M&A Wars Continued: Does the Seller Have an Exit Strategy?

By: Lori S. Smith, Marc S. Casarino and Thomas B. Fiddler
Corporate and Securities Alert
6.5.20

A great deal has been written about the M&A wars, including our prior alerts regarding the issues that arise when a buyer attempts to terminate a deal as a result of a seller material adverse effect (MAE) or the inability of a seller to satisfy closing conditions such as operating in the ordinary course between signing and closing of an acquisition agreement. However, little attention has been focused on the issue of what would happen if a seller wishes to walk away from a signed deal.

Historically, certainty of closing has been very important to sellers, and therefore, deal documents have leaned toward protections for sellers against buyer termination. Deal documents have not historically contemplated the many situations where a seller would want to terminate an acquisition agreement between signing and closing other than mutual agreement, drop dead dates and fiduciary outs for superior offers. There are a number of reasons, however, why sellers could potentially want to terminate a signed M&A deal as a result of the COVID-19 pandemic.

The pandemic has potentially resulted in significant changes to a seller's business and such intervening events could make various provisions of the executed agreements unreasonable or unacceptable because they significantly impact the purchase price or seller's ability to get the benefit of its bargain. Among others, the most likely impacted provisions include purchase price adjustments, earn-out calculations, potential post-closing indemnification claims for breach of representations and warranties or a material adverse change in the buyer and its business and operations. As result of the foregoing, there is potential need for an expansive view of fiduciary outs as intervening events make it necessary for the board to consider whether consummating the transaction on the agreed terms at this time would constitute a breach of the duty of care.

A seller's desire to exit a deal because of intervening events will not necessarily translate into the ability to terminate the deal without potentially significant liability. Commercial litigators and corporate lawyers will need to scour the deal documents to determine what arguments, if any, can be credibly asserted that the seller no longer has an obligation to close. The success of those arguments will be driven by the language of the agreements, the creativity of the lawyers and the receptiveness of the courts to their arguments.

Discussion

Purchase Price Adjustments. Most deals are done on a cash-free, debt-free basis with a target working capital or net asset requirement (focused mostly on accounts receivable, accounts payable and inventory, as well as certain tax attributes). While some of these deals contain collars around these adjustments, a large percentage do not. Working capital for purposes of most acquisition agreements is defined to mean the amount calculated by subtracting current liabilities from current assets. According to the American Bar Association's 2019 Private Targets Mergers and Acquisitions Deal Points Study (ABA 2019 Study), 95% of deals reviewed for 2018 and 2019 included a post-closing purchase price adjustment and 92% were based on working capital adjustments. Further, 76% of the reviewed deals included an adjustment for debt. Over 40% of the deals reviewed included tax assets and tax liabilities within the working capital adjustment.

Working capital adjustments are generally tied to looking back and determining a normalized level of working capital for the business over prior periods to ensure that the buyer is getting a business that reflects normal operating levels of accounts payable, accounts receivable and inventory to permit for a smooth transition to post-closing operations without huge infusions of cash by the buyer.

However, for deals in progress that were signed prior to, or toward, the beginning of the government stay-at-home orders, accounts payable may be up significantly from normalized levels due to costs of the pandemic or the slowing down of cash flow leading to slower payment cycles. Accounts receivable may also be down due to reduction in sales and the imposed shut down. Inventory may be impacted by sales cycle or supply chain issues. Tax obligations have been impacted by legislation that has modified or deferred obligations during 2020, creating anomalies in what is "normal."

The pandemic may also have caused the seller to take out unanticipated loans. In the case of Payroll Protection Loans under the CARES Act, these may be loans that could potentially be forgiven, but this may not be known for certain for many months given the current rules and the uncertainty of constantly changing guidance, regulations and additional proposed legislation. Therefore, at this time it is not clear how a buyer will treat these loans for purposes of various purchase price-related calculations, but any additional indebtedness existing at closing is likely to reduce the purchase price. For deals not yet signed, it may be possible to draft around this issue by building in further adjustments for forgiveness and related tax impacts of these loans, but even the rules around forgiveness and its accounting and tax treatment currently remain in flux.

All of the above adjustments could lead to an unanticipated downward adjustment in the purchase price, and the need for the seller to either leave cash in the business (which it had previously intended to distribute to stockholders) or have the buyer infuse cash into the business and reduce purchase price. The amount of these adjustments may make the purchase price much less attractive to the seller. The seller may view these as potentially short-term issues that could resolve themselves if the sale were delayed – but the agreement likely requires that they use commercially reasonable efforts to satisfy the conditions to closing and most likely does not have an exit ramp in a situation where the terms no longer make commercial sense.

Earn-Outs. Similarly, and perhaps potentially more detrimental, purchase price adjustments can occur in deals with low upfront payments at closing and large earn-out components to the purchase price. Earn-outs are often used to bridge the valuation gap between what a seller perceives as fair value for the business and what a buyer is willing to pay based on historical financial results and perceived risks. Earn-outs are frequently used with businesses in a growth phase to give the selling stockholders the benefit of continued growth, or in businesses that are service oriented or reliant on retention of customers to ensure that the business remains intact for a period post-closing.

Earn-outs tend to be more prevalent in times when the bid and ask between buyers and sellers grows, which often is the case in a declining or volatile market, such as the one we are experiencing right now. According to the ABA 2019 study, of the reviewed deals, only 27% included earn-outs of which 29% were based on top line revenues and 31% were based on earnings or EBITDA. However, earn-outs calculated based on, for example, a percentage increase over trailing revenues or EBITDA may no longer make sense (and the definition of EBITDA itself may be impacted by changes in the law and governmental programs such as the various CARES Act lending programs). Earn-outs that include any period within 2020, and potentially 2021, could be severely impacted by the shutdown period and ramp up to return to work.

The targets set for the earn-out component of the purchase price, if set prior to government shutdown orders or early in the pandemic, may be completely unrealistic, making this a bad time to sell because the chances of earning anything beyond the down payment at closing will be very low. Achieving an earn-out may be dependent on the buyer's supply or distribution chain or other factors relating to resources that the buyer brings to the table and therefore could also be impacted by damage to the buyer's business caused by the pandemic (see below on buyer MAE). Earn-outs may also create tension between preferred stockholders and founders/management, as buyers sometimes try to shift the earn-out portion of consideration or some vesting of consideration to the "working" stockholders. While logic would dictate that if the seller can not achieve the earn-out, then the buyer is also getting a damaged property, that is not always the case.

Good earn-out targets should be achievable at least in large part in a normalized market, especially where the buyer wants to continue to incentivize the selling stockholders who are part of continuing management. But often the targets are set unrealistically high or include non-financial milestones, and the buyer would be perfectly content with the business at the upfront price if the earn-out is not met. The seller, however, would be greatly disappointed in a sale at that price. Changed circumstances and intervening events may lead to total misalignment between the buyer and the seller making the deal unpalatable to the seller and its stockholders. A buyer, however, may see other synergies or value in the business even if sales or earnings are off because they are buying key technology, functionality or people who have a long-term value to their business. If this is true, getting the business for solely the upfront payment may be a windfall.

Another twist on earn-outs is the negotiation of the covenants around operation of the business post-closing. Achieving the earn-out is largely dependent on commitments made as to how the business will be managed and run post-closing. These covenants are highly negotiated with sellers pushing for covenants that the buyer will operate the business in the ordinary course consistent with past practice. However, according to the ABA 2019 Study, only a small percentage of transactions include the foregoing covenant. An even smaller percentage require that the buyer run the business to maximize the earn-out. Further, 29% of the reviewed deals include the right of the buyer to operate the business at the buyer's discretion during the earn-out period; 15% include an express disclaimer of fiduciary duties by the buyer to the seller; and 66% allow offset of indemnity claims against any earn-out amount (as discussed below, indemnity claims could be a bigger issue as a result of the pandemic if a seller is forced to close a deal knowing that there have been breaches of representations caused by the pandemic and actions taken in response thereto). If the deal closes and the buyer needs to make adjustments in the business, such as layoffs, closing facilities or incurring additional expenses to address the pandemic, this could further impact the likelihood that any portion of the earn-out will be earned.

Fiduciary Outs. Most, if not all deals, include no shop or lock up provisions that prohibit the seller from soliciting offers or engaging with any other potential buyer between signing and closing. However, because board's have a fiduciary duty of care to act in the best interest of and maximize value for the stockholders of the corporation, agreements often contain "fiduciary outs." Historically, fiduciary outs were designed to allow a seller to terminate an agreement in the event the seller received a superior offer. In such a case, especially in deals involving public companies, the seller would have to pay a pre-negotiated break-up fee to reasonably compensate the buyer for the cost of the lost deal. Fiduciary outs have been expanded in some cases to include intervening events, but the language of such provisions varies.

A typical provision requires that the intervening event be unknown to the target's board as of the date of the agreement, is material, and was not foreseeable at the time of signing. In other words, if something arises that the board could not have known about and considered when originally committing to recommend the deal to the stockholders, then the company would have an out. However, given the nature of the pandemic, a seller's argument as to use of the fiduciary out would likely would be similar to the arguments being made around MAE and the MAE carve-outs. If there is a pandemic exclusion in the MAE, then the arguments for a fiduciary out would be limited under most formulations of these provisions as it would be seen as a known risk at the time of signing. However, the progress of the pandemic, its impact on the business, the extent of potential purchase price adjustments and ability of the seller to perform under the acquisition agreement, may not have been known and the current totality of the facts and circumstances may mean that a board of directors is faced with a situation where its reasonable business judgment would weigh against proceeding with the deal.

Further, the deal documents for private company deals may not even include a fiduciary out. There could be situations where the seller's board believes that the short-term value of selling at a deflated price (because of considerations like those above that impact the price – or others discussed below), is not in the best interests of the stockholders. In this case, even under efficient breach theories that would justify the breach, they would still be liable for damages.[1] If there is no negotiated break-up fee to look to for guidance, this could open the company up to a significant risk of a damage award. Query whether a court of equity would impose some reasonable

standard for forcing renegotiation under a theory of good faith and fair dealing so that each party would get the benefit of their bargain – as there is an inability to carry out the true intent of the parties. This result is highly unlikely because at least Delaware courts routinely enforce the strict language of contracts absent ambiguity.[2] Delaware case law also holds that even with a negotiated break-up fee, the termination fee may not be the exclusive remedy[3] placing the board between a rock and a hard place – a bad deal or a damages lawsuit against an already damaged company.

Sandbagging/Anti-Sandbagging. A sandbagging provision permits a buyer to make a claim for breach of a representation or warranty post-closing even if it knew of the breach pre-closing. This means that a buyer can close a deal and still make an indemnification claim. An anti-sandbagging provision is the opposite, and prohibits a buyer from making a claim for any known breach. There are many variations as to how these provisions are drafted but the majority of deals (59%, according to the ABA 2019 study) are completely silent on the issue. In the absence of an express provision, the parties to the transaction need to look to state law; therefore, choice of law in the agreement becomes crucial. Delaware is known to generally be a pro-sandbagging state. Absent an express anti-sandbagging provision, Delaware law holds sellers to the express terms of their representations regardless of a buyer's knowledge of a pre-closing breach.[4] New York, like Delaware is known to be a pro-sandbagging state, but with a qualification. New York will consider whether the source of the buyer's knowledge of the breach is the seller's disclosure or something that a buyer may have discovered on its own during the course of its due diligence.[5]

As a result of the pandemic, sellers may be in a position where there are known breaches of their representations and warranties, and they will be forced to close knowing that they are going to be subject to indemnification claims, which may be quite large. Another contractual issue that has interplay with the potential breaches of a seller's representations and warranties is an ability of the seller to update disclosure schedules – which is often very limited. According to the ABA 2019 study, 62% of deals were silent on this issue and 34% required or permitted updating (but of those, 64% did not limit a buyers rights to seek indemnification for updated matters). A seller may not want to close if there is the chance of a large indemnification claim post-closing that will wipe out any escrowed funds or contingent consideration or further result in claims against its stockholders. The materiality standard for closing may be such that a buyer will be required to, or will elect to, close over the breaches. But how does a seller protect against a large claim that a buyer did not consider a MAE? A seller usually has limited opportunity to walk. While we have seen deals where sellers negotiate an out if there are known claims in excess of some threshold dollar amount, the flip side is that the buyer will often ask for the same standard which would give buyers what has historically been an unwanted optionality to close for something less than an MAE.

Buyer MAE. While we see buyer MAEs in some deals, particularly those where buyer equity is part of the consideration, a buyer MAE is rare. According to the ABA 2019 study only 1% of deals included the buyers' ability to operate a target's business post-closing in the manner operated by the seller as part of the definition of MAE. Buyer MAEs are more prevalent in deals where a portion of the consideration is to be paid in buyer equity. However, in situations such as a pandemic, there are other issues that could arise like buyer liquidity to pay an earn-out or ability to support the business in the promised manner to allow for achieving the earn-out. Buyer liquidity could also impact a deferred purchase price (*e.g.*, possibly, new buyer debt obligations could limit their ability to pay consideration structured as a seller note, which is usually subordinated to obligations of the successor/surviving corporation of a merger to any institutional lender). There may also be issues as to the buyer being a good home for the business long-term from the seller's standpoint. Often in smaller businesses, the owners have built a company over many years and their employees are like family. They want a buyer who will offer a secure long-term home to their employees, but a buyer may not see it that way if it is going through its own financial restructuring. Changed circumstances could change these type of integration analyses.

Changed Price Impacting Allocation of Purchase Price. The dynamics between preferred and common stock may make the deal less attractive if the purchase price decreases as a result of any of the above or valuation issues tied to purchase price (*e.g.*, if purchase price is a multiple of trailing EBITDA). At the higher pre-COVID price, the preferred stockholders may be willing to convert to common stock and forego any liquidation preference (assuming it is non-participating), making this an acceptable deal for the common stock. At

a lower price impacted by COVID-19, the preferred stockholders may still be willing to proceed, but may not convert preferring to take their liquidation preference, in which case there may be little or nothing left for the common stockholders. Further, the preferred stockholders may not have the ability to close the deal in that situation. Even with a drag along, there may be fiduciary duty issues. For example, Delaware case law consistently has found that directors' fiduciary duties run to the common stock, and not preferred stockholders – viewing preferred rights as contractual in nature. To the extent a preferred stockholder is a controller it may owe fiduciary duties to minority investors.

Summary

While a lot of attention has been focused on buyers, there are a number of issues that may arise as well from the seller perspective. Experienced practitioners representing sellers will need to carefully analyze M&A documentation not only from the viewpoint of protecting against buyer "outs" but also from the viewpoint of protecting against being forced to do a deal that no longer makes economic sense. This will be a complex and tortuous process and creative M&A lawyers will surely come up with new provisions that will further lengthen and complicate documents that have grown exponentially in size over time.

M&A litigators will likely be examining all of these issues in formulating creative arguments to protect sellers from being forced to carry through with unreasonable deals in light of the changed circumstances. It is likely that litigators will be making equitable arguments in the event that the deal documents do not contain obvious termination rights or breaches by the buyer. Without clear rights to terminate the deal, sellers may have a difficult time convincing courts that the post-pandemic changes that result in lower purchase prices or other inequities should result in the ability to terminate the deal. Courts tend to hold sellers to their bargain unless the parties have contractually allocated the risk to the buyers. Although courts have many powers, those powers do not include the ability to re-write the terms of agreements solemnly entered into by the parties. But faced with deals that make little or no economic sense, sellers may have little choice but to litigate creative legal arguments, technical breaches or equitable claims.

Absent an express clause permitting a seller to terminate for a buyer MAE or an agreement containing representations and warranties by the buyer as to its business and operations that have resulted in material breaches as a result of the pandemic (*e.g.*, sufficiency of funds, absence of changes) or a very broadly written fiduciary out provision, sellers are likely to have very limited or no escape hatches from a signed M&A deal under current agreements that follow market standard constructs. Going forward, sellers and their counsel may want to reconsider a balancing between certainty of closing and inclusion of provisions that allow for more flexibility in the period between signing and closing to address unanticipated events including broader fiduciary outs. Query whether buyers should also have fiduciary outs rather than relying solely on MAE clauses? Alternatively, both buyers and sellers may want to consider crafting provisions to allow for good faith negotiation to adjust formulas for purchase price adjustments, earn-outs and other financial metrics and potentially to address sandbagging issues that arise out of unforeseeable events beyond the control of either party (*i.e.*, a form of *force majeure* provision) so as to allow a path forward for completion of a deal on terms that make reasonable business sense for both sides and avoid litigation as the inevitable outcome of a deal that no longer is commercially viable on its originally agreed upon terms.

For more information or if you have any questions, contact Tom Fiddler (fiddlert@whiteandwilliams.com; 215.864.7081) or another member of the Corporate and Securities or Commercial Litigation groups.

As we continue to monitor the novel coronavirus (COVID-19), White and Williams lawyers are working collaboratively to stay current on developments and counsel clients through the various legal and business issues that may arise across a variety of sectors. Read all of the updates here.

[1] *E.g., Leaf Invenergy Co. v. Invenergy Renewables LLC*, 210 A.3d 688 (Del. 2019)

[2] See,"Delaware Court Enforces Strict Compliance With Notice Provisions" (May 17, 2018) and "No Revisionist History: Supreme Court of Delaware Narrowly Interprets Post-Closing Obligations Under Representations and Warranties, Earn-out and Indemnification Provisions" (October 18, 2013)

[3] *See, Genuine Parts Company v. Essendant, Inc.*, 2019 WL 4257160, (Del. Ch. Sept. 9, 2019).

[4] *E.g., Akorn Inc. v. Fresenius Kabi Ag.*, 2018 Del. Ch. LEXIS 325 at *180-81 (Del. Ch. Oct. 1, 2018)

[5] *E.g., Promuto v. Waste Mgmt.*, 44 F. Supp. 2d 628, 648 (S.D.N.Y. 1999)

This correspondence should not be construed as legal advice or legal opinion on any specific facts or circumstances. The contents are intended for general informational purposes only and you are urged to consult a lawyer concerning your own situation and legal questions.