

# COVID-19 IMPACT ON DOMESTIC MIDDLE MARKET MERGERS & ACQUISITIONS

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## INTRODUCTION

The continued unfolding of the COVID-19 pandemic has already had a massive impact on the global economy and the economy of the United States. Businesses across almost every industry have been adversely impacted by the consequences of social distancing and state and local shelter-in-place requirements. Unemployment numbers have skyrocketed. Consumer demand has begun to plummet as mass layoffs occur and consumers struggle to pay for even basic necessities. With commerce largely at a standstill, mergers and acquisitions activity is also slowing significantly as companies and private equity groups struggle to understand the impact of COVID-19 on (i) transactions that have already closed, (ii) transactions that have been signed but not yet closed, and (iii) transactions that are currently being negotiated. This article reviews some of the consequences and considerations with respect to mergers and acquisitions transactions in light of the COVID-19 pandemic and potential opportunities resulting from COVID-19 disruption.

## CLOSED TRANSACTIONS

For transactions that were closed in prior years or more recently, COVID-19 is having an unexpected effect. Transactions that included contingent consideration based on financial performance are starting to see adverse consequences.

With respect to earnout provisions, sellers that agreed to contingent consideration based on financial performance, whether tied to revenue or profitability (or both) or customer retention, and that had an earnout period that extended into February or March of this year have likely seen a significant decrease in financial performance or customer retention and its resulting impact on the seller's achievement of earnout targets. The failure to achieve expected targets and to receive anticipated earnout consideration is an issue currently being addressed by a number of buyers and sellers. Discussions around modifications to earnout provisions are underway to ensure continued performance alignment between buyers and sellers. These discussions will play out over the upcoming months and may lead to a significant number of transactional modifications and the potential for litigation in the context of "frustration of purpose."

In addition, transactions funded with excessive debt are facing possible covenant defaults. The underlying operating companies are now forced to focus on preserving capital and maintaining liquidity to fund operations. Focus needs to shift from growth to maintenance of customer relationships, supply chain continuity, rationalization of products or services, and employee retention. Balance sheet management has become paramount as senior lenders try to understand the long-term impact of a borrower's cash flows and their ability to service the debt.

## TRANSACTIONS IN PROCESS

There are a number of transactions that were executed prior to the significant changes in the U.S. economy resulting from the myriad of state and local shelter-in-place orders and significant disruption beginning in early March, with closing of the transactions subject to satisfaction of a number of closing conditions, including the condition that no material adverse change (MAC) occurred between the time of execution and closing. The MAC definition in a transaction is typically treated as fairly standard and provides a context under which a buyer has the ability to terminate a transaction in the event there has been a “material adverse change” in the seller during the time between signing and closing. This provision is rarely used as a mechanism to terminate a transaction as courts have set a high bar for establishing that a MAC has occurred. Given the significant financial disruption resulting from the COVID-19 pandemic, buyers are now evaluating the MAC provisions in their transaction documents and assessing their ability to terminate the transactions as a result of the occurrence of a MAC.

At a minimum, buyers are exploring purchase price reductions based on deterioration of the seller’s business. Courts in Delaware and New York have recognized a buyer’s right to terminate a transaction based upon a deterioration in the financial condition of a seller, but the bar to demonstrate that a MAC has occurred remains relatively high.

As the economy and business performance continue to decline, more and more transactions that were executed in advance of COVID-19 will be at risk as buyers and sellers that are under contract continue to evaluate financial projections and the possibility of a return to normalcy in the near- to mid-term.

## TRANSACTIONS UNDER CONSIDERATION

For companies and private equity groups that are currently engaged in transactions that are under letters of intent, COVID-19 and its ramifications on those transactions are manifold. In particular, transaction parties are evaluating or re-evaluating valuation, key deal provisions such as interim operations, material adverse effect, and force majeure provisions, and regulatory approval requirements. In addition, buyers and sellers are reassessing representations and warranties and indemnification in their transactions and trying desperately to understand how representations and warranties insurance can help get deals across the finish line.

With respect to valuation and its relation to payment terms, buyers and sellers are evaluating issues on both sides. In an attempt to correctly apportion risk arising from the COVID-19 pandemic, buyers and sellers are entertaining earnout, deferred, or contingent consideration. The discussions around this risk apportionment through contingent consideration have anecdotally been short-term thus far, meaning that buyers and sellers are looking at a “return to normalcy” and historic and/or projected financial performance within the next 12 to 24 months. Assuming that “return to normalcy,” proposed purchase price would be paid.

Equally important is the need to assess a buyer’s ability to finance a pending transaction as lenders try to understand the impact of the pandemic on the underlying operating company’s cash flow. Renegotiating the transaction purchase price may be a necessity for some industries harder hit such as consumer products or hospitality and entertainment. These industries have seen valuation reductions by as much as two turns.

For buyers that propose paying a portion of their purchase price in the form of their own equity, sellers are more stringently evaluating whether they want to take that equity, the actual value of that equity, and whether to adjust the amount of buyer equity they are receiving in a transaction.

Sellers are also having to take a harder look at MAC provisions in purchase agreements. A typical MAC definition in a purchase agreement will look something like the following:

“Material Adverse Change” means any event, change, development, or occurrence that, individually or together with any other event, change, development, or occurrence, is or could be reasonably expected to be materially adverse to the Seller, its Business, assets, operations or prospects (financial or otherwise).

More specifically, sellers have begun to insert specific carve-outs related to COVID-19 or public health issues more broadly. Buyers, on the other hand, are increasingly amenable to some sort of public health-related carve-out, provided that buyers can still walk away from a deal if there is a disproportionate impact or effect on the seller or its specific line of business, and buyers are requesting “disproportionate impact” language that would allow such terminations. In addition to public health-specific carve-outs, sellers are also seeking to expand MAC definitions to include changes broadly affecting the United States economy, changes affecting particular industries as a whole, and changes in applicable law.

In addition to MAC definitions and clauses, sellers are taking a much harder look at other representations and warranties made in purchase agreements to take into account COVID-19 and its economic impacts to ameliorate the risk of breaches. Representations and warranties that are receiving particular scrutiny include accounts receivable, labor and employment, customers and suppliers, inventory, compliance with law, and full disclosure. In each case, sellers are seeking modification to these representations and warranties to account for the impacts of COVID-19. At a minimum, sellers are seeking to include a specific exception to these representations and warranties with an introductory sentence such as, “Except as arising from, related, or in connection with, directly or indirectly, the COVID-19 pandemic....”

For those transactions that are structured to be closed on a date following execution of the purchase agreement, subject to satisfaction of various conditions, the standard “operation of business” covenant is also being addressed to reflect the changing economic and operational conditions caused by COVID-19. An example of a modified provision is provided below:

“Except for any action taken or not taken by Seller or the Owners in good faith to respond to the actual or anticipated effect on the operation of the business resulting directly or indirectly from the COVID-19 pandemic or measures related to the COVID-19 pandemic, including but not limited to, any quarantine, shelter in place, stay at home, shut down, workplace closure, social distancing, or other Law, Order, directive, recommendation, or guidelines by any Governmental Authority in connection with or related to the COVID-19 pandemic (collectively, “COVID-19 Measures”), Seller will conduct its business in the Ordinary Course of Business and will use commercially reasonable efforts to maintain and preserve its relationship with suppliers, customers, distributors, landlords, creditors, employees, independent contractors, and other parties having business relationships with Seller.”

Another issue to consider in transactions that have been signed and are to be closed pending receipt of certain regulatory approvals is the delay in receipt of those approvals caused by the COVID-19 pandemic. If there is a drop-dead closing date contemplated in the termination section of a purchase agreement, parties should consider extending drop-dead dates to account for these potential delays.

## OPPORTUNITIES BORNE FROM DISRUPTION

In the midst of the chaos and disruption in the economy and in the mergers and acquisitions market resulting from the COVID-19 pandemic, opportunities exist for market consolidation and distressed acquisitions.

When businesses struggle, consideration of strategic relationships or synergistic mergers inevitably arises. Consolidations that allow for product or service diversity, geographic market diversity, or supply

chain synergies that might enable businesses to survive or better weather market disruption become common.

In addition to considerations around business survival or improvement, businesses and private equity that have cash to deploy go looking for acquisition opportunities, whether in the form of direct discussions with competitors or industry targets, or pursuing acquisitions under Section 363 of the Bankruptcy Code and buying assets from businesses that are in bankruptcy.

More and more businesses and private equity groups are approaching struggling businesses to explore investments, recapitalizations, and acquisitions. Financially distressed companies are becoming more amenable to these discussions as a potential lifeline to continue their businesses or as an ultimate exit.

## CONCLUSION

Amid the considerable disruption and economic uncertainty caused by the COVID-19 pandemic, the mergers and acquisitions market has been significantly impacted. Transactions closed in prior years, transactions currently under contract, and transactions that are being contemplated all have a new consideration—how to factor the COVID-19 pandemic and its myriad complications into the transaction. As with any disruption, opportunities for business combinations and acquisitions that improve market efficiency should be explored.



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