Evolving Private Company M&A Considerations in the COVID-19 Era

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Introduction

The virus that causes COVID-19 has ushered in unprecedented times for our country and our global community. Certainly, the pandemic is impacting the way M&A transactions are looked at, papered, implemented, and even priced. This article identifies some of the higher-level, pandemic-related considerations evolving in the private company M&A world.

Legal Due Diligence

The typical buyer-side legal diligence checklist casts a broad net to bring to the surface legal risks and other potential concerns with the target business. Even with its breadth, the standard legal diligence checklist may need pandemic-specific questions, including those focusing on: force majeure clauses; supply-chain disruptions; employee accommodations; safe working environments; whistleblower claims relating to COVID-19; on-site contagion risk management; business continuity and disaster recovery plans; classification of business services as "essential"; CARES Act loans, credits, and the like; and analysis of relevant insurance coverage.

Target Representations and Warranties (Reps)

Many target reps customarily seen in an M&A agreement may need expansion to cover pandemic-related matters, and at the same time, those matters may warrant broader inclusion in the target's disclosure schedules. The reps most likely to warrant specific pandemic consideration would be those covering the topics as noted above, likely including reps as to operation in the ordinary course and absence of a material adverse effect or change; compliance with laws; labor and employment matters; financial statements; and no undisclosed liabilities.

Earnouts

Earnouts are often helpful in bridging a "valuation gap" as between buyer and seller. A valuation gap is more likely to occur when the target is facing economic uncertainty, such as the impact of the COVID-19 pandemic. At the same time, earnouts bring their own uncertainty and may "kick the can down the road" and simply defer a "miss" in agreement as to pricing. Careful, precise language is critical so that the earnout—itself a tool for hedging against uncertainties—functions properly and as the parties intended, without bringing undue risks of disputes into the post-closing business venture.

Disclosure Schedules and Their Updating

Disclosure schedules provide fact-specific disclosures (or exceptions to specific statements) relating to a target's reps. As such, they impact the scope of responsibility for those reps. The COVID-19 pandemic has underscored this aspect of M&A practice. Targets are seeking to disclose to buyers more pandemic-related matters and consequences—past, present, and future—on their disclosure schedules.

For transactions in which an M&A purchase agreement has been signed but has not yet closed, sellers are looking to their purchase agreements to see how the topic of disclosure schedule updating is addressed. The parties have a wide range of alternatives they can use to address disclosure schedule updating within a purchase agreement. These in turn raise deal points as to what can or must be disclosed and the effect of those updated disclosures on the buyer's termination and pre- or post-closing indemnification rights.

Renegotiating LOI Terms

There may well be a "gap period" between when a normal, "nonbinding" letter of intent (LOI) is signed and a binding purchase agreement is entered into (either prior to or simultaneously with the deal closing). Even if nonbinding, typical M&A LOIs will set forth expectations on key deal points such as price, closing conditions, and the like. During that post-LOI period, sellers may experience pandemic-related impacts on operations that may decrease cash flow, revenues, and other metrics involved in the sale. Buyers may find that their expectations for cash flow, revenues, and the other metrics may be significantly depressed as they approach a binding commitment on terms. As a result, the parties may need to adjust the LOI terms.

It is important to spell out in an LOI what metrics may be subject to adjustment and when. This is important even if the LOI is nonbinding; even in that context, parties normally expect that key terms in the LOI will be honored absent unexpected circumstances or facts, and if nothing else, clarity as to whether the parties can revisit key terms will only help the deal dynamic should those discussions become necessary.

Net Working Capital Adjustments

Most purchase price adjustments (apart from those relating to indebtedness, cash, and transaction expenses) are based on net working capital of the target—specifically, the difference between net working capital at closing and a previously agreed-upon target level. This target working capital is usually intended to reflect a "representative" or "normalized" level of working capital for the business. However, this may be difficult to ascertain as a target level in light of the rate and extent to which the pandemic has impacted business conditions. Parties might consider a mechanism for adjusting the target working capital level between signing and closing if the original level becomes, with the benefit of knowledge learned through additional time, painfully optimistic.

Standalone Indemnities

The effect of the pandemic on a target's preclosing business is potentially the "type" of topic or matter that a buyer might conclude should not be "its problem." Buyers may reason that their deal pricing and modeling did not take into account pandemic-related economic risk, at least through closing. They may view pandemic issues, and their impact on the target business, as one of those "toxic" categories of risks that they consider to be "on the seller's watch." The scope of target reps on these matters is an important mechanism for risk allocation.

If the parties agree that all or some pandemic-related impact on the target business should be borne by the seller, a standalone indemnity—a mechanism already commonly used in M&A agreements for unusual or toxic risks—may, alongside target reps, be an important part of the overall structural solution.

MAC Provisions

"Material adverse impact" or "material adverse change" provisions (referred to together as MAC provisions or clauses) are commonly seen within M&A agreements and serve three purposes: (1) as the subject of an affirmative target rep (i.e., that since a certain date there has been no MAC); (2) as a qualifier and limitation to one or more other target reps (e.g., that the target business has qualified to do business in all applicable states except where the failure to qualify would not have a MAC); and (3) to provide a termination right to the buyer after signing but prior to closing, giving the buyer a right to walk away if a MAC occurs in the intervening period.

Under a plain reading of typical contemporary MAC provisions, the COVID-19 pandemic is likely to fall within one of the more common "causal exceptions" to a MAC, such as those for general economic conditions, acts of God, or natural disasters. It is possible that a particular set of pandemic-related circumstances may nonetheless fall within a customary "disproportionate effects" exception to the exclusion (thereby making it a MAC), though this will likely be an uphill battle as well because disproportionality is usually measured by reference to comparable businesses within the same industry.

Notwithstanding the likelihood that existing, best-practices MAC provisions will normally exclude pandemic-related consequences from coverage, parties are beginning to include MAC language that does so more expressly and

affirmatively, either through a specific exclusion from a MAC definition for the COVID-19 pandemic and its effects, or within disclosures to MAC-related representations and warranties. At the same time, given present economic volatility, buyers may seek to include the pandemic as a MAC event for purposes of providing a termination right if pandemic-related consequences become materially worse (or to include a pandemic-specific termination right). Target companies and sellers will, of course, resist these efforts.

Other Purchase Agreement Provisions

Invariably, other provisions of a typical M&A purchase agreement must be re-examined in light of the COVID-19 pandemic. These could include provisions relating to outside closing dates (should outside closing dates be extended in the event of pandemic-related delays beyond the parties' control, e.g., if third-party consents, confirmatory diligence visits, or government approvals are not forthcoming as quickly as would normally be the case); interim operating covenants (which may need refinement to reflect pandemic-related realities on the ground); and choice-of-law provisions (given that some states will have more established case law than others as to certain M&A topics of heightened post-pandemic relevance).

PPP Loans

Loans to a target company under the CARES Act through its paycheck protection program (PPP) also warrant specific attention as part of an M&A transaction. The parties will need to consider whether the transaction will alter the target's eligibility as a PPP borrower (or applicant), whether prior to or after the closing or even the execution of a definitive purchase agreement, and whether approval of the U.S. Small Business Administration (SBA) is needed in connection with the acquisition of the target with outstanding PPP loans.

RWI Insurance

The use of representation and warranty insurance (RWI) in M&A transactions has exploded over the past 10+ years. As a general matter, RWI will cover unknown risks that trigger a breach of a target rep. Specified, known risks are routinely excluded, such as those disclosed within the target's disclosure schedules, known industry risks, and the like. The COVID-19 pandemic now is, of course, a well-known matter. Accordingly, RWI underwriters are expressly including pandemic-related exposures and losses as known risks outside of the scope of a normal RWI policy. Insurers might also consider "reading in" an express pandemic exclusion to a MAC definition and/or carving out from coverage any target reps that are specifically related to COVID-19. Of course, all of this is happening in real-time in response to fast-changing circumstances on the ground.

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