contract and completion, the purchaser will often request that the warranties are given both at signature and on completion. The seller will often agree to this only on the basis that the purchaser should not be entitled to be compensated if a breach of warranty is caused by an event beyond their control arising between signature and completion. A compromise solution is often reached by allowing the purchaser a right to terminate the contract if an event occurs which would render the warranties materially inaccurate at completion, but not allowing them to claim damages for such breach if they elect to nevertheless proceed. In such a case, the seller will often be required to immediately notify the purchaser of any event which may result in the warranties being inaccurate.

In a sale of shares agreement, purchasers will often request an indemnity clause in addition to the warranties provided by the purchaser. This is because typically the normal measure of damages in the case of a breach of warranty is the difference (if any) between the value of the shares on the notional basis that the warranty had been fulfilled and their value in fact, i.e., on the basis of the breach thereof. In cases where a breach of warranty may not necessarily affect the value of the shares (for example, if there is a breach of the warranty that the books of the company are in order), the purchaser may not have a claim, even if costs have to be incurred to remedy the breach. An indemnity clause seeks to ensure that the purchaser is compensated, on a breach of warranty, for the actual loss the target company suffers due to that breach, even though the loss may not be reflected in the value of the shares in the target company. A further benefit of an indemnity clause is that a purchaser is not required (as with a damages claim for a breach of warranty) to take reasonable steps to mitigate its loss.

During negotiations the seller will endeavour to reduce the scope of the warranties and/or indemnities sought by the purchaser by various means. One of the ways a seller will typically seek to do this is by adding a qualification that the warranty is given 'to the best of its knowledge, information and belief'. In such a case the purchaser would only be protected against liabilities which it could prove the seller knew about or, most probably, of which the seller had constructive knowledge. The seller will also seek to limit the persons whose knowledge can be attributed to it to specifically identified persons. To the extent that the purchaser agrees to include a qualification of this nature, it will generally seek to limit this qualifier by asking for the addition of the words "after making full and careful enquiries".

In addition to the specific warranties provided by the seller, the purchaser may ask for more general warranties, such as a warranty that the seller is not aware of any facts which have not been disclosed to the purchaser, and which if disclosed would have resulted in the purchaser not entering into the agreement, or entering into the agreement on different terms. The purchaser will generally be reluctant to give general warranties of this nature, as they greatly extend its potential liability.

The seller may also seek to limit its maximum liability under the warranties and indemnities. Such a maximum is often based on the purchase price paid by the purchaser, and where the parties have equal bargaining power this is often the position that is reached. It is unusual to see anything lower than this being agreed to. Even if a purchaser agrees to cap the seller's liability however, it is usual to exclude from the limit certain important warranties and indemnities, for example, such as warranties as to title to the shares or assets being sold, or warranties in relation to tax matters. It is common to try to agree to limit claims under the warranties to those in excess of a specified figure for any particular claim and/or all claims in aggregate to prevent costly and time-consuming litigation for small amounts. To the extent that the purchaser agrees to such a limitation, it may seek to provide that to the extent that the minimum threshold is exceeded, the full amount can be claimed (and not just the amount by which the threshold is exceeded).

The seller generally seeks to impose time limits within which the purchaser must claim under warranties and indemnities. Typically, the seller will suggest a period of twelve months or so, whilst the purchaser will argue for a period of at least two to three years. Often, a period of eighteen months to two years will be settled on, the principle being that an audit cycle will have been completed within that time, and most problems will have revealed themselves by that stage. A longer limitation period is often agreed for tax matters, typically three years or so for normal tax matters and five years or so for self assessment tax matters, being the periods which the South African Revenue Services has for assessing past taxation matters. Often there is also a carve-out for circumstances where the South African Revenue Services may have an unlimited period within which to impose penalties on the target – for example the situation where the target may have fraudulently disclosed certain matters in its tax returns. The seller may also wish to limit its liability under the warranties to the period of their ownership of the target or business. The typical counter-argument from the purchaser would be that the seller is receiving full consideration for the business, and therefore they should bear the risk.

8. Dispute resolution

More often than not, arbitration is the favoured method of dispute resolution in South African acquisition agreements. Generally, litigating in the South African courts can be an expensive and lengthy process, and South Africa has a well developed arbitration infrastructure, which offers a number of advantages. One of the key advantages is the relative speed of the arbitration process. This is because much of the legal and procedural manoeuvring that may be employed in litigation is not available in arbitration. There is little or no motion practice and discovery and the rules of evidence are relaxed. Other factors that contribute to a faster arbitration process include avoidance of crowded court dockets and the greater control the parties and their lawyers have over scheduling. This also generally means that arbitration, whilst not necessarily cheap, is often considerably less expensive than litigation.

Arbitration also offers other benefits. Firstly, it allows for greater procedural flexibility. The parties are free to arrange the procedure and the time and venue of the hearing in accordance to what is mutually convenient to them. Secondly, it gives the parties greater control over the person presiding over the dispute. They can ensure that someone with relevant industry experience and knowledge decides any dispute. Thirdly, it gives the parties greater certainty, as arbitration awards are also generally final. Review of arbitration awards is limited and does not involve a review of the correctness of the award. Arbitration awards are generally not subject to appeal (unless the rules so provide). Finally, it allows parties greater privacy. Whilst the courts are a public forum, arbitration is private and is generally closed to non-participants and the press. In addition, arbitrators are expected to maintain confidentiality and the parties to an arbitration agreement may agree to confidentiality. For all these reasons, arbitration is generally the favoured method of dispute resolution.

If the buyer or seller is an offshore entity, they may often request that arbitration or dispute resolution is held in a neutral venue, to ensure the independence of the process. The South African party will generally resist this. Due to the relative weakness of the South African currency, arbitration or dispute resolution in an offshore jurisdiction will be prohibitively expensive for them. What is decided will generally depend on the bargaining strength of the parties involved.

To the extent that the parties do not elect to go the arbitration route, typically they will seek to agree to submit to the jurisdiction of a particular court or forum for the purposes of any dispute between them. They will also typically agree on the governing law which will apply to the agreement.

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