A (post) Covid-19 approach to sale and purchase agreements

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A (POST) COVID-19 APPROACH TO SALE AND PURCHASE AGREEMENTS

A lot has been written about the macro-economic environment in which we expect to find ourselves as we emerge from the COVID-19 pandemic. For deal makers it is also worth contemplating exactly what individual transactions might look like as we navigate the 'new normal' – an environment that most expect to be at risk of follow-on shocks and that will invariably remain impacted by systemic weaknesses for a significant period to come.

In this environment, what characteristics can parties expect to become more prevalent in deal documentation? What types of provisions will buyers and sellers seek with increasing frequency? How will parties seek to mitigate risks that, if not exactly novel, have certainly been brought into greater focus and made more acute since the start of the year?

Global Transactions partner **Jochen Ellrott** explores these questions and more, and provides insights into how the SPA of tomorrow may look:

Buyers of businesses may have been excited when they signed a deal a few months ago, but the world has changed in unprecedented ways since then and consummating the deal in a post-COVID-19 world may have lost most of its appeal. A couple of examples: it appears that LVMH is keen on wriggling out of, or better yet renegotiating, its deal to acquire Tiffany for $16.5bn. Private equity firm Sycamore Partners made L Brands agree to cancel Sycamore's acquisition of L Brands' trophy, yet troubled, brand "Victoria's Secret", after suing for breach of pre-closing covenants on the basis of store closures, inventory cut-backs, non-payment of rent, and employee furloughs. There is also a very interesting ongoing case in the English High Court involving WEX, eNett and Optal, which relates to the invocation of a material adverse effect (MAE) clause. There are other, known and unknown, cases of "deal remorse" out there that have led to pre-closing disputes, and their number is certainly going to increase.

Meanwhile, potential buyers are lining up to forge ahead with existing expansion plans that were delayed due to the pandemic or take advantage of the opportunities that the post-COVID-19 economic landscape may present. Both sets of parties will need to pay very careful attention to the interpretation and negotiation of sale and purchase agreements.

Construing pre-COVID-19 contracts

Globally, lawyers are busy reviewing M&A transaction documents to explore whether there are ways for their clients to back out of deals that are in the pre-completion stage.

You might assume that in the M&A world with its globalised deal technology and internationalised contract styles, this analysis would be done in the wink of an eye and the result would be reasonably clear. Far from it. In any transaction of a meaningful size, standard clauses off a law firm's shelf are varied, adapted to the circumstances, adjusted, reinvented, negotiated at length and sometimes litigated, before ultimately being added to the firm's standard forms – only to go through the same process again when the next deal is up.

Even if the relevant clauses on two separate deals are identical, the courts in most jurisdictions would likely interpret them differently if the parties, the background, or other circumstances of the deals are different. And rightfully so: it *does* matter whether the take-over was agreed in the pre-pandemic days of November (like the Tiffany deal), in January when the pandemic had barely begun, in February when there was more awareness of the virus, but no sign of global lockdowns yet (Victoria's Secret) or in April when the pandemic was in full swing – not least in terms of understanding the circumstances that were in the contemplation of the parties when contracting.

If the reporting on each of these deals is to be believed, the relevant terms and circumstances of each differ significantly, and thus each deal gives us a different example of how buyers and sellers have tried to navigate the fallout of the pandemic.

LVMH's attempt to terminate the Tiffany deal (the older of the two deals) is perceived by some to be less based on a genuine disagreement on the interpretation of the deal documents (the Financial Times refers to the deal's "iron-tight merger agreement"), at least since Tiffany reached an agreement with its lenders to amend its debt covenants (it is understood that a default under Tiffany's borrowing facilities would have been a breach of the merger agreement). LVMH's manoeuvre is rather perceived by many as yet another example of LVMH's head Bernard Arnault, the "wolf in cashmere", using his infamous deal-making tactics to back out of a deal that has become unpalatable in the post-pandemic economic environment.

By contrast, the Victoria's Secret dispute seems to have centred much more around differing analyses of the actual language of the deal document provisions – namely L Brands' undertaking not to "*change any cash management policies, practices, principles or methodologies used with respect to [the Victoria's Secret business]*" during the pre-closing period. Now, it is of course debatable whether protecting a business against the consequences of a pandemic can actually amount to a breach of practices and principles. Nonetheless, L Brands agreed to terminate the deal and focus its "*efforts entirely on navigating this environment […] rather than engaging in costly and distracting litigation […].*" That seems reasonable when you picture the time, cost and effort a protracted lawsuit against Sycamore would have required. In many cases, sellers (particularly those in need of a quick receipt of cash) will indeed not be able to wait for the outcome of a lengthy dispute, but prefer to agree to a termination in return for a settlement payment, before perhaps trying to implement a fresh sale to another buyer.

Deal tactics, bargaining power and desperation will play a major role in any dispute but if the matter is ultimately brought before a judicial body, the wording of the transaction documents (interpreted in their context) actually matters. The likely outcome of any such court proceedings or arbitration might also drive the parties' appetite for a settlement before proceedings are commenced. Consequently, as any lawyer will enthusiastically confirm, taking a closer look at the actual language of the contract will always have its merits.

Transaction documents agreed during the COVID-19 pandemic are likely to address the consequences of the crisis in one way or another. However, that is unlikely to be the case for those negotiated before the outbreak, and very few will expressly provide for an opt-out due to a pandemic. If a pre-COVID-19 contract does include a MAE or material adverse change (MAC) clause, it typically only allows the buyer to walk away from the deal if the adverse change is specific to the acquired business (a so-called "business MAC" clause). Market or even macroeconomic changes or events (dubbed "market MAC") are typically carved out from the definition.

Accordingly, buyers will try to find other leverage to terminate the deal or at least renegotiate its terms. Some options might be:

- Has the pandemic caused a breach of a representation that is sufficiently severe to entitle the buyer to resist consummation of the transaction? For instance, the pandemic may have caused a material subsidiary of the target to become insolvent or a major customer contract to fall away. If so, has this caused a breach of a representation and does that breach trigger contractual rescission rights?
- The target may also have breached its undertakings given for the period between signing and closing of the deal. As an example, it may have incurred additional debt to overcome its cash

flow issues brought about by the pandemic – was this a violation of the contractual covenants and, again, does that violation give the buyer a right to refuse closing? For example, in the Tiffany case, is the pre-closing undertaking violated if Tiffany defaults under its debt instruments and does this give LVMH a termination right? Similarly, on the Victoria's Secret deal, were the target's responses to the pandemic a breach of the "ordinary course" elements of the covenants?

- If the contract does not provide for a reliable way-out for the buyer, do concepts of *force majeure*, frustration or similar, perhaps even new doctrines (which many clients are currently craving), give a right to cancel or at least amend the deal?
- And, as a last resort, is sacrificing the acquisition vehicle into insolvency less of an ordeal than going through with the deal (bearing in mind reputational risk and possible liability of parent companies)?

Regardless of whether any such "out" is available, the contractual fall-out from the COVID-19 pandemic, and the profound impact the unprecedented global crisis is having on the world of mergers and acquisitions, has highlighted the sometimes imperfect protection buyers have against "black swan" type events.

Constructing post-COVID-19 contracts

Changing perspective and looking ahead, both buyers and sellers will therefore naturally want to pay very careful attention to the interpretation and negotiation of sale and purchase agreements. However, in an environment of increased uncertainty around the impact of the pandemic and the target business's development, how should sale and purchase agreements on future deals address these uncertainties? How can this uncertainty be catered for in the context of an M&A deal?

Valuation and purchase price mechanics

In most cases, it will be difficult for quite some time to predict the impact of the pandemic on a target business's revenue, profitability and, accordingly, its valuation. For that reason, many buyers will not rush to execute deals, but will rather want to review a minimum of two quarters of "COVID-19 financials", i.e. the financial results of two quarters after the pandemic took effect on the business. In most cases, this will mean that financials for at least the first two, if not three quarters of 2020 will need to be available.

It is safe to assume that even the availability of COVID-19 financials will not eliminate uncertainty around valuation completely. How can that be addressed in the context of a sale and purchase agreement? Buyers are likely to drive a return to the use of completion accounts, whereas in many markets fixed price arrangements – mostly in their locked box manifestation – have previously been the norm. It is paramount to note, however, that closing accounts typically only capture a cash drain or working capital erosion between signing and closing; they do not capture long-term revenue or profitability loss and are thus an imperfect tool to address the valuation dilemma.

It is therefore worth considering a purchase price adjustment for revenue or EBITDA loss between signing (or the last balance sheet date) and a defined future point in time. If the anticipated time between signing and closing of a deal is sufficiently long and therefore likely to register most of the impact of the pandemic, closing accounts – in a broader sense as they would capture more than net debt and working capital movements – are the obvious choice to adjust the purchase price. If the impact is likely to show or increase meaningfully after closing, earn-outs or earn-ins may be the better option to bridge the gap and more closely align the valuation with the ongoing performance of the acquired business.

Earn-outs / earn-ins

Earn-outs provide for an increase of a (lower) initial purchase price in case of better-than-expected financial performance of the target business as measured in sales, revenue, EBITDA, free cash flow, average revenue per user or any other appropriate metric. "Earn-ins" are the seller-friendlier inverse to earn-outs and require the seller to repay a portion of the (higher) initial purchase price at a future point in time based on a decline in the defined metrics.

In both cases, parties can agree a limit to the adjustment to establish a floor on what the seller will receive or a cap on what the buyer must pay, as applicable. For obvious reasons, earn-outs are favoured by buyers as they will only be required to use liquidity if and when the higher purchase price has become definitive, whereas sellers naturally prefer earn-ins.

Whatever form of price adjustment is employed, the parties will need to work hard to agree and define the metrics of the adjustments, the process for agreeing them and, in the case of contingent consideration, the permitted operating parameters within which the target must operate to achieve its targets. Parties should keep in mind that even if the metrics and calculation methods are clearly defined and properly drafted, disputes are still likely. Parties may therefore want to consider binary mechanics where a specified event (e.g. a further lock-down of a minimum length in a second wave of infections; legislation impacting the target's supply chain in a defined manner; or the imposition of specific import or trade restrictions) or development (e.g. a shrinking of the relevant economy by a certain percentage of GDP; or a drop in average revenue or EBITDA in the relevant in sector) will trigger a fixed change to the purchase price. However, parties will likely shy away from such, rather simplistic automatisms and prefer to rely on more elaborate, yet more complicated (and dispute-prone) solutions.

Payor covenant strength

In the case of an earn-out / earn-in, the party entitled to receive the adjustment payment will want comfort that the counterparty is good for the money if a payment obligation does indeed arise. When considering ways of creating that comfort, parties should consider the relative commercial terms for different payment support mechanisms. For example, bank guarantees may be costly but are typically favoured over escrow mechanics, where the entire amount at stake is parked somewhere secure without earning meaningful interest. In the current economic climate, however, the cost of capital of bank guarantees and escrow payments will not be too dissimilar.

A parent company guarantee will undoubtedly be the least costly option, though this provides imperfect protection if the parent itself is not immune to financial distress. (It is also worth noting that the parent's financing arrangements may limit the ability to provide collateral to a third party making this an unfeasible solution).

Earn-outs will be less attractive to distressed or insolvent sellers as there will be an inherent requirement for the seller to realise the full sale proceeds and, in the case of insolvency, distributed to creditors quickly. Insolvency administrators, receivers and similar officeholder are notorious for rejecting any purchase price adjustment whatsoever. It is nonetheless fair to assume that earn-outs will become a much more common feature of M&A transactions as deals terms become more buyer-friendly, and buyers focus more on ensuring valuations match the ongoing viability and operational health of target businesses. Annual earn-out tests or milestone payments providing for earlier, yet staggered cash inflow to sellers may make the approach more palatable to them.

Payment in kind

Another way of addressing valuation uncertainty is paying a portion or all of the purchase price with buyer stock, at least in cases where the purchaser is a strategic buyer from the same industry. This obviously assumes that the axiom "cash is king" does not apply in the transaction where such payment in kind is considered, which will be the exception. If both parties are players in the same sector, there is a fair argument that in the current climate, any swing in the performance of the target business caused by the pandemic or its aftermath is likely going to affect the buyer's business and hence its stock price similarly. The purchase price will therefore be subject to some degree of automatic indirect adjustment and, while such adjustment will not be a dollar-for-dollar reflection of the target's performance, a stock deal can help level out some of the volatility of valuations.

If share consideration is to be considered, a number of factors will need to be explored beyond simply the commercial merits, including:

- the extent to which the seller will be able to conduct due diligence on the buyer giving the share consideration (this may depend on the buyer's willingness to allow diligence but also whether the seller is in a position to devote resources to this);
- depending on the relative size of the buyer and the seller, whether certain listing requirement issues could be triggered by the new shares; and
- the extent to which anti-trust rules will apply if the buyer and the seller operate in the same markets.

Anti-embarrassment

From the seller's side, the risk of mis-pricing a disposal and becoming subject to subsequent accusations of having sold too cheaply as a knee-jerk response to a global market shock, can be mitigated to some degree by the use of anti-embarrassment (or "anti-flip") clauses which may see a comeback. These clauses provide for a top-up of the purchase price if and to the extent that the buyer on-sells the target business to a third party within a certain period of time (typically one to three years) at a significant premium to the price the buyer paid to the original seller.

Conditionality

Regulatory

It is safe to assume that even the traditionally more seller-friendly markets in Europe will see a resurgence of regulatory conditionality in M&A contracts. With foreign investment control regimes globally becoming more encompassing and stringent by the minute – a movement that has only been exacerbated by the pandemic – a blanket acceptance of regulatory risk is unlikely to go down well with buyers.

Merger control risk seemed to be fairly predictable despite prolonged review periods at the beginning of the crisis. However, the EU's plan to create a new screening system of foreign state backed/financed investment into Europe may be indicative of a trend of tightening merger control regimes, which parties might have to extrapolate when discussing regulatory conditionality.

It may be even more difficult to predict the outcome of foreign investment control reviews that are ever more driven by increasing protectionism and politicisation. It goes without saying that this is particularly acute in industries traditionally deemed of national strategic importance, though it is worth acknowledging that the COVID-19 crisis has also shown that disruptions in myriad areas can

give rise to significant domestic issues, potentially broadening the scope of transactions that may catch the eye of foreign investment control regulators.

As a consequence, buyers will resist blanket "hell or high water" clauses much more frequently, perhaps in exchange for sizable break fees. As a compromise, parties can refine customary regulatory conditionality clauses such that, for example, any material changes to the underlying regulatory regime between signing and closing convert a generic "hell or high water" clause into a buyer's walk-right with a break fee. In any event, the fact that the time allowed by regulators and indeed required for regulatory review processes has been extended in many jurisdictions will require more relaxed long-stop dates, lengthening the pre-closing period.

Financing

Ensuring that acquisition financing remains available during lengthy pre-closing periods may be a challenge for buyers. The financing markets have stayed surprisingly robust and acquisition financing appears to be generally available. Accordingly, sellers will continue to insist on certain funds at signing. However, financing may take longer to arrange or may only be capable of being arranged after signing, e.g. in fire sale scenarios. If the regulatory review process is expected to take longer than before the pandemic, financing sources might be expected to only commit their funding if the terms of the debt can be flexed depending on market developments.

Consequently, buyers may need a financing-out if financing is no longer available at acceptable terms. Any such condition should be clearly defined and will in all likelihood only be acceptable to the seller if it comes with a meaningful break fee that may need to be collateralised by a bank guarantee, escrow or similar payment.

Warranty "bring-down"

It is arguable whether a request for a so-called "bring-down" of the seller's representations and warranties, where the buyer is entitled to deny closing in case of a material breach of certain representations or warranties (and possibly covenants) – as is often seen in US-style SPAs –, is more justifiable now compared with prior to the pandemic, but such conditions might become more common with market dynamics shifting in favour of buyers.

It is important to note that the time pressure, demands and complexities of running a business in a pandemic may have led or lead to a certain disregard for legal compliance and governance procedures during the height of the crisis. Accordingly, such a condition is going to be more attractive from a buyer's perspective, but conversely much less palatable on the seller's side.

The lengthier pre-closing periods may at least provide buyers with stronger arguments for a repetition of business warranties at closing, alongside the more fundamental-type warranties buyers would traditionally expect to be repeated.

MAC clauses

Buyers' insistence on MAC clauses will be ubiquitous in the post-COVID-19 world. However, the customary "business MAC" will not help. If buyers want the right to walk away from the deal if the pandemic (or other related systemic shocks) entails further unforeseen consequences not exclusive to the target business, the definition will need to be broadened to include so-called "market MACs".

If sellers are actually willing to entertain the notion of such a clause, they will surely insist on limiting its application to market developments triggering a defined measurable impact on the target business. Again, the parties may want to consider sketching out certain scenarios that would trigger the walk-

right, e.g. a shutdown of the target business's operations for a certain period, an interruption of vital supply chains, or the loss of revenue or EBITDA by more than an agreed amount or percentage or, alternatively, in excess of the industry average.

In this respect, parties will need to stay alive to the current business conditions and ensure the drafting of such clause is sufficiently encompassing as the after-effects of the pandemic percolate through the markets (e.g. while initial disruptions have been caused by government-mandated shutdowns, as many countries start to move on, different obstacles to conducting business may begin to arise).

To avoid protracted uncertainty around the applicability of the MAC clause, parties will be well advised to provide for an accelerated MAC determination mechanism where an independent expert or group of such experts decides whether a MAC has occurred in a short period of not more than a few weeks. In a volatile world, neither party will want to rely on, and wait for, a court or arbitration tribunal to render its decision after lengthy deliberations and appeals.

Deposits / break fees

As buyers push back on shouldering the enhanced regulatory risk and argue – with recent historic justification – for more tailored market MAC provisions, sellers will need to address the consequent decrease in certainty of completion.

Deposits (or earnest money) may be the price of sellers agreeing to open up their books to due diligence processes which, as a result of the pandemic, may be increasingly thorough and invasive and demanding of senior management's time in a period where many targets will need close monitoring and operational oversight.

Similarly, termination rights in the guise of more permissive MAC clauses, financing-outs, or less arduous regulatory undertakings may be paired with obligations for buyers to pay a substantial break fee in order to walk away.

Representations and warranties, indemnities

With negotiation power tilting towards buyers, the catalogue of deal protection provisions that a buyer is able to assert may expand again. Buyers will need to capitalise on this by first maximising the areas on which they conduct due diligence (where certain matters will need particular focus) and then translating any concerns into useful representations and warranties, and indemnities.

The importance of due diligence

As much now as ever before the importance of due diligence on a target business cannot be overstated. In an environment where many businesses have been subject to significant and wide-ranging adverse shocks – from their earnings to their supply-chains, from their employee base to their distribution logistics –, gaining an insight into the state of a target business will be vital for buyers looking to execute confidently on deals.

In terms of legal due diligence processes, in addition to the customary reviews, areas of particular interest may include:

- compliance with state aid terms where the target has obtained government support (buyers should also seek to cover state aid received by the sellers for the benefit of the target business as state aid repayment liability may travel with the business);

- “crisis compliance”, both in terms of how the target has dealt with existing crises such as COVID-19-induced financial distress (or even an outbreak of coronavirus itself within the business) but also the robustness of business continuity / crisis planning in the event of a crisis event post-signing;
- occupational safety and data protection in employment matters as well as generally (given the increased use of new communication technology used for working remotely as well as contact tracing applications); and
- disputes around *force majeure* in supply chains.

The biggest challenge to the due diligence will be difficult to capture with reps and warranties: how reliable and instructive are the financials and business plan of the target in an unprecedented crisis where business planning may by as conducive as crystal ball reading?

W&I insurance

In most major transactions, sufficient warranty coverage will require that warranty & indemnity (W&I) insurance remains available on acceptable terms. This appears to be holding true, but will be tested when the number of distressed transactions increases and parties become more litigious, as they typically do in times of crisis. It is also possible that we will see a return to “sell-side” W&I policies (which had become far less common immediately prior to COVID-19) given the more buyer-friendly environment.

While sellers may no longer be in a position to reject broad sets of representations and warranties, W&I insurance will continue to be a valuable tool to bridge the gap between (distressed) sellers’ desire for a clean exit and buyers’ need for contractual protection.

Buyers will need to keep in mind that W&I insurance will only cover areas that have been diligenced properly and that insurers are requiring more up-to-date diligence with increased focus on areas of the business affected by COVID-19 (if insurers do not exclude COVID-19 issues entirely).

In any event, where it is unclear whether a seller will be “good for the money” in case of actual warranty claims, W&I insurance will be (if available) a more efficient tool than costly bank guarantees, escrow or similar arrangements. Advisors should dust off their templates for such arrangements anyway.

While W&I insurance may continue to be available on sensible terms to cover unknown risks, they will typically not cover known risks, which we may come across more frequently in an unsteady deal environment. Significantly, any loss relating to breaches resulting from COVID-19 have been specifically excluded in most W&I policies we have seen so far, though we are aware of policies increasing in sophistication with more targeted exclusions.

Buyers will therefore need to either factor the risk in when calculating the purchase price or, where that is not possible with reasonable accuracy, insist on being indemnified by the seller. This in turn will only be valuable if there is certainty that the seller will be able to honour its obligations or if appropriate collateral is provided.

Qualifications and disclosures

Both buyers and sellers are likely to focus on the extent that COVID-19 related market conditions will be taken to qualify the warranties. A move to a more buyer-friendly deal environment will likely see more reduced specific disclosures, though sellers are likely to seek wider general disclosures or

otherwise ensure that information about market conditions is deemed to be within the knowledge of the buyer (conversely buyers will likely seek to restrict the scope of this definition to the actual knowledge of named individuals).

Undertakings

Undertakings, or covenants, limiting the seller's ability to carry on the target business between signing and closing may also need to be refined or recalibrated in a post-pandemic world – subject always to regulatory gun-jumping restrictions – particularly where pre-closing periods may become lengthier to accommodate extended regulatory reviews.

Many businesses are roaming in unchartered territory, and therefore a target may have to take un-precedented action that may not immediately appear to fall within the usual "ordinary course" exclu-sion, or otherwise be "consistent with past practice". Parties should therefore consider defining a broader leeway within which a target business can manoeuvre without the buyer's consent, e.g. an increase in debt up to a limit that may be higher than in normal times, permitting capital increases, defining certain human resource-related measures required to respond to a (further) deterioration of the business, discontinuation of (shortlisted) business lines or variations to the (capex) budget within a corridor – and the ability to cure breaches within an appropriate time frame.

In any event, given the volatility and unpredictability of the markets, swift decisions may have to be made and so the time allowed for the buyer to consent to a proposed action should be reasonably short, with the buyer's consent should deemed given if it does not object explicitly within such period.