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The Impact of COVID-19 on M&A Transactions

Written By C. Joseph DelPapa (cjdelpapa@wardandsmith.com) **and Michael E. Kohagen** (mekohagen@wardandsmith.com)

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As the impact of COVID-19 on financial markets continues to play out, so does its effect on M&A transactions.

Many deals have been cancelled or are on hold as parties struggle with valuation, availability of financing, and uncertainty with respect to business models. But M&A has not halted altogether; in light of diminished valuations, buyers with strong capital positions may actually see increased activity. There is no doubt, however, the terms of purchase agreements will evolve due to the pandemic. This article will explore the impact of COVID-19 on allocation of risk associated with valuation, due diligence concerns, and a buyer's ability to walk away from a deal turned unfavorable as a result of the pandemic.

Valuation and Allocation of Risk

In view of the market volatility caused by COVID-19, buyers and sellers are more likely than ever to have difficulty aligning on valuation. Buyers uncertain of a target company's ability to rebound post-pandemic are likely to look to forms of contingent consideration and purchase price adjustments for refuge.

One common form of contingent consideration is an **earnout** mechanism. An earnout mechanism generally conditions a buyer's payment of some portion of the purchase price on a seller's post-closing financial performance (which performance is generally measured against agreed upon projected earnings). Earnouts are often used by buyers to address downside risk, while allowing sellers to obtain full value following the closing, if the purchased business performs in line with the parties' expectations.

Given the market volatility caused by COVID-19, buyers are likely to push for use of earnouts to ensure they do not overpay for a company which does not rebound following the pandemic. Sellers, on the other hand, will generally seek to steer clear of earnouts and other forms of contingent consideration. Sellers without sufficient bargaining power to avoid use of contingent consideration would be wise to condition earnouts on non-financial metrics where possible, or use flexible financial milestones which provide sufficient time to ride out current market turbulence.

Purchase price adjustments are another mechanism commonly used to allocate valuation risks. In general, purchase price adjustments are used to compensate the appropriate party if certain financial measures, often based on working capital, deviate from a negotiated "target" level at closing. These target levels are often

based on historic balances over a long trailing period. However, bearing in mind recent volatility, the parties may have difficulty agreeing on what trailing period should be used.

For example, during the pandemic, sellers may be experiencing unusual reductions in accounts receivable and/or deferring payments to manage liquidity—each of which may significantly impact target working capital levels compared to historical performance. In general, it would behoove sellers to push for a "target" level which takes into account the current and future financial impact of COVID-19, or use a "collar" to ensure the purchase price is not decreased beyond an acceptable amount.

Of course, there are a number of other creative ways that buyers and sellers can bridge the valuation gap issue. However, establishing a fair and reasonable solution to the valuation gap issue is only one piece of the puzzle. Another piece of the puzzle, and potentially one of the most important pieces, is how to implement that solution.

Sellers are going to be concerned about having appropriate oversight of the business they just sold and/or some type of say in making sure the valuation gap mechanism achieves the highest possible result for them. On the other hand, buyers have their own agenda that may not entirely align with those of sellers. Instead, buyers may be focused on growing their new business acquisition, and that may require infrastructure changes or financing, each of which creates an increased burden on the acquired business. This process, ultimately, is a balancing act that requires creative thinking and compromise on both sides in hopes of achieving a successful result for both parties.

Enhanced Due Diligence Concerns

As our economy continues to adapt to the "new normal" following the arrival of COVID-19, every business has been, and will continue to be, impacted in some manner, whether in a positive or negative light. Forcing businesses and their owners to react and adapt on such an accelerated timeline created, and continues to create, havoc not only from a financial perspective, but certainly from a legal perspective. As buyers look at acquisition opportunities during these uncertain times, an **enhanced due diligence** process is a must.

Many businesses applied for, and were fortunate to receive, Paycheck Protection Program (PPP) loans. As we all know, the SBA and the Treasury Department have struggled since the inception of the program to develop a clear, concise and final set of rules regarding the use and potential forgiveness of these loans. This uncertainty raises a number of questions for buyers, such as:

- Were the PPP loan proceeds appropriately received?
- Will the PPP loan proceeds actually be granted forgiveness?
- And how can potentially negative consequences arising from this program be mitigated?

To address these questions and concerns, heightened scrutiny of businesses which received PPP loans is a natural reaction.

In addition to scrutinizing PPP loans, there are a number of other areas of a seller's business that will require increased attention, such as ensuring that existing contracts have appropriate carve-outs for these types of unforeseen events, reviewing employee layoffs or furloughs to ensure they were properly handled, confirming that taxes have been properly reported, withheld and paid, and evaluating the debts and liabilities of the business to better understand any potential or contingent obligations or liens that may now encumber the seller's business.

With enhanced due diligence becoming more of a focus and priority for buyers, it is incumbent upon sellers to be proactive by reviewing their business operations for legal compliance, and appropriately addressing any

discovered issues. Sellers do not want to sit back and simply wait to fix any discovered issues as it may either be too late, or their reactionary efforts may cost them additional monies or, worse, a viable buyer.

Walking Away from a Bad Deal

The question that often comes up is how can buyers and sellers protect themselves from unforeseen events or circumstance in the context of deal. The "**material adverse event**" clause, or "MAE clause," is common solution in most stock and asset acquisition agreements. An MAE clause conditions a buyer's obligation to close a transaction on whether or not the target has suffered a material adverse event from the time of signing. What constitutes such a "material adverse event" is usually a subject of negotiation, but in general a material adverse event is a dramatic downturn, of durational significance, in the overall earnings potential or value of the target company (or its assets).

Buyers which have recently executed acquisition agreements may seek to invoke MAE clauses if the target company experiences significant financial downturn as a result of COVID-19. MAE clauses, however, often exclude events with broad market impacts, such as natural disasters and other "acts of God." These sorts of exclusions can be utilized by sellers to ensure buyers are not able to walk away from a deal as a result of a downturn in the seller's business which results from COVID-19.

Buyers and sellers in the process of negotiating a purchase agreement are likely to spend significant time negotiating what constitutes a material adverse event. In particular, buyers are likely, at minimum, to seek an "exception to the exception" described above for events which disproportionately impact the seller's business. In other words, buyers will seek to ensure that if the target's business is disproportionately impacted by COVID-19, as compared to other businesses in the same industry, such impact will be considered a material adverse event and allow them to walk away.

On the other hand, sellers are likely to push for a narrow MAE clause to ensure any event impacting their business which also more broadly effects their industry does not constitute a material adverse event. Although there is not a one size fits all solution, this fairly standard deal concept needs to be carefully considered by both buyers and sellers during these uncertain times.

Conclusion

While COVID-19 has had dramatic impact on the M&A market, the risk and uncertainty it brings to deal work can be overcome through appropriate allocation of risk between the parties and proper due diligence. Our business attorneys stand ready to work with you and your management team to ensure the transactions vital to your business are not put on hold.

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