COVID-19: IMPLICATIONS ON M&A TRANSACTIONS

Date: 20 March 2020

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As the spread of COVID-19 continues to accelerate throughout the world and the financial markets experience increasing amounts of turmoil, companies engaged in mergers and acquisitions are grappling with increased risk and uncertainty posed by the spread of the virus. The status of pending M&A transaction varies widely in response to these developments.

The primary focus of this alert is on acquisition processes where the parties have not yet signed an acquisition agreement. Those are the situations where the parties and their advisors have the most opportunity to approach the deal differently in light of COVID-19 and the related market and economic impacts. Of course, there are also deals that have signed acquisition agreements but have not closed–those parties are assessing whether or not they are required to close in light of the COVID-19 impact on the closing conditions.

IMPACT ON M&A PROCESS GENERALLY

Many acquisition processes are being put on hold, presumably temporarily, pending further clarity on the broader health and economic consequences of the pandemic. Some deals are steaming ahead as planned and others are proceeding with renegotiated purchase prices. In many instances, transactions are moving forward at a slower and more cautious pace due to economic uncertainty and/or deal team logistics caused by impaired travel, office closures, etc. Similarly, some acquisitions are moving forward as to due diligence, contract negotiation, and other workstreams, with the parties explicitly or implicitly holding off on signing until the impact on the target company's business or industry or the availability of acquisition financing is more evident.

As for the COVID-19 impact on some specific types of transactions or companies: (i) for sell-side auctions in their infancy, sellers are halting or slowing down market tests or investment bank-led sale processes in order to determine whether this is the right time to exit through a sale process; (ii) for buyers needing third-party acquisition financing (especially private equity buyers), in addition to all of the other COVID-19 ramifications, they are needing to reassess the credit markets and the amount, pricing and certainty of debt; (iii) with the inevitable negative impact of COVID-19 on many industries and companies, M&A participants are preparing for a new wave of distressed/workout deals; and (iv) as with any major socio-economic upheaval, there will be industry "winners" (e.g., hand sanitizer manufacturers or industries that improve workplace efficiencies and business productivity) and "losers" (e.g., cruise lines or industries that rely heavily on supply chains in heavily impacted areas) among market participants.

Below are a few considerations and protective measures for the parties and their advisors to consider as they navigate M&A transactions during these uncertain times.

DUE DILIGENCE

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Parties are approaching due diligence with heightened scrutiny to assess the risks posed by COVID-19. This includes all functional areas of due diligence, including business, accounting/financial, operational, human resources and legal review. As buyers engage legal counsel and other third party advisors to conduct due diligence for potential transactions, they should seek to understand the extent to which target companies are capable of navigating or capitalizing on the potential impacts stemming from the novel coronavirus outbreak.

Specific areas where due diligence is becoming more robust include the following subject matters (many of which overlap):

- Financial. What is the likely impact on the target company's future financial performance?
- Customers. To what extent is customer behavior likely to be altered?
- Suppliers. What is the anticipated impact on supply chains?
- Operations. Will the target company be able to perform its obligations under material contracts?
- Force Majeure Clauses. Are there force majeure clauses in the target company's key contracts that could change the parties' obligations?
- Employees. Are essential employees located in high risk or containment areas?
- Information Technology. Does the target company have sufficient IT capabilities to ensure productivity and provide network access to employees working from home or remotely?
- Emergency Preparedness. Does the target company have emergency preparedness plans in place?
- Insurance. Does the target company's insurance policies cover losses related to COVID-19?
- Liquidity. Is the target company likely to be cash-flow positive such that it will have sufficient liquidity to support itself post-closing, or will the buyer need to provide access to financing?

ACQUISITION AGREEMENTS

There are a number of ways to allocate risk brought on by COVID-19 between buyers and sellers in acquisition agreements. These contractual mechanisms include earn-outs, representations and warranties, interim operating covenants, closing conditions, termination fees and special indemnification provisions based on coronavirus-related due diligence findings and/or otherwise related to the coronavirus pandemic. In addition, buyers often use representation and warranty insurance to address unknown risks related to target companies in a negotiated M&A transaction.

Purchase Price; Economic Protections

In many cases, buyers may wish to reduce the headline purchase price of a target company to reflect lowered valuation projections based on the target company's pro forma EBITDA. There are other measures that offer alternatives to bridging gaps in valuation, including: (i) deferring payment of a portion of the purchase price until a later date; (ii) structuring a portion of the purchase price in the form of an earn-out such that future payment to the seller is contingent upon the future performance of the target company (e.g., achievement of revenue or EBITDA hurdles); and (iii) for deals with private equity buyers, requiring sellers to "roll over" a portion of their existing equity into the new deal such that the purchase price is partially in the form of the buyer's equity. We expect these

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sorts of valuation-related issues (and mechanisms to address them) to continue to command the utmost attention of buyers and sellers.

Representations and Warranties

Because the ramifications of the COVID-19 crisis are so wide-ranging, numerous representations and warranties in a typical acquisition agreement have the potential to be impacted. Buyers will want to consider expanding certain representations. Conversely, sellers should consider carveouts to various representations and/or exceptions on the disclosure schedule to the representations. Some of the most common representations that are likely to be impacted are:

- Absence of Certain Changes. Many businesses are not currently operating in the ordinary course of business consistent with past practices.
- Compliance with Laws. With greater attention to existing health and safety laws as well as new laws being enacted in response to the pandemic, target companies need to ensure that they can make accurate compliance representations.
- Customers and Suppliers. Through no fault of the target company, the COVID-19 crisis may be materially adversely affecting its relationships with some of its key customers or suppliers.
- Human Resources. Employee safety is getting much more attention.
- Information Technology. Buyers may want expanded representations to help ensure the target company's IT systems are robust enough to allow for greater remote access.
- Material Contracts. As a result of the pandemic, there is a greater likelihood that parties may be in breach of material contracts.

Interim Operating Covenants

We are seeing parties negotiate exceptions to operating covenants to address the impact of COVID-19 in acquisition agreements for the interim period between signing of the acquisition agreement and closing. Sellers should ensure they have appropriate flexibility to operate their business outside of the ordinary course in response to COVID-19 during the interim period without risk of failing to satisfy a closing condition. As such, the parties may wish to exclude from the interim operating covenants the ability to take actions to comply with legal or public health requirements or recommendations and to protect their business, including with respect to employees, contractors, assets, properties, supply chains and customer relationships.

Closing Conditions

Knowing that the COVID-19 crisis has the potential to worsen, buyers can preserve their ability to avoid consummating a transaction through multiple closing conditions, including both traditional means such as material adverse change or material adverse effect ("MAE") conditions as well as independent closing conditions specially tailored to the impact of the crisis on the target company.

The primary function of an MAE condition is to establish a standard of materiality for the financial condition and results of operations of the target company such that the occurrence of an MAE would entitle the buyer to not close the transaction and, in some cases, to not pay any termination fees. It is worth noting that general MAE conditions historically have been very difficult to enforce.

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Through MAE clauses, many parties have opted to reallocate risks and liabilities associated with COVID-19 as the pandemic has taken shape in recent weeks. The initial trend in larger transactions has been to clarify that any negative impact of COVID-19 on a party will not give the other party the opportunity to walk away from the transaction unless the party is disproportionately affected as compared to other companies in its industry. A more seller-favorable approach would be to eliminate any qualification that there be a disproportionate affect as compared to similarly situated or peer companies. This can be accomplished through contract drafting by express reference to the COVID-19 virus and/or more general reference to pandemics, national emergencies, disease outbreaks and public health emergencies (or, in each case, an escalation or worsening thereof) in the list of events and circumstances that are carved out from MAE definitions in acquisition agreements.

In contrast to the more generalized MAE approach, we are also seeing parties design more specific COVID-19 closing conditions. For example, in a recent cross-border acquisition of a professional services business, a closing condition was added to enable the buyer to walk away from the transaction without liability if a certain number of the target company's employees or any key employees are diagnosed with COVID-19 or go into self-isolation as a result of close contact with another person diagnosed with COVID-19 during the period between signing and closing.

REPRESENTATIONS AND WARRANTIES INSURANCE ("RWI")

RWI policyholders should anticipate exclusions from coverage under their RWI policy for business interruptions or losses related to COVID-19 as insurers have begun adding these coverage exclusions to their non-binding indication letters when evaluating new M&A transactions. Instead, policyholders should work with their insurance brokers and legal counsel to limit coverage exclusions by tailoring the language to specific jurisdictions or other limited, known circumstances. As part of the underwriting process, policyholders should prepare for increased due diligence related to the novel coronavirus' impact, particularly with respect to workforce and supply chain disruptions. We will cover the impact of COVID-19 on RWI policies in greater detail in an upcoming client alert.

TIMING

Parties will need to build additional time into transactions and plan for logistical challenges and other disruptions presented by travel restrictions (such as inability to meet in person with management teams or conduct on-site due diligence), additional coronavirus-related due diligence, delayed regulatory responses or approvals and greater challenges with acquisition financing.

As a result of the coronavirus pandemic, regulatory filings are moving slower. For example, the U.S. Federal Trade Commission and U.S. Department of Justice have suspended expedited clearances in connection with federal antitrust approvals required under the Hart-Scott-Rodino Antitrust Improvements Act ("HSR") for acquisitions of a certain magnitude. In other words, filers will now need to wait at least 30 days before consummating any such acquisitions in order to comply with HSR requirements. Moreover, complex antitrust reviews may take significantly longer than 30 days, as shown in the recent delays of the $4.9 billion merger of Waste Management and Advanced Disposal Services.

These contingencies ought to be taken into account when parties are negotiating specific dates and deadlines in acquisition agreements. In particular, the parties should consider whether to extend the outside date (at which time the transaction would terminate for failure to close prior to the specified date) in non-simultaneous sign-and-

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close transactions to account for anticipated delays as well as the post-closing timeline for determining any working capital or other adjustments to the purchase price.

CONCLUSION

As this public health and economic crisis continues to evolve, we are monitoring its impact on M&A transactions and are working closely with clients to offer practical solutions to the unique challenges brought on by COVID-19. If you have questions regarding how to navigate this new environment, please do not hesitate to reach out to any of us at K&L Gates.

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