

McDermott
Will & Emery



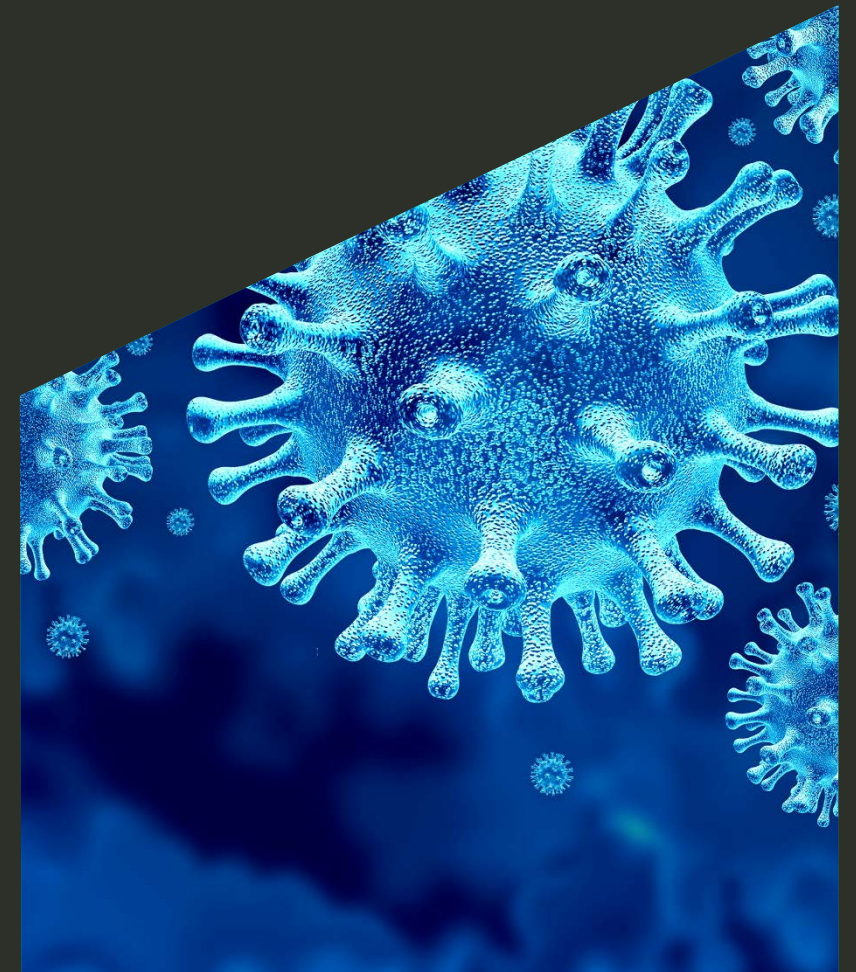
CORONAVIRUS IMPACT ON PRIVATE M&A TERMS

Tom Sauermilch (New York)
Nicolas Azis (London)
David Lipkin (Silicon Valley)

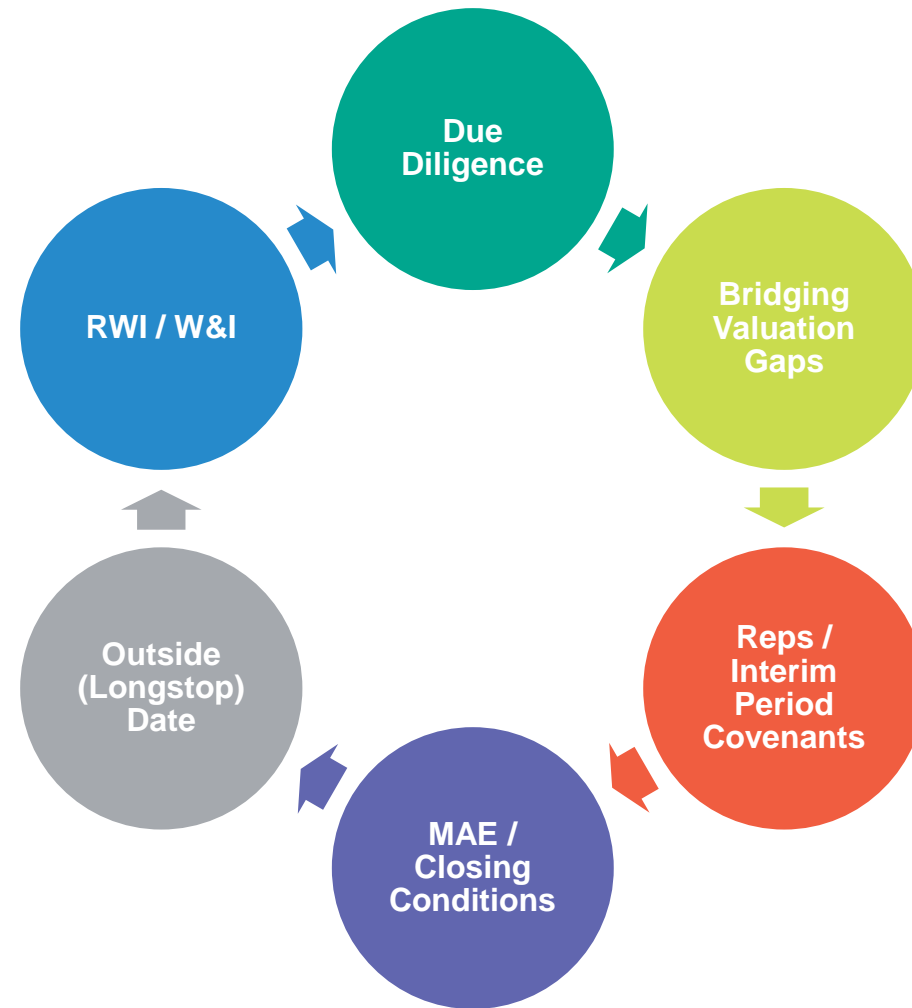
Rob Goldstein (New York)
Lindsey Reighard (Dallas)
Nicolas Lafont (Paris)

April 24, 2020

mwe.com



CORONAVIRUS IMPACT ON PRIVATE M&A TERMS



WHICH TYPE OF DEALS ARE MOVING FORWARD IN THE CURRENT ENVIRONMENT?

- Agreements signed pre-Coronavirus
- Deals where site visits and management presentations were completed pre-Coronavirus
- Familiarity of parties (on the shopping list; knowledge of physical assets)
- Strategically compelling deals at attractive price not requiring financing / having committed financing
- Distressed sales out of bankruptcy
- Strategic transactions structured as equity investments (with preferred shares / options) or joint ventures (with puts/calls)
- Hot sectors (e.g., home care, remote medical visits, tech for remote work, fintech, software, entertainment, disinfectant materials, vaccine development, diagnostics, logistics)
- Pause button hit on many deals – out of 50 mid-market auctions expected to hit the market in the U.S. by March, none has been initiated; about 300 were expected to launch in 2020 and most are in a holding pattern

CURRENT DEALMAKING ENVIRONMENT

- Strategic and private equity buyers are facing their own business and operational challenges
- Strategic buyers may conclude that some cash that they would otherwise have used for M&A should be used for financing their own operating costs and replacing their own lost revenue
- But private equity and strategic buyers continue to be “cash-rich” and can generally afford to bide their time to find the right acquisition targets at the right price
- Public stock valuations have declined significantly but rebounded significantly in April
- The immediate slowdown in dealmaking as the crisis took hold in March 2020 will only serve to increase the relative leverage of buyers
- Effect on deal pricing will not be uniform — sellers in industries that have been more significantly impacted by the pandemic will be more significantly impacted than others less affected or even enhanced by the crisis (videoconferencing and other online technologies, biotech, food delivery, online shopping)
- Sellers will pursue deal terms that protect them from closing uncertainty, although potentially at the expense of price

THE END OF THE SELLERS' MARKET?

- Current deal dynamics generally favor buyers, although some deals in hot sectors appear less affected
- More discussions around continued suitability of traditional deal terms, e.g, purchase price adjustment mechanics, special closing conditions, indemnification parameters and size of seller escrows (with or without RWI)
- More earn-outs, milestone payments, seller notes to be expected
- Too early to tell whether emerging practices and terms have staying power; after the 2008 Financial Crisis, sellers' market returned within a few years

DUE DILIGENCE AND PROCESS

- VDRs and virtual meetings: *CEO of BlueJeans (Zoom competitor) after sale to Verizon – “negotiations over video the new norm”*
- Familiarity with management and operations helps
- Constraints: gathering of materials for VDR and Q+A
- Not everything can be done virtually: environmental assessments, surveys, notarial deeds (although that is evolving), site visits by drone?
- For deals with RWI, anticipate detailed underwriter questions regarding Coronavirus (see below)
- Expect longer and more rigorous due diligence process and deal preparation

BRIDGING VALUATION GAPS AND PROTECTING VALUE

- Customary valuation methods less meaningful; uncertainty where multiples will settle
- Do we see more earn-outs / seller financing? Anecdotally more discussions around earn-outs but not many have pulled the trigger (yet)
- Earn-outs add complexity and dispute potential: hold-separate / integration / control, metrics, accounting rules, term and acceleration etc.
- Currently see more basic forms (as opposed to pages) in situations requiring speed of execution
- Careful attention to potential effect of price adjustment provisions (working capital, cash, indebtedness) becoming more important

CURRENT MWE EXPERIENCE:

Deal 1 (US): Buyer commits to maintain stand-alone business but has unfettered management control limited only by covenant not to take any steps with the intent to reduce earn-out consideration

Deal 2 (Germany) Buyer's business plan, *ab initio*, is to maintain separateness of target business

BRIDGING VALUATION GAPS AND PROTECTING VALUE (CONT.)

- **Purchase Price Adjustments**

- U.S. practice: post-closing true up of Cash / Indebtedness and Net Working Capital (against target); generally provides more protection in a down cycle than “locked box” deals
- Expect more negotiations around NWC targets and definitions

- Europe: many deals (≈50%) use a “locked box” (purchase price fixed based on pre-signing date financials) subject to adjustment for “leakage”
- Parties likely to revisit based on meaningfulness of pre-signing date financials; hybrid models emerging
- Some chatter about other adjustment metrics (EBITDA, revenues) but not aware of actual agreements to that effect

REPRESENTATIONS AND WARRANTIES

- In U.S. practice reps and warranties serve as (i) trigger for indemnification / insurance and (ii) a closing condition (“bring-down” qualified by varying degrees of materiality); in European practice bring-down traditionally less frequent but parties likely to revisit
- Reps and warranties that may be affected include Customers and Suppliers; Labor and OSHA; Compliance with Laws; Absence of Changes; Accounts Receivable/Accounts Payable/Inventory
- Many U.S. agreements rely primarily on traditional language for Coronavirus disclosures (which can be broad); some have specific language on absence of certain Coronavirus related actions to elicit more granular disclosures (e.g., work stoppage, furloughs, declarations of force majeure by company or its significant customers and suppliers, etc).
- Limited recourse for breaches in transactions covered by RWI due to Coronavirus related exclusions (see below)

DEFINITIONS NOT ENTIRELY SETTLED

Example:

"Coronavirus" means the COVID-19 disease, the SARS-CoV-2 virus, or any evolution or mutation of the foregoing.

REPRESENTATIONS AND WARRANTIES (CONT.)

Example re Customers and Suppliers: *Except as set forth in the Disclosure Schedule [or as has not resulted or would not reasonably be expected to result in a MAE"1"], (a) [as of the date hereof"2"] (i) none of the Major Customers or Major Suppliers has within the 12-month period prior the date of this Agreement notified the Company of the termination of its Contract with the Company or of any declaration of force majeure, delay or suspension of its performance under its Contract with the Company"3" or threatened to take any of such actions and (ii) to the Knowledge of the Company, no Major Customer or Major Supplier is experiencing any material restrictions on its ability to perform under its Contract with the Company pursuant to the terms thereof as a result of Coronavirus"4" and (b) no Material Customer or Material Supplier has reduced its purchases or supplies from or to the Company by more than [●]% over [comparison period]"5"; (c) [no breach etc.]*

Example re Absence of Changes: *Except as disclosed in Schedule • or as a result of the effects of health epidemics, including the recent outbreak of the novel strain of coronavirus (COVID-19),.. "6"*

REPRESENTATIONS AND WARRANTIES (CONT.)

- Note 1: Seller-friendly; depending on MAE carve-outs (see below) may eliminate need for Coronavirus disclosures
- Note 2: Seller-friendly; eliminates interim period from “bring-down” to closing
- Note 3: Buyer-friendly; expands rep for typical Coronavirus-related risks
- Note 4: Buyer friendly: expands rep to other risks affecting performance (e.g., work-stoppage, absence of sufficient workforce)
- Note 5: Buyer-friendly; closing condition of performance metrics (including interim period), subject to materiality standard for “bring-down” – alternatively consider special closing condition)
- Note 6: Very Seller-friendly: eliminates need for any Coronavirus disclosures

INTERIM COVENANTS COVERING THE PERIOD BETWEEN SIGNING AND CLOSING

- Trend in mid-market deals is towards simultaneous sign/close or short interim period
- In upper mid-market or multi-jurisdictional deals negotiation of interim covenants is becoming more critical in light of impact of Coronavirus
- U.S. practice re interim business operation covenants: Closing condition (to be performed “in all material respects”) and, to lesser extent, indemnification trigger (although buyers may increasingly revisit the latter)
- In European practice performance of interim business operation covenants typically not a closing condition but would give rise to a damages claim for breach (although buyers may increasingly revisit the former)
- Beware of gun jumping rules (competition / antitrust) in structuring framework or consent requirements in connection with Coronavirus Measures (e.g., pricing, capacity, bidding)

INTERIM COVENANTS COVERING THE PERIOD BETWEEN SIGNING AND CLOSING (CONT.)

- **Example re Interim Business Operation Covenants:**

- Except (a) [as required by applicable Law or any Governmental Authority”1”], (b) as Buyer may consent, which consent may not be unreasonably withheld, conditioned or delayed, [including in respect of any Coronavirus Measures”2”], or [(c) as set forth on Schedule •,”3”] during the period from the date hereof until the earlier of the Closing Date and termination of this Agreement: (i) the Company shall conduct its business in the ordinary course and shall use reasonable commercial efforts to preserve intact its business in all material respects and (ii) other than in the ordinary course of business”4”] the Company shall not: (1) amend or modify in any material respect, or terminate any Material Contract or enter into any Contract that if in effect on the date hereof would be a Material Contract (2)

“ordinary course of business” means the regular and usual course of business of the Company [consistent with past practice”4”] [and any actions that the Company determines in good faith are necessary or appropriate in response to Coronavirus] [provided that such actions are consistent with those taken by Seller in respect of its other businesses”5”].

“Coronavirus Measures” means any [mandatory or advisory] restriction, isolation, quarantine, “shelter in place”, “stay at home”, workforce reduction, social distancing, shut down, furlough or closure issued or action ordered or threatened by any Governmental Authority in connection to Coronavirus.

Schedule • sets forth, consistent with applicable Law, an agreed framework with respect to Coronavirus Measures of the Company

INTERIM COVENANTS COVERING THE PERIOD BETWEEN SIGNING AND CLOSING (CONT.)

- Note 1: Gives wide latitude to Company in respect of mandatory Coronavirus measures; NTD: consider including “advisory” pronouncements in respect of Coronavirus
- Note 2: Middle ground – provides some oversight to Buyer without unreasonably restricting Company
- Note 3: More Buyer-friendly; allows for agreed framework for Coronavirus measures; NTD: beware of gun jumping rules
- Note 4: Would limit / restrict Company depending on ocb definition
- Note 5: Middle ground for acquisitions from corporate sellers – gives assurance and flexibility so long as measures are not discriminatory

INTERIM COVENANTS COVERING THE PERIOD BETWEEN SIGNING AND CLOSING (CONT.)

- Other Examples giving / restricting latitude re Coronavirus Measures
 - .. any inability to perform the covenants provided in this Section • to the extent due to the direct impact of the COVID-19 virus shall not be deemed to be a violation of this Section •
 - The Company will during any period of full or partial suspension of operations due to the COVID-19 virus use commercially reasonable efforts (i) to treat its corporate Business employees in a manner substantially similar to how Seller treats its corporate employees and (ii)

Closing Condition Development

- Ability of a Buyer to terminate for failure of Seller to operate the business in the ordinary course 'consistent with past practice' due to Coronavirus measures will be tested in Delaware (Sycamore Partners terminated deal with L Brands on these grounds); MAE provision contained a carve-out for pandemics, but interim covenant was apparently silent and scope and application of carve-out in MAE provision to obligation of Seller to perform its obligations is at issue

MAE PROVISIONS AND CLOSING CONDITIONS

Material Adverse Effect / Material Adverse Change (“MAE”) Provisions

MAE provisions serve a number of purposes in M&A agreements, including establishing the parameters for a buyer to terminate (or refuse to close) if there has been any change, event etc. that has or would reasonably be expected to have a material adverse effect on the business, results of operations or financial condition of the target business

- In U.S. practice almost all M&A agreements contain MAE provisions which are typically silent as to precise financial metrics and contain carve-outs for systemic risks that a buyer is expected to bear (including changes in general economic conditions or in the industry, changes in Law, natural disasters, certain acts of God including sometimes epidemics etc.) which again are frequently subject to exceptions for a “disproportionate effect” (in which case seller bears risk of the portion of effect greater than others in the same industry)
- In European practice few M&A agreements (≈20%) include MAE provisions and, if they do, they are often defined as to the required impact on EBITDA or other metrics; less than 50% of those agreements include carve-outs and “disproportionate effect” exceptions from carve-outs

MAE PROVISIONS AND CLOSING CONDITIONS (CONT.)

- For M&A agreements signed pre-Coronavirus:
 - Under Delaware law, a finding of Coronavirus constituting an MAE depends on (i) analysis of carve-outs (in the absence of a carve-out for epidemics, more general carve-outs may apply, e.g. general economic conditions, changes in Law which in most cases would preclude an MAE) and (ii) whether a buyer can meet the substantial burden of showing the requisite long-term material effect of Coronavirus (which remains unclear at this point and is a high bar)
 - Under Delaware law the finding of an MAE is fact-specific and must *substantially* threaten the overall earnings potential of the target business in a *durationaly significant manner* (measured in years rather than months); a short-term hiccup in earnings is not sufficient
 - Under English and Continental European law the analysis may be different, especially if MAE provisions establish clear metrics and do not contain the requisite carve-outs
 - Under English law, the MAE must expressly include epidemics and pandemics as a category to invoke the MAE and the change must also be “*significant*” and the effect must be of a “*long lasting nature*” even if the event is temporary, which generally creates a high bar
 - Under Continental European law there is very little case law and absent specific thresholds the impact must be substantial and proportionate to the consequence (termination)

MAE PROVISIONS AND CLOSING CONDITIONS (CONT.)

- For M&A agreements negotiated or signed post-Coronavirus:
 - Language of MAE provision is paramount (see also Sycamore Partners / L Brands p15 above)
 - Is there express language that a “material worsening of epidemics, pandemics (including Coronavirus)” constitutes a MAE or is there express carve-out language regarding “epidemics, pandemics (including Coronavirus)”
 - In case of applicable carve-outs, are they qualified by “disproportionate effect” language? How is “disproportionate effect” determined (industry, participants, geography) and does only the incremental effect count in determining a MAE?
 - Sellers generally push for a comprehensive carve-out of Coronavirus including any worsening of conditions and resist any disproportionate effect exceptions, often with the argument that Coronavirus is a known existing condition
 - Under Delaware law, the court in *Akorn* declined to find an implied “knowledge” carve-out and upheld the specific language of the MAE provision as to risk allocation; in other jurisdictions a known condition may not qualify as an MAE unless expressly included in MAE definition

MAE PROVISIONS AND CLOSING CONDITIONS (CONT.)

- Limited effect of MAE provisions: Neither 9/11 nor the 2008 Financial Crisis resulted in U.S. court decisions that an MAE occurred
- Following the 2008 Financial Crisis more agreements included specific closing conditions as to satisfaction of certain financial metrics (EBITDA, revenue targets, order back-log etc.); practice faded in subsequent sellers' market
- Currently more room again for closing conditions as to above financial metrics and non-financial metrics (no plant closures, no material capacity reductions or supply interruptions, completion of material contracts or extensions etc.)

No event, circumstance, change, occurrence, development or effect shall have occurred as a result of the COVID-19 disease or the SARS-CoV-2 virus that, individually or in the aggregate, has resulted or would reasonably be expected to result in the loss of \$● or more of EBITDA of the Company on an annualized basis.

OUTSIDE DATE / LONGSTOP DATE

- Concerns over timing of merger control and foreign investment approvals; difficult environment for deals that are sensitive regarding antitrust / national security
- Before the crisis merger investigations in the U.S. ran on average 10 months (DOJ) to 16 months (FTC) and European Commission investigations ran from 8 months (Phase 1 investigations (with remedies) to more than 13 months (Phase 2 investigations). In prior years it was not unusual for sensitive transactions to have 12-months Outside Date, subject to either party's right to seek further extensions up to 18 months
- While U.S. antitrust agencies currently stay for simple notifications within initial 30-day HSR period, "pull and refile" requests add time to initial reviews; Second Request period is extended; European Commission accepts simple filings, but complex filings are discouraged; some reviews of EU Member States subject to delays; CFIUS currently stays within schedule, but concerns over delays of voluntary notifications on the rise
- Example
 - **Termination** ..(b) by any of Seller or Buyer by giving written notice to the other after • *[date that is 120 days from the date of this Agreement]*, (as extended pursuant to this Section • (b), the "Outside Date") if the Closing shall not have occurred on or prior the Outside Date;.. *provided that if the Closing shall not have occurred due to the failure of the condition in Section • to be satisfied on or before the Outside Date as a result of any delays or failure in processing or accepting notifications or in completing the review process by any applicable Competition / Investment Authority due to Coronavirus, Parent shall be entitled to extend the Outside Date once by [period equal delay / up to sixty (60) days];*

REPRESENTATION AND WARRANTY INSURANCE (RWI)

- Good news: all RWI carriers are open for business and devote full resources to underwriting process
- Bad news: Coronavirus exclusions can result in coverage gaps in current environment
- Wide spectrum of exclusions (some more nuanced, others very broad)
- Seller escrows for some coverage gaps
- Upward pressure on the size (typically expressed as a percentage of deal value) of indemnity escrows or holdbacks in non-RWI deals may lead more sellers to demand that buyers use RWI

REPRESENTATION AND WARRANTY INSURANCE (RWI) (CONT.)

Coronavirus Exclusions

- arising out of or resulting from disruptions or other material adverse effects to the target (including its supply chain or operations) that are directly attributable in whole or in part to coronavirus, and are proximately caused by:
 - a. the failure of the target to comply with applicable workplace health and safety laws, regulations and guidance (including, *inter alia*, the Occupational Safety and Health Act and coronavirus measures) and any resulting post-closing plant closures, non-performance of services, non-fulfilment of production orders, contracts or agreements attributable to that failure; or
 - b. any termination, amendment or non-renewal of any contracts or any event which constitutes or may result in a force majeure event.
- For the purposes of this Policy, the words “ordinary course of business” as used in the acquisition agreement shall be deemed to account in full and in all respects for the effect of coronavirus and coronavirus measures on the target.

REPRESENTATION AND WARRANTY INSURANCE (RWI) (CONT.)

Coronavirus Exclusions

material disruptions to the Company's supply chain or operations or material adverse effects on the Company's customers, suppliers or workforce that are attributable to COVID-19 disease or the SARS-CoV-2 virus, including, but not limited to, (a) the failure of the Company's suppliers to timely manufacture and/or ship the Company's products or raw materials, (b) labor shortages, (c) government enforced quarantines, (d) reduction in customer demand or (e) any related force majeure events

REPRESENTATION AND WARRANTY INSURANCE (RWI) (CONT.)

Agenda for Underwriting Call re Coronavirus

- In relation to coronavirus (COVID-19 and SARS-CoV-2), please confirm the following:

General questions

- i. what has been, and what will be, the impacts to the Target business and revenue as a result of coronavirus? Has the target shut its business down (or part of its business)? Has the seller disclosed all relevant risks related to coronavirus?
- ii. what business continuity plans or precautions has the target implemented? Has it closed any locations?
- iii. have you included any coronavirus protections into the Acquisition Agreement, either through the drafting of the reps and warranties or MAC termination rights?
- iv. how have you factored the impact of the current coronavirus outbreak into your business plan and investment thesis (in the short, medium and long-term)? How has it impacted your valuation of the business? Are any concessions being sought from the sellers?
- v. what changes or delays has the Target made to any strategic plans (eg, acquisition, disposals, restructurings, etc), capex, testing, etc, as a result of coronavirus?
- vi. have you assessed the impact of changing laws and regulations on the target and the deal in general?
- vii. post-closing, what additional steps do you plan to take for the Target business in response to the coronavirus outbreak?
- viii. has the Target sought financial or other government support or relief (eg from tax)? If please describe the terms.

REPRESENTATION AND WARRANTY INSURANCE (RWI) (CONT.)

Material contracts

- i. how have the Target's material customers or material suppliers been affected by coronavirus? Have customers or suppliers reduced orders or supplies, or informed the target that they will be doing so? Has the outbreak affected the target's ability to fulfil its material contracts?
- ii. have you identified any material contracts which include force majeure protections? What analysis has been undertaken to identify if the provisions extend to capture coronavirus as a force majeure event? Has the Target or its suppliers, customers, distributors, etc, issued or received any force majeure notices to excuse non-performance due to coronavirus?
- iii. where applicable, how have you seen transportation costs increase since the coronavirus outbreak and how has the Target been impacted by increased shipping times and costs?
- iv. does the target undertake long term contracts (including material real estate leases)? If so, have any of these been subject to delay, renegotiation or cancellation?
- v. What supply chain and distribution/transport network disruption has there been? Have supply/transport network arrangements been changed (including pricing)? Has Target discussed and received confirmation from suppliers regarding business continuity? Have any suppliers been unable to fulfil obligations under supply contracts/ practical/ oral arrangements?

REPRESENTATION AND WARRANTY INSURANCE (RWI) (CONT.)

Inventory

- If the Target has closed its operations, is the Target's inventory protected from the elements/vermin/etc? Will it be merchantable/useable once the facility has reopened? Has the valuation of inventory been adjusted accordingly (i.e. reduced) to reflect any of the above?

Financials

- i. does target have a sufficient cash reserve or access to lending/credit as may be required? Have you stress tested your forecasts in light of potential unknown disruptions and have potential disruptions been factored into your forecasts to assess whether the Target will have sufficient liquidity?
- ii. have you agreed any specific provisions to govern the calculation of net working capital in light of COVID-19 and how have you looked to factor COVID-19 into your calculation of the net working capital target? How have you got comfortable that the Target will have a sufficient level of working capital moving forward in light of potential disruptions?
- iii. what assessment has been undertaken to identify potential liabilities of the Target which are not currently disclosed on the balance sheet as a result of US (or other local) government regulations and measures put in place to mitigate the impact of COVID-19 (e.g. staff wage guarantees / furlough / restrictions on property contracting)?
- iv. in relation to any long term contracts, how are you comfortable that the balance sheet accurately reflects the status of these contracts (i.e the deferred revenue, costs to complete and accrued revenue balances been updated for any changes to percentage of completion due to COVID-19). Have any contracts become loss-making, with the associated loss recognized in P&L)?

REPRESENTATION AND WARRANTY INSURANCE (RWI) (CONT.)

IT

- i. how has the Target's IT systems responded to increased remote working? What elements of the Target's business cannot be undertaken remotely and how is this issue being addressed?
- ii. How are you comfortable with the security of your systems and data if remote working is being undertaken?

Employment

- how many employees of the Target have been diagnosed with coronavirus, been on sick leave for an extended period of time, or been isolated/quarantined? What is the Target's payroll policy currently being applied to staff impacted by COVID-19?
- how many staff are on furlough? Are there plans to make any of them redundant at the end of any forecast furlough period?

Insurance

- who in management is covered by key man insurance and does the policy cover the effects of coronavirus / global pandemics?
- have you reviewed relevant insurance policies to identify any coverage for business interruption as a result of coronavirus / global pandemics? Have any insurance claims been made due to cancellations of events or business interruption due to coronavirus and what is their current status?

This material is for general information purposes only and should not be construed as legal advice or any other advice on any specific facts or circumstances. No one should act or refrain from acting based upon any information herein without seeking professional legal advice. McDermott Will & Emery* (McDermott) makes no warranties, representations, or claims of any kind concerning the content herein. McDermott and the contributing presenters or authors expressly disclaim all liability to any person in respect of the consequences of anything done or not done in reliance upon the use of contents included herein. *For a complete list of McDermott entities visit mwe.com/legalnotices.

©2020 McDermott Will & Emery. All rights reserved. Any use of these materials including reproduction, modification, distribution or republication, without the prior written consent of McDermott is strictly prohibited. This may be considered attorney advertising. Prior results do not guarantee a similar outcome.

