COVID-19: DISTRESSED M&A IN THE ERA OF A PANDEMIC - PART 2, DÉJÀ VU ALL OVER AGAIN?

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INTRODUCTION

Part 1 of this Distressed M&A series addressed the unique aspects of acquiring distressed companies (as compared to financially healthy companies).[1] So, are the distressed M&A aspects of this COVID-19 era distinct from those in past distressed markets, such as the 2008 Great Recession? Or is it déjà vu all over again?[2]

Yes and no—classic lawyer response, right? There is much in the current M&A market that shares features of past distressed markets, but the more interesting discussion revolves around what is different. In this alert, members of K&L Gates corporate and restructuring and insolvency practices analyze unique COVID-19 developments as they relate to distressed M&A in the areas of:

- Antitrust/competition,
- Cross-border transactions,
- Government loans,
- Representations and warranties insurance, and
- Tax.

These topics are addressed at a high level in this article, but more detailed information is available in the linked articles by our K&L Gates colleagues in the footnotes.

Part 3 (coming shortly) will outline the pros and cons of different distressed M&A transaction structures, such as bankruptcy (including Section 363 sales), state law receiverships and assignments for the benefit of creditors, Article 9 sales, and sale processes without judicial or statutory involvement.

ANTITRUST/COMPETITION

Most countries have antitrust/competition laws prohibiting acquisitions that threaten to substantially lessen competition. For the benefit of parties to a distressed acquisition, however, many jurisdictions (including the European Union and the United States) recognize a “failing firm” exemption or defense.[3] The rationale for such a defense is that if a company is going out of business anyway, then its acquisition by a competitor is not going to lessen competition; the number of competitors is going to be reduced by one in any event. The defense is generally viewed as an extraordinary measure, and parties face a heavy burden in proving it. A number of countries have had recent activity in this area.

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In the United Kingdom, the Competition and Markets Authority (CMA) recently cleared an acquisition citing the target's financial deterioration caused by COVID-19 as the main factor. In reviewing the arguments for the failing firm defense, the CMA referred to the COVID-19 circumstances as “wholly unprecedented.”

In the United States, Senator Elizabeth Warren and Representative Alexandria Ocasio-Cortez recently announced plans to introduce legislation that would ban most M&A by companies over a certain size while the country recovers from COVID-19.[4] While many are skeptical that this proposed legislation will get traction, we continue to monitor this situation.

CROSS-BORDER TRANSACTIONS

As a result of the worldwide impact of COVID-19, buyers are noticing distressed opportunities in other countries. This is causing federal governments to examine new protectionist measures.

In the United States, the Committee on Foreign Investment in the United States (CFIUS) evaluates the national security impact of non-U.S. companies investing in U.S. businesses that operate in sectors sensitive to U.S. national security interests (e.g., technology, defense, and personal data) or in close proximity to sensitive U.S. governmental facilities. Even before the COVID-19 pandemic, CFIUS has taken an increasingly aggressive approach to reviewing, and in some cases prohibiting, foreign investment into U.S. companies.[5]

On 5 May 2020, U.S. Representative Jim Banks introduced legislation to protect U.S. companies from predatory investment by the Chinese government during the coronavirus pandemic. Named the “Restricting Predatory Acquisition During COVID-19 Act,” this bill would (i) entirely block certain acquisitions (e.g., Chinese government owning more than 51 percent of critical infrastructure); and (ii) expand CFIUS jurisdiction to cover certain types of businesses (e.g., news media outlets) that are not currently expressly covered, in each case during the pendency of the COVID-19 crisis. We are tracking the development of this proposed legislation.

GOVERNMENT LOANS

In response to the coronavirus pandemic, governments are spending unprecedented amounts to stimulate economies and much of this money is in the form of government loans to businesses. For example, the U.S. Coronavirus Aid, Relief, and Economic Security (CARES) Act provides $1.8 trillion in direct aid to individuals and businesses, the largest stimulus package in U.S. history. This CARES Act funding includes $659 billion in loans through the “Paycheck Protection Program” (PPP) and another $600 billion in loans through the “Main Street” program.

To understand the impact on M&A, let's examine the PPP loans. If a distressed target has received a PPP loan, a buyer should conduct due diligence to assess PPP compliance and determine whether the proposed acquisition would violate the terms of the PPP loan documents. PPP loan documents typically contain broad change of control or ownership provisions. If these provisions are problematic, the buyer may want to ensure that the PPP loan is repaid or forgiven prior to the acquisition closing.

More detailed information about M&A considerations for government stimulus participants will follow in an upcoming K&L Gates article.

REPRESENTATIONS AND WARRANTIES INSURANCE (RWI)

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RWI was not widely available in 2008, or during prior distressed markets, but the prevalence of RWI has exploded in recent years.

Distressed deals often involve sellers that have incurred a substantial financial loss. Thus, sellers are often unwilling to provide significant protection to the buyer in the form of contingent purchase price, indemnification or escrows, or meaningful guarantees. However, even if sellers are willing to offer some contractual protection, they may or may not be creditworthy. A buyer is sometimes able to bridge this gap through RWI.

However, RWI policies increasingly exclude COVID-19 risks from coverage. Most insurers will include a broad COVID-19 exclusion as part of their quotations of coverage (i.e., nonbinding indication letters or NBILs).[6] After that, the market practice regarding maintaining such exclusion and the scope of the exclusion varies widely and depends on many factors, such as the specific insurer and its COVID-19 policies, the target company's operations, and the specific COVID-19 implications for its business, the buyer, and the industry sector.

TAX

As part of programs to assist companies struggling with the impact of COVID-19, governments have enacted tax measures to extend deadlines, increase liquidity, encourage investment, and sustain employment. These measures can be especially relevant for distressed targets and, because of increased reputational and audit risk resulting from the utilization of some such measures, their potential buyers.

For example, the CARES Act now permits a limited carryback of current and recent net operating losses (NOLs), which carryback may generate refunds for distressed targets but might also create additional preclosing tax risk.[7] Additionally, a buyer should be on the lookout for a target's adoption of other CARES Act measures, such as deferral of employment taxes or acceptance of tax credits.[8] A target's utilization of these measures may increase postclosing tax liabilities for a buyer. Sellers and buyers of distressed companies should consult their tax advisors to properly consider and address any available or previously claimed COVID-19 tax benefits and the related risks.

CONCLUSION

In response to the COVID-19 pandemic, governments have enacted new legislation to alleviate the financial burdens on businesses or to protect certain industries. Buyers and sellers with an eye on undertaking a distressed transaction should educate themselves now and engage experienced counsel to monitor the ever-changing landscape of distressed M&A in the wake of the COVID-19 pandemic.

FOR MORE INFORMATION

Be on the lookout for the next article in our Distressed M&A series, which will be coming out shortly. This series of articles is written by a number of attorneys from K&L Gates' cross-disciplinary distressed M&A team, including attorneys from our M&A and bankruptcy/insolvency/restructuring practice groups, as well as our specialists in the areas of antitrust/competition, COVID-19, finance, international trade, RWI, and tax. While the primary authors are U.S.-based, most of the commentary above applies internationally. Our global distressed M&A team, with attorneys in Asia, Australia, Europe, Middle East, North America and South America, stands ready to assist you.

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FOOTNOTES

[1] For Part 1 (Eyes Wide Open) of this Distressed M&A series, see COVID-19: Distressed M&A in the Era of a Pandemic.

[2] Thanks to baseball legend Yogi Berra for this humorously redundant phrase.

[3] For more on the "failing firm" defense, see COVID-19: Will Today's COVID-19 Distressed Businesses Become Tomorrow's Antitrust-Cured Acquisition Targets?

[4] For more on the proposed M&A ban, see COVID-19: Proposed Legislation Would Prohibit Many Mergers and Acquisitions During Pandemic.

[5] For more on CFIUS developments, see Recent Actions By CFIUS Underscore Importance of Review Process.

[6] For more, see COVID-19: Implications on M&A Transactions.

[7] For more on NOLs and the tax implications of PPP loan forgiveness, see COVID-19: Tax Implications of Paycheck Protection Loan Forgiveness.

[8] For more on employment taxes, see COVID-19: CARES Act Employer Payroll Retention Tax Credit.

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