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Impact of Coronavirus (COVID-19) on M&A and Private Equity

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As with every other aspect of normal life as we know it, the COVID-19 crisis is having a disorienting and disruptive effect on the M&A process, including the acquisition agreement that we have come to rely on for the orderly progression of transactions.

Buyers are trying to assess in what various ways and to what extent this coronavirus will affect the business and employees of the target company, efforts which the target company is often addressing concurrently. Boards are seeking guidance regarding special fiduciary issues raised by the COVID-19 crisis in approving potential transactions. Buyers are dealing with increasing uncertainty in securing acquisition financing as lenders seek assurances and support from federal and state banking agencies to continue funding loans. Target companies are confronted with their sudden vulnerability to unsolicited bids or hostile takeovers, causing them to explore defense tactics such as poison pills. As a result of recent events, even the previously routine provisions of the acquisition agreement now require careful analysis to account for the impact of COVID-19.

To assist in navigating the M&A process in this unprecedented and uncertain environment, we have prepared this article to share some general insights that we are gaining about certain aspects of the acquisition agreement from ongoing transactions. We encourage you to reach out to your Stinson contact to discuss any specific questions or issues that you may have regarding your particular situation.

1. MAE/MAC Provisions

A material adverse effect or material adverse change (MAE or MAC) generally means any occurrence or change that is, or could reasonably be expected to become, individually or in the aggregate, materially adverse to the target business or to the ability of the seller of the target company to complete the transaction on a timely basis. In essence, these provisions are intended to capture unforeseen events or consequences that have a long-term, dramatic adverse impact on the value of the target company.

What constitutes a MAC is negotiated between the parties and is often subject to a number of exclusions, which in turn may be subject to exclusions or exceptions. For example, a MAC may exclude any change or event affecting any of the industries in which the target company operates in the United States or the worldwide economy generally, except to the extent the applicable change or event has a disproportionate effect on the target business as compared to other companies in the same industry. As a result, the determination of what constitutes a MAC is highly fact-specific.

MAC clauses are used primarily in two ways: (i) to limit a post-closing remedy of the buyer by qualifying the seller's representations and warranties (i.e., even if the seller makes an inaccurate representation about the condition of the business during its sale, as long as the inaccuracy is not a MAC with respect to the business, the seller will avoid the liability to reimburse the buyer); or (ii) to allow the buyer to terminate the acquisition agreement if there is a MAC with respect to the target business after the signing date (i.e., the buyer is excused from closing the transaction if a MAC occurs prior to closing).

Whether the impact of COVID-19 will constitute a MAC depends on what the parties knew on the date the agreement was signed, the long-term consequential effect on the target company's earnings, and what the specific MAC definition says about the inclusion or exclusion of the coronavirus. In instances that make no specific reference to COVID-19 (or to pandemics or epidemics generally), the analysis will likely be focused on whether the definition that typically excludes general economic or market conditions and other broad based factors that impact the business climate or the target company's industry generally is sufficient to also exclude the impact of COVID-19. Parties may also argue about whether the potential impact of the virus was reasonably foreseeable at the time the agreement was signed or whether the impact will be sufficiently long-lasting to be considered a MAC under applicable state law. It should be noted, though, that relying on a MAC as a basis to terminate a transaction has been an extremely difficult task under the laws of many states.

For new acquisition agreements, parties should negotiate language to address explicitly the COVID-19 risk in a MAC provision. We are beginning to see a number of agreements that specifically exclude the impact of COVID-19 from the scope of a MAC definition. Some alternatives to this exclusion for parties to consider may be to specify a quantitative or qualitative level of financial or operational impact from COVID-19 that, if reached, would constitute a MAC (e.g., revenue or net earnings fall below a certain level or a certain number of factories are closed); this type of specificity may prevent or reduce the possibility of unexpected results. Buyers are starting to insist on a MAC clause that captures COVID-19 and other pandemic or epidemic risks to give them the ability to terminate a transaction if the situation continues to deteriorate. Sellers will likely resist on the grounds that the coronavirus risk has been broadly publicized and is now well known to market participants. Parties may compromise so that situations where the impact of the coronavirus on the target business is disproportionate to other businesses in the same industry or jurisdiction, or where there is a disproportionate impact of the coronavirus on specific material contracts, would trigger the MAC clause.

Another notable issue emerging in the banking industry with respect to MAC clauses is that many companies are beginning to draw down their credit facilities, purportedly as precautionary actions to strengthen cash positions on their balance sheets to absorb the impact of COVID-19. Lenders are beginning to express some concern, though, that if this trend continues, the credit system might become stressed, possibly requiring large potential cash calls for lenders. As lenders are monitoring this situation, they are also evaluating MAC clauses in loan documents to assess whether a material adverse change has occurred, constituting a default by the borrower and providing the lender a basis to refuse a draw request or event to terminate the credit facilities.

2. Other Termination Rights

Outside Date

Other than a MAC or MAE, acquisition agreements often have a "drop-dead date," "outside date" or "long stop date" termination provision which is triggered if the transaction has not closed by a specified date. We are advising clients to focus more attention on this seemingly routine provision to account for the impact of COVID-19 on the operations of each of the parties and their ability to obtain third-party consents and government approvals and complete other closing conditions.

A rapidly increasing number of office closures, government mandates for people to "stay at home," and dislocation of employees at various government departments and agencies and in the private sector means that parties should expect governmental and regulatory approvals and other change of control approvals, third-party consents, board and stockholder approvals and the due diligence process to take longer than normal. As credit markets are becoming increasingly volatile, parties should expect financing to become less certain, and previously established norms for the terms of financing commitments and definitive agreements to change.

In light of all of this, parties should make adjustments for outside dates accordingly. If the outside date is in place and the closing is unlikely to occur as a result of COVID-19, a party should consider: (i) whether the counterparty has an option to terminate the agreement under such a provision, as well as any requisite conditions that must be satisfied to exercise the option; and (ii) whether the outside date can be extended through mutual agreement of the parties. We are currently seeing parties that are motivated to preserve their M&A transaction extending outside dates and making other necessary compromises to agreements to appropriately allocate the impact of COVID-19 between the parties.

For those parties who will be inserting an outside date in a new agreement, they should consider whether this specified date is feasible in light of the coronavirus, or if the relevant date should be set farther in the future than would otherwise be typical in order for the situation to be monitored or adapted as necessary. The parties should also consider automatic extensions of outside dates when the only unsatisfied conditions are with respect to highly affected jurisdictions, but only if the relevant party has used, and continues to use, appropriate efforts to satisfy the relevant conditions. In a debt-financed acquisition, the buyer should confirm that the outside date in the acquisition agreement is not extended beyond the outside date in the debt commitment papers.

Financing Failure

The private equity M&A market has a commonly used provision to address what has been viewed as a fairly remote risk of a "financing failure," which, if triggered, requires the buyer to pay a reverse termination fee and limits the seller's specific performance rights when the debt provider is refusing to fund. In this current environment, the parties may want to consider revising this financing failure arrangement to reflect the greater risk and to fairly allocate such risk between the parties. In current transactions, we are seeing some private equity buyers, as an alternative to terminating the transaction, preparing to close with their own cash with the intention to obtain financing for the transaction post-closing.

3. Force Majeure; Common Law Principles

Force Majeure

A force majeure provision excuses a party's failure to perform its obligations under a contract when such failure is caused by certain extraordinary events beyond that party's control (e.g., an "act of God" such as a natural disaster or an act of terrorism or war). A force majeure provision does not operate automatically, but rather the parties must expressly include this provision in the agreement. To determine whether a particular force majeure provision applies, courts generally take a narrow approach and consider whether the event at issue is included in the specific drafting of the provision, whether the nonperforming party could have foreseen and mitigated the nonperformance, and whether the performance is merely impracticable or economically difficult rather than truly impossible (e.g., undertaking precautionary measures or making a voluntary decision not to perform does not qualify).

Recent events, including the declaration by the World Health Organization of COVID-19 as a "pandemic" and government regulations restricting travel and large gatherings and ordering the temporary closure of non-essential businesses and employees to "stay at home," have drawn attention to force majeure provisions that expressly account for such events as "pandemics," "epidemics," "diseases," "quarantines," "acts of government" or "states of emergency." In these instances, the parties may, depending on the circumstances, assert force majeure as a defense to non-performance or anticipatory breach, provided the other elements to trigger this clause are also met (i.e., that steps were taken to mitigate the damage and that performance is truly impossible).

More commonly though, a force majeure provision contains a "catch-all" phrase (e.g., "act of God") or a non-exclusive list of triggering events rather than enumerating an exclusive list of events. The general approach of courts in these cases is to consider whether the nonperforming parties could have expected this particular event to occur when entering into the agreement. If the court determines that the event at issue was foreseeable on the agreement date, then it may consider the nonperforming party to have waived its right to use force majeure as a defense if such event is not mentioned in the acquisition agreement. On the other hand, if the COVID-19 outbreak is determined to be so unusual or abnormal that it could not have been anticipated or expected under normal circumstances by the parties on the agreement date, then the parties may be able to avail themselves of the force majeure provision.

Impossibility, Impracticability or Frustration

While courts will likely reject a force majeure claim if the agreement does not contain a force majeure clause or if the clause is silent as to the particular event, a party seeking to excuse nonperformance may still avail itself of the common law doctrines of (i) impossibility or, in some jurisdictions, impracticability; or (ii) frustration of purpose.

The doctrines of impossibility or impracticability may excuse nonperformance where a party establishes that: (i) an unexpected or extraordinary intervening event has occurred; (ii) a basic assumption of the parties in making the agreement was that the event would not occur; and (iii) the unexpected event made contractual performance impossible or impracticable. Under the doctrine of impossibility, contractual duties will be discharged where it has become impossible to perform them. Courts will apply an objective assessment of whether the performance sought to be excused is impossible (i.e., the duties could not be performed by anyone; whether a party seeking relief believes it had the ability to perform is irrelevant). The event giving rise to the impossibility must arise after the parties entered into the agreement. And where an agreement is discharged because of impossibility, each party will be excused from obligations arising under the agreement that are yet to be fulfilled. In some jurisdictions, contractual duties may be excused under the doctrine of impracticability where performance would require extreme and unreasonable difficulty or expense, and such difficulty was not anticipated. In effect, these jurisdictions allow relief for nonperformance where subjective impossibility is found.

Another common alternative in the absence of a force majeure clause is the doctrine of frustration of purpose. This principle functions similarly to impracticability and impossibility, but focuses on whether the event at issue has eliminated the purpose of the contract (i.e., rendered it valueless) rather than has made a party's performance impractical or impossible. Frustration of purpose requires many of the same elements as the principles of impossibility or impracticability, but does not require a supervening event that impedes a party's performance: (i) there is some supervening event leading to the frustration; (ii) at the time of entering into the agreement, the parties did not reasonably foresee the act or event occurring; (iii) the purpose of the agreement has been completely or almost completely destroyed by the event; and (iv) the purpose of the agreement was realized by both parties at the time of entering into the agreement. There are two primary obstacles to successfully invoking this frustration of purpose defense. First, courts interpret a party's "purpose" broadly, and the mere fact that an event has prevented a party from taking advantage of the agreement in an expected manner may be insufficient. Second, frustration must be near total, that is, it is not enough that a transaction was previously expected to be profitable, but is now unprofitable.

As the COVID-19 pandemic continues to develop, businesses should take proactive steps to ensure continuity of operations sufficient to meet existing contractual obligations and evaluate whether their counterparties are doing the same. If companies expect that COVID-19 may result in their own or their counterparties' inability to satisfy contractual obligations, they should assess the viability of either force majeure or common law principles discussed above.

4. Due diligence; Representations & Warranties; Insurance

Due Diligence

Both buyers and sellers are faced with increased challenges in the due diligence process as a result of COVID-19. Many offices, factories and retail locations in the communities most affected by the coronavirus largely remain closed or are very limited in operation. Moreover, "shelter-in-place," significant travel restrictions, social distancing and quarantine measures have made in-person management presentations and site visits extremely challenging and, in an increasing number of locations, impossible. As a result, transaction parties will need to adjust expectations and timetables accordingly.

Buyers should ensure their due diligence on the target business extends to such items as existing insurance policies and their coverage (including business interruption policies); the effectiveness of business continuity plans and crisis management procedures; supply chain risk and the availability and costs of alternative sources of supply; exposure of the business to jurisdictions highly impacted by the coronavirus epidemic; regulatory, licensing and data privacy implications as a result of remote working arrangements; solvency or going concern risk and the ability to service debt; and the ability of the target business or its counterparties to perform, suspend or walk away from obligations under material contracts, including exercising force majeure or similar provisions.

Sellers should be prepared for this expanded due diligence request for information dealing with the impact of COVID-19 on the target business and relevant mitigation efforts. Sellers should also be prepared to manage due diligence expectations and be prepared and organized, including making use of third-party resources to help manage the due diligence process, as its own employees continue to manage the disruptions caused by COVID-19.

Representations and Warranties

Buyers have been seeking additional representations and warranties relating to the target business's emergency protocols, contingency planning, business continuity processes and other similar matters to learn more about the exposures and safeguards the seller has related to the coronavirus and any associated operational and financial impacts on its business. If sellers are willing to agree to such expanded representation and warranty coverage, they will likely ask for knowledge and materiality qualifiers, resist forward-looking representations and warranties, and insist on appropriate "bring-down" standards at closing. In addition, sellers should disclose as much as possible in the disclosure schedules about the impact or potential impact of the coronavirus on the target business and its effects or potential effects to ensure adequate defenses in the event of a claim. If parties are considering utilizing representations and warranties insurance (RWI), they should pay close attention to the policy exclusions (i.e., since coronavirus is a known risk, insurers have started to specifically exclude coronavirus-related losses from their policy coverage).

Representations and Warranties Insurance

In M&A transactions in the United States, RWI has become a common method for buyers to offset some of the risk associated with the seller's representations and warranties being untrue. As the coronavirus outbreak has developed, as noted above we have learned that RWI insurers are specifically excluding losses related to any business interruption or downturn due to the coronavirus. If RWI insurers are unwilling to provide coverage for these types of risks, the allocation of such risk between the buyer and seller via the representations and warranties and related indemnities becomes even more critical.

Business Interruption and Contingent Business Interruption Insurance

Companies anticipating potential business interruption should also review potentially applicable insurance policies and provisions, including business interruption and contingent business interruption insurance. Business interruption insurance is intended to cover losses resulting from direct interruptions to a business's operations, and generally covers lost revenue, fixed expenses such as rent and utility, or expenses from operating from a temporary location. Similarly, contingent business interruption insurance is intended to cover lost profits and costs that indirectly result from disruptions in a company's supply chain, including failures of suppliers or downstream customers. While these policies most frequently relate to physical property damage, businesses have increasingly submitted claims for coverage of losses due to business interruptions resulting from COVID-19. The viability of these claims depends on the terms of the insurance policy at issue, but the historical trend, based on prior viral epidemics, has been against coverage for business interruptions related to a pandemic like COVID-19.

5. Interim Operating Covenants

Between the signing and deferred closing of an M&A transaction, the buyer wants the seller to operate the target business in the ordinary course to ensure that at the closing the acquired business will be virtually the same as the business the buyer agreed to purchase upon signing. Given the fast-changing environment in reaction to the COVID-19 pandemic, a longer period between signing and closing of a transaction will mean greater risk on the operations of target businesses, and buyers should account for this when negotiating clauses such as purchase price adjustment mechanisms and MAC clauses, as well as the scope and level of detail in interim operating covenants.

As referenced above, a common covenant during this interim period requires the target company to continue operating "in the ordinary course of business," which generally means the seller must continue to run the business as it has on a normal basis in the past. A target company subject to this covenant will likely be deemed to be in breach, however, if it is forced to suspend a meaningful portion of its business due to COVID-19. Under this current situation, sellers should request the right to operate outside the ordinary course of business without the buyer's consent in order to properly manage the disruptions caused by the COVID-19 outbreak, including taking actions necessary for the protection of public health (such as implementing remote working policies).

From the buyer's perspective, it should consider drafting with specificity additional protections from the impact of the coronavirus during this period. Liquidity maintenance, debt refinancing and working capital management will require special attention in these interim operating covenants. With a heightened risk of closing failure or delay, the buyer should consider very detailed interim operating covenants on the target business. Parties should also anticipate the effect of forced government shut-downs of non-essential businesses or for some industries Defense Production Act orders.

6. Conditions Precedent

At the time of signing of the agreement, there are generally a number of matters that the parties must take care of before the closing of the transaction can occur. Each party seeks assurances from the other party that such actions will be taken as required during this period, and confirmation that these items have been completed by the closing. In light of the COVID-19 pandemic, the parties will need to consider whether the terms of these conditions can be satisfied.

Data Security and Information Technology

The widespread institution of work-from-home policies to help combat the spread of COVID-19 could have an impact on the security or privacy of certain sensitive company or customer information. In this case, a party may be more likely to fail to satisfy a condition that requires compliance between signing and closing with all applicable laws and internal policies related to data security and information technology due to the higher incidence of its employees working from home for extended periods of time.

Regulatory Approvals

The United States competition agencies have announced temporary changes in their merger review procedures as a result of the COVID-19 pandemic. The Federal Trade Commission (FTC) and Antitrust Division of the Department of Justice (DOJ) will not grant any requests for early termination of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act. The DOJ announced that "[f]or mergers currently pending or that may be proposed, the Antitrust Division is requesting from merging parties an additional 30 days to timing agreements to complete its review of transactions after the parties have complied with document requests."

Competition review and approval delays are likely to occur on a global basis given the magnitude of this pandemic. The FTC's Bureau of Competition announced that it is "conducting a matter-by-matter review of our investigations and litigations to consider appropriate modifications of statutory or agreed-to timing," and that "[p]arties and their counsel should expect that we will be in touch to discuss proposed modifications." In addition, nearly all of the agencies' staff are working remotely and, with rare exception, meetings are being held by telephone or videoconference. If this pattern of behavior continues, which we believe it likely will, it will increase the possibilities that transactions fail because of an inability to satisfy the relevant regulatory conditions in the required timeframe.

7. Purchase Price Adjustments; Valuations

The impact of the COVID-19 crisis will likely require a deviation from the customary approach to purchase price adjustments. What constitutes 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 and may seek floors or collars in their purchase price adjustment mechanisms to avoid being unduly penalized during the crisis, especially if the effects on the U.S. economy prove to be only temporary. Conversely, buyers will be focused on ensuring they will be acquiring a business with acceptable levels of working capital and liquidity.

The uncertainty around the durational impact of the COVID-19 crisis on businesses is making valuations more challenging. Because this crisis will likely have a negative effect on revenue and earnings forecasts, the metrics upon which deals are commonly priced, certain buyers may be tempted to see this as an opportunity to secure more favorable pricing. On the other hand, because the effects of the COVID-19 crisis are unknown and may be relatively short-term, sellers are likely to resist such attempts and take the position that the effects and duration of the outbreak are atypical and that business fundamentals will be largely unaffected or recover quickly. How negotiations unfold on this issue will become apparent as the ultimate scope and duration of this COVID-19 crisis becomes more certain.

8. Shareholder Rights Plans

The COVID-19 pandemic has sent the stock prices for a number of companies spiraling down. For certain private equity firms and activist investors, this has created opportunities to purchase or take controlling interests in target public companies to force changes. We anticipate an increase in hostile take-over offers and shareholder activists seeking to force drastic changes at companies, such as senior management changes, restructuring the board of directors, divesting of non-core businesses or reductions in the size of the company's workforce.

Companies whose stock price has decreased dramatically as a result of the COVID-19 pandemic or other external market forces (such as the recent drop in oil prices) should consider whether to adopt shareholder rights plans (also known as "poison pills") or other defensive strategies in response to the heightened threat of hostile takeovers and shareholder activism. Before taking such a drastic step, companies should consider undertaking a thorough review their preparedness for such an event, which could include board education with respect to fiduciary duties, putting in place a stock watch program, conducting a vulnerability self-assessment, creating a response plan and whether to place a rights plan on the "shelf" or, if the situation warrants it, adopting a rights plan at this time.

9. Choice of Governing Law

This article provides a general discussion of the law in providing context for our observations and insights regarding the impact of the COVID-19 outbreak on certain aspects of the acquisition agreement. Because the interpretation and enforcement of contractual clauses (e.g., MAC and force majeure clauses) may vary by state, occasionally in a manner that has conflicting outcomes, any specific questions should be analyzed under the governing law of the acquisition agreement.