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M&A Practice Update: Lessons from the Eurozone Crisis

BY GARRETT HAYES & ROSS MCNAUGHTON

I. Introduction

Greece's recent second bailout of €130bn and related debt cut has successfully resulted in the country averting a disorderly default and exit from the eurozone, for now at least. It has also provided an element of stability to the uncertainty that had previously plagued the future of the euro and its members generally, though underlying doubts remain over the health of several of the economically weaker eurozone nations.

The uncertainty and speculation that the problems faced by certain of the weaker eurozone countries might lead to a breakup of the eurozone in some form or another, has undoubtedly had somewhat of a suppressant effect on the European M&A market in recent months. However, the practical experience, legal analysis and market commentary regarding the issues over the past several months as the crisis has unfolded have given rise to some key practice points for cross-border European M&A deals and for buyers' assessments of eurozone risks.

As the eurozone crisis continues to play out, there are certain key steps and approaches that M&A market participants can and should take to seek to quantify and assess deal risks going forward. This Stay Current identifies and discusses certain key practice points and will be of interest to those looking to acquire businesses or assets with significant European exposure. It will also be of use to multinationals who already have European operations and who are looking internally to analyse and assess their current risk.

II. Implications for M&A: key practice points

Interest in European M&A investment is increasing. However, any potential purchaser will remain concerned to ensure that the risks involved in acquiring a business with significant exposure to some of the weaker member states are adequately understood, assessed and, to the extent possible, protected.

In this regard, the two principal ways in which the purchaser would want to re-focus its M&A practice and protections are:

(a) **Due diligence** – obtaining as complete a picture as possible of the relevant eurozone risks associated with the target business; and

(b) **SPA protection** – obtaining appropriate protection in its share or asset purchase agreement.

Each of these aspects is discussed in more detail below.

A. Due diligence

If a purchaser is looking at a target with pan-European operations, including in one or more of the economically weaker member states, then the principal risks it will be looking to assess are what might happen if any of those member states ultimately abandons the euro and adopts its own currency.

The implications for the target business may be wide and extremely varied and will turn on the business in hand and the method by which the member state withdraws from the euro, so at first glance may seem impossible to call. That said, amongst other things (and depending on the member state withdrawing), it is likely that in such an event there would be a devaluation of the member state's new currency and a general deterioration in business confidence (although exports could be expected to increase in the medium- to long-term). It is also foreseeable that there could be a default from the hardest hit banks and corporates in that territory, as well as other business disruptions and legal disputes. Even without a default or a withdrawal from the euro, the increased austerity measures in many of the member states could have an impact on a target's operations.

However, a potential purchaser can assess and understand a target's exposure by asking the right questions during its due diligence. This would include consideration of the following:

- What are the scale of the operations and associated revenues and earnings of the target in the relevant member state? Does it have financial investments or cash in that country?
- How would a devaluation of the withdrawing member state's currency affect the target's business, customers, trading partners, suppliers, lenders and other counterparties?
- What are the trade credit terms given to customers and others in higher risk jurisdictions and can/should they be tightened?
- Will there be problems with the target's third party contracts if the withdrawing member state imposes foreign exchange controls or other currency restrictions?
- To what extent would an insolvency or downgrade of any of the target's key counterparties adversely affect the business?
- What are the terms of the target's material contracts and, if they provide for the target to make payments or be paid in euro, would they be susceptible to payment in the new currency after the member state withdraws? (The analysis of what contractual terms could affect the currency of the contract will turn on, amongst other things, clauses such as: (i) governing law and jurisdiction (i.e. that of the withdrawing member state or otherwise), (ii) definition of key terms, such as "euro", (iii) specified place of payments, and (iv) force majeure or material adverse event provisions.)
- What debt arrangements does the target have in place? Do any of its relevant member state subsidiaries owe debts in euro that may make it prohibitively expensive to settle in the event of a currency conversion (and devaluation)?
- What systems might need to change in the event of a currency change (e.g. payroll, accounts payable, etc.)? What contingency planning may be needed? Should the purchaser be looking to obtain appropriate insurance coverage or otherwise hedge its exposure after the acquisition?
- Where are the target's bank accounts kept and how easily can they be moved, if required?

In any event, listed purchasers will be expected to analyse these risks to comply with their ongoing reporting requirements after the acquisition. For example, the Financial Reporting Council has recently published an update for directors[1], which provides guidance in relation to UK listed companies' disclosures when a company has a material exposure to country and/or currency risk and which emphasizes the importance for listed companies of conveying a balanced and understandable assessment of that company's position and prospects in the context of those risks. Similar guidance has also recently been published by ESMA[2] and the SEC[3].

B. SPA protection

As well as an enhanced due diligence focus when dealing with targets in the higher risk member states, purchasers should also be seeking appropriate contractual protection in the share or asset purchase agreement governing the acquisition. Similar principles would also apply where there is a seller located in one of those jurisdictions. These include:

- **Conditionality** – if there is anticipated to be a significant delay between signing and completion of the transaction, then purchasers should consider the extent to which they would require a specific condition, or a carefully drafted material adverse event clause, relating to a default by an applicable member state or its withdrawal from the euro;
- **Currency** – the purchaser should consider whether to expressly provide for consideration to be payable in euro, or whether some other currency may be more appropriate;
- **Guarantee** – if the seller is incorporated or located in a higher risk member state, then purchasers should consider insisting on a parent company or other guarantee;
- **Limitations on liability** – financial caps are often based on a percentage of the overall consideration. If the consideration is payable in euro and the underlying target business is based in a higher risk jurisdiction, purchasers should consider whether to include a specific provision dealing with the exchange rate that will be applied to determine whether a monetary limit or threshold has been reached;
- **Funding commitments** – the precise terms of any equity or financing commitments will also need to be considered and closely analysed to ensure consistency with the underlying acquisition terms;
- **Transitional services** – to the extent any transitional services from the seller are required, then similar considerations will apply to the contractual terms to ensure as much certainty as possible over the terms in the event of a default or withdrawal of a member state;
- **Governing law and jurisdiction** – the parties should give careful consideration to the most appropriate governing law and dispute resolution forum for any disputes arising out of the acquisition.

III. Conclusion

When embarking on any M&A activity involving any of the higher risk member states, purchasers should be alert to any country or currency risks that might be applicable. However, there are methods to ensure that purchasers obtain as much information about those risks as possible, which should enable them to identify and assess those risks and seek appropriate protection in the sale documentation. Ultimately, a purchaser's aim will be to feel comfortable that it has enough information about the target's risks and exposures as a result of the applicable member state's issues to be able to price them into the deal with a reasonable degree of certainty and confidence.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

London

Garrett Hayes
44.20.3023.5153
garretthayes@paulhastings.com

Ross McNaughton
44.20.3023.5124
rossmcnaughton@paulhastings.com

Ronan P. O'Sullivan
44.20.3023.5127
ronanosullivan@paulhastings.com

[1] Financial Reporting Council "An Update for Directors of Listed Companies", January 2012.

[2] European Securities and Markets Authority "Sovereign Debt in IFRS Financial Statements", November 2011

[3] U.S. Securities and Exchange Commission "CF Disclosure Guidance: Topic No. 4, European Sovereign Debt Exposures," January 2012.

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