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ADG Insights

How COVID-19 is impacting ADG M&A

Special series focused on the impact of the COVID-19 pandemic on the Aerospace, Defense, and Government Services industry

March 27, 2020

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While fundamentals remain healthy for much of the government market because of dedicated spending priorities and strong budgets, broader economic fallout as a result of the novel coronavirus (COVID-19) may affect the ADG merger and acquisition (M&A) environment.

Many buyers and sellers are adopting a "wait and see" approach to M&A activity in the current environment. With the sprawling impact of COVID-19 on the economy, businesses, and our communities, parties to M&A transactions that have already signed, but not yet closed, are studying closely the terms of their acquisition agreements. The principal questions being raised are whether the existence or effect of the coronavirus on the business of a target company (i) is a material adverse effect (MAE), (ii) results in a breach of the covenant to operate the business in the ordinary course between signing and closing, and (iii) results in a breach of the bring-down closing condition.

Whether the impact of the coronavirus is an MAE depends on the specific definition in an acquisition agreement and the law governing the acquisition agreement. MAE is commonly defined as any event, change, occurrence, circumstance, or effect that has had or would reasonably be expected to have a material adverse effect on the business, assets, liabilities, operations, and results of operations of the target company, subject to certain enumerated exceptions. Customary exceptions to an MAE include changes in conditions in the financial markets, credit markets, or capital markets and changes generally affecting the industry in which the target company operates. Some acquisition agreements specifically provide that pandemics, acts of god, or force majeure are exceptions to an MAE, which is helpful for a seller. However, often the preceding exceptions are qualified by language that provides that such an exception will not apply if the changes impact the target company in a disproportionate manner compared to other participants in the target's industry. In this case, the buyer may be able to assert an MAE if the buyer can prove that coronavirus-related disruptions impacted the target company in a disproportionately adverse manner.

Generally, there is a high bar to prove that an MAE has occurred. The burden of proof is on the buyer and the analysis is fact intensive. In Delaware, for example, there is only one reported decision where the Delaware Chancery Court agreed with a buyer and found that an MAE occurred permitting the buyer to walk away from the transaction. In Akorn, Inc. v. Fresenius Kabi AG, C.A. No. 2018-0300-JTL, the Delaware Chancery Court found that the seller could not force the buyer to close, pointing to facts showing that the decline in the target company's business was material and "durationally significant." The Delaware Chancery Court stated: "A buyer faces a heavy burden when it attempts to invoke a material adverse effect clause in order to avoid its obligation to close.... A short-term hiccup in earnings should not suffice... the effect should substantially threaten the overall earnings potential of the target in a durationally-significant manner."

Other provisions implicated by the current pandemic include the seller's obligation to operate the target business in the ordinary course between signing and closing and the closing condition requiring the representations and warranties of the seller and target company to be true and correct as of the closing; except for, in many cases, any inaccuracies that do not rise to the level of an MAE. In the current environment where a buyer may be exploring ways to get out of a transaction, a buyer may argue that the target has failed to comply with its covenant to operate in the ordinary course between signing and closing because it had to shut down or scale back its business operations. For target companies that are in states where local governments have imposed mandatory closures of businesses, a target may be able to argue that its failure to comply with the interim covenant to operate in the ordinary course is the result of complying with applicable law, a common exception to the target company's ordinary course interim covenant. Similarly, a buyer may also argue that the seller's or target company's representations and warranties will not be true and correct on the closing date and therefore the buyer is not obligated to close, but given customary MAE exceptions, that argument likely turns on the analysis above.

The success of all of these arguments in a court of law will depend on the specific language in the acquisition agreement, the law governing the transaction, and the facts at issue. While we are in unchartered territory with this pandemic and sellers and buyers may be closely considering options, a buyer's ability to walk away from a transaction for an MAE remains a high burden. Nevertheless, from a long-term perspective, valuations remain high in the ADG industry and there continues to be a strong budget environment. Deal makers in the ADG space should be prepared for continued or resumed M&A activity.

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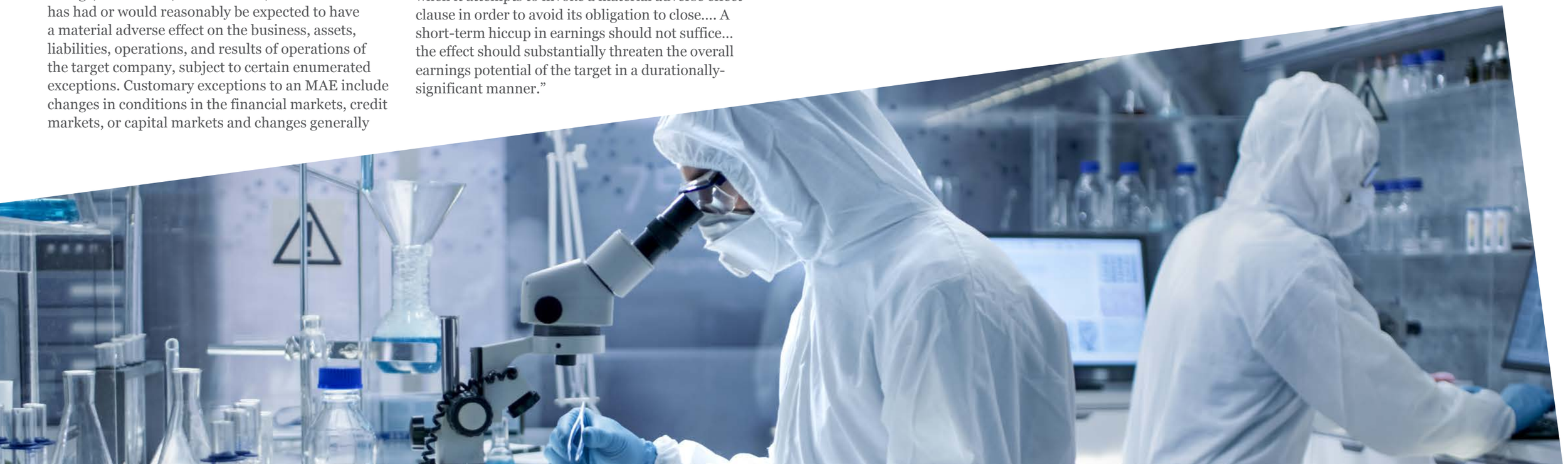

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