



AMERICAN BAR ASSOCIATION

Business Law Section

M&A in Europe: Impact of COVID-19

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Today's topics

- **The macro view: deal flow today, tomorrow and after return to "normal"**
- **Getting to signing and from signing to closing**
- **Deal economics: pricing and allocation of risks**
- **Buyer's protections: due diligence, reps/warranties, indemnification**
- **Rep & warranties insurance**
- **Deal mechanics**

The macro view: current & future deal flow (1/4)

Worldwide

- Cross-border M&A
 - Downward pressure on FDI flows could range from **30% to 40%** during 2020-2021 (at the beginning of March this was projected at -5% to -15%).
 - Hardest-hit: energy and basic materials industries (-208% for energy, with the additional shock caused by the recent drop in oil prices), airlines (-116%) and the automotive industry (-47%)
 - Sharp drop in number of announced cross-border M&A deals: average of 1,200 per month in 2019, but total was 874 in February and 385 in March (through 20 March)
- Possible scenarios include:
 - "With a little bit of luck. . . virus in Europe and the United States would be controlled effectively with between 2 to 3 months of economic shutdown. . . a strong rebound could begin after the virus was contained at the end of Q2 2020. . . all countries would experience sharp GDP declines in Q2, most of which would be unprecedented."
 - "In [a] more pessimistic scenario, . . . physical distancing and quarantines throughout the summer. . . 35-40% [annualized GP decline] in Q2. . . huge spike in unemployment and business closures . . . it could take more than two years before GDP recovers to its pre-virus level."

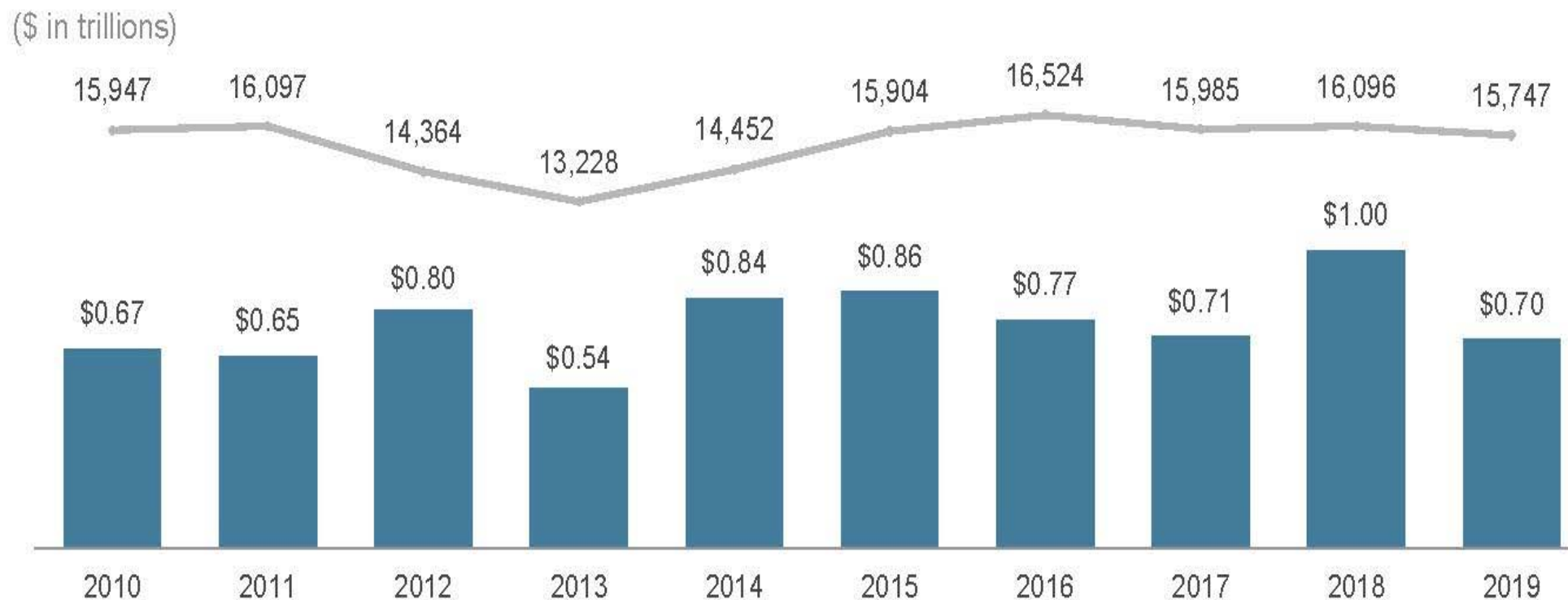
(Source: McKinsey & Co. accessed April 4, 2020)

(Source: UNCTAD)

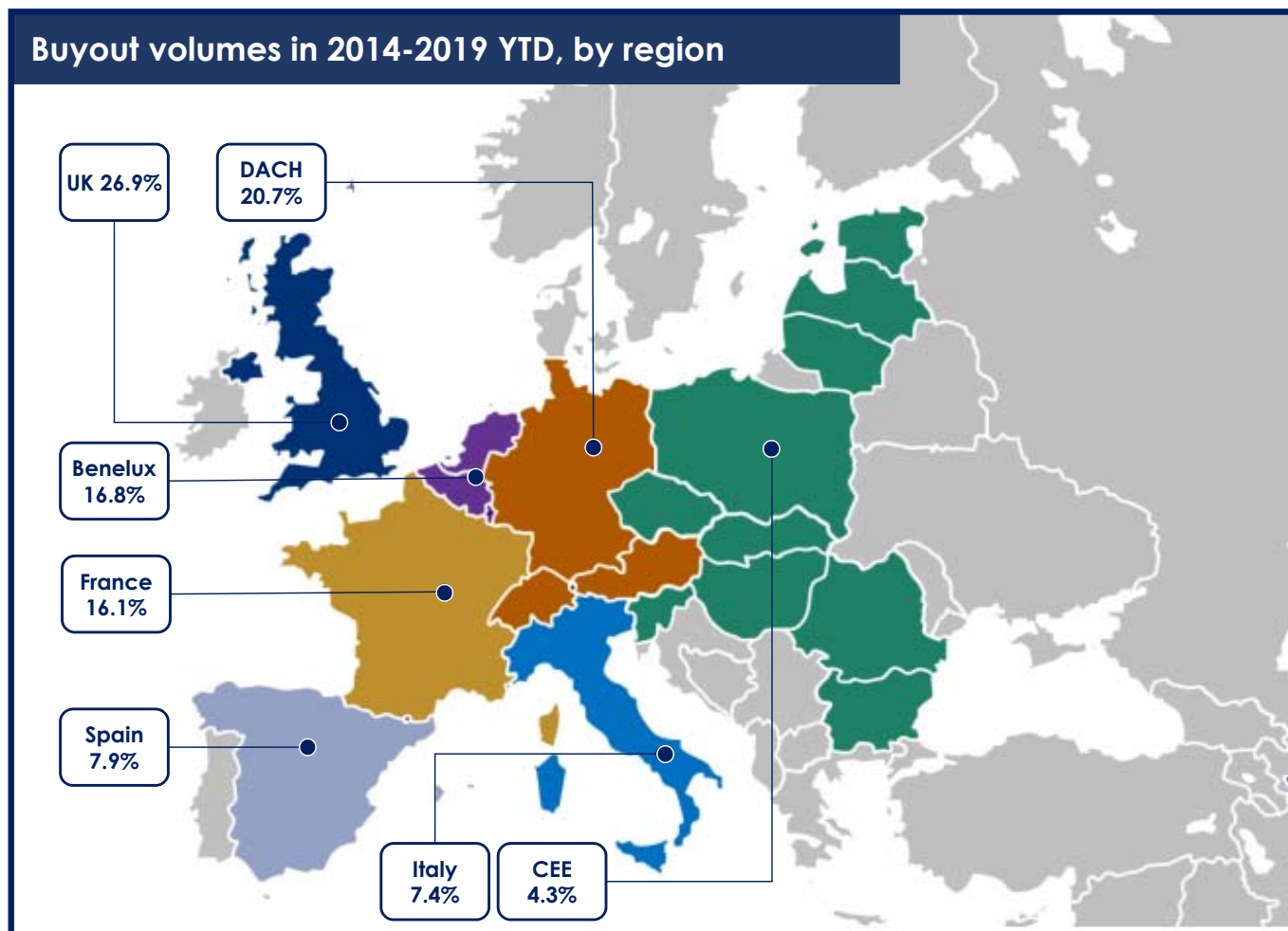
The macro view: current & future deal flow (2/4)

Europe M&A Volume

(Source: Houlihan Lokey, February 1, 2020)



The macro view: current & future deal flow (3/4)



(Source: DC Advisory Mid-market Private Equity Roundup June 2019)

The macro view: current & future deal flow (4/4)

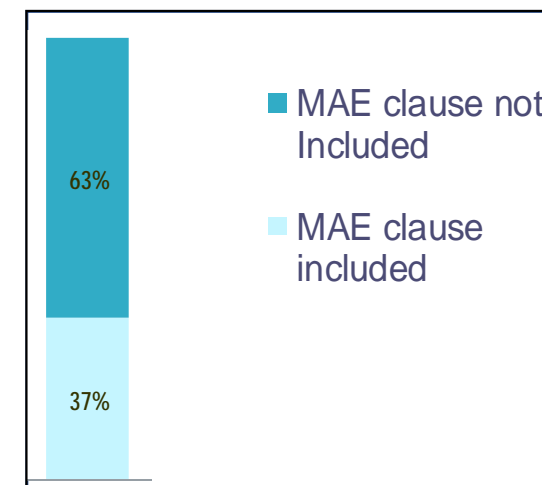
In Europe

- General trends
 - signed deals are proceeding to closing (with a few exceptions)
 - deals in advanced stage of negotiation tend to proceed to signature
 - new deals are mostly on hold (as of today)
- Impact varies by sector
 - those hit most severely include automotive, airlines, hospitality and entertainment
 - less impacted: software/tech, healthcare and life sciences/biotech
 - focus on financial services
 - Banking: relative stability and confidence with some exceptions (e.g., Italian pre-crisis banking situation; impact of moratoriums on loan payments; possible holes in EU lenders' balance sheets resulting from post-2008 accounting rules)
- Funds industry: due to evaporation of liquidity in fixed-income markets; redemption requests moderate so far (€48B net outflows in equity funds sold in Europe in March). PE (with \$1.5T dry powder) eyeing industries hit by Covid-19; first wave of new opportunistic reaction (e.g. PEs looking at buying debt from their portfolio companies, putting themselves forward as alternative sources of capital)
- Key impediments to starting new deals include uncertainty as to valuations, attention of deal teams to other issues
- Incentives for restarting deal flow
 - dry powder remains available
 - possible divestiture of portfolio companies?

Getting to Signing and from Signing to Closing (1/5)

- **The European deal environment**

- Pre-contractual negotiations: duty of good faith
 - consequences of breach may be limited
 - seller's good-faith obligations may be limited by rules of the bidding process
 - advent of COVID-19 probably justifies buyer breaking off the process (taking care not to mislead the seller)
- Differences in M&A practice compared with the U.S. may include:
 - price clauses: widespread use of locked-box mechanisms
 - reps/warranties: tendency to rely on financial statement and other reps without adding "full disclosure" or "no undisclosed liabilities" reps
 - pro-sandbagging clauses less frequent than in the U.S.
 - closing may be seen as a technicality only, with MAC/MAE conditions to closing less frequent than in the U.S.



- **What is the impact of the pandemic today on a deal signed and awaiting closing?**

Getting to Signing and from Signing to Closing (2/5)

- Typical closing conditions (without MAC clause)
 - regulatory
 - merger control clearance
 - foreign investment control clearance
 - accuracy of reps – when will the pandemic make this condition fail?
 - historically in most European deals accuracy of reps is not a closing condition (although in most deals reps are stated to be accurate both when made and at closing)
 - if accuracy of reps is a closing condition, it is sometimes qualified by materiality
 - financing?
- The buyer might appeal to general principles of the governing law (which differ across jurisdictions)
 - force majeure
 - impact of contract terms
 - attention to boilerplate language
 - *imprévision*
 - fundamental change of circumstances
 - frustration/hardship
- Applying these principles may well lead to an exit right of the buyer or at least to an adjustment of the deal terms

Getting to Signing and from Signing to Closing (3/5)

- **Causes of delay or failure to close**
 - Regulatory
 - foreign investment control clearance
 - Legislation and scrutiny by authorities may change rapidly, including tightening of scope of industries monitored and standard of review, possibly increased scrutiny for sectors greatly impacted by pandemic e.g. hotels
 - Note statement by EU Commission: "EU's openness to foreign investment needs to be balanced by appropriate screening tools" (March 26, 2020)
 - industry-specific regulatory hurdles (e.g. in the defense industry)
 - national governments may seek to prevent takeovers of important companies which appear undervalued due to the crisis (e.g. Spain)
 - In view of extensive national state aid programs being put in place, state participations or at least state influence (e.g. consent requirements) in targets are likely to increase (e.g. in airlines, retail chains)
 - Delays may be expected in obtaining third-party consents and regulatory approvals, due to backlogs and reduced capacities at authorities
 - Buyer-side financing might be more difficult to obtain, and therefore financing-out provisions may become relevant again
 - **It will take longer to close deals, and it will be more risky!**

Getting to Signing and from Signing to Closing (4/5)

- **When closing conditions include a MAC clause**

Stand-Alone: Since the date of this Agreement there has not been any Material Adverse Change [in respect of the Target]

Back-Door: Since the Balance Sheet date, there has not been any Material Adverse Change . . .

plus "bring down" formulation of "accuracy of representations" condition

"Material Adverse Change" means any result, occurrence, fact, change, event or effect that has a material adverse effect on the business, assets, liabilities, capitalization, condition (financial or otherwise), results of operations [or prospects] of the Target.

Seller's proposal: "but excluding any epidemic, pandemic, disease outbreak or other health crisis or worsening thereof"

Possible carve-out to the exclusion: "except to the extent of any [material] disproportionate effect on the Target as compared to others in its industry"

Getting to Signing and from Signing to Closing (5/5)

- **When closing conditions include a MAC clause (cont'd)**
 - Traditionally MAC clauses have not been designed to allocate systemic risks to the seller
 - European courts are likely to be cautious in interpreting such clauses - precise drafting is key
 - Buyer who seeks protection should therefore insist on COVID-19 language:
 - closing condition should be clearly tied to material deterioration of target's business due to COVID-19, the market in which the target operates or financing conditions
 - include specific thresholds to define materiality and allocate risks between the parties (e.g. COVID-19-related decline in revenue by a certain %, loss of a certain % of customers, shutdown period/length of production downtimes or import/export bans)
 - reinforce interim covenants on conduct of business, add new closing conditions (e.g., relocation of manufacturing capabilities outside of "red zone" or end of the quarantine within a certain timeframe)
 - From a seller's perspective: exclusion of statutory law that might trigger buyer's right to "pull the plug" – effective ?

Deal economics – pricing and allocation of risk (1/5)

- **Purchase price: the volatility challenge going forward**

- Locked box pricing mechanism (simplified example)

The purchase price for the Shares shall amount to €_____ [plus interest thereon . . . calculated . . .]. The Seller shall procure that from the Signing Date until the Closing none of the Target Group Companies incur any Leakage other than Permitted Leakage.

"Leakage" means dividend distributions, return of capital, transaction expenses, non-commercial intra-group transfers, transaction bonuses, increases in compensation, . . .

"Permitted Leakage" means payments to the extent reserved in the Financial Statements, [a dividend payment to the Founders of €_____; compensation increases as set out in ____], . . .

Deal economics – pricing and allocation of risk (2/5)

- **Purchase price: the volatility challenge going forward (cont'd)**

- Post-closing purchase price adjustment (simplified example)

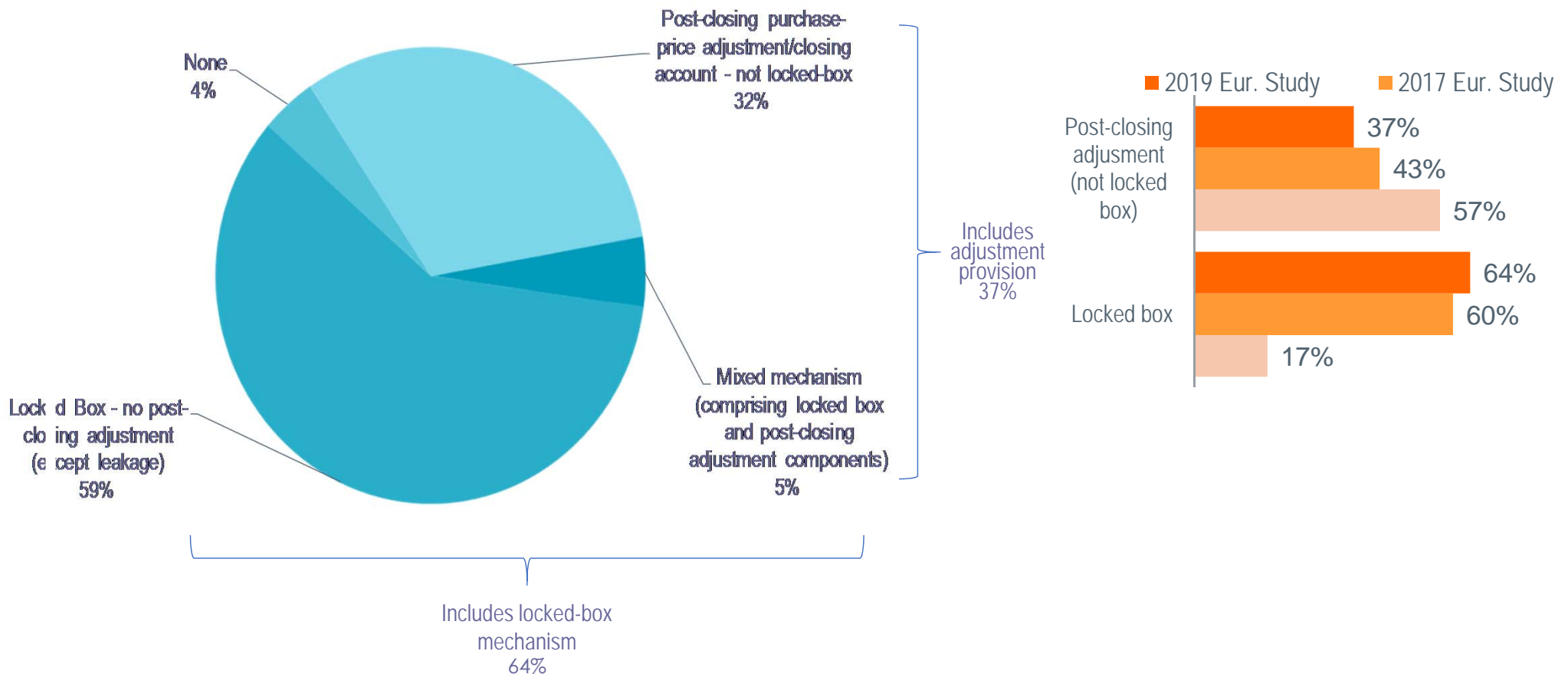
At least ___ Business Days prior to the Closing Date the Sellers will prepare and deliver to the Buyer a statement setting forth (a) a good faith estimate of the aggregate Net Working Capital of the Companies as of . . . and (b) the amount by which the Estimated Net Working Capital exceeds or is lower than the Target Net Working Capital . . .

Within ___ calendar days after the Closing Date, the Buyer shall deliver to the Sellers a statement which shall (i) quantify in reasonable detail the items constituting the Net Working Capital as of . . . and (ii) set forth the amount by which the Net Working Capital as shown on the Net Working Capital Statement exceeds or is lower than the Estimated Net Working Capital

The Sellers shall have ___ calendar days to review . . . and in case of disagreement . . .

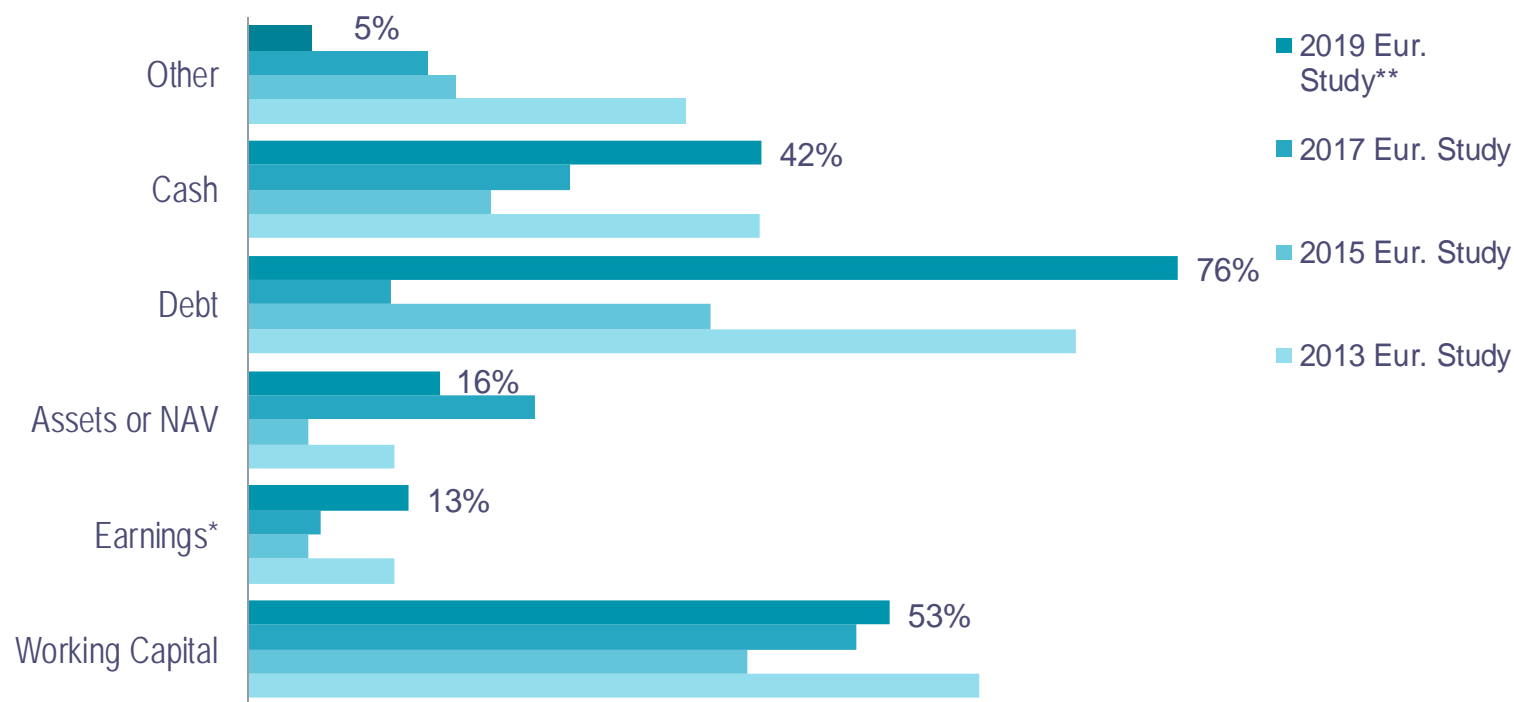
Deal economics – pricing and allocation of risk (3/5)

Prevalence pre COVID-19 of the locked box



Deal economics – pricing and allocation of risk (4/5)

Persistence of post-closing price adjustment – key metrics



* Includes EBITDA or other measure of earnings.

** In 2019 Study 63% of the subset featured more than one metric.

Deal economics – pricing and allocation of risk (5/5)

- **For deals signed but not yet closed**
 - renegotiations under force-majeure-like concepts may be considered but unlikely to succeed under typical terms , in most European jurisdictions
- **For new deals**
 - volatility undermines locked-box mechanism, which assumes continuity of profitability
 - other solutions (as complements to locked-box mechanisms)
 - earn-outs: a means to bridge larger valuation gaps between buyers and sellers, likely to be heavily negotiated (and adversely impact rhythm of deal), with earn-out periods likely outlasting the expected duration of COVID-19 containment measures
 - payment at least in part in shares of (strategic) buyer
 - partial or increased level of rollover by investor intending to exit being negotiated in on some deals, between signing and closing

Buyer's protections: due diligence (1/2)

- Trend pre-COVID-19: significant limitations to the due diligence process (limited scope, "helicopter-view" reviews)
- Post- COVID-19: focus on features of business sensitive to this and other pandemics or other major disruptions
- Special issues for deals ongoing during containment: limitations on site visits, physical inspections, interface with management
- Areas of increased due diligence (deals in progress and future deals)
 - Operational
 - Business continuity plans & capacity analysis (both in a falling off, but also increase, in demand, depending on the business and circumstances)
 - Supply chain integrity, ability to adjust/switch/diversify supply if necessary
 - IT systems – robustness and integrity, disaster recovery planning

Buyer's protections: due diligence (2/2)

- **Financial**

- Have target's financial statements and models/business plans been adjusted appropriately? Have they been sufficiently stress tested?
- Working capital cycle/general insolvency risk (particularly where lengthy gap period may be required to close the deal due to regulatory clearances) , including integrity of accounts receivable, adequacy of cash reserves and ability to pay suppliers
- How will buyers and their accountants adequately assess 2020 financial information for transactions done in 2021/22?

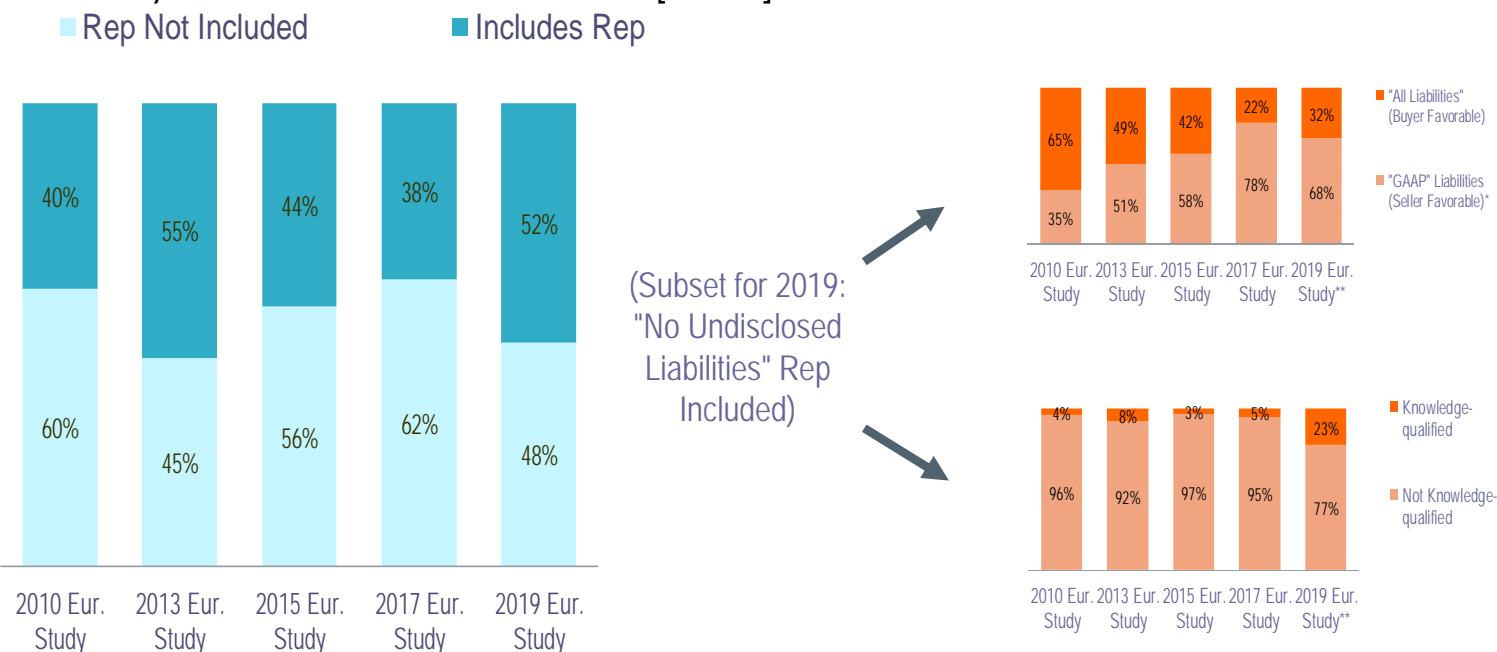
- **Legal/insurance**

- Material contracts – over-reliance/concentration risk, termination rights (including insolvency and force majeure style triggers)
- Personnel and HR – reliance on permanent vs temporary/agency staff, ability to adjust/tailor workforce to meet increase/decreased requirements
- Impact of Covid-19 (and pandemics/other "acts of God"/force-majeure-style general carve-outs) on target's general insurance program
- General Q&A/focus on target's approach to and compliance with Covid-19-related legislative and governmental assistance programs

Buyer's protections: reps/warranties (1/4)

Limited use of "no undisclosed liabilities" rep

Target has no liability [to the Knowledge of Seller] [of the type required to be disclosed under GAAP], except for liabilities reflected in the [financial statements] and liabilities incurred in the ordinary course of business since [date].



Buyer's protections: reps/warranties (2/4)

- New representations and warranties might be proposed to deal explicitly with COVID-19-related disruptions, for example:
 - specific rep confirming full disclosure of COVID-19 related disruptions and actions taken in connection therewith, which sellers may be willing to provide to some extent
 - protection against consequences of such disruptions and actions, which sellers can be expected to resist except when scope is circumscribed (e.g., where buyer's cannot conduct adequate due diligence)
- Simplified example of possible new reps:

Seller has complied with: . . . (x) all rules with respect to health and safety and obligations to its employees in respect thereof, including in connection with the advent of the COVID-19 pandemic; (y) all obligations under Laws adopted in response the COVID-19 pandemic including in respect of activities carried out during the containment period (as defined in . . .) and assistance it has received from any Government under such legislation; . . ."

Buyer's protections: reps/warranties (3/4)

- Key standard reps/warranties will require careful consideration of carve-outs and disclosure for Covid-19-related matters, for example:
 - Accounting/financial statements

[Except as set out in __,_] the Management Accounts have been prepared with due care and attention, on bases consistent with those adopted in the preparation of previous management accounts, and show with reasonable accuracy (x) the state of affairs of the Target Group as at the date to which they have been prepared; and (y) the profits/losses of the Target Group for the period in respect of which they have been prepared.
 - Operations during interim period

[Except as set out in __,_] since the Accounts Date (x) there has been no material deterioration in the financial position of the Target Group; (y) the Target Group has carried on its business in the ordinary and usual course; and (z) no Target Group Company has assumed or incurred any liability for capital expenditure otherwise than in the ordinary and usual course of trading or involving an amount in excess of €_____.

Buyer's protections: reps/warranties (4/4)

- Key standard reps/warranties will require careful consideration of carve-outs and disclosure (cont'd)
 - trading risk

[Except as set out in __, __], no material supplier to or customer of a Target Group Company has, during the last 12 months, ceased or notified to any Target Group Company [in writing] an intention to cease (or to materially reduce the volume of) trading with that Target Group Company or to modify prices materially or [to the Seller's knowledge] are likely to do so.
 - insolvency

No insolvency or similar proceeding has been, or to the Knowledge of Sellers has been threatened to be, opened over the assets of any Target Group Company and there are no circumstances that would require the opening of or application for such proceedings under applicable Law [subject to confirmation and continuation of Covid-19 Government Aid Measures as set out in _____].
- For live deals, the seller should consider whether accuracy of reps at closing can be confirmed and the buyer should consider its recourse if such bring-down is not already in the agreement.

Buyer's protections: indemnification (1/4)

- Impact of COVID-19 on buyer's indemnification rights in light of:
 - covenant on operations during interim period

On or prior to the Closing Date, Sellers shall cause the Companies to operate and maintain the Business according to their ordinary course of business consistent with past practice and in compliance with all applicable Laws and, without limitation of the foregoing, Sellers shall not (and shall cause the Companies not to): . . .

example of possible carve-out:

provided, however, that Sellers and Target Group may before Closing carry out any actions which the Parent Company's Board, acting [reasonably and] in good faith, determines is prudent, reasonable and proportionate having regard to the impact of Covid-19 on the health of its Employees and operations of the Business, other than any of the actions contemplated by clauses [e.g., issuing securities, taking on new debt, divestment, . . .]
 - definitions of knowledge

"Knowledge" means the actual knowledge of the directors and officers of Target [and the knowledge that each such person in his/her role should have] (after due and careful inquiry).

Buyer's protections: indemnification (2/3)

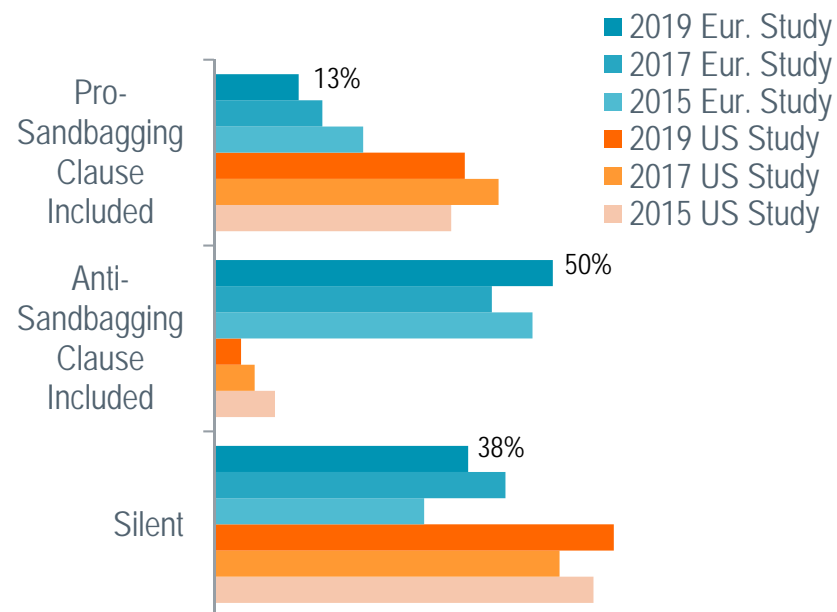
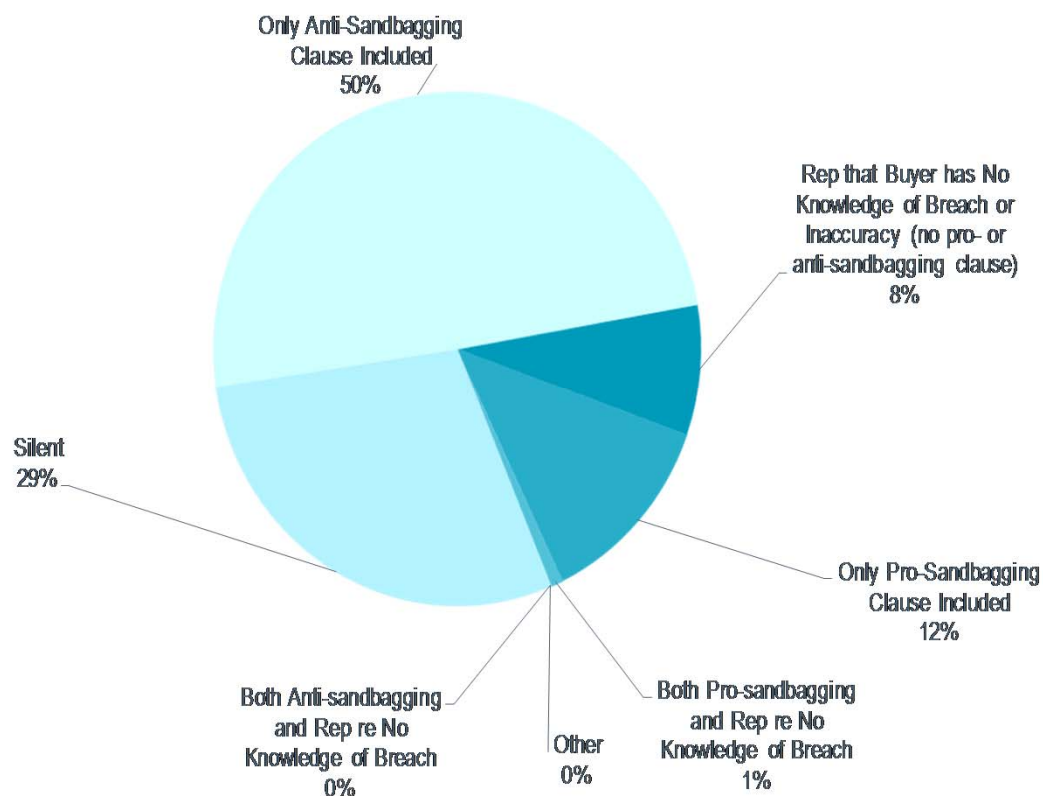
- Impact of COVID-19 on buyer's indemnification rights in light of (cont'd):
 - drafting options regarding sandbagging, including:
 - pro-sandbagging clause

The right of Buyer to indemnification will not be affected by any knowledge actually acquired [or capable of being acquired] by Buyer whether before or after the Closing Date with respect to the accuracy or inaccuracy of such representation or warranty.
 - anti-sandbagging clause

Seller shall not be liable for any Losses resulting from a breach of the Representations and Warranties if prior to the Closing Buyer had knowledge of such breach and/or the facts and/or circumstances giving rise thereto.
 - silence

Buyer's protections: indemnification (3/4)

- Use of pro- and anti-sandbagging clauses in Europe



Buyer's protections: indemnification (4/4)

- The COVID-19 time-line:
 - Dec. 31, 2019: Chinese health officials inform the WHO of a cluster of 41 patients
 - Jan. 11, 2020: first death in China linked to the coronavirus
 - Jan. 20, 2020: first US case was reported
 - Jan. 23, 2020: Wuhan and nearby cities placed under quarantine
 - Jan. 30, 2020: WHO declared a "public-health emergency of international concern"
 - Jan. 31, 2020: foreign nationals barred from entering the US if they had been in China within the prior two weeks
- What impact on
 - covenant re interim period operations?
 - reps/warranties qualified by knowledge?
 - the buyer's assertion of breaches of reps/warranties?

Rep/warranty insurance (1/4)

- **General trends**
 - Significant slowdown in new transactions and instructions (reflective of broader market)
 - Deals in underwriting are moving more slowly
 - Competition among underwriters remains in evidence and may encourage flexible approach to Covid-related exclusions and premium competition (but for how long?)
 - Competition heightened by presence of MGAs with no underwriting capacity themselves who must write business to survive
- **Areas of special scrutiny by underwriters**
 - Understanding buyer's approach to valuation/modelling/cash-flow analysis
 - No MAC since the last statutory accounts date – may be qualified by a Covid-specific or general sector related exclusion
 - Supply chain/material supplier-related warranties
 - Adequacy of IT systems, disaster recovery, business continuity – qualified by reference to business in its "normal course", as opposed to business "currently conducted"

Rep/warranty insurance (2/4)

- Approach to exclusions on live deals: currently, underwriters broadly adopting one of the following approaches:
 - Negotiating broad exclusions in policy language and of general applicability
 - Noting requirement for a Covid-related exclusion at NBI stage but seeking to narrow its application during the underwriting process
 - Relying on “known risks” language without the need for a specific exclusion
- Policy language is evolving in real time and underwriters are looking to a combination of LMA wording, and each other (where they get sight of a lead insurer's policy as part of a participation in a large insurance program)

Rep/warranty insurance (3/4)

Examples of recently used/proposed underwriter exclusions

- *.....directly arising out of or directly resulting from any business interruption, material operational change or negative trading impact directly caused by the novel coronavirus (including any resulting Covid-19 sickness) including non-performance of services, non-fulfilment of agreements, or non-compliance with measures to mitigate respective risks or any government or other regulatory response (including sanctions) thereto*
- *The Underwriters will not be liable to pay (i) any Loss if and to the extent it arises from, or (ii) any increase in any Loss to the extent that such increase arises from:
variation of SARS CoV-2)*
- *"Coronavirus" (means Coronavirus disease (COVID-19), severe acute respiratory syndrome coronavirus-2 (SARS-CoV-2) or any mutation or*
- *any business interruption, to the extent such business interruption arises out of or is related to the Coronavirus pandemic (including any resulting COVID-19 sickness or related viral strain) or any voluntary, governmental or other regulatory response thereto*
- *the presence or transmission of a novel coronavirus, including the coronavirus disease (COVID19) or any evolution thereof, and/or (ii) any mandatory or advisory restriction issued, or action ordered, by any public authority, regulatory body or government in connection therewith*

Rep/warranty insurance (4/4)

Mark-up points to consider when dealing with proposed carve-outs

- *Can the underwriter be persuaded to rely on the general “known risks” exclusion?*
- *Try to avoid amending the definition of “Loss” itself (as some underwriters have initially proposed), thus requiring the insured to prove that its Covid-19-related loss fits the definition, but instead consider a separate policy exclusion, so that the insurer has the burden of proof for excluding recovery.*
- *Try to avoid language such as “relating to” or “in any way related to” but instead choose formulation such as “arising directly out of” or if possible “arising directly and exclusively out of”*
- *Try to narrow the exclusion to only that portion of loss directly resulting from Covid-19, with wording such as “to the extent that” or “that portion of Loss directly resulting from”*
- *Try to limit the application of the exclusion to certain reps/warranties only, or to make the exclusion inapplicable to some, such as title to stock and assets, capacity to transact, payment of taxes and regulatory permissions.*
- *When the exclusion applies to reps/warranties with a look-back period (e.g. 3-6 years of compliance with laws, no litigation etc.), limit exclusions to a short look-back period covering the Covid-19 crisis.*
- *Ensure that the exclusion relates only to the current Covid-19 pandemic, as opposed to a general “coronavirus” exclusion.*

Deal mechanics

- Freeze on in-person meetings might have an impact on building relationships leading to successful agreement on some deals, since face-to-face discussions are often essential, particularly for deals involving entrepreneur/family owned businesses
- Will remote signing/closing be the new "normal"?
 - relaxation of corporate meetings requirements
 - differing roles of notaries across EU jurisdictions
 - rules regarding electronic signature



Questions?

