Hogan Lovells

Negotiating M&A Transactions in the COVID-19 Era

Considerations for Navigating New Opportunities in Uncertain Waters

As businesses around the world continue to adapt to new day-to-day realities and challenges brought about by the COVID-19 pandemic, priorities necessarily shift to near-term concerns. Nevertheless, times of significant disruption also give rise to new opportunities for both strategic buyers and financial sponsors.

Whether in the form of distressed M&A, defensive M&A or strategic combinations – many industries are expected to see rapid, significant change in the weeks and months ahead. Evaluating M&A opportunities in the world that will exist as economies around the globe find a way forward calls for a fresh, comprehensive approach to thinking through every aspect of a transaction – and with this we could see some divergence from pre-COVID-19 market practice.

This is necessary not only to account for how the world has changed already, but also to anticipate and prepare for the uncertainties that lie ahead.

On the following pages we share our thoughts on some of the key issues to consider when negotiating M&A transactions in the COVID-19 era and outline how we expect the approaches taken by buyers and sellers to differ from those taken previously.

Pre-Signing Considerations

Sale Process, Due Diligence and Deal Rationale

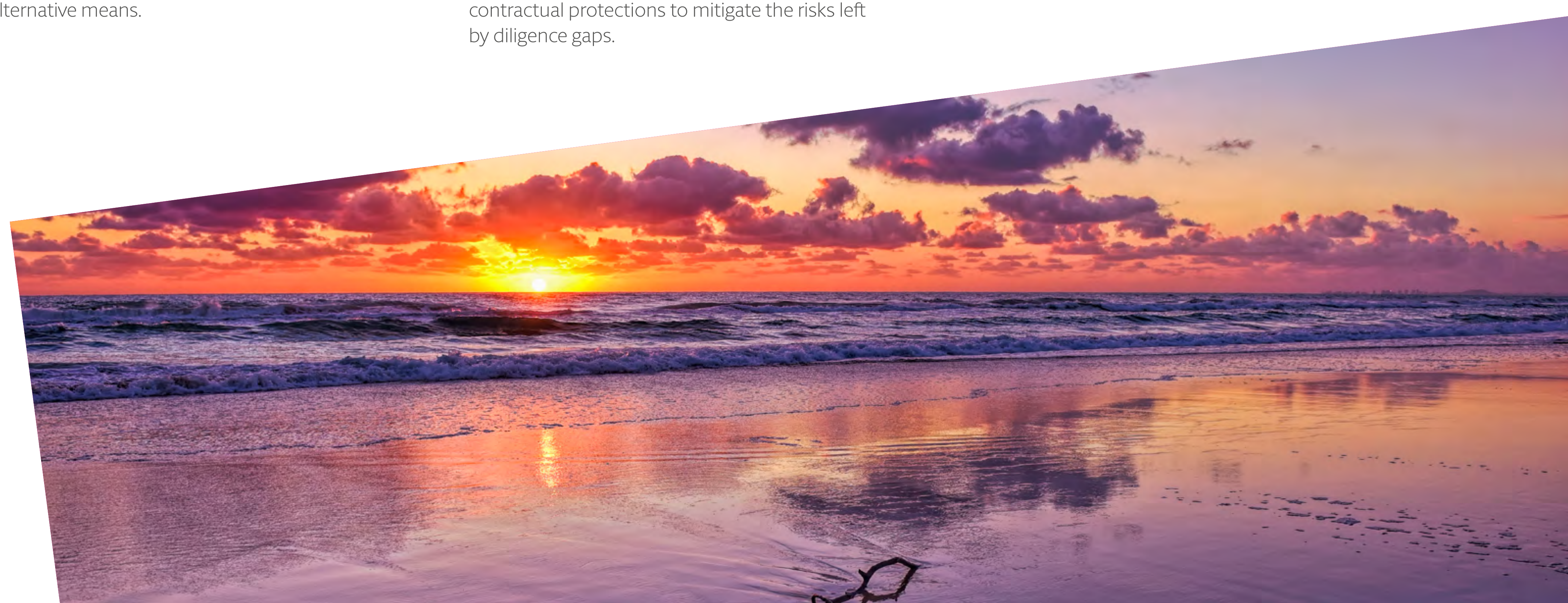
How will COVID-19 impact a seller's ability to conduct a sale process, and a buyer's ability to evaluate M&A opportunities?

M&A sale processes often include in-person management presentations, site visits and meetings with key employees and stakeholders. In the era of COVID-19, travel restrictions, 'stay-at-home' orders and shutdowns imposed by governments may make in-person interactions difficult, if not impossible. Buyers and sellers will need to consider whether meetings, site tours and presentations can be carried out virtually, through video conference or alternative means.

What limitations does COVID-19 impose on a buyer's diligence process? Are workarounds available or will risks previously addressed in diligence need to be mitigated through alternative means?

Onsite vs. Virtual 'In Person' Diligence: Certain critical diligence activities, including inspection of physical assets, may not be possible to conduct in person. To address such limitations, buyers may utilize alternative sources of information, such as historic third party reports, and may substitute on-site diligence with the use of drones and other remote technologies. Buyers may also seek additional contractual protections to mitigate the risks left by diligence gaps.

Environmental/Real Estate Due Diligence: Travel restrictions and shutdowns imposed by governments may delay or prevent environmental due diligence such as Phase I and Phase II site assessments and/or real estate surveys. Parties will need to consider whether alternative forms of diligence (e.g., desktop reports) will be sufficient, or whether additional contractual protection is required.



Pre-Signing Considerations

Sale Process, Due Diligence and Deal Rationale

How will COVID-19 affect the scope of a buyer's due diligence?

COVID-19 Specific Diligence: In addition to assessing the impacts on a target's business caused by the pandemic, buyers should conduct additional diligence around steps taken by targets to respond to COVID-19, including for example the extent to which the target is receiving government support and the target's compliance with social distancing and other COVID-19-related restrictions. Buyers will also need to put diligence plans in place to mitigate future implications of COVID-19, including potential longer term impacts on operations.

Contract Diligence: Material commercial agreements should be assessed to determine whether they provide sufficient supply chain and revenue protection in an uncertain COVID-19 world. Force majeure provisions, termination and change or remedy provisions should be assessed in the context of impacts to date, as well as uncertainties around the duration and extent of COVID-19. Supply chains are likely to be more vulnerable to disruption if they are longer or span across multiple jurisdictions.

Buyers may need to adjust their usual scope of contractual due diligence to focus on areas impacted by the pandemic.

To what extent will COVID-19 impact the business rationale of the deal and introduce new integration risk?

With significant disruption expected across a number of industries, strategic buyers and financial investors will have wide-ranging business rationales for pursuing M&A transactions. Depending on the deal rationale, significant post-closing integration work could be required including, for example, supply chain consolidation, further divestments, technological alignment, business rationalization and cultural integration. Achieving post-closing integration plans may be particularly complex in the current climate, and the scope and nature of a buyer's due diligence will necessarily be heavily influenced by the deal rationale and the type and extent of post-closing integration work that is anticipated.

Integration planning with respect to global organizations should also take into account transfer pricing issues, which will need to be carefully balanced with commercial and regulatory risk when planning for operations in the post-COVID-19 world.

Pre-Signing Considerations

R&W / W&I Insurance

Will transactional risk insurance provide sufficient recourse to buyers so that a buy-side policy can serve as a replacement for or supplement to a traditional warranty and indemnity package?

Insurers are evaluating the risk of COVID-19 in underwriting policies, and may seek to include broad exclusions for the effects of COVID-19 from coverage under the policy, or alternatively to exclude losses related to COVID-19 from coverage of particular representations and warranties. Parties will need to consider carefully the availability of transactional insurance coverage and any additional carve-outs that may be requested by insurers. Buyers should work with their brokers pre-signing in order to address the scope of any COVID-19-related exclusions.

Insurers are also requiring that a robust due diligence exercise has been undertaken in light of the pandemic, especially in relation to the financial and operational aspects of the target business and the steps the target has taken to address the impacts of COVID-19. Insurers may request further exclusions from coverage as a result of COVID-19-related gaps in a buyer's diligence process.

Parties will also need to consider the allocation of 'interim breach' risks, which generally are not covered by transactional insurance, particularly in the context of COVID-19.

Disclosure and Buyer's Knowledge

Are the impacts of COVID-19 appropriately disclosed?

Sellers will seek to include specific disclosures to take into account the effects of COVID-19. However, buyers should ensure that any such disclosures are sufficiently tailored so as to not overly limit the buyers' ability to recover for breaches of representations and warranties.

Buyers may also seek to allocate certain COVID-19 risks to sellers, particularly where transactional insurance is not available for disclosed risks.

In Europe, the entire data room is typically disclosed against the warranties (subject to a fair disclosure standard), so buyers will need to be mindful of the extent to which a seller's liability is qualified as a result of disclosures relating to the impact of COVID-19 that are apparent from the documents available in the data room.

What are the implications of COVID-19 for pro-/ anti-sandbagging provisions?

In the U.S. in particular, negotiation of pro-/ anti-sandbagging provisions will need to be considered carefully in light of the pandemic, particularly given the difficulties in assessing the magnitude and extent of COVID-19 impacts. For example, is it appropriate for a buyer to preserve a claim for breach of a representation and warranty knowing that such representation and warranty was untrue as a result of COVID-19? By comparison in the UK, pro-sandbagging provisions are rarely included as it is unlikely that a buyer can recover substantive damages for a warranty claim in relation to something it was aware of at signing.

Pre-Signing Considerations

Financial Distress Considerations

What additional considerations apply where the seller or target is distressed or has the potential to become distressed?

As the COVID-19 pandemic puts significant pressure on markets, supply chains and economies, many sellers and targets may either be distressed or potentially distressed (or even insolvent) during a sale process. This puts additional pressure on directors of these companies, who will need to be mindful of their fiduciary duties, including any potential shift in those duties such that they become owed to creditors rather than the company.

Buyers looking to acquire businesses from distressed sellers will also need to consider the potential for fraudulent conveyance or other creditor challenges to the transaction, given that obtaining 'too good a deal' may have consequences later. Specifically, acquiring assets for less than 'fair market value' from a seller that is insolvent or rendered insolvent by the transfer risks a subsequent creditor challenge that could result in a damages claim or an unwinding of the transaction.

A buyer acquiring a business from a financially distressed or potentially distressed seller will want to avoid becoming involved in any decision-making processes on the part of the seller, and verify that relevant decisions regarding price and transaction structure are properly documented. This will be important to ensure that, if the seller subsequently enters into a bankruptcy, insolvency or restructuring process, the buyer is able to demonstrate that its transaction took place on a commercial, arm's-length basis so that it is free from any risk of challenge in the bankruptcy, insolvency or restructuring.

Logistical Considerations

Are signing and closing arrangements feasible given COVID-19-related government closures and limited operations?

In light of government-mandated closures, parties may need to explore alternative signing and closing arrangements, including the use of electronic signatures where permissible. Any corporate meetings necessary to authorize the transaction should also be considered well in advance, including whether authorization can be given via written consent or telephonic (or video) meetings. In addition, if the transaction requires documents or regulatory filings to be executed before a notary or apostilled, early engagement with notaries and/or relevant government bodies should be arranged.

Parties will also need to take into account the more limited operations of couriers, which may result in longer lead times for delivery of any required original signatures or certificates. Similarly, closures or reduced staff at governmental agencies may impact timing and parties' ability to make filings on the anticipated closing date.

Will there be delays in obtaining governmental or third party approvals or consents as a result of COVID-19?

If key governmental or third party approvals are required in connection with the transaction – for example, antitrust or foreign investment approvals, or consents under key customer contracts – parties should take into account any likely delays in obtaining these consents or approvals as a result of government-imposed shutdowns and limited operations.

Valuation

Locked Box, Net Working Capital and Net Debt Adjustments

How should parties allocate the financial benefits and burdens of the business between signing and closing, particularly given uncertainty related to COVID-19?

In Europe, where the locked box pricing method is commonly used as an alternative to a post-closing adjustment regime, especially in deals involving a private equity or other financial investor, we may see more of a return to a post-closing adjustment, in view of the greater need to mitigate against uncertainty during the pre-closing period.

Does the purchase price adjustment take into account potential swings in net working capital due to COVID-19 impacts on business performance or extended timelines to closing?

If a post-closing net working capital adjustment is used, parties should consider whether limitations may be appropriate to mitigate the risk of fluctuations in working capital due to COVID-19, such as a floor and/or ceiling on the adjustment amount to help limit the impact of swings in net working capital on the purchase price agreed at signing. Parties may also reconsider the target working capital amount against which adjustments are measured to take into account impacts of COVID-19.

How should constraints on cash flow, implications for indebtedness and COVID-19 specific impacts to the balance sheet be factored in to the transaction?

Buyers will need to pay close attention to net debt levels and the impact of any net debt adjustments to purchase price, given that debt is likely to be used to a greater extent as a means of managing cash flow constraints. The treatment in the closing statements of non-ordinary course COVID-19 specific items, such as furlough or stimulus payments due or received under government support schemes, will also need to be carefully considered.

Earn-Outs

Can pricing uncertainty caused by COVID-19 be addressed by a portion of the purchase price being tied to longer term financial performance of the business?

Earn-outs are a possible approach to bridge valuation gaps given the current uncertainty by allowing sellers to share in future growth post-COVID-19. Parties will need to consider whether such a mechanic delays potential disputes regarding the purchase price. Sellers will also need to make sure they are comfortable tying part of the purchase price to the financial performance of the business during a period in which the business is controlled by the buyer, which may address the impact of COVID-19 differently than the seller.

Valuation

Distressed Sales

How is tax-efficient deal and integration planning impacted by COVID-19?

Shifts in valuations resulting from COVID-19 may impact parties' considerations regarding transaction structure and integration planning. For example, in a cross-border transaction involving a target group with significant R&D and valuable intellectual property (e.g., patents, know-how and brands), the valuation of such intangible assets may be significantly lower than pre-COVID-19. This opens up an opportunity to negotiate a more tax efficient deal – however appropriate analysis and modelling is required to ensure that this does not create a cost further down the line. Consideration needs to be given to post-closing management and ownership structure and 'the best locations' for holding intellectual property and carrying out R&D activities in the COVID-19 era. Parties will need to analyze whether tax considerations impact the purchase price allocation or even the deal structure – is an asset deal now more attractive than a share deal or vice versa? Buyers will also need to give thought to how the transaction will impact the target's current supply chain and business model. The challenge will be to maximize post-integration efficiencies to take advantage of the COVID-19-era incentives without incurring greater tax cost further down the line.

How will the financial position of the parties at the time of negotiating the transaction impact valuation?

Any change in a party's financial situation could have implications for the transaction structure and terms. Increased financial stress of a seller may favor a simpler, cleaner transaction at a lower price with limited recourse to the seller, as opposed to a more complex deal at a higher price where the buyer has ongoing recourse to the seller for breach of warranties and indemnities.

Similarly, buyers may be unwilling to rely on indemnities and recourse to sellers under financial stress, and may require other recourse, for example to escrowed funds or third party sources such as transactional insurance.

Any transaction where a party is in the 'zone of insolvency' has the potential for fraudulent conveyance and similar creditor challenges to the transaction, which must be considered carefully.

Interim Period and Closing Considerations

Interim Covenants

Do interim covenants include appropriate carve-outs to take into account the effects of COVID-19, including government-mandated shutdowns?

Sellers will seek to include appropriate carve-outs from standard interim period covenants, such as any covenant to operate the business in the ordinary course. Sellers will need to consider exceptions to allow for compliance with government-imposed restrictions and other factors that may impact a target's normal operations, as well as to respond to changing market and industry dynamics and events impacting customers, suppliers and employees.

Parties will need to balance the need for interim covenants to provide sellers with sufficient latitude to operate the target business during the interim period in these unusual circumstances, while allowing buyers to have input on key decisions.

Does the buyer have a walk away right if interim covenants are breached?

Parties will need to negotiate whether it is appropriate in the current circumstances for the buyer to have a walk away right for breach of an interim covenant, which is common in the U.S., typically being structured as a closing condition requiring the seller to have performed its interim covenants in all material respects, or whether a buyer should be entitled to a damages claim only, which is fairly typical in Europe. Walk away rights will need to be considered carefully together with excused departures from typical 'ordinary course' operating covenants due to COVID-19 disruptions.

MAC / MAE Closing Condition

What are the consequences if there is a material adverse change in the target business as a result of the impacts of COVID-19 between signing and closing?

Parties should carefully consider the inclusion of any closing condition that no 'material adverse effect' has occurred with respect to the business between signing and closing. Parties will need to negotiate allocation of the risk for a significant downturn in the business after signing as a result of the effects of COVID-19.

MAC / MAE provisions often exclude macro-economic events such as market-wide downturns. However, COVID-19 may have an uneven effect even within certain markets or segments and so the exact wording of the 'MAC / MAE' definition will be closely scrutinized and likely subject to intense negotiation. Sellers may seek to exclude the effects of COVID-19 entirely or the effects of COVID-19 except where the pandemic has a disproportionate effect on the target business compared to other businesses in the industry in which the target operates.

The standard for proving a MAC / MAE is typically high, requiring a buyer to establish the occurrence of events that substantially threaten the overall earnings potential of the target for a significant duration. Parties negotiating MAC / MAE clauses in the COVID-19 era should consider carefully the intended allocation of risk of the impact of COVID-19 on the target business.

Bring-down of R&W / Repetition of Warranties

Can a seller bring-down or repeat its signing representations and warranties given the implications of COVID-19?

Parties will need to consider the implications of the seller 'bringing down' or 'repeating' representations and warranties at closing in light of changes to the target's business that may occur between signing and closing as a result of COVID-19. In particular, parties will need to agree whether any breach of the bring-down condition / repeated warranties should give the buyer a termination right (typically subject to a materiality or material adverse effect qualifier) or a claim for damages only. Repetition of all representations and warranties at closing has historically been more common in the U.S. than in Europe, but market practice on this point may evolve as parties navigate the complexities of risk allocation for the pre-closing period in the COVID-19 era.

Antitrust, Political and Tax Landscape

Antitrust Risk Analysis

Has the substantive antitrust risk associated with a potential transaction changed as a result of COVID-19?

While the substantive antitrust framework applicable to transactions is unlikely to change as a result of COVID-19, with limited exceptions (for example, acquisitions of failing or 'flailing' firms), changing commercial conditions can significantly impact the expected competitive effects of a transaction. Significant financial pressure on an industry can limit the ability of companies to invest in expansion and innovation – both of which may be more feasible through strategic M&A. Similarly, steep declines in demand can result in significant underutilized capacity, thereby bolstering the ability of customers to drive prices down and increase the likelihood that a transaction may result in the realization of significant efficiencies.

If there are multiple consolidations within an industry, antitrust agencies will review transactions in the order in which they are filed. It will be important for parties to consider other transactions already under consideration at the time when evaluating risk of antitrust clearance.

Antitrust Clearance / Covenants

Is there sufficient time built into the longstop/drop dead date to secure antitrust clearance and satisfaction of other conditions?

In agreeing on an appropriate longstop/drop dead date for satisfaction of closing conditions, parties should take into account that antitrust and other regulatory bodies (in the U.S., EU, and elsewhere around the globe) may close temporarily, work remotely, or otherwise work under alternative procedures, which could create timing implications for the parties' ability to obtain necessary clearances and approvals. Even deals without substantive issues may face longer clearance timelines – parties should be prepared to do more to help the agencies understand the industry and products upfront.

What implications does COVID-19 have for any antitrust covenants given by the parties?

Risk-shifting covenants, particularly covenants to comply with a potential Second Request in the U.S., Phase 2 in the EU or extended reviews in other jurisdictions, and to pursue litigation and other remedies, can have a significant impact on the deal timeline in 'normal' circumstances. This impact will be magnified in the COVID-19 era. In addition to timing, carefully consider where a divestiture or other remedy may be required – particularly where there may be a limited number of divestiture or remedy partners available. Remedy partners will need to be vetted to confirm their suitability, which requires, among other things, establishing the financial stability of the partner.

Antitrust, Political and Tax Landscape

Political Landscape

How will the political landscape affect deal making in the COVID-19 era?

As governments increasingly focus on rebuilding economic activity after the sharp hit of recent weeks and months, they will take a keen interest in attracting fresh investment and supporting business-critical acquisitions. Securing jobs will likely be a key feature. This presents opportunities for businesses and deal-making. Given the likelihood that government support programs and regulatory initiatives will have a material impact on many businesses in the coming months and years, political intelligence and active engagement with policymakers could play an increasingly important role in M&A transactions. Governments are set to become more active players in the business world, and so shaping government response to the pandemic may give businesses a competitive advantage in the post-COVID era.

Is the COVID-19 tax landscape helpful or unhelpful to M&A?

The cost of COVID-19 to each country's fiscal budget is significant and ultimately will need to be financed in part through increased taxes. Fiscal authorities globally will now, more than ever before, be fighting for their revenue. One of the challenges for governments will be hitting the right balance between offering incentives to encourage investment and raising revenues through taxes, while simultaneously addressing the political/ public pressure for corporates to pay their 'fair share of tax'. As a result, the tax landscape across the globe will need to shift to address the impacts of COVID-19. But, wherever that takes us, we do see opportunities coming out of COVID-19 to enhance M&A deal efficiencies during various stages of transactions, including by taking into account factors such as revised asset valuations, COVID-19 measures to incentivize business and the COVID-19 impact on supply chain.

Financing and Execution Risk

Acquisition Financing

What are the consequences of a buyer's financing failure in an uncertain COVID-19 environment?

Buyers may face additional hurdles in obtaining acquisition financing given the uncertainty in the credit markets that exists today, and those complexities may develop as the effects of COVID-19 on the global economy continue to evolve. With this in mind, parties should consider carefully applicable termination rights in the event of a failure to obtain acquisition financing. Buyers may be more likely to request a 'financing out' where one may not have been required previously, to address an increase in financing uncertainty. Sellers in turn may require additional protection through reverse break fees for financing failures, secured by guaranties or deposits at signing, which would be forfeited in the event of a financing failure. Lenders will continue to be focused on the terms of acquisition agreements, including how COVID-19 impacts and uncertainties are addressed.

Will COVID-19 funding challenges have wider tax implications?

Buyers looking to finance acquisitions will need to analyze whether the available acquisition funding ensures that the overall post-integration structure remains tax efficient. For example, if post-integration, a newly acquired target is intended to be a 'limited risk' entity (i.e., retaining limited risk and so a small margin with the higher risk and margin moving to a more tax efficient jurisdiction), buyers will need to ensure they can still satisfy bank covenants contemplated by available acquisition financing. This is because such covenants are likely to include debt ratios based on EBITDA that are stricter than those in loans issued pre-COVID-19 and therefore more challenging for 'limited risk' entities to meet. Striking the right balance between tax optimization and the requisite level of funding will be crucial.

Failure by Buyer to Close

What are a seller's remedies if a buyer is unable or unwilling to close in breach of the sale agreement as a result of the impacts of COVID-19?

Buyers experiencing the effects of COVID-19 in their own industries or businesses may seek to revisit signed deals and either refuse to close or seek to re-negotiate the price or terms, despite closing conditions having been satisfied. In this scenario – depending on the governing law of the agreement – sellers may seek specific performance to force buyers to consummate the transaction where specific performance is expressly contemplated by the sale agreement. In the absence of an express provision in the sale agreement, specific performance is an equitable remedy and thus (depending on the governing law of the agreement) could be awarded by the courts where damages would be inadequate. Parties should consider carefully available remedies and recourse if a transaction fails as a result of COVID-19-related impacts on the parties.

Global M&A at Hogan Lovells

Our mergers and acquisitions practice is built upon four pillars. Technical excellence. Industry knowledge. Full-service capabilities. Global reach. These resources, taken together, allow us to provide our clients with world-class support on their transactions.

We are ranked among the Top 15 law firms in the world for M&A, based on the value and volume of deals on which we have advised globally, across Europe, the United States, and within the United Kingdom, France, Germany, Spain, and Japan.

We put our clients first, delivering attentive, client-focused services wherever and whenever needed.

Top 15 M&A rankings

Source: Bloomberg, Mergermarket, Refinitiv 2019

- Global
- Europe
- United States
- United Kingdom
- Germany
- France
- Spain
- Japan

Technical excellence

Executing transactions effectively

Our M&A lawyers are recognized as leaders in their field. We provide the highest quality work product to our clients. We help our clients innovate with cutting-edge M&A strategies that enable them to lead the way in their industries, and partner with their financial advisors to maximize their success. We invest in ongoing training of our M&A lawyers to stay on top of market trends and developments. Our M&A group includes lawyers who have been recognized as American Lawyer Dealmakers of the Year, FT Innovative Lawyers, and have been lauded in numerous other awards.

Industry knowledge

Understanding issues in regulated industries

We understand the industries in which our clients operate and have organized our law firm to foster that understanding. Our M&A practitioners serve as members of Industry Sector Groups composed of corporate, commercial, and regulatory lawyers who immerse themselves in specific industries. These groups include lawyers with high-level government and industry backgrounds in their relevant sectors. Our multidisciplinary industry focus enables us to identify, and even anticipate, regulatory changes, market dynamics, and trends that can impact our clients' business transactions.

Full-service capabilities

Solving problems, on time and efficiently

We offer the full range of legal capabilities necessary to achieve success in your transactions, on time and efficiently. Whether a transaction gives rise to antitrust review, employee benefit considerations, intellectual property safeguards, tax-efficient structuring, or other issues, our M&A team can draw upon over 50 practice areas across our firm. We work together across practice areas and offices, leveraging the transactional knowledge and subject matter experience of our lawyers to provide our clients with seamless support.

Global reach

Worldwide reach, with local knowledge

Our M&A practice extends across the world's major commercial centers and emerging markets. We continuously assess our geographic capabilities and growth plans, not only in light of where business is, but where business is heading. With 500 M&A lawyers in over 45 offices across Africa, Asia, Australia, Europe, Latin America, the Middle East, and the United States, our global reach ensures that we can help with inbound, outbound, cross-border, and domestic M&A, wherever a deal takes our clients.

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