The future of buyer-friendly terms in M&A

Whilst clients report some 'green shoots of recovery' across various sectors, it remains to be seen whether these will flourish or whether they will wither with the onset of autumn and a possible 'second wave' of the pandemic. In the meantime, we anticipate that the terms of the transactions that do proceed will shift towards the buyer-friendly, as we saw in the 2007 financial crisis. In this paper, we consider seven key areas of negotiation in an M&A transaction and the likely impact of the pandemic on final negotiated positions. CMS publishes an annual study of key market trends in legal documentation in deals on which our European offices advised in the previous year, the CMS European M&A Study. The statistics used in this paper are taken from a number of CMS European M&A Studies and, unless stated otherwise, are Europe-wide.

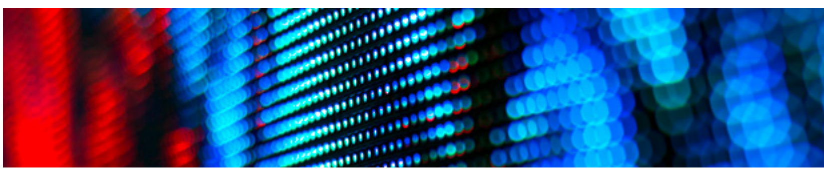
Locked box versus completion accounts

Locked box mechanisms provide for the purchase price for the target to be calculated by reference to an agreed set of historic accounts. Provided that there is no "leakage" of value since the date of those accounts to the date of completion, the purchase price will not be subject to adjustment. Locked box mechanisms are generally perceived to be seller-friendly because they give the seller certainty over the price it will ultimately receive. In contrast, a completion accounts mechanism provides for the purchase price to be adjusted by reference to actual levels of cash, debt and/or working capital in the target business at completion. A completion accounts mechanism is generally perceived to be buyer-friendly because typically the buyer will prepare the special accounts used to determine the levels of cash, debt and/or working capital and can do so as part of a thorough investigation of the business post-completion.

Locked box mechanisms have increased in popularity between 2010 and 2019, in keeping with what was an increasingly seller-friendly market. In the current crisis we would expect completion accounts to be more popular in the UK and, correspondingly, locked box mechanisms to become less so, reflective of a buyers' market.

What to expect

- Increased use of completion accounts and decreased used of locked box accounts.
- Continued increase in earn-outs.
- Overall decline in use of basket thresholds for warranty claims but, for those basket thresholds that remain, more 'first dollar'/ 'tipping' thresholds and lower thresholds.
- Higher liability caps proportionate to purchase price in uninsured deals.
- Continued increase in use of W&I insurance.
- Greater use of MAC clauses, particularly COVID-19 specific.
- Enhanced due diligence; broader warranties; greater levels of buyer control between exchange and completion.



Earn-outs

An earn-out mechanism provides for additional consideration to be payable by the buyer after completion, with the quantum being dependent on the performance of the acquired business during an agreed period. Such provisions are generally considered to be buyer-friendly – the risk of over-paying for an under-performing business is reduced and the sellers, if they remain engaged in the business, are motivated to help it perform.

Since the 2007 financial crisis, the use of earn-out clauses has consistently increased year-on-year, and we expect this overall trend to continue as buyers in a turbulent market seek to share the risk of M&A. During the 2007 financial crisis, earn outs increased significantly in popularity, particularly those calculated by reference to turnover, as opposed to EBITDA. This trend has continued and in 2019 turnover was the most common criterion for determining earn-out consideration. We anticipate this popularity to continue reflecting the view that turnover is a more easily verifiable metric whilst EBITDA can be open to a greater range of accounting interpretations.

Basket

Many M&A agreements apply a "basket" threshold to warranty claims, which prevents claims from being made if or to the extent the total amount claimed in respect of all warranty breaches is less than an agreed threshold amount. This amount is often calculated as a percentage of the purchase price. The overall market trend in recent years has been a slight decrease, year-on-year, in the use of such provisions. This is most likely due to the increased use of warranty and indemnity insurance (W&I insurance), particularly in the UK, with a low deductible – the basket is no longer relevant as the equivalent liability is assumed by the W&I insurer. For those transactions proceeding without W&I insurance, we expect basket provisions to become more buyer-friendly, as we saw during the 2007 financial crisis. This is likely to mean the inclusion of more "first-dollar" or "tipping" baskets. Under these the buyer can, once the threshold has been met, claim for the full amount of all eligible claims, as opposed to only the amount in excess of the basket threshold and lower basket thresholds.

Liability caps

Even in a buyer friendly market, sellers will generally seek certainty that their liability in respect of warranty and tax claims will not exceed a pre-agreed amount. Traditionally, this amount has been no more than the purchase price, as a seller would expect not to return to the buyer any more than it has been paid for the target business. In 2019, 58% of European M&A deals applied a liability cap of less than 50% of the purchase price. This statistic has been virtually static for the past five years. By contrast, during the 2007 financial crisis, liability caps increased, increasing the sellers' exposure. For deals not backed by W&I insurance, we anticipate a similar increase over the next year.

W&I insurance

The proportion of deals backed by W&I insurance is rising year-on-year. However, the use of W&I insurance post-dates the 2007 financial crisis so we are not able to predict, based purely on the last financial crisis, on what may happen as a result of the pandemic. We might reasonably expect that W&I insurance will continue to increase in popularity, particularly in distressed situations where a buyer may not want to take a credit risk on the sellers. Buyers may rely on the current buyer-friendly market, however, to increasingly ask sellers to make a contribution to the premium (or make a related chip to the purchase price).

MAC clauses

Material Adverse Change clauses (MAC clauses) entitle the buyer to terminate an M&A agreement if a specified event occurs between signing and closing (e.g. the loss of a significant customer). Such events are often subject to extensive and detailed negotiations. A seller will usually seek to exclude certain events (e.g. those affecting the industry generally, as opposed to the target business specifically) from triggering the MAC clause, so that the risk of any such event is borne by the buyer.

In 2019, MAC clauses were used in only 16% of deals with a split exchange and completion. This figure represents the continuing high success rate of sellers in resisting MAC clauses which generally demonstrates their strong commercial position in recent years, especially in auction processes.

The popularity of MAC clauses did not increase during the 2007 financial crisis. This time around, it is possible that there will be an increase in COVID-specific MAC clauses. We are already seeing buyers asking for such clauses to be introduced. In the face of continued resistance from sellers to MAC clauses, we anticipate buyers seeking to use other transaction conditions to give them an option to terminate in certain circumstances. For example, a right of the buyer to rescind or terminate the SPA in the event that warranties given as of signing would not, if repeated at any time between signing and closing, remain true and accurate (known as a "back-door' MAC clause).

Other emerging buyer trends

We have recently seen an increased concern among buyers that they could be acquiring a business at an overvalue, or with a liability exposure. Buyers have, therefore, been undertaking more detailed due diligence, particularly in areas such as material supply contracts, employees, IT and trading outlook, and/or asking for a related broader set of warranties.

We have also recently seen an increase in the number of buyers seeking additional security for warranty claims, for example, in the form of consideration held in escrow or a guarantor to stand behind any claims. We can expect this trend to continue.

In the case of deals with a split signing and closing, there has been an increasing tendency of buyers to seek greater control of the target business between signing and closing and, in some cases, expecting the seller to covenant maintenance and management of working capital, liquidity and debt levels during that period. Again, while market uncertainty prevails, this trend is likely to continue.

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