Impacts of COVID-19 on M&A Transactions

March 20, 2020

Diligence

- Buyers should take this opportunity to conduct up-to-the-minute diligence on target companies, including their customer relationships, supply chains, insurance coverage, ability to operate remotely and the potential for business interruptions during the coming months.

- Buyers should not rely on an outdated quality of earnings report (QofE) to validate the financial health of a target. The most recent month may be more important than the trailing twelve months to evaluate the relevant trends that will show how a target company will weather the current environment.

- Responding to diligence requests and disclosure schedule production will continue to get more burdensome for targets, especially founder-owned businesses, which may not have sufficient human capital to both manage their business through the current storm and adequately respond to buyers and their advisors in order to move deal processes forward.

Representation and Warranty Insurance (RWI)

- The widespread, almost universal use of RWI in U.S. M&A transactions has yet to be tested by a major macroeconomic event, but that time appears to be here.

- Now more than ever, RWI insurers are looking to ensure that buyers are conducting sufficient diligence on target companies – and that their diligence is detailed and recent. The extent to which RWI insurers will be more rigorous in stress testing buyers' diligence will differ greatly from industry to industry, with those that rely on strained supply chains or that are hampered by "social distancing" efforts getting a more strenuous review. That said, all industries are likely to be affected in one way or another, and so COVID-19 will need to be front and center in every buyer's diligence process if they want to continue to rely on RWI.

- Responses from the RWI market as it relates to policy exclusions and areas of heightened risk related to COVID-19 run the gamut from full exclusions of any losses that "result from or are increased by" the COVID-19 virus or any related governmental action (which seems very broad and likely would result in little/no coverage to a buyer) to more targeted, tighter carveouts of identified risks and specific representations.

- When in the market for RWI coverage, buyers should negotiate exclusion language up front and also should evaluate whether there are insurers that will not insist on an exclusion for COVID-19 losses. Insurers will likely still reserve on the ability to impose an exclusion for COVID-19 on a deal-by-deal basis based on the outcome of diligence, but buyers should try to push back against a broad exclusion similar to some of the ones we have seen proposed. We would expect that buyers in some industries may choose to go without RWI and solicit larger escrows from nervous sellers.

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Consideration and Adjustments

- Prior to the COVID-19 crisis, in the ongoing effort to ensure that working capital positions and cash positions are adequately accounted for at closing, many buyers and sellers (especially in deals with a material international component) have recently availed themselves of a "locked box" structure. Under this construct, the buyer conducts diligence on financial statements that may precede the closing date by a number of months, and ultimately "buys" that balance sheet – subject to a locked box (i.e., so long as the company operates in the ordinary course after the locked box date). This construct allows the parties to agree to a pre-closing balance sheet and part ways at closing without the need for a tedious post-closing adjustment to "true up" any cash, debt or working capital discrepancies on the estimated closing date balance sheet.

- In the evolving current environment, we expect buyers to negotiate for a return to the "estimate and true-up" structure of the past, which will allow buyers to take into account fluctuations of working capital and cash up to the closing date. This construct will also allow buyers to apply hindsight in evaluating the closing balance sheet months from now and to make any adjustments that they feel are required by GAAP (e.g., writing off certain A/R).

- In transactions where valuation gaps are bridged by means of earnouts, two of the most heavily negotiated items are operating covenants and subordination provisions.

- Even in the best of times, buyers are hesitant to agree to covenants that restrict their ability to operate a newly acquired company during an earnout measurement period. This is primarily due to the fact that when a company misses an earnout threshold, a seller can point to a breached buyer covenant as an explanation and seek full payment. Sellers – on the other hand – want to ensure that buyers do not operate companies so as to deprive them of their earnout, especially where earnouts are based on more malleable measures such as EBITDA (as opposed to top line revenue). In this environment it is likely that more and more earnouts will be missed and thus the negotiations around these covenants will be a key consideration in each and every agreement containing an earnout.

- Financial buyers quite often seek to subordinate earnouts to their senior debt. In good times, sellers may not bat an eye, but in the emerging market, these provisions will need to be addressed head-on to ensure that buyers can comply with covenants in senior credit documents, while sellers are reasonably assured that they will see their earnout.

Leverage

- In acquisitions or sales requiring Hart-Scott-Rodino (HSR), Committee on Foreign Investment in the United States (CFIUS) or other approvals prior to closing, buyers should resist stand-alone minimum EBITDA conditions or maximum leverage conditions in debt commitment letters. While it has yet to be seen how material adverse effect (MAE) clauses will be applied and interpreted in purchase agreements (see below) and whether parties will rely on them as justification to walk away from deals, the inclusion of bright-line conditions to funding like minimum EBITDA and maximum leverage would give lenders very clear contractual outs if they decide they do not want to fund.

- For add-on acquisitions and other investments by companies within a sponsor's portfolio, we are seeing borrowers with dedicated delayed-draw term loans and revolving facilities having more success in getting access to liquidity to fund deals. Given the uncommitted nature of accordion facilities and the related incurrence tests which must be met to tap into these funds, we anticipate it will be tougher for borrowers to complete debt-financed accretive acquisitions as debt markets tighten over time.

- We are anticipating that lenders will conduct more rigorous diligence processes in this climate extending beyond the perfection of the borrower's collateral but also taking a deeper dive into supply-chain risks and exposure to instability in foreign markets. We also anticipate seeing covenant-lite structures begin to fall away and some retrenchment on lenders agreeing to uncapped add-backs (e.g., run rate synergies, non-recurring extraordinary items, and other similar items).

Timing

- Buyers should negotiate for a simultaneous sign-and-close where possible so that the risk remains with the sellers for as long as possible. This will mean negotiating to extend exclusivity with sellers through the closing date rather than a potentially earlier signing date.

- In deals in unregulated industries, the longest timing concern is often the HSR filing. In the current climate the FTC is not granting early termination for any transactions. Until that changes, parties need to assume the HSR waiting period will run the full 30 days whenever an HSR filing is required.

- An HSR filing is not always required, even in cases where enterprise value exceeds $94 million. One example is where the buyer is a new fund making its first acquisition. Another is where the sellers are retaining their rollover equity in the same entity they own already, and the buyer is purchasing less than $94 million. Buyers and sellers should work with counsel to explore whether the particular transaction structure under discussion would or would not require an HSR filing.

- Parties should keep in mind, of course, that the antitrust laws apply to all transactions – whether an HSR filing is required or not.

- If an HSR filing is required or there are material third party consents that would – in normal times – require the parties to structure a transaction as a staggered sign-then-close, buyers can try to leverage current market conditions to conduct these processes before a definitive agreement is signed. This will require both that the buyer will sink more costs into a deal (e.g., HSR filing fees paid prior to signing) and that the seller will take more market risk (e.g., longer time to close, reaching out for third party consents prior to signing) prior to a deal signing.

Interim Covenants

- If a simultaneous sign-and-close is not workable, for whatever reason, there are a number of issues that buyers and sellers will need to grapple with in structuring the interim period between signing and closing.

- Even in the best of times, deciding what constraints to put on a company's operations while still under the sellers' ownership can be fraught with detail-laden considerations. With the current market fluctuations and uncertainty, these considerations are placed under a magnifying glass – as sellers crave deal certainty and buyers will look for the opportunity to exit a deal if the target's business sours. Interim covenants that require buyer's consent prior to incurrence of indebtedness, handling of employment matters, entry into material contracts, etc. will require detailed negotiation/consideration, especially as sellers seek to react quickly to the changing environment and will not want to have to seek consent at each turn (especially if buyers have a right to walk away – see below).

MAE Definitions

- Prior to the onset of the COVID-19 pandemic, the definition of "MAE" or "Material Adverse Effect" sometimes contained exclusions for epidemic/pandemic diseases, but for the most part, they did not. Therefore, it is possible that in some instances buyers could argue for an "out" in purchase agreements signed prior to the past week.

- Sellers signing purchase agreements in the COVID-19 world will want to ensure that COVID-19 related effects are specifically excluded from the definition of MAE and that the presence of the virus and disease (and government responses) would not allow a reticent buyer to pull the plug on a transaction. Buyers, on the other hand, should insist on MAE language that takes COVID-19 into account to the extent that COVID-19 disproportionately affects the target's business as compared to other businesses in the target's industry. This will allow a company-specific (rather than industry-specific) effect to be captured and to allow a buyer to walk away.

- Note that Delaware courts have only found an MAE to exist once in the recent past (*Akorn, Inc. v. Fresenius Kabi AG*). In that decision, the court expressed that an MAE would only be found if the impact was of a long-term – rather than a short-term – nature. It remains unclear how the court's position will play out in the COVID-19 context, so it is up to the parties to negotiate meaningful MAE provisions.

FOR MORE INFORMATION

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