10. Negotiating, Closing or Exiting M&A Transactions in the Age of COVID-19

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Introduction

The outbreak of the COVID-19 pandemic has negatively affected many businesses around the world and is posing specific problems in the context of M&A transactions.

More than often it is the buyer of a company that is now trying to cancel a takeover that had been agreed upon prior to the COVID-19 crisis. Recent prominent examples include the cancellation of a $1.1 billion takeover deal of Victoria's Secret by Sycamore Partners or SoftBank Group's backout of a deal to buy $3 billion worth of WeWork shares from investors and former and current employees.

While economic uncertainties often make it more attractive to seek an investment (and therefore capital) from a buyout investor, a buyer is often concerned about hedging its bets from downside risks involved in every M&A transaction.

Each party needs to ensure that the transactional risks are sufficiently addressed in the purchase agreement, ancillary agreements and documents. Because American courts will generally look at the verbiage agreed upon by the parties (whether or not it is "fair" to both parties or not), great care needs to be taken during the due diligence phase, the structure of the transaction (asset or share deal) and the protections built into the deal documents.

Legal Risks Resulting from Letter of Intents

Most M&A transactions involving the purchase of a private company start with the execution of a letter of intent ("LOI") which outlines the deal structure, purchase price, key employee issues and other deal specific items that the parties deem critical. Buyer should insist on a "no shop" provision in the LOI preventing the seller from negotiating with other parties for a specific period of time. It is crucial that the verbiage used in a letter of intent not create an obligation to close the acquisition resulting in a damages claim by the other party.

Depending on the agreed upon transaction structure, the parties will agree upon a simultaneously sign and close or deferred closing transaction structure. The sign and close closing structure can be beneficial to both parties because it eliminates the transaction risk for the time period between the execution of the purchase agreement and closing, when the shares or assets will be transferred to the buyer. On the other hand, a simultaneously sign and close structure may result in a heavily negotiated purchase agreement where changes can be made until the very last minute prior to closing.

Drop-Dead Dates in Purchase Agreement and Walk-Rights of Buyer

Many legal disputes currently arising from M&A transactions result from a deferred closing transaction structure, when the buyer refuses to close the purchase because the COVID-19 epidemy has resulted in a business slowdown in the target company after the purchase agreement had been signed. From a legal point of view, the question is whether the conditions precedent for closing that have been agreed upon by the parties in the purchase agreement have been met by the seller and whether buyer has the right to terminate the purchase agreement.

Government Mandated Shutdowns and Drop-Dead Date Deadlines

Many purchase agreements contain a "drop-dead" date provision whereby one party has the right to terminate the purchase agreement if the closing does not take place on or before a specific date. The drop-dead date can become problematic if one of the agreements or documents that are a closing deliverable and condition precedent for such closing (such as the execution of agreements with key personal, major customers or vendors or required consents) are not executed and delivered on time. Due to government mandated shutdowns that disrupt the business operations of many companies, meeting deadlines and therefore a drop-dead date can easily become a problem.

Breach of Agreements Prior to Closing

Another possible legal way for a buyer to get out of a M&A transaction is to allege that one of the conditions precedent for closing has not been met. In a purchase agreement, a buyer generally has to provide certain representations, warranties and covenants that will need to be confirmed by the seller to be materially true and correct as of the closing date through the delivery of a bring-down certificate. One such warranty is that there is no breach of an agreement with a third person.

Many companies have opted to reserve cash flow by ceasing to make rent payments or unilaterally reducing rent payments to landlords. Whether these companies have a right to do so or not under applicable Force Majeure provisions in the respective lease agreements or other provisions that cover government mandated shutdowns will often be up to interpretation (which will be occupying courts in the United States for years to come). Landlords will often preemptively declare an event of default under the lease agreement. Another often underestimated legal risk for a seller is the breach of financial covenants contained in loan agreements with lenders that can trigger a repayment right of the lender of the outstanding principal loan amount (for example due to a deterioration of seller's cashflow to debt ratio).

Because the representation made by seller that there is not material breach of an agreement needs to be confirmed through a bring-down certificate at closing, seller will no longer be in a position to do so and buyer may use its walk-right to terminate the purchase agreement.

Material Adverse Change Conditions

The purchase agreement typically contains a representation whereby there has been no material adverse change ("MAC") in the business, operations, financial conditions, liabilities or assets of seller. As a consequence of the economic downturn caused by COVID-19, a MAC representation often gives a buyer another legal way out of a deal that is no longer attractive.

During the negotiation of the purchase agreement, the seller can try to mitigate the risk that the buyer backs out of a deal based on a MAC condition by adding carveouts in the respective provision (for example for any change resulting from conditions for the industry in which the seller operates or from changes in the general business or economic conditions). Having said this, a buyer will most likely resist such a carveout as it wants assurances that the business it is acquiring has not suffered a material adverse change since the date of the seller's most recent balance sheet which was the basis for the execution of the purchase agreement.

Deal Breakers Discovered in "Simultaneous Sign and Close" Transaction

If the parties to a M&A transaction decide to use a "simultaneous sign and close" transaction model whereby all acquisition agreements are signed at closing, some of these issues (such as the occurrence of a MAC condition or a breach of an agreement in the period between signing of the purchase agreement and the closing) will not give the buyer a walk right. Having said this, a buyer will not be willing to execute a purchase agreement until it has completed its due diligence of the target company. If such due diligence is performed properly and the seller is truthful with providing all requested information, the buyer will discover possible deal-breakers and back away from executing the purchase agreement, thereby refraining from consummating the acquisition.

Every experienced M&A practitioner will confirm that one tactic used by a seller is to delay providing requested information that it deems problematic until both parties are close to negotiating the purchase agreement. Another tactic deployed by many sellers is to gradually release negative information about the target company in disclosure schedules, which are the documents accompanying an acquisition agreement in which the target or its shareholders are required to disclose specific aspects of the business operations, material agreements or other matters.

Mitigation of M&A Risks

Despite general risks involved in every M&A transaction, expanding business operations through the acquisition of another business is often still the preferred option for many transatlantic investors compared to a "green field" investment. Many investors underestimate the time, efforts and money that will be required for the acquisition of land, construction of facilities, hiring of qualified and reliable employees and building up business operations in the United States. As opposed to operating essentially a "start-up" business, acquiring an established business provides an investor the opportunity to operate a fully functioning business the day after closing.

In addition, the economic uncertainty brought by the COVID-19 epidemy will most likely result in company valuations that are more favorable to a buyer than they have been in the last couple years.

In order to mitigate the investment risk for a buyer that consists primarily in overpaying for a target company, a couple of legal strategies should be considered:

Due Diligence is King

The first is to perform a thorough financial and legal due diligence of the target company through experienced and qualified advisors. More than often, transaction risks will be identified during the due diligence phase. When the acquisition risks are identified properly, they can be addressed in the purchase agreement and ancillary documents. Matter of fact, sellers usually have the best negotiation position at the time of execution of the LOI. The more information the buyer acquires about the target, the more leverage on price and deal terms it will get.On the other hand, if due diligence is not properly performed, the buyer will most likely pay for the consequences (the takeover of Monsanto by Bayer is a poster child for a deal gone wrong). Despite the fact that a buyer may have a breach of contract or fraud claim against a seller that makes representations that turn out to be incorrect after closing, the costs and hassle of litigation should be avoided by identifying transaction risks early on, so that the buyer can either back out of the deal or negotiate better terms and conditions in the respective agreements.

Post-Closing Adjustments

Buyer may request the use of a post-closing adjustment of the purchase price that is based on the increase or decrease in various balance sheet items as of the closing date as compared to those same items at a specific date agreed upon in the purchase agreement (such as working capital or sales).

Use of Purchase Price Holdbacks

Another possible risk mitigation strategy is the use of a holdback structure whereby a portion of the purchase price is deferred until certain events have occurred or not occurred or to use funds as leverage against the seller for a breach of the purchase agreement. For example, a part of the purchase price could be held back until a pending litigation or dispute has been resolved.

Use of Earnouts

Another way to link the purchase price paid to the seller to the performance of the target company is the use of earnout which gives the target or its shareholders the right to receive additional consideration if the target company's performance meets certain negotiated thresholds (such as financial targets like EBITDA, retention of key customers or future sales of certain products). Often sellers are hesitant to agree to earnouts because they are no longer involved in the operation of the target company. In middle market transactions where shareholders are often executives of the target company, earnouts are often more acceptable, especially if sellers continue to be employed by the target company after closing or are providing services as consultants under a transition services agreement. In such case, an earnout could also be agreed upon indirectly as part of the compensation package that is paid to such employee or consultant.

While these are just a few examples on risk mitigation strategies, each planned acquisition poses a different set of challenges. Therefore it is crucial for an investor to have a clear picture of the target business when negotiating acquisition documents so that the takeover will be a financial success.

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