COVID-19: Germany Update — How Will the Pandemic Affect Private M&A Deals in Europe?

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April 13, 2020

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The COVID-19 pandemic has heavily disrupted M&A activity around the globe and many projects have been put on hold. However, as soon as the pandemic is beyond its peak and lockdown measures have been eased, sellers and buyers are likely to assess whether to pick up these deals from where they left off and on which terms. The damage caused by the pandemic to the global economy and the risk of a setback in the fight against the pandemic will play a role in any such decision. While it is too early to predict the impacts of the pandemic on private M&A deal activity in the near- and mid-term, it is already clear that this uncertainty will not only effect the "economics" of deals, but also the legal terms under which they are agreed upon.

Process and Due Diligence

Process. While virtual data rooms, as well as telephone and videoconferencing, are already commonplace in M&A transactions, important trust- and relationship-building measures — such as in-person site visits, "getting to know you" meetings and negotiations — seem almost certain to remain restricted for quite some time. As a result, the dealmaking process will become more virtual until in-person restrictions are lifted. While this should not have a significant adverse impact on the ability to complete deals, the circumstances will require more preparation and a different approach to meetings since it will not be possible "read" your counterparty as if you are sitting opposite each other in the same room.

Due Diligence. While due diligence timelines have generally become much shorter in recent years, targets also have been much better prepared for this exercise through vendor due diligence reviews and reports made available to interested parties. However, we expect that the duration and depth of due diligence reviews of deals that will be picked up will increase once the effects of the pandemic begin to subside. Not only will prospective buyers want to understand in detail the mid- and long-term effects of COVID-19 on the target's business model and performance, they also will want to evaluate the "resilience" of the target's business by examining its:

- vulnerability to pandemics;
- cash-flow profile and liquidity position in a crisis scenario; and
- operational preparedness and capability to deal with another similar scenario (*e.g.*, ability to maintain production and other core functions despite a lockdown).

Timing. These changes to the M&A process will almost certainly increase the timeline necessary to get a deal done. Both parties will have to account for this in their process timelines.

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Transaction Documentation

Similar to what happened after the 2008 financial crisis, legal deal terms may, over time, return to where they were prior to the pandemic. However, in the coming months the allocation of risk between seller and buyer will have to be critically assessed and discussed in ways that often may deviate from normal market practice prior to the COVID-19 outbreak in order to be able to "get a deal done" notwithstanding the uncertainties.

Locked-Box vs. Closing Date Accounts. While the European M&A market has gravitated toward the locked-box concept with a fixed purchase price and no post-closing adjustment of the purchase price based on closing accounts, the fixed purchase price concept may not work as well in the current environment. With many targets' financial situations hurt by the recent events, it will often be quite difficult to agree in advance on the estimated equity value of the target on the projected closing date. The projection as to when closing will occur in itself also will be a challenge, as discussed below under "Regulatory Approvals and Long-Stop-Date." A prudent buyer will be hesitant to lock in the equity value and likely will be inclined to insist on a typical post-closing true-up mechanism based on the actual net financial position of the target as of the closing date. The buyer's view also will be driven by the fact that obtaining regulatory clearances for M&A deals in the coming months likely will often take longer than prior to the pandemic, given that the relevant governmental authorities are locked down or wrestling with the challenges of "working from home." If a closing accounts mechanism is agreed upon, the parties will need to carefully assess whether the definitions of the relevant financial metrics (typically "cash," "financial debt" and "working capital") still work and how to determine an appropriate "normalized" working capital target.

Material Adverse Change (MAC) Provisions. As in every major crisis, this pandemic will (again) trigger discussions as to whether transaction documentation should include a "no MAC" closing condition that would allow the buyer to shift to the seller the risk of a renewed outbreak of the virus or similarly disruptive adverse event occurring between signing and closing. Outside of the U.S., "no MAC" closing conditions and similar provisions remain relatively rare. This is particularly true in European private M&A transactions, and it remains to be seen whether the pandemic will trigger an increase of "no MAC" provisions. However, when discussing the inclusion of such provisions in the sale and purchase agreement (SPA), parties should be aware of the following:

- While the pandemic has had — and will continue to have for some time — materially adverse effects on many businesses, a state-of-the-art "business MAC" (*i.e.*, a "no MAC" provision that tracks adverse impacts on the target business) in most cases would not have offered adequate protection for a buyer. This is because such clauses usually contain carveouts to eliminate all such events from the definition of what constitutes MAC events, which have an industry-wide effect and are not specifically adverse for the target.
- To protect against another pandemic event, a buyer would therefore need to include in the SPA a "market MAC" provision (*i.e.*, a "no MAC" provision that a buyer can invoke if certain macroeconomic events occur between signing and closing that materially adversely affect, for example, public markets or the currency trading system). Those provisions also could be specifically tied to a pandemic event. Accordingly, underwriters of public offerings have been quick to adjust their usual template documents to specifically include pandemics as MAC triggering events in their underwriting or similar agreements.
- If this risk is to be shifted to the seller through a "no MAC" closing condition or walk-away right, the parties should negotiate specific provisions to capture the risks they are most concerned about and carefully review the final wording to make sure it captures what they are trying to achieve precisely enough. Otherwise, the ability to actually invoke such a clause may be subject to substantial litigation risk for both parties. In this context, parties also need to be aware that, in part because of the lack of precedent cases, courts or arbitral tribunals will find it difficult to determine whether or not a MAC has occurred if the clause itself is broadly drafted without reference to specific trigger events.

Financing Certainty. One of the most important topics in M&A deals to be signed in the coming weeks and months will be financing certainty. In a European context, a seller with an attractive asset would require an interested party to provide evidence of "certain funds"-style financing for the entire purchase price due at closing being available at the time of signing for it to win the auction. This effectively means that the buyer has received, at the time of signing, binding and fully documented commitments from its ultimate parent (or the relevant private equity fund) for the equity portion of the financing, as well as an (interim) debt facility agreement in combination with a conditions precedent satisfaction letter, for the remaining amount. Whether and to what extent certain funds-style debt financing will be available in the coming weeks is unclear. This forces sellers who are eager (or under pressure) to get a deal done into the uncomfortable position of having to assess whether they are prepared to take the financing risk by agreeing to a financing out in favor of the buyer, perhaps to be combined with a reverse-break fee payable by the buyer if it invokes the financing out. In competitive situations, (private equity) buyers will have to consider whether they would prefer to increase the equity portion of the financing to bridge any shortfall in the available debt financing. Alternatively, debt funds — which may have a higher risk appetite than banks — may be better placed to bridge the gap or provide the entire debt portion.

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Regulatory Approval and Long-Stop-Date. As mentioned above, some European regulatory bodies have suspended or decelerated approval processes for the coming weeks. Competition authorities across the globe also have adjusted timetables for merger review procedures in response to evolving working conditions resulting from the pandemic. Additionally, regulatory bodies for foreign investment control are expected to have delays in handling cases. The resulting backlog of cases may cause delays in obtaining regulatory clearances in the coming weeks and months. Another likely impact of the pandemic is that governments will reconsider which businesses they view as being critical for the support of their own people and further tighten foreign investment rules, a trend that has been ongoing for some time. These effects will, in many transactions, result in longer time periods being required to get a deal closed, which increases the risk for buyers that something could happen to the newly acquired business in this time period. This increased risk will put further pressure on discussions around protection through closing accounts and "no MAC" provisions.

Interim Conduct of Business. Given these uncertain times, customary "ordinary cause of business" covenants may stand in the way of the target's ability to combat the impact of the pandemic. As a result, interim business covenants will have to be carefully drafted to ensure they do not limit a seller's ability to react to a pandemic situation (these measures will by definition be "outside the ordinary course"). Otherwise, the seller's ability to quickly respond to a crisis may be restricted by the requirement to obtain the buyer's approval for the relevant action. If the transaction documentation contains bring-down provisions (*i.e.*, closing conditions that can be invoked by the buyer if a material breach of representations and/or covenants by the seller becomes apparent before closing), an ill-drafted set of interim conduct of business covenants may provide a buyer with a reason to renegotiate or walk away from the deal.

Representations and Warranties. The representations and warranties in the SPA may be the one area where not much changes as a result of the pandemic, except that buyers are more likely to seek to include representations about the "adequacy" of the target's protocols and processes to efficiently respond to another pandemic. Protection in relation to customary inventory levels, material contracts and the collectability of trade receivables will need to be reviewed carefully to make sure they are true and correct in light of the impact of the pandemic on the target's business. Sellers may seek to qualify representations by excluding the impacts the pandemic has had, or may have, from the scope of the representations. An additional area to be monitored will be the reaction to the pandemic by underwriters to warranty and indemnity insurance and whether their willingness to underwrite risk (of any kind) will be adversely affected by the impacts the crisis has on their balance sheets.

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