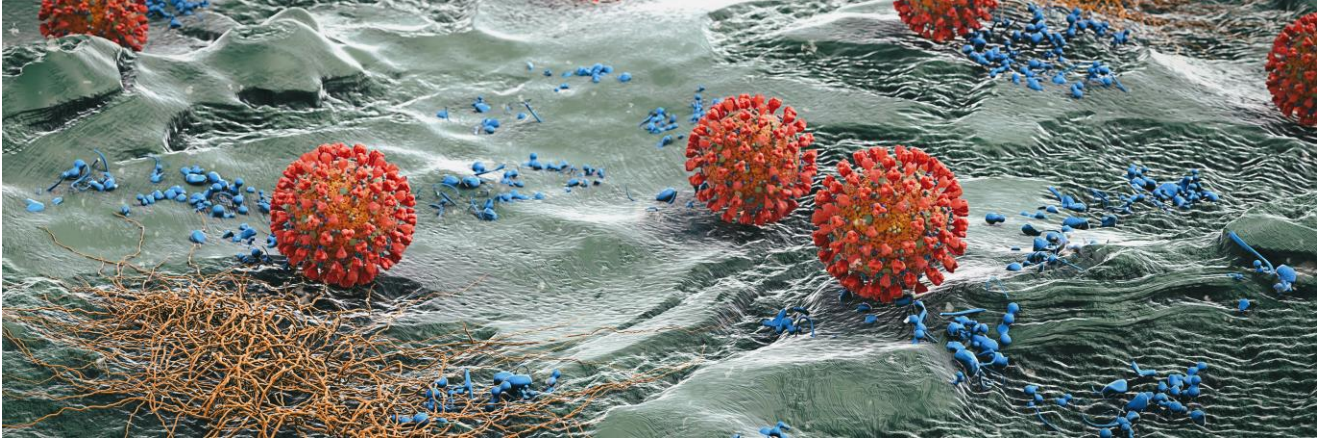


ALERT: When the market sneezes...



M&A transactions are by no means immune to the chaos enveloping global markets due to the coronavirus pandemic. The questions arising in this connection are by no means academic ones. So, what is the potential impact of the coronavirus crisis on planned transactions and, at least as urgently, on transactions which have already been closed and are now being implemented? We hope that the following summary of key issues may be of assistance.

1. Valuation

Valuation of the business of the company constituting the object of the planned transaction (definition of its equity value) generally refers to components such as the enterprise value, debt, cash and current capital (current assets minus current debts).

The general idea is to gauge the potential of the business / company to generate income for its owner. In this context, critical importance attaches to the normalised EBITDA. Debt burdens, cash reserves, and the level of capital needed for day-to-day operations, meanwhile, depend on how the target is financed and provide a snapshot of its financial condition as at the moment of valuation and predicate the enterprise value to equity value bridge which, in most M&A transactions, is crucial to the cash-free, debt-free valuation concept.

All in all, transaction valuations depend on certain financial indicators which are recognised as universal norms. Alas, the present crisis swelling up as a result of the coronavirus pandemic may make it quite difficult to speak of universal norms. Current revenue, expenditure, and cost structures, and likewise current financing needs, may vary significantly from what was hereuntil the standard for the given company and for what comprised its ordinary course of business. Accordingly, this problem should be taken into account already at the transaction negotiation stage so that the participants may secure their interests accordingly. Sudden exigencies such as supply chain disruption,

production standstill, or delays in settlements may do much to cause deterioration of the company's current results. The question whether – and, if so, to what extent – circumstances such as these impact the fundamental, long-term value of the business is an open one. In practice, there are various legal structures which may diminish the impact of such unexpected events on the transaction valuation, for example exclusion of their results (within defined ranges) from the price calculations or predication of the final / total price upon future results (which would be assessed, hopefully, once the coronavirus crisis has abated). There is no one-size-fits-all solution here – every prospective deal must be approached individually so as to duly account for the current corona-crisis.

2. Interim period obligations and the ordinary course of business

A prominent feature of many M&A transaction timelines is comprised in the interim period, i.e. the time intervening between the signing of the transaction documentation and the closing, when the shares finally pass onto the buyer.

Apart from fulfilment of any conditions precedent, the buyer will be looking to make sure that, colloquially speaking, he ends up buying the same company that he signed for, and a critical aspect will be continued operations within the ordinary course of business throughout the interim period. The buyer will, naturally enough, expect to be informed about any deviations from the ordinary course of business and to have at least some say in this regard, if only on a consultation basis. In some cases, breach of ordinary course of business obligations may lead to rescission of the contract and abortion of the transaction.

The simplest, and often used, definition of “ordinary course of business” refers to the manner of operations kept up in the past. Yet, given the successive economic shockwaves unleashed by the coronavirus pandemic, expecting operations on a business-as-usual basis would be unreasonable, as would be expecting the management and supervisory board of a company to sit back and passively watch the disaster play out. Accordingly, it is now more important than ever to make sure that the transaction documentation provides for swiftly reacting to new problems as they manifest themselves, and that it motivates all the entities involved in the transaction to actively cooperate in this regard (for example by way of the default assumption that lack of response within a set deadline shall be tantamount to permission). New significance is also assumed by wording which expands the “ordinary course of business” to encompass actions undertaken to ensure the company's continuous operations, or even extraordinary measures taken in response to an extraordinary situation.

3. Representations and warranties

The next issue is that of truthfulness, as at every consecutive day, of the reps and warranties made in the transaction documentation. Current events may well render many representations and warranties formulated in good faith in saner times – whether they refer to the status as at signing, or as at closing – untrue. Accordingly, it will be

important for the seller to ensure, already at the signing stage, that he will have the possibility of presenting a disclosure letter in which he can point out any departures from the reps and warranties made as at signing and/or as at closing, thus excluding seller's liability. It is also advisable to address, in advance, the question of what happens once untruthfulness is disclosed.

There are other possibilities of contractual provisions protecting the party making the reps and warranties against liability for untruthfulness, especially where it is caused by implementation of new laws during the interim period.

On the other hand, regarded from the perspective of the investor, the present situation may well justify augmenting the standard catalogue of representations and warranties with new ones associated with adapting the business to the new normal of the coronavirus pandemic (examples might include reps and warranties referring to adequate inventory levels, alternative / emergency supply sources, or the company's ability to operate under a special epidemiological regime).

Some purchasers may actually find themselves reviewing the very foundations of the transaction, asking themselves whether they should go ahead in a situation where the market has undergone a seismic shift since the deal was agreed. A well-structured investment agreement affords all the parties a modicum of comfort in this regard, for example through incorporation of a material adverse change clause.

4. Material Adverse Change

In general, MAC clauses refer to an extraordinary change of circumstances which exerts a negative impact on the company / enterprise constituting the object of the transaction between the signing and the closing, one which strips the company of a material asset or significantly hobbles it with respect to future profit potential; where such extraordinary detriment arises, the buyer may abort the deal. The well-worn image often used to illustrate a MAC event is that of a burning factory, but life has a way of surprising us, and the present coronavirus crisis gives the MAC clause an entirely new dimension.

Many of the disruptions precipitated by the coronavirus crisis – to mention only travel restrictions, employee quarantines, reduced supplies, or impossibility of selling goods due to administrative (epidemiological) restrictions – will handily qualify as extraordinary changes of circumstances. From the perspective of a purchaser, the possibility of aborting a transaction will certainly be considered. Yet the typical MAC clause as drafted for the purposes of transaction documentation usually follows not a formal tack (a description of certain events or circumstances), but approaches the matter from the side of the enterprise (description of the impact on its operations). Practice demonstrates that, in many cases, the parties will strive for an objective element, for example by describing the negative impact on the enterprise in terms of a specific drop in sales levels. Every such solution is bound to have shortcomings of some sort, but experience also teaches us that, if a crisis does materialise, anything in the way of an objective, empirical point of reference

will be preferable to lack of any objective criteria at all; in the latter case, the field is left open to emotions.

Any decision to invoke a material adverse change clause should be preceded by detailed analysis of the relevant contractual provisions so as to ascertain that rescission of the contract is in fact an option.

Proceeding to any negotiations now pending, it will be natural, especially from the perspective of the seller, to agree upon wording which excludes the present pandemic and its effects from application of a material adverse change clause.

5. Closing

The closing is the actual conclusion and performance of the transaction, understood as the various actions (e.g. payment of the price, release of the shares) necessary to complete the sale of the asset in question and for the passing of legal title onto the purchaser.

These days, it may well transpire that individuals who must be in attendance at the closing are unable to show up, for example due to the impossibility of catching a flight or crossing the border. This would generally qualify as a force majeure event which provides grounds for rescheduling of the closing. Or, the closing may prove outright impossible due to a blanket travel ban or the lockdown of an entire city.

In such an event, the parties may consider ways of proceeding via electronic communications technologies, or the granting of appropriate powers of attorney. Again, there can be no single solution suitable for every scenario, and the parties should seek to consider the broader picture and to show understanding for their partners. Completion of closing on a “virtual” or “remote” basis or postponing it will, more often than not, be possible provided that all the parties work together to achieve such an outcome. In the event that the closing is deferred to a future date, it will be necessary to duly consider the implications for the parties in areas such as any material adverse changes clauses or truthfulness of representations and warranties.

6. Emergency financing

In many cases, the general disruption occasioned by the coronavirus pandemic may leave companies in need of emergency financing. In a small business, the relevant decisions can often be taken by a single person; in more complex corporate organisms, the question of emergency financing may be addressed in the shareholders agreement. Such provisions are generally intended to address a situation where some shareholders still see hope and are willing to make additional contributions to the company while others balk at the increased exposure. The shareholders agreement may provide for increase of the share capital, for additional contributions, or for a loan convertible into equity. It is standard practice to provide that, at least in its initial stage, any such capital injection preserves the original balance between the stakes of the respective shareholders.

As long as all the shareholders have the same basic outlook on how the company should be run in boom times as well as when the going gets hard, provisions regulating emergency financing are little but a formality. Once any controversies develop, however, such provisions prove to be very important – the future of the company may depend on them.

It would be stating the obvious to write that this is a difficult time for all, and that all aspects of running a business will somehow be affected. Yet the same basic rules apply – decision makers should think ahead, hedging their risks in different scenarios before such scenarios materialise. This also holds true for M&A transactions, especially ones which have not been concluded yet, where there is still room for negotiation. Now, perhaps more than ever, we see that business is all about speed and flexibility, but also about responsibility and a sense of fair play

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