Navigate your deal through a volatile market

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The M&A market has entered a volatile period, but there are several strategies that you as a seller or buyer can use to navigate your deal through to completion. These strategies may be particularly relevant for buyers who have secured financing or large cash reserves. We also expect that it will generally be a buyer's market for some time to come.

Purchase price mechanism

In the Nordics a predetermined, set purchase price, or locked box, has long been a popular purchase price mechanism. Given the increased financial uncertainty for many businesses, a completion accounts / closing balance sheet model may be increasingly suitable for buyers. The primary benefit for the buyer is that any events during the period between signing and closing that negatively affect the target company's operations are reflected in the completion accounts and thus also in the purchase price. But if market volatility is expected to persist over a longer time horizon than 2-3 months (which is the average time period between a split signing and closing), then other pricing models may also be considered. Two examples of this are a carefully drafted earnout or supplemental purchase price, or a conditional holdback or escrow; however, buyers should note that such mechanisms are not always attractive to sellers (and perhaps even less so in times of uncertain prospects). A purchase price payable in assets other than cash—most commonly, share swaps and non-cash consideration—may also be considered, as well as buying just a controlling stake (instead of 100%) and thus continuing to run the business together with existing shareholders and thereby sharing the upside and downside.

Contractual protection

Carefully consider what warranties can and should be given in the acquisition agreement by both seller and buyer. In many cases, warranties that essentially were market practice to give in the fall of 2019 may need to be modified in tomorrow's acquisition agreement, as many companies' earning capacity, customer base and employee arrangements—to name just a few examples—will probably look different in 2020. Sellers who wish to close deals under prevailing conditions should carefully review the seller's warranty catalogue and consider if carve-outs will now be necessary from the warranties that previously constituted market practice. Given the rapid twists and turns that society is currently undergoing, a buyer should ensure that the seller's warranties given at signing are also repeated at closing, in order to ensure that contractual protection survives when the actual reality may have shifted during the period between signing and closing. Sellers and buyers should also reflect on the possible side effects of a volatile market for the target company's operations: do any of the consequences of such side effects need to be regulated in the acquisition agreement as specific obligations for any party? Examples of risks that may need to be addressed specifically are losses in deliveries, capacity and financing.

Due diligence

Achieving the contractual protection mentioned above in a volatile market will require in-depth due diligence, both legally and commercially. A company's contractual obligations and the consequences of breach of contract—a subject that was previously important but is now surely essential—will require more comprehensive diligence and analysis than before. This is the case not least as regards identifying available remedies upon problems or delays in a supply chain, for example, but also as regards the possibilities for a target company to invoke contractual rights vis-à-vis its own customers or other counter-parties, should problems arise. Operational dependency on counter-parties should also be analysed: what capacity does the target company have to continue to perform its obligations and run the business if a material supplier or partner can no longer perform or goes bankrupt? In addition, our expectation is that in many cases M&A or RW&I insurance will exclude specific risks arising from Covid-19's impact on a business, because such insurance does not normally cover known risks. That said, it remains to be seen how quickly M&A insurers adapt to the current situation and how big their risk appetite proves to be.

Financing

Many buyers have sizable cash reserves that still need to be placed on the market. But for the buyer who needs to finance a transaction with external loans, it is important to ensure that the banks or other financiers' loans are sufficiently secured. To put it another way: exactly how and to what extent has the lender guaranteed financing? Are there any provisions in the financing documentation that potentially entitle the lenders to refuse to provide the financing due to the current market situation? It may be worth noting that the commitment documents may in some cases contain conditional provisions that no material adverse change (MAC) has occurred on the lending markets, capital markets or stock markets; if so, MAC clauses could potentially give the lender the right to refuse to provide the financing due to the market situation.

Although MAC provisions are less common in the actual loan agreements themselves (as opposed to the commitment documents), there may nonetheless be provisions in loan agreements and other financing documents that could potentially entitle the lender to refuse to provide the financing, such material adverse effect and similar provisions. For these reasons it is worthwhile for a potential buyer / borrower to carefully review the loan agreement and other financing documents to ensure that the financing is de facto sufficiently secured, and that there are no provisions that can directly or indirectly entitle a lender to withdraw from the financing. Certain funds and other provisions that raise the threshold for when lenders have the right to withdraw financing have been in loan agreements for a long time, but in the current market situation, it may be particularly important to include such provisions in the financing documents.

Additionally, both buyers and sellers should evaluate their ability to act if the bank's funding is withdrawn. Buyers should carefully consider the risks, opportunities and costs of ensuring that financing is adequately secured and, at the same time, evaluate the possibilities of withdrawing from the acquisition agreement if financing disappears. Of course, the one option does not preclude the other, and hybrid, middle-ground solutions may well be the most efficient in terms of risk and cost. Similarly, sellers should consider how confident they are of the buyer's financing. Where there are several potential buyers, each buyer's financing arrangements may be of great interest to the seller, and the buyer who has secure, committed financing may enjoy a considerable competitive advantage over other potential buyers.

Beyond ensuring that financing is sufficiently secured, a buyer / borrower should also pay particular attention

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to—and formulate with care—the financial and other obligations in the loan agreement that are to be fulfilled and complied with post-acquisition, in order to ensure that the borrower and the borrower group will indeed continue to be able to live up to the obligations in the loan agreement. It should also be noted that certain funds and similar provisions that raise the threshold for when lenders are entitled to withdraw financing usually only apply for a certain period of time and, after the expiry of such period, the "normal" provisions come back into force, which can entitle the borrower to take action and seek remedies pursuant to the loan agreement for breach of contract, such as demanding repayment of the loans.

Allowing for an "out"

Deal certainty will certainly continue to be highly valued going forward, but prevailing circumstances call upon parties to consider introducing flexibility in the acquisition agreement for one or both parties to walk away (see also above under Financing). Such flexibility can be achieved in a number of ways, such as by agreeing upon a carefully chosen long stop date, or by inserting closing conditions that forbid certain events occurring during the period between signing and closing. An oft-debated hot topic now is the use of different types of MAC clauses as conditions to closing. Over the past decade, MAC clauses have not been particularly common as closing conditions in the Nordics (unlike in North America where they instead are market practice), and surprisingly few have been tested in court on either side of the Atlantic. We expect to see an increase in carefully formulated, defined MAC clauses in the wake of the current market situation.

Merger filings

Covid-19 has already had an impact on the merger notification and filing process with competition authorities, as we have already highlighted in this previous article. Parties who determine - ideally following a careful competition and antitrust analysis - that the deal at hand will not require a merger filing, will be able to complete the deal much faster (all other things being equal). While that is hardly news, in a competitive auction situation with several bidders, such buyers may enjoy an even greater advantage than before.

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