Hogan Lovells

Distressed M&A in the Corona crisis III – Performance option of the insolvency administrator – (No) risk for M&A transactions?

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The Corona crisis has recently brought M&A activity almost to a standstill. With our series of articles 'Distressed M&A in the Corona Crisis' we aim to promote further M&A activity. The crisis only changes the rules of the game - and we take a closer look at these changed rules.

If the seller falls into insolvency after the completion of the M&A transaction, the transaction may be jeopardized for various reasons under insolvency law. In case the transaction has not yet been completed by the parties in full with regard to the mutual performance claims, the insolvency administrator has the right to opt for performance in accordance with § 103 InsO. In this article of our series, we analyse the risks for the transaction resulting from such performance option and elaborate on how these risks can be mitigated.

Even if the parties have fulfilled the performance claims, further risks result from the insolvency of seller; in particular due to cancellation rights under insolvency law and due to the default of the seller as debtor for guarantee or indemnity claims. We will publish further articles on these topics in this series shortly.

The insolvency administrator's performance option pursuant to § 103 InsO

If, at the time of the opening of the insolvency proceedings, a mutual contract is not or not completely fulfilled by the parties with regard to the performance claims or (more significant) secondary obligations, the insolvency administrator has the right pursuant to section 103 InsO to request further fulfilment of the contract or to refuse further performance.

If the insolvency administrator refuses performance, the contract will not be dissolved, but will be 'frozen' in the actual state of mutual performance; the parties are not obliged to fulfil further claims, but can object further performance. The contractor of the insolvent party can only assert claims for non-performance as a creditor in insolvency, which clams are limited to the insolvency quota.

If the insolvency administrator, on the other hand, opts for performance, he establishes binding claims on the insolvency assets which shall be satisfied with priority and in full from the

insolvency assets, for which the insolvency administrator may be personally liable in the event the insolvency assets do not cover all such claims established by the insolvency administrator.

The performance option is particularly critical in several scenarios: On the one hand, the insolvency administrator will always reject further performance if the contractor has made advance payments - then it is advantageous for the insolvency estate if the insolvency administrator does not fulfil the contract at the expense of the insolvency estate and at the same time the contractual partner's claims for non-performance or compensation are subordinated as simple insolvency claims.

If both parties have performed the contract in equal parts (but not in full), or if the insolvency debtor has made advance payments, the insolvency administrator will always examine whether further performance is advantageous or disadvantageous for the insolvency estate and, thus, for the creditors. In these cases, the insolvency administrator will always refuse performance if the performance owed by the contractual partner is not equivalent to the performance rendered by the insolvency debtor. The insolvency administrator will then be entitled to claims under the principle of unjustified enrichment with regard to his 'over-performance' in terms of value, which he will demand in favour of the insolvency estate.

Risks for M&A transactions

For M&A transactions, risks always arise from the performance option if the transaction is not completely fulfilled by the buyer and the seller at the time of the opening of insolvency proceedings. According to the case law of the German Federal Court of Justice (BGH), not only the main performance obligations must be completely fulfilled, but also all secondary obligations, which are not insignificant.

As laid down, the performance option does not trigger a reversal of the yet performed services. The parties are only not obliged to continue performance. Differences in the value of previous services may have to be compensated according to the principle of unjustified enrichment. From the buyer's point of view, the performance option therefore only constitutes a particular risk if the buyer has made an advance payment.

In the M&A context, the completion of a transaction requires various mutual obligations, not all of which are fulfilled as closing actions on the closing date itself, but which are typically fulfilled before or after the closing date.

The performance option exists until all of these obligations are fully performed by both parties.

Seller's purchase price claims are only satisfied when the purchase price has been paid in full. In case the purchase price is calculated as at the closing date with a closing accounts concept and subject to adjustment payments after the closing date, the purchase price is only fulfilled after final settlement and payment of the adjustment amounts. If the purchase price is paid in several tranches or subject to an earn-out mechanism, the purchase price is only settled upon payment of the last tranche respectively the last earn-out payment.

Even customary retention or holdback amounts or escrow deposits to secure the seller's liability for breaches of representations and warranties and indemnities avoid full settlement of the purchase price and allow the insolvency administrator to reject performance until the retention or deposit amount has been settled in full respectively the escrow amount is released.

If the seller transfers the business (shares or assets) on the closing date in turn for the closing payment, remaining purchase price tranches which become payable at a later date (in the form of

further purchase price tranches, earn-outs or retentions) do not constitute a particular risk for the buyer: in the absence of advance performance, the insolvency administrator will opt for further performance (otherwise he would not be entitled to claim payment of the outstanding purchase price tranches). If, however, the closing accounts settlement results in a repayment by the seller: the insolvency administrator could prevent such a repayment by refusing further performance.

Representation and warranty claims and indemnity claims are treated differently. If – as usual – representation and warranties are established as independent claims, no performance claims remain unsettled at closing. The agreement of a customary guarantee regime itself does not allow the insolvency administrator to reject performance of the entire transaction agreement. In case of guarantee breaches, the right to reject performance is thus only relevant when the buyer asserts a guarantee claim. In the event of insolvency of the seller, however, guarantee claims are usually valueless as insolvency claims; the rejection of performance therefore does not represent a considerable additional risk.

The legal assessment with regard to indemnity claims is not finally clear: an indemnity claim is not an independent claim (like a guarantee claim), but a pending claim at closing. The indemnity claim does not require a separate claim notification, which suggests that the performance option can be exercised for the entire contract until all indemnity claims have been finally fulfilled.

Finally, the performance option can also be exercised until the buyer and the seller have fulfilled all further obligations after the actual closing, such as mutual obligations in the context of post-merger integration, transitional services or licensing agreements.

M&A structures to exclude the performance option

In the context of distressed M&A transactions pre-insolvency of the seller, the buyer should avoid making any advance payments. Furthermore, secondary claims should be secured in order to avoid the risk that the insolvency administrator rejects further performance.

With regard to the purchase price, the performance option is excluded if the purchase price is paid in full at closing, as this is usually the case with a locked-box purchase price concept. Also a closing accounts concept is not per se harmful: to avoid that the insolvency administrator evade a reverse adjustment payment to the buyer by rejecting further performance, the buyer should retain a certain portion of the purchase price to secure the potential repayment.

For guarantee claims, the performance option does not constitute a risk for the overall contract; rather, the insolvency administrator can reject a guarantee claim after it has been asserted by refusing performance. However, it is advisable for the buyer to take out a warranty and indemnity insurance (W&I Insurance) to secure warranty claims anyway, since in case of insolvency of the seller warranty claims become valueless insolvency claims - even without refusal of performance.

Indemnity claims also become mere insolvency claims after insolvency of the seller. To secure indemnification claims, retention of a purchase price portion can help the buyer, preventing an 'advance payment' of the buyer on account of the indemnity claims. The refusal of performance would be disadvantageous for the insolvency administrator, as he would also lose claims to payment of (parts of) the purchase price retention after settlement of the secured claims.

Summary

Customary M&A closing provisions often include obligations of the parties beyond the actual closing date. After the insolvency of the seller, the insolvency administrator has the option of

whether he continues to fulfil the sale and purchase agreement or whether he rejects further performance.

However, the refusal of (further) fulfilment only establishes a risk for the buyer if the buyer has made advance payments to the seller or if he has unsecured claims against the seller.

Although purchase price retentions exclude full performance at closing and allow the insolvency administrator to reject performance, they offer effective protection against refusal of performance: refusal of performance would be economically disadvantageous for the insolvency administrator.

Nevertheless, in order to avoid cancellation rights of the insolvency administrator under insolvency law, it may be necessary to pay the purchase price in full upon execution. We shall present strategies for avoiding the cancellation right in another article in this series soon.

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