



COVID-19

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**Coronavirus / COVID-19
Response Team**

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**Select COVID-19
Considerations in M&A
Transactions**

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Today's Topics

- M&A Market Trends
- Valuation & Purchase Price Considerations
- Material Adverse Change / Effect
- Key Representations and Warranties
- “Ordinary Course of Business”
- Regulatory Approvals, Closing Conditions and Timing Considerations
- Representation & Warranty Insurance Trends
- Due Diligence

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M&A Market Trends

- The value of M&A activity in Q1 2020 was significantly lower than Q4 2019, down 35% globally and 39% in the United States
- In Q1 2020, the value of worldwide M&A activity fell 25% from Q1 2019
- In the United States, the decline was even worse, with a 50% year-over-year decline in overall M&A value in Q1 2020
- 2020 represented the worst first quarter for M&A activity since 2016, as the overall number of deals declined 13% from a year ago and hit a six-year low

Valuation & Purchase Price Considerations

- COVID-19 has fundamentally disrupted operations and financial performance for most businesses
 - This disruption creates challenges for determining appropriate metrics for valuation and purchase price adjustments (e.g., EBITDA, net working capital, etc.)
 - Likely to see increased use of earnouts and other contingent / deferred purchase price structures
 - For debt-financed transactions, this will require careful negotiation of subordination terms as well
 - Potential increased use of buyer stock / equity as consideration to facilitate agreement on relative valuations of buyer and seller

Definition of Material Adverse Change / Effect

- Sample pro-buyer definition without any exceptions (from ABA Model Asset Purchase Agreement):
 - *“Material Adverse Change” means any event, change, development, or occurrence that, individually or together with any other event, change, development, or occurrence, is or could reasonably be expected to be materially adverse to (a) Seller or the Business, or its condition (financial or otherwise), assets, results of operations, or prospects; or (b) Seller’s ability to consummate and perform the Transactions.*
- Increased emphasis on negotiating exceptions (and “exceptions-to-exceptions”) in MAC definitions

Material Adverse Change / Effect Exception...

- Possible pro-seller exception:
 - “... any epidemic, pandemic, disease outbreak (including COVID-19 and its evolutions) or other health crisis or public health event, or the worsening of any of the foregoing;”
- Possible buyer “exception-to-exception” response:
 - “... except to the extent such event, change, development, or occurrence has a disproportionate effect on the Business as compared to other [similarly-situated] businesses in the [industry/geography] in which the Business operates.”
- If the MAC definition is too nebulous to allocate risk, consider specific closing conditions
 - Financials, customers/vendors, facilities/operations, etc.

Material Adverse Change / Effect: Other Possible Exceptions

- Other potentially relevant MAC exceptions include:
 - General economic, financial or regulatory conditions
 - General conditions / changes in relevant industry
 - Changes in laws
 - Acts of God
 - Failures to meet projections / estimates (but not the underlying reasons therefor)
- Typically, would also be subject to “exception-to-exception” / disproportionate effect language
- In part due to exceptions, very hard to prove MAC
 - No MACs were judicially declared in aftermath of 9/11 or during the 2008 financial crisis

Customer & Supplier Representations & Warranties

- Representations and warranties relating to customer and supplier relationships are even more important:
 - No terminations, cancellations or defaults
 - No adverse changes to key terms or economics
 - No renegotiations (or attempted renegotiations)
 - No *force majeure* declarations
 - No significant delays in deliveries or payments
 - No bankruptcies / insolvencies
 - Essential vs. non-essential status of key customers / suppliers
- Also more difficult to obtain insurance coverage for these representations

Other Key Representations & Warranties

- Legal compliance
- Labor and employment matters
- IT, cybersecurity and privacy
- Inventory, A/R and other financials
- Participation in government stimulus / loan programs (e.g., PPP, Main St. Lending)
 - Exposure to future audits / whistleblower claims
 - May restrict business operations post-closing (e.g., executive compensation, dividends, union relations)

Interim Operations and “Ordinary Course of Business”

- Backward-looking representations concerning recent “ordinary course” operation of the business
- Forward-looking covenant to operate in the “ordinary course of business” before closing
- COVID-19 environment is not “ordinary course”
 - Need to include appropriate flexibility to allow target business to operate reasonably / safely and react to circumstances without constantly seeking buyer permission
 - May need to loosen language around maintaining consistent relationships with employees and other key business partners
 - Specific exception for COVID-19 measures / response plans

Regulatory Approvals, Closing Conditions and Timelines

- Regulatory approvals (e.g., HSR, CFIUS, EU merger reviews, etc.) likely to be slower for some time, particularly for deals requiring formal proceedings
- Other closing conditions may take longer to satisfy, including third party consents, shareholder approvals, debt marketing periods, etc.
- In light of longer lead-times, consider extending “drop-dead dates” beyond customary periods for comparable past transactions
 - Alternatively, use automatic extensions of “drop-dead” date based on status of closing conditions / COVID-19

Impact on Representation & Warranty Insurance Policies

- R&W insurers developing new underwriting practices and policies relating to COVID-19:
 - Exclusions for COVID-19 exposures and government responses
 - Heightened sensitivity and expectations relating to buyer due diligence of COVID-19 risks, plans and impacts
 - Excluding COVID-19-specific reps and warranties from coverage
 - Extending exclusions to *force majeure* declarations, labor disruptions, supply chain, customer impacts, business interruption
 - Monitoring COVID-19 issues between signing and closing and follow-up during “bring down” due diligence conferences pre-closing
- Though the situation is fluid, be prepared to address COVID-19 risks as if they will not be insured

Heightened Due Diligence

- Particularly given the more extensive R&W insurance exclusions, due diligence relating to the impact of COVID-19 is / will be paramount
 - More than ever, buyers cannot view due diligence as a rote, “box-checking” exercise
 - Effective due diligence will require more engagement across disciplines (e.g., operations, accounting, legal) and practice areas (e.g., corporate, labor, employment, IT, privacy)
 - Diligence should be more forward-looking than ever before: what is the plan to emerge as a stronger business?
- Distinction between “business issues” and “legal issues” means even less in the current environment

Conclusions

- Current M&A market significantly depressed
- COVID-19 impact on M&A process and practices will be significant and lasting
- In some cases, “new” developments actually represent an acceleration of trends that were already underway and emerging
- Be prepared for a less predictable, less stable M&A market in the near-term and possibly longer



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