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BACK TO THE BASICS

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TRANSACTIONS PRACTICE GROUP

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Evaluating your next Disclosure Letter

A Disclosure Letter (**DL**) is a key risk allocation tool in any M&A/PE/VC transaction. In the discussions below, we cover a few elemental aspects of a DL, both from a Sellers' and Buyers' perspective.

Who does a DL protect?

Conventional wisdom says that a DL protects the Seller, as it passes certain pre-existing liabilities to the account of the Buyer. However, as a corollary, it also protects the Buyer by presenting details of potential land mines ahead as well as limit his exposure to those it is willing to accept, based on DL negotiations.

What does a DL protect against?

A DL is a protection against breach of certain representations/warranties, and a potential indemnity claim arising therefrom on the Seller. In other words, it is not blanket passing of that liability to the Buyer. There can be provisions in the Investment Agreement to cover the same red flags as a specific indemnity item or a pre-closing liability, which should still be to the account of the Seller only. A DL is not intended to dilute these positions, should the parties agree upon the same. This is where we suggest that there be clarity in drafting.

Specific Disclosure v Constructive Disclosure?

It is a common practice for the Seller to provide itemized disclosures against a list of representations/warranties. While there may be an inclination to focus on a long list of **specific disclosures** once the Buyer receives it (and flagging off any major liabilities that were indeed freshly disclosed at that stage), there is good reason to first get done with the substantive paras leading into the itemized list. These paras often contain **constructive disclosures**, which are generic in nature. E.g. financial statements of the last 3 years, any information shared over email, any other matter discussed between the parties and such like.

In the first instance, this would seem like a win for the Seller because it places the onus on the Buyer to interpret such wide and generic baskets of information received at any stage during a deal to a separately negotiated list of representations/warranties. However, it remains largely untested whether when liability is disputed between the two sides, a seller could successfully demonstrate that the generic/constructive disclosure did allow the Buyer to determine what the intended liability protection was between the parties and against which particular representation/warranty. In other words, was there a consensus ad idem between the parties on such subject matter under the DL?

While a DL is often considered to be a document that is negotiated based on facts and risk appetite, there are legal issues aplenty. Therefore, companies and deal stakeholders would be well-advised to evaluate these legal consequences when drafting a DL.

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