M&A Deals in the Middle Market After COVID-19

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This Article discusses the effect of COVID-19 and the various ensuing government shutdowns and restrictions (collectively the "Crisis") on new M&A deals being negotiated after the Crisis. The focus is negotiated transactions in the middle and lower middle market. Public deals and very large deals, as well as distressed deals, are not addressed. As we review the middle and lower middle market, we expect a number of changes to the deal process as a result of the Crisis, including:

- Fewer Deals
- More Extensive Due Diligence
- Longer Duration between Initiation and Closing
- New and More Extensive Representations; More Disclosures by Sellers
- Heavier Negotiation of Certain Provisions in Executory Deals
- Increased Incentive for Asset Purchases?
- Increased Use of Provisions to Bridge Valuation Gaps
- Leverage Shifting to Buyers
- Decreased Use of Representation and Warranty Insurance?

The Crisis Environment

The Crisis has had far-reaching impacts on businesses. Government imposed requirements such as shutdowns and shelter in place rules have changed whether and how businesses can operate. A number of consumers and businesses are not making, or have delayed, required payments. Businesses face the risk that companies they do business with may become insolvent or try to avoid their obligations. Businesses that have changed operations, especially by working remotely, may have enhanced risk of data privacy or cyber violations.

Many businesses have furloughed or laid off employees and/or reduced compensation to employees. COVID-19 exposure of employees is a significant concern. Businesses have had to change operations to address this concern and to comply with government requirements.

The Deal Environment

All of these factors have had a major depressing effect on the deal environment. Where there was a signed purchase agreement pre-Crisis, some buyers are trying to get out of the deal. Where parties were in exclusive negotiations, such as pursuant to a letter of intent, many transactions have either been terminated or put on pause. Similarly, many sellers who were engaged in a sales process have either terminated the process or put it on pause. (My experience matches this general description, with one seller client postponing going to market until at least 2021, another potential seller putting their sales process on hold, and a seller and buyer who were under an LOI with due diligence completed putting off any negotiation of a purchase agreement.)

Most strategic buyers are focused on dealing with their own internal problems and are conserving cash to address those problems. Private equity firms in large part are focused on issues at their portfolio companies. The lending environment is less certain, although we do not appear to have disruption at the level that existed in the 08/09 downturn. An overwhelming concern for buyers and sellers is the depressed economy and uncertainty as to whether it will get worse and as to when and at what pace the economy will recover.

It is expected that overall pricing will be down for deals which do start up in the new environment. The overall economic climate, likely uncertainty about many target's economic prospects and a likely lowering of the leverage available for the borrowed portion of the purchase price are among the factors contributing to this. If pricing is down, this might lead some sellers - who have pre-Crisis multiples in their mind - to pull back from the market. This occurred during 08/09 downturn.

Changes in Deals Resulting from the Crisis

A number of changes in M&A deals are likely to occur as a result of the Crisis.

Fewer Deals

Especially early on, there will be fewer deals. The question will be the pace at which deals start to recover. One helpful factor is the large amount of "dry powder" that PE firms have, which they will be under continuing pressure to deploy. As compared to 08/09, the lending market should be in better condition, which should help get deals moving.

It is also likely that, as has always been the case, the market will continue to be good for strong sellers. It is likely that deals that have some complexities or "hairs on them" will be the most negatively impacted.

More Extensive Due Diligence

There will be new areas of due diligence, as well as areas where the diligence likely will be more intense than it was in the past. These include:

- the target's exposure under PPP loans and other government supported loans;
- supply chain exposure;
- viability of major customers. For suppliers and major customers, and counterparties to major contracts, issues will include insolvency risks and issues to their business arising from operational changes required due to the Crisis;
- risks under material contracts for the target, including the other party avoiding a contract based on material adverse change ("MAC") clauses and other provisions;
- ability of the target to function effectively under new government requirements, including the ability to work remotely where required;
- exposure to claims under employment laws, including from furloughs or layoffs and from changes in work requirements;
- employee claims for COVID-19 risks;
- exposure to data privacy and cyber risks, in particular due to engaging in remote operations.

These new areas for diligence, buyers' concern to get things right in the more stressed economic environment, and the requirement to do diligence remotely in many cases, mean that diligence will likely take longer than it has in the past

Longer Duration Between Initiation and Closing

It also is likely that it will take longer to do deals. As noted, diligence will likely take longer. Near term, the difficulties of doing a deal remotely will be significant. Although the legal side of deals often was handled without in-person meetings even before the Crisis, such meetings will still be necessary between the business principals. Some of the more business-focused due diligence also is not amenable to being carried out remotely.

Negotiation of purchase agreements also will likely take longer because of the changes in agreement provisions driven by the Crisis.

Governmental filings or approvals also can be expected to take longer. Many government offices are working remotely and may have reduced operations. This can be significant for lender requirements. Third-party approvals also may take longer given the changed operations at many companies.

New and More Extensive Representations; More Disclosure by Sellers

All the areas noted above for new or expanded diligence also will result in new or expanded representations and warranties. More negotiation can be anticipated until norms start to be established.

Sellers can be expected to try to exhaustively disclose all problems arising from the Crisis, so as to limit exposure. Buyers likely will push back. In some cases buyers might seek specific indemnification relating to

disclosed matters.

In Executory Deals, Much Heavier Negotiation of Certain Provisions

In deals where there is a gap between signing and closing, some provisions which had become relatively settled now will be much more heavily negotiated. Two examples are the ordinary course of business covenant and the MAC condition to closing. In deals signed pre-Crisis, these are some of the primary provisions that buyers have relied on when trying to get out of a transaction. Sellers therefore will try to limit their exposure under these provisions in any new deals. A major focus by sellers will be trying to carve out changes and problems arising from new requirements and ways of doing business post-Crisis. (There usually is an ordinary of course of business representation and a representation that there have been no MAC's. Those representations also will be heavily negotiated.)

Even where a MAC condition is included, successfully utilizing a MAC to get out of a deal has proven to be quite difficult. Buyers therefore might propose more specifically crafted conditions to closing in the hope that they might be more enforceable. Possible examples might include a condition tied to the Target's EBITDA for a specified period of time, or references to specific events-such as new government requirements - which impact the target's business.

Increased Incentive for Asset Purchases?

It is difficult to quantify the level of risk in some of the new areas of concern for buyers, basically because there is no experience to rely on. An example is exposure under PPP loans and under other new government regulations. Another is employee claims for COVID-19 exposure and relating to actions which have been taken in response to the Crisis.

This will increase the incentive to do asset purchases rather than entity purchases, since in general an asset purchase should leave the exposure with the seller. Buyers might insist on this. Beyond that, this approach will avoid difficult negotiations regarding exposure, indemnification and the like.

Increased Use of Provisions to Bridge Valuation Gaps

The increased risks and uncertainties likely will make it more difficult for buyers and sellers to agree on valuation. This could lead to an increased use of earnouts to bridge the valuation gap. Even where both parties are acting in good faith, earnouts sometimes do not materialize. Sellers therefore will have to consider if they are willing to do the deal if the closing consideration is all that they ultimately receive. Both parties have to recognize that there is a significantly greater risk of disputes where an earnout is present.

In private equity deals where the target will be a platform company, another bridging possibility might be paying part of the consideration as equity in the platform company. This could be preferable for sellers since,

where properly done, the interests of the seller and the buyer are aligned. By contrast, an earnout is inherently adversarial. However, there are issues, especially for the buyer. One is the value to be given to the equity (although there might be some approaches that could address this). Also, unless otherwise agreed, the return on the equity is not capped, where an earnout almost always is.

Leverage Shifting to Buyers

Pre-Crisis, the large number of buyers seeking deals meant that sellers had significant leverage. As happened in 08/09, this likely will shift in buyers' favor. This improved leverage could be reflected in various places in the negotiations. Some candidates are longer periods of exclusivity during the letter of intent phase, longer periods in which to get the deal done (i.e. drop dead dates being extended) and perhaps greater acceptance of conditions to the buyer's obligations to close, such as a financing condition.

Decreased Use of Representation & Warranty (R&W) Insurance?

Especially in private equity deals over a certain size, R&W insurance was close to becoming the norm pre-Crisis. In many such deals, sellers were able to avoid indemnification escrows (other than perhaps for 1/2% of the purchase price) and, except for fundamental representations, have buyers look solely to the R&W insurance for breaches of representations. Sellers therefore had less at risk and received their funds sooner. Buyers accepted this both because of the competitive market and because they were able to obtain acceptable coverage under the R&W insurance.

Early indications are that insurance carriers are proposing some broad exclusions related to COVID-19 related risks. If this persists, buyers may insist on indemnification from sellers on the excluded matters, and also require an escrow to secure that indemnification. If so, this would erode some of the special attractions to sellers of using R&W insurance.

It is hard to tell, but this might result in some shift back to deals being done in the old way, with an indemnification escrow and negotiated caps and limits, but no R&W insurance.

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