

COVID-19 AND THE IMPACT ON M&A

Although COVID-19 is rightfully viewed primarily as a public health and humanitarian issue, it is worth considering the potential impacts of the virus on M&A activity as this dynamic situation unfolds. We are seeing the issue find its way into M&A processes in various ways, and we have highlighted many of the issues below.

IMPACT ON DUE DILIGENCE

Timing

Perhaps the most immediate impact of COVID-19 will be on the timing of negotiations. Cross-border travel is being greatly curtailed, both to those countries most affected and, increasingly, to other countries and domestically. As a result, site visits (especially in impacted areas) are being delayed, which is slowing the diligence process. This may be further exacerbated in the event target companies, buyers, and their service providers implement policies to combat the spread of COVID-19, such as voluntary, preemptive self-quarantines.

Scope of Diligence

Amidst many contradicting views as to the scope and length of the impact that COVID-19 will have, some consideration should be given to increased legal diligence on contractual provisions that will excuse or toll performance, such as force majeure provisions both on customer and supply contracts. In addition, legal diligence teams should focus more on the results of operational diligence to see whether representations and warranties and interim operating covenants (discussed below) may need to change.

Some key diligence questions that could impact the definitive agreement are:

1. How dependent is the business on supply chains from heavily impacted areas such as China? And what impact will that have on the flow of inventory, continued supply and pricing, and the business' ability to meet its contractual obligations?
2. Is the business responding to a short-term shortfall by second sourcing from a costlier source, both from an internal coordination and an external cost perspective?
3. How are travel restrictions impacting the ability of employees to be where they need to be in terms of internal operations and outside sales, including call center operations?
4. Are customers in impacted areas able to pay invoices in a timely manner?



5. Does the insurance of the business adequately cover the potential disruption caused by COVID-19?

IMPACT ON DEFINITIVE AGREEMENT AND NEGOTIATIONS

Material Adverse Change (MAC) Clauses

During periods of severe market dislocation, one of the most discussed topics is the ability to terminate a pending deal using the material adverse change closing condition. MAC clauses allow a buyer or seller to back out of a deal in the event of a material change in the business, operations or financial conditions of a company. MAC clauses, however, are difficult to successfully invoke, with the buyer needing to prove that there has been a sustained decline in the business rather than something caused by a short-term event. Further, MAC clauses are generally intended to protect a buyer from material adverse changes that are specific to the target business, not broad based events or conditions. This has been borne out in various Delaware court cases (e.g., Tyson Foods' attempt to terminate its merger with IBP in 2001).

Attempting to trigger a MAC clause has been used more effectively to cause a negotiated change in purchase price. Regardless of the purpose for which the MAC clause is invoked, buyers and sellers are placing increased focus on the exceptions to the MAC definition to ensure an event like COVID-19 are addressed as intended. The most obvious exception would be a specific carveout for acts of gods, pandemics and similar language. Attention should, however, be given to all of the other exceptions because carveouts for things like changes in credit markets or general economic conditions can be argued to cover the same ground.

No Financing Out Deals and Reverse Termination Fees

To stay competitive in the current deal environment, it is increasingly typical for buyers who need to obtain debt financing to not condition their deal on obtaining debt financing. This is often backstopped with a reverse termination fee provision that is triggered if all other conditions to closing are satisfied but the buyer cannot close the deal (i.e., for lack of financing). Currently, lenders have indicated that they would continue to honor existing commitments. But buyers are increasingly asking what their path would be if the lenders cannot lend into a committed deal.

Given that the MAC clause is a difficult remedy to invoke, some buyers may see this as an opportunity to push for a financing out (or at least a limited one) while others are considering a tolling provision tied to COVID-19. Regardless of the path, the importance is in the details of how the applicable provision is drafted.

Adjustments to Purchase Price

The traditional adjustments to purchase price (working capital, cash and indebtedness) are all likely to be impacted to a greater or lesser extent. In particular, the working capital adjustment will have some unique challenges. One is how to develop the working capital target peg. Since this is oftentimes based on some historical average or analysis of working capital, buyers and

sellers are doing additional work to account for the COVID-19 related adjustments (e.g., slower AR collections/AP payments, non-recurring penalty payments, etc.). More work is also being done to adequately address more than short-term changes (e.g., increases in supply pricing caused by moving to a second source). Another issue is whether, if the commercial environment continues to worsen, the business will be able to achieve that target and whether the peg needs to float.

Representations and Warranties and Disclosures

There are a number of representations and warranties (and the disclosures related thereto) that are coming under increased attention. Some of these include:

1. *Inventory* – considering increased reps around adequacy of supply chain and inventory, ability to maintain sufficient inventory or extent of shortfall, etc.
2. *Financial Statements* – obtaining financial statements that reflect the financial condition during the outbreak.
3. *Collectability of AR/Payment of AP* – increased disclosure around the ability to collect AR during the outbreak and payment of AP.
4. *Suppliers* – increased reps and disclosure around how the supply chain has been impacted during the outbreak and possibly the longer-term consequences (e.g., will the business move away from a more expensive secondary source supplier and what is the price impact from the original supplier).
5. *Non-Reliance* – sellers are increasingly reviewing the non-reliance provisions to ensure that buyers cannot rely on projections and forecasts.

Interim Operating Covenants

The diligence process may reveal a number of actions that the business is contemplating as a result of COVID-19 that would violate the ordinary course of business interim operating covenant. Parties are spending more time discussing key decisions and actions that may need to be taken (e.g., moving to a secondary supplier at a higher cost, shutting down a facility temporarily, not paying certain vendors or accepting delayed collections on AR, etc.) and are increasingly trying to agree upon and document crucial items.

Impact on Regulatory Approvals

Regulatory agencies may be slower in responding to applications and filings due to staffing shortages or potential complete physical shutdowns of relevant agencies. In light of this, parties are considering longer drop-dead dates and otherwise providing for additional time and protection in the event of any delays in the processing of applications.



CONCLUSION

While the full impact of COVID-19 on transactions remains to be seen, it is clear that buyers and sellers alike should be reviewing the M&A process with fresh eyes. We will continue to monitor this situation as it develops and provide further updates as warranted.

COVID-19 has many other potential legal impacts beyond M&A. Private equity funds should consider the impact of COVID-19 on credit agreements and equity co-investor side letters, including notice obligations. Operationally, funds should review insurance policy coverage and requirements as well as review the numerous impacts COVID-19 will have on their workforce and workplace safety, including leaves of absence, remote working accommodations, travel restrictions, and discrimination and privacy concerns. Please see the following Goodwin alert for more information: **Responding to the Coronavirus Outbreak: Ten Questions and Answers for Employers**

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