

Planning for and Negotiating Mergers & Acquisitions In Light of COVID-19

Whether your company is at the outset of exploring a potential M&A transaction or in the days leading up to closing the deal, the ongoing COVID-19 pandemic has introduced unprecedented levels of uncertainty into transactions for sellers and acquirors alike. This alert highlights potential considerations for sellers and acquirors in M&A transactions as a result of COVID-19.

Transaction Consideration

At the outset, acquirors will need to carefully consider how they will structure M&A consideration in upcoming transactions. Acquirors may find that cash that would have been available for acquisitions will need to be preserved for their own operations and existing obligations, while also potentially facing difficulty in obtaining financing. In addition, public companies may be facing increased volatility in their stock price. In pending transactions, acquirors should review the transaction agreement to confirm that they are, and will remain, in compliance with any representations or warranties to sellers and/or target companies regarding the sources of financing for the transaction consideration.

Earn-Outs will allow transaction parties to defer a portion of transaction consideration. Still these mechanisms will shift more of the risk on valuation to sellers while it remains uncertain how long the economic impact of COVID-19 will continue.

Enhanced Due Diligence

Sellers should prepare to face enhanced due diligence that takes into account the potential effects of COVID-19 on their business and its ongoing liabilities and obligations. This review should include an analysis of the impacts on capital and operating expenses, loan and credit facilities, financial forecasts and budgets, vendors and supply chains, customers, workforce matters, and business insurance coverage, among others. Insufficient responses to these questions may drive reductions in transaction consideration or acquiror requests for special holdbacks, escrows, and indemnities. In addition, sellers and acquirors alike will need to prepare for due diligence processes that are performed entirely virtually and across distributed teams.



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Allocating Risk & Indemnification

COVID-19 is highlighting new and shifting risks for businesses in many industries and sectors. As a result, acquirors may seek to address these risks by negotiating additional representations & warranties, increased escrows and holdbacks of transaction consideration, and additional indemnification. Sellers should seek to make these provisions as narrow and specific as possible.

Material Adverse Changes & Effects

For parties in the midst of negotiating a transaction or with signed transaction agreements where closing is pending, the wording of “material adverse effect” or “material adverse change” provisions (commonly referred to as “MAE” or “MAC” provisions) will be critical. Such provisions allow the acquiror to decline to consummate the transaction if the target company has experienced a material adverse effect on, or change in, its operations during the period since the signing of the transaction agreement and prior to the closing.

MAE/MAC provisions are often subject to numerous (and intensely negotiated) exceptions and carve-outs. Common exclusions include general changes in economic or political conditions, changes that affect an industry generally, changes in laws or accounting principles, military actions, acts of terrorism, natural disasters, or other acts of god or calamity.

Acquirors are held to a high standard in showing that a MAE/MAC has occurred with respect to a target company. For example, the Delaware chancery court recently held that such a change must threaten the overall earnings of the target in a manner that has long-term significance. At this time, it’s difficult to know if the impacts of COVID-19 will meet such a standard.

As a result, whether the impacts of COVID-19 on a business rise to the level of a MAE/MAC will depend entirely on the specific language of the transaction document, as well as the duration of the pandemic itself. Parties currently negotiating transactions may wish to expressly state whether changes related to COVID-19 will be included or excluded as a MAC/MAE.

Pre-Closing Covenants

Many M&A agreements contain interim operating covenants that impact how the target company runs its business in the period between signing and closing. These covenants may be affirmative obligations, such as conducting business in the ordinary course and retaining the company’s workforce, or negative obligations, such as not making material changes to the company’s equity structure or incurring indebtedness.

In the coming weeks and months, sellers may find that the “ordinary course” of business is not feasible, and should negotiate these covenants carefully in light of COVID-19, and parties to existing transactions should review existing covenants to determine any potential issues with ongoing compliance or breaches that may have already occurred.

Closing Conditions

Similar to pre-closing covenants, parties should review and evaluate closing conditions in light of COVID-19 to assess whether specific conditions may be subject to delays, or become impracticable or impossible to satisfy. For example, a common closing condition is the receipt of necessary governmental approvals. However, due to shelter-in-place orders and other demands and constraints on government resources,

government approvals may be delayed depending on the agencies involved.

Many transaction agreements provide “outside” closing dates, after which one or more parties can terminate the agreement and decide to walk away from the transaction. Parties should review and discuss possible extensions to these outside closing dates now.

Conclusion

COVID-19 will introduce further uncertainty and complexity into the negotiation and closing of M&A transactions. Acquirors and sellers should work closely with their transaction counsel to navigate the negotiation of deal terms and possible amendments in light of the ongoing pandemic.

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