GIBSON DUNN

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M&A AMID THE CORONAVIRUS (COVID-19) CRISIS: A CHECKLIST

To Our Clients and Friends:

The emergence and rapid escalation of COVID-19 continues to alter every facet of daily life across the globe. For businesses, challenges range from protecting and supporting employees and customers, to contributing to evolving efforts to battle COVID-19, to fighting for survival by preserving liquidity and adapting to new and dramatically different operating conditions. Against this backdrop, the outlook for M&A activity is—understandably—highly uncertain. Assessing value and marshalling necessary financial and human resources are already challenging, and ongoing market volatility may well exacerbate this. Nevertheless, for various reasons, including strategy, opportunity and necessity, both companies and financial sponsors will continue to consider—and where appropriate pursue—transactions. In addition, they will need to address pending transactions that were signed pre-crisis and that now may or may not close.

To assist companies in navigating the M&A process in this unprecedented environment, we have prepared a checklist of key considerations, focusing on areas of particular risk and uncertainty. This checklist is intended as a starting point, as the analysis of each deal making situation will be highly fact-specific. We encourage you to reach out to your Gibson Dunn contact to discuss specific questions or issues that may arise.

1. MAE/MAC provisions. Relying on a material adverse effect or material adverse change (MAE or MAC) as a basis to terminate a transaction has long been extremely difficult under the laws of many states. As a general matter, an MAE or MAC is intended to capture unforeseen events or consequences that have a long-term, dramatic adverse impact on the value of the target. The impact of COVID-19 and its consequences continue to evolve. Whether the impact of the virus will be considered an MAE/MAC will depend upon both what is known at the time a transaction is signed and what the relevant agreement's MAE/MAC definition says about the inclusion or exclusion of the virus. A pre-crisis MAE/MAC definition that makes no reference to COVID-19 (or even to pandemics or epidemics generally) may or may not be found to include the effects of COVID-19 in determining whether an MAE/MAC has occurred. In such cases, disputes may focus on whether definitional language that typically excludes general economic or market conditions and other broad based factors impacting the business climate or the target's industry generally is sufficient to exclude the impact of COVID-19. Parties also may debate whether the potential impact of the virus was reasonably foreseeable at the time the agreement was signed or whether the impact is sufficiently long-lasting to be considered an MAE/MAC under applicable state law.

At this point, though, both buyers and sellers would be well-advised to negotiate explicit language to address COVID-19 risk-allocation in the context of an MAE/MAC provision. We have seen this practice followed in response to past crises. We have already seen a fair number of more recent agreements that specifically exclude the impact of COVID-19 (most often building on an exclusion for any "pandemic" or "epidemic," and sometimes only if it does not disproportionately affect a party) from the scope of an MAE/MAC definition. Whether excluding it completely or specifying a quantitative or qualitative level of financial or operational impact from COVID-19 that, if reached, would give rise to an MAE/MAC, specificity will guard against unexpected results.

2. Termination rights and fees. Always a heavily negotiated deal term, these provisions merit particular attention in the current environment. Aside from MAE/MAC termination rights, parties should give extra attention to the seemingly routine "outside date" termination provision, since requirements for third-party consents and/or government approvals and other closing conditions may be substantially more difficult or take far longer to achieve under current conditions. Who bears the risk of delay, and for what period? How long can buyer and seller wait between signing and closing, and what degree of change in the target's financial results and operations will be allowed if the pre-closing period is particularly long? Deals that require shareholder approvals and filings with (and clearances from) the Securities and Exchange Commission may face particular delays, as these implicate risks of slower governmental action and potential challenges of obtaining stockholder approvals. In the U.S., the government has already suspended the early termination option for Hart-Scott-Rodino Act antitrust review (meaning that clearance will take at least 30 days in all circumstances), and other agency review and clearance processes may be delayed or uncertain, due to staffing shortages, teleworking and prioritization of resources to crisis demands.

With continued volatility in the financing markets, transactions that depend on third-party debt financing can present particular challenges. Providers of both long-term and bridge financing options may offer less certainty, and well-established norms for the terms of financing commitments and definitive agreements may be changing. Both buyers and sellers will want to explore and understand the added risk and volatility in order to address these factors appropriately in decisions about whether, and on what terms, to proceed. The private equity M&A market has a well-established and often used construct to address what is generally viewed as a fairly remote risk of a "financing failure"—including payment by the buyer of a reverse termination fee and limiting the seller's specific performance rights where the debt provider is refusing to fund. In the current environment, buyers and sellers may want to consider whether this risk is greater and whether the "standard" financing-failure arrangements fairly allocate that risk between the parties. We expect that both buyers and sellers will argue as to which one is facing greater risk from financing market volatility at present and what "reallocation" of risk—if any—is "fair." In addition, with the judicial system and other dispute resolution forums increasingly shutting down and consequent delays in the adjudication and enforcement of remedies such as specific performance, the parties' view of the relative value and utility of different types of remedies may change over the near term.

3. Due diligence and representations and warranties. Due diligence in the COVID-19 context confronts both buyers and sellers with marked challenges. Some of the information that a buyer would seek—such as how a target has weathered similar conditions in the past—may simply not be available, even from the most well-intentioned seller. Projections, which always carry a fair element of uncertainty, will be particularly difficult to prepare and assess. Also, site visits and in-person meetings may be inadvisable or impermissible, particularly in a cross-border deal or where the target business has multi-national operations.

COVID-19-specific representations may help inject some greater degree of certainty and promote additional information-sharing, though crafting appropriate representations amid a constantly changing environment could present new hurdles. Moreover, addressing the appropriateness and adequacy of remedies for breaches may be challenging. Would any material breach give rise to a termination right? If, by contrast, breaches would be subject to an overall MAE/MAC standard for termination, how would the MAE/MAC definition apply (as discussed above)? Would a post-closing indemnity right be sufficient? If the post-closing remedy is for the buyer to make a claim against a representation and warranty insurance policy, and if, as discussed below, COVID-19-related claims are likely to be excluded from coverage, will traditional seller-funded indemnities (in deals where they are feasible) experience a level of re-emergence—at least for COVID-19-related claims? Where a seller's sole exposure for post-closing damage claims is for "fraud," should sellers react to fast-changing conditions by providing more extensive pre-closing disclosure updates?

4. Interim operating covenants. Between signing and closing of an M&A transaction, buyers generally want sellers to operate the target business in the "ordinary course" to protect the value of the business they have agreed to purchase (with any deviations requiring buyer's consent). However, interim operating covenants do not constitute an obligation to maintain the financial condition of the target, only to operate the target consistent with the ordinary course of business. Buyers should consider drafting with specificity if they want to have additional protections as to the virus.

Liquidity maintenance, debt refinancing, and working capital management will all require special attention in the interim operating covenants. With a heightened risk of closing failure or delay, the impact of tight interim operating covenants on a business should be considered carefully. Risks exist both pre-termination (with too-tight interim operating covenants potentially laying the groundwork for breach instead of compliance) and, from the seller's perspective, post-termination in terms of potential impact on the target in the event the transaction does not close. The "ordinary course" interim operating covenants also may be tested by operational exigencies resulting from COVID-19 and necessitating an injection of additional working capital or liquidity. "Customary" exceptions for changes required by law or regulation also may take on new meaning and significance in the current environment. Fiduciary duties may push a seller to take actions arguably in breach of an interim operating covenant and risk exposing itself to a breach claim, despite the seller believing its actions are in the best interests of the target, its employees and possibly the public. Parties should consider whether and how to account for all of these factors. Interim financial reporting and specially crafted termination rights if pre-closing performance falls below extreme levels may be relevant in certain circumstances.

5. Representation and warranty and business interruption insurance. If either the seller or the buyer is seeking to obtain representation and warranty insurance as a source of post-closing indemnity on a deal, they will need to focus on how exclusions and limitations will apply to the impact of the virus. Because COVID-19 is a known risk, expect insurers to specifically exclude coronavirus-related losses from their policy coverage, and for pending deals signed prior to the COVID-19 outbreak, to insist on a blanket exclusion of COVID-19 impact when the representations made as of the signing date are "brought down" to closing. In addition, the scope of virus-specific or ancillary diligence, as well as any requirement for post-signing "updates" from a seller, and their effect on the insured party's knowledge should be carefully addressed with counsel in the context of representation and warranty insurance, since an insured's "knowledge" of a situation typically excludes that situation from policy coverage. Business interruption insurance also may be worth considering—if it is available at a reasonable cost. However, the definition of a covered "business interruption" within the scope of the policy must be carefully reviewed.

6. Purchase price adjustments. The impact of the COVID-19 crisis may necessitate a deviation from the customary approach to purchase price adjustments. As discussed above in terms of interim operating covenants, what constitutes "normalized" working capital may need to be adjusted given the impact of the virus. Sellers may need to take drastic measures to maintain acceptable liquidity at the target company level and may want to seek floors or collars in their purchase price adjustment mechanisms to avoid being unduly penalized during the crisis. Conversely, buyers will be understandably focused on ensuring they will be acquiring a business with levels of working capital and liquidity that are within defined parameters.

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Gibson Dunn's lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 outbreak. For additional information, please contact any member of the firm's ***Coronavirus (COVID-19) Response Team****.*

Gibson Dunn's lawyers regularly counsel strategic and private equity buyers and sellers on the legal issues raised by this pandemic in the M&A context. Please also feel free to contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's ***Mergers and Acquisitions*** *or* ***Private Equity*** *practice groups, or the authors:*

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