US private M&A drafting considerations in light of COVID-19

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Parties to M&A agreements are grappling with increased risk and uncertainty in light of the COVID-19 pandemic. To assist companies in navigating M&A agreements in this unprecedented time, we highlight below some drafting considerations for relevant areas of acquisition agreements to allocate risk, taking into account recent M&A litigation arguments buyers have made to terminate transactions and sellers' defenses in an effort to force closing.

Recent M&A litigation shows common focus on interim operating covenants and materially adverse effect/change ("MAE") provisions

There have been, thus far, only a few substantive rulings in M&A disputes arising out of COVID-19. Although each decision will be fact and circumstance specific, the analysis will also depend on the specific language of the agreement, and thus a number of pending and settled M&A lawsuits offer valuable insight into certain provisions in M&A agreements that warrant particular attention. Commonly cited grounds for a buyer's refusal to close signed transactions include:

(1) breach of the interim operating covenants (most prevalently, failure to operate in the "ordinary course of business," to abide by specified negative covenants and to provide adequate access or inspection); and

(2) the occurrence of a material adverse effect/change ("MAE").

Some buyers have also sought relief by claiming a failure by seller to bring down representations and warranties at closing, frustration of purpose and/or impossibility or the failure to obtain debt financing.

❖ **Interim operating covenants**

- Interim operating covenants ("IOCs") typically require that, prior to closing, the target operate in the ordinary course of business (frequently "consistent with past practice") and maintain the existing business organization, refrain from taking certain actions (e.g. diverting from identified business plans, incurring debt, firing employees) without the buyer's consent, and provide facility access and inspection to buyer. However, during (and possibly after) COVID-19, compliance may not be possible or practicable.

- Sellers should consider certain modifications to IOCs. These may include:

    - (1) qualify the covenants by an efforts standard (e.g. commercially reasonable efforts);

    - (2) insert exceptions for actions in response to COVID-19 to protect the health and safety of their personnel and comply with law and public health directives and guidance;

    - (3) loosen certain obligations under the IOCs to enable responsive measures to exigent developments;

    - (4) seek to remove any reference to the past practices of seller; and

    - (5) modify the standard for buyer's consent to seller actions to be not unreasonably withheld, delayed or conditioned.

- Buyers may attempt to narrow down such modifications and preserve as much oversight and control of the business as possible, subject to gun jumping and competition law concerns. For example, to require that:
    - (1) the actions be “required” to comply with COVID-19 related changes in law;
    - (2) the actions be commercially reasonable and/or consistent with target’s peers; and/or
    - (3) any such extraordinary actions be taken only after approval or consultation with the buyer.
- Amidst the pandemic, it may be difficult for sellers to certify, at closing, compliance with certain covenants made at signing, even if the closing condition is qualified by materiality. Sellers may wish to seek to have the closing condition with respect to IOCs qualified by an MAE standard and not the lower standard of “in all material respects,” or require that the scope of the closing condition be confined to only certain specified pre-closing covenants.
- Takeaways: In drafting the covenants, sellers should consider seeking to include exceptions to IOCs that permit the target to take reasonable steps in response to COVID-19 without buyer’s consent, whereas buyers should be wary to cede excessive autonomy to sellers.

❖ **MAE provision**

- The MAE provision, which allows a buyer to terminate where a material adverse change occurs to a target company, should be negotiated to clearly allocate the risk of the impact of COVID-19 and other future epidemic, pandemic or health crisis.
- The MAE definition generally lists exclusions, the effect of which are not considered MAEs, except to the extent those effects have a “disproportionate impact” on the target as compared to other companies in the same industry. To limit uncertainty over whether the effects of COVID-19 constitute an MAE, sellers can:
    - (1) seek to explicitly carve-out COVID-19 and/or material worsening of such matters and other epidemic, pandemic or similar health crisis from the definition of MAE; and
    - (2) seek to narrow the common “disproportionate impact” exception to a specified industry segment, geographic area and/or companies that are a similar size) so seller can claim that the pandemic does not disproportionately impact the target.
- Buyers can:
    - (1) seek to include COVID-19 in the definition of an MAE;
    - (2) if COVID-19 is excluded from the definition of an MAE, seek to include a “disproportionate impact” exception to the exclusion, with a broad peer industry group as the comparator for the “disproportionate” impact qualification;
    - (3) seek to have the MAE definition cover both material adverse changes to the financial condition of the target as well as the performance of the seller; and
    - (4) seek to include a clear and objective test to determine what constitutes an MAE, such as the failure to achieve specified financial metrics over an identified period of time, or specify the

time duration required for an adverse event to constitute an MAE, since courts have historically set the bar very high in finding that an MAE has occurred.

- Takeaways: Post-COVID-19, we have seen that parties are carving out pandemics, epidemics and similar disease outbreaks as an MAE. Parties should pay special attention that the "disproportionate impact" exception, if any, is appropriately drafted to their situation.

Additional key drafting considerations for acquisition agreements

❖ **Representations and warranties and closing "bring down" condition**

- Parties should pay attention to the representations and warranties ("R/Ws") that may be impacted by COVID-19, as well as including additional R/Ws that may be specific to COVID-19, which include:

    - Customer and supplier terminations, quantity reductions, supply chain risks, actual and anticipated defaults and insolvency risk.

    - Emergency protocols, business continuity policies and contingency plans.

    - Accuracy of financial statements, including adequacy of reserves for accounts receivable and absence of undisclosed liabilities.

    - Compliance with governmental laws, orders or guidelines related to COVID-19.

    - Compliance with any COVID-19-related loan.

    - Labor matters (layoffs, shutdowns or changes to benefits or compensation and worker safety).

    - IT systems, data security, privacy and HIPAA compliance (to account in part for remote working).

    - Absence of adverse changes (noting that this kind of warranty can function as a back-door MAE if such representation must be brought down to the closing).

- If specific COVID-19 R/Ws or expanded versions of certain R/Ws are included, sellers can consider the following to limit their exposure to breaches outside of their control:

    - (1) qualifying R/Ws with appropriate materiality, MAE and/or knowledge qualifiers;

    - (2) having certain R/Ws limited to dates as of or prior to signing; and

    - (3) removing any forward-looking provisions, carving out the expected effects of the COVID-19 crisis on the business.

- Sellers will need to disclose against the problematic representations in the disclosure schedules. Sellers may seek to have specific R/Ws related to known or anticipated effects of COVID-19 in one single representation to limit their COVID-19-related indemnification exposure to this one specific representation. Buyers will want to quantify the exposure.

- Parties should be mindful that R/Ws insurers have begun to specifically exclude losses related to COVID-19 from their policy coverage (although some insurers are implementing narrowly-tailored exclusions on a case-by-case basis). If buyers are not able to secure insurance for such losses, the parties should prepare to negotiate on how to address such risks.

- Sellers may have difficulties certifying at closing the accuracy of certain R/Ws made at signing, even if the "bring down" condition is qualified by materiality. Sellers can seek to have the "bring down" closing condition for R/Ws (other than "fundamental" R/Ws) qualified by an MAE standard, and not the lower standard of "in all material respects."

❖ **Special COVID-19 indemnities**

- If parties identify potential issues related to COVID-19 through the due diligence process, a buyer can consider adding special standalone seller indemnities for such matters and can seek to escrow funds to cover the potential liability and/or negotiate for an increase in any indemnification cap. Special COVID-19 indemnities may be a potential solution to protect sellers against buyer "outs" for material breaches of R/Ws and/or pre-closing covenants and to protect buyers from COVID-19 consequences.

- At the same time, special indemnities allocate all of the COVID-19 consequences to the seller. A seller may argue that a special indemnity is not appropriate, given that COVID-19 is a known issue, and that the buyer's purchase price is based on a valuation model that already considers the downside risk of COVID-19.

- The burden of special COVID-19 indemnification may not be acceptable to sellers because of the resulting lower purchase price. Although not typical, a seller may wish to negotiate for protection from being forced to close a transaction that does not make economic sense as a result of changed circumstances beyond its control.

❖ **Valuation; pricing mechanism**

- Parties should carefully consider how to structure the transaction price to accommodate a divergence in valuation expectations as the uncertainty surrounding the impact of COVID-19 makes the valuation of a target difficult. In addition, acquisition financing may be difficult to obtain or may have an interest rate or other terms that are not acceptable to a buyer. Even when buyers have available cash, alternative forms of consideration may be more attractive.

- We expect buyers to prefer a mechanism for adjusting the purchase price using measures based on closing date financial statements, rather than a locked-box mechanism, which sets the purchase price based on a historic balance sheet. The most common post-closing mechanism is an adjustment based on working capital, which measures the closing working capital against a defined target based on a historic measure. Parties may wish to reconsider the target working capital amount against which adjustments are measured as what constitutes "normalized" working capital may need to be adjusted to take into account impacts of COVID-19, including for reductions in accounts receivable, abnormal inventories and seller deferrals of payments to manage liquidity.

- In drafting the post-closing adjustment provisions, the parties should consider:

    - (1) specifying in detail what accounting principles governing the preparation of the closing accounts will apply;

    - (2) thresholds or ranges for the measured items so that fluctuations within the ranges does not cause a purchase price adjustment;

    - (3) floors or ceilings to cap parties' adjustment exposure and to ensure that the price is within an acceptable range; and

    - (4) a working capital holdback from the purchase price paid at closing or a separate or increased escrow amount to account for a downward purchase price adjustment.

- To bridge valuation gap expectations and/or to satisfy a buyer's necessity or desire to use alternative forms of consideration, the parties may consider:

    - (1) use of an earn-out contingent on achievement of financial metrics, milestones and/or targets post-closing;

    - (2) deferring payment of a portion of the purchase price until a later date or the occurrence of a future event; and

    - (3) paying a portion of the purchase price in buyer's equity.

❖ **Outside date**

For deals that require regulatory approvals, government agencies are expected to have a longer review time period with reduced capacity. Therefore, and also to allow for travel restrictions and other disruptions caused by the pandemic, parties should consider (i) a longer "outside date" in the M&A agreement, or (ii) an automatic extension or a tolling mechanism that is linked to COVID-19-related delays. In addition, if parties cannot agree on an allocation of delayed closing risks, they may consider termination fees to resolve the issue.