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COVID-related clauses to consider adding to your M&A documents

Although the M&A market may have slowed since the beginning of the COVID-19 pandemic, strategic buyers with strong balance sheets and financial buyers with sufficient “dry powder” continue to eye opportunistic acquisitions. M&A practitioners must consider tailoring their deal documents to specifically address issues unique to the new operating environment that the pandemic has created for many businesses. Below are a few features to keep in mind when navigating due diligence and preparing deal documents in a post-COVID world.

1. Due diligence

Acquirers may need to update their diligence checklists to identify specific responses that a prospective target may have taken as a result of the pandemic and their resulting impact on purchase price. For example, has it furloughed or terminated employees, implemented new technology solutions to accommodate work from home protocols, experienced collection issues with accounts receivable, delayed critical capital expenditures, sought relief from vendors, applied for any of the CARES Act lending programs or deferred paying certain payroll taxes under the CARES Act? Understanding what unique liabilities a prospective target might have incurred when navigating through the pandemic could be critical to an acquirer's valuation and desired transaction structure.

2. Exclusivity

All parties should expect a protracted due diligence process. Accordingly, at the letter of intent or expression of interest stage, acquirers should consider seeking a longer exclusivity period or requiring the exclusivity period to be extended if unexpected results surface or changes occur - for example, on-site diligence is delayed or suspended due to a governmental stay-at-home order.

3. Purchase price impacts

Acquisitions are typically made on a cash-free, debt-free basis, meaning the seller receives credit for the prospective target's cash-on-hand (subject to an adjustment for normalized working capital) and the purchase price proceeds are used to pay off the target's existing debt and transaction-related expenses.

If the target has received a loan under the CARES Act - for example a PPP loan, the parties will need to determine how that loan will be treated. Will it remain outstanding post-closing, or be repaid? For equity transactions, if the loan remains outstanding, will the PPP lender's consent be required and how will the parties treat amounts that are forgiven? For asset deals where the loan is an excluded liability, will the parties delay the closing date past the forgiveness period so the target can seek forgiveness for the entire PPP loan amount?

Similarly, negotiating the working capital adjustment might be more difficult. The parties will need to determine if the target working capital amount should take into account short-term impacts of COVID-19 or reflect what was normal pre-COVID. Given the potential for unusual swings in a business's accounts receivables, inventory and current liabilities (which are the core components of working capital) during the pandemic, acquirers may want to insist on a working capital holdback or escrow from the purchase price, and sellers might consider requesting a cap on the adjustment amount.

4. Interim covenants

For transactions with a gap between signing and closing, sellers typically agree to operate the prospective target in the “ordinary course” of business leading up to closing and obtain the acquirer's prior consent before taking actions outside the ordinary course. But, during (and possibly after) the pandemic, that might not be possible or practicable. A seller-oriented approach would be to qualify the ordinary course standard to include reasonable actions taken by the target in response to COVID-19. However, acquirers might prefer to use a pre-pandemic

ordinary course standard and negotiate with sellers to identify targeted exceptions that give them sufficient latitude to operate the target in these unusual circumstances.

5. Pre-closing taxes and tax refunds

Businesses may defer payment of certain payroll taxes under the CARES Act until December 2021 and 2022. In equity transactions, sellers bear responsibility for pre-closing taxes. Acquirers should consider clarifying that those deferred taxes are pre-closing taxes and ensure those liabilities are reflected in the working capital or debt adjustment to the purchase price.

In addition, the CARES Act allows net operating losses (NOLs) incurred by a corporation in 2018, 2019 and 2020 to be carried back and offset taxable income in the previous five taxable years. For equity transactions involving prospective targets that are corporations, this change requires parties to take a closer look at how tax refund provisions in the deal documents operate. Typically, pre-closing tax refunds go to sellers, but acquirers could negotiate for the opportunity to share in refunds attributable to a NOL carryback.

6. Additional closing conditions

Acquirers typically reserve the right to walk away from or terminate a transaction if the prospective target experiences a material adverse change (MAC). MAC clauses typically exclude events that lead to market-wide downturns - for example, acts of war, natural disasters or pandemics like COVID-19 - unless the target was disproportionately affected, and the standard for proving a MAC occurred is usually high. An acquirer must prove the adverse change significantly impacted the target's long-term earnings power. As a result, an acquirer might consider adding specific financial targets or other conditions - essentially "MAC-light" conditions - to preserve its walk away right if the target's business significantly deteriorates before closing due to the effects of COVID-19.

Please reach out to the experienced Thompson Coburn mergers and acquisitions attorneys below if you would like more information about the M&A process in the time of COVID-19.

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