
COVID-19: SELECTED ISSUES DURING THE PRE-ACQUISITION PERIOD AND THE PERIOD BETWEEN SIGNING AND CLOSING IN ACQUISITION DEALS (PART 1)

The recent spread of COVID-19 in Europe and around the world has triggered unprecedented administrative measures (e.g. restrictions on movement or prohibition of gatherings) that have been slowing merger and acquisition activities.

The Luxembourg Government declared a state of emergency due to the COVID-19 crisis on 18 March 2020 in accordance with Article 32(4) of the Luxembourg Constitution. This decision was confirmed and extended by the Luxembourg Parliament on 21 March 2020 for a period of three months.

In this context, the crisis has had a direct impact on deal activity and there is uncertainty as to how COVID-19 would be interpreted under the ongoing M&A agreements governed by the laws of the Grand Duchy of Luxembourg at different stages of the M&A transactions and parties' abilities to enforce or terminate their obligations or performance thereunder.

Some parties would like to walk away from deals and agreement entered into, while others would wish to continue and complete the transaction swiftly.

This newsflash briefly summarises and analyses the main issues raised by the COVID-19 crisis during the pre-acquisition period and the period between signing and closing of the SPA.

1. PRE-ACQUISITION PERIOD

a. Letter of intent

The letter of intent (LOI) is commonly used in M&A transactions. Generally speaking, it expresses an intention to make an acquisition and it defines the main terms of discussion and the framework of negotiations of such acquisition.

The LOI is in principle non-binding, unless otherwise agreed. It often contains a binding exclusivity period during which the seller may only discuss with the buyer.

In most cases, the LOI does not contain any binding force majeure clause at such an early stage of negotiations.

In the context of COVID-19, if a M&A transaction has only reached the stage of a signed LOI at the point when the pandemic spread, one of the parties may be tempted to break off negotiations. However, the right to break off negotiations may constitute an abuse where the party breaking off negotiations commits a fault in the exercise of this right in light of the principle of good faith. The longer the period of negotiation, the more brutal the break-off, which in the absence of legitimate grounds may be considered abusive^[1].

In practice, parties often have a mutual interest to keep the transaction going and to agree to accommodate the disruption caused by COVID-19.

For any acquisitions where an LOI needs to be signed, it would be helpful to include provisions to anticipate possible impacts of COVID-19, including a force majeure clause covering measures taken by the governments of the countries involved which could disrupt the pre-acquisition process.

b. Due diligence, on-site visits, management Q&A, etc. – impact on the timeline, access to the documents, information and Q&A may be impacted due to confinement measures

Although most or all due diligence process has become virtual and many steps can be managed remotely by the sellers and buyers, there are still steps which require physical meetings or presence, especially in domestic M&A in Luxembourg.

Given the significant measures implemented to slow the spread of COVID-19, all steps which would require physical meetings have been impacted: management Q&A meetings, on-site visits, and other meetings between buyers and sellers. Many of them can be conducted by calls or videoconference but the current situation has certainly impacted the negotiation procedure.

Buyers and sellers should be prepared for a longer than usual due diligence period. Sellers may have difficulty providing access to certain documents and materials which require the physical presence of employees in the office.

c. Exclusivity period – negotiation of an extension

In most LOIs, a binding exclusivity period is usually defined, during which the parties to the LOIs

are required to negotiate exclusively among themselves, without having the right to negotiate with a third party.

If an exclusivity period is in place and it is now unlikely that the parties can negotiate the terms and conditions of the agreement within the contemplated timeline as a result of COVID-19, the exclusivity period should be extended by mutual agreement of the parties.

It would also be relevant to consider whether inserting an exclusivity period is feasible in light of COVID-19, or if the relevant date should be specified as being further in the future, in order for the negotiations to be adapted as necessary in light of the rapidly evolving situation.

2. PERIOD BETWEEN SIGNING AND CLOSING

If the SPA was already signed but the acquisition has not closed yet, parties are legally bound and have obligations to fulfil pursuant to the terms of the SPA prior to closing (conditions precedent, pre-closing covenants, etc.). The pandemic may have adverse impacts on some items.

a. Impact on the respect of “ordinary course of business” covenant

Standard interim period clauses or interim operating covenants require the sellers to operate the target in the "ordinary course of business", generally in accordance with past practice, including specific restrictions against staff reductions, material changes in personnel policies and changes in compensation. In addition, maintaining liquidity, refinancing debt and managing working capital are also necessary to operate the target in the "ordinary course of business".

A seller going through an interim period between signing and closing will likely face challenges in complying with its obligations in the context of COVID-19. For example, such interim covenants may be tested by operational requirements resulting from COVID-19 that require an injection of working capital or additional cash.

Given that we have already seen many businesses lockdown or severely curtail their operations due to pandemic-related restrictions, the affected seller may be in breach of its interim covenants, which may give buyers the right to walk away from the contract or claim damages.

If the parties are willing to continue the deal, they could review and adjust the terms of their interim covenants to determine the steps to be taken and the extent to which the buyer's consent is required before making a decision.

Buyers may wish to have enhanced information rights in the event of significant events such as the occurrence of epidemics or pandemics between signing and closing, so that they are not obliged to acquire a business that has not complied with the interim covenants.

Sellers should be able to rely on specific emergency or disaster exclusion clauses, which may be included in the SPA. A provision could be included whereby the consent of the buyer may not be unreasonably withheld or delayed, allowing the seller to implement urgent decisions if they are reasonably necessary, irrespective of the buyer's consent.

b. Material changes in the target's business and financial situation with impact on final purchase price

As mentioned above, such material changes in the target's business and financial situation may have an impact on the final purchase price.

In Luxembourg, a significant number of transactions are entered into on the basis of the so-called "locked box" mechanism, whereby the price paid by the buyer on closing is determined on the basis of the accounts of the target available at the time of the signing of the SPA. Under the "locked box" mechanism, changes in the financial situation of the target between signing and closing, as mentioned above, are not covered except for the "leakages".

Given the impact of COVID-19 on the financial situation of many companies, buyers will likely refuse to accept a "locked box" mechanism. The parties may also seek to bridge any disagreement on the purchase price resulting from the current crisis by means of earn-out clauses or other forms of post-closing adjustments designed to reflect the future financial performance of the target.

c. Representations and warranties

Given the sudden and changing impact of the pandemic on most businesses, representations and warranties regarding the target and its business that were true at signing may no longer be true at closing.

In SPAs, it is often provided that the seller's failure to confirm that its representations and warranties are true at closing may give the buyer the right to terminate the contract and claim damages under the indemnification provisions.

Thus, it is important to monitor any changes in the truthfulness of the representations and warranties resulting from the effects of COVID-19.

More particularly, buyers should insist that the relevant representations and warranties given by the sellers take into account the following aspects:

- Material Contracts: any contractual rights or legal principles that may excuse non-compliance or allow contracts to be terminated (including force majeure)?
- Compliance with laws: change in law risk (including the impact of travel restrictions, quarantine measures and government-mandated closures) and government initiatives?
- Labour and employment: health issues, including the implementation of appropriate precautionary measures? Any regulatory, licensing and data privacy implications as a result of remote working arrangements?
- Insurance: adequacy of business and event insurance policies?
- Accuracy of the financial statements: actual and potential liability exposure not yet covered by financial forecasts?
- Risk assessments: scenario planning and adverse impact of the virus? impact on revenues and solvency risk? ability to service its debt and comply with covenants under its debt documents?
- Business continuity plans and emergency response protocols ?
- Suppliers: alternative suppliers?

Sellers should pay attention to the following when giving the representations and warranties:

- consider including general disclosures regarding the impact of COVID-19 and its general impact as well as any specific required disclosures (e.g., in response to any number of representations, including those mentioned above that a buyer may require the seller to make);
- consider a general coronavirus-related exclusion of liability, so that coronavirus-related claims can only be made under specific warranties and not under general warranties.

MOLITOR AVOCATS A LA COUR

Molitor Avocats à la Cour's Corporate M&A team have been assisting our clients in on-going M&A transactions. If you have any questions, please contact any of MOLITOR's Corporate & M&A team.

[1] Danièle Dardy. (2019). Formaliser une lettre d'intention. Fiches pratiques Lexis Nexis.

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