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M&A Alert

COVID-19 M&A Closing Considerations

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Even though we are in the early days of assessing the impact of the COVID-19 pandemic on mergers and acquisitions, much has already been written about the extent to which this crisis could amount to a material adverse change (MAC) under acquisition agreements that are pending closing. Of course, the answer depends on what the agreement says and whether the change satisfies the materiality and durational significance standards under applicable law (see, e.g., Akorn v. Fresenius (Del. 2018)). This note highlights related issues that buyers and sellers should also consider as they march toward closing:

- **Interim Operating Covenants.** Acquisition agreements invariably require sellers to conduct the business in the ordinary course consistent with past practice, and expressly limit a laundry list of extraordinary activities. Despite a seller's best intentions to comply with such covenants, it may become necessary to incur additional debt, accelerate collections, stretch payables, lay off staff, or defer capital expenditures or otherwise deviate from its operating budget – actions that could blow the covenant and give the buyer a walk right. Sellers currently negotiating an acquisition agreement would be wise to build in additional latitude to manage operations and comply with pending or anticipated governmental orders to prevent an easy out for a skittish buyer. In addition, buyers and sellers should craft operating covenants to account for an extended interim period, and consider carefully whether events and circumstances such as mandatory "work from home" policies, supply chain disruptions and governmental orders (e.g., shelter-in-place) fall within the concepts of "ordinary course" and "past practice".

- **"Bring Down" of Reps.** Sellers may have an equally difficult time certifying at closing the accuracy of representations and warranties made at signing, even if the "bring down" condition is qualified by materiality. Representations with respect to undisclosed liabilities, the status of material contracts and commercial relationships, indebtedness, and full disclosure may present clear concerns, but there may be more subtle representations that can no longer be credibly made at closing. Sellers should have more leeway if the "bring down" condition is qualified by the MAC standard in the agreement (which is very often the case in private deals – 67% of the time according to the latest ABA Private Target Deal Points Study), but that will also depend on the particulars of the agreement. (Sellers will rightly be focused on their representations as of signing as well; in the current environment it may be impossible to make any number of typical representations (such as, for example, that sellers have conducted the business in the ordinary course since December 31, 2019, that sellers have no reason to believe that top customers will reduce orders, or that receivables will be collectible in the ordinary course, etc.) without taking corresponding exceptions in the disclosure schedules.)

- **Financing Concerns.** For well-advised buyers financing an acquisition, the material adverse change conditions in the financing and acquisition agreements should effectively align with or mirror one another, so if the buyer can't terminate the acquisition for a MAC, its lenders can't terminate the financing either. However, there may be other conditions in the financing documents, such as the combined financial performance of the target and the buyer (e.g., a pro forma maximum leverage test at closing), which, if unsatisfied, could give the lenders an out. The nightmare scenario – where the effects of COVID-19 on a target company's financial performance don't rise to the level of a MAC, but nonetheless crater the financing (perhaps because the buyer itself is subject to COVID-19 problems) – could force a buyer to close without debt financing (or trigger a reverse termination fee). While many borrower-buyers have enjoyed limited conditionality financing commitments in recent years (post-SunGard), it's conceivable that lenders could insist on pro forma financial conditions in a post-COVID-19 world.

- **Working Capital Calculations and Adjustments.** Assuming the COVID-19 crisis has negatively impacted a target company's working capital relative to historical or normalized levels upon which the working capital peg was based, sellers should anticipate greater than expected post-closing adjustments. However, if the agreement caps the adjustment – either expressly or effectively as a result of a finite working capital escrow – the buyer should anticipate having to pony up any working capital shortfall necessary to run the business post-closing, keeping in mind that any such shortfall is likely to be exacerbated by the COVID-19 crisis itself. Relatedly, if the parties agree to an extended closing timeline (see below for further discussion on this point), they should also consider the impact of this longer period on the working capital adjustment.

- **Representation and Warranty Insurance.** Insurers have widely begun adding coverage exclusions relating to the impact of COVID-19 in their non-binding indication letters and policies. The scope and specific terms of such exclusions vary; some have excluded the novel, coronavirus-specific representations that have cropped up in acquisition agreements currently under negotiation (e.g., "To the Knowledge of the Company, none of the Key Employees has been diagnosed (presumptively or otherwise) with the coronavirus disease"). For new deals, the parties should expect enhanced due diligence by underwriters, and buyers should expect longer, more detailed bring-down calls for pending deals. Buyers should carefully check the terms of policies bound prior to the COVID-19 outbreak as coverage could potentially be available absent these express exclusions.

- **Outside Dates/Closing Timing.** In setting the outside or "drop dead" date for a new deal, the parties should consider allowing for the additional time expected to obtain governmental and third party consents, as many companies, regulators and secretaries of state are operating with delays and reduced staffing. For example, at present, requesting early termination is no longer an option for Hart-Scott-Rodino filings. The parties might consider incorporating a tolling concept (akin to those sometimes employed in antitrust covenants) to automatically extend the outside date.

Foley Hoag has formed a firm-wide, multi-disciplinary task force dedicated to client matters related to the novel coronavirus (COVID-19). For more guidance on your COVID-19 issues, visit our Resource Page or contact your Foley Hoag attorney.

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