

Client Alert

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Coronavirus/COVID-19: Considerations for M&A Transactions

The current outbreak of respiratory disease, named “Coronavirus Disease 2019” (COVID-19), caused by the novel coronavirus has now been detected in more than 60 locations worldwide, including hundreds of cases in the United States. The coronavirus has demonstrated the capability to spread rapidly, leading to major short- and long-term implications for public and private companies facing potentially significant supply chain disruptions, store and office closures, reduced consumer spending and other commercial and logistical issues. These issues, and the travel restrictions, market volatility and general uncertainty caused by the COVID-19 outbreak, have had, and will continue to have, an impact on M&A transactions worldwide, even on transactions without a direct nexus to China or other countries most severely affected by COVID-19. As the ongoing outbreak intensifies, many of our clients are reaching out to us for advice on how they can manage their M&A transactions in light of the economic, commercial and practical implications arising from this rapidly evolving situation.

While the human impact of COVID-19 is significant and not to be minimized, this article focuses on some of the considerations that buyers and sellers should proactively consider in the context of an M&A transaction in a post-outbreak world.

Pre-Signing Considerations

Valuation

Achieving alignment on valuation is challenging enough for buyers and sellers during times of relative stability. The market volatility and general uncertainty caused by the COVID-19 outbreak will only increase the likelihood of a meaningful valuation gap. Buyers and sellers alike will have to go through the exercise of identifying, understanding and evaluating the potential short- and long-term impacts of the COVID-19 outbreak on a target company’s business, financial condition, prospects, liquidity, contracts, customers, suppliers and costs. Given the rapidly evolving nature of the outbreak, quantifying these impacts will be challenging and purchase price negotiations may be more prolonged than usual. Many sellers may elect to defer sale processes that were previously contemplated. At the same time, the situation may also create opportunities for some buyers.

Due Diligence – Scope

The deluge of media coverage regarding the outbreak has shined a global spotlight on the risks associated with the virus. As a result, buyers will understandably focus on the affects of COVID-19 on a target company during the due diligence period. In anticipation of buyer sensitivity, sellers should proactively aggregate information about the current and anticipated impact of the virus on the target company including, where relevant, mitigation efforts and contingency plans, and make that information available to potential buyers early in the due diligence process.

Though quantifying the impacts of the COVID-19 outbreak on a target company will be challenging, buyers should focus their due diligence efforts to understand the following considerations, among others:

- the ability of the target company and its counterparties to perform, pause or terminate their obligations under material contracts;
- any commercial re-negotiations with counterparties under existing material contracts that are underway or suspension or termination rights that have already been exercised;
- local regulatory actions and restrictions applicable to the target company, which will require reviewing existing regulations and staying current on new regulations in real time to ascertain their impact on the target company and its existing contractual commitments;
- the existence and implementation of succession and business continuity plans and crisis management and disaster recovery procedures;
- the implementation of appropriate precautionary measures for employee health and safety, and any resulting regulatory and data privacy implications;
- the necessity, availability and cost of alternative suppliers through the target company's supply chain;
- solvency risk and the target company's ability to service its debt and otherwise comply with covenants under its debt documents;
- existing insurance policies and their coverage, including business interruption policies, and any other available lines of insurance or contractual indemnification, such as insurance issued to counterparties; and
- general exposure of the business to jurisdictions highly impacted by the COVID-19 outbreak.

Due Diligence – Timing

As governments and businesses worldwide impose and expand measures to slow the spread of the virus, including travel restrictions, mandatory quarantines and requiring employees to work remotely, a buyer's due diligence activities will likely be delayed and certain customary practices, such as on-site visits, audits and inspections, may be challenging or impossible to coordinate. While these delays can be mitigated by a seller through the use of virtual data rooms and leveraging third-party advisors and other resources to manage the due diligence process, buyers should prepare themselves to experience a longer-than-usual due diligence period.

Availability of Financing

The uncertainty created by the COVID-19 outbreak will likely impact a buyer's ability to forecast future business performance and a lender's ability to predict market conditions, both of which could affect the availability of acquisition financing and the terms of any new commitments, including borrowing cost, market flex provisions and enhanced diligence requirements. This may result in potential closing delays and decreased certainty of closing for transactions where the buyer requires financing, which will give buyers with available cash on hand an advantage in a competitive sale process and, potentially, the opportunity to acquire the target company at a lower valuation.

Acquisition Agreement Considerations

Adjustments to Purchase Price

For many companies, the traditional adjustments to purchase price, such as net working capital, cash and indebtedness, may be impacted by the COVID-19 outbreak to some degree. For example, it may be more

challenging for the parties to establish the net working capital target, which is often set using an historical average or a similar analysis. Parties should go through the exercise of determining whether any COVID-19-related adjustments should be incorporated into the net working capital calculation (e.g., atypical collection of A/R or payment of A/P, non-recurring penalty payments, etc.). Parties should also consider whether the net working capital target should remain fixed, or be subject to adjustment to account for any unforeseen conditions arising from the COVID-19 outbreak during the period of time between signing and closing.

Representations and Warranties

Buyers may consider requesting representations and warranties regarding the target company's succession and business continuity plans, crisis management and disaster recovery procedures, internal controls monitoring the effects of the virus, undisclosed liabilities relating to the virus, the status of material contracts and performance thereunder, the adequacy of supply chain and inventory, collectability of A/R, ability to pay A/P and other adverse impacts of the virus.

If sellers are amenable to the inclusion of these representations and warranties, they should seek appropriate knowledge and materiality qualifiers, avoid subjective or forward-looking representation and warranties and seek appropriate bring-down standards at closing. Sellers should also attempt to ring-fence their representations and warranties to protect against buyers' having the ability to make COVID-19-related claims across the entire suite of representations and warranties. In addition, sellers should carefully consider the need for COVID-19-related disclosures, being as specific as possible about the impact or potential impact of COVID-19 on the target company, to avoid buyer claims around representations and warranties.

Exclusions in Representations and Warranties Insurance Policies

If buyers or sellers are looking to obtain a representations and warranties insurance policy, note that some insurers have already started to add policy exclusions relating to COVID-19-related losses. Even if such losses are not excluded from the policy, the policy recipient should anticipate that the insurers may consider the COVID-19 outbreak a known, enhanced risk and will expect that the parties have proactively considered and assessed losses that have arisen and those that are likely to arise. If the buyer is obtaining the policy, the insurer will likely test the adequacy of the buyer's and its advisors' legal and financial due diligence investigation into the impact of COVID-19 on the target company.

Interim Operating Covenants

Sellers who agree to operate the target company in the ordinary course of business during the period of time between signing and closing, or otherwise agree that the target company will not undertake specific actions without the buyer's consent during that time, should consider including a carve-out to provide sufficient flexibility for the target company to carry out contingency measures needed to control the impact of the outbreak on its business and employees (e.g., moving to a secondary supplier at a higher cost, temporarily shutting down a facility, not paying certain vendors or accepting delayed collections on A/R, etc.). Sellers should also ensure that the acquisition agreement provides that the buyer has to act reasonably and promptly at all times when considering matters where the buyer's consent is required.

Material Adverse Effect

The market volatility and general uncertainty caused by the COVID-19 outbreak has led to increased focus on the parties' ability to terminate a pending transaction using a material adverse effect (MAE) closing condition. MAE clauses generally allow a buyer to back out of a deal (or, more likely, force parties back to the negotiating table to discuss changes to the purchase price) if there is a material change in the business, operations or financial conditions of the target company.

The particular wording of MAE clauses in pending and future transactions will significantly affect how the risk of adverse developments from the COVID-19 outbreak will be allocated between the buyer and seller. While MAE clauses will often carve out pandemics, epidemics and similar health events from a situation that would otherwise be an MAE, as well as acts of God, natural disasters, changes in economic conditions and similar big picture events, there could be ambiguity in some contracts regarding whether the impact of the COVID-19 outbreak on the target company would be considered an MAE under those clauses. Given the importance of MAE clauses in an acquisition agreement, parties should specifically address the extent to which the negative impact of the COVID-19 outbreak will be factored into whether an MAE has occurred.

Third-Party Approvals/Consents and Termination Dates

Parties should anticipate that governmental and regulatory approvals and other change of control approvals or third-party consents could take longer than normal in the jurisdictions affected by the COVID-19 outbreak due to staffing shortages, office closures and similar events. In light of this, parties should consider extending drop-dead dates and otherwise providing for additional time and protection in the event of any related delays. These extended periods of time between signing and closing will increase the risk of material changes to the target company's operations and buyers should keep this in mind when negotiating purchase price adjustments, interim operating covenants and MAE clauses, each as discussed above.

Conclusion

The parties to M&A transactions affected by the COVID-19 outbreak should anticipate changes to typical deal timelines and should carefully draft the terms of their transaction documents to address the challenges arising from the COVID-19 outbreak. If buyers and sellers (and their advisors) proactively engage with each other on these issues, there can be a path forward to successfully completing these transactions.

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