M&A Newsletter Series

Part 6: Pre-Closing Covenants

The purpose of this Baker McKenzie M&A Newsletter series is to give an insight to prospective sellers or purchasers into some key legal documents and/or provisions they will most likely be confronted with when entering into any sale or acquisition process concerning a Luxembourg commercial company.

Part 6: Pre-Closing Covenants

This sixth newsletter deals with pre-closing covenants (alternatively known as pre-closing obligations or pre-closing undertakings)[1] in share sale and purchase agreements, which are used in virtually all share deals that are structured with a signing date and a closing date.

THE PURPOSE OF PRE-CLOSING COVENANTS IS BASICALLY TO ARRANGE THE MANAGEMENT OF THE TARGET (AND, TO THE EXTENT APPLICABLE, OF ITS SUBSIDIARIES) BETWEEN THE SIGNING DATE AND THE CLOSING DATE OF A DEAL. ARE GENERALLY DIVIDED INTO TWO MAIN TYPES: (A) POSITIVE COVENANTS (ENGAGEMENTS DE FAIRE) ON THE ONE HAND AND (B) NEGATIVE COVENANTS (ENGAGEMENTS DE NE PAS FAIRE) ON THE OTHER HAND.

The purpose of pre-closing covenants is basically to (a) arrange the management of the target (and, to the extent applicable, of its subsidiaries) between the signing date and the closing date of a deal and (b) establish, if and to the extent necessary, a list of determined actions to be taken by one or several of the parties in order to prepare for the closing.

Pre-closing covenants are most usually agreed in the interest of the purchaser. However, some pre-closing covenants can be agreed in the interest of the seller as well. They are generally divided into two main types: (a) positive covenants (engagements de faire) on the one hand and (b) negative covenants (engagements de ne pas faire) on the other hand.

There is no exhaustive list of pre-closing covenants under share sale and purchase agreements. However, some pre-closing covenants, whether positive or negative, are typically present — in a short or long form — in almost any share deal. These typical pre-closing covenants concern the following subjects: (a) conduct of the business of the target, (b) restrictions to the conduct of business of the target, (c) right of information of the purchaser, (d) release of the seller's guarantees, (e) repayment of the seller's indebtedness, (f) obtaining of third parties' consents, (g) information for the personnel and (h) notification of the breach of the seller's representations and warranties.

[1] The UK law firms usually prefer to use the terms pre-completion of covenants, obligations or undertakings.

Moreover, in complex M&A transactions, and when a purchaser is willing to acquire part of the assets and liabilities of a target only, pre-closing covenants can also include so-called carve- out obligations in order to "clean" the target's assets and liabilities accordingly.

We will briefly develop and discuss each of these classic pre-closing covenants (except for the carve-out provisions) below.1

1. Conduct of the business of the target

In any share deal transaction, the purchaser will usually require a general undertaking from the seller to cause the target and its subsidiaries (collectively "Group Companies") to be managed in the ordinary course of their business between signing and closing.

THE DEFINITION OF "ORDINARY COURSE OF BUSINESS," IS NOT LEGALLY DEFINED AND MAY THEREFORE BE CONSTRUED MORE OR LESS EXTENSIVELY

When drafting such a covenant, the parties must be notably careful to agree on (a) the definition of "ordinary course of business," which is not legally defined and may therefore be construed more or less extensively; (b) the level of strength of the seller's undertakings in this respect (obligation de porte fort vs. obligation de moyen); and (c) the sanctions to be applied in the event of the breach of such covenant (as, more generally, for the breach of any other pre-closing covenants).[2]

The purchaser should further be reminded that it is not the controlling shareholder of the target until completion occurs. Conversely, the seller should hear that the purchaser reasonably needs some comfort as to the fact that the seller will use (at least) its best or reasonable efforts to maintain the Group Companies' trade and trade connection in the same position as on the signing date.

The purchase price mechanism chosen by the parties under the share sale and purchase agreement (closing accounts mechanism or locked-box mechanism) will indirectly impact such discussions to some extent, due to self-speaking considerations concerning the transfer of the financial risk relating to the business.

2. Restrictions to the conduct of the business of the target

Alongside a general undertaking from the seller to ensure the Group Companies' business is conducted in "ordinary course of business" between signing and closing, the purchaser will usually further list a series of material actions that the seller will not be authorized to take without its prior written consent (which must not be unreasonably withheld).

This list of restrictions on the conduct of the target business by the seller will be more or less extensive. It usually leads to animated discussions between the parties, with the seller considering there to be no sale before closing and the purchaser considering itself already the new owner of the target. This list will include, for example, undertakings from the seller not to, and to ensure the Group Companies do not, (a) make any payment other than routine payments in the ordinary course of business, (b) incur any expenditure exceeding a determined amount, (c) grant or subscribe to any new credit or loans, (d) acquire or dispose of any material assets, (e) create any encumbrance on its assets, (f) increase or decrease their share capital, (g) redeem all or part of their shares, (h) amend their articles of association, (i) declare, pay or make any dividend or other distribution, (j) enter or terminate any material agreement, etc.

The parties should negotiate this negative covenant list in a pragmatic and reasonable manner. They should, for example, at least reasonably consider excluding — on a case-by-case basis — any operations performed by the Group Companies in their ordinary course of business and agreeing on some materiality thresholds, to reach a balanced solution.

[2] Indeed, a breach of pre-closing covenant may or may not be treated (in whole or in part) as a breach of representations and warranties.

PURPOSE OF THE RESTRICTIONS ON THE CONDUCT OF THE GROUP COMPANIES' BUSINESS SHOULD REMAIN LIMITED TO ENSURE THE PRESERVATION OF THE ECONOMIC VALUE OF THE GROUP COMPANIES DURING THE INTERIM PERIOD BETWEEN SIGNING AND CLOSING

Indeed, the purpose of the restrictions on the conduct of the Group Companies' business should remain limited to ensure the preservation of the economic value of the Group Companies during the interim period between signing and closing. It should never be extended beyond such perfectly legitimate goal, for example to allow the purchaser to directly or indirectly exercise decisive influence over the Group Companies before closing, particularly in the case of transactions between competitors, in which an overly extended list could trigger antitrust issues.

3. Right of information of the purchaser

Between the signing date and the closing date, the purchaser will frequently ask the seller and/or the target to grant it access, on an appropriate confidential basis, to various information and/or data relating to (the conduct of) the Group Companies' business, in order to prepare the takeover of their management from the closing date.

Provided that the level of access requested by the purchaser remains reasonable and is not likely to disturb the normal functioning of the Group Companies, there should be no fundamental reason for the parties not to agree on such information rights.

However, any time a transaction is likely to be subject to any merger concentration control, the parties shall be extremely careful with respect to the transfer of detailed commercially sensitive information concerning the Group Companies, in order to reduce the antitrust risks related to gun-jumping and exchange of competitively sensitive information.

4. Release of seller's guarantees

Any seller must carefully check prior to signing that it did not grant (directly or indirectly, through any of its affiliates or related parties) any form of guarantee (sûretés réelles ou personnelles) for securing the proper performance of all or part of the Group Companies' obligations. If the seller did, it must plan, to the fullest extent possible, for the prior full and irrevocable release of the guarantees or, as applicable, substitution by the purchaser's equivalent guarantees, with effect as of the closing date at the latest.

Conversely, the purchaser must make sure that none of the Group Companies granted any form of guarantee for securing the performance of any obligations of the seller, its affiliates or related persons. If it did, the parties must agree on the manner to organize the full and irrevocable release of the guarantees prior to or during closing. Should, for any specific reason, the parties not be in a position to organize such a release or substitution between signing and closing, they will convert their contemplated pre-closing covenant into a post-closing undertaking, with an appropriate "hold harmless" mechanism until the release or substitution effectively occurs.

5. Repayment of seller's indebtedness

Between signing and closing, the parties will also usually agree to organize (a) the reimbursement of any amount due by any of the Group Companies to the seller, an affiliate of the seller or a related party of the seller respectively, prior to closing; and (b) the reimbursement of any amount due from the seller, an affiliate of the seller or a related party of the seller prior to the same date. Such obligation of repayment of indebtedness will also be extended, from time to time, to the repayment by the Group Companies of all their financial debts, in which case the pre-closing undertaking will usually instead be aimed at ensuring such repayment is effective on the closing date only.

6. Third-party consent

In many transactions, the purchaser's due diligence reveals that some material agreements entered into by the Group Companies are subject to change of control provisions, i.e., provisions enabling their relevant co-contractors to terminate (or sometimes amend to some extent) their agreements with the Group Companies early in the case of a transfer of all or part of their shares, unless they give their prior written consent.

Typical examples of contracts with change of control provisions include credit facility agreements, loan agreements, discretionary management agreements, exclusive purchase agreements, exclusive distribution agreements, franchising agreements, etc.

In the case of material contracts affected by change of control clauses, two approaches are usually possible: (a) the purchaser makes the obtaining of all or part of these so-called third-party consents a condition precedent to the closing of the sale and purchase of the shares; or (b) the purchaser makes the obtaining of all or part of these so-called third-party consents a pre-closing undertaking of the seller only.

When making the obtaining of third-party consents a pre-closing undertaking, the parties must determine with care the level of legal commitment of the seller to obtain such third-party consent (obligation de moyen or obligation de résultat). They must also determine with the greatest care the sanctions that would apply in the event the seller is not in a position to deliver all the required third-party consents upon closing: reduction of the purchase price, indemnification obligation or termination right for the purchaser (whether or not subject to a materiality threshold).

7. Information to the personnel

Under Luxembourg law, the transfer of all or part of the shares of a company does not trigger any obligation to obtain the prior approval of the (representatives of the) personnel of the relevant company prior to the completion of the contemplated transfer. However, the (representatives of the) personnel should be informed and consulted in some specific circumstances; [3] this is usually done between signing and closing.

In the case of a transfer of business (transfert d'entreprise), the representatives of the personnel, if any, or in the absence thereof, the personnel shall be informed in a timely manner and prior to closing. The information must be provided both by the seller and the purchaser and include information on the date of the transfer, the reason for the transfer, the legal/economic/social consequences of the transfer for the employees and any measures planned for the personnel. If measures are planned, the seller and the purchaser shall consult the representatives of the personnel in order to reach an agreement.

However, in the case of acquisition of an international group of companies, the parties must be careful to ensure that there are no more stringent rules under the relevant applicable foreign laws, such as, for example, the Loi Hamon in France.

8. Notification of breach of the seller's representations and warranties

Finally, if at any time the seller agreed to repeat its representations and warranties on the closing date, the seller will usually have a correlative obligation to notify the purchaser of any breach of the seller's representations and warranties between signing and closing in order to enable the purchaser either to terminate the agreement prior to closing (if it benefits from a walk-away mechanism) or adopt other actions as applicable.

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[3] For example, when the contemplated transaction includes measures that are likely to affect the structure of the business or the level of employment within the business operated by the Luxembourg target(s).