



# M&A in the Light of COVID-19

## – An Analysis by DLA Piper’s Corporate M&A Department

This DLA Piper analysis describes a number of issues which parties involved in M&A transactions should take into consideration and reflect upon in light of the COVID-19 pandemic. Contact one of DLA Piper’s M&A lawyers to discuss these issues in further detail. We further refer to DLA Piper’s daily updates on the different legal options for mitigating and managing the consequences of COVID-19, which are available on our website, [www.dlapiper.dk](http://www.dlapiper.dk).

### 1. Transactions where a sale and purchase agreement has not yet been signed

Naturally, the outbreak of COVID-19 will also impact M&A transactions. That does not imply that ongoing or contemplated transactions must necessarily be put on hold, but the current situation calls for both the seller and the buyer to consider certain issues, including:

#### 1.1 INCREASED FOCUS ON DUE DILIGENCE

It is to be expected that the buyer will have an increased focus on due diligence of the target company’s commercial contracts, including in relation to customers and supply chain as well as in relation to the employees of the target company. As seller, one should ensure, before initiating a sales process, that the target company has its ducks in a row in terms of updated and market-consistent contract terms.

#### 1.2 DEAL CERTAINTY AND RISK ALLOCATION

To a greater extent than before, we expect to see tough negotiations about the allocation of risk between the seller and the buyer in connection with the wording of the sale and purchase agreement.

While the seller will try to achieve greatest possible deal certainty, it is to be expected that the buyer will seek to ensure that it has the right to terminate the agreement in the event of any material adverse change in the target company in the period between signing and closing (MAC clauses or similar provisions, see also section 2.2. below) and demand that the representations and warranties made in the sale and purchase agreement be repeated at closing. Furthermore, it is to be expected that the buyer – particularly in leveraged buyout transactions – will stipulate that the obligation to carry out

closing is conditional on the lender's actual disbursement of the finance.

### 1.3 CONTROL OF TARGET'S CONDUCT OF BUSINESS BETWEEN SIGNING AND CLOSING

In particular in transactions with a presumed sustained period of time between signing and closing, it is to be expected that the buyer will seek to commit the seller to conduct the business of the target company in a manner protecting the interests of the buyer. However, this desire is restricted in respect of transactions that are subject to merger control review by the competition law rules prohibiting "gun jumping" (unlawful coordination between parties to a proposed merger transaction before it has been approved by the competition authorities).

### 1.4 DETERMINATION OF THE PURCHASE PRICE

During recent years, the number of deals using the locked box pricing mechanism has increased. The locked box mechanism entails that the buyer assumes the risk for the target company's financial performance as from the locked box date, which is normally a few months before the signing date. Particularly in deals where the target company is to be expected to be negatively impacted by COVID-19 (or other pandemics), the buyer should consider whether the equity value is to be determined by using the closing accounts mechanism instead of the locked box mechanism. If the closing accounts mechanism is used, both parties should furthermore consider how the temporary financial support packages introduced by the Danish Government (or others) may affect the target company's income statement and balance sheet.

In respect of transactions where the target company has been, or is expected to be, adversely affected by the COVID-19 outbreak, we anticipate an increased use of earn out (in some form or another). See more on earn out in section 4.

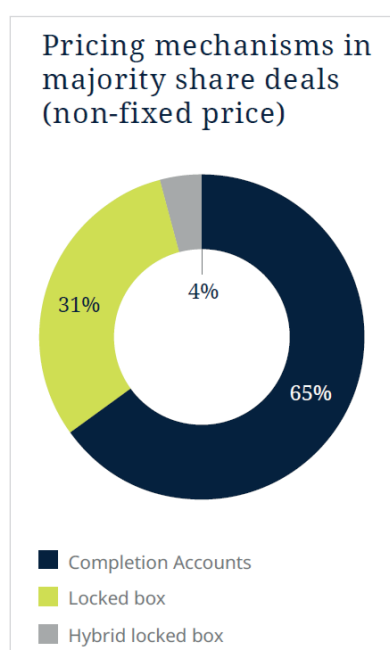


Figure 1 - Use of locked box

### 1.5 PAYMENT OF PURCHASE PRICE

The seller should have a continued – and perhaps even increased – focus on ensuring that the buyer is able to pay the purchase price at closing. In most cases, this will imply that the buyer will have to document to the seller that the buyer has obtained an unconditional funding commitment already at signing.

### 1.6 WARRANTIES AND W&I INSURANCE

We expect to see an increase in the scope of warranties required to be given by the seller within a number of areas, including in particular customers and supply chain. Correspondingly, we expect to see an increased demand for provision of security by the seller for its ability to indemnify any claims under such warranties, which will presumably lead to an increased number of deals where W&I insurance is taken out to cover the seller's risk (in whole or in part).

### 1.7 EXCLUSIVITY, COST RECOVERY AND BREAK FEES

If the buyer has been granted exclusivity – or any other pre-emption right – it will depend on the wording of the individual contract provision to what extent the buyer is entitled to "back out of" the deal and, if so, whether the seller is entitled to recover part of its costs. Cost sharing is also an issue which is expected to be given increased focus by both buyer and seller.

Agreements on break fees (also referred to as break-up fees, break-away fees, option fees, etc.) payable to the seller in the event that the deal is not closed are not very common in M&A transactions that are subject to Danish law.

## 2. Transactions where the sale and purchase agreement has been signed, but closing has not yet taken place

If the sale and purchase agreement was signed before the scope and implications of the COVID-19 outbreak were known, but closing of the deal has not yet occurred, the following will be relevant for the parties:

### 2.1 SATISFACTION OF CLOSING CONDITIONS

If the sale and purchase agreement is conditional on approval by the buyer's board of directors or finance source(s), such conditions – depending on their wording – may enable the buyer to withdraw from the deal without incurring any liability to pay damages to the seller. However, the increased focus on deal certainty means that such open conditions are not a common feature.

### 2.2 MAC CLAUSE AGREED?

A provision concerning Material Adverse Change (MAC clause) gives the buyer the right to terminate the sale and purchase agreement between signing and closing, if events occur that are detrimental to the target company.

MAC clauses are not often used in “purely” Danish transactions but are used slightly more often in cross-border transactions. DLA Piper’s annual Global M&A Intelligence Report shows that MAC clauses are more commonly used in international M&A transactions.

The report is available [here](#).

The wording of MAC clauses varies, but generally such clauses usually allocate the risk between the parties to the effect that the buyer assumes the risk relating to systemic and macroeconomic factors, whereas the seller assumes the risk relating to factors which have a material and prolonged adverse effect on the target company’s financial position. Hence, whether or not the buyer may rely on the agreed MAC clause in the current situation depends on a specific interpretation of the clause.

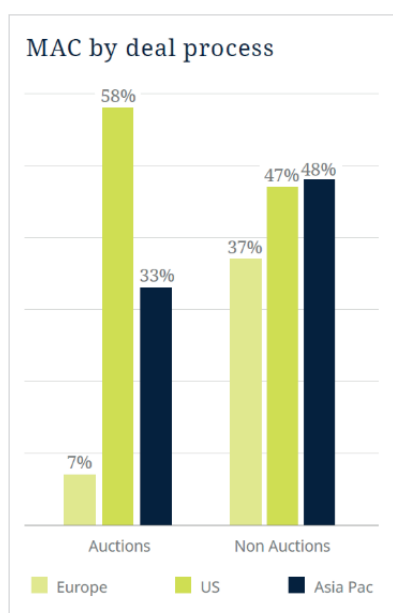


Figure 2 - Use of MAC clauses

### 2.3 NO MAC CLAUSE OR OTHER CONDITIONS AGREED?

Danish law does not currently provide for the seller or buyer in an M&A transaction to rescind or amend an already concluded sale and purchase agreement on the grounds of force majeure, failure of basic assumptions (roughly equivalent to frustration in Anglo-American law) or other non-agreed criteria. As mentioned in section 1 above, when negotiating the sale and purchase agreement, the parties should therefore have an increased focus on the potential implications of COVID-19 for the specific target company in order to achieve a fair risk allocation. If the sale and purchase agreement has already been concluded, it will generally be too late to enter into an agreement on a fair risk allocation between the parties, unless the buyer has a right to withdraw from the deal, cf. section 2.1 above, or is able to convince the seller that, in the absence of such an agreement, the buyer will no longer be able to finance the purchase.

### 2.4 REPETITION OF WARRANTIES AT CLOSING

In continental transactions, including Danish and Nordic, where no W&I insurance has been agreed, the main part of the warranties made by the seller at signing will be repeated at closing. In other words, the seller assumes the risk for any breach of warranty in the period between signing and closing without the possibility of becoming exempt from liability by notifying the buyer of such breach.

COVID-19 has already created challenges for the supply chain of many enterprises, and many enterprises have also received cancellations from material customers. Such circumstances will often constitute a breach of warranty. The buyer must therefore pay particular attention to its post-closing follow-up on warranties.

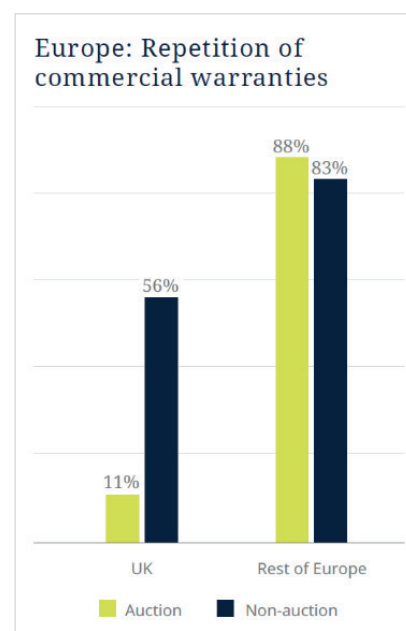


Figure 3 - Repetition of warranties at closing

### 2.5 DETERMINATION OF EQUITY VALUE

If the parties have agreed to use the closing accounts pricing mechanism, both buyer and seller must be aware that the financial support packages introduced by the Danish Government (and the governments in other countries) may affect the determination of the target company’s net debt and working capital (and the normalised working capital).

## 3. Transactions where closing has taken place

If closing has taken place, the buyer will usually only be entitled to rely on the warranties made by the seller in the sale and purchase agreement. Unless specific warranties have been made concerning e.g. future earnings and budget performance, the business impacts of COVID-19 will not, in itself, result in the buyer having a claim against the seller.

As a general rule, neither force majeure clauses nor provisions concerning failure of basic assumptions entitle the buyer to terminate the sale and purchase agreement or demand amendments thereof. Likewise, a market-consistent sale and purchase agreement will usually preclude the buyer from cancelling the deal, even in the event of material defects.

A special circumstance is where the seller and the buyer have agreed an earn-out payment. This is dealt with separately below.

## 4. Specific considerations about earn-out

### 4.1 INTRODUCTION

Earn-outs are typically used as a compromise when the seller and buyer cannot agree on a fixed purchase price.

DLA Piper's Global M&A Intelligence Report shows that earn-outs were used in 28% of total transactions completed last year.

An earn-out is often based on the target company's earnings or revenue during a certain post-closing period, normally one to three years.

The balancing of, on the one hand, the seller's need to protect its interests and, on the other hand, the buyer's right, post-closing, to run the company as it sees fit is often an important element in structuring an earn-out.

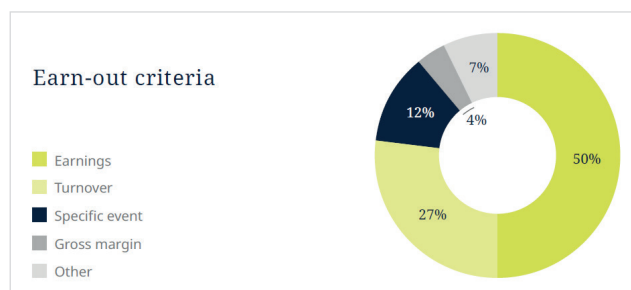


Figure 4 – Earn-out criteria

### 4.2 ALREADY CONCLUDED EARN-OUT AGREEMENTS

Depending on industry, the COVID-19 pandemic can impact quite significantly on the target company, and thus also on the value of an already concluded earn-out agreement.



Figure 5 – Seller earn-out protections

Under Danish law, the paramount rule is that the seller will *not* be able to rely on COVID-19 as an event triggering a right to demand renegotiation of or amendments to be made to an already concluded earn-out agreement, unless the earn-out agreement itself provides for this possibility. The reason for this is that it will be difficult to rely on force majeure in relation to an earn-out agreement, and the same applies to failure of basic assumptions or the like in an agreement (presumably) containing comprehensive provisions on the performance of the target.

In other words, the seller will have to accept that the value of the earn-out agreement will diminish unless the agreement reserves to the seller a right to object to specific measures, which in that case can be used by the seller as a lever for a general renegotiation of the earn-out agreement.

However, the financial support measures introduced by the Danish Government (and other governments) may affect the calculation of earn-out payments. For instance, this may be the case for the calculation of earnings, net debt and working capital (and the normalised working capital).

Where there is a reason to do so – e.g. because the buyer wishes to incentivise a seller who is still active in the target company – the parties may decide to extend the earn-out period.

### 4.3 EARN-OUT AGREEMENTS WHICH HAVE NOT YET BEEN CONCLUDED

It is to be expected that COVID-19 will lead to an increased use of agreements on earn-out (or other deferred calculation of the purchase price) in transactions than was previously the case.

In such contexts, the seller and buyer should pay particular attention to among others the issues described above in section 4.2. Furthermore, it should be considered whether the earn-out agreement is to contain a so-called reasonableness provision, which ensures that the parties have a right of adjustment or renegotiation if, subsequently, there are material adverse changes in the assumptions made by the parties at the time of conclusion of the agreement as a result of or related to COVID-19 (or similar pandemics).

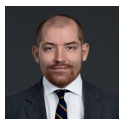
## Contact

You are welcome to contact us.

### Copenhagen



**Jens Krogh Petersen**  
Partner  
T: +45 33 34 00 46  
M: +45 23 31 31 91  
jens.krogh@dlapiper.com



**John Emil Lyngfeldt Svenson**  
Partner  
T: +45 33 34 01 68  
M: +45 24 81 51 60  
john.svenson@dlapiper.com



**Karsten Pedersen**  
Partner  
T: +45 33 34 00 87  
M: +45 25 24 51 87  
karsten.pedersen@dlapiper.com



**Michael Vinther**  
Partner  
T: +45 33 34 01 89  
M: +45 25 24 51 89  
michael.vinther@dlapiper.com



**Nicholas Lerche-Gredal**  
Partner  
T: +45 33 34 00 73  
M: +45 30 10 39 25  
nicholas.lerche-gredal@dlapiper.com



**Sebastian Ingversen**  
Partner  
T: +45 33 34 00 07  
M: +45 61 30 99 51  
sebastian.ingversen@dlapiper.com



**Thomas Salicath**  
Partner  
T: +45 33 34 02 80  
M: +45 20 96 99 00  
thomas.salicath@dlapiper.com



**Ulrik Bangsbo Hansen**  
Partner  
T: +45 33 34 00 08  
M: +45 51 99 90 17  
ulrik.bangsbo@dlapiper.com

### Aarhus



**Carl Erik Skovgaard**  
Partner  
T: +45 33 34 07 30  
M: +45 40 32 44 99  
carl.erik.skovgaard@dlapiper.com



**Eskil Bielefeldt**  
Partner  
T: +45 33 34 07 20  
M: +45 20 86 92 54  
eskil.bielefeldt@dlapiper.com



**Jan Børjesson**  
Partner  
T: +45 33 34 08 60  
M: +45 51 20 71 60  
jan.boerjesson@dlapiper.com



**Jan Snogdal**  
Partner  
T: +45 33 34 08 40  
M: +45 40 71 53 00  
jan.snogdal@dlapiper.com



**Kristian Hjølund Nielsen**  
Partner  
T: +45 33 34 08 44  
M: +45 30 71 63 15  
kristian.hjoelund.nielsen@dlapiper.com



**Kristian Tokkesdal**  
Partner  
T: +45 33 34 07 10  
M: +45 23 26 00 40  
kristian.tokkesdal@dlapiper.com

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