CLIFFORD CHANCE

CORONAVIRUS: KEY CONSIDERATIONS, TECHNIQUES AND STRATEGIES FOR EXECUTING M&A DEALS IN A TURBULENT U.S. MARKET

The COVID-19 pandemic continues to upend lives around the world. Hospital capacity is being tested and projections are dire. Federal, state and local governments have imposed drastic measures such as travel restrictions, border closures and "stay-at-home" orders that have shut down or otherwise dramatically altered all forms of economic activity and virtually every other aspect of life. In response, Congress and the Federal Reserve have unleashed an avalanche of unprecedented monetary and fiscal policy legislation and other programs designed to support and stimulate the economy. Not surprisingly, first quarter M&A deal volume was down from the same period last year, and market participants anticipate continued declines.[1] The duration and magnitude of this crisis remains unknown, and buyers and sellers that continue to pursue deals from the pre-crisis period, or that otherwise seek to remain active in U.S. M&A markets, are trying to understand some of the key considerations, techniques and strategies for executing transactions during a period of historic volatility and uncertainty.

Key Considerations, Techniques and Strategies for executing U.S. M&A

This briefing covers:

- Bridging the Valuation Gap
- "MAC Outs" and Specific Conditions
- Interim Operating Covenants and "Ordinary Course of Business"
- Outside Dates
- Due Diligence
- Representations and Warranties, Disclosure and Rep and Warranty Insurance

Bridging the Valuation Gap

Buyers using typical valuation methods based on forecasts of revenue and earnings may seek to obtain more favorable pricing given the clear negative top-line and bottom-line effect the crisis is having on businesses across most industries. Sellers, however, are likely to argue that business fundamentals remain the same, that the crisis is short-term and that revenue and earnings levels are expected to rebound quickly after the crisis abates, including as soon as the

[1] See: (i) Boston Consulting Group's analysis of "COVID-19's Impact on Global M&A" https://www.bcg.com/publications/2020/covid-impact-global-mergers-and-acquisitions.aspx; and (ii) for commentary from market sources, The Wall Street Journal, Coronavirus Throws Deal Making Into Disarray (March 31, 2020) https://www.wsj.com/articles/coronavirus-throws-deal-making-into-disarray-11585652400.

third quarter. Compounding the challenge of agreeing a base-level valuation, determining a "customary" or "normalized" level of working capital often used in U.S.-style purchase price adjustment provisions is particularly difficult as well when "customary" and "normalized" may have lost their meaning.

While aligning buyer and seller price expectations may seem insurmountable, there are several techniques that can sometimes be helpful to bridge the gap such as caps, collars or floors with respect to working capital adjustments, and earn-outs, milestone or other forms of deferred or contingent payments. While it is true that these types of provisions can be difficult to negotiate in a climate where so much is unknown and revenue, earnings and other financial and business performance metrics will be impacted by factors that do not relate to a target's underlying business fundamentals, it is equally true that they often help to facilitate agreement that might not otherwise be obtained.

Alternative investment strategies can also sometimes be helpful to bridge the valuation gap. For example, the use of stock coupled with contingent, priority ranking or interest-linked rights (including convertible preferred stock or liquidation preferences), or seller financing in the form of seller notes or retained equity stakes, allows the risk on valuation to be shared between buyer and seller. These types of instruments could be structured to contain features such as put/calls, prepayment and buyback obligations, each of which could be triggered by the passage of time, future performance, or other triggers that make sense in the context of a particular business. Consortia and "club" deals also present a potential solution to valuation issues by allowing buyers to combine resources and, accordingly, commit less capital and reduce overall exposure to valuation risk. Clearly, moving to any of these alternative structures creates additional complexity that would need to be considered, particularly in a competitive auction setting in which speed and commerciality are critical, but equally, in the right situation, these types of structures may facilitate deal making by spreading the risk over a number of parties.

"MAC Outs" and Specific Conditions

In a period of market disruption, sellers are more likely to be particularly focused on ensuring that the transaction, once announced, is certain to close. Buyers, conversely, may not be willing to do the deal, even for a significantly reduced price, and are more likely to be looking to preserve their ability to walk away without penalty if circumstances change between signing and closing.

As was the case in past crises environments, such as the "dot com" crash, the period following the September 11 terrorist attacks and the global financial crisis, ill-informed buyers often assume that they will be protected by a "MAC Out" (i.e., a condition to closing included in a purchase agreement that, if triggered, excuses the buyer's obligation to close). The reality, however, is far more complex as MAE/MAC definitions now typically expressly provide that any material adverse effects or changes that are attributable to, among other things, general economic conditions, terrorist actions, natural disasters and even epidemics or pandemics are not to be considered when determining whether an MAE/MAC has occurred.

Although excluding epidemics and pandemics has traditionally been less common, in today's environment the express exclusion of epidemics and pandemics is becoming non-negotiable for many sellers, and may even specifically refer to effects or changes that are attributable to COVID-19.[2] Buyers will of course continue to seek to mitigate the consequence of these types of exclusions by providing that any material adverse effects or changes that are attributable to, among other things, epidemics or pandemics are to be considered when determining whether an MAE/MAC has occurred to the extent that such effects or changes have a disproportionate impact on the target business as compared to the impact such effects or changes have on other businesses in the same industry, similar to what is currently done as it relates to other similar broad-based exclusions such as for general economic conditions. But regardless, with or without these types of exclusionary provisions, any buyer seeking to walk away from a deal by invoking a MAC Out must overcome an exceptionally heavy burden by demonstrating that the material adverse effect or change is "consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months."[3]

To create greater certainty protecting the buyer's right to refuse to close a transaction based on the effects of COVID-19, buyers are well-advised to negotiate objectively verifiable closing conditions that are specifically tailored to the pandemic. For instance, a condition that the target meets certain minimal financial metrics at closing, that certain facilities or other operations of the target remain open and fully operational at closing or if certain types or levels of employees become infected with COVID-19 rendering them unable to work. Sellers, on the other hand, will likely resist such conditions given the uncertainty created by the pandemic and the potential adverse consequences to the target business if the seller announces a deal that does not close.

Interim Operating Covenants and "Ordinary Course of Business"

Interim operating covenants that require sellers to operate the target's business in the ordinary course of business consistent with past practice between signing and closing may need to be relaxed to give the target company greater operational freedom as a result of the effects the pandemic is having on the target's operations, including to enable a seller to take actions necessary for the protection of public health. For example, it is clear that few businesses are operating in the ordinary course of business at this time, let alone in a manner that is consistent with past practice, so prudent sellers will look to refine the "ordinary course" concept and the level of efforts required actually to operate in the ordinary course. In addition, although it is common for interim operating covenants to require the target company to be operated in compliance with laws between signing and closing, many states have enacted social-distancing and other "recommendations" rather than legally enforceable orders. In those cases, sellers may seek expanded language to ensure that they can comply with governmental recommendations even if such recommendations do not have the force of law. Sellers will need

[2] See e.g., the definition of (i) "Company Material Adverse Effect" in the Agreement and Plan of Merger, dated as of February 20, 2020, by and among Morgan Stanley, Moon-Eagle Merger Sub, Inc., and E*TRADE Financial Corporation and (ii) "Aon Material Adverse Effect" / "WTW Material Adverse Effect" in the Business Combination Agreement, dated as of March 9, 2020, by and between Aon plc and Willis Towers Watson Public Limited Company.

[3] See e.g. Akorn, Inc. v. Fresenius Kabi AG, C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018), Hexion Specialty Chemicals, Inc. v. Huntsman Corp., 965 A.2d 715 (Del. Ch. 2008) and our briefing Delaware Chancery Court Upholds Invocation of MAC Out.

prompt access to the buyer's decision-makers if the seller needs permission for the target company to take certain extraordinary actions that would otherwise be prohibited by the covenant. As a practical measure, although parties must remain mindful of antitrust "gun-jumping" concerns, parties could consider establishing committees comprised of representatives of both buyer and seller who can regularly discuss the effect of the pandemic on a target between signing and closing and could be empowered to make prompt decisions with respect to COVID-19 related operational matters, including with respect to the actions prohibited by the covenant.

Outside Dates

Working remotely and other factors may result in potential delays in merger and other regulatory clearance timelines and third-party consents may take longer to obtain. Given the still unknown effects on regulatory agencies and financing sources, many buyers and sellers have agreed to extended "outside date" provisions that permit termination of an acquisition agreement if the transaction has not closed prior to the outside date. Another approach would to select a more customary outside date, but specifically allow either party to extend such outside date if all conditions are satisfied except for certain conditions, such as required merger or other regulatory clearances. Such extension periods could even be longer than would normally be the case given the current climate.

With respect to U.S. antitrust clearance, although the Federal Trade Commission (FTC) initially suspended the ability for parties to receive expedited clearance (so-called "early termination") as a result of the pandemic, it has announced that early termination will again be granted, albeit on a more limited basis to fewer applicants during the pandemic shut-down. This may be an effect of the FTC creating an effective system to work remotely while under stay-at-home orders or it may reflect an overall decline in clearance requests such that backlogs are no longer a concern.

Due Diligence

Numerous forms of traditional due diligence, such as physical management presentations and site visits, are impractical or even impossible at this time. Nonetheless, with virtual data rooms and the ability to hold virtual meetings, a considerable portion of due diligence activity can continue, though populating new virtual data rooms may prove challenging for a target if it doesn't have ready access to the materials proposed to be included in the virtual data room.

Buyer's should also expand their due diligence as a result of the pandemic, including for example with respect to the impact of pandemic-related governmental orders and recommendations; the ability of the target to continue operations with an extended period of reduced cash flow; the extent of readily-available insurance coverage, in particular business interruption insurance and any stop-gap health coverage for target employees; the pandemic's impact on the target's supply chain, sufficiency of inventory, customers and goods and services fulfillment capability and collection of accounts receivable. Detailed focus should be given to the ability of the target to continue complying with its material contracts and the ability for the target's counterparties to suspend or terminate obligations under force majeure or similar provisions and continued regulatory compliance while working remotely, in particular for targets in heavily regulated industries such as financial services (see our briefing Coronavirus: Operational and Regulatory Risk-Off Strategies for SEC-Registered Investment Advisers) or for targets that hold extensive information covered by the European General Data Protection Regulation (GDPR), The California Consumer Privacy Act (CCPA) or other similar privacy laws and regulations. And target businesses that are subject to remote working arrangements will of course also provide an opportunity for buyers to further assess the strength of a target's IT systems.

Representations and Warranties, Disclosure and Rep and Warranty Insurance

To backstop the buyer's due diligence, buyers continue to seek representation and warranty protection specifically related to the pandemic, for instance by seeking representations and warranties with respect to the extent of infection within the target company's employee population, the target company's compliance with governmental recommendations/orders and the effect the pandemic is having on the target company's suppliers and customers and the related underlying contractual arrangements. On the other hand, sellers are seeking disclosures against many, and in some cases all, representations and warranties to exclude the effects of the pandemic entirely. Moreover, sellers may take a more strict view on what representations and warranties will have to remain true at closing (the so-called "bring down"), for instance providing that representations and warranties with respect to key customers and suppliers would only need to be accurate at signing and not also at closing as is customarily the case, because a seller will have less control of whether certain representations and warranties are capable of being brought down to closing in such a volatile environment. Buyers, by contrast, may seek to move away from the traditional MAE/MAC bring down construct in which all of the seller's representations and warranties (other than certain fundamental representations and warranties) have to be true at closing unless the failure to be true would result in an MAE/MAC, and instead require each of the seller's representations and warranties to be true at closing in all material respects. Buyers may also take a tougher stance and have less appetite for risk around non-coronavirus issues that are identified through due diligence and put further pressure on valuation, and may look for those issues to be addressed at the seller's cost through special indemnities or further price concessions.

Many providers of rep and warranty insurance, now a mainstay in U.S. M&A practice, are seeking broad exclusions from coverage for certain risks arising from COVID-19. Until the effects of the pandemic are better understood, many such providers will likely continue to seek broad exclusions rather than more narrowly-tailored exclusions related to the target. Insureds under rep and warranty insurance policies should resist broad exclusions given the numerous effects that can arise out of the pandemic, for instance by limiting any exclusion to losses resulting from specifically-identified risks of business interruption to the target itself. It is important to understand a rep and warranty insurance provider's position and approach to COVID-19 related coverage and exclusions prior to entering into the underwriting process.

Even in instances where insureds under such insurance policies are successful in obtaining coverage with narrowly-tailored exclusions, for transactions that have a delay between signing and closing, it is important to consider potential changes in the business of the target that may arise in this interim period due to COVID-19. To the extent such changes come to light prior to closing a transaction, coverage under a typical rep and warranty insurance policy could be negatively affected. Parties to M&A transactions should consider such potential changes when structuring any indemnification protection which may apply in addition to rep and warranty insurance coverage. Due to the general uncertainty relating to the economic impacts of COVID-19 as well as related government responses, parties should also consider a potential formalized process following signing for continuing or bring-down diligence prior to closing. The impact of identifying issues based on such additional diligence on rep and warranty insurance coverage, indemnities and the ability to invoke rights under any enhanced closing condition package that may be negotiated in light of the effects of COVID-19 should also be reviewed.

Further information

You may find the following resources relating to Covid-19 helpful:
www.cliffordchance.com/insights/thought_leadership/coronavirus.html

CLIFFORD CHANCE

AUTHORS

David Brinton
Partner

T +1 212 878 8276
E david.brinton@cliffordchance.com

Benjamin Sibbett
Partner

T +1 212 878 8491
E benjamin.sibbett@cliffordchance.com

Matthew Warner
Counsel

T +1 212 878 3249
E matthew.warner@cliffordchance.com

Neil Barlow
Legal Consultant

T +1 212 878 4912
E neil.barlow@cliffordchance.com

CONTACTS

Michael Bonsignore
Partner

T +1 202 912 5122
E michael.bonsignore@cliffordchance.com

Gary Boss
Partner

T +1 212 878 8063
E gary.boss@cliffordchance.com

Thais Garcia
Partner

T +1 212 878 8497
E thais.garcia@cliffordchance.com

John Healy
Partner

T +1 212 878 8281
E john.healy@cliffordchance.com

Sarah Jones
Partner

T +1 212 878 3321
E sarah.jones@cliffordchance.com

Kevin Lehpamer
Partner

T +1 212 878 4924
E kevin.lehpamer@cliffordchance.com

Anand Saha
Partner

T +1 212 878 8301
E anand.saha@cliffordchance.com