

Mergers and Acquisitions in the COVID Era: Lessons in the “New Normal”

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Presentation Overview

- Closing Uncertainty
 - Material Adverse Effect
 - Interim Operating Covenants
 - Financing Risk and Termination
- Purchase Price Adjustments and Mechanisms
- Representations and Warranties
- Regulatory and Third Party Delays
- Due Diligence
- PPP Loans

COVID-19's Impact on M&A Activity

- M&A activity in early months of pandemic slowed significantly as buyers and sellers evaluated market and economic conditions.
 - Bloomberg Law reported deal volume for middle-market (\$100M < \$1B) and larger market (\$1B<\$10B) deals YTD as of mid-May 2020 were both down approximately 30% compared to same period for 2019.
- Recent numbers reported by Barrons and Dealogic indicate that the number of US transactions YTD remain down 23% and deal values are down 56% compared to 2019.
- However, M&A activity appears to be rebounding. Bloomberg reports that in July 2020 there were 41 deals in excess of \$1B, in line with 2019 levels. Interest rates remain low, credit markets appear to be stabilizing and there is significant pent-up demand for high-quality assets.

Active Delaware Courts

- During the early months of the pandemic, parties under signed deals resorted to litigation to enforce their rights.
 - Buyers seeking to renegotiate terms and enforce termination rights
 - Sellers seeking specific performance
- Common themes in litigation were whether a Material Adverse Effect (MAE) had occurred and/or interim operating covenants had been breached.
- Beginning in early April 2020, there were at least nine high profile M&A cases filed in Delaware Chancery Court resulting from impacts of the pandemic. In all of those cases, a key issue was whether or not the agreements specifically addressed the pandemic in the definition of MAE.
 - Seven (7) of those cases involved agreements **without** pandemic carve-outs to MAE and two (2) involved Agreements **with** pandemic carve-outs to MAE.
 - Over the summer many of these cases have settled out of court, in some cases with buyers paying termination fees or the parties closing at lower valuations.

Material Adverse Effect

- Absence of MAE is a customary closing condition, such that buyer is not obligated to close if such an event or effect occurs between signing and closing
- MAEs typically focus on:
 - A material adverse effect on the business, financial condition, assets, results of operations of the **target or business** on a consolidated basis
 - A material adverse effect on the **seller's ability to perform** its obligations under the purchase agreement or consummate the transaction
- MAE is a very high standard – effects that substantially threaten the overall earnings potential for a period that is durationally significant
- Until the *Akorn* case in 2018, no Delaware court had found that an MAE had occurred (i.e., no MAEs arising out of 9/11 or 2008 financial crisis)

MAE: Carve-outs

- A typical MAE definition contains standard **carve-outs** for a seller's benefit which, if they are the cause for the adverse effect on the business or the ability to perform, do not excuse buyer's obligation to close including:
 - Changes in general economic or market conditions or legal framework
 - Acts of God, natural disasters, war, terrorism
- While negotiated in every deal, broadly the effect of carve-outs is to allocate market or industry risks to buyer and company specific risks to seller.
- Prior to COVID-19 outbreak, relatively rare to include explicit reference pandemics or epidemics.
- Since February 2020, explicit carve-out for pandemics and epidemics have become a permanent fixture in the list of MAE carve-outs.

Since COVID-19: Carve-outs for Pandemics

- Some sample formulations for the MAE carve-out include:
 - “any epidemic, pandemic, disease, outbreak (including COVID-19) or other health crisis or public health event, or the worsening of any of the foregoing”
 - “the outbreak of contagious disease, epidemic or pandemic (including COVID-19), any quarantine, shelter-in-place or similar or related directive, policy or guidance or other action by any Governmental Authority”
 - “global health conditions (including any epidemic, pandemic or disease outbreak (including COVID-19))”
 - “any epidemic, pandemic or disease outbreak (including the COVID-19 pandemic), or any law, pronouncement or guideline (or changes in any law, pronouncement or guideline or interpretation) issued by a governmental authority, the Centers for Disease Control and Prevention, the World Health Organization or industry group providing for business closures, “sheltering-in-place” or other related restrictions”
- As a Seller, if you don’t include a pandemic carve-out, Buyers will argue you assumed the risk. (Check your sell-side forms!)

MAE: Disproportionate Impact

- Buyers typically require a disproportionate impact exception to MAE carve-outs
- A common formulation would provide Seller the benefit of the carve-out (e.g., for global market conditions) “except to the extent such event has a disproportionate effect on the Business compared **to other participants in the industry in which the Business operates**”
 - Sellers should expressly limit the Buyer’s exception such that only the **incremental** disproportionate effect is considered in whether an MAE has occurred
- Post COVID-19, parties should focus on whether a more specific definition of the peer group is appropriate, such as specifying
 - a particular industry (e.g., financial services)
 - a particular geography (e.g., regional or national)
 - similar sized / situated companies

MAE: Seller's Ability to Perform

- In stock and asset deals, the MAE definition often will include a clause such that an MAE is triggered because of a material adverse effect on the **Seller's** ability to “**perform its obligations under the Agreement or** consummate the transactions contemplated by the Agreement”
 - KEY COVENANT: *operate the business in the ordinary course*
- Often performance is **not qualified** by the litany of carve-outs that apply to a material adverse effect on the target's business
- In recent *L Brands / Sycamore Partners* case, MAE definition included a pandemic carve-out for the operations of the target business
 - However, buyer argued that an MAE had occurred because there was a material adverse effect on Seller's ability to perform its obligation to cause the target to comply with interim operating covenants

MAE: Other Considerations

- Are there better protections for Buyers than MAE?
 - Rather than relying on the unlikely finding of an MAE, consider insisting on objective closing conditions that would trigger a walk right, such as
 - Specific financial targets that the target business must hit or maintain
 - Key facilities or operations remaining open
 - No loss of specified key customers / key vendors and suppliers
 - Post COVID-19, Buyers may have more leverage to insist on these types of closing conditions

Interim Operating Covenants

- In transactions that require an interim period between signing and closing, acquisition agreements typically require Sellers to comply with certain affirmative and negative covenants prior to closing.
- One of the primary affirmative obligations is to operate the target business in the “ordinary course of business”.
- Post COVID-19, failure to operate in the ordinary course has been one of the most common arguments Buyers have made as a basis for terminating deals.
- Typically, Buyer need only prove that the variance in performance is “material” and need not necessarily rise to the level of a MAE.
- A number of the recent post-COVID cases focused on whether the buyer can terminate as a result of material covenant breach resulting from target response to the pandemic.

Interim Operating Covenants

- Parties should carefully review the obligations imposed on the Seller and target business and the extent to which Sellers have been given room to operate in response to COVID-19, as well as the consent standard for Buyer (e.g., not to be unreasonably withheld, conditioned or delayed).
- Key drafting considerations for parties negotiating interim covenants, include
 - Definition of “ordinary course of business”
 - Standard applied to compliance – unqualified obligation, best efforts, commercially reasonable efforts, etc.
 - Specific carve-outs to the covenants for emergencies, rescue measures, legal compliance
 - Covenants for parties to cooperate in response to the pandemic and re-opening planning / Buyer approved COVID-19 response plan

Operating in the Ordinary Course

- Recent examples of more Seller favorable drafting post-COVID:
 - Seller may define ordinary course as “**actions generally consistent with actions taken or not taken by similarly situated businesses**” (rather than, or in addition to, “consistent with past practice”).
 - Some ordinary course covenants now specifically reference COVID-19 “**in the ordinary course of business (taking into account all COVID-19 Actions)**”
- **COVID-19 Actions** defined as:
 - “all reasonable actions taken or planned to be taken in response to events, occurrences, conditions, circumstances, or developments arising directly or indirectly as a result of the COVID-19 outbreak, its impact on economic conditions, or actions taken by Governmental Authorities or other Persons in response thereto.”
 - “any commercially reasonable actions that the Sellers or Parent reasonably determine are necessary or prudent for the Sellers, Parent or any of their Subsidiaries to take in connection with (i) events surrounding any pandemic or public health emergency caused by COVID-19, (ii) reinitiating operation of all or a portion of the Properties, (iii) mitigating the adverse effects such events, pandemic or public health emergency on the business of one or more of the Companies, and (iv) protecting the health and safety of customers, employees and other business relationships and to ensure compliance with any Law, in each case (A) as generally applied by Parent to its operations that are subject to substantially similar recommendations or restrictions imposed by the Centers for Disease Control and Prevention or any other governmental or quasi-governmental authorities having jurisdiction over the applicable properties or (B) undertaken with [Buyer]’s consent, such consent not to be unreasonably withheld, conditioned or delayed.”

Financing Risk and Termination Liability

- Financing Risks

- Buyers increasingly may seek flexibility to address financing risks and volatility in financial markets.
- Buyers with leverage may seek financing outs or otherwise more Buyer-favorable formulations of
 - Longer periods of time to arrange financing
 - Financing cooperation covenants
 - Reverse termination fees
 - Specific performance
- In auction context, PE can distinguish itself with an equity commitment letter; post-COVID, PE may rethink exposing its balance sheet absent clear termination rights

- Termination Liability

- Parties need to carefully consider the scope of liability upon termination
- Do the parties remain liable for any breach or something more narrow like willful breach or fraud?

Pandemic Impacts on Business Terms

- Buyers will factor pandemic impacts into the business deal, such as
 - Lowering valuation
 - Introducing earnouts
 - Increasing rollover equity
 - In division or asset sales, narrowing the scope of the acquired business or assets
- Sellers need to think strategically about their response, including
 - Rationale why pandemic impacts have not been and will not be material
 - Updating forecasts with reasonable projections
 - Demonstrating to Buyer that Seller has solid pandemic response plan and is actively implementing it
 - Revisiting specific allocation of valuation among lines of business

Purchase Price and Valuation Issues

- Price Adjustments – common purchase price adjustments for transactions with gaps between signing and closing, such as net working capital and debt-like items will need increased scrutiny
 - **Working Capital Target** – becomes more challenging to set as trailing averages may not be indicative of future working capital levels or needs → consider lags in both A/R and A/P
 - **Floors and Caps** – parties may consider collars on the adjustment amount
 - **Deferred Payroll Tax Liability** – payroll taxes deferred pursuant to the CARES Act treated as debt (or other dollar for dollar downward adjustment to price)
 - **Impact of government support programs** – parties need to agree on treatment of PPP loans and other government relief programs (PPP Loans addressed later in presentation)

Purchase Price and Valuation Issues

- ***Contingent Purchase Price / Earnouts*** – Parties will increasingly seek to bridge valuation uncertainty with earnouts or other forms of contingent purchase price
 - As always, earnouts need to be carefully crafted to avoid future dispute
 - Impact of CARES Act and COVID-19 need to be factored into EBITDA or other earnout targets (e.g., does target exclude non-recurring items like PPP loan forgiveness?)
 - Buyer's level of commitment to operate the target business after closing and impact on the earnout will be heavily negotiated. Like interim covenants, parties will need to consider impact of COVID-19 recovery plans.
- ***Net Operating Losses*** - CARES Act provides that NOLs arising in a tax year beginning in 2018, 2019 or 2020 can be carried back up to five years. NOL valuation and related structuring need to be analyzed.

Sellers in Distress

- Buyer's assessment of a Seller's creditworthiness and appropriate protections become increasingly important if Seller has become financially distressed because of the pandemic or otherwise.
- Fraudulent Conveyance – risks of transaction being characterized as such, can be reduced where
 - Seller runs a robust auction (creating a strong record that the business was sold for fair market value)
 - Secured lenders consent to the transaction and release liens
- Protecting post-closing Seller obligations – Buyers need to consider mechanisms to protect purchase price adjustments or indemnity obligations that are not covered by RWI, including
 - Holdbacks – Buyer retains a portion of purchase price for a specified period as security for indemnity (strongest position for Buyer)
 - Letters of Credit (LCs) – Seller delivers a letter of credit that buyer can draw down upon (typically does not become part of bankruptcy estate)
 - Escrow – Buyer delivers portion of purchase price to be held by a third party bank (typically becomes part of bankruptcy estate)
 - “Naked” Indemnity – In a bankruptcy, claim would typically be an unsecured general claim for damages and paid out with other unsecured claims (often pennies on the dollar)

Representations and Warranties

- Sellers should expect Buyers to be reviewing all reps with heightened sensitivity to risks related to the pandemic, including
 - Financial statements (impairment charges, write downs)
 - Accounts receivable / accounts payable / inventory
 - No undisclosed liabilities
 - No MAE and absence of changes
 - Defaults under material contracts
 - Loss of suppliers and customers
 - Litigation
 - Insurance coverage
 - Employee issues (layoffs, furloughs)
 - Compliance with law (including participation in government relief programs)
 - Privacy and cybersecurity
- Sellers need to be mindful of appropriate disclosure and exceptions to the reps taking into account the impact of the pandemic.
- Parties need to carefully consider the “bring down” standard applied to the reps. While MAE is often the standard for non-fundamental reps, Buyers may have more leverage to apply an “all material respects” standard for the reps.

Reps and Warranty Insurance

- RWI coverage remains available with current premiums generally in line with pre-pandemic rates. There are over 20 market participants competing for deals.
 - However, in a recent report, AIG warns that “a correction of M&A insurance pricing is inevitable,” in light of increasing claim severity and the onset of an economic downturn.
- RWI policies insure **unknown risks** and specific exclusions for COVID-19 risks are becoming prevalent (with some flexibility to narrow exclusion scope, limit to certain reps, etc.).
- Expect heightened focus from RWI underwriters on Buyer’s due diligence related to the pandemic, including supply chains, material contracts, underlying insurance and employment matters, and more extensive bring-down diligence.

Regulatory Delays and Outside Date

- Parties need to consider and build-in additional time for regulatory approvals and other third party consents
- Antitrust / merger control agencies are working remotely
 - US antitrust agencies initially suspended Early Termination as an option, but have since restored in light of reduced deal volume
 - Transactions involving second requests and large document productions will take more time
- The outside / drop-dead date needs to be set far enough in the future to account for regulatory delays or specific mechanisms need to be built in to allow for an extension if a closing condition is not satisfied due to anticipated delay
- Other required third party approvals will also take additional time
 - Shareholder votes and meetings handled remotely
 - Lenders and other third parties likely not as responsive in the current environment
- Responsiveness of state-level agencies for corporate and other filings varies (e.g., no significant delays in DE, but other states have not returned to pre-COVID service levels) .

Due Diligence

- Parties should expect longer timelines for due diligence given challenges to access to facilities, travel limitations and assembling data room materials
 - Deal professionals are getting creative (e.g., professional film crew sent for a factory tour)
- Key Areas of Focus
 - COVID-19 specific
 - impact on business and prospects
 - response plan and emergency preparedness
 - supply chain / distribution disruptions
 - impact of federal and state regulation
 - participation in government programs, like PPP
 - Key Contracts
 - Force Majeure
 - Termination rights
 - Efforts standards
 - Ability to perform (limitations on delivery or performance at locations)
 - Debt covenant compliance
 - Employee / workforce (WARN Act and health / safety)
 - Cybersecurity
 - Insurance coverage
 - Business continuity
 - Counterparty risk
 - Valuation
- Underwriters for financing sources and RWI will be digging in

PPP Loans In M&A Transactions - General

- Numerous considerations for parties to an M&A transaction involving a PPP Loan, including:
 - The effect of the transaction on PPP eligibility
 - Target borrower's compliance with PPP loan terms
 - Transaction treatment of an outstanding PPP loan
 - PPP loan forgiveness issues

PPP Loans – Effect on Eligibility

- PPP Loan eligibility should be considered by both Buyer and Seller
 - Target Sellers considering applying for a PPP Loan during the transaction process need to consider affiliation with the Buyer
 - SBA “Present Effect” rule needs to be taken into consideration
 - Buyer may be considered to be affiliated with/control the Target even before the acquisition is completed
 - “Agreements in Principle” including term sheets, may lead to affiliation determination
 - Parties should carefully consider and try to avoid hallmarks of “agreements in principle” under present effect rule (definitive price and terms, exclusivity, few conditions to deal completion) and structure any LOI or term sheet as non-binding and allow parties to withdraw, without definitive pricing, and include numerous conditions
 - Buyers who might be considering PPP or other government relief program also must consider affiliation with Target (again, even before transaction is closed)

PPP Loans – Necessity Certification

- CARES Act/PPP Loan necessity certification required(s) borrowers to certify that:
 - “the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient.”
 - Borrowers were required to take into account “their current business activity and their ability to access other sources of liquidity sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business”
- Targets applying for PPP Loan needed to take into account a potential M&A transaction in making the certification (or similar certifications under other government relief program), including on its liquidity and working capital
- Although there does not appear to be a legal basis for re-evaluation of the necessity certification due to a subsequent M&A transaction, it is possible retroactive scrutiny may be applied in the loan forgiveness and audit processes (see below)

PPP Loans – Transaction Treatment

- Initial determinations in acquiring a Target with a PPP Loan:
 - Confirm lender requirements
 - Need to check loan terms/note – most (including SBA form note) require lender consent to a change of control of the borrower if loan will be kept in place following transaction
 - Under SBA form note – lender consent for equity sale clearly required, probably required in asset sale
 - Not all PPP lenders used SBA form, so variances may exist regarding consent
 - SBA loan guidelines also technically require the lender to obtain SBA approval prior to transaction closing
 - Lender plus SBA consent requirements result in transaction timing considerations for transaction parties
 - Anecdotally, some lenders may initially be unaware of SBA consent requirement – parties (especially Buyer assuming loan) should ensure that SBA consent is considered and obtained
 - Possible that lender will require repayment of the loan, but so far that has not been our experience

PPP Loans – Transaction Treatment (cont'd.)

- Repay the Loan:
 - Many Buyers will lean toward repayment of the loan prior to transaction closing for several reasons:
 - Negative publicity regarding PPP loan program
 - Until forgiveness, loan is indebtedness, and most transactions are on a cash-free/debt-free basis
 - Desire not to deal with forgiveness complications (including timing) and risk
 - Forgiveness process may take up to 150 days (or longer) from submission of complete forgiveness application (60 days for lender approval, then 90 days for SBA)
 - PPP loan program was revised to allow for disbursement of proceeds through to the earlier of (i) 24 weeks after PPP loan origination date and (ii) December 31, 2020 – if Target has not disbursed proceeds, forgiveness may be additionally delayed
 - Closing before forgiveness requires parties to account for risk – potentially escrows, indemnities, etc. and addressing loan amount in working capital and purchase price adjustments
 - Potential liabilities from Target certifications and audit risk

PPP Loan – Transaction Treatment (Cont'd.)

- Sellers will argue for keeping the loan and being compensated for the loan amount:
 - Argument that forgiveness will be obtained, and therefore loan is essentially a grant to Target that occurred while sellers operated Target
 - Aggressive Sellers will even argue for distribution of some/all cash prior to/at closing - akin to a customary sweep of Seller cash
- Repaying the loan appears to be the prevalent treatment in M&A transactions
- Keep the Loan
 - Some Buyers may be amenable to keeping the loan in place and/or providing Sellers consideration for all or portion of the loan amount
 - Providing Sellers consideration for loan amount generally requires assumption of forgiveness – Buyers will want to thoroughly diligence the loan, insist on vetting the forgiveness application before submission, and have some recourse if loan is not forgiven (discussed below)

PPP Loan – Transaction Treatment – Employee Retention Credit (ERC)

- Employee Retention Credit (ERC): CARES Act credit against employee payroll tax
- Companies are prohibited from obtaining a PPP loan and claiming ERC
- Buyers acquiring Targets who received PPP loans would be ineligible for ERC going forward
- Unclear if Buyer would be prohibited from claiming ERC for pre-acquisition period

PPP Loan – Forgiveness Considerations If Loan Not Repaid

- Timing options:
 - Close transaction before forgiveness application or while pending
 - Sign purchase agreement and make forgiveness a condition to closing
 - Wait until forgiveness determination to sign and close transaction simultaneously
 - Could be 150 days or longer for forgiveness determination; often parties will not want to wait this long to close
 - Closing transaction with loan in place will in any event require lender and SBA consent

PPP Loan – Forgiveness Considerations If Loan Not Repaid (Cont'd.)

- Options if Forgiveness Pending at Transaction Closing:
 - Escrow/holdback amount of loan from closing consideration and pay when/if forgiveness is granted
 - Reduce purchase price by loan amount and pay when/if forgiveness granted
 - Provide credit for some/all of loan amount at closing and adjust purchase price post-closing depending on forgiveness determination
 - Provide some credit for loan amount with no post-closing adjustment (in essence, a discounted valuation adjustment)
 - Buyers agreeing to provide credit at closing for loan amount will want to have diligenced the loan thoroughly and determined that forgiveness is likely
- Working Capital Considerations:
 - Need to account for PPP loan amounts in setting a working capital target for purchase price adjustment purposes
 - Loan amounts (both asset and liability) could be removed when reviewing historical “normalized” working capital and setting target

PPP Loan – Buyer Due Diligence

- Loans present numerous risk areas for Buyers, including:
 - Potential criminal liability for fraudulent statements
 - Potential False Claims Act liability (including treble damages)
 - Audit risks (all loans above \$2M will all be “reviewed”)
 - Liability continues for 6 years
- Due Diligence Areas:
 - Loan Eligibility:
 - Necessity certification (including back-up support and whether Target had other liquidity sources)
 - Any affiliation issues
 - Loan amount calculations
 - Loan Disbursement Compliance
 - Documentation and review/audit of loan uses and expenditures
 - Forgiveness Application, including back-up support
- Due to the nature of the review, Buyer’s outside accountants may perform much of the loan diligence

PPP Loan – Buyer Due Diligence

- General Due Diligence Request List:
 - All documentation supporting Target's eligibility for the loan, including all support for its "necessity" certification;
 - All documentation supporting the Target's calculation of the amount of its PPP loan;
 - All documentation regarding Target's disbursement of the loan proceeds;
 - Target's loan application and any documentation or correspondence with Target's lender regarding the loan;
 - If a draft is underway, draft forgiveness application; and
 - All supporting documentation that has been/will be submitted with the forgiveness application.

PPP Loan – Risk Allocation Issues

- Buyers assuming a PPP Loan will want Target/Sellers to make additional representations and warranties regarding PPP loan matters:
 - Any participation in governmental relief programs, including PPP
 - Eligibility for PPP loan and accuracy/completeness of application and certifications
 - Compliance with loan and program terms with respect to use of loan proceeds, including forgivable uses
 - If forgiveness application made as of signing or closing - accuracy and completeness
- Potential Protections/Recourse:
 - Specific indemnity escrow (possibly dribbled out over a period of years given 6 year liability)
 - Excluding PPP matters from baskets/caps and extending survival period for related reps and claims
 - Specific indemnity recourse
 - Separate/higher cap for PPP loan matters

PPP Loan – Risk Allocation Issues (Cont'd.)

- Insurance:
 - Representations and Warranties Insurance: Due to the uncertainties and changing guidance surrounding PPP loans in general, it is unclear, if unlikely, that traditional RWI will cover PPP loan matters
 - PPP Loan Insurance:
 - Some insurers have begun to offer PPP loan insurance policies; these are evolving
 - Initial products covered:
 - “Necessity certification” and additional certifications at the time of the loan application, including employee counts
 - Lack of eligibility, including the amount of the loan (if required to be repaid), defense costs, fines, penalties and treble damages
 - Unclear if policies will cover forgiveness itself
 - Some initial products would not cover forgiveness denial unless resulting from lack of eligibility for loan
 - Initial pricing = 4-5% of loan value plus underwriting fee; pricing still evolving (we have heard anecdotally of lower pricing)

PPP Loan – Government Contractor Issues

- If Target is a government contractor, parties should also consider:
 - DOD position that government contractors whose PPP loans are forgiven and used loan proceeds for reimbursable DOD contract costs are not entitled to reimbursement/should credit government for those costs
 - CARES Act Section 3610: government contractor-specific CARES Act relief provision
 - No “double dipping” for same costs under both PPP Loan and 3610 relief

Questions?