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Risk allocation and risk coverage in M&A agreements

This article shall give an overview of current trends with respect to contractual provisions dealing with risk allocations in the relationship between sellers and buyers in share purchase agreements. Which method the parties will agree on depends especially on individual circumstances and the negotiation strength of each party. Thus, there are no prescribed rules but rather different techniques that have developed in practice.

Selected risk allocations for the benefit of the purchaser with seller responsibility

■ Purchase price

A purchase price reduction is an instrument often used to take into account an anticipated risk. The potential future damage – a materialization of the risk – results in a reduction of the purchase price for the direct benefit of the buyer, regardless of whether a damage case occurs or not. If the risk materializes, the buyer is not entitled to further recourse if the purchase price was reduced upfront (prevention of so-called “double dips“).

■ Guarantees/warranties

Guarantees or warranties are typical devices in SPAs to protect the purchaser against certain risks relating to the business or the shares therein. As a rule, guarantees describe a contractually intended condition being present at the time of signing or closing (but generally not after this period!). If facts and circumstances deviate detrimentally from the situation warranted and guaranteed, the risk materializes. In this event, the seller usually has to pay restitution and/or has to compensate for damages.

Indemnifications

Indemnifications are common as regards taxes, but also with regard to environmental risks or other specific risks identified in the course of the due diligence. In contrast to guarantees and warranties, the seller assumes vis-à-vis the purchaser the risk of a future exposure of the company, e.g. future tax payments accruing for tax periods that expire prior to signing or closing.

Indemnifications or waivers can also protect the purchaser with regard to legal relationships between the seller, its affiliates and the target company, since these legal relationships are intended to end after the transaction or are to be renewed on new contractual grounds.

Selected risk allocation for the benefit of the seller with purchaser responsibility

Exclusion of claims

The parties typically agree that the recourse regime shall exclusively be governed by the provisions oft he SPA. Consequently, liabilities of the seller based on the law are being excluded to the degree legally permissible. Therefore, claims under the law can only be made if the seller has acted willfully or fraudulently, in particular as regards the disclosure process during the due diligence.

Limitation of liability

Provisions dealing with legal consequences in case of breaches of guarantees and warranties typically provide for a limitation of the liability of the seller. Liability may be excluded if certain damage amounts are not being exceeded ("de minimis"). Further, claims may be excluded if and to the extent that the damages being suffered do not exceed in aggregate a certain agreed minimum amount ("threshold"). Furthermore, it is common that certain guarantees and warranties are subject to a liability cap. The amount of the cap typically relates to the enterprise or equity value of the transaction.

Limitation of the definition of damages

The limitation of the definition of damages is a standard device to limit the recourse against the seller in case of a breach of guarantees and partly also in case of indemnifications provided in the agreement. For example, the parties may agree, that the seller is not liable for consequential damages or loss of profit of the purchaser.

- **Statute of limitation**

Provisions dealing with a statute of limitation are appropriate to limit the liability of the seller in case of a breach of guarantees and warranties or indemnifications. Guarantees relating to the operations of the business are typically subject to a statute of limitation of one or two years from the date of closing. Guarantees regarding title in the shares or other assets as well as indemnification obligations are typically subject to a longer period of limitation (three or five years or more, e.g. until finalization of a tax audit).

- **Legal relationship between seller and target company**

The Seller may ask the purchaser for an indemnification for potential claims of the target company vis-à-vis the seller. Therefore, it is common in case of a sale that such legal relationships will be terminated or based on new contractual grounds. Further claims shall expressly be excluded.

- **Risk allocation through variable purchase price („closing accounts“)**

If the parties agree on closing accounts, the net debt of the target company as well as an adequate working capital shall be confirmed as of closing. The net equity of the target company may also be verified. These closing accounts serve the purpose of flexibly adjusting the purchase price to the financial situation of the target company as of closing.

The net debt adjustment serves the verification of cash and cash equivalents as well as financial debt, in particular mid- and long-term bank debt but also quasi financial debt, including taxes, pensions or other deductibles, as agreed by the parties.

With regard to working capital, the parties typically agree on adequate working capital of the company in order to permit a continuation of the operations in the ordinary course of business immediately after the closing.

While net debt obligations are typically deductible when the equity value (purchase price) derived from the enterprise value is determined, the working capital may be agreed as a corridor of an adequate working capital figure. If such figure is exceeded or undercut, the purchase price will be adjusted accordingly.

These adjustment mechanisms conceptually protect both parties with regard to an economically reasonable purchase price and avoid deteriorations during the transaction process, including additional leverage being assumed prior to signing/closing.

Contrary to the above, the net equity determination generally only protects the purchaser. From an economic and pragmatic point of view, it has the function of a catch-all guarantee to protect the purchaser against any and all risks which may have an impact on the equity of the company and which are not addressed in specific guarantees and warranties of the SPA. From the perspective of the seller, such a guarantee is hardly acceptable.

- **Risk allocation based on the locked-box concept**

As an alternative to the closing accounts (see above) the locked-box principle has been established. The locked-box concept does not lead to an adjustment of the purchase price but rather references recent interim financials of the target company, which typically are being guaranteed by the seller. Furthermore, the seller guarantees that, as of the date of the interim accounts, no direct or indirect leakages to the seller or its affiliates have occurred, such as dividend payments.

This segregation mechanism is less precise compared with the concept of closing accounts. However, the locked-box concept has the advantage that potential breaches are transparent and that the determination of the correct purchase price does not require expensive audit discussions or arbitration proceedings as may be the case for closing accounts.

- **Security for the seller**

The seller has the greatest security interest to receive the full purchase price by the purchaser. Therefore, the seller may, as early as of signing, require a certain collateral from the purchaser as regards the liability of the purchaser to pay the purchase price. This may comprise guarantees of third parties with regard to the purchase price, equity commitments and/or debt commitments (secured funds) based on term sheets or finance agreements.

- **Security for the purchaser**

For the purchaser it is of particular relevance that potential claims for breach of guarantees and indemnifications can be fulfilled by the seller. Therefore, the parties may agree on a partial retention of the purchase price or escrow arrangements with a notary public.

In addition, a vendor loan may be a device to secure the claims of the purchaser, which then may be fulfilled by settling the claim to repay the loan of the seller with counterclaims of the purchaser.

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