

CLIENT ALERT

COVID-19 Considerations in Private M&A

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The coronavirus pandemic (COVID-19) has had a significant impact on M&A activity globally. Amongst other things, the pandemic has given rise to issues of valuation and funding and caused certain possible buyers and sellers to defer ongoing transactions in order to focus on mitigating the effect of the virus on their business operations. Where parties nevertheless continue to pursue M&A transactions in the current climate, they are advised to consider the impact of COVID-19 on their contractual protections and exposure and on transaction logistics and timing. This note briefly considers certain key areas of relevance from a U.S. and U.K. standpoint.

Contractual Protections in Acquisition Documentation

Valuation and Price Adjustment

- The medium and long term financial impact of COVID-19 on the viability and value of many industries and industry participants is presently impossible to assess with any degree of certainty. COVID-19 may therefore cause a significant disconnect in the valuation of certain target businesses by buyers and sellers. This is likely to result in an increase in the adoption of price adjustment mechanisms relating to the financial performance of the target business during a prescribed period after closing – for example, an earn-out formula based on the future performance of the target and its achievement of specified financial metrics, or a contingent value right where payment of a deferred portion of the consideration is conditional on the occurrence of a future event.
- Separately, since the COVID-19 impact on any business in the short term will be difficult to assess, buyers are likely to push for the use of a post-closing purchase price adjustment mechanism (also known as closing accounts) rather than a European style locked box mechanism in order to determine the final purchase price payable by the buyer; in particular, where there is a gap between signing and closing or where the target's industry has been materially affected by the pandemic. This would mark a change in U.K. market practice, given that a locked box mechanism has been adopted in the majority of English law transactions in recent years. However, post-closing purchase price adjustments have remained the default position in U.S. deals.
- In a European style locked box transaction, the parties agree a price payable for the target based on a balance sheet drawn up as of an agreed date in advance of signing; and the seller covenants not to extract value from the target from the balance sheet date. As a result, the buyer typically assumes the risk relating to the ordinary course trading performance of the target group during the period between the balance sheet date and closing. In the current climate, there may be significant adverse changes to the target's working capital and debt position in this period.
- Conversely, in a transaction utilizing a post-closing purchase price adjustment, the purchase price is adjusted by reference to a set of accounts showing the financial position of the target as of closing. There is then a dollar for dollar adjustment to the purchase price to the extent that the value of certain assets and liabilities is greater or less than a target figure agreed by the parties prior to signing the purchase agreement. The assets and liabilities in question are

generally limited to cash, debt and working capital, but other measures (such as net assets) can be used depending on the target's industry and valuation basis.

- Where a post-closing purchase price adjustment mechanism is used in a transaction, we expect that the accounting policies governing the preparation of the closing accounts will be heavily negotiated. In particular, the parties may disagree on the extent to which certain specific policies should be introduced to reflect the changing market conditions arising from the pandemic, including in connection with the collection periods for receivables and increases in doubtful account reserves. Similarly, it may not be straightforward to agree on an appropriate target figure for working capital if the business' working capital requirements have become subject to significant change during the recent period.

Pre-Closing Covenants

- If there is a gap between signing and closing, the seller usually commits to operating the target business in the ordinary course and agrees to restrictions on certain actions by the target during the period between signing and closing. The parties should consider the extent to which the purchase agreement affords flexibility to the target business to respond to unforeseen events in light of any potential impact of COVID-19. Equally, buyers should consider the incorporation into the purchase agreement of additional pre-closing covenants which are specific to COVID-19. These may include, for example, the target's compliance with government measures adopted in respect of its employees and the finalisation of contingency planning.

Conditions to Closing

- In any M&A transaction there is tension between, on the one hand, the seller's desire to ensure deal certainty by limiting the buyer's ability to terminate the transaction and, on the other hand, the buyer's desire to retain flexibility to withdraw from the acquisition in the event that it becomes aware of information adverse to the target. While termination rights are uncommon in English law transactions, we expect that U.K. buyers may push for U.S.-style conditionality in the current climate if signing and closing are not simultaneous. These termination rights would include the occurrence of a material adverse change (MAC) in the business of the target and bringdown conditions relating to the accuracy of the seller's representations and warranties as at closing.
- However, buyers should not assume that a typical MAC clause would be triggered by COVID-19 given that MAC clauses are generally intended to capture events which are unforeseen as of the time of signing. As a result, we have seen instances of traditional MAC clauses being expanded to cover the occurrence of a limited and specified category of risk arising from COVID-19. These may include, for example, the effect of the pandemic on the target's relationship with certain key customers and suppliers; the forced closure of the target's facilities; and the impact of the pandemic on the target's workforce due to illness or new workplace requirements adversely affecting productivity. Alternatively, buyers are pushing for the incorporation of similar conditionality related to the target business outside of the MAC clause.

Representations and Warranties

- Buyers should seek additional representations and warranties on the impact of COVID-19 on the target business, including revenue and solvency; performance of material contracts; supply chain risks; employee benefits/executive compensation; insurance coverage; and scenario planning and risk assessments. Where specific COVID-19 related issues are identified by a buyer through due diligence, it should take a cautious approach and request that the relevant issues

are addressed at the seller's cost through a standalone indemnity or purchase price adjustment. Further, if there is a gap between signing and closing, we expect buyers to require that representations and warranties be true and correct at closing. While this is customary in U.S. transactions, it would represent a deviation in practice for English law deals.

- Conversely, sellers should seek to limit their liability in respect of COVID-19 related claims by pushing for buyers to purchase Representation and Warranty Insurance and/or by providing that such claims may be brought only in respect of a limited category of representations and warranties. Where the buyer has recourse to Representation and Warranty Insurance, it should ensure that COVID-19 risks are not excluded from coverage. This in turn would depend on the underwriter's assessment of the impact of COVID-19 on the target business. Underwriters are undertaking increased diligence in certain areas for this purpose, particularly around financial forecasts, valuations, supply chain management, material contracts and employment matters.

Transaction Logistics

Antitrust and Regulatory Consents

- The parties to an acquisition should consider how review deadlines imposed on competition and other regulatory authorities, such as the Committee on Foreign Investment in the United States (CFIUS), have been affected by COVID-19 in circumstances where a merger clearance or regulatory approval is required to be obtained prior to closing.
- The European Commission is encouraging companies to delay merger notifications until further notice, where possible. The Commission expects delays in the collection of information from third parties, such as customers, competitors and suppliers. In addition, Commission officials may face some challenges accessing information as they are working remotely as of March 16, 2020. The Commission reportedly suspended three Phase II merger investigations due to companies failing to comply with information deadlines.
- The U.S. Federal Trade Commission and Department of Justice continue to process merger notifications and to investigate transactions, but in practice the process has slowed. The agencies have advised that grants of early termination of waiting periods will be more limited and dependent on resources and, if granted, will likely be delayed. Both agencies have actively sought to extend ongoing merger investigations by 30 to 120 days. However, it is worth noting that the agencies have announced that they are accelerating the business review letter process for collaborations intended to address the COVID-19 crisis, committing to respond within seven days of application.
- CFIUS continues to process declarations/notices and remains subject to its statutory timelines. Members of Congress and representatives from the Department of Defense have cautioned that COVID-19 may leave companies that are in economic distress vulnerable to foreign take-over attempts, increasing the importance of a robust CFIUS review, particularly of transactions that are in the Government supply chain.

Engagement with Target Management and Employees

- Buyers will be unable to carry out onsite visits in jurisdictions where lockdown restrictions remain in place and any engagement with target management and employees for due diligence purposes will have to be carried on via electronic means. In the context of asset purchases, practical difficulties will arise in connection with the requirement for collective consultation of target employees under the European Acquired Rights Directive (*Directive 2001/23/EC*) and its implementing regulations in European member states.

Transitional Services

- Transitional services to be provided by the target group after closing may be affected by social distancing and other measures which have been introduced as a result of COVID-19. If so, this could impact the timeline for the separation of business functions, including, where relevant, the migration of services and data to support those functions.

Corporate Authorizations and Electronic Signatures

- Where board and/or shareholder approvals are required for an M&A transaction, the constitutional documents of the relevant company should be checked to ensure that the meetings are permitted to be held by telephone or video conference or that resolutions and consents may be given in writing. If the company's tax residence is a relevant factor, consideration should also be given to the appropriate venue for board meetings.
- While employees continue to work from home, companies should consider the use of electronic signatures to execute purchase agreements and ancillary documentation, provided that this is permitted by the company's constitutional documents and the agreement in question. Companies are advised to use a formalized signing platform, such as DocuSign, that records the signature, how and when it took place and the document that has been signed. While electronic signatures are generally accepted in many jurisdictions, such as the U.K. and the U.S., the parties should confirm if wet-ink signatures are required to be obtained in respect of certain documents, including those filed with the U.K. Land Registry or tax authorities, documents to be notarized or apostilled, and documents to be executed by way of deed. Similarly, if a transaction is leveraged, lenders should be consulted in advance regarding wet-ink signature requirements.
- We note that, in the U.K., HMRC has confirmed that it is currently accepting electronic signatures on stock transfer forms. Where the stamping application is approved, HMRC is sending a confirmation letter by email in which it provides assurance that there will be no penalty against the target company for registering the new ownership of its shares in the register of members.

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