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TRANSFORMING M&A – THE LASTING IMPACT OF COVID-19 AND THE CARES ACT

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Our M&A Master Class Series has been thoughtfully designed to highlight critical topics and legal implications throughout the life cycle of a transaction. We look forward to continuing this important dialogue through events and other communications in 2021.

Today's mergers and acquisitions environment has grown significantly more complex based on the influence of novel events in 2020, most notably, the Coronavirus (COVID-19) and the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). As a result, the process and substance of business transactions will continue transforming into 2021.

When considering selling or acquiring a business (whether its equity interests or its assets), or making or receiving a significant investment in a company, a number of key considerations should be made in evaluating a transaction in this changing environment. In the next two weeks, we will issue a multi-part series to assist in identifying potential challenges and factors in anticipation of a sale or acquisition. The series is designed to draw attention to the specific impact of COVID-19 and the CARES Act, rather than serve as a start-to-finish guide or detailed analysis of how/where these concepts fit into business overall.

Part 1: Market Opportunism, Valuation and Risk Allocation

Today's mergers and acquisitions environment has grown significantly more complex based on the influence of novel events in 2020, most notably, the Coronavirus (COVID-19) and the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). We look forward to sharing key considerations with you over the next couple of weeks as part of our three-part series. This first installment will discuss the current landscape as it relates to market opportunism, as well as the impact on valuation and risk allocation in a somewhat volatile environment.

MARKET OPPORTUNISM:

From the perspective of a buyer who has capital to deploy, the current landscape could ripen the opportunity for both strategic and add-on acquisitions of target businesses lacking sufficient cash or resources to weather the economic downturn. While this fertile landscape creates an attractive scenario for buyers, bringing everyone to the deal table is merely the beginning.

VALUATION AND RISK ALLOCATION:

In the pre-COVID-19 era, historical earnings were a useful tool to value a business. However, valuation tools predicated on historical earnings may not offer a buyer an acceptable level of comfort and predictability for a business' future performance. A core issue precipitated by unpredictability of future performance is which party, the buyer or the seller, should bear the risk of an underperforming business post-closing? Parties should consider the following when assessing current and future performance of a target business:

- ***Post-Closing Adjustments and Paycheck Protection Program (PPP) Loans*:**If a target business received a PPP loan offered under the CARES Act, but has not yet applied for loan forgiveness, the parties should consider where this risk is best addressed. Depending on the deal's timeline and closing, the parties could address this risk in post-closing adjustments (short-term period for resolution), or in a seller's indemnification obligations (long-term period for resolution). Sellers should also consider appropriate covenants regarding a buyer's post-closing operations that may impact forgiveness, as well as procedures for making the forgiveness application. In the event a PPP loan deducted from the purchase price is later forgiven, the parties should memorialize how that forgiveness will be treated – for example, as a debt adjustement, or as a post-closing payout to the seller from the buyer (or from escrow). The parties should also account for procedures and risks relating to any remaining audit period for the PPP loan. Alternatively, the parties could completely exclude the PPP loan from initial purchase price adjustments and negotiate for any amounts failing to be forgiven in a separate escrow or as leverage in other areas of the overall transaction.

- ***Net Operating Losses (NOLs)*:**The CARES Act allows businesses to carryback NOLs up to five years from taxable years 2018, 2019 and 2020. Parties should consider whether a buyer is required (or incentivized) to amend prior tax returns, and to what extent the parties will allocate the benefit derived from the pre-closing time period.

- ***Earn-outs:*** Despite earn-outs' troubled reputation as a source of post-closing disputes, they may become more attractive in the current environment because they enable parties to exercise control today over events occurring in the future (i.e., the method and manner of earn-out payments). A buyer can reduce the risk of overpaying for a target business impacted by COVID-19, while simultaneously presenting the seller an immediate opportunity to exit during a turbulent economic environment with the potential for more gain in the future. Pre-COVID-19, it would be normal to see an earn-out period range from 12 to 24 months; however, given the uncertainty of COVID-19 and its far-reaching economic effects, parties may consider extending earn-out periods to 36 or even 48 months. With an increase of duration, however, buyers may be less willing to agree on post-closing management covenants (e.g., restrictions on daily operations, separate accounting requirements and fundamental governance of the business), which could further prompt a buyer to require an option to buy out the earn-out (or a seller to require various acceleration triggers). Additionally, if the target business received a PPP loan, the parties should consider how the loan forgiveness, or lack thereof, will be accounted for in the overall earn-out scheme. Typically, an earn-out would be based upon operating earnings, such that the parties might exclude any income generated by forgiveness of a PPP loan.

- ***Equity Rollovers*****:** This risk allocation tool is most often employed by private equity firms. It is possible, however, that we'll see the use of equity rollovers outside of the private equity space if a seller impacted by COVID-19 is not looking for an immediate exit or payout from the target business and buyers are receptive to sharing control of a newly purchased entity or retaining passive sellers as investors post-closing. An allowance for passive sellers as investors could be justified by the buyer's short-term benefit from the reduction of cash paid at closing. Pre-COVID-19, it was common for the equity rollover percentage to range from 10% to 20% of the purchase price, but if the parties are motivated to complete the deal with the use of an equity rollover, the percentage could increase significantly pending a buyer's inability to access capital or the desire for additional operating capital in the business amidst COVID-19 concerns.
- ***Cash/Equity fluidity*****:** For deals that closed pre-COVID-19 or during COVID-19 with parties currently operating under an earn-out scheme coupled with related buyer obligations or operating restrictions, a lose-lose scenario may result if the pre-COVID-19 method of operating the business is proving no longer to be viable. In a lose-lose scenario, buyers with post-closing obligations and operating restrictions should not immediately disregard new profit-driven developments just because the developments could run afoul of such obligations or operating restrictions. If the seller is willing to agree with the buyer's vision to develop the business in a new manner, the parties could swap-out the buyer's cash payment (or lack thereof) under the earn-out with equity back to the seller. With this arrangement, both parties

share the risk of deviating from the current business model and the potential benefit from the buyer's new business developments.

Part 2: Due Diligence

DUE DILIGENCE – BUSINESS RECORDS AND INSPECTIONS:

A seller that can confidently present a clear picture of the performance and operations of a target business is more likely to attract a buyer and close the deal. Sellers can best position themselves by conducting due diligence prior to entering into significant discussions with a buyer. This preemptory due diligence can help to identify existing issues and create opportunities to resolve those issues that could have otherwise extended due diligence periods, increased deal costs, shifted leverage during negotiations, or worse – caused a buyer to walk away.

In addition, although filings with government offices, such as the Secretary of State, may have taken mere days pre-COVID-19, it is not uncommon today for those offices to experience significant backlogs or even complete closures. These potential delays highlight the importance of addressing regulatory and governance issues at a very early point in the process to avoid unexpected delays. Other governmental directives requiring quarantine or impacting the operations of business may stymie buyers wanting to conduct thorough inspections of facilities, physical assets, employee interviews, customer visits and in-person management meetings. Business interruptions resulting from the pandemic may also increase the time required to obtain consents to assignment and other actions. Such timing considerations may argue in favor of using a deal structure that does not require such consents.

DUE DILIGENCE – COVID-19 PREPARATION AND EMPLOYEE HEALTH INFORMATION:

Businesses were and may still be subject to local and state regulations requiring the implementation of COVID-19 preventative measures in the course of continuing, shutting down or reopening business operations. Compliance with the multi-layered and often contradictory regulations created a moving target for some businesses. In an attempt to prevent inadvertent issues surrounding employee information and corresponding health care-related violations, caution should be exercised when soliciting and receiving employee information and general business operations records. Buyers should consider evaluating how the seller reacted to the regulations, as well as voluntary guidance from governmental or health organizations – were employees treated properly, which policies and preventative measures were implemented, were any of the regulations or laws disobeyed or broken, did any of the preventative measures inadvertently collect or store personally identifiable information or health-related information implicating related legal concerns (e.g. HIPAA violations)? If a target business received a PPP loan and subsequently made employee cuts or took unfavorable action that reduced workforce numbers, how should the parties account for those actions in relation to jeopardizing PPP loan forgiveness? How have such actions impacted employee morale, knowledge transfer and business continuity?

Part 3: Carve-outs and Limitations

SPECIFIC CARVE-OUTS AND LIMITATIONS:

Sellers should consider how to effectively qualify the representations and warranties given about the business as they relate to COVID-19 and the CARES Act, to ensure a buyer is adequately informed and the seller does not mistakenly misrepresent or omit information related to the target business. Below are some example qualifications and issues related to the overall presentation of representations and warranties to consider:

- ***Knowledge*:** Parties negotiating the definition of knowledge should contemplate defining "knowledge" to include the knowledge of employee(s) who were hired, or who by circumstances served, as subject matter experts in designing and implementing COVID-19 preventative and operational measures. The knowledge gained from implementing such plans could be of significant value, and buyers should question whether the executives and managers typically tied to the knowledge qualifiers have that knowledge or if it would be beneficial to include the employee(s) tasked with COVID-19-related duties within the definition of knowledge.
- ***Material Adverse Effects (MAE)*:** Parties will need to consider whether COVID-19 and its impact on the parties and target business are excluded from the definition of an MAE. If a seller requests a COVID-19 carve-out from the MAE definition, buyers may consider making a reciprocal request or further qualifying the COVID-19 carve-out by an exception for disproportionate effects. Since the existing case law has overwhelmingly ruled against a finding of an MAE in most circumstances, parties should consider whether they want to introduce a COVID-19 qualifier or introduce a separate provision solely dedicated to facts, circumstances and triggers associated with COVID-19.
- ***Force Majeure*:** The pandemic has created delays and performance issues in countless contractual relationships. Whether a delay or instance of non-performance constitutes a breach of the contract depends heavily on the wording of the force majeure provision in the underlying contract, if any. In crafting the purchase agreement representations and warranties regarding contract breaches and

assembling the related disclosure schedules, the seller will need to carefully analyze these provisions to assess whether a breach has occurred and requires disclosure. At the same time, the buyer will want to make its own analysis to measure the risk and respond accordingly. These potential breaches may cause the buyer to request additional escrowed funds, longer survival periods or smaller baskets and larger caps with respect to indemnification.

- ***Ordinary Course of Business*:** It is unlikely any business has operated in the ordinary course of business over the past few months. Seller-related representations regarding prior acts and covenants regarding actions between the time of signing and closing merit more attention as a result of COVID-19. The parties may consider drafting language that creates a margin of deviation associated with COVID-19 and the CARES Act or specific allowances/prohibitions on actions caused by COVID-19, e.g., employee furloughs, layoffs, reduction of operating hours, incurring new debt obligations, etc.

GENERAL CARVE-OUTS AND LIMITATIONS:

Sellers may want to consider including a general carve-out in their representations and warranties for the impacts of COVID-19 on their business and operations. This helps lighten the disclosure requirement for various representations and warranties in the agreement, as well as shifts risk to the buyer for the impact of COVID-19. Buyers typically will resist this broad approach but may be willing to provide for more targeted carve-outs if they gain sufficient comfort on the seller's COVID-19 response through due diligence or other means (particularly if they are strategic purchasers already operating in the industry).

This concludes our three-part series on the transformation of M&A in light of COVID-19 and the CARES Act. Please contact one of the authors, or your regular AT attorney, should you have any questions. We will continue to monitor developments in this area and hope you'll join us in the new year for additional discussion around evolving deal making topics. Sign up now to receive additional communications from Armstrong Teasdale about related events and information in 2021.