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DISCUSSION ON THE MAIN IMPACTS OF THE CURRENT HEALTH CRISIS ON SHARE PURCHASE AGREEMENTS

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The consequences of the health crisis have not spared share purchase transactions. The parties in an ongoing transaction[1] may question the content and nature of the existing agreements. Negotiators and drafters of future contracts will need to rethink the wording of certain clauses in order to try to prevent the new risks that will arise out of the period of uncertainty that is now beginning[2].

In the light of numerous exchanges with our clients, this article aims at analyzing a certain number of these questions, by going over the central themes and provisions of a share purchase agreement (SPA).

Price provisions

- Is the use of the "locked box" mechanism more risky in view of the current period of uncertainty?

The "locked box" mechanism is based on the determination by the purchaser of the price on the basis of (i) reference accounts, (ii) its ability to anticipate and integrate in its valuation the results of the interim period (i.e., the period between the date of these accounts and the closing date) and (iii) the absence of cash outflow from the target group to the sellers (and assimilated) during this period.

The uncertainties generated by the health crisis can make it difficult to anticipate the performance of the target group during this period and thus increase the risk of underperformance borne for the purchaser in such a mechanism. As a result, it is possible that more purchasers may be tempted to temporarily abandon this mechanism in favour of the "closing accounts" mechanism. The latter mechanism, which is based on the establishment of an accounting situation on the closing date and an adjustment of the initial price according to certain accounting elements on that date (net debt, working capital, etc.), allows the purchaser to align the valuation of the target group with the date of transfer of ownership and thus to bear, to a lesser extent, the results of the interim period.

However, while the purchaser may feel more comfortable with a "closing accounts" mechanism, its drawbacks (e.g. cost of establishing an accounting situation, uncertainty as to the final price, greater risk of post-closing litigation) may hinder the parties and, in particular, the sellers, who, for their part, may insist on using the "locked box" mechanism (combined, if necessary, with more frequent granting of MAC clauses[3]) or, under these conditions, wish to postpone their sale project.

- Are performance criteria in earn-out or put/call option clauses still relevant?

Earnout mechanisms or put/call options are based on contractual price formulas that generally include the achievement of a certain level of performance by the target group, expressed in terms of financial aggregates such as EBITDA, EBIT or GOP.

As a result, a certain number of current SPAs incorporating performance criteria and which would be determined on the basis of the current period or close future periods could result in a price determination significantly lower than projected by the parties, leading to windfall effects for purchasers and very unfavorable effects for sellers. This being said, these mechanisms are based on the principle of managing the target group in the normal course of business, which must not be conducted in a way that is likely to have a negative impact on the fulfilment of the performance criteria during the relevant period. However, the sudden impact of the health crisis on the normal course of business is not an element that is entirely within the control of the parties (even if the management of the target group by its executives is an important element in limiting, or on the contrary aggravating, this impact) and, as such, is generally not included in the commitments of the parties in respect of the reference period for the achievement of the performance criteria.

With respect to existing contracts, the legal mechanism provided for in article 1195 of the French Civil Code and introduced into French law in 2016, which allows a contract to be renegotiated in the event of an unforeseen change in circumstances that would make its performance excessively onerous for one of the parties (if necessary, through a judge), is not applicable to transactions relating to shares entered into after 1 October 2018. It is moreover generally excluded by the parties in contracts executed before that date. Thus, only a contractual renegotiation of the adjustment mechanisms provided for could be requested. In this respect, the obligation of good faith in the performance of the contract on the parties probably does not in itself result in obliging the purchaser to renegotiate.

Regarding earnout mechanisms in existing contracts which are based on the assistance from the seller during a transitional period (which includes the current period), a reduction (or even cessation) of activity during this period has significant effect on both the granting of such assistance and the conditions triggering the payment of the earnout. In addition, cash flow difficulties could lead the purchaser to ask for a delay in the payment of the earnouts due in 2020. Thus, both parties may have an interest in renegotiating the current contractual mechanism.

In any case, the key financial metrics to be taken into account (with, if necessary, the setting of floor amounts), as well as the reference period of the chosen metrics (which could integrate several periods in order to reduce the impact of the crisis on the fulfilment of the criteria) will have to be carefully calibrated.

We believe that these considerations also apply to coming SPAs because of the uncertainties surrounding the "normal" conduct of business in the coming months. Indeed, in a context of difficult company valuations, resulting in more conservative and thus lower valuations, the insertion of earnouts taking into account the future performance of the target group could be more frequent. However, the Covid 19 impact may be difficult to anticipate and calibrate. The same difficulty exists with respect to the pricing of call and put options.

- Existing contracts with a "closing accounts" mechanism: can the parties request an extension of the contractual deadlines provided for in the post-closing price adjustment procedure?

SPAs containing a price adjustment mechanism on the basis of closing accounts typically organize a procedure for determining the final price after closing, after the closing accounts have been drawn up and the purchaser has communicated its proposal for the initial price adjustment on the basis of these accounts. This contractual procedure is governed by deadlines for the exchange of adjustment proposals between the purchaser and the seller. In this respect, it is often provided that, in the absence of a reply from the seller within a specified period of time after receipt of the purchaser's first proposal, the seller is deemed to accept that proposal, thus enabling the final price to be determined definitively. Thus, the respect of these contractual deadlines has a significant impact, especially for the seller. However, the current period may make it more difficult and longer to implement this adjustment procedure.

In this context, some question the possibility of requesting the application of Article 4 of ordinance no. 2020-306 of 25 March 2020, as amended by ordinance no. 2020-247 of 15 April 2020 (the **Ordinance**) to allow the extension of the contractual time limits applicable to the adjustment procedure - alongside, of course, the possibility for the parties to extend these time limits by mutual agreement by means of an amendment to the contract. In any case, this extension may under no circumstances be requested on the basis of Article 2 of the Ordinance, which provides for a mechanism to extend the legal and regulatory time limits, to the exclusion of contractual time limits.

Article 4 of the Ordinance relates to contractual matters and postpones the effects of a termination or forfeiture clause, the purpose of which is to sanction the non-performance of a contractual obligation which had to be performed within a period expiring during the "protected period" (corresponding, subject to modification, to the period from 12 March to 24 June 2020) or after the said period (provided, in the latter case, that the relevant obligation does not concern a sum of money).

The question of the application of this article arises in particular with regard to the above-mentioned mandatory time limit granted to the seller to respond to the purchaser's proposal for the adjustment of the initial price. This clause could be considered as a clause entailing forfeiture of a right (that of contesting the purchaser's price proposal) within the meaning of the Ordinance. If the Ordinance were to apply, the effects of such a forfeiture would be postponed after the "protected period", at the end of a period calculated in accordance with its terms[4]. In such a case, would it mean that the postponement of the effects of the forfeiture indirectly extends the seller's time period to reply to the purchaser? In any event, it remains to be determined, whether the purpose of this clause is intended to sanction the seller's failure to perform a contractual obligation, namely that of replying within a specified period. The answer may be debatable: it may indeed be considered that the seller has no obligation to reply and may choose to abstain; however, if he wishes to reply, his obligation is indeed to reply within a mandatory time limit.

Conditions precedent

- Could a purchaser invoke the negative consequences of the health crisis on the target group to exit the contract between signing and closing?

Under French law, as indicated above, a SPA[5] does not generally benefit from the legal mechanism provided for in Article 1195 of the French Civil Code[6].

Consequently, a purchaser wishing to have the opportunity to exit a contract between signing and closing must negotiate a MAC (Material Adverse Change) clause, which generally takes the form of a condition precedent allowing the parties (generally the purchaser) not to close the transaction in the event of the occurrence of a significant adverse event between signing and closing. Although the MAC clause is common in the United States and in United-Kingdom, it is much less frequent in the French "pre-Covid" market, which is relatively favorable to sellers. As a result, few current contracts to date contain such a clause.

In any event, the MAC clause, if provided, is generally of the "company MAC" type. These types of clauses are limited to events attributable to the target group itself (industrial accident, strike, loss of significant contracts, etc.), as opposed to the "market MAC" which covers events outside the target group (such as a financial, political or social crisis or one affecting raw materials).

Consequently, with regard to coming contracts, the demand for the introduction of "market MAC" type clauses covering the consequences of an epidemic (lockdown, site shutdown, requisitioning of production, etc.) could increase, particularly in sectors of activity that are particularly sensitive to this type of health disaster (tourism, catering, entertainment and leisure in general, etc.) and in consideration of a possible second wave of contamination and new lockdown. In any event, the drafting of MAC clauses will have to be carefully discussed so that their implementation is proportionate to the

parties' objectives and does not constitute an opportunity for the purchaser to exit a transaction or to renegotiate the terms unilaterally. Otherwise, sellers may adopt a wait-and-see attitude, not wishing to negotiate under too adverse conditions.

- Will the insertion of a condition precedent of financing again become common?

Given the financing facilities of the recent years (low rates and important cash flows), a certain number of players (notably in private equity) were not requesting for a condition precedent of financing in SPAs. Instead, the insertion of a « certain funds » clause tended to be more and more frequent, pursuant to which the purchaser was giving the seller the guarantee that it would receive the necessary financing on closing (or, even, on signing), without the need to provide for a condition precedent in this respect. Depending on the impact of the Covid-19 pandemic on access to financing in the upcoming weeks and months, this could change and the conditions precedent of financing could appear again. However, the insertion of this kind of provision in auction deals could still be a discriminatory factor.

- Can the parties to an ongoing SPA ask for the extension of the « long stop date »?

SPAs which are executed under conditions precedent provide that failing the completion of the sale by a specific date at the latest (the « long stop date ») and unless otherwise agreed upon by the parties, the agreement shall lapse. The current situation is impacting the completion of the conditions precedent, notably those linked to an authorization given by an authority[7] or a third party. However, as mentioned above, the time periods for satisfying the conditions precedent which expire during the "protected period" have not been extended by Article 2 of the Ordinance.

One could argue that the legal requirement related to the performance of contracts in good faith should result in each party's duty to consider a request from the other party which is linked to the delay in the transaction timing, in particular with respect to conditions precedent which are not totally under the control of the parties and provided the party in charge of the satisfaction of such condition has made its best efforts to complete this condition by the required time limit. Conversely, a party willing to walk away from the transaction and, thus, would not make its best efforts to satisfy a condition precedent which is under its responsibility could be blamed on the ground of Article 1304-3 of the French Civil Code which provides that "*the condition precedent is deemed satisfied if one party who had an interest in doing so has prevented its satisfaction*". However, the success of a request of extension or a claim on the ground of Article 1304-3 is uncertain.

Consequently, some question about the possibility to ask for an extension of the « long stop date » on the ground of the abovementioned Article 4 of the Ordinance. The "long stop date" can indeed be qualified as a termination clause (or at least a clause entailing the forfeiture of a right, i.e. the right to proceed with the completion of the transaction). If this Article was applicable, would the delay in the entry into effect of the forfeiture caused by the non-compliance with the "long stop date" enable the parties to be granted an additional period to satisfy the conditions precedent? [8] The question relates in particular as to whether the purpose of the "long stop date" provision is to sanction the non-performance by a party of its contractual obligations. It supposes that the non-satisfaction of a condition precedent within the prescribed time limit is deemed to be a breach of a contractual obligation; which in any case should probably not be the case where the party has made its best efforts to satisfy such condition. Does it mean that the Ordinance could apply only when the parties do not perform correctly their contractual obligations[9]? No obvious answer can be provided here.

Conduct of the business between signing and closing

- How can the impact of the Covid-10 pandemic be managed in the parties' obligations during the period between signing and closing?

The clause of "conduct of business between signing and closing" enables the purchaser to ensure that the seller, during this period, manages the target group in a reasonable manner (which refers to the previous French concept of "*en bon père de famille*") and under the normal course of business. The seller generally undertakes to keep the purchaser informed of any significant event which could impact the target group and not perform certain transactions outside the ordinary course of business, or above a certain materiality threshold, without the purchaser's prior consent.

The drafting of this clause must be reviewed carefully to limit certain risks : (i) a too important involvement of the purchaser could be contrary to competition law[10]; (ii) it may also expose the purchaser to a risk of liability, if a loss is suffered by the target group or the seller and, depending on the circumstances, could jeopardize the purchaser's position in a potential claim for breach by the seller of the representations and warranties.

The current period increases however the risk (or the necessity) of a management outside the ordinary course of business during signing and closing. This could be still the case over the next months.

Consequently, certain purchasers, during the coming months, may wish to reinforce the seller's obligations during the period between signing and closing. Because of the drafting of the majority of the clauses of "conduct of business between signing and closing", purchasers may be more involved than as usual in the management of this period, which increase the abovementioned risks.

Representation and warranties (R&W) and contractual indemnification provisions

- Due diligences: which matters could be more carefully reviewed in the future transactions?

Due diligences carried out by the purchasers shall be probably reinforced to analyze (i) how the current crisis has, and its consequences have, been dealt with and (ii) the preparation of the target group, if new business interruptions or a new health crisis occurs.

For this purpose, the purchaser will probably be very vigilant on the following aspects: existence (or not) of a continuation business plan in the event of an health crisis (e.g. with respect to health security conditions and work organization, in connection with the employees' representatives), inclusion (or not) of penalty or force majeure clauses in material agreements (customers and suppliers), definition of force majeure, geographic allocation of the supply chain and the commercial partners, compliance with the conditions to obtain Covid-19 State aids (*PGE*, postponements of social charges and taxes, partial unemployment schemes), how the breach of finance covenants (if any) has been dealt with.

These matters will be included, as the case may be, in the R&W or in specific provisions of the SPA.

- Will the consequences of the health crisis increase the risk of breach by the seller of the R&W between signing and closing? How this risk can be covered?

The reiteration by the seller of the R&W on the closing date is a usual practice (even if not systematic). The breach by the seller of the R&W between signing and closing triggers, in most cases, the seller's liability pursuant to the terms and conditions of the contractual indemnification provisions. Indeed, few agreements grant the purchaser or the seller a walk away right in such a case or a right for the seller to update the disclosures between signing and closing on an exemption liability basis (i.e. this update is generally provided for information purposes but does not reduce the seller's liability).

The health crisis could however increase the occurrence of events having an impact on the accuracy of the R&W reiterated on the closing date, notably with respect to those relating to relationships with suppliers and customers, payment terms and litigations.

This situation could also impact future contracts due to the business risks resulting from the upcoming economic crisis or if new periods of interruption of activity were necessary.

The parties could thus try to cover more specifically this period between signing and closing, by inserting walk away clauses enabling the purchaser (or the parties) to exit the transaction if there is a beach of the R&W during this period which have a negative impact (subject to thresholds to be negotiated), which in fact would result in the introduction of a kind of MAC clause but very specific to a situation.

However it will be necessary to find the right balance between the protection of the seller (who will not want to enable the purchaser to stop easily the transaction before closing and who could be significantly impacted by the triggering of its liability as a result of events occurring between signing and closing) and the purchaser (the fact the breach of the R&W between signing and closing is dealt with by the contractual indemnification provisions could be not sufficient depending on the event concerned and because this protection is uncertain and long to implement).

- How will the mechanisms which are currently used to secure the payment obligations of the seller/warrantor evolve?

Any economic crisis increases the willing and necessity for the creditors to secure the payment obligation of their debtors. Consequently, the purchase transactions will probably not be kept out of this trend. The purchasers will thus want to reinforce their protection against any default of payment by the seller when the indemnification procedure is implemented. It will probably be the same on the seller's side with respect to the purchaser's differed payment obligations.

Although the bank first demand guarantee appears to be the more protective mechanism for the purchaser, its cost, which is already high and is likely to increase given the higher risk of occurrence of its implementation, should not facilitate its use. The mother company guarantee will still be an answer when the seller belongs to a financially strong group. The escrow mechanism will still be used even if it is not easy to trigger when there is a disagreement between the parties and thus does not appear to bring a lot comfort to the purchaser.

Given the weaknesses of the abovementioned mechanisms, the use of warranty issuance policies tends to develop over the recent years (especially in auction processes). If this mechanism is based on a substitution (in part or in full) of the seller by the insurer, it should also evolve.

- How will the warranty insurance offer evolve?

The warranty issurance policy is normally an ancillary contract based on the contractual R&W indemnification provisions and thus supposes the granting by the seller of such R&W (even if the current policies enable a clean exit of the seller, i.e. without any residual liability lying on the latter, except if the event of a fraud). Failing the granting of R&W by the seller, they could be granted by the management of the target group instead, but probably provided that the insurer does not have any legal right of action against the management.

In addition, in order for the insured company to benefit from a satisfactory coverage, due diligences must be carried out in the areas covered by the insurance policy, which results for the latter in the occurrence of costs that could be significant and could impact the timing of the transaction.

It will thus be necessary to follow the changes in the warranty insurance offer in the context of an economic crisis as well as in the cost of such an insurance policy (which, due to increasing competition, was reducing), in particular in the sectors which are the most impacted by the crisis or because R&W granted by the sellers could be less frequent or the purchaser will (probably) be willing to reduce its transaction costs.

- Can the purchaser of an ongoing SPA ask for the extension of the term of the contractual indemnification provisions?

The term of the contractual indemnification provisions corresponds to the time limit after which the purchaser is no longer entitled to trigger their implementation for breach of the R&W. The warrantor is thus released from its indemnification payment obligations following the expiration of this term.

What about the application of the abovementioned Article 4 of the Ordinance to the contractual indemnification provisions whose term is expiring during or after the "protected period"? If the clause on the duration of the warrantor's indemnification obligations results in the forfeiture of the purchaser's right to claim for an indemnification, does its purpose aims at sanctioning the non-performance by the latter of its contractual obligations? Indeed, the purchaser does not have the obligation to notify claims but, if it does it, it must be done before the contractual term. As a consequence, it should be difficult for the purchaser to ask for a general extension of the contractual term of the indemnification provisions based on the ground of the abovementioned Article 4 of the Ordinance. It could however be questioned in a situation where the purchaser would be prevented from notifying a specific claim revealed during the "protected period" because this claim was not notified before the term. If the purchaser could usefully ask for a delay in the starting date of the forfeiture of its indemnification right, it would thus benefit from an additional period to notify its claim. The application of the abovementioned Article 4 of the Ordinance here is again debatable.

Practical note from August Debouzy : you have other questions on these matters ; do not hesitate to communicate them to us *(vdesbois@august-debouzy.com). They will be commented in a next flash, as the case may be.*

[1] i.e., between signing and closing or still at the stage of performance of certain contractual obligations.

[2] In particular if new waves of contamination and lockdown were decided or because of the difficulty to fully appreciate the consequences of the current period.

[3] As detailed below.

[4] In the case of a response period expiring during the "protected period", the time limit would be extended, for a period starting on the expiry of the protected period and equal to the time elapsed between 12 March 2020 (or, the date on which the obligation arises, if the SPA is executed after) and the date on which the obligation should have been performed (i.e., the deadline for response). In the case of a response deadline that expires after the "protected period", the deadline would be extended by a period equal to the time between 12 March 2020 (or, the date on which the obligation arises, if the SPA is executed after) and the end of the "protected period".

[5] Unlike contracts for the sale of "*parts sociales*" in SARL, *société civile* or SNC.

[6] Share transactions were indeed excluded from the scope of this article by the 2018 law ratifying the February 2016 ordinance reforming contract law.

[7] Notably because of the suspension by the Ordinance of the administrative time periods and the proceedings.

[8] If the « long stop date » expires during the "protected period", this date would be extended during a period running after the "protected period" and corresponding to the period from 12 March 2020 (or, the date on which the obligation arises, if the SPA is executed after) to the date on which the obligation should have been performed (i.e. the « long stop date »). If the « long stop date » expires after the "protected period", this date would be extended during a period corresponding to the period from 12 March 2020 (or, the date on which the obligation arises, if the SPA is executed after) to the expiration date of the "protected period".

[9] In such a situation, the parties could in certain circumstances claim for the application of 1304-3 of the French Civil Code, even if (as mentioned above) the success of such a claim is uncertain.

[10] Risk of « gun jumping », i.e. prohibition to complete a transaction subject to merger control before the approval is obtained.