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The Impact of the crisis on the M&A deals

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1. Introduction.

The current lack of available credit and the migration of the downturn in the financial economy to a downturn in the real economy have had a significant impact not only on the volume – due to the lack of high value transactions - but also on the kind of M&A deals getting done compared with the previous yearly trends. The picture of the Italian M&A market in the second quarter of 2013 reveals that the majority of the deals done have been *buy out* transactions, followed by *expansion* and *early stage* transactions, especially this latter in the private equity and venture capital activities. In this scenario there has been an increase of *distressed* transactions which has shown an upward trend in the third and four quarter of 2013.
The assessment of the health of the target is material for choosing the deal structure of an M&A transaction (i.e. asset deal vs share deal) both at cross border and Italian level. For sake of concision it is worth focusing on the main features of share deals targeting distressed companies under the Italian law.

Generally speaking, a company in financial distress may become available at an attractive price[1], considering the low negotiating power of

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[1] The purchase price of shares/*quota* of a target fully owned by a company goes into bankrupt if not corresponding with the real value of the shareholding acquired may be

sellers and their need to close the deal in a short time in order to recover cash. Under this scenario buyers with the ability to fund the transaction by themselves or with easy access to financing may capitalize on significant opportunities. However, buying distressed assets and companies inside or outside of bankruptcy court poses certain potential dangers and challenges that do not present themselves in the non-distressed M&A market, but also offers more significant upside opportunities for potential purchasers.

2.The preliminary phase: focus on the capital structure of the target company.

The economic and financial crisis of the target may impact on its capital structure with crucial consequences to bear in mind in the building of an M&A deal.

As a matter of fact, at a preliminary stage it is essential to weight the degree of the financial difficulty of the target company considering that any financial difficulty which - may cause irreversibly the impossibility for the company to fulfil regularly its economic obligations – may be qualified as insolvency which is the leading factor causing the bankruptcy of the entrepreneur pursuant to article 5 of Royal Decree No 16/3/1942 No 267 (hereinafter "**Insolvency Act**") [2]. In case of insolvency - as per article No 5 of the Insolvency Act - the duty of the directors of the target company is not to perform any activity and/or decisions capable to delay the beginning of the bankruptcy procedure, any conduct in this regard may cause a criminal liability of the directors according to article 217 of the Insolvency Act [3]. Moreover, the priority is to verify whether any financial difficulty generates any losses which may impact the share capital of the company and, if so, in

deemed as unfair and the relevant transaction may be subject to claw- back action. The claw-back action is applied to the extent the receiver is able to prove that the sale has been undervalued and executed in the suspect period (e.g. six months before the declaration of the bankruptcy) the buyers have had the knowledge of the company's insolvent state (see Cassazione civile sez. I, 14 March 2000 No 2909, in Fallimento 2001, 568). The undervalued transactions are not subject to claw-back action if included in restructuring plans of any Composition with Creditors (*Concordato Preventivo*) or Debt-Restructuring Agreement (*Accordi di Ristrutturazione*).

[2] Article 5, paragraph No 2 Bankruptcy Law : "*the state of insolvency is established by such failures or other factors which demonstrate that the debtor is no longer able to regularly fulfil its obligations"*

[3] A. DONATO *in L'intervento delle banche in caso di financial distress su "Crisi di Ristrutturazione e rilancio dell'impresa.*

which measure the share capital is affected by losses caused by such financial difficulty. In the event of any loss equal to 1/3 of the share capital (provided that the minimum capital requirement with respect to the kind of company – *Società a responsabilità limitata* or *Società per Azioni* - remains), the governing body must call a shareholders' meeting to resolve upon the proportional reduction in the share capital or the carrying forward of the loss into the next financial (see article 2446 Italian civil code), if the loss is carried forward, it will become mandatory in such next year to reduce the share capital proportionate to the loss if such loss still equals a third of the share capital. However, in the event of any loss exceeds one third of the share capital, reduced as a result of the losses to the minimum amount of share capital, the governing body must call a shareholders' meeting to resolve upon the proportional reduction of the share capital and its increase up to minimum threshold, if not the target company has to be deemed as expired with the consequence that the directors have the duty of starting with the liquidation procedures or converting the company in a different entity with a lesser share capital according to the corporate provisions applicable under the Italian civil code.

The said assessment is fundamental in the due diligence phase in order to monitor the activity of the management which mostly be in charge also after the acquisition and to find an agreement on the funding and on the capital structure of the target in view to the completion of the deal.

Giving the time constraints due to the risk of insolvency, the buyer may negotiate an injection of money into the equity of the company by the existing shareholders or by itself before the acquisition, this solution may impact on the purchase price of the shares which might be set forth with mechanism of adjustments post- closing.

Hence the distressed status of the target affects the deal, the contractual provisions aim on one hand at balancing the different interests of the parties and on the other hand at minimizing the risk of the buyers. To give a synthetic picture of the contractual tools mainly in use in the distressed transaction, the following focus is on the timing of the completion, the post-closing mechanism and the representations and warranties.

3. The strategic approach: the timing of the completion, the conditions

precedent to the closing.

Usually the deal is structured by a preliminary share purchase agreement (i.e. the so called SPA), negotiated on the basis of a due diligence process if conducted by the buyer, followed by a final agreement to be executed at the closing date whose technicalities depend on the type of target company [4]

The SPA sets forth the terms and conditions of the transaction on case by case basis and on the assumption that the target company is technically solvent.

Normally the timing of a distressed transaction depends on the due diligence process but also on the number of "players" involved in the game (i.e. lenders, banks). The length of the pre-closing period varies, but is often one to three months and in any case there is typically a gap in time between the latest available financial statements and the closing date, which may cause the parties to consider a post-closing adjustment price.. In order to reduce these risk of the worsening of the financial conditions of the target company, it is common practice to provide simultaneous signing of the SPA and closing; this possibility cannot be practicable if the buyer requires a due diligence investigation which can jeopardize the completion of the transaction.

If it is not possible to plan the signing of the SPA and the closing simultaneously the closing conditions (e.g. MAC clauses), the extensive rights of access/control up to the closing are set forth are functional to protect the buyer during the pre-closing phase. During this period, the seller typically manages the business being sold directly or by means of the management in charge at the time of the signing. It is common practice to provide the SPA with "Interim Period" provisions aiming to stop the sellers from running the company by making decisions which can affect the target company before the closing (e.g. previous authorization of the buyers about expenditures, distribution of dividends, signing of agreement whose value exceeding a certain cap).

[4] **(i)** The deed of transfer for the shareholding of an S.p.A. has to be executed by a notarial deed (*atto pubblico*) endorsing the transferred shares (if not in material form) certified by the same public notary, and the relevant registration in the shareholders book, whereas **(ii)** the transfer agreement for the *quota* of an S.r.l. has to be executed by a notarial deed (*atto pubblico*) or by a private agreement to be certified by a public notary.

As far as the post closing period, the said circumstances provide the primary rationale for the use of adjustment price mechanisms which bridge the gap between the financial condition of the seller at the time of signing the definitive purchase agreement and its condition as of the closing date. The post-closing adjustment usually (but not always) allocates to the seller the economic risks and profits of continued operation of the target during this period. However, a post-closing adjustment is not a substitute for a "material adverse change" closing condition, which allows the buyer to refuse to close if the target's financial results have materially deteriorated in comparison with the agreed financial statements used in the negotiation process.

4 . The SPA tools to minimize the buyer's risk.

In the lack of the due diligence process, the balance of the risk for the buyer is guaranteed with exhaustive representations and warranties (the "**Reps & War**"). In any case, buyers may reduce their risk by negotiating favorable Reps and War in order to be indemnified by the sellers.

The negotiation of the warranties[5] and the relevant provisions in the SPA strongly depend on the results arising from the due diligence process and on the terms upon which the due diligence process is considered in the share deal.

Normally legal warranties are provided for by sellers in relation to the ownership and the *status* of the shares/*quota* to be sold, the absence of encumbrances and of any rights which may limit the transfer of the

[5] For a wide picture of the warranties in M&A transactions, see: F. BONELLI – M. DE ANDRE' *Acquisizioni di società e di pacchetti azionari di riferimento* Milano, 1990; O. CAGNASSO- M. IRRERA, *Il trasferimento della partecipazione di controllo nelle società di capitali,* Torino, 1994; PROVERBIO, *Le clausole di garanzia nella vendita delle partecipazioni sociali,* IPSOA, 2000; S. TERSILLA, *Le clausole di garanzia nei contratti di acquisizione,* in Dir. Comm. Internaz. 2004, 1, 101; M. RUBINO DE RITIS, *Trasferimenti di pacchetti azionari di controllo: clausole contrattuali e limiti all'autonomia privata,* in Giur. Comm 1997, 6, page 879 M. SPERANZIN, *Vendita della partecipazione di "controllo" e garanzie contrattuali,* Milano 2006; G. IORIO, *Strutture e fnzioni delle clausole di garanzia nella vendita di partecipazioni sociali,* Milano 2006; U. DRAETTA – C. MONESI, *I contratti di acquisizione di società e di aziende,* Milano 2007; F. BONELLI, *Acquisizioni di società e di pacchetti azionari di riferimento: Le garanzie del venditore*, in Dir. Comm. Internaz. 2007, 2, page 293.

participation, indeed acquiring a shareholding may not be free from encumbrances – such as pledges [6]or other securities - which go with the acquired participation. The business warranties in a M&A context are different depending on the contractual instrument chosen by the parties. Practical and theoretical problems are connected with business warranties in relation to the value of the assets of the target company. Despite the fact that for the common operators the sale of shares constitutes an instrument by means of which all the assets are purchased, scholars and case law alike agree in stating that a sale of shares does not transfer the assets of the company that will still pertain to the company itself. As a consequence, since the assets are not subject to the acquisition, the statutory remedies provided by the Italian civil code shall not apply to the assets, therefore the buyer shall be compelled to set forth specific warranties and indemnities in the SPA. Giving that, the parties traditionally substitute the statutory rules and remedies with the covenants embodied in the SPA and the specific warranties and remedies provide thereby with the further specifications by means of the "no other remedies" clause only the contractual provisions shall apply. In the event no contractual warranties are provided for by the sellers, and the assets do not correspond with the value represented by the sellers, a buyer does not have any remedy except in the case of fraud or gross negligence.

It is worth noting that sellers try to limit the warranties, if any, by relying on the buyers' knowledge of the *status* of the more crucial areas (e.g. environmental issues, employees) and inserting in the acquisition agreement reference to the due diligence process as a premise of the deal and attaching annexes as exceptions. Buyers at least try to obtain as a business warranty that there are no losses exceeding one third of the share capital or that do not affect the minimum threshold of the share capital provided by law. On the other hand, buyers try to insert provisions (*clausola di accuratezza*) warranting as to the truth and completeness of

[6] The form of the pledge depends on the type of limited liability company (S.p.A. or S.r.l.) and the form of issuance of shares (in paper form or through a clearing system) or *quota.* With reference to a pledge over shares, it is worth noting that under article 4 of the Italian Legislative Decree no. 170 of 21 Mach 2004 (introducing EU directive no. 47 of 6 June 2002), where applicable, the secured creditor is authorised to directly sell or keep the shares over which the pledge has been granted in accordance with the provisions agreed by the parties in the security documents.

all of the representations and statements provided for by the sellers in order to provide the basis for challenge in any case of fraud.

To sum up, the Reps & War provided for the acquisition of a distressed company depend on the concrete situation but may be fewer than in the standard deal with a short post-closing period for the indemnification of any relevant breach. As matter of fact, sellers may exit from the distressed company in time to limit their loss in terms of investment, but may be liable for any breach of Reps & War provided to buyers and then be obliged to indemnify the buyers for a certain period after the sale of the relevant participation. As a consequence indemnity clauses are strictly connected to the structure of the warranties – as described above - provided by the sellers. Usually the indemnity is encompassed between a maximum, normally equal to a percentage of the purchase price, and a minimum amount. It is common to provide for a set - off between the indemnity amount due by the sellers and a portion of purchase price. The challenge between buyers and sellers in order to limit or extend the indemnity consists of the definition of “damages” due to any breach of the seller’s warranties which may include current and contingent loss, capital loss, expenses, damages. Normally, the claim for indemnity has to be notified within 24 months from the effective date of the agreement. Needless to say that the strength of any indemnity provision is based on the methods used by the buyers to enforce it in case of any breach of the Reps & War: one of the most useful instrument is to keep a certain amount in escrow in favour of the buyers for the same the duration of the Reps & War.

For completeness, it is remarked that other methods consists of a guarantee issued by a guarantor (e.g. a bank or an insurance company) for a certain amount of money on behalf of the sellers and in favour of the buyer. This kind of tool entitles buyers to claim to be indemnified for damages due to the breach of any Rep & War by the sellers upon a simple request directly to the bank and without any evidence of the damages suffered. At buyer’s request, the guarantor must pay the sum claimed without any objection. The duration of the guarantee may be less than the duration of the Rep & War, as usually it is depends on a case-by- case transaction.

In conclusion, the negotiation of a M&A deal targeting a distressed company imposes more attention and a deep awareness of the contractual instruments in use in the best practice and provided by the Italian civil code which can balance the risks borne the by buyers.

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