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M&A and COVID-19 – Change in the Legal Landscape?

We are currently living in exceptional and unprecedented times, to say the least. The COVID-19 pandemic has been keeping a tight grip on the world for months, leading to a virtual standstill in many areas of our normal lives.

Undeniably, this has also affected (or shall we say "infected") the M&A market. A significant number of deals were cancelled or at least postponed. Potential strategic investors seem hesitant about spending their cash balances on inorganic growth. Private Equity funds might not be able to obtain the required approvals from their investment committees given this uncertainty. A tightening of debt markets takes an additional toll on deal financing. At the same time, sellers who are not forced to sell might be reluctant to enter an M&A market with anticipated lower valuations.

All in all, it appears as if market participants are practicing their own kind of safe distancing to curb the impact of COVID-19.

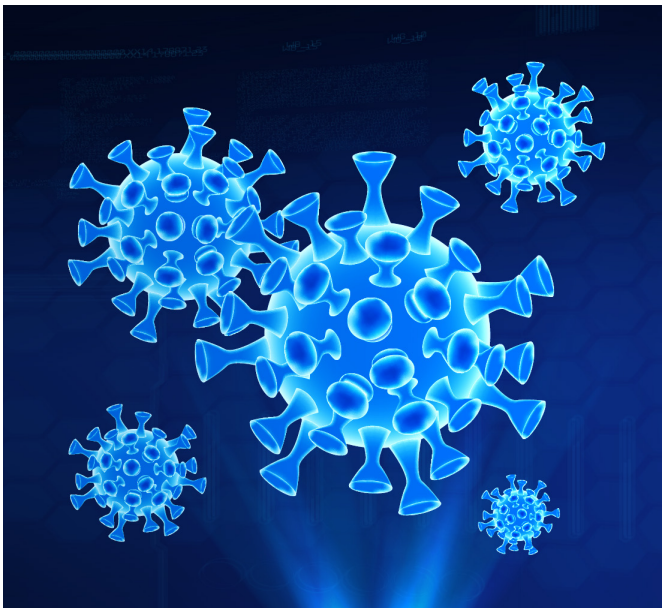
Quite a substantial amount of ink was spilled in the last few weeks on how COVID-19 might influence the legal M&A landscape. In this briefing we summarise the current trends and discussions and add our own thoughts and observations of the market. The goal is to provide a comprehensive overview that brings our readers up to speed.

Before we begin, a word of caution: the current situation remains fluid and subject to continuous evolvement and changes.

I. Introductory Remarks

We split this briefing into separate chapters for due diligence, transaction documents, consideration mechanisms, W&I insurance and other implications for transaction management consolidated at the end. Where applicable and required, we discuss how ongoing deals might be impacted by COVID-19 and how COVID-19 (or similar pandemics) might shape M&A deals in the future.

Wherever we refer to "COVID-19 measures", we refer to any applicable laws or other recommendations and guidelines issued



by governmental authorities in connection with or as a response to COVID-19, including quarantine, "shelter in place", "stay at home", social distancing, shut-down or closure measures.

II. Due Diligence

We expect an increase in due diligence work on the following points, both for ongoing and future M&A deals:

- Susceptibility of target business to COVID-19 measures and similar pandemics.

- Resilience of supply chains as well as quality and financial soundness of customer base. General contractual framework with customers and suppliers (*force majeure* clauses, specific termination rights, minimum purchase quantities) considering COVID-19 or similar pandemics. Verification whether any supplier, customer or other third-party contrac-

tor declared *force majeure* or was otherwise unable to fulfil its contractual obligations during the COVID-19 pandemic.

- Scrutiny of other material contracts (e.g. financing contracts) and potential defaults thereunder triggered by COVID-19.

- General legal regime in target jurisdictions that might excuse performance of counterparties (e.g. frustration of contract, undue hardship or doctrine of *clausula rebus sic stantibus*).

- Contingency and mitigation plans to deal with COVID-19 or similar pandemics.

- Insurance coverage for COVID-19 related losses.

- Solvency risks of target group (taking into account any intermittent regulations allowing the extension of insolvency time limits and monetary thresholds introduced by COVID-19 measures). Purchasers will need to contemplate whether the parties are in a distressed M&A scenario whereby an additional legal framework applies, including provisions for voidance of transactions, such as transactions at an undervalue or unfair preference.

- Maintenance of employee health, safety and welfare during COVID-19. HR related responses to COVID-19 measures.

- Implication of COVID-19 measures on cybersecurity and protection of confidential information when working remotely.

We believe that a "COVID-19 stress test" will likely become part of any future due diligence exercise in the near term. In a post-COVID-19 world, such stress tests might also give interesting insights on the "anti-fragility" of the target business and, in particular, the capability of management to deal with extraordinary situations.

Last but not least, we must not overlook the most basic practical implications:

- One client encountered issues in a recent deal with the population of a dataroom as employees did not have remote access to office files. Similar experiences like this might contribute to an increasing trend of digitization.

- Physical site visits are practically impossible due to COVID-19 measures.

III. Transaction Documents

1. Material Adverse Change

Not surprisingly, this is currently the "hottest" topic: Material Adverse Change ("MAC") clauses. NB: We use MAC interchangeably with Material Adverse Effect ("MAE") and conceptually do not distinguish between them.

The predominant use of a MAC clause in transaction documents is the absence of a MAC as a condition precedent to Closing. This could be a standalone condition precedent or in combination with a breach of representations and warranties whereby such breach results, or is reasonably likely to result, in a MAC. The interpretation of a MAC clause, in particular if COVID-19 falls thereunder, lies first and foremost in its particular drafting. The devil is in the detail:

- Usually MAC covers changes, effects or other events (sometimes in addition developments or conditions) which are materially adverse to the assets, financial condition or results of operations of the target group. NB: If prospects of the target group are also included, this might prove to be significantly wider.

- Market-standard MAC clauses will contain quite a substantial number of carve-outs in favour of seller for changes, effects or other events which do not qualify as a MAC. Classic examples of such carveouts are natural disasters, acts of war, terrorism, sabotage or, intended as a catch-all, other *force majeure* events. Prior to COVID-19, we rarely encountered tailored language for a pandemic or health crisis. However, there are in our view sound arguments to support that COVID-19 (or a similar pandemic) would fall at least under the generic term "*force majeure*". NB: Based on recent US deals, the following language seems to have emerged as an additional description for *force majeure* events: "*epidemic, pandemic, disease outbreak or other health crisis*". We expect such language to pop-up more often going forward.

- Even if a pandemic is not covered under *force majeure*, other ordinary carve-outs to a MAC relate to a deterioration in general market conditions or other circumstances affecting the industries in which the target group operates in general. The same applies for changes in applicable law. All such examples might provide, in our view, a sound basis to subsume COVID-19 (or a similar pandemic) thereunder.

- However, this is not the end. Sometimes, a carve-out to such carve-out is implemented, covering situations where the target group is disproportionally affected by such changes, effects or other events as compared to similarly situated businesses operating in the industries in which the target group is active. Thus, such matters will only be excluded from considering whether a MAC occurred to the extent such matters do not disproportionately affect the target group. The task is then to establish the peer group to gauge and measure any disproportionate effects. It will be interesting to see if this will be specified further, even naming certain competitors as a benchmark for comparisons and clearly listing the specific industries which are relevant.

- What if the changes, events or effects occurred or were otherwise known to purchaser prior to Signing? We deem the chances for a purchaser to succeed with a MAC in such circumstances to be rather low. The purpose of MAC clauses is to cover unknown and non-foreseeable risks – although it can be splendidly argued about what is a truly non-foreseeable event. The case might be different for escalation of events between Signing and Closing.

- That said, does the COVID-19 pandemic qualify as a MAC at all? Again, this will depend on drafting of the specific MAC clauses and the industry the target group is associated with. Throughout jurisdictions we are active in, MAC clauses have been applied very narrowly by courts with the requirement of a substantial and long-lasting effect. One might make a reasonable case in the hospitality and tourism sector whereby other sectors might only be temporarily affected.

- We have to point out that case law is spare – a MAC clause is something that is typically included in the transaction documents but hardly relied on. It is not unlikely that parties will further tie down MAC, such as inclusion of specific financial or operational thresholds (loss of orders, loss of material contracts etc) or non-closure of certain essential facilities.

It will be interesting to see if there will be a change in risk-allocations of a MAC. Currently the risk of a pandemic such as COVID-19 emerging or escalating between Signing and Closing is rather borne by the purchaser. If the next months turn out to be a buyers' market, then – maybe – the general risk of pandemics or other *force majeure* events will be shifted to seller by omitting the carve-outs to a MAC discussed above. It would also not surprise us that for as long as the COVID-19 pandemic is ongoing, a purchaser might push for a specific condition precedent besides a MAC clause, dealing with a worsening or escalation of COVID-19. Sellers will then need to decide whether to – reluctantly – accept such condition or face the alternative of calling-off the transaction. This will go hand-in-hand with the question on whether such risks are already priced in by the purchaser in the purchase price. If so, sellers will presumably refuse to additionally bear the burden of deal uncertainty.

We expect increasing usage of MAC clauses in jurisdictions where MAC as a condition precedent is not yet common.

2. Interim Covenants

An interim covenant customarily included in transaction documents where there is a gap between Signing and Closing is a "conduct of business" covenant. Conduct of business covenants oblige the seller to conduct the target business in the ordinary course consistent with past practice and to materially preserve and maintain the goodwill and relationship with customer and suppliers of the target group. Usually, there is also a catalogue added with specific prohibited activities and actions. The COVID-19 pandemic might necessitate adjustments in form of carve-outs thereto.

During the COVID-19 pandemic:

- A seller will insist on a certain flexibility in order to comply with COVID-19 measures or generally to tackle and mitigate the impact of COVID-19. This might reach from "good-faith measures" which the seller is entitled to implement without purchaser's involvement to only implementing such measures with the prior consent of the purchaser (for "gun-jumping", see below). In between is a solution that the seller is entitled to take actions consistent with actions taken by comparable companies in the industries the target group is active or pursuant to a dedicated COVID-19 contingency plan pre-agreed with purchaser.

- Deal parties will also need to take into account whether the covenant is given on absolute terms or only on a reasonable/best efforts basis and bear uncertainties on how such standards are to be interpreted and treated in these times.

Following the COVID-19 pandemic:

- We do see it as rather unlikely that any measures taken in connection with a pandemic or other *force majeure* events will become a standard carve-out to interim covenants. Rat-

her, we deem that parties will tend to agree that any such measures need to be aligned with the purchaser and the implementation appropriately monitored.

Caveat: For any interaction of the parties between Signing and Closing "gun jumping" prohibitions should be kept in mind. Such prohibitions interdict the premature implementation of mergers before anti-trust clearance is granted.

Two final points:

- It remains to be seen if covenant breaches related to COVID-19 are used to torpedo transactions as the (material) compliance with pre-Closing covenants is a standard condition precedent in transaction documents.

- Transaction documents frequently include a general carve-out to the compliance with interim covenants for actions required to be taken in order to comply with applicable laws. By and large, COVID-19 measures are applicable laws. Further, also in Pre-COVID-19 times, we sometimes encountered carve-outs to interim covenants for the implementation of emergency measures in order to mitigate a material adverse impact on the target business. Purchasers should be aware: In case the seller is not in a breach of an interim covenant and *force majeure* events are not covered by a MAC, then a purchaser might be forced to close an M&A deal despite the target being in in a significantly different shape as it was in during the time the valuation was locked-in. We expect that purchasers will be more aware of the ramifications of any such carve-outs going forward and make sure that these carve-outs are not be taken as a free-ride to implement measures without purchaser's involvement or consent.

3. Representation and Warranties

Areas for potential breaches of representation and warranties ("R&Ws") are myriad: Default under material contracts, loss of suppliers or customers, bad debt provisions for receivables, redundancies and other HR measures, write-down of assets and other impairments, just to name a few.

During the COVID-19 pandemic:

- We recommend to our sell-side clients to go through the R&Ws section (material contracts, suppliers and customers, compliance, human resource etc) carefully and religiously disclose against them. We expect more negotiation on the addition, respectively exclusion, of knowledge qualifiers.

- If the deal is already caught between Signing and Closing, there is customarily a bring-down of R&Ws at Closing as a condition precedent, usually tied to a MAC qualifier. We hardly see, at least in jurisdictions we are active in, mechanisms accepted whereby the seller is entitled to disclose against the R&Ws in-between Signing and Closing. So there are usually two outcomes: A breach of R&Ws which qualifies as a MAC entitles the purchaser (and usually only the purchaser) to walk away from the deal or, practically, to at least bring the seller back to the negotiation table. A breach of R&Ws which is below the MAC threshold would force the purchaser to close the transaction but leave the purchaser with a claim against the seller.

Post-COVID-19 pandemic:

- It will be interesting to see if tailored "pandemic" R&Ws will emerge and will be included in transaction documents (i.e. sufficient safeguards in place to handle pandemics, resilience of target group against pandemics etc).

4. Specific Indemnities?

Although currently discussed in the market, we deem it to be rather unlikely that a seller will be willing to give specific indemnities to compensate a purchaser for any COVID-19 related losses. Much will depend on the respective bargaining power. Since there are reasonable grounds to expect that the next few months will be a buyers' market, we would not entirely rule out such possibility.

5. Force Majeure Clauses

Force majeure clauses (as encountered in commercial contracts) are so far hardly seen in transaction documents. And rightly so: Such specific *force majeure* clauses do not fit into the spectrum of M&A deals and their "strict" nature. It runs counter their structure as currently facilitated via the conditions precedent and would open a side-door jeopardizing deal security. Rather, the battles will be fought elsewhere, in particular on the definition of MACs and potentially the inclusion of new conditions precedent.

IV. Consideration Mechanisms

Judging from discussions in the market, it appears that "lockedbox" mechanisms are in serious peril following the COVID-19 pandemic. Most market participants expect a decisive shift to closing accounts with financial debt and working capital adjustment at Closing as one way to – at least partially – safeguard against pandemic risks.

However, this is not a panacea. Since the calculations of enterprise values on a cash-free / debt-free basis is usually based on EBITDA or other earning multipliers, the better question is whether these are still achievable going forward. So the "go-to" solution appears to be either (i) pricing in COVID-19 or other pandemic risks from the outset (and risking the attractiveness of the offer) or (ii) implementing earn-out mechanisms to somewhat share the risk between seller and purchaser.

On the latter, earn-outs also come along with their own intricacies:

- First, what is the base of earn-out payments (revenue, EBITDA, EBIT, profits etc) and the time-line? Then parties need to consider which additional covenants and obligations are required. We usually see at least a covenant that parties shall refrain from any actions with the primary intent to avoid earn-out payments and that a purchaser shall use its reasonable efforts to conduct the business in substantially the same way as conducted prior to closing. But it does not stop there: What happens in a change of control over the target group post-Closing or business is transferred elsewhere? Any funding commitments for the acquired business or restrictions on OPEX or CAPEX? General restrictions on business activity? Treatment of intra-group charges? How are extra-ordinary and non-recurring items to be treated? Which line items do actually form part of EBITDA or EBIT? If the sellers are to remain on board – what happens in case the employment relationship with the sellers gets terminated during the earn-out period? These are just some aspects that need to be thought through and taken care of – expect tough and sometimes also emotional negotiations.

- Given these covenants, purchasers need to be aware that they lose a certain degree of control and flexibility in conducting the target business post-Closing in an earn-out scenario.

- Earn-outs are a highly contentious area where disputes are more likely than not.

It will be interesting to see whether any hybrid models emerge: Lowering of a certain portion of the consideration (possibly plus an earn-out kicking in) in case of the occurrence of a pandemic or other *force majeure* events during a certain period post-Closing. This again comes along with its own complications.

As debt markets are substantially tightened, we anticipate that purchasers might approach sellers to partly finance an M&A deal via the use of seller notes. Alternatively, the purchaser might offer share-for-share consideration for at least a portion of the purchase price whereby the consideration shares are valued by applying the same valuation as applied to the target shares. Question here is on whether there will be a fixed exchange ratio or a true-up at Closing to take care of any fluctuations in the value of the consideration shares.

V. W&I Insurance

In a nutshell: A cover for COVID-19 related losses under a W&I (Warranty & Indemnity) insurance is very unlikely. In fact, we expect such losses to be fully excluded under W&I policies.

VI. Other Implications for Transaction Management

1. Longer Timelines

Deal parties should expect longer time frames between Signing and Closing due to the extended timelines for regulatory approvals as well as existing travel restrictions. All such considerations should be reflected in an appropriate timing for long-stop dates.

Whether more due diligence time will have to be scheduled in deal planning to cover additional COVID-19 items during the due diligence exercise is yet to be seen.

2. Remote Signing and Closing

In most common law jurisdictions, Signing and Closing can be handled remotely with circulation of originals afterwards if required for filing purposes. Civil law countries might need the involvement of a notary and personal presence of representatives. Additional pre-cautions need to be taken in light of COVID-19 measures.

A practical point worth noting: Although a lot can be done remotely, face-to-face negotiations have proven in the past to be an extremely efficient way to hammer out material points amongst principals. It will be interesting to see how this evolves.

VII. Conclusion

We need to stress that we are in unchartered waters and, to lean on a famous quote, it is difficult to predict, especially the future.

That said, we do expect M&A activity to pick up again once the first dust has settled and there is more certainty in the planning process. European countries are taking the first cautious steps towards easing the strict lockdown measures with the expectation that most economies will gradually reopen from the beginning of May. Here in Southeast Asia we observe similar trends. However, much will depend on the availability of an effectual treatment for or vaccine against COVID-19.

Various factors could reignite M&A activity: Vertical integration to secure supply chains or sales, buying out of joint venture partners, distressed sales and special opportunities or simply low valuations due to the COVID-19 pandemic. Evidence suggests that those that acted quickly in 2008 when all the other market participants were fearful benefited after the market recovery.

On the flipside, at least in Europe and most recently also in India, voices are gathering for stricter foreign take-over rules to shield vulnerable companies from potential hostile take-overs from abroad. This might significantly dampen foreign direct investment flow from purchasers with a substantial cash war-chest.

Whatever lies ahead, it is paramount to be in the best possible shape for a time post-COVID-19 – and there will be such time. We will be ready to guide and support you!

VIII. Your Contact Person

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