COVID-19 Considerations In Private Company M&A Transactions

March 26, 2020

Introduction

The COVID-19 virus has ushered in unprecedented and challenging times for our country and our global community. From the deeply personal pain and suffering caused by the virus as a health pandemic to behavioral adjustments in the consumer population at large ("social distancing," etc.) to the everyday, but very real, burdens created by business closures and shelter in place orders, the full force and impact of the virus on our society won't be known for a long time. Apart from these personal and social consequences, of course, the economic downturn is almost certainly just beginning to be seen.

And yet businesses move forward, even in a very different and challenging environment. Businesses now confront practical, real-world decisions with economic and human impact. How do I keep my workforce safe? How do I run my business without travel or face-to-face meetings? How do I deal with current contracts that I know my business can't perform? Do I have any rights for rent abatement under my leases? Is my business exempt from government closures as an essential business?

Private companies that are acquisitive, or in the midst of an M&A transaction or series of transactions, may find opportunities within the universe of challenges. Certainly, the COVID-19 virus is impacting the way M&A transactions are being looked at, papered, and implemented. This article identifies some of the higher level COVID-related considerations in the private company M&A world.

Legal Due Diligence

The typical buyer-side legal diligence checklist deliberately casts a broad net to ensure that it will drive to the surface, in its responses and follow-up, legal risks and issues with the target business. That said, even with its breadth, the standard legal diligence checklist will likely benefit from a COVID-specific supplement or set of questions. The questions, of course, should be tailored to the particular target and its industry, but amongst the sector-neutral diligence questions we're seeing are the following (using the term "Company" to refer to the target business being acquired):

1. Has the Company issued or received *force majeure* notices to excuse non-performance of contractual obligations due to business interruptions or losses caused by the COVID-19 virus? If so, please provide a brief description and any relevant documentation.
2. Does the Company have knowledge of, or has the Company any received notices of: any actual or threatened breach or default; any requirement to notify or obtain consent or a

permit from any other person; any termination, modification or acceleration; or any lien on properties or assets - in each case arising under any agreements or permits due to business interruptions or losses caused by the COVID-19 virus? If so, please provide a brief description and any relevant documentation.

3. Please describe any supply chain disruptions or delays relating to COVID-19.
4. Please provide a brief description of any accommodations the Company has made for employees or independent contractors, including any policies regarding working remotely in compliance with the CDC and other public health protocols and guidelines regarding the COVID-19 virus.
5. Has the Company received any complaints or claims for failing to provide a safe working environment or accommodation in relation to the COVID-19 virus? If so, please provide a brief description and any relevant documentation.
6. Is the Company required to develop a hazard assessment or other program under OSHA or analogous laws related to the COVID-19 virus? If so, please provide a summary.
7. Please summarize any Company plans and policies, current and anticipated, concerning employee absences, or reductions in workforce, relating to the COVID-19 virus, including any related analysis under the Family Medical Leave Act, the Americans with Disability Act, or otherwise.
8. Please summarize any workers' compensation claims relating to the COVID-19 virus made to date.
9. Has the Company experienced any employee refusals to work (or "whistleblower complaints") due to workplace danger beliefs relating to the COVID-19 virus?
10. Please provide a summary of any stress testing the Company has done with respect to its IT systems and cybersecurity functions to allow or require employees to work remotely and/or to protect against COVID-19-related hacking or fraud attempts.
11. Do Company benefit plans (including but not limited to health, dental and disability) allow extended coverage for employees on furlough? If so, please provide details.
12. Do the Company deferred compensation plans allow cancellation of deferrals and/or unscheduled distributions due to COVID-19? If so, please provide details.
13. Has the Company delayed or accelerated any deferred compensation payments due to COVID-19? If so, please provide details.
14. Has the Company taken any actions to cancel or reprice equity awards due to changes in value due to COVID-19? If so, please provide details.
15. Has the Company developed guidelines as to what questions and information can and cannot be asked and requested of employees concerning health-related aspects of the COVID-19 virus? If so, please provide a copy of those guidelines.

16. Please provide any Business Continuity Plans (BCPs) or Disaster Recovery Plans (DRPs) that the Company has in place with a summary of how and to what extent those BCPs or DRPs have been implanted or triggered in connection with the COVID-19 virus.*
17. Have any aspects of the Company's business operations been deemed "essential" or otherwise exempt from government-ordered closures or other actions?
18. Please summarize any plans and policies to protect third party entrants (customers, suppliers or others) from health risks at the Company's location(s), including those relating to cleaning, sanitation, social distancing, and the like.
19. Identify any provisions under existing real estate lease(s) relating to timing, deferral or abatement of lease payments (or other obligations) or to lease termination or deferral, triggered by the COVID-19 virus.
20. Please confirm whether any claims have been made or are intended to be made to the Company's landlord(s) with respect to rent or other relief under the Company's real estate leases, including those relating to claims of breach of quiet enjoyment, interruption of service, impossibility of performance, frustration of purpose or otherwise.
21. Does the Company have knowledge, or has the Company received notices, of any plans by the landlord(s) under the Company's real estate lease(s) to change landlord services or other practices at the leased location(s) as a result of the COVID-19 virus (including as to common area maintenance, tenant improvements, hours of operations, visitor/customer limitations or otherwise)?
22. Please confirm whether any claims have been made or are intended to be made to the Company's insurance providers due to the COVID-19 virus.
23. Has the Company assessed potential coverage under its insurance policies for losses relating to the COVID-19 virus, including under any such policies (as applicable) for: business interruption; supply chain disruption; civil authority matters; first-party property damage; event cancellation; other liabilities (CGL, D&O, and E&O); or specialized policies or coverage extensions? If so please provide summaries of any such assessment.

M&A Agreement Provisions

COVID-19 and its consequences are resulting in changes to, and/or disclosures against, various provisions typically included within an M&A agreement, including the following:

- ***MAC Provisions***. Notwithstanding the practical likelihood that existing, best practices "material adverse impact" or "material adverse change" provisions (referred to together as "MAC" provisions or clauses) will normally exclude COVID-19 consequences from coverage, as discussed below, we are already starting to see MAC language do so expressly and affirmatively - - either through a specific exclusion from a MAC definition for COVID-19 and its effects or within disclosures to MAC-related representations and warranties. At the same time, given the unprecedented volatility in the economy, buyers may seek push to include COVID-19 as a MAC event for purposes of providing it a termination right if COVID-19

consequences get materially worse (or to include a COVID-specific termination right). Target companies will, of course, resist these efforts.

- ***Target Representations and Warranties (Reps).*** Many target reps customarily seen in an M&A agreement may need to be expanded to specifically cover recent circumstances relating to COVID-19 - -and either those expanded reps or the pre-COVID reps may need broader exceptions or discussion in the target's disclosure schedule to adequately disclose the virus' impact on the target and its business. These could include the following:

    - ***Reps as to Contingency Plans, Etc.*** These topics are sometimes treated somewhat lightly (relative to other reps, though depending on the target and industry), and may be subsumed and scattered within a variety of disparate target reps. A business' contingency plans, disaster recovery plans, business continuity plans, and other crisis-related protocols have of course become of elevated importance since COVID-19. Accordingly, one can expect to see target reps deal with these issues in more detail and specificity.
    - ***Supplier and Customer Representations***. These target reps might need expansion beyond the normal listing of contract parties along with disclosure of defaults or issues with the business relationships, to include supply chain delays or disruptions; force majeure discussions with suppliers and customers; or whether any material supplier or customer is under government-imposed operational limitations or is otherwise facing known financial duress.
    - ***Operation in the Ordinary Course of Business and Absence of MAC***. These reps will likely warrant additional disclosures as a result of COVID-19; most businesses have not been operated in the ordinary course since its proliferation. Target companies may seek to exclude COVID-19 impacts generally from the definition of "ordinary course of business" (if the agreement includes such a definition), but buyers are likely to prefer more refined and rep-specific disclosures.
    - ***Other Seller-Side Reps***. Any number of other customary seller reps in an M&A agreement may also warrant expansion, and/or additional disclosure by the target, in light of COVID-19. Amongst the most likely of these would be seller reps as to: (i) compliance with laws; (ii) labor and employment matters; (iii) financial statements and no undisclosed liabilities (and financial statement constituent reps re; inventory and accounts receivables); and (iv) IT and tech infrastructure.
- ***Earnouts***. Generally viewed warily by targets and their counsel, and always negotiated heavily in the best of times, the economic volatility wrought by COVID-19 will almost certainly make earnout terms more difficult to draft and agree upon.
- ***Purchase Price 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" level of working capital for the business and is sometimes calculated as the

average level in the prior twelve months or some other period. However, "normalized" working capital may be difficult to ascertain as a target level in light of the rate and extent to which COVID-19 has impacted business conditions. It is conceivable that parties could seek to "carve-out" the virus-related effects on working capital and deal with those separately as a commercial matter. Parties may also consider a mechanism for adjusting the target working capital level between signing and closing if the original target working capital level becomes, with the benefit of knowledge learned through additional time, painfully optimistic.

- ***Outside Closing Dates.*** Should outside closing dates be extended and pushed out in the event of virus-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 be the case in pre-COVID days? These extension rights might be limited appropriately to a party who has previously used commercially reasonable efforts to avoid such a delay. Should the buyer and target have mutual covenants to cooperate in good faith to deal with COVID-19 impacts on the transaction process in a separate manner? Should termination fees kick in at some point? All uncharted waters for sure.
- ***Interim Operating Covenants.*** Similarly, the traditional covenants by the target to operate the subject business in the ordinary course prior to closing may need refinement, tailored to COVID-19 realities on the ground.
- ***Choice of Law Provisions***. Buyers and targets alike will be looking at these provisions through a new lens. Some states do in fact have more established and settled case law than others as to certain M&A topics but, for that very reason, those laws may be resisted by the party lesser favored on those topics.

MAC Provisions: Are They Triggered in Current Agreements?

MAC provisions are clauses commonly seen within M&A agreements and usually 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) to be 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.

As a practical matter, currently, the typical MAC clause is unlikely to provide a buyer with an easy "out" from the agreement due to post-signing, pre-closing stresses resulting from the COVID-19 virus.

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

Generally, courts impose a high burden on a party seeking to invoke a MAC clause, applying a fact-based inquiry to determine if the circumstances at issue had a meaningful, long-term impact on the

financial well-being of the target company. As explained in an oft-cited Delaware case from 2018, the event must "substantially threaten" the earning potential of the business in a "durationally significant manner."[3] Courts will tend to view M&A transactions as reflecting long-term business investments where the buyer assumes the risk of general economic trends and developments when entering into the agreement - - unless, of course, the M&A agreement specifies with clarity that the parties have decided otherwise.

RWI Insurance

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

[1] Daniel Avery is a Director in the corporate law and M&A practice at Goulston & Storrs, P.C., resident in the firm's D.C. and Boston offices. Mr. Avery is a member of the American Bar Association's working group which publishes the ABA's Private Target M&A Deal Points Study every two years (the "ABA Study") and is the author of a 25-article series on M&A deal point trends published with Bloomberg Law. These articles are currently being updated to reflect the 2019 ABA Study and can be found at https://www.goulstonstorrs.com/whats-market-blog/

[2] For example, a COVID-19 legal diligence supplement will appropriately focus on different topics if the target is, on the one hand, a business in the retail sector, as opposed to, on the other hand, a health care provider.

[3] *Akorn, Inc., v. Fresenius Kabi AG, et al.,* C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018), at page 130 (*quoting In Re IPB Shareholders Litigation*, 789 A.2d 14, 68 (2001)("[The] provision is best read as a backstop protecting the acquirer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquirer").