"Middle Market M&A: The Latest Developments"

Thursday, May 21, 2020

Audio Archive

The middle market is where most of the deals are, and the issues that arise are always changing, and often quite different from larger company M&A. This program will bring you up to speed on the state of the middle market and the issues dealmakers are confronting in 2020.

Join these experts:

- **Charles Aquino**, Managing Director, Citizens M&A Advisory
- **Marc Mantell**, Member, Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C.
- **Richard Silfen**, Partner, Duane Morris LLP

John Jenkins, *Editor, DealLawyers.com*: Hi. This is John Jenkins, editor of DealLawyers.com, and I'd like to welcome you to today's program, Middle Market M&A: The Latest Developments. The middle market is where most of the deals are, and the issues that arise are always changing. Of course, this year, we have the 500-pound gorilla of issues confronting all dealmakers, and that's the fallout from the COVID-19 crisis.

We've got a great panel here today to get you up to speed on the latest developments in the middle market. Joining me today are Chuck Aquino. Chuck is a managing director of Citizens M&A Advisory; Marc Mantell, who's a partner at Mintz Levin; and Rich Silfen who's a partner at Duane Morris.

With that, I'm going to turn it over to Chuck to kick off the discussion with an overview of the current market conditions. Chuck?

Market Overview

Charles Aquino, *Managing Director, Citizens M&A Advisory*: Thank you, John. Good afternoon, everybody. Pleased to be with you all. Happy to share my thoughts, insights and observations as to what we're seeing real time in this environment.

I'll touch on a number of topics at a high level. Some of this will be based on public report and statistics, what little we have at this juncture; others, again, as I mentioned, observations or direct conversations we are having with clients, prospects, private equity groups and other types of buyers.

We're on the frontlines here in our M&A practice, seeing this play out in real time. It's a fluid situation as I'm sure everyone on the phone can appreciate. We're in the early stages

of this. I know it feels like it's been going on now for months on end, but when you think about it from the standpoint of trying to observe reported data and compare that to the pre-COVID environment, again, we're only in the middle of May.

It's probably too early to close out April statistics, so that leaves us with March from an LTM standpoint. It's kind of the latest month at which you can observe any consistently published set of statistics. March was a mixed bag. Most of the country didn't go on widespread shutdown until just after the middle of the month just prior to St. Patrick's Day. There was still a lot of momentum from a deal-making standpoint heading into the beginning of the month, and we certainly riding a nice wave from 2019 and 2018.

By all accounts, 2020 — absent anything unforeseen — we were expecting another strong market, and the first couple of months of the year certainly played to that. Then, suddenly and within a very short span of time, most, if not all, of the states across the country had gone on state-wide shutdowns. That quickly trickled into the M&A markets.

Here we are now two months later in full shutdown mode. We are optimistic that we will emerge later this year, but that remains to be seen. I think a lot of folks are just waiting to see if there's going to be some sort of resurgence or re-emergence of infections on a broader scale in the fall when kids go back to school and most of us back to the office.

With that, a couple of topics I'll touch on from an M&A market standpoint: just some statistics that I've observed and had been published in the market and, again, through an LTM period ending in March; process observations that we are seeing play out in real time, and what we're seeing in some of our engagements and expectations that we have here in the near term; and observations and anecdotes that I've heard directly through conversations with private equity groups. We've got a lot of close relationships in the financial sponsor space.

It's been interesting to hear what buyers and sellers alike are thinking and observing in this market. We have a number of clients and prospects who may be considering a significant liquidity event — or may have pre-COVID — and now may be amending those plans in this environment. And then there are the banks, from a financing standpoint, and I will touch on some high-level observations there as well.

From a statistical standpoint, in the U.S. and, again, bear in mind that from an LTM standpoint ending in March, we were still riding a very strong wave through February and the early part of the month. It is noteworthy to point out across both the middle market and large cap market in the M&A space that one set of published statistics put out by Robert Baird noted an 18% year-over-year decrease in deal value in March 2020 vs. 2019.

That's certainly a noticeable decline, but that's one month versus one month the prior year. Keep in mind that oftentimes, within the month, most deals tend to get announced at month's end, and many of those may have been put on the shelf as the shutdowns set in. In looking at January through March of 2020 versus 2019; deal count was down just 1.5% in terms of deal volume, but if we look at deal value, we saw a more noticeable decline of about 46%.

That's partly a function of fewer announced transactions and probably more so due to fewer mega deals being announced in the first three months of this year versus the year prior. What's interesting though from an LTM perspective — and this is where you pick up the momentum we experienced for much of last year — the number of announced transactions through March of 2020 was actually up almost 19%, but again, dollar value is

down about 10%, and again that's due mostly to fewer mega deals that tend to skew values upward.

I'll give you some middle market statistics really quickly. Deal count in March actually decreased only about 6%. The middle market, as we tend to see in these volatile cycles, tend to be a little bit more resilient. Middle market buyers tend to be a little more flexible and/or opportunistic in such environments, and they're not making the same size equity bets that large cap buyers are in the mega deals. So, we tend to see more deals in the middle market find their way across the finish line during periods of uncertainty.

In the middle market, the number of announced transactions in the first quarter of 2020 actually increased versus last year. And for the LTM period ending in March 2020, deal count was up 20% versus the comparable period ending in March 2019.

From a valuation standpoint, we haven't really seen much degradation in terms of multiples. But again, keep in mind these are published statistics through March, so any deal that had been closed in March was likely "fully baked" before any impacts from COVID would have been felt.

In the middle market, deal multiples in terms of revenue, EBITDA and EBIT were very consistent year over year for both March, the first quarter and the LTM period. Premiums paid in the case of public sellers were also quite consistent.

In terms of real time observations of the M&A process, here are a few themes that we're seeing in this market. Certainly, a significant portion of those deals that were either in the pre-market or pre-bid phases prior to the widespread shutdowns have been put on pause.

Investors and operators alike continue to analyze the business impact of COVID-19. Nobody knows if we've hit bottom yet. Nobody knows when we're going to re-emerge. Financial institutions certainly have heightened lending restrictions at the moment, and this too is trickling into the M&A markets. The cost of capital in terms of acquisition financing has certainly gone up as banks are constricting and focusing more on current credit portfolios, so the availability and cost of this debt financing is not what it was just a few months ago. We believe this is temporary, but certainly having an impact as well on the ability to get certain deals done right now.

In response, many acquirers are forced to finance acquisitions mostly through equity and/or cash on the balance sheet, perhaps look more toward an asset-based loan structure or identify other readily available sources of capital. For operators, they may be forced to draw more heavily on their existing lines of credit to fund operations in the ordinary course, and also, what few acquisitions that they think that can get done in this environment.

Despite the challenges, there are deals getting done in this environment. These tend to represent low-risk opportunities for buyers, ones that present significant synergies and/or strategic opportunities and are relatively straightforward from an integration standpoint. In other words, they're highly accretive on a risk-adjusted basis.

We certainly expect the M&A market to recover, the beginnings of which certainly could be as early as late third quarter or early fourth quarter of this year. However, that also assumes we don't see a major relapse of COVID infections in the fall.

But it may be early-to-mid next year you really see the M&A markets return to any kind of sense of normalcy or pre-COVID momentum. A lot of that is going to be predicated on the ability of these companies who want to go to market to be able to demonstrate that they

have recovered from impacts of the shutdowns, and that they are showing demonstrable traction toward their pre-pandemic budgets.

Like in any recession or crisis, it presents an opportunity for dealmakers, especially those who are well financed or have access to available capital, to find good acquisition opportunities at prices that seem like a bargain compared to the last few years. So, not surprisingly, we're seeing an uptick in interest by well-capitalized buyers hunting for such opportunistic.

As mentioned before, from a process standpoint, any of our processes that were either in the pre-marketing or pre-bid phases have largely been put on hold. I suspect these deals will re-launch once we and our clients can demonstrate to the market they are on a path toward monthly and annual run rate levels commensurate with the pre-pandemic, pre-shutdown period, which will mean tangible pipeline visibility and at least one or two months of actual results.

Any of our processes that were in market, especially those in the post-bid phases, we are seeing elongated timelines. In an environment without in-person interactions, facility visits, third-party diligence and deal documentation is certainly more challenging. Buyers are generally asking for more time and are finding creative workarounds. And while we're taking advantage of technology right now in terms of virtual meetings and walkthroughs, at some point you need to get all parties in the room together. And on top of all this, and not to steal any thunder from the other presenters who will touch on this in more detail, we are seeing buyers revisit both deal value and structure, if they feel there is an opportunity to do so, even post-final bids in this environment as well, particularly following their initial bids.

Finally, for any deals that were post-LOI and far along in diligence before the shutdowns took effect, a good number of these processes have, in fact, gotten done. But that assumes financing was fully committed, the purchase agreement was finished or on its final turn and all third-party diligence complete. If any of these elements weren't as far along, there still stood a good possibility of the process being delayed.

I have gone a little bit longer than I had anticipated. Let me turn this over to Marc Mantell, who's going to dive deeper into what he's seeing from the standpoint of valuation and deal structure, and how buyers and sellers are bridging that gap in this market.

Bridging Valuation Gaps in the Current Environment

Marc Mantell, *Partner, Mintz Levin:* Great. Thanks, Chuck. That was a great summary. Really appreciate that. We're seeing very similar things as well. So, what do I mean by a valuation gap? During a downturn, any downturn really, current performance suffers. Projections are either modified or become less reliable, and milestones are pushed back. So, buyers and sellers are disagreeing on the current value of a business.

There's nothing really new about it. It's not just a COVID thing. Buyers and sellers often don't agree on the long-term value of a business, particularly in high-growth areas like health care and technology, so they use earnouts to bridge the gap.

In the recent SRS survey, it was about 83% of biotech and 77% of med device deals already had earnouts. This is as of 2019, and around 20% of non-life science deals. Again, many of the folks on the phone here probably use earnouts pretty regularly.

But, here we're in an environment where there's even less visibility than usual into the future performance of the business. What we're actually seeing is deals that had an earnout now potentially having two or three different earnouts and deals that were a cash

at closing deal now being flipped into an earnout deal. So, as Chuck said, adjustments are being made sort of on the fly, and the lawyers and the deal participants are reacting to that.

In terms of process points and practice pointers, if your cash at closing deal flips into an earnout deal, there's a number of things you should keep in mind. We're not going to go into all of them because that's a webcast in itself, but a couple of things I think are really important.

One is to have clarity on the target metrics. It sounds simple, but it's actually not. A lot of earnouts will attach detailed schedules, sample calculations. That's really critical because they smoke out misunderstandings regarding accounting issues and other items that either should or shouldn't be counted toward — or excluded from — the earnout.

One of my favorite illustrations of this is a case from several years ago, the Comet Systems case, where part of the earnout was based on the operating cost of the business after the closing. It did carve out one-time non-recurring expenses and said those things won't count against the calculations to the detriment of the sellers.

Well, in the deal, there were merger bonuses that were granted to the target employees. In calculating the earnout, buyer counted those as operating expenses, so the merger bonuses were deducts for purposes for the earnout. The sellers disagreed and said they should have been excluded as one-time, non-recurring expenses.

The court in that case found that those merger bonus payments should have been one-time non-recurring expenses, so they ruled in favor of the sellers. Interestingly, though, these expenses would not have been an extraordinary item under GAP.

I think the case is important for two reasons. One is the words really do matter, and if the words in the contract were "extraordinary item" under GAP as opposed to one-time non-recurring expense, this case probably would have gone the other way.

Even more important than that is that this wasn't some future unknown event that caught people by surprise. Everyone knew about these payments. They were done in the deal, and they were written up in the documents. Everyone knew exactly what they were and what they were for, and still we had a dispute that went all the way into the chancery court in Delaware.

People talk about earnouts as a recipe for litigation. That can be true, but there's a lot we can do as lawyers to help smoke out some of these issues when we're drafting the documents.

So, just a couple more notes. One is, in addition to clarity and target metrics, folks should really consider when a cash at closing deal flips whether there should be other additional representations or covenants from the buyer. It's no longer a cash at closing deal. Of course, buyers will be very concerned about it, very resistant to any the restrictions on their ability to run their business. Sometimes additional protection for the seller can be appropriate.

Also, think about here we are in the middle market where we often have detailed comprehensive indemnity provisions in our documents. Think about how the earnout impacts that. Buyers will often seek to have setoff rights against earnout payments, and the parties need to make sure they consider and think through what that interplay is like and whether these types of provisions can undermine the agreed upon indemnity limitations.

There are some other gap fillers that we can talk about, but I'll ask Rich if he's seeing the same thing, if he's seeing deals with earnouts more often or deals that used to not have an earnout flip into an earnout in this environment.

Richard Silfen, *Partner, Duane Morris*: Sure. Thanks very much for leading into that, Marc. I think one of the things that I've noticed is definitely more use of earnouts, but also seeing the use of milestones outside the life science space seems to be an intriguing thing.

I'd open it up to both Marc, you and Chuck, in terms of — I read something the other day that said, "expect to start seeing notes as part of the consideration," as part of these gap pillars.

And, in a way, we're used to the idea of taking stock in a transaction and we morph into a reverse due diligence mode. I think if you take notes and, Mark, as you mentioned on the seller diligence on the earnout-type payments, the kind of diligence and reps and warranties, etc. that the seller might want of the buyer that are designed to assure payment, right. I'd sure be interested in what you think about those issues.

Aquino: I would say we've always seen seller notes, earn-outs and other similar concepts work their way into transaction structures. The way we typically view these is that a seller note can be an effective a way to bridge a financing gap, and an earn-out is often utilized to bridge any valuation gap.

In this market, these structural features tend to be common, if not essential, in helping to get a deal done. As budgets and financial outlooks remain murky, buyers are looking to share more of the risk, and specifically the post-deal risk, with sellers. Sellers aren't necessarily willing to capitulate on value due to a sudden, yet temporary disruption of their business due to factors beyond their control, but they do understand the risks buyers are taking in closing transactions without clear visibility to when the business will materially rebound.

If given the choice of the two, clearly, from our client's perspective, seller financing is typically a lower risk proposition. Yes, you are a creditor to your own transaction to some degree, but you are earning interest on that paper while it's outstanding. Earn-outs are structured based on future performance of the company, which may or may not rest solely within the purview of the business owner or which could be impacted by some extraneous economic, legislative or other event (i.e. COVID-19). For these and other reasons, earn-outs typically lead to disputes over payout obligations, which can quickly sour the relationship between buyer and seller.

In a seller finance situation, the seller is higher up the credit chain in terms of liquidity, and payout isn't predicated on specific performance hurdles. As long as the company has the available free cash flow to service its debt obligations, these notes are paid. They are less risky than earn-out structures and thus the preferred method (from the seller's point of view) to bridge any expectation divide. In this environment, given the uncertainties we're seeing in both company performance and the financing markets, we're seeing both of these mechanisms employed.

Mantell: Yes, it's a great point. I'd also just say that, again, people talk about the downside of the earnout, the potential for disputes regarding whether those targets have been hit. The other big complaint I get from my buy side clients is that target managers are only concerned about the earnout after the closing and not growing the business.

While you can get a disalignment of incentives that potentially might not be the case; it'll be less of the case if this would be done either through seller financing, stock

consideration or some other structure.

COVID-19's Implications for Deal Structure and Process

Aquino: Right. Marc, should we move into some of the other deal structure topics aside from deferred or contingent consideration issues?

Mantell: Yes, I think that's great. Rich, do you want to kick off the deal structure and process section?

Silfen: Sure. That makes perfect sense to me. So, again, it's an interesting issue because I think one of the things that we see in this space now, in middle market M&A is that while — as Chuck mentioned — the market has sort of slid from being a seller's market to looking like a buyer's market.

There are a couple of places where we still see strong interest. Maybe not such compelling pricing, but still strong interest and targets is where you see entities that have high strategic value to buyers and well-capitalized buyers particularly when they're strategic acquirers. And so, I think you see less of these issues in that space.

Getting beyond how the consideration is structured, I think one of the things that we see is that it seems like in transactions — and I don't know if this is going to be a trend, or if it's just something that really affected deals that were in the middle when COVID sort of came on the scene — but one of the things that we saw a bit of is acquirers decide, "Maybe I don't really want to acquire the whole company now. Maybe what I'd like to do is make either a minority or even majority investment in the company with some ability to take out the rest at this point."

Of course, those bring up many, many more issues that are probably a webcast just of themselves. It's worth thinking about in terms of what do you do because it can preserve valuation, but it also kicks into a lot of governance and other type issues that have to do with how the company goes forward like that.

I was hoping that we could do this a little more interactively, so with that, I'll pause and see if Marc or Chuck want to comment on that issue.

Aquino: Yes. It's a timely issue, and I was probably going to mention it upfront if my opening monologue wasn't so long. In this environment, we are seeing many examples of good companies with bad balance sheets in need of a capital injection to help them build a bridge from now until a point when their end markets return and financial performance rebounds

These are typically companies who, pre-COVID, exhibited consistent top line growth and operating margins have strong management teams, strong brands, established track records, robust pipelines and good visibility into their forecasts. Absent this pandemic, many of these companies would likely be contemplating a major liquidity event to take advantage of a historically strong M&A market.

Well, now, because of the widespread shutdowns and the resulting negative impacts to these companies' business models, cash flows are depleted, and without the ability to service debt, capex and other working capital obligations, their balance sheets are stressed.

These companies need a temporary bridge to get from point A to point B down the road. What we're hearing and seeing firsthand is that a lot of private equity firms recognize this market dynamic and the opportunity to put capital to work. While during more normal

times, they might be more focused on traditional majority recaps, they see the temporary market dislocation as an opportunity to get their foot in the door with some very good companies now and possibly do a more substantial deal down the road.

What we're talking about here is lending capital. This isn't conventional acquisition lending per se, but investing capital in a more structured manner that provides for downside protection, minimum returns, priority over the common in the credit chain and some combination of current and deferred dividend income during their investment.

Preferred equity structures like these offer not only the capital, but the flexibility businesses need in this environment to get through the short-term cash crunch while maintaining the ability to meet payroll, pay vendors, invest in working capital and essential capex, etc.

These structures also typically allow investors to participate in the long-term upside performance of the business through some form of conversion feature, or the investment may be redeemed through a more traditional majority sale of the business. So, yes, we're seeing quite a few of these situations in this environment.

Silfen: Thanks, Chuck. Another thing that I wanted to hit on a little bit is, in the middle market space for deal structure issues, one of the things that always tends to come up is this ability to sign and close simultaneously versus having a deferred closing.

One of the things that we've also observed is tremendous pressure by buyers to try to figure out ways to chew on a deal where you might even have a short period between sign and close to — even for things that used to be like a pre-closing transaction to try to push a cellar to consummate a bunch of pre-closing transactions.

For instance, sometimes you see this with the first time — a family-owned business is sold into private equity and maybe you have real estate that's outside of business or something like that and various types of equity that needs to be moved around for tax planning.

These are things that need to be thought about because it's a little dangerous for a seller to start shifting around equity interest, real estate etc. in ways that often trigger income taxes, but not have assigned contracts for the purchase. So, in the case that I'm thinking of that I'm aware that's active right now, that things were done that were irrevocable, and then the buyer just decided for whatever reason not to sign the purchase agreement.

I think most of the lawyers were familiar with being under circumstances like that; there's really not a lot that the seller can easily do because there's no contract.

The last thing that I want to talk on is structure before we say a few things about process. I don't know if there's a lot to say about this now, but thinking about what is likely to come is to start thinking about this likely in the fall when money gets a little bit easier to come by and the longer-term impact of COVID takes effect on many of the companies.

I think you might start seeing some transactions that are either distressed companies or bankruptcy-assisted transactions like reorg-type, Chapter 11, 363 sales etc. In those transactions, the due diligence becomes really heightened in terms of importance because there are special issues that have to do with limited contractual recourse.

If you don't take all of the entities, sometimes they are joined with several liability issues when you leave things behind, and you have to figure out a way to allocate that and you might be dealing with insolvent businesses that are left behind. It's often very difficult to

ensure those things, so those can be really difficult things. Marc, anything you want to add on that before we talk process for a couple of minutes?

Mantell: Rich, I think you make some good points. The issue about the broken sign and close, I think some of the points we'll talk about later and the nitty-gritty deal terms do have to do with deal risk.

You raised a great point that in this environment, for the seller to go down this path and potentially even take irrevocable actions without surety that the deal is going to close is a real risk; it is a real issue.

Silfen: Terrific. So, let's talk process. As a background on that, I think a lot of times we lawyers tend to think that so much of the process is really on our backs and our responsibility.

As Chuck mentioned in the beginning, the inability to really have face-to-face meetings so easily and to shifting those things into Zoom or WebEx has caused some real difficulty. Work from home generally is causing some issues around that, but let's think that in terms of process you have pre-deal process, you have transaction process, and then you have integration-type process and all of them are creating special issues.

Even at the board-process level, one of the things that we've seen more of is boards asking management teams and the owners of the companies why this transaction is happening now because you're putting pressure on our obligations etc. in a circumstance where maybe it's suboptimal to be transacting.

I think that the diligence process is evolving in ways that are almost difficult to predict. One of the things that we've seen a bit of is that, in the context of quality of earnings reviews, you see companies that over very short periods are trying to adjust various types of expenses and other elements of EBITDA so that they have an adjusted EBITDA that they're somehow adjusting out things that are COVID related.

Of course, that puts a lot of pressure on a QLE analysis and generally makes it very difficult to have conversation about valuation in the ways that Marc mentioned in his little section before this one.

As Chuck also mentioned, because of face-to-face issues, it's difficult to do the due diligence. Obviously, things like contract review is just data room based. But there are a lot of issues now in due diligence that you have to watch for that are things like contract non-renewals, contract cancellations.

You know, you have reps and warranties and contracts typically that have to do with nobody having given notice of non-renewals. When you see the kind of conversations that are happening between management teams of targets and their customers or vendors and various types of contract problems, you can see that this is likely going to be an area of dispute coming because you don't really know if whatever was the noise or uncertainty about something becomes a breach of the contract or termination of the contract later, that maybe something that seemed innocuous upfront actually becomes something that looks a bit more like breach of warranty later.

There's a lot of business disruptions in terms of commercial contracts, and you have to think in terms of what the force majeure-type provisions might be. Cash issues are becoming very difficult, and a source of a lot of diligence and maybe a lot of times not really done by lawyers. But the issue has to do primarily with non-payment and slow payment by customers.

Another area where we have seen diligence issues crop up is the impact of delays from suppliers and vendors. With that, I'll pause and see if maybe Marc or Chuck want to weigh in.

Aquino: Sure. What resonates with me and what we deal with oftentimes in our M&A processes and especially when we're representing sellers is thinking about the concept of adjusted EBITDA or adjusted earnings.

These one-time adjustments and addbacks for non-operating, special and/or one-time circumstances often get a lot of focus and attention and rightfully so. Oftentimes both sides try to put forth their own quality of earnings-backed analysis to defend their position or challenge the other side's position. One of these adjustments that almost any company who undertakes a sale process during the next few years will claim is the pandemic.

The challenge that we're seeing play out in real time — and this goes to my point earlier about process timing — is we really don't know yet when we're going to be able to fully quantify this addback. Many businesses are still feeling the pandemic's impact on their suppliers, customers, employees and end markets, and very few have any concrete sense as to when they'll emerge.

What we're seeing is that companies with more variable cost structures, and those who can pivot or evolve to meet the demands of the moment, are certainly faring better than those with a more rigid, fixed cost structure unable to scale down to maintain profitability. In this environment, buyers and investors alike are clearly more interested in the former than the latter.

And then, quite frankly, there are a few businesses and sectors out there that are getting a nice tailwind from the pandemic. So, while you might expect many sellers to be adjusting earnings for the negative impacts of COVID, there are instances where buyers might take the opposite position. They may be concerned about an overly positive but temporary impact or even accelerated performance in the current year at the expense of next year, and adjust for that to better ascertain performance of the business post-COVID.

Silfen: Right. So, the last thing that I wanted to touch on is the integration process. A lot of that can be really challenging as a result of closed facilities, work from home, etc.

One of the things that we've seen a bit as of late is acquirers becoming very concerned about how it is that you get a workforce that is the subject of an acquisition transaction but doesn't really know who their new business leaders are. All of a sudden, they're working for another company, but they're not showing up at a place of employment that has anybody. There are new people, and it's very difficult to get a feel for people over the phone or over Zoom.

Some things like whether it's LinkedIn or another sort of technology like that makes it much, much easier to identify talent of these companies so that competitors of these companies There is a lot of concern that we've been hearing that it is very easy for competitors to be able to identify employees that, in the dislocation period around the acquisition transaction, might be right for picking and trying to think about new packages and new incentives to create that are not normal for most normal-type acquisitions to just ensure that you don't lose your workforce in the face of that.

With that, I would turn it back to Marc for the next section.

Evolution of Deal Terms in the COVID-19 Environment

Mantell: Sure. Thanks, Rich. I'm going to finish up here, get into a little bit of the nitty-gritty on deal terms. So, I'm going to start by talking about the MAE, material adverse effect, or MAC clause. I think we're all probably familiar with it, and it's been getting a lot of attention lately.

The primary purpose for a MAC is to allocate the risk between sign and close. So, if there is a MAC, then buyer does not need to close. If no MAC, buyer is required to close, subject to the other closing conditions. It's a very high standard in Delaware, and I think in most places.

Delaware has only found one in the Acorn case, and it's generally reserved for unknown changes that really dramatically, I think, alter the earnings potential of the target. It has to be in a durationally significant manner. It can't be a blip on the screen.

For those of you that have negotiated those provisions, there's typically a number of carve-outs. By carve-outs I mean risks that are expressly allocated to the buyer. So, things like acts of war, changes in GAP or laws, sometimes risks related to the announcement of the deal itself.

The effects of those things are not permitted to be taken into account for purposes of determining whether a MAC has occurred. And now, we're increasingly seeing sellers try to include references to pandemics, epidemics and even COVID-19 or coronavirus in that list of things that are allocated to the buyer.

When we do see it pop in, it's usually subject to the disproportionate effect clause that we typically see which says, even if it's carved out to the extent that it disproportionately affects this target related to other industry participants, then it can be considered. It's sort of the exception to the exception, so we are seeing an increase in the action on this. In many cases, buyers are willing to add it as a carve-out subject to the disproportionate effect clause.

If you really look at it, I think the reality is that even if a buyer is able to successfully exclude it as a carve-out, meaning it can still be the basis for a MAC, I think that's probably the easier hill to climb and the buyer would still have a difficult time using the COVID effect as a MAC for deals that are started now — for deals that are being entered into now that the COVID impact has begun to have severe effects because I think you're still going to have to show that this is really an unknown change that's going to have a dramatic impact in a durationally significant manner.

So, while the MAC clause is important, whether or not a seller is able to exclude COVID from the MAC clauses is really only the beginning. And, for buyers, I'm telling them that that doesn't mean you've won.

If you really are concerned about the impact of this lack of visibility or the potential disruption of the business based on COVID, you should really be thinking about what your interim covenants look like, what your closing conditions look like and potentially putting closing conditions relating to the preservation of the business, so rather than speculate as to whether a court may agree that something is or isn't a MAC.

I'm going to want to open it up to see what my colleagues are seeing, but I mentioned the interim covenants. For deals that have a broken sign and close, I think one of the critical provisions and one that tends not to get a lot of attention is the obligation for the target to operate in the ordinary course.

Buyers naturally want to receive at closing the same business they agreed to buy. They typically have affirmative covenants that the target needs to preserve its business and

operate the ordinary course as well as a number of more specific negative covenants.

That affirmative covenant to operate in the ordinary course is a real issue these days. There's been a lot of attention paid to the Sycamore Partners case — not a case, actually, but it's a complaint they filed to break the Victoria's Secret deal.

That deal didn't go to trial. The parties agreed to terminate the deal outside of court, but that gets a lot of attention as a MAC case. I think it's really more of a breach of contract case. It's really more of an interim operating covenant case.

What Sycamore said is that, okay, you essentially closed your stores, but that's probably okay because that was required by law. But you also furloughed employees and cut salaries. You stopped paying rent, and that wasn't required by law. That was not in the ordinary course.

That's really important in this environment for buyers and sellers to think about what this ordinary course means. Often, it's not specifically defined. Does it mean it's consistent with past practice or not and should there be a qualification only to use commercially reasonable efforts or for it to be satisfied in all material respects.

A lot of thought needs to go into whether any type of additional flexibility is important or even a carve-out for compliance with law, what is appropriate or what about some of these guidelines and policies that are coming out regarding COVID safety measures.

That's not necessarily law (maybe only policy), but should compliance with those be something that's permitted as part of the interim covenants even if it's disruptive for the business? I think the answer can be different in different cases, but I'll ask if Rich or Chuck have seen any of that themselves.

Silfen: I think one of the things that's kind of humorous about the MAC carve-outs is the idea that when this first happened we had clients that would say to us routinely, not that there were that many deals — maybe that's not the right word to use — but that the buyer basically has agreed to assume all risk of COVID-19.

Once you start talking about that and thinking about the manner in which you might write words in a contract to actually cause that to occur, what you find out is that what the buyer's concern really is is that it's less a COVID-19 thing and the direct impact on the company.

It's what does a recovery look like? Like, are you looking at a V-shaped recovery, a U-shaped, a flat U and are you concerned about a double dip? Because if the fall comes and the exact same thing happens all over again, people are worried that maybe that kind of thing doesn't really make it so easy to buy the company.

Some of the things, interestingly, go beyond this closing condition or MAC issue because, when you start listening, I've kind of sat there and wondered really talking about what this thing is going to look like once you own the company, and that's not our problem any longer.

I do think that these are more like your diligence-type issues that can be very tricky in the environment and likely, as people think through them more, will slow deals down a bit until people get a stronger handle on them and decide how they want to deal with this.

Mantell: Yes. On a related point, I think the diligence issues are key. Some of the changes we are seeing to the reps and warranties I think reflect that. So, you've got your different buckets, for example, your CARES Act bucket.

Companies have taken out PPP loans. There are rules around qualification for loans under the affiliate rules. There are restrictions on use of funds. How does the buyer know if eligibility was appropriately determined or whether the funds are being used properly? So, we're seeing reps in that regard.

There can be refundable tax credits and payroll tax deferrals. How are those addressed? Is that part of working capital? Even from a deal structure perspective, is the deal structured in such a way that any restrictions might actually infect the buyer's business or existing entity?

We're seeing CARES Act stuff. We're seeing standards there. Reps and warranties that we were always concerned about, but now we're more concerned about with the supply chain issues, your customer and supplier reps.

These reps are often looking an awful lot like guarantees and same with your receivables rep. Does that make sense here? Maybe that's exactly what it should look like given that the buyer is concerned about preservation of the business. You mentioned before, Rich, focus on contracts and force majeure clauses. That becomes more of a focus now because we're seeing a lot of litigation on that side.

Lastly, I'd call out the on the IT front. Cybersecurity is a much bigger concern just with the sheer volume of work that's being done remotely. But it's not just that. It's also, frankly, does the target have the ability to support a remote workforce? Does it have the hardware?

There is more of an issue in companies that have broad employee groups. It may be less of an issue for some of the more virtual companies already on the technology or life science side, but we're definitely seeing a lot of concern and a lot of thought about the reps and reaction to those same issues that, Rich, you mentioned on the diligence.

Silfen: Marc, are you seeing situations where when companies are bought like, say, out of a corporate control group that there's a lot of tax diligence around the ability for NOL, rollbacks etc. because a lot of times the one that gets separated out could easily be the loss company.

It may be that when it comes out, there needs to be thought about who gets the benefit of the NOLs because the CARES Act did a lot to allow the ability to recover that. It's contractual in nature as to whether which of those parties actually gets the benefit or whether it's shared.

Mantell: That's a good question. I haven't seen that issue specifically come up, but again, our tax folks have been very active in trying to grapple with these. It's easy to put in an interim covenant saying thou shalt not take advantage of these provisions. But it's trickier once the companies are already taking advantage of the CARES Act, dissecting it and seeing how it impacts the tax issues or potential liability down the road.

I saw a proposed rep about whether employees have been diagnosed with COVID after showing symptoms. A lot of companies are exploring here. They're trying to figure out the path forward.

Same with rep and warranty insurers. They're open for business, and their deal volume is down. They're trying to get deals done. While they are very concerned about this COVID environment and are seeking exclusions relating to COVID, those exclusions can be narrowed through diligently showing mitigation efforts and through focusing on broader concepts rather than continually expressly focusing on COVID in the document itself because insurers are looking to do deals.

Silfen: Is your experience that the way to narrow the exclusions in the RNW space to basically help the insurer see that you've done enough work in certain areas, that what you're really talking about that you want coverage for is something that is unknown, because their issue is that anything that looks like a known problem is really something that you need to cover between and seller? Correct?

Mantell: Yes, absolutely. You focus on the risk mitigation provision in the document itself. You focus on why this type of business is not the type of business they should be really concerned about because of X, Y and Z from an industry perspective.

You put in the employment reps that in the last 18 months you have not done any layoffs of furloughs above x amount. You don't say in response to COVID you did not do X, Y and Z because I think the more you sort of signal that there is a COVID-related concern, the more the insurer is going to be on edge.

Jenkins: We've certainly covered an awful lot of ground here today. I'm going to draw the proceedings to a close by thanking all of our panelists for a really great and very wide-ranging discussion. Thanks to all of you for joining us here today. This concludes today's webcast.