

CLIENT ALERT

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MERGERS & ACQUISITIONS

M&A PRACTICES IN A POST-COVID-19 WORLD

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This is certainly a situation where the (purportedly) ancient curse would seem to apply: May you live in interesting times. Living, however, implies moving forward, and that is what the business world is trying to do. While we as a Firm have seen several current acquisition or disposition transactions slow down, we have not seen any abandoned yet. In fact, we have clients who are witnessing the upheavals of the last few weeks and seeing opportunity.

We should, therefore, see whether we need to be doing anything different in our documents and practices to respond to the COVID-19 pandemic and its effects. Here are a few topics that deserve a fresh look.

Deferring Purchase Price Payments

Enterprise value is typically based on some measure of the target company's revenues or earnings, or some combination thereof. Factoring in the long-term and short-term impact of the pandemic on such measuring sticks is virtually impossible at the present time. Transaction parties may want to consider some sort of post-closing calculation and payment arrangement for a portion of the purchase price. For example, an earn-out will enable the buyer to condition certain purchase price payments on the target achieving certain post-closing performance metrics, while encouraging the seller to meet those goals.

Material Adverse Change Definitions

Most purchase agreements have a concept of (and often a definition for) a material adverse change or material adverse effect. This describes a situation where either a seller is representing that something is true but doesn't have a material adverse effect on the seller or the business being sold, or sometimes is even used as a closing condition so that a buyer need not complete the transaction if there has been a material adverse change to the target business. Without getting into detail, there are often exceptions in these definitions which exclude certain events from being categorized as triggering a material adverse effect. We anticipate that sellers will want to exclude not just effects arising from the current coronavirus situation, but more generally exclude the effects of pandemics or other general public health events. Buyers may bow to the inevitability of accepting this as an unforeseen situation, while trying to limit it to truly general events affecting the economy as a whole, and which don't have a disproportionate effect on the target.

Representations and Warranties

Buyers and sellers generally provide representations to each other about the current state of their business situation. Buyers want promises regarding the seller's business and to learn what the seller knows that may not be evident from its own due diligence inquiries. From the seller's side, it will want to accurately describe the current situation, but allow for changes that might be outside of its control. In both circumstances, we should review several of the standard representations to see if they should be updated.

For example, sellers are generally asked to describe their relationships with customers and suppliers, perhaps with respect to having received notice regarding terminating a contract or reducing contracted volumes.

Buyers may start asking sellers for assurance regarding whether any of their customers or suppliers have issued notices claiming force majeure or otherwise delaying or threatening to delay their performance. Arguably, this may have been covered under the prior language, but we might anticipate as sellers, or initiate as buyers, having language more specifically addressing these issues "in an abundance of caution."

It is easy to imagine other provisions that might be affected. Representations regarding employees, compliance with laws, taxes, accuracy of financial statements, undisclosed liabilities, and probably others deserve a second look under the current circumstances.

Operating the Business Pending Closing

Many deals are structured as sign-and-close transactions, meaning that the purchase agreement is signed and the deal closes simultaneously. However, in deals which include a period between signing and closing, buyers generally want to restrict how the seller will operate the business during that interim period. Sellers often commit to continue operating the target business in the ordinary course, consistent with past practices, maintaining good relationships with their employees, customers, suppliers, and other business associates, and preserving their business structure, property, equipment, and so forth. How can a seller observe its commitments if it suddenly, under governmental order, has to close down its operations, curtail its sales, and lay off its employees? We expect it is essential for sellers to be given exceptions in these covenants that allow them to respond to unanticipated events without triggering a breach of these covenants.

Deal Timing

We certainly expect that transaction timing, like many matters, is going to get stretched during this immediate period. It remains to be seen how long this will last, but it is probably worth anticipating that it will take longer to get customer consents, bank approvals, landlord approvals, governmental approvals, UCC searches, environmental reviews, surveys, and just about anything else needed to complete a deal for the foreseeable future. Even a buyer's internal approval process could be impaired. Thus, take a look at any deadline requirements in light of the current situation and adjust them accordingly. Even when initiating a deal, consider whether it would be good to obtain a longer exclusivity period to allow for unanticipated stumbling blocks. Yes, deadlines can always be amended or waived, but providing for a realistic time frame can help keep everyone's attention on the substance of the deal, and not be distracted by watching the calendar.

Representation and Warranty Insurance

Representation and warranty insurance has become, if not standard, at least an accepted part of the M&A landscape. In our experience, that is not likely to change going forward. What may very well change is some of the coverage provided by these policies, and certainly some of the information required in the policy applications. We are hearing reports that exclusions are being added to policies with respect to COVID-19 effects as they are "known issues" that the insureds are able to assess for themselves, but that these exclusions are subject to negotiation. Different insurers are taking different approaches and evidencing different levels of flexibility on these issues, so it might be worthwhile to do a little more shopping around. Suffice it to say that the whole area is in flux, and an insurer's approach today may be dramatically different a week later.

Due Diligence

Certainly coming out of the changes in representations, covenants, and R&W insurance, buyers should do a deep dive into their due diligence questionnaires. Obvious topics include the anticipated effects on a target's business operations, employees, and facilities from any shutdown orders, as well as availability of business interruption insurance coverage and stopgap health and disability coverage for the target's employees and welfare plans. Second level inquiries might focus on what the seller has learned from its suppliers and customers, and examine other supply chain risks. Has the target experienced logistical difficulties? Has it updated its business plan? How are its IT systems coping? Has it experienced recent layoffs, and does it anticipate that these will be temporary? How is it keeping employees safe, and have any employees questioned that process? The topics are almost limitless.

Sellers should anticipate the needs of the buyer (and related lenders, R&W insurers, etc.) and preemptively gather the appropriate information/data that will be requested. While it has always been the case that a well-prepared seller improves the chances that a deal will close, that is especially true in today's environment.

Conclusion

These are interesting times, indeed. It remains to be seen whether this is a minor disruption or one that will have lasting effects on our world, and on our transaction processes. We anticipate many of these provisions on pandemics, like references to "terrorist events" after 9/11, will become part of the boilerplate language in most situations. It is in our job descriptions to consider risks, and help our clients pragmatically respond to and evaluate them. It is not in our nature to shy away from these challenges, and, in that case, perhaps being interesting can also be inspiring.

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