

Typical disputes following M&A transactions in Germany



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More frequently than in the past, provisions of share purchase agreements (SPAs) are becoming the subject of disputes amongst parties in Germany. The majority of these disputes are being resolved as part of arbitration proceedings rather than proceedings before the ordinary courts.

Disputes typically may arise in the context of, among other things, purchase price adjustments, closing conditions, representations and warranties and indemnifications.

The purchase price may be adjusted based on closing accounts. Closing accounts determine the cash and debt status of the target company as well as the working capital status as of closing. It is important to precisely define which items will be considered in the relevant closing accounts. The applicable accounting principles also need to be addressed in detail in the SPA.

Whereas parties typically seem to pay attention to defining debt and quasi-debt positions for purposes of the SPA, so-called trapped cash (for example cash which for regulatory, contractual or other purposes is not easily accessible) may give rise to disputes.

Given these and other conceptual issues, the locked box mechanism seems to have become the prevailing purchase price adjustment principle in recent years. Certain agreements also combine the locked box principle with a working capital adjustment – limited closing accounts.

When applying the locked box principle it is important to precisely define relevant leakages which typically do not only include dividends but may also include other payments from the target company and its subsidiaries to the seller and its affiliates. In addition to the definition of leakage it is important to define precisely the relevant leakage period. For the time period between the signing and closing, the parties may consider covenants as to information obligations of the seller regarding payments and potential breaches of the no leakage provision.

In addition to cash/debt adjustments or locked box arrangements, the earn-out is quite often discussed and agreed in order to build a bridge if the seller's and purchaser's price expectations deviate substantially. The prevailing risks relating to the earn-out provision are typically with the seller. Due to restructurings and similar developments, the purchaser may be in a position to dilute the relevant parameters of an earn-out. Contractual protection in this regard is limited. Therefore, from the seller's perspective an earn-out may only be acceptable if it relates to top line parameters such as turnover, quantities of sold products, or comparable parameters rather than Ebitda, Ebit or other performance-related criteria.

THE LOCKED BOX MECHANISM SEEMS TO HAVE BECOME THE PREVAILING PURCHASE PRICE ADJUSTMENT PRINCIPLE

As for closing conditions, the material adverse change (MAC) as a closing condition shifts the risk of certain extraordinary events, for the

time period between signing and closing of a transaction to the seller. If an MAC needs to be accepted by the seller, it is obviously in his best interest to precisely define the circumstances which will create an MAC. It is apparent, however, that certain unforeseeable future events can typically only be worded by using broad language.

Potential disputes between seller and purchaser can be reduced by adding a price tag at least to a business MAC regarding the financial and operational situation of the target company. Political circumstances, general economic circumstances and capital market circumstances, however, may be much more difficult to apply and can therefore be subject to disputes in particular given the present Euro and sovereign debt problems.

PRIVATE EQUITY

Finally, representations and warranties and indemnifications may be the basis for a wide range of potential disputes. Disputes may typically arise, for example, from subjective standards such as “best knowledge”. Furthermore, disputes may arise if qualifications such as “material” or “substantial” are being agreed upon by the parties.

When it comes to net equity guarantees, the accounting treatment of reserves may create substantial problems. The seller must be aware that certain circumstances may give rise to competing claims of the purchaser which may end up in a double dip scenario (for example circumstances which are relevant for a cash/debt adjustment as well as a breach of representations and warranties or indemnifications).

Substantial disputes may also arise in the context of the treatment of non-recurring items for purposes of performance guarantees (Ebit or Ebitda, for example).

Frequently, disputes also arise because the wording of a representation and warranty or indemnification does not precisely define the relevant time which triggers the application of such a provision. For example, an indemnification relating to product liability needs to be precise as regards liability triggers: is the production of the defect product relevant, is the time of its production relevant, is the time of its distribution relevant, or is the point in time of a damage event relevant?

State of the art construction may help to resolve some of the issues described here. However, and more importantly, precise contractual wording including illustrative examples to demonstrate certain (economic) effects of complex provisions are appropriate tools in reducing the dispute/litigation exposure of SPAs.