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Managing COVID-19 risks in corporate deals

The COVID-19 global pandemic undoubtedly creates a challenging environment for corporate deals. In this note, we look at the likely impact on M&A transactions and the steps that can be taken to manage the risks arising from the pandemic.

Due diligence

We expect to see an even greater focus on due diligence generally, but in particular around areas such as insurance, supply chain risks, business continuity and disaster recovery plans, workforce and health and safety policies and procedures and the terms of material contracts (including termination rights, material adverse change and force majeure provisions). Sellers should ensure that they disclose all relevant material information in relation to these matters, including up to date details of their contingency planning in respect of COVID-19 and the mitigation steps that are being taken in the target business. Buyers will inevitably focus on these matters and sellers will be best served by being on the front foot and making it clear to buyers that they are adequately prepared.

Costs cover

Greater uncertainty around reaching signing or closing will lead to increased concern as to deal costs.

In practice, costs cover is difficult to negotiate in the early stages of a deal and we expect that buyers will continue to bear their share of the risk that a deal falls over, leaving them with sunk costs. Buyers may therefore want to manage their costs exposure by prioritising key areas of due diligence, deferring other expenditure to later in the process when there is more certainty that agreement can be reached.

It may be easier for a buyer to negotiate costs cover: in a bilateral process; late in an auction process (particularly where the buyer is refused exclusivity, or is asked to accept a contract race); or where exclusivity has been granted and the costs cover is limited to circumstances where the seller breaches that exclusivity or ceases to deal in good faith (with the aim of waiting the exclusivity period out). Ultimately, whether a buyer can negotiate costs cover will depend largely on the respective negotiating power of the parties, and in particular on the level of competition for the relevant asset.

Where agreement is reached but a gap between signing and closing is required, the party on the hook for costs cover in the event that closing does not occur will usually be the one that fails to satisfy a particular condition to closing or is otherwise in default. In these instances, costs cover often comes in the form of a break fee, although seller's should consider asking for a non-refundable deposit if they have concerns over a buyer's ability to pay.

Price protection

Valuations are undoubtedly challenging in a volatile market. Although the fundamentals of a business may be otherwise sound, the inherent uncertainties surrounding the impact of COVID-19 will lead to downward pressure on prices. In these circumstances, an earn out (where payment of a material part of the purchase price is contingent on the future performance of the target business) may help bridge the valuation gap and we may see their use increase. That said, it's possible that high levels of uncertainty may mean sellers that have a choice (and some may not) are not willing to accept an earn out structure.

The use of an earnout often creates significant tension between buyer and seller. Buyers see earn outs as being highly contingent, whilst seller's often view them as a form of deferred consideration. Further, during the earn-out period, the buyer will want to integrate the target business and run it with a view to long term value creation. The seller, on the other hand, will want the target business to continue to operate as before, focusing on short term performance. So called 'earn-out protections' (regulating what the buyer can and cannot do during the earn-out period) are keenly negotiated, and greater use of earn-outs (which may cover a more significant proportion of the purchase price) will likely add to this tension, making deals harder to broker.

Price adjustment

Price certainty is a good thing for sellers, in any market. Over recent years, locked box pricing has become an increasingly common feature of M&A deals globally, other than in the US. We can expect sellers to continue to push for a locked box structure, particularly in an auction context, but a lack of flexibility in this regard could be fatal.

Given the extent of the impact COVID-19 could have on current trading, many buyers may insist on post completion price adjustment in the form of a traditional completion accounts mechanic. Historically, the most common bases for adjustment were net debt and working capital. However, given the scale of current volatility, buyers may also seek adjustment based on revenue or earnings up to completion.

Sellers can manage this risk, to an extent, by seeking collars (minimum adjustment levels required before any adjustment is made) and caps (maximum adjustments) as part of a completion accounts package but, given current market conditions, buyers are likely to take a different view.

Deferrals, retentions & escrows

In a period of market uncertainty, buyers are more likely to seek to defer part of the purchase price, even if there are no substantive conditions attached to payment other than passing of time.

Many deferrals will turn into retentions, where a buyer has the ability to dip into the deferred consideration to cover purchase price adjustments, warranty claims and other contractual recourse against the seller. Buyers will be particularly interested in securing retentions where: there are multiple sellers; the sellers include individuals; or there is any concern over the solvency of one or more sellers post completion.

Sellers will normally push back against a retention, or at least seek an escrow (where the deferred consideration is held by a third party). This gives sellers more comfort that they will ultimately get their money, and can also provide them with comfort if they have any concerns over buyer solvency post completion.

Conditionality & termination rights

M&A deals commonly include conditions (e.g. antitrust approval) that must be satisfied (or waived) before a longstop. Completion can only take place once the conditions are satisfied or waived, failing which one or other of the parties can walk away from the deal.

It is in the interest of all parties to ensure that conditions are clear and tightly drafted. Well drafted conditions will prevent a party walking away from a deal for reasons that were never intended to be covered by the condition they are relying on. For deals that signed before COVID-19 hit (or at least before people became conscious of the possible implications), it may be that one party (most likely the buyer) will look to terminate based on a broad or vague condition including any MAC clause (see further comments below). In these circumstances, litigation is highly likely. It may also be that delays in the usual timetable for obtaining (e.g.) regulatory clearances (we are already seeing many regulators working to longer timelines) mean that longstop dates by which conditions must be satisfied come into play. In these circumstances a buyer may have a walkaway right simply because the process takes longer than expected. Again, expect close scrutiny of the drafting and in particular provisions around extending these dates.

For deals that have yet to sign, we are likely to see an increased focus on conditionality in light of the challenges posed by COVID-19. For example:

- long-stop dates: there may be increased pressure to extend long-stop dates, in particular if regulatory conditions need to be fulfilled. As noted above, the impact of movement and travel restrictions affecting staff at regulators may mean that in practice consents take longer to obtain; and
- key contracts: conditions relating to the continuation of key supply and customer contracts could become more prevalent, in particular where such contracts are vital to the ongoing viability of the target business.

Close attention should also be paid to interim covenants, which regulate the conduct of the target business between signing and completion. Sellers in particular will seek maximum flexibility to respond to COVID-19 issues as they arise in the target business, without having to obtain the buyer's consent first. This could be addressed by allowing actions to be taken that are consistent with the target's disclosed contingency plans and/or reasonable actions taken in response to public health and government guidance.

MAC clauses

Material adverse change (MAC) (also referred to as material adverse effect or MAE) clauses are more common in some jurisdictions (e.g. the US) than others, are typically heavily negotiated and are generally viewed unfavourably by sellers. We are, however, starting to see more attention being given to MAC clauses in the current environment as a means of addressing risks posed by COVID-19.

It is unlikely that a "traditional" MAC clause will cover the impact of COVID-19 on the target business – typically, MAC clauses exclude industry-wide or generic market factors such as pandemics and are designed to cater for unknown rather than known risks. A specific MAC clause relating to COVID-19 would therefore need to be negotiated, most likely to cover a situation where the virus has a disproportionate effect on the target business when compared to other businesses in the same sector or jurisdiction. It would also need to address issues such as how material adverse effects are measured (e.g. by reference to a reduction in EBITDA, a one-off loss or other balance sheet impact or loss of a material contract) and whether/how to define materiality parameters (e.g. by reference to a monetary amount or percentage reduction in the relevant measure). We have seen some recent examples of sellers seeking to avoid any uncertainty by specifically excluding pandemics generally from the scope of a MAC provision.

Sellers need to be particularly wary of ‘backdoor’ MAC provisions. These arise where ‘no adverse change’ or similar warranties are repeated at closing and the buyer has a right to terminate in the event of a material breach of warranty. In these circumstances, the buyer has, in effect, a MAC get out.

Sellers should also take care in relation to interim covenants which seek to regulate what sellers can and cannot do in the period between signing and closing. Interim covenants which are well drafted from the seller’s perspective should be matters within the seller’s control and therefore an external event such as a pandemic should not of itself be a material breach (which may give the buyer a termination right). However, in an environment where nobody is operating in the ordinary course of business consistent with past practice, a breach of these covenants is more likely. Consequently, sellers should think hard before agreeing that a breach of any covenants which are outside of their control should give rise to a termination right for the buyer.

Financing

Both buyers and sellers will want to ensure that any conditions in the buyer’s financing facilities are aligned to those set out in the sale and purchase agreement. Failure to address this could lead to the parties finding themselves with an unconditional deal for which financing is not available. Buyers are often reluctant to share details of their finance package with sellers but sellers should now insists on this information. Funding conditions linked to the financial performance of the target may well bite even if a MAC clause in the acquisition documents does not.

At present, it remains unclear how COVID-19 will impact debt markets. Central banks around the world are working hard to maintain liquidity but if, notwithstanding these efforts, there is some dislocation, it may be difficult for the committed lenders to successfully syndicate debt. This may result in lead lenders exercising market flex rights, which would result in higher pricing than the buyer had hoped to receive at closing. If the buyer modelled a worst-case scenario from a financing perspective, there should not be a material impact beyond a decrease in the return on investment. That being said, if the buyer does not have a plan in place to account for this likely increase in financing costs, it is entirely possible that we may see certain transactions close (for instance, if the buyer has a contractual obligation to close and the lender has a contractual obligation to lend) which result in the target/buyer potentially facing covenant or payment default very shortly thereafter.

Many transactions will have both a debt and equity financing component and all of the issues which apply to debt financing apply equally to any equity commitment. Conditions to any equity financing are crucial, as is the robustness of the counter-party. The equity funder may be reluctant to share details of its funding arrangements and there will often be offshore components, making the robustness of counterparties more difficult to verify. Buyers should consider deposits or advance funding where they cannot get sufficient certainty.

Warranties & indemnities

In addition to warranties that either directly or indirectly address COVID-19 impacts, including those relating to the target's material contracts, financial position and contingency plans, buyers could seek to address specifically identified risks by way of indemnity. Sellers should consider ring-fencing warranties most relevant to COVID-19 risks and seek appropriate materiality and awareness qualifications.

Buyers may also be in a stronger position to insist on the repetition of warranties at completion. Equally, sellers will want to ensure that they have fully disclosed all COVID-19 risks as far as possible in order to mitigate their exposure to claims.

If W&I insurance is contemplated, policy exclusions should be carefully reviewed. It's likely that as COVID-19 is a known risk, related losses will be excluded from W&I policies.

Distressed targets

Any significant market disruption creates opportunities and COVID-19 will not be any different. In particular, for businesses that were already struggling, the impact could well push them beyond the tipping point. We expect to see some accelerated sales processes both outside and inside formal insolvency. These inevitably impact pricing, meaning sellers may be forced to a price which will be low by historic standards. If the only alternative to a sale is insolvency, sellers may have very little choice, but they may want to consider anti-embarrassment provisions which at least provide a level of protection against a quick flip of the business by the buyer for a significantly inflated price.

Alternative structures

Building on emerging trends we are already seeing in the M&A market, we may also see potential buyers mitigating their risk by adopting a different approach to transactions, for example by:

- acquiring a majority or minority stake in the target rather than acquiring 100% of the shares – with or without an option to increase the stake in the future when the market has stabilised;
- investing in alternative forms of capital such as convertible loan notes, convertible preference shares or other instruments which give a right or ability to acquire shares in the future; or
- team or consortia acquisitions (by financial buyers or possibly by trade and financial buyers in partnership) – enabling deal risks to be shared.

Concluding remarks

Significant M&A transactions are always a big step for buyers and sellers, and there is even more to consider in a market shrouded in uncertainty. Parties need good advisers who understand their business objectives and the markets in which they operate. DLA Piper has been the world's busiest M&A practice for over a decade. Having executed more transactions than any other law firm, we've seen most things before, we know what's market and we understand what it takes to get deals done.

If you are considering a transaction or have any queries, please feel free to reach out to your DLA Piper relationship partner or other member of the DLA Piper M&A team.

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