CORPORATE M&A IN TIMES OF THE CORONA CRISIS: SPECIFIC CONSEQUENCES OF THE PANDEMIC FOR THE GERMAN TRANSACTION BUSINESS

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The Impact of Insolvency Law on the M&A Transaction Business

The cross-sectoral economic effects of the Corona crisis are likely to lead to an increased number of transactions in the medium term where the seller or the target companies, but in certain cases also the purchaser, are operating under distress or the threat of impending insolvency. This trend should apply irrespective of the German Act on the Temporary Suspension of the Insolvency Filing Obligation and Liability Limitation of Corporate Body in cases of Insolvency caused by the COVID-19 Pandemic[1] ("COVInsAG") that recently entered into force.[2]

This kind of crisis scenario makes the initial planning and structuring of M&A transactions, as well as the later implementation thereof, particularly challenging for the parties: both sides are forced to make an informed risk assessment on a potential insolvency of their contract partner and/or the target involved and then settle on a structure that best prevents or mitigates such risk. The possible privileges accorded by the COVInsAG, if applicable, will be of particular interest to the parties. If the seller is in distress, the purchaser should, for instance, evaluate up front whether it might be preferable in terms of legal certainty to acquire the target in the framework of a "pre-packaged deal" in subsequent insolvency proceedings. To the extent, however, that either the seller and/or its main creditors do not consent to this approach, the purchaser is only left with the choice of either not proceeding with the desired transaction or trying to mitigate the risks of a later seller insolvency to the largest extent possible.

If German insolvency law is applicable to one of the contract parties, either due to the fact that the "center of main interest" ("COMI"), which is used to determine the applicable insolvency law, is in Germany or because there would be an option of opening German secondary insolvency proceedings (*Sekundärinsolvenzverfahren*) on the basis of the parties' German operations, the contracting parties are, in particular, faced with two main risks triggered by a later insolvency: On the one hand, the insolvency administrator (or in case of debtor-in-possession proceedings, the insolvent contract party itself) could choose to reject the continued performance of the enterprise sale and transfer agreement ("Acquisition Agreement") if this mutual agreement at the time of the opening of insolvency proceedings has not yet been completely fulfilled by at least one of the two contract parties. On the other hand, the insolvency administrator might under certain circumstances decide to contest either the Acquisition Agreement itself and/or individual completion acts or actions thereunder.

Under both scenarios, the solvent counterparty (typically, the purchaser) could be faced with significant disadvantages including a near-total loss of its own performance actions already rendered (payment of purchase price) while, at the same time, either not receiving title and ownership in the target or facing a restitution and unraveling of an already occurred transfer of ownership.

Rejection Risk of Mutually Unfulfilled Contracts and Potential Safeguards

If insolvency proceedings are opened over the estate of a contract party (seller) at a time when the Acquisition Agreement has not yet been fully performed by, at least, one of its parties, the insolvency administrator is entitled to choose whether or not to continue to perform under the agreement (§§ 103 et seq. of the Insolvency Code (*Insolvenzordnung*—"InsO")). If the insolvency administrator elects non-performance and contract rejection, the mutual obligation not yet fully performed or satisfied become unenforceable. The counterclaims of the solvent contract party due to such non-performance become regular insolvency claims that must be filed to the insolvency table and which in the normal run of events are, thus, almost completely worthless in economic terms.

In the time period between the signing of the Acquisition Agreement and the closing there is significant potential for delays based on the customary closing conditions such as merger clearances(s) and other regulatory clearances, further required corporate steps such as board approvals and/or share transfer restrictions, necessary waivers of pre-emption rights, the change of the fiscal year or the termination of existing enterprise agreements (*Unternehmensverträgen*). Furthermore, there are many cases where the seller and the purchaser have agreed on ancillary agreements like transition services or license agreements between the seller and the target, the details of which are finally negotiated in the time window between the signing and the closing of the Acquisition Agreement. Such agreements are often a key component of the overall transaction but are also themselves subject to the risk of contract rejection by the insolvency administrator.

If the closing under the Acquisition Agreement has already taken place, *i.e.* the in rem transfer of title has occurred or, at least, the purchase price component owed at closing has already been paid, purchasers often feel they are on safe ground. However, since the assessment of the question whether a contract is indeed fully performed and obligations have been completely satisfied does not only take into account the performance of the mutual primary obligations (*Hauptleistungspflicht*) of the parties, but also any currently open ancillary obligations (*Nebenpflicht*), it will, in practice, be very difficult in most relevant acquisitions to argue successfully that all relevant contract obligations of one party are already fully performed. This is even more so in pending, not yet fully performed transactions concluded in times prior to the Corona pandemic where the parties would in most cases not have had reason to dig deeper into potential insolvency-related issues.

There are a number of customary clauses that may end up acting as regular barriers against a successful argument of full performance of the Acquisition Agreement even if the closing has already taken place, including purchase price adjustment clauses, earn-out agreements or purchase price retention amounts aimed at securing possible breaches of representations and warranties. As far as asset deals are concerned, but sometimes also in share deals, where certain target entities are not all owned by one central holding company, certain individual transfer acts under applicable foreign laws are often deferred at the closing date, be it because local share certificates may yet have to be handed over under mandatory local laws or because the necessary registration of an asset or share transfer in a local jurisdictions has not yet been duly made with the competent authorities. To the extent mandatory third party consent to certain transfer steps is necessary (for example, for contract assumptions or transfers), the seller is also unable to argue that the complete fulfillment of all aspects of the agreement has already occurred. There, in addition, are typical other purchaser rights such as potential claims due to breaches of representations and warranties and/or indemnities or non-compete undertakings with time limitations of often several years, as well as obligations to release or replace seller securities granted by the seller for the benefit of the targets, which the insolvency administrator is likely to use as auxiliary considerations to support his argument that the Acquisition Agreement as such has not yet been completely satisfied by at least one of the parties.

In order to avoid or mitigate these risks, the following potential safeguards (which, of course, cannot be addressed comprehensively in this context) should be considered when negotiating future transaction documents with parties in distress.

The purchaser is particularly well-advised to document in scenarios where the seller has (urgent) liquidity needs or where the transaction could be viewed as a “fire-sale” that the purchase price negotiated and ultimately agreed on is a fair market price. Because the insolvency administrator will otherwise (be forced to) reject the continued performance of a mutually not yet fully fulfilled mutual contract if such contract is shown to be unduly disadvantageous. A competitive auction procedure or a fairness opinion may further militate against such decision by the insolvency administrator. The insolvency administrator may, furthermore, consider such contract rejection in asset deal scenarios based on the argument of individual creditors being unduly disadvantaged if the purchaser only assumes selective liabilities of the seller, because in a later insolvency it can be argued that such selective debt assumption unduly benefits creditors whose claims end up fully paid by the assuming purchaser to the detriment of the remaining creditors of the insolvent seller who will only receive the far-lower insolvency quota on their claims which the purchaser chose not to assume.

To agree on specific insolvency-based contractual termination rights in favor of the purchaser in the time period between the signing and closing of the Acquisition Agreement in order to address a possible seller insolvency are very likely to be viewed as an impermissible circumvention of the insolvency administrator's contract rejection right. A contractual termination right of the purchaser based on a mere deterioration of the seller's financial position may, however, be feasible.

To reduce the time window between signing and closing as much as possible could be a tool to minimize or mitigate the risk of a (further) deterioration in the financial position of a party in distress. To the extent legally possible and depending on the individual bargaining power in each specific case, the purchaser could also try to negotiate weather or that certain legal steps and circumstances that usually become closing conditions or closing actions can already be implemented prior to the signing of the Acquisition Agreement.

The complete fulfillment of the contract by the purchaser can probably only be argued beyond material doubt if the purchaser pays a final one-off purchase price at closing without any additional purchase price adjustments or earn-out provisions being agreed on. As a tendency, a sale agreement with a locked-box mechanism would, therefore, appear to be the preferred choice in such crisis scenarios. From an insolvency-law perspective, it should also be considered to forfeit any attempts to negotiate purchase price retention amounts as a means of securing potential claims under representations and warranties or indemnities (even if such retention amounts are paid to an escrow account), because such structures also mean that the seller has not yet received the purchase price in full. An alternative worth exploring would be a directly enforceable bank guarantee (*selbstschuldnerische Bankbürgschaft*) or to take out W&I insurance to secure such claims of the purchaser.

With a view to avoiding multiple transfer acts at closing, a share deal will often be the preferred option to an asset deal. If the parties nevertheless opt for an asset deal, the corresponding transfer acts at closing should be prepared meticulously and in detail and should all be taken on or about the closing date. In the context of movable assets, the purchaser may acquire a strongly protected position already via a retention of title (*Eigentumsvorbehalt*) and regarding real estate may protect itself against contract rejection by way of a recorded priority notice (*Vormerkung*).[3] As far as acquiring rights (shares, IP, receivables) is concerned, no such expectant or inchoate rights worthy of protection (*schutzfähige Anwartschaftsrechte*) are granted in the context of the insolvency administrator's election right to perform or reject contracts.

In certain cases, the provisions in the Insolvency Code on already made partial performance[4] may also help the purchaser as such partial performance do not have to be restituted as a rule. For instance, if individual transfer measures regarding certain—usually non-essential—assets in a transaction remain pending, such partial performance may be argued to exist. It would follow that the insolvency administrator usually could not reclaim or unravel the already transferred parts of the business solely based on his choice not to perform the outstanding contract as a whole. As far as business sales are concerned, such separate deal parts are, however, only assumed to exist if there is a separate partial business unit (*Teilbetrieb*) and the outstanding transfer act or implementation measure does not concern the "inseparable core business."

In cases where the conclusion of ancillary transition services agreements, license, lease or supply agreements with the insolvent seller is provided for in connection with the closing of the Acquisition Agreement, the purchaser should be aware that each of these agreements may, in turn, be subject to selective contract rejections rights of the insolvency administrator.

The solvent party is able to achieve legal certainty on the continued fate of the mutually unfulfilled agreement by formally requesting the insolvency administrator to exercise the corresponding election right.

At the end of the day, a comfortable safeguard against the risk of potential rejection of further contract performance by the insolvency administrator will only be realistic for the purchaser if the Acquisition Agreement contains a fixed purchase price based on a locked-box transaction which is settled in full at closing. Indemnities or claims for breaches of representations and warranties could, in addition, be secured by a directly enforceable bank guarantee (*selbstschuldnerische Bankbürgschaft*) or W&I insurance taken out by the purchaser.

Contestation Risk and Precautionary Steps

A further possible challenge to the existence and implementation of a business acquisition lies in the risk of a later insolvency contestation (*Insolvenzanfechtung*). If the relevant prerequisites are met, the insolvency administrator may contest the Acquisition Agreement itself and/or individual performance acts related thereto.[5] Under certain circumstances and if the contestation succeeds in the seller's insolvency, the purchaser may have to re-transfer the performance received by him (*i.e.*, the ownership of company assets or shares) back to the insolvent estate, while his corresponding repayment claim regarding the purchase price paid will normally only be a regular unsecured insolvency claim and, thus, be largely worthless in economic terms due to the low insolvency quota.

The contestation rights of the insolvency administrator are manifold. Under certain circumstances, however, the COVInsAG, which recently entered into force, may privilege the Acquisition Agreement and/or measures taken to implement it for a transitional period. In addition, certain general, precautionary measures are well-advised which will, at least, mitigate the risk of subsequent insolvency contestation.

Contestation of the Acquisition Agreement Itself

In the first instance, the new provisions of the COVInsAG which will be in force until September 30, 2020[6] aim at suspending the obligation to file for insolvency in spite of existing illiquidity caused by COVID-19 and privilege the conduct of the corporate bodies in such scenarios. From a contestation perspective, in particular, loan agreements which provide new liquidity are privileged and exempted from later contestation for a limited period of time. However, the new law stops short of expressly declaring all agreements contestation-proof which were concluded during the period where the obligation to file for insolvency was suspended and which serve restructuring purposes. As far as the contestability of the Acquisition Agreement itself is concerned, the existing contestation rules are, therefore, likely to apply.

When structuring and drafting the Acquisition Agreement, it is, thus, of particular importance to prevent a potential later contestation of the Acquisition Agreement based on an argument that creditors are directly disadvantaged.[7] This contestation option exists if the disadvantage for creditors is directly caused by the Acquisition Agreement itself, the seller was illiquid at the time of the signing of the Acquisition Agreement and the purchaser knew of these circumstances, provided that the conclusion of the Acquisition Agreement occurred in a period three months prior to the filing for insolvency or after such filing. The argument that the purchase price was set below the threshold of the fair market value can be refuted by reference to a competitive auction process. Alternatively, a fairness opinion by an independent expert can be obtained. If the purchaser does, however, assume selected but not all of the seller's liabilities in an asset deal, a disadvantage for creditors in a later insolvency may already be seen in the fact that only the creditors of the assumed liabilities were fully satisfied by the purchaser, whereas the remaining creditors of the seller were left to settle for the much lower quota.

Any imputed knowledge of illiquidity can, in practice, be refuted by a positive confirmation of solvency in an analysis of the insolvency status prepared by an expert according to standard IDW S 11 (*Analyse der Insolvenzreife nach IDW S 11*). In certain cases, it may also be opportune to fix a closing date that is more than three months after the signing of the Acquisition Agreement. However, such approach runs contrary to the above suggested aim of quickly achieving full performance of the agreement in order to preempt the insolvency administrator' election right to either reject or continue to perform under a contract which is partly still unfulfilled by both parties.

The contestation of the Acquisition Agreement due to disadvantaging creditors with intent[8] in cases of impending illiquidity (*drohende Zahlungsunfähigkeit*) of the seller and seller's intention to disadvantage his creditors requires the purchaser to know of such circumstances. The purchaser can protect himself against such allegation by submitting an expert analysis of the insolvency status, which also covers impending illiquidity, as well as a restructuring expert opinion under standard IDW S 6, which concludes that the seller's restructuring efforts have a serious expectation of being successful.

Contestation of Closing Actions / Performance Measures

The newly enacted COVInsAG[9] generally declares performance acts which are congruent in terms of time and substance to be exempt from contestation for a transitional period until September 30, 2020,[10] unless the restructuring and refinancing efforts of the seller were unsuitable to remedy the crisis and the buyer knew about this. According to the wording, the privileged exemption applies without restrictions to all performance acts, *i.e.*, a restriction to performance acts related to credit agreements is not provided for in the new law. Having said that, the official legal justification of the new law (*Gesetzesbegründung*) reasons that the new provision is intended to protect the performance of existing contracts with suppliers or under recurring long-term obligations against insolvency contestation rights, as the relevant counterparties would otherwise be forced to terminate the business or contractual relationship, which, in turn, would frustrate restructuring efforts. Even though there is not yet any indication for a prevailing opinion on the scope of this protection clause against contestation under the COVInsAG, there are good reasons to argue that it also covers performance actions under an Acquisition Agreement. The purchaser would, thus, be protected if he is able to submit an expert opinion on the restructuring of the company which considers a successful restructuring to be likely when taking into account the transaction proceeds.

If the privileged exemption under COVInsAG is held not to apply, the seller would again need to evidence that the seller was not illiquid at the closing date by submitting an expert analysis of the insolvency status to avoid a contestation risk under the header of contestation of congruent performance actions.[11]

When attempting to avoid a contestation under the header of intentionally disadvantaging creditors through performance acts that are congruent from a temporal and substantive perspective,[12] the solvent party may refute the allegation that actual illiquidity existed at the time the closing actions were taken by submitting an expert analysis on the insolvency status according to standard IDW S 11. The counterparty's imputed knowledge of a debtor's possible intent to disadvantage creditors presumed by law is likely rebutted as well, although this has not yet been confirmed by rulings of the highest court(s). An update as of closing of the expert restructuring opinion pursuant to standard IDW S 6 already obtained at signing should eliminate any remaining grounds for the insolvency administrator to justify a contestation based on intent.

Furthermore, if the purchaser succeeds in structuring the performance of the agreement as a so-called "cash deal,"[13] the contestation rights of the insolvency administrator to challenge performance actions are excluded per se, with the exception of disadvantaging creditors with intent.[14] In order to qualify a transaction as a cash deal, the parties must exchange performances of equivalent worth directly, *i.e.*, in close temporal proximity. Since the exchanged performance must be objectively of equivalent value, absolute deal certainty can ultimately only be obtained by way of a valuation expert opinion. However, a competitive auction process or, if applicable, a fairness opinion might also provide meaningful indications in this regard.

The necessary temporal link permits staggered closing actions or implementation steps only to a very limited extent, even though strictly simultaneous performance (*Zug-um-Zug*) is not mandatory but recommended. Purchase price retention amounts to secure potential claims for breaches of representations and warranties, purchase price adjustment clauses and, especially, earn-out provisions should be avoided. If the purchaser wants to agree on and implement a "cash deal" within the meaning of insolvency law, he should, as a precaution, also consider not to include a conditional assignment of share title already in the Acquisition Agreement.

Finally, specific issues arise if the seller also concludes further ancillary agreements either with the purchaser or the target at the closing, such as lease or tenure agreements (*Miet-oder Pachtverträge*), license agreements, supply agreements, transitional services agreements or the like, which, in turn, are subject to separate contestation rights.

Unlike in the case of the insolvency administrator's election right to either reject or continue to perform under pending contracts, the insolvency administrator cannot be forced into a timely decision on his potential contestation right. This causes considerable uncertainty for the purchaser (whilst giving the insolvency administrator strong leverage in negotiations) since the contestation right is only limited by the regular three year time limitation period under German law.

In summary, reducing the risk of possible subsequent contestation requires some effort on the part of the purchaser. In addition to a fairness opinion and an expert analysis of the insolvency status, a restructuring expert opinion in accordance with standard IDW S 6 may also be well-advised, but the purchaser will have to rely on the cooperation of the seller in this regard. The respective mutual performance actions should, in an ideal case, be agreed upon and implemented as a cash deal with a simultaneous exchange of performance actions. At least on a literal reading of the wording, the purchaser could also rely on COVInsAG to make performance actions taken during the transitional period contestation-proof if a positive expert restructuring opinion exists.

COVID-19 and M&A Transactions in Germany

Whereas the start of 2020 was still characterized by lively M&A activities, the German market was taken by surprise in March by the speed and massive impact of the COVID-19 pandemic. For the majority of investors and companies, measures to stabilize sales and liquidity were and are still the focus of attention.

In this situation, a share purchase agreement (the "Acquisition Agreement") already signed but not yet closed may represent a welcome influx of liquidity for the seller, while the same agreement may now be viewed as a drain on liquidity by the buyer which might no longer be welcome. Various contractual and legal provisions may play a role in this dilemma, which are outlined below and may also serve as guidelines for negotiations of Acquisition Agreements in the near future.

Termination Clauses

The respective Acquisition Agreement usually provides for a termination provision which, in principle, allows both parties to terminate the agreement if the transaction has not been completed (closing) by a certain long stop date. Also, further provisions, which frequently are agreed and allow unilateral termination before the long stop date has occurred, usually require that the closing has become impossible due to the definitive frustration of a closing condition. Not least because deal certainty is regularly a priority for both parties to an Acquisition Agreement, it seems fair to expect that in German transactions a general right of termination or a termination due to the effects of COVID-19 can only in rare cases be based on the agreed upon regular termination provisions. However, even if the conditions for terminating the Acquisition Agreement are met, the actual exercise of this right will require careful review of whether such termination would, in turn, result in an obligation to pay any pre-agreed contractual penalties, break-up fees or damages to the counterparty.

Specific Closing Conditions: Merger Clearance and Material Adverse Change

(i) Merger Clearance. If a contractual termination right in the Acquisition Agreement is tied to the failure of closing occurring within a certain agreed-upon timeframe, the necessary analysis must consider, first and foremost, the specific closing conditions agreed in each individual case. One of the key closing conditions in this context regularly is obtaining merger clearance by the specifically named anti-trust authorities. The impact of the COVID-19 pandemic on the work of these anti-trust authorities varies greatly from jurisdiction to jurisdiction.[15] In the case of M&A transactions that have been signed but have not yet closed, the contract parties would, thus, be well-advised to examine in each case whether the originally envisaged time frame is (still) sufficient, whether and which complications and delays are possible and what measures could or even must be taken to further ongoing proceedings. Where appropriate, it is recommended to enter into timely discussions on the potential adjustment of the long stop date.

If no amicable agreement can be reached in this respect, further questions under contract law could arise. This is so because, irrespective of any potential statutory obligations to adjust or modify the contract (see below *Statutory Provisions on the Refusal to Perform or the Adaptation of the Agreement)*, there may be contractual provisions in the Acquisition Agreement which could conceivably result in an obligation of a contracting party to agree to an adjustment of the contract. In practice, there are some cases, for instance, where a general mutual obligation to cooperate and facilitate the closing is included in the Acquisition Agreement or the severability clause provides for an obligation to agree on a fair commercial solution if unforeseen or unforeseeable contractual gaps or omissions later become apparent. Whether such provisions indeed lead to a contractual adjustment obligation of a contracting party can only be assessed on the basis of the individual provision in the relevant Acquisition Agreements.

(ii) Material Adverse Change. Another contractual provision in the Acquisition Agreement, which may lead to either a contract adjustment, potential compensation payments or even to the termination of the Acquisition Agreement, depending on the substance of the clause in question, are so-called Material Adverse Effect (MAE) or Material Adverse Change (MAC) clauses. Essentially, these are clauses which—if agreed as a closing condition or as a right of rescission—provide for a closing reservation to address the occurrence of unforeseen, material adverse developments of the target company's business (so-called Business or Target MAC) between signing and closing, or, less frequently, with regard to the industry in which the target company operates (so-called Market MAC), which have a value-diminishing long-term impact on the target company. If such an adverse development occurs or exists, the purchaser does not have to close or complete the transaction.

Under the seller-friendly M&A market conditions prevalent in recent years, the inclusion of such clauses in German transactions has become more rare. However, if the Acquisition Agreement contains a MAC clause, the issue of its interpretation will likely come more into focus now. Whether the COVID-19 pandemic and its consequences actually constitute a material adverse change event must be carefully determined on the basis of the specifically agreed clause and the details and spheres of knowledge of the parties at the time of entering into the Acquisition Agreement. Even if the MAC clause does not contain any specific wording regarding the inclusion or exclusion of epidemics or pandemics, this is only the starting point for such an analysis.

In a second step, the agreed-upon exclusions then need to be assessed. In particular, it may be required to clarify whether the frequently used exclusion of general or industry-specific negative market developments is applicable here, and then again whether there might be a counter-exception in case the target company is disproportionately affected by these developments.

A further issue that needs reviewing in the specific MAC clause is the exact reference point in time for, and probability threshold of, the MAC event occurring. There will also be cases where—depending on the industry—certain adverse effects are (partly) becoming apparent already now, but have not yet (fully) materialized. In such scenarios, the outcome will depend on whether the wording of the clause only covers disadvantages that have already occurred or also—already foreseeable—future consequences.

It is also crucial by which criteria the materiality of an event is to be measured. In some cases, the parties agree on specific thresholds (*e.g.*, a reduction of EBITDA by x%). If such materiality criterion is not defined in greater detail, this must be assessed by interpreting the agreement with specific focus on the target company.

Finally, even if a MAC event has occurred, the contractual consequences provided for in the agreement must be clarified. Withdrawal from the Acquisition Agreement or a refusal to close the deal may only be the ultima ratio. It would also be conceivable to negotiate in good faith on the adaptation of the Acquisition Agreement to the changed commercial circumstances.

Statutory Provisions on the Refusal to Perform or the Adaptation of the Agreement

The issue whether the parties to an Acquisition Agreement may also rely on the statutory provisions in view of the COVID-19 pandemic is likely to be a matter of increasing activity for (arbitration) tribunals in the near future: In particular, the legal instruments in the event of a disruption to the basis of the transaction (*Störung der Geschäftsgrundlage*) pursuant to § 313 of the German Civil Code (*Bürgerliches Gesetzbuch*—"BGB") are likely to be at the forefront. These rules allow the adaptation of the contract or, in case of impossibility or unreasonableness of such adaptation, the rescission of the contract, if the parties' mutual conceptions on which the agreement was based have changed to such an extent that one party cannot reasonably be expected to adhere to the unchanged contract. With the COVID-19 pandemic, the various restrictive governmental measures to combat the spread of the virus, but also, in turn, specific governmental stabilization and support measures and, in many cases, the grave effects thereof on the business of the target company, its profitability and the assumptions in the business plan, may be seen, at a first glance, as such momentous changes arising from the COVID-19 pandemic without either of the parties having been in a position to foresee such impact or be held responsible for the consequences. However, even if the manifold economic effects resulting from the outbreak of the pandemic seem to be a textbook example of a disruption of the contractual performance obligations, the legal significance of such disruption must be analyzed in a differentiated manner and on the basis of the specific contractual agreements.

In the Acquisition Agreement, the parties often agree on specific comprehensive exclusions of the statutory provisions, which may in certain cases also include the—generally negotiable—provision in § 313 BGB. However, even if such an exclusion is not expressly provided for, it may, for example, follow from a past effective date, on which the (economic) transfer of risk is deemed to occur, that any risks which materialize after such date have to be borne by the purchaser. The conclusion may be similar in the case of a MAC clause contained in the Acquisition Agreement. As specific expression of the intentions of the parties, such concrete agreements must, in principle, be given priority and can, as a specifically agreed contractual allocation of risk, override or exclude the application of § 313 BGB even for unforeseen circumstances. All of this does not *per se* exclude a possible adjustment of the contract due to disruption of the basis of the transaction, as any contractual provision (including an exclusion) could also have been affected by the parties' underlying fundamental misconceptions. In any case, however, the hurdles to be overcome would then be significantly higher and require a comprehensive evaluation of the wording and spirit of the Acquisition Agreement.

If these initial hurdles can be overcome, the second step is to examine whether there has been, taking into account the circumstances of the individual case, such a momentous change in the parties' underlying conceptions of the agreement that adherence to the contract would be unreasonable. Here, similar considerations will then play a role as discussed above when assessing the application and interpretation of MAC clauses, *i.e.*, what did the parties know at the time of signing the Acquisition Agreement, do the contractual provisions as agreed entail a certain allocation of risk between the parties, how significant are the changes for the subject matter of the contract and how significant would the consequences of an application of § 313 BGB be for the parties.

To make matters worse, there is another major factor of uncertainty: It is currently completely unclear how COVID-19 and its consequences will pan out (internationally) in purely factual terms. The length of the restrictions in the individual countries, possible further waves of outbreaks, economic catch-up effects, government support and economic stimulus programs and the concrete effects on the respective target companies—these and many other aspects will only reveal themselves fully in the future. In any case, the individual allocation of risk between the parties of future Acquisition Agreements is likely to play a greater role again in the respective contract negotiations going forward—also with a view to possible further COVID-19 "waves."

Purchase Price Mechanics and Evaluation Matters

When predicting the development of the M&A market in the near and medium term future, COVID-19 and the economic effects of the pandemic will be one of the central issues in determining the value of a company and, thus, also the purchase price. The discussions are likely to focus on the question whether the fair enterprise value can be justified on the basis of normalized EBITDA, taking into account or excluding the effects of the COVID-19 pandemic, among other things. However, this is also likely to play a major role in the case of already concluded Acquisition Agreements with earn-out or staggered payment regulations or in connection with management incentive schemes or bonus arrangements. In these cases, EBITDA is also regularly used as a benchmark and specific rules are agreed on to determine it.

With regard to the two main approaches for determining the purchase price, the following considerations are fundamental: If the parties have agreed on a so-called fixed purchase price (locked-box approach), this should basically be exactly that, a definitive purchase price which is typically not subject to any later adjustment. The purchase price is determined by reference to an economic reference date and the risk of changes in value transfers to the purchaser on such date. In principle, there is no mechanism for some kind of value clarification regarding the underlying valuation assumptions. Instead, the purchaser is protected against changes in value after the reference date until the closing date by means of positive and negative covenants and guarantees (ring-fencing), which are essentially related to the conduct of the business in the ordinary course.

As far as variable purchase prices are concerned, there are ultimately many different approaches to agreeing such a variable purchase price. In the first instance, the reference values agreed on by the parties for determining the purchase price and the influence of the COVID-19 pandemic on these values must be taken into account. Under the so-called closing accounts method, which is often used in German transactions in this regard, the parties generally agree on a fixed enterprise value, which is typically not subject to adjustments. Only the reconciliation bridge to the equity value is based on a subsequent adjustment of cash, debt and (normalized) working capital positions in the so-called closing accounts prepared by reference to the agreed economic effective date. It follows that COVID-19 effects are therefore only recorded under this method to the extent that they affect the aforementioned reference values. The extent to which changes are then to be reflected depends on the principles laid down for the preparation of the closing date accounts (including the degree to which any value-adjusting facts are taken into account), it being understood that the parties regulate the granularity of these principles to varying degrees. A particularly thorough and careful assessment of the provisions in the Acquisition Agreement is required in this regard, which should not only include the necessary legal analysis but also cover the commercial and economic evaluation and accounting methods to be applied.

The questions raised in this context are also likely to feature prominently when interpreting agreed clauses on purchase price components payable only in the future, as in the case of earn-outs or other staggered payment arrangements, if these are related to key company benchmark figures (and not, for example, to the realization of future minimum exit sale proceeds). Here, too, the payment of the additional purchase price components is linked to certain economic reference values, the determination of which is governed by the individual agreement regarding the applicable (accounting) provisions. The parties would, therefore, be well-advised also with regard to already existing earn-out regimes to monitor the likely effects of the COVID-19 pandemic on the company's key benchmark figures at this early stage and consider their evaluation impact and suitable accounting treatment as well as their potential scope for maneuver under the specific, individually agreed upon provisions.

W&I Insurance in Times of COVID-19

Among the consequences of the COVID-19 pandemic have been certain new trends and challenges in the private equity and M&A arena, including W&I insurances. Even though there are no current indications that W&I insurances will generally become unavailable in transactions, COVID-19 certainly has an influence on the insurer's risk assessments and the details of the insurance policies that are on offer.

Potential Impact of COVID-19 on the Future Scope of W&I Insurance

At the moment, there is no market trend that insurers are generally re-considering the scope of the guarantees and representations and warranties that can be insured. Having said that, to insure certain, previously customary and coverable representations and warranties in new policies not concluded prior to the occurrence of the COVID-19 pandemic will now and in future be subject to a more detailed insurance assessment (see below) regarding the consequences for the underwriting process. This, in particular, concerns guarantees which are related to a contractually defined reference or balance sheet date and the absence of material disadvantageous deteriorations regarding the target entities or their business operations since then, as well as guarantees that refer to an adequate level of insurance coverage of the sold business operations—it being understood, for instance, that, depending on the business model, the question whether and under which circumstances a particular business interruption insurance policy provides "adequate" insurance coverage may well have been affected and modified by the COVID-19 pandemic. A further focus is likely to be on guarantees regarding compliance with all (material) laws and regulations, in particular on health and safety, and on customer and supplier relationships. With a view to the scope of damages covered, several insurers currently exclude any and all damages that are caused by and arise from the pandemic in their entirety. Other insurers are willing not to insist on such a blanket exclusion of damages and negotiate modified, specifically defined and tailored damage exclusions. This means that in these Corona times the selection of the W&I insurer and the ensuing negotiation of the actual W&I policy have gained added practical relevance and are more important than ever before, especially since the contractual provisions agreed on in the transaction documentation with the purchaser might in many cases allow recourse to the seller for certain uninsurable risks.

Impact on the Underwriting Process

It is nothing new that the insurers have always put special emphasis on the topics most critical for the insurance's potential liability during the underwriting process. If the purchaser's due diligence exercise on such specific risk topics is not sufficiently thorough from an insurer's perspective, the policy will usually contain corresponding exclusions of insurance coverage. Furthermore, an exclusion from insurance coverage of all known problematic issues and risks, which had been identified in the course of the due diligence process by the purchaser or which arose and were identified in the time window between the signing and the closing of the transaction, was customary in the past already.

Currently, this conclusion is of particular and increased relevance for the potential impact and consequences of the COVID-19 crisis on the business operations of a company undergoing a sales process and the corresponding catalogue of guarantees contained in the sale and transfer agreement: It depends on the nature of the business sector and the industry of the sold business how strict the insurer's parameters for this evaluation will be and whether they may differ to a significant degree—reflecting the fact that not all enterprises are affected by the current crisis in the same manner, relative to the nature and structure of their business, their geographic footprint, potential interdependencies in their production procedures and supply chain, the consequences of the pandemic for their customers, suppliers and staff, and, of course, the existence of any liquidity or balance sheet reserves and buffers. As far as (material) customer and supply agreements are concerned, it is especially pertinent whether such contracts—based on the respective applicable law—may be terminated or modified based on force majeure or an undue change of the underlying common commercial understanding of the parties (*Änderung der Geschäftsgrundlage*) or whether there may, at least, be a (temporary) defense of withholding or delaying performance (*Leistungsverweigerungsrecht*). Another point of special importance for the insurers is the question how the parties deal in the transaction documentation with the particular further transaction risks potentially triggered by the COVID-19 crisis in the time between signing and closing, *e.g.*, by way of relevant closing conditions, specific termination rights prior to closing or the inclusion of a specially-tailored MAC clause. We are under the general impression that the insurers have a current market expectation that the parties should normally agree on express provisions in their sale and transfer agreements dealing with the potential COVID-19 risks. This means that the insured party should therefore examine and assess the impact and consequences of COVID-19 on the business operations of the target extra-thoroughly and with specific care to put themselves in a position where they can negotiate with the insurer on a solid factual basis on a successful, moderate exclusion of such risks rather than being hit with a blanket exclusion of all COVID-19-related risks.

Special Case: Occurrence of the Pandemic between Signing and Closing

The above considerations apply to those cases where the negotiation and conclusion of the insurance policy and its terms are completed subsequent to the occurrence of the COVID-19 pandemic. The second, also practically relevant scenario concerns cases where the signing of the transaction (and, thus, the insurance policy) predate COVID-19 but the closing only occurs thereafter. W&I insurances regularly provide for the disclosure of new facts and circumstances, which arose in the time period between signing and closing and which result in breaches of guarantees and representations and warranties, and then exclude them from insurance coverage, at least, for such guarantees which are repeated at closing (so-called bring-down). The details and scope of such additional disclosure is, in particular, stipulated in the insurance policy negotiated between the insurer and the insured party and is normally limited to facts and circumstances occurring between signing and closing which would result in a breach of a guarantee as of the closing date had they been left undisclosed. Irrespective of such underlying contractual agreement, however, certain insurers have already requested blanket disclosure of all abstract consequences of COVID-19 for the transaction and have asked for a description of the concrete measures the target has taken in order to mitigate the impact of the pandemic or the purchaser's assessment of the changed business case of the target entities or have enquired whether the parties may have settled on modified transaction parameters to address the crisis. Normally, such questions are likely designed to allow an argument that the corresponding consequences and adaptations identified can then be excluded from coverage as a disclosed known risk. The parties should therefore take the utmost care to limit such disclosure in terms of its content and scope strictly to the contractually agreed degree and not make any further-reaching, sweeping written or oral generalizations on the target entities or the transaction vis-à-vis the insurer so that their W&I policy is not compromised unduly. However, the insured party must, in turn, also take care that it does not fall short in fulfilling its contractually agreed disclosure and information obligations, because a breach of such obligations could also result in a loss of insurance coverage.

Outlook

COVID-19 places new and difficult challenges and demands on both the insurers and the insured party when it comes to structuring M&A procedures and developing tailor-made, risk-appropriate W&I solutions. It nevertheless is to be expected that the W&I insurance will continue to remain a practical and valuable tool for the purchaser to ensure adequate coverage for damages caused by breaches of contractual guarantees or representations and warranties—irrespective of their bargaining power in the sales process and the solvency position of the seller. Taking into account the expected shift of the M&A markets towards an even more buyer-friendly market climate, potential purchasers will be well-advised to evaluate the suitable liability recourse structure for the time after closing (*e.g.*, seller's liability, W&I insurance or a mixture of both) with particular emphasis in each individual case on the potential exclusions of insurance coverage that can be expected under new W&I policies. There is, at least, some good news in the short term for the potential insured party, however, in that the current decrease in the number of M&A transactions during times of crisis could easily result in a trend towards lower insurance premiums in the immediate short term.

ENDNOTES:

[1] *Gesetz zur vorübergehenden Aussetzung der Insolvenzantragspflicht und zur Begrenzung der Organhaftung bei einer durch die COVID-19-Pandemie bedingten Insolvenz.*

[2] In this context, also *see*: https://www.gibsondunn.com/whatever-it-takes-german-parliament-passes-far-reaching-legal-measures-in-response-to-the-covid-19-pandemic/, under section II.2, as well as with further analysis in this regard https://www.gibsondunn.com/european-and-german-programs-counteracting-liquidity-shortfalls-and-relaxations-in-german-insolvency-law/.

[3] *See* §§ 106, 107 InsO.

[4] § 105 InsO.

[5] §§ 129 et seq. InsO.

[6] The temporal application of these provisions may be extended by way of governmental regulation until March 31, 2021.

[7] § 132 InsO.

[8] § 133 InsO.

[9] § 2 para. 1 no. 4.

[10]Regarding the potential extension option, please *see* endnote 6 above.

[11]§ 130 InsO—*Kongruenzanfechtung von Erfüllungshandlungen*.

[12]§ 133 para. 3 InsO—*Anfechtung wegen vorsätzlicher Benachteiligung durch inhaltlich und zeitlich kongruente Erfüllungshandlungen*.

[13]§ 142 InsO—*Bargeschäft*.

[14]§ 133 para. 3 InsO.

[15]Reference is again made to: https://www.gibsondunn.com/corporate-ma-in-times-of-the-corona-crisis-current-legal-developments-for-german-business/, *see* Section 4 (Anti-Trust and Merger Control in Times of COVID-19), available in German and in English.