

Checklist of Considerations: Transactions During the Pandemic and After

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Who Needs to Know

Buyers and sellers.

Why It Matters

In an economy bearing the effects of the COVID-19 pandemic, buyers and sellers continue to seek opportunities and address liquidity needs. We offer this checklist of brief reminders to supplement the more typical list of considerations evaluated by buyers and sellers in pursuing transactions. The checklist touches on many issues, which might be more important than usual in light of the pandemic, and their effects on buyers and sellers.

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The checklist below is not meant to fully explore issues related to each of these topics. Each of them will require additional examination through the lens of your transaction's particular set of circumstances.

1. ***Bridging the Gap on Valuation.*** In these uncertain times, buyers often hesitate to use established valuation methodologies, or to apply multiples, that were commonplace as recently as 2019. As a result, buyers may offer less consideration than previously expected for a potential target. Instead of paying cash at a closing, parties may explore alternate approaches to consideration to help bridge the gap on valuation. For example, consideration which is only payable upon the achievement of post-closing financial or other goals, commonly referred to as an "earnout," can allow sellers to receive the consideration they expect their business is worth (if proven out after closing), while providing buyers with comfort that they are not paying for promised future results (unless the promised results are achieved). Other alternate types of consideration include (1) using a promissory note to finance a portion of the purchase price, (2) providing some of the consideration in stock of the buyer, and (3)

allowing the seller to retain a portion of the stock of the company. Each of these has different tax and strategic advantages and disadvantages but can be used, in part, as a substitute for cash.

2. **Longer Exclusivity/Diligence Period.** The COVID-19 pandemic has created logistical issues that can slow the process of completing due diligence. The pandemic also has created a need to complete a diligence review for more topics than those typically explored by buyers, including for example, PPP loans, employee layoffs, and modifications to third-party contracts that address and resolve issues created by interruptions in operations. Diligence is more involved and time consuming than ever and concerns novel issues that parties have not previously addressed in transactions. As a result, buyers should consider requesting a longer diligence/exclusivity period than normal in any letter of intent or term sheet.

3. **Diligence Issues.** Buyers need to watch for new and previously unexamined topics and issues that arose due to the pandemic. Also, due diligence questionnaires should be reevaluated to provide appropriate requests for issues the target may have faced during 2020, such as those listed below.

a. *Issues Related to Covid-19 and Working Remotely.* Buyers should consider the following labor-related questions in their diligence of a target:

- i. Ability of the target to support a remote work environment for employees.
- ii. Ability of the target to support the remote delivery of services to customers.
- iii. Ability of the target to support a remote working environment and delivery of services to customers in a manner that complies with customer contracts and laws relating to data and IT security.
- iv. Evaluating the target's back-to-work plan and its compliance with local, state, and federal guidelines.
- v. Have any employees of the target brought complaints (internal or external) that the workplace is unsafe or that they have contracted COVID-19 at work?
- vi. Have any employees requested COVID-19-related leave under federal, state, or local law?

b. *Valuation and Financials.* Does the latest valuation of the business incorporate the negative effects caused by greater dependence on technology and increased health, safety, and compliance costs? Does the latest valuation include nonrecurring revenue or cost savings created as a result of the pandemic?

c. *Terminations and Return to Full Staffing.* Were all laws complied with in connection with any layoffs, furloughs, and adjustments to terms of employment as a result of the crisis? What are the next steps for addressing furloughed workers? What are the plans for retaining employees and returning them to the workplace?

d. *Insurance Claims.* Were any business interruption insurance claims made by the target? Many insureds that have made claims for business interruption coverage have failed to succeed in obtaining a recovery due to policy exclusions. Consider the merits of any such claim made by a target prior to providing "credit" for those dollars in the purchase price negotiation.

e. *Agreement Violations.* Were there breaches of leases, loan/financing agreements, and other third-party contracts? Has a forbearance agreement been entered into that resolves the related issues and waives the rights of the non-breaching party related to the incident? If not, is the target still in breach and are there cure costs to pay or actions to take resulting from noncompliance with a contract?

f. *PPP Loans.*

i. If the target obtained a PPP loan, has it shared the appropriate background materials evaluated by the target board in establishing the loan eligibility?

ii. Has it timely filed for forgiveness? If not, has it evaluated whether forgiveness is appropriate? Consider the arrangements necessary to address an outstanding PPP loan at the time of a transaction

iii. In a distressed situation, the borrower's management may be tempted to use the proceeds of a PPP loan for purposes not contemplated by the statute or the regulations. Does the target have documentation to show how it used the proceeds of the PPP loan?

g. *Payroll Taxes.* Under the CARES Act, through December 31, 2020, employers were entitled to defer the payment of the employer's portion of Social Security tax. Half of the deferred amount is due on December 31, 2021, and the other half is due on December 31, 2022. Buyers should consider whether sellers have elected, per the CARES Act, to defer the payment of pre-closing payroll taxes to a post-closing period, and if so, how to account for the tax liability.

4. **Financing.** Banks may have new or more stringent underwriting requirements or covenants that may make historical debt-to-equity ratios no longer a reliable option. Alternative financing sources may need to be explored to finance an acquisition, or upper-level guarantees may be required as a condition to obtaining financing. Other financing-related issues include:

a. *Termination for Failure to Obtain Financing.* Given the relative uncertainty of the debt underwriting process, reverse termination fees may become more prevalent in transaction agreements as buyers will likely push hard for a financing out if a new secured debt facility must be obtained to pay the purchase price for the transaction.

b. *Replicating Unique Financing Arrangements.* Were there alternative sources of financing put in place to support or add to the target's existing financing? Were affiliate or upper-tier entity guarantees provided? If so, must comparable affiliate guarantees or other support be replaced or is debt from another lender available on more favorable terms?

Legal Compliance for Finders. In the face of unprecedented circumstances, targets needed financing in order to continue to sustain operations and satisfy their commitments. Did the target arrange for emergency financing? If so, did it utilize the services of a finder that was not a registered broker-dealer?

5. **Transaction Agreement Provisions.**

a. *Working Capital Escrow.* Consider whether previous approaches to sizing a working capital true up escrow

amount remain applicable to the business being sold. Buyers may seek to have escrows larger and would have been previously typical to take into account a more volatile short-term swing in the target's working capital.

b. *Representations and Warranties.*

- i. Sellers likely will seek a broad exception to representations relating to the effects of COVID-19.
- ii. Buyers will want any such exception removed as the additional disclosure should prove useful in confirming COVID-19's impact on the target, including its contracts, employees, and obligations, as well as how this related to buyer's assumptions regarding the business.
- iii. Buyers likely will seek representations regarding whether the target has complied with COVID-19 federal, state, and local guidance and requirements that apply to employees, whether the target has received any complaints from employees relating to COVID-19, workplace safety, leave arising from COVID-19-related issues, and whether the target has complied with all applicable laws in connection with its response to COVID-19 (including but not limited to wage and hours and discrimination laws).

c. *Tailored Interim Operating Covenants.* If an executory period is required such that there is a period of time between the execution of the purchase agreement and the closing date, then attention must be paid to interim operating covenants. Buyers will want more involvement and control in the target's ability to take actions (including those typically considered to be in the ordinary course of business) and will want notices of lender correspondence, customer correspondence, and personnel actions, among other things. Targets will likely press harder than ever for more flexibility to address the evolving impact of COVID-19, evolving regulatory requirements, and potential new cases. Decision-making is all the more important in unprecedented times, and each party to the transaction may want more executory period control than usual.

d. *Closing Conditions.* Similar to interim operating covenants, buyers will take care to draft the conditions to its closing obligations in a manner that requires specific financial or operational goals or circumstances to be achieved or to continue to exist during these unique circumstances.

- i. Buyers will want to ensure that the effects of COVID-19 are not excluded from the "material adverse effect" condition (the MAE) in their agreement, while targets will want such effects excluded from the MAE (or at least contain a caveat that they are to be considered if the target is disproportionately affected by COVID-19 when compared with other members of its industry/geography).

Even though purchase agreements typically have a MAE condition protecting a buyer, few true material adverse effects have been recognized by courts. If the buyer requires that a certain negative event not occur, it should not rely on the MAE. Instead, specific conditions targeting the specific circumstances will provide for clarity and predictability for both buyers and sellers.

e. *Equity Commitment Letter.* Financial sponsor-affiliated buyers should be prepared for sellers to seek more equity commitment comfort for a transaction than for comparable pre-pandemic transactions. In addition, a buyer should carefully consider which remedies it is willing to provide to the seller in the event of a financing failure and whether the ECL should terminate if and when a buyer brought any claims against buyer's equity sponsor other

than claims to enforce the ECL and guarantee.

f. *Extended Outside Date.* Given the effects of COVID-19 and the logistical hurdles it has created for transaction participants in 2020 — from an inability to travel to in-person meetings, the closure of state offices that provide certified documents, and the additional time that is generally required due to remote working environments — more time than usual will be needed to consummate the closing of a transaction. If a transaction has an executory period between signing the purchase agreement and closing the transaction, parties should take care in selecting an appropriately distant “outside date” after which a seller or buyer could terminate the agreement and walk away from a transaction. That period likely may take longer than was previously needed.

g. *Updates to Disclosure Schedules During the Executory Period.*

i. Sellers might seek permission to update the disclosure schedules to the purchase agreement from time to time during the executory period (for updates that do not constitute breaches as of the signing of the agreement), including for unexpected events and circumstances related to the COVID 19 pandemic, without such update triggering the buyer's right to terminate the agreement.

ii. Buyers may attempt to narrowly tailor how any notifications from a seller may update the disclosure schedules and will strive to ensure that a buyer has an appropriate indemnification or other remedy to address the potential issue, loss, or claim that any event or circumstance may cause.

iii. Since representation and warranty insurance policies will not cover any known issues, a seller's ability to freely notify the buyer of non-breach issues and the ability of seller to update the disclosure schedules can provide for a potentially troublesome situation, where the parties cannot rely on RWI. If such updates are permitted, buyers should endeavor to have corresponding termination rights or another satisfactory remedy for any material notification or update of the disclosure schedules, even if such notification or update does not result in a breach of the purchase agreement, in the event that the buyer's and seller's discussions regarding a corresponding specific indemnity break down.

h. *R&W Insurance.* Buyers should not expect representations and warranties insurance to provide the same level of coverage that a comparable policy might have provided prior to the pandemic. Policies now commonly exclude losses related to COVID-19. In addition, as mentioned above, RWI policies do not cover known facts, circumstances, and claims. As a result of the buyer's necessarily enhanced diligence, there is a greater likelihood of more claims being excluded from coverage and a need for the parties to agree on an appropriate remedy (e.g., a specific indemnity addressing a known issue) to fill the gap that such an exclusion from RWI coverage has created.

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