

# Covid-19: Black Swan Event between Signing and Closing?

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## 1. Introduction

▶ While a large number of transactions have been suspended or discontinued, ongoing transactions that have reached the stage between signing and closing are being tested to the breaking point in light of the current situation.

The buyer may have to expect to acquire a less valuable target company and to have to secure the continued existence of the target company with additional liquidity for an unforeseeable period of time. Furthermore, because of the uncertainty with regard to how long the lockdown will continue and the foreseeable phase shifts once the economies of the affected countries start to operate again, considerable disruptions to the supply chain can also be expected. This may increase the risk that catch-up effects will not occur after the crisis has ended, or will take place much later.

Depending on the purchase price model chosen, the seller may have to accept a significant purchase price reduction at the closing especially in cases where no precautions have been taken, for example, by agreeing a minimum purchase price. In addition, the seller is at risk of being held liable under warranties that have been provided (also) as per the closing date, for example, if essential obligations under material contracts (e.g. contracts with major customers) are breached.

Another area of concern is earn-out clauses that have recently been used more frequently to bridge different perceptions of the valuation of the target company. Due to a certain variable portion of the purchase price only being paid if the target company reaches certain financial goals for the seller, this may mean that such portion of the purchase price will be lost under certain circumstances, either because an agreed threshold (floor) cannot be reached at all or because it cannot be reached within the earn out period agreed between the parties. This may happen in particular if the parties have not agreed to catch-up rules and thresholds which level out a varying financial performance of the target company during the earn-out period.

The current situation is aggravated by the fact that, depending on the scope of the required closing actions, the phase between signing and closing can be expected to be considerably longer and that measures necessary to fulfil certain closing conditions, e.g. operational measures as part of a carve-out, may not be implemented within the scheduled timeframe in view of the lockdown and the resulting impediments to operations of the target company and involved third parties. Furthermore, the handling of required official approvals by public authorities has slowed down considerably in recent weeks.

As a general rule, sale and purchase agreements do not provide for a right to withdraw from the transaction at this advanced stage, and where such a right exists, it tends to be considerably restricted. This applies in particular to exogenous risks, such as the coronavirus pandemic, which materialise at the level of the target company as a material adverse change – for example, in the form of a substantial decline in sales. Provisions that entitle the purchaser to withdraw from the sale and purchase agreement in such a situation (so-called Market-Mac-Clauses) and subsequently shift the risks to the seller are generally not negotiable in European transactions.

In exceptional cases, however, a purchaser's right to rescind may be subject to the breach of certain material warranties between signing and closing, e.g. if a certain number of employees resigns or threatened damages from a breach of warranty between signing and closing exceed a limit predefined in the sale and purchase agreement. It is therefore possible that an unforeseen exogenous event could de facto lead to a breach of seller's warranties anchored in the purchase contract and, due to the serious consequences, to the right of the buyer to withdraw from the contract. As it has become apparent in the last few weeks after the lockdown, the problem of potential breaches of seller's warranties, especially with regard to material contracts and their fulfilment, has already reached M&A practice.

A right to rescind can also become relevant in the current situation if deadlines for the fulfilment of certain

closing conditions (long stop dates) agreed upon between the parties are exceeded. The current significant slowdown in official approval procedures in Germany and abroad and the limited capacity to act on the part of third parties involved due to short-time work or plant closures may result in the completion of the transaction being jeopardized by an agreed deadline. The question is, therefore, whether the party that wishes to adhere to the contract can argue that the deadline needs to be either reasonably extended or suspended, as the circumstances caused by the Covid-19 crisis were not taken into consideration by the parties when entering into the sale and purchase agreement. The answer to this question will depend on whether, taking into account the principles of good faith under German law, the specific provision can be interpreted and extended to the effect that a delay in the closing caused by the Covid-19 crisis gives rise to a claim for suspension of the deadline. If the respective provision is open to such an interpretation, must be examined in the light of protective purpose of the provision intended by the parties.

## 2. Recommendations and Conclusion

### 2.1 Potential Breaches of Warranty between Signing and Closing

In the event of a potential breach of warranty between signing and closing, the seller should examine possible remedies in a timely manner and involve the purchaser proactively in their implementation. This can help reduce the potential for disputes shortly before the closing. In the event that a warranty and indemnity (W&I) insurance policy has been taken out, the seller should additionally examine whether the impending breach of warranty is covered by such policy. In principle, this will be the case, since customary insurance conditions follow the guarantee and liability concept implemented in the sale and purchase agreement and – at least for the time being – do not contain any exclusions for pandemic related breaches of warranty.

In case of crisis-related measures between signing and closing that might go beyond the ordinary course of business, the seller should also ensure that the covenants agreed in the sale and purchase agreement with respect to the continuation of business operations after signing are observed. In this respect it is also important that the seller acts with foresight and, where necessary, seeks coordination with the purchaser.

### 2.2 Long Stop Dates

From the point of view of both parties, it is advisable to take up an emerging deadline problem at an early stage and to look for a solution acceptable to both sides. There is nothing more awkward than having to work “against the clock” in a closing procedure without having ultimate control over the available time-frame. Preference is to be given to the suspension or

substantial extension of the deadline, which can be effected as a pure implementation agreement and thus does not have to meet the same formal requirements as an amendment to the sale and purchase agreement (e.g. notarization).

### 2.3 Payment of the Purchase Price, Earn-out

If the purchase price is fully or partially debt-financed, the seller should secure his position by asking for a new financing confirmation, as previously applicable pay-out conditions may no longer be met at the closing.

In variable purchase price models that include an earn-out component, both parties should attempt to use the period between signing and closing to negotiate an adjustment in order to eliminate Covid-19-related distortions. In particular, a general postponement of the relevant calculation periods and the implementation of the possibility of catching up financial targets over the entire earn-out period could be an appropriate solution. Furthermore, it would also be conceivable to link the duration of the earn-out period to certain events whose cumulative fulfilment give an indication for the normalisation of the target company’s business, such as the availability of preliminary products for production, reopening of customer centres, trade fairs, etc.

### 2.4 Conclusion

The impact of Covid-19 on M&A transactions that have reached the stage between signing and closing is in some cases significant and has caught the parties completely unprepared. As with other Black Swan events in the past, it will therefore be important to respond quickly and flexibly to the resulting challenges and changing circumstances. In this situation, advisors are required to find mediating solutions. As a rule, insisting on uncompromising negotiating positions at this stage will result in further delays that will adversely affect the continuation of the target company. In order to make future transactions “Black Swan proof”, sale and purchase agreements should proactively describe ways to enable both parties to find a solution in line with their interests and prevent deadlocks in this sensitive phase of the transaction. ■



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