The Impact of COVID-19 on M&A Transactions

Part 1: Due Diligence and Operational Issues

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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.

Due diligence in connection with ongoing and future M&A transactions will have an increased importance, due to substantial disruptions to businesses that may not have previously been accounted for in a target's financial statements. Given the expansive nature of COVID-19's impact on businesses, these due diligence considerations are likely to be significant beyond the immediate triage measures a company may have taken in response to the pandemic. Specifically, due diligence should be focused in the following areas:

Material Contracts. The parties should carefully review a target's supplier and customer contracts to determine whether the target has breached any material provisions under such contracts in connection with its response to COVID-19. Any breaches and consequences thereto should be identified and addressed as early in the process as possible, so that the responsibility of any ongoing obligations or future potential liability can be appropriately allocated between the parties. In particular, force majeure, material adverse change and nonperformance provisions in material contracts should be analyzed in light of the pandemic and the target's ability to continue to fulfill its obligations under such contracts.

Financials and Solvency. As usual, prospective buyers should work with their financial advisers to conduct comprehensive financial due diligence on a target, with an increased focus on determining whether a target is solvent or potentially approaching insolvency. The insolvency of a target could require its board of directors to take certain actions to minimize liabilities or focus on certain matters in connection with discharging their fiduciary duties.

Supply Chain. Many businesses have and will continue to face issues or delays in obtaining resources due to disruptions in their supply chains. The target and its suppliers may have been affected by factory closures, limited staffing and other limitations on the target's ability to serve its customers, which could force the target to seek alternative supply sources that are more difficult or expensive to secure.

Risk Management Protocols. Specific attention to the target's business continuity plan and crisis management procedures is strongly advised. It is important to understand the target's strategy in navigating this period of financial uncertainty, and assess its ability to succeed and operate moving forward.

Employment. The pandemic has prompted a series of employment law reforms that have manifested in both temporary and permanent accommodations for employees (e.g., extension of paid sick leave). Given that employment laws have been rapidly evolving to address new issues, all businesses will need to adapt accordingly and prospective buyers should carefully evaluate a target's ongoing compliance with applicable laws with respect to privacy policies, safety and health procedures for employees, layoffs or furlough arrangements and remote-working arrangements.

Insurance Policies. Insurance contracts should also be a critical focus in any due diligence investigation. Prospective buyers should be sure to conduct a comprehensive review of the target's insurance coverage in order to flag any recourse or flaws, particularly with respect to health and disability coverage for employees. Prospective buyers should also carefully review the target's unemployment insurance policies and assess whether any reductions in the target's workforce could lead to additional financial obligations in connection with its unemployment insurance (e.g., a spike in unemployment claims could cause employer premiums to dramatically increase).

Regulatory Approvals and Filings. Securing regulatory approvals and other governmental filings (e.g., preclearance merger certificates), performing lien and litigation searches and obtaining good standing certificates may be delayed due to Secretary of State offices being insufficiently staffed. Federal filings may also be impacted, such as filings with the Committee on Foreign Investment in the United States, whose reviews are currently delayed. Further, as the pandemic has substantially impacted the finances of local, state, and federal agencies, governmental authorities may cut expenses by reducing their workforce, resulting in additional backlogs.

Increased scrutiny in these areas of due diligence will help any prospective buyer or investor evaluate transaction opportunities that arise post-COVID-19. Note that comprehensive due diligence is even more important for acquisitions or investments into distressed companies, due to the difficulty in recovering under indemnification provisions post-closing.

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