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# 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. Due to the substantial impact of the virus to date and the uncertainty of the impact to come, transaction parties are carefully considering and drafting modifications to relevant provisions of acquisition agreements to mitigate and reallocate risk.**

Although there have been, thus far, a small number of substantive judicial rulings in M&A disputes arising out of COVID-19, a number of pending lawsuits, as well as lawsuits that were filed but quickly settled, offer valuable insight into certain provisions in M&A agreements that warrant particular attention in light of the ongoing pandemic. Buyer justifications asserted for termination of signed agreements commonly include a material adverse effect/change justification, as well as formerly less-used potential outs such as breach of the covenant to operate in the "ordinary course of business," failure to bring down representations and warranties at closing, or breaches of other pre-closing covenants such as a failure by the seller to provide adequate access to information or facilities for inspection. Some buyers have also sought relief by claiming frustration of purpose and/or impossibility.

In response, sellers are generally asserting that the material adverse effect/change provisions carve out general market or industry-wide risk posed by the nature of the pandemic and its effects and allocate it to the buyer; that the pandemic does not disproportionately impact the target business; and that the target continues to be operational such that the buyers have not satisfied the applicable agreement's efforts standard (e.g. "commercially reasonable efforts") to close. Sellers have also defended pre-closing actions taken in response to the pandemic as being consistent with "ordinary course of business" measures, noting that others in similar industries have taken comparable actions; and that the steps the target took were necessary to comply with law and COVID-19-related government mandates and legislation.

While transaction parties await further judicial guidance on how these arguments will be received in court, there are some practical drafting takeaways that are already apparent. We highlight some of these considerations below, together with other key drafting areas parties in US private M&A transactions should consider to allocate risk amidst the business disruption related to COVID-19 and the uncertainty of a target's future performance and prospects.

## Valuation; pricing mechanism

Given the uncertainty surrounding the short-term and long-term impact of COVID-19, determining the valuation of a target can be difficult and it may be challenging to align valuation expectations between buyers and sellers. 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 to pay the purchase price, alternative forms of consideration may be more attractive to them. As a result, parties should carefully consider how to structure the transaction price.

- In terms of pricing structures, we expect buyers to be more comfortable with a post-closing purchase price adjustment mechanism which calculates the final price for the target based on accounts prepared as of the closing date, and not a locked-box mechanism, which calculates the final price based on a historical balance sheet at a pre-signing date. Purchase price adjustment provisions most commonly address fluctuations in a target's working capital between signing and closing, measured against a peg (representing a normalized level of working capital), set at the time of signing, and based on historical information. Businesses affected by COVID-19 may be seeing significant reductions in accounts receivable, abnormal inventories and may be deferring payments to manage liquidity, which could distort working capital compared with historic norms. Accordingly, both parties will need to give careful consideration to how COVID-19 will affect the seller's working capital and whether and what adjustments to target working capital are appropriate. In drafting the post-closing adjustment provisions, the parties should specify what accounting principles governing the preparation of the closing accounts will apply. In light of the pandemic, parties may wish to include thresholds or ranges for the measured items so that fluctuations within the ranges does not cause a purchase price adjustment. Parties may also negotiate to cap their adjustment exposure by establishing a "ceiling" (an upper limit to any purchase price increase paid by a buyer to a seller) and/or a "floor" (a lower limit to any purchase price decrease paid by a seller to a buyer) to ensure that the price is within an acceptable range. Depending on the financial situation of the seller, buyers may wish to consider a working capital holdback from the purchase price paid at closing, a separate escrow or an increased general 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 can consider (i) structuring a portion of the purchase price in the form of an earn-out that is contingent on achievement of certain financial metrics, milestone events and/or targets during a specified period after closing, (ii) deferring payment of a portion of the purchase price until a later date or the occurrence of a future event, and/or (iii) paying a portion of the purchase price in the form of the buyer's equity.

## Materially adverse effect/change ("MAE") provision

The MAE provision, which allows a buyer to terminate where a material adverse change occurs to a target company during the interim period between execution and closing, should be negotiated by parties to clearly allocate the risk of the impact of the COVID-19 pandemic and any other future epidemic, pandemic or health crisis (or actions taken in response thereto) that might arise in the future. The MAE definition will generally list exclusions, the effects of which are to be disregarded for purposes of determining whether an MAE has occurred, except to the extent those effects have a disproportionate impact on the target relative to other companies in the same industry.

- Sellers can seek to explicitly carve-out COVID-19 and other epidemic, pandemic or similar outbreak or health crisis and/or material worsening of such matters from the definition of the MAE. Recently, there has been a significant uptick in the use of explicit MAE definition carve-outs for any "epidemic, pandemic or other similar outbreak or health crisis (including the COVID-19 virus) or other force majeure event." Sellers may also seek to narrow the "disproportionate impact" exception to an applicable industry or peer group (e.g. by limiting it to a specified industry segment, geographic area and/or companies that are a similar size) as COVID-19 has affected many companies and sectors within an industry or geographical footprint differently.
- Buyers can seek to include future unexpected impacts from COVID-19 in the definition of an MAE. If COVID-19 is excluded from the definition of an MAE, a buyer may insist on the inclusion of a "disproportionate impact" exception to the exclusions. Buyers may also look to identify a broad peer industry group as the comparator for the "disproportionate" impact" qualification to make it easier to assert a disproportionate impact. Further, buyers may also seek to have the MAE definition cover both material adverse changes to the financial condition or business of the target as well as any change that prevents or materially impedes the performance of the seller under the agreement.

- Since courts have historically set the bar very high in finding whether a MAE has occurred (including the time period for which a MAE must subsist), parties should consider including a clear and objective test to determine what constitutes an MAE to minimize litigation uncertainty (e.g. failure to achieve specified financial metrics over an identified time period, the loss of specified contracts, the loss of customer orders or supplier deliveries in excess of a specific materiality threshold, or the closure of a named facility for more than a defined period), or specifying the time duration required for an adverse event to constitute an MAE. Unfortunately, from a practical perspective, we rarely see parties ever actually specify objective tests for determining whether an MAE has occurred – often suggested but never drafted this way.

## Representations and warranties/ disclosure schedules

Buyers should consider seeking additional representations and warranties in the acquisition agreement with respect to the impact of COVID-19 on the target business, with particular reference to the following:

- Adequacy of the target company's IT systems and data privacy ([to account for][considering] the increased infrastructure costs for employees working remotely).
- Adequacy of the target company's emergency and disaster protocols and plans, policies and procedures for business continuity, and contingency plans.
- Customer and supplier terminations, quantity reductions, supply chain risks and delivery delays, actual and anticipated defaults, insolvency risk, and material restrictions on the their operations.
- Compliance with any governmental laws, orders, guidelines or recommendations related to COVID-19.
- Compliance with any COVID-19-related loan, or financial support, such as the Paycheck Protection Program loan under the CARES Act, the Economic Stabilization Fund loan or any other United States Small Business Administration loan.

In addition, buyers should consider whether standard representations should be expanded or modified in light of the impact of the COVID-19 pandemic, such as: (i) accuracy of financial statements and absence of undisclosed liabilities (e.g. increased costs to address the pandemic), (ii) labor matters (e.g. labor shortage or workforce changes, including terminations, layoffs, furloughs, shutdowns or any changes to benefit or compensation programs and worker safety issues due to COVID-19), (iii) adequacy of inventory; (iv) adequacy of reserves for accounts receivable; (v) with respect to material contracts representations, whether counterparties have asserted force majeure claims; and (vi) 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 sellers agree to accept expanded versions of certain representations, sellers can consider the following to limit their exposure to breaches outside of their control during the pre-closing period:

- Qualifying representations with appropriate materiality, MAE and/or knowledge/awareness qualifiers.
- Having certain representations limited to dates as of or prior to signing.
- Qualifying representations as to compliance with law to be subject to changes in relevant laws and regulations.
- Removing any forward-looking provisions, including with respect to 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 representations and warranties related to known or anticipated effects of COVID-19 in one single representation to limit their indemnification obligations relating to COVID-19 to those discrete representations.

The dilemma for the parties is if in light of expanded COVID-19 related representations, the seller proposes broad COVID-19 related disclosures against the applicable representations. The buyer can push back with a view to make the disclosures as specific as possible and tailored to the explicit representations that are affected. The buyer will want to quantify the exposure and will need guidance from the target's management about the costs related to the impact of COVID-19.

## "Bring Down" of representations and warranties

Amidst the pandemic, sellers may have a difficult time certifying at closing the accuracy of certain representations and warranties made at signing, even if the "bring down" condition is qualified by materiality. Representations with respect to changes in the business since a specified balance sheet date, undisclosed liabilities, adequacy of inventory or accounts receivable reserves, the status of material contracts and commercial relationships, indebtedness, and availability of the workforce are examples of representations that may present concerns. Sellers can seek to have the "bring down" closing condition for representations and warranties (other than fundamental representations) qualified by an MAE standard in the agreement, and not the lower standard of "in all material respects."

## Representation and warranty insurance

If parties are using representations and warranties insurance ("RWI"), parties should be mindful that RWI insurers have begun to specifically exclude losses related to COVID-19 from their policy coverage. A number of RWI insurers are implementing narrowly-tailored exclusions on a case-by-case basis, but some RWI insurers have adopted broad COVID-19 exclusions on every transaction. The approach taken by RWI insurers varies greatly. RWI insurers will analyze the target's business and industry and how COVID-19 has affected the target overall and take this into account when quoting deals, pricing deals and proposing exclusions. In general, the response to COVID-19 by RWI insurers continues to evolve, but buyers should expect expanded underwriting due diligence requirements with specific questions about the effects of COVID-19 on the business on the target and comprehensive bring down calls. In addition, many policies do not cover breaches that first arise and become known between signing and closing. If buyers are not able to secure RWI protection for losses related to COVID-19, buyers should prepare to negotiate with sellers on how to address such risks.

## Interim operating covenants

Acquisition agreements typically require the target to operate in the ordinary course of business and to refrain from taking certain actions (e.g. diverting from identified business plans, incurrence of debt, and hiring or firing of employees) between signing and closing without the buyer's consent. The rationale is that all these matters are (or should be) within the seller's control. However, during (and possibly after) the COVID-19 pandemic, compliance may not be possible or practicable. Sellers should consider certain modifications to the "ordinary course of business" covenant. Sellers can seek to retain sufficient authority and flexibility in the agreement to take steps which potentially breach pre-closing covenants to be able to respond quickly to protect their personnel, comply with law and public health requirements (including guidance) and orders and undertake any other extraordinary measures that may be deemed necessary or prudent to battle the current pandemic, a second COVID-19 wave and/or other health crises. Sellers can seek to remove any reference to the past practices of seller and specify that any departures from ordinary course operations must materially impact the target business in a way that is disproportionate to the impact on other business in the relevant industry or peer group in order for a covenant breach to occur. Another seller-oriented approach is for seller to provide that the target only needs to use a specified level of efforts (i.e. "commercially reasonable efforts") to operate in the ordinary course of business, which is a more forgiving standard on the seller than an unqualified covenant. Sellers can also seek covenants by the buyer to not unreasonably withhold, delay or condition consent to operational issues resulting from the pandemic or the agreement can provide that certain COVID-19-related actions taken will expressly be deemed reasonable.

Buyers may be open to certain exceptions to limitations on operating covenants in principle, but may worry about a target making imprudent financial or strategic decisions, failing to invest in the business, or making irreparable staffing or other decisions during the interim period. Accordingly, they may attempt to narrow down such exceptions and include limitations. For example, to require that (i) the actions in question be "required" to comply with changes in law, (ii) the actions be commercially reasonable and/or generally consistent with those taken by the target's peer companies, and/or (iii) requiring that any such extraordinary actions be taken only after approval or consultation with the buyer. From a buyer's perspective (and subject to normal gun jumping and competition law concerns), it will wish to have as much oversight and control of the business (and the implementation of business continuity and contingency planning) as is possible during the interim period. Buyers can also seek to include in the agreement additional pre-closing covenants of the seller which are specific to COVID-19. For example, these covenants may include the target's compliance with applicable government laws and orders adopted in respect of its employees and facilities and the completion of business continuity and contingency planning. Ultimately, the buyer needs to determine certain circumstances where a seller has irreparably harmed the target between signing and closing and consider a walk right when certain specific covenants are breached without the consent of the buyer.

## Interim operating covenants closing condition

Interim operating covenants typically have to be performed and complied with at closing. If these are not met, it gives the buyer the right to terminate the deal. 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. Operational changes made by sellers in response to COVID-19 and to governmental restrictions (e.g. suspension of operations, termination or furloughing of employees, borrowing, or not providing facility access and inspection to buyer) may arguably breach standard operating covenants depending on the language of the covenant. In addition to potential modifications to the language of the covenants, sellers may wish to seek to have the closing condition with respect to those pre-closing covenants potentially affected by COVID-19 qualified by a MAE standard, as defined, 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 in the agreement. Parties will need to determine whether it is appropriate amidst COVID-19 for the buyer to have a right to terminate the agreement for breaches of an interim operating covenant that fall short of an MAE, particularly in cases where the seller has conceded that a form of MAE will apply to address the consequences of COVID-19, or whether a buyer should be entitled to a damages claim only and the limits, if any, on the amount of such damages.

## Special COVID-19 indemnities and/or closing conditions

If there are identified potential risks or issues related to COVID-19 discovered through the due diligence process, a buyer can consider adding special standalone seller indemnities for such matters. If the potential liability is significant, the buyer can consider requiring the seller to escrow funds to cover the potential liability and/or negotiate for an increase in any indemnification cap. The problem is that the effect of having a specific indemnity for COVID-19 related risks allocates all of the COVID-19 consequences to the seller. The seller should argue that a special indemnity is not appropriate, given that this is a known global issue, and that the buyer should appropriately adjust the purchase price based on a revised valuation model that takes into account the downside risk of COVID-19 and its effects on the target.

Separately, while special indemnities may be a potential solution for the parties from the standpoint of protecting against buyer "outs" for material breaches by the seller of representations and warranties as a result of COVID-19, there may be instances where because of the resulting lower purchase price, seller indemnification will not be acceptable to the seller, depending on any negotiated caps on the seller's indemnification obligations. Although not typical, sellers may wish to negotiate for protection from being forced to close a transaction that does not make economic sense as result of changed circumstances beyond its control.

Buyers generally face a heavy burden when attempting to invoke an MAE. Delaware courts look to whether the adverse effect would "substantially threaten the overall earnings potential of the target in a durationally -significant manner," which, in the M&A context, "one would expect to be measured in years rather than months." As a result, if the parties have not included specific, measurable tests for determining whether an MAE has occurred, a buyer might consider adding specific, objective financial measures or other conditions to close to preserve its right to terminate the agreement if the target's business significantly deteriorates before closing due to the effects of COVID-19.

## Acquisition financing

Given the limited availability of acquisition financing in the credit markets today, parties in transactions that depend on third-party debt financing should consider the added risk of whether to proceed and what happens if buyers fail to secure such financing. The parties will want to ensure that the MAE closing condition provision in the acquisition agreement and the financing documents are consistent so that pandemic related risks are allocated consistently. Buyers will also want to carefully consider any condition to fund or borrow in the financing documents that is tied to the financial performance of the target and the associated assumptions regarding financial performance.

Buyers concerned about committed funds being unavailable may wish to mitigate their risk by negotiating a reverse break-up fee if it cannot obtain financing and liming the seller's specific performance rights where the financing source is refusing to fund. Sellers that may be willing to accept some risk in this environment with respect to financing failure arrangements, may wish to require buyer deposits at signing, which would be forfeited in the event of a financing failure, or satisfactory guarantees by or on behalf of the buyer.

## Outside date

For deals that require regulatory approvals, government and regulatory agencies are expected to have a longer review time period as government employees in the United States and abroad have been forced to work remotely or work in shifts. Therefore, parties should consider (i) a longer "outside date" or (ii) an automatic extension, but only if the relevant party has used applicable efforts to satisfy the relevant conditions. In addition, to the extent parties are unable to agree on an allocation of closing risks associated with timely regulatory approvals, they may consider termination fees as a means to resolve the issue.

While removing all risk from transactions in relation to the COVID-19 pandemic is impossible, transaction parties are able to negotiate to identify and allocate COVID-19 risks through careful drafting. We are now seeing some movement in market practice with acquisition agreements addressing the current COVID-19 pandemic and future virus outbreaks (as well as the economic fallout from them) with more clarity as to what constitutes an MAE, operation in the ordinary course, commercially reasonable efforts, reasonableness of withholding consent and other provisions driving some adjustments in risk allocation and deal protection measures between well- advised buyer and sellers.

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