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The Impact of COVID-19 on M&A Transactions
Part 2: Deal Terms

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The COVID-19 pandemic has caused severe disruption, distress and uncertainty for companies across almost every industry. While this initially resulted in a substantial slow-down in the M&A market, transactional activity is expected to accelerate in certain areas as the economy begins to recover; for example, we expect to see more carveouts by companies that seek to divest non-core assets, acquisitions of distressed companies, financings of independent companies that may have liquidity issues, and divestitures or joint ventures by private equity funds that seek to exit investments or bring in new partners. Prospective sellers and buyers alike should have an increased focus on specific considerations as they evaluate new opportunities during and post-COVID-19.

We anticipate lasting changes to three main categories of deal terms in M&A transactions as companies and the economy begin to recover from the pandemic: execution risk, risk allocation and purchase price. Special considerations that should be taken into account in each of those categories include the following:

1. Execution Risk

Contractual Issues – Any contractual issues that may have surfaced in connection with a target's failure to perform all of its obligations under its existing contracts due to the COVID-19 pandemic (e.g., withholding rent or failing to fulfill orders within a specified timeline), and any potential liability associated with such nonperformance, should be addressed prior to closing. Parties should consider whether force majeure provisions contained in the target's contracts are applicable and may excuse certain of the target's contractual obligations.

Third Party Consents – The parties should coordinate closely to obtain any third party consents required under existing contracts—particularly with respect to contracts that the Company has not been in compliance with—taking into account whether there will be any significant delays in obtaining such consents due to limitations on third parties' operations in connection with the pandemic.

Material Adverse Change – The parties should consider including coronavirus-related carveouts in material adverse change provisions, pursuant to which a party may be permitted to terminate a definitive agreement due to changes in the target's business between the signing and closing. The parties should consider how long the impact of the pandemic on the target's business must continue in order to declare a material adverse change, whether the adverse impact on a target is disproportionate to that of other companies in the target's industry, and whether such threshold is subject to exclusions specific to the target's business.

Closing Conditions and Operating Covenants – The closing conditions should allocate responsibility among the parties for cleaning up any actions taken by the target in response to COVID-19 (e.g., furloughing employees or delaying accounts payable). Covenants requiring the target to operate in the ordinary course of business consistent with past practices

between signing and closing may need to be modified, and disclosures related to any material changes to the target's business due to COVD-19 should be closely evaluated and specifically-tailored to its business.

Bringdown of Representations – Sellers and buyers should have an increased focus on confirming that representations and warranties are true as of signing and the closing, and making sure to address any issues or inconsistencies that arise between signing and closing. Potential buyers may want to have more leverage to walk away from a deal in the event there is a change in representations and warranties made at the time of signing that are no longer true at closing.

Termination Rights – If negotiating an "outside date" in a definitive agreement, on which an agreement terminates if the transaction has not been consummated by such date, the parties should take into account any delays that could occur from a more extensive due diligence process and acquisition financing process, and additional possible delays that could occur in connection with seeking governmental, regulatory and third party approvals. Parties may want to consider building in automatic extensions of the outside date under certain circumstances.

2. Risk Allocation

Strong Representations – Parties should ensure that the target's representations cover all business risks and regulatory risks; specifically, increased representations around the target's supply chain, business continuity plans, cyber security infrastructure, employment matters and general compliance with laws—and the inclusion of non-reliance language—should be considered.

Increased Enforcement – Given the significant impact of COVID-19 on federal, state and local government budgets, we expect to see increased enforcement in various areas by government agencies (e.g., anti-price gouging enforcement by the Federal Trade Commission, and enforcement in connection with Paycheck Protection Program loans by the Small Business Administration). The parties should carefully analyze the target's compliance with all material applicable laws and regulations and evaluate potential risks arising out of past or future noncompliance through the lens that regulatory compliance could face increased scrutiny moving forward.

Indemnification – In a distressed transaction, it may be more difficult to fully recover under indemnification provisions, given that a distressed seller may not have the ability or resources to cover its indemnification obligations post-closing. The parties should consider using an escrow to set aside sufficient cash to cover potential indemnification claims or requiring a financial sponsor or parent entity to provide a guaranty.

Representations and Warranties Insurance – Representations and warranties insurance coverage is likely to be limited in scope, as insurance carriers will seek broad carveouts and exclusions from policies for losses arising out of or incurred in connection with the pandemic, as it has become a heightened risk area. The parties should endeavor to negotiate very specific carveouts or exclusions that would make a representations and warranties insurance policy more attractive.

3. Purchase Price

CARES Act Liabilities – If the target received assistance in connection with the Paycheck Protection Program or Main Street Lending Program under the CARES Act, the parties should confirm that the proposed transaction does not interfere with eligibility to receive such loans, evaluate potential tax implications and determine whether such loans are forgivable.

Other Loans or Debt-Like Items – It will be important to evaluate whether the target has incurred any other loans or debt-like obligations (e.g., delays in paying accounts payable), and understand how these amounts will be treated in the context of a proposed transaction. Companies that were seeking to preserve cash may not have paid their vendors as bills became due, which could become a future liability.

Valuation – Given that valuations are typically generated using projected future earnings based on historical financial metrics of a target, it will become increasingly challenging for buyers and sellers to agree on deal pricing. As a target's current revenues and operations may not be an accurate indicator of its future earnings due to immediate disruptions to

its business and market volatility, parties may turn to other methodologies of valuation, such as using an earnout based on future performance over a negotiated period of time or tying performance to an outside benchmark.

Purchase Price Adjustments – Purchase price adjustments using measures such as working capital between the signing and closing of a deal will need to be tailored to specific situations. Because a working capital calculation is often based on a historical average of working capital, parties will need to take into account adjustments related to the pandemic, such as delays in collecting accounts receivable and paying accounts payable. There may also be changes in working capital relating to changes in pricing differences if the supply chain changes, or whether a company can achieve a net working capital target due to changed circumstances following the pandemic. Methodologies to determine net working capital for interim operations may need to be adjusted.

Obtaining Financing – Due to market uncertainty and constraints on a target's liquidity, lenders are likely to be more conservative and buyers may have difficulty in securing adequate debt financing. When a lender determines whether to provide acquisition financing, it generally does so based on the target's financial performance, which may have declined significantly in connection with the pandemic. To the bridge the gap created by challenges in obtaining financing, we expect to see the utilization of more seller notes or larger rollovers by sellers.

Deal terms will inherently be very fact-specific, but these are critical considerations that should be flagged at the outset of any M&A transaction as potential buyers and sellers evaluate new opportunities post-COVID-19. We are happy to discuss if you have any questions or concerns regarding a new opportunity.

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