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Material Adverse Effect in the Uncertain World of COVID-19

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COVID-19 has spread throughout the world at devastating speed, causing unprecedented lockdowns and quarantines in numerous countries, disrupting global supply chains and plunging capital markets dramatically lower. Companies across a variety of industries have already experienced and anticipate future substantial declines in their businesses and financial performance.

For M&A transactions that have already been signed but have yet to close, and for those currently being negotiated, COVID-19 and its fallout increase the risk that buyers may try to walk away from transactions, or renegotiate central deal terms by asserting the target or borrower suffered a material adverse effect or material adverse change (MAE). For financing transactions, similar to the aftermath of the 2008 financial crisis when MAE clauses dominated headlines after several high profile transactions collapsed, COVID-19 and its fallout increase the risk that lenders may try to pull back their commitments claiming an MAE has occurred, as typically one of the conditions to financing is that an MAE has not occurred since a referenced date.

Complaints recently filed in the Delaware Court of Chancery may portend similar litigation trends while the world struggles with COVID-19. In that pending dispute, Sycamore Partners refused to consummate its affiliate's acquisition of a majority stake in Victoria's Secret and related businesses owned by L Brands, Inc. In its complaint filed on April 22, 2020, Sycamore Partners alleged that actions undertaken by L Brands in response to the pandemic and closure of its retail stores breached multiple provisions of the parties' agreement, and that an MAE had occurred. One day later, on April 23, L Brands filed its complaint seeking to specifically enforce certain obligations of Sycamore, and highlighting the continued minority ownership interest in the target businesses held by L Brands and similar commercial steps undertaken by Sycamore Partners' portfolio companies in response to COVID-19. Subsequently, L Brands and Sycamore Partners announced that they would settle the litigation and have mutually agreed to terminate the transaction agreement.

This article seeks to guide transaction participants in approaching what is a fact-intensive inquiry governing MAE determinations by highlighting key questions for self-analysis of potential MAE events. It offers practical suggestions to help those in pending transactions and negotiations begin to mitigate risks in connection with potential MAE litigation as an expected consequence of COVID-19 and the resulting turbulent market conditions.

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Key Features of an MAE Clause

Courts scrutinize the specific language of the MAE clause at issue, and so transaction participants should pay close attention to the precise wording of the clause, particularly any deviations from the commonly used language in both M&A and financing agreements. MAE is a contractual construct which is deceptively simple in wording but complex in its application to specific events.

As traditionally drafted, a market standard MAE is defined as an event or circumstance that has had, or is reasonably expected to have, a material adverse effect on the target's business, assets, liabilities or results of operations. However, changes generally affecting the target's markets and industries, and items outside of the target, such as synergies, are usually excluded. Although New York and Delaware case law provides helpful guidance, each case is highly fact specific. The lack of clarity in interpretation of MAEs may actually advantage a buyer, which can leverage its threat of termination against the risk adversity of a seller to renegotiate more favorable terms whether or not it may actually have a viable claim.

Buyer bears the burden of proof but the seller bears substantial litigation risk. As a general matter, it is worth noting that courts, including in both the two recent 2018 Delaware cases, *Akorn, Inc. v. Fresenius Kabi AG, Quercus Acquisition, Inc. (Akorn),* the first case in which a Delaware court affirmatively determined an MAE had occurred, and *Channel Medsystems, Inc. v. Boston Scientific Corporation and NXT Merger Corp. (Channel),* the first post-*Akorn* Delaware case addressing an MAE determination, held that buyers bear the burden of proof in establishing the occurrence of an MAE.

Further, as explained in *Akorn*, "[a] buyer faces a heavy burden when it attempts to invoke a material adverse change clause in order to avoid its obligation to close" and that a detailed facts and circumstances determination is required. Nevertheless, in the negotiation context, counter-balancing the buyer's high burden of proof is the buyer's significant leverage created in calling an MAE, forcing the seller to consider the risk of a failed transaction on its business and the cost of the all or nothing litigation that may follow.

Does COVID-19 Trigger an MAE?

Because of the highly contextual nature of determining whether an MAE occurred, buyers, sellers and lenders should carefully evaluate the specific factual basis for any assertion of an MAE in light of the express language of the MAE provision. In light of this fact-specific inquiry and the evidentiary burdens imposed on the buyer, the existence of the COVID-19 pandemic and the impact of the fallout from it may or may not be an MAE. Indeed, target companies across industries, and within an industry, have been affected differently by COVID-19. While no one size fits all, some of the key common thematic questions that should be analyzed are discussed below.

Are pandemics specifically excluded? Most directly, the determination of whether the coronavirus triggers an MAE will be affected by whether, like most MAE clauses, 'acts of god' are excluded or whether, as had become common even before COVID-19, epidemics, pandemics or international calamity are excluded. It will of course be more difficult to prove an MAE has occurred as a result of COVID-19 if epidemics, pandemics and/or international calamity are expressly excluded in the MAE definition. According to a recent American Bar Association webinar, for example, approximately 80% of publicly filed deals signed in February 2020 expressly excluded 'epidemics' and 'pandemics' in the MAE definition, compared to less than 10% in January 2020.

Known risks and general market risks. MAE definitions very often, by some estimates, over

90%, provide exclusions for 'changes generally affecting target markets and industries' unless they cause specific disproportionate effects on the target company. Case law in various states from prior downturns generally strongly supports the concept that general economic or market conditions are risks assumed by the buyer, but they are less clear on whether the buyer's pre-signing knowledge of actual or potential events precludes an MAE finding.

The application of these findings to the rapidly changing COVID-19 landscape which is at once (i) the world's general issue as well as (ii) a corporation's specific crisis, and which has been known in some form since January 2020, but with evolving understanding of its expected scope and detailed impact, will be a matter of contention by parties in MAE litigation and negotiations. The reasonableness of a claimed MAE will likely be significantly affected by the facts known with respect to the particular companies and industries at issue on the date the transaction was signed.

In favor of allocation of known and general market risks to the buyer is the landmark MAE decision, in *In Re IBP Inc. v. Tyson Foods Inc. (IBP),* where a Delaware court, applying New York law, declined to find an MAE. The MAE clause was silent on whether industry effects were specifically excluded. The buyer claimed an MAE because the financial performance of the seller, a beef producer, suffered due to cyclical effects in the meat industry and the *IBP* court specifically rejected the concept that industry wide factors were either automatically excluded from constituting an MAE or sufficient to automatically qualify as an MAE, and, instead held that an MAE clause is best read as "a backstop protecting the buyer from the occurrence of unknown events …."

However, the court in *Akorn* rejected the argument based on *IBP* that MAE provisions implicitly exclude risks that the buyer knew or could have discovered through ordinary due diligence and addressed through representations and warranties, emphasizing that the parties could have drafted appropriate carve-outs in the applicable representation and warranty.

Is failure of projections of the target enough?

The target's failure to meet its financial projections is itself generally not enough to create an MAE. A customary MAE definition usually allocates to buyers any risk of failure to meet financial projections and this allocation is reinforced by other provisions commonly included in negotiated agreements. In 2008, in the midst of the financial crisis, the Delaware court in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp. ("Hexion")* found that *Huntsman*, a chemicals company, had not experienced an MAE. Shortly after the signing, *Huntsman* showed poor quarterly earnings for 2008 and *Hexion* claimed the merger, if consummated, would produce an insolvent company, and therefore, an MAE had occurred.

The court noted that "poor earnings results must be expected to persist significantly into the future" to constitute an MAE. The court further noted that the merger agreement "explicitly disclaims any representation or warranty by *Huntsman*" with respect to any projections, forecasts or other estimates. *Huntsman*'s failure to meet projections did not constitute an MAE as the parties had "specifically allocated the risk to *Hexion* that *Huntsman*'s performance would not live up to management's expectations at the time."

Similarly, as is now less common, if the MAE clause specifically includes events that 'would reasonably be expected to be an MAE' or includes an event which is an MAE on the target company prospects, courts are likely to interpret such MAE definitions in ways that provide more buyer flexibility in terms of arguments that COVID-19 could be considered an MAE. Such forward-looking language will still require not a mere risk of an MAE but an evidentiary showing

for such claim, and will tend to focus on how disruptive to business operations a particular effect appears to be.

Synergies of the target are no longer feasible, and the combined company may go bankrupt. In the current situation, a seller may be concerned that if it does not accept a price reduction, the combined company may go bankrupt, whereas the buyer may be concerned that the threat of bankruptcy by the combined company post-closing may not be an MAE. A court will generally not assess the materiality of a potential MAE from the perspective of a buyer's post-closing assumptions unless specifically required by the applicable MAE definition.

The court in *Channel,* for example, declined to take into account the buyer's calculation of loss, including anticipated merger synergies, noting that the target should be valued on a standalone basis. For example, if both the target and the buyer suffer a decline as a result of COVID-19 and the buyer would, as a result, be unable to satisfy the proposed business performance covenants under its financing post-closing, the buyer's decline would be irrelevant to an MAE analysis under guiding case law. Rather, a court's MAE analysis would focus on the target's independent and separate performance.

Are adverse events durationally significant, and how adverse are they? It has long been established that an MAE requires truly significant adverse events with a lasting impact on the target's business. In its final analysis, the court in *IBP* required an MAE to "substantially threaten the overall earnings potential of the target in a durationally significant manner." Prior to *Akorn*, an MAE had never been found to have occurred by Delaware courts, even in the wake of the stock market crash of 1987, the bursting of the tech bubble of 2001 and the financial crisis of 2008.

Courts have repeatedly determined that short-term adverse events, even dramatically negative quarterly results, earnings restatements and negative effects of 'acts of god,' such as unusually harsh winters, are not MAE events. Instead, they have focused on whether such events are 'durationally significant,' measured in years of decline in a target acquired by a strategic buyer, with possibly some flexibility for financial buyers.

Courts have evaluated whether in order to constitute an MAE, poor results are expected to persist significantly into the future and have a long-term or lasting impact in light of long-term acquisition strategies such as the multi-year horizon needed to integrate complex businesses. While the exact time horizon that is significant is factual, it is clear that the courts may consider the identity of the buyer and its investment horizon, for example, whether they are a strategic buyer with a longer time horizon, as was noted in *IBP*, and the period of time negotiated as the long stop or termination date upon which the transaction could be terminated.

In *Akorn*, by contrast, the court found a 'dramatic' year-long business decline based on business-specific problems that included, among other things, unexpected new market entrants competing with the target's top products and the unexpected loss of a key customer, with no signs of abating, a sufficient durational effect to constitute an MAE. Note that in *Akorn* the magnitude of the claimed MAE events was significant during this period. In *Akorn*, the remediation costs alone were approximately 21% of the equity value implied by the merger agreement, and court held that 20% "would reasonably be expected to result in an MAE." *Channel* noted that there is no bright-line quantitative test, but seemed to consider 20% as a floor.

Is it also a force majeure, or even something else? Unlike prior iterations of the MAE debate and case law related to solely economic contractions in 1987, 2001 and 2008, the question of whether COVID-19 constitutes an

MAE will likely also be intertwined with similar questions of whether the events constitute force majeure, assuming the contract has such a provision, or whether such events implicated the common law defenses of frustration or impossibility, if the contract does not include a specific force majeure clause.

Similar considerations from those described in this article are involved in such determinations, such as the language of the applicable contract, the nature and scope of the effect on a party's ability to perform its obligations under the contract, and, under some state laws, the steps the invoking party took to avoid the negative consequences of the virus. Most US states recognize common law doctrines similar to 'frustration' or 'impossibility.'

In fact, in a significant Delaware case arising out of the failure to close a transaction as a result of COVID-19, it was unclear from the complaint whether an MAE was invoked by the reticent acquirer. According to Bed, Bath and Beyond's complaint, its buyer, 1-800-Flowers, simply refused to close; while the MAE is described in the complaint, the complaint does not say that 1-800-Flowers expressly asserted an MAE or claimed force majeure, instead simply requesting a delay of the closing as a result of COVID-19 without a clear contractual basis.

Similarly, in another recent case, the We Company filed suit against Softbank in Delaware. Although there was no MAE termination right, other than an absence of MAE representation related to other closing conditions, in the financing and tender offer agreement, Softbank refused to close the transaction in response to circumstances alleged by We Company to be similar to an MAE.

Moreover, Woodward and Hexcel Corp. jointly called off their all stock merger of equals given the radical swings in value, both had recently fallen over 50% in value. These events indicate that COVID-19 may transcend some of the customary MAE arguments and involve new fact patterns and approaches than prior MAE case law arising during previous economic downturns.

MAE metrics and benchmarks. In the world of COVID-19, the length of the quarantine, business interruption, furlough or other adverse events will be relevant to determining an MAE. What we know is that the determination of an MAE and whether events are sufficiently severe to constitute an MAE will be intensely fact specific. When considering the measurements of materiality, courts will generally take into account both quantitative and qualitative aspects of the transaction in question.

Although financial metrics, e.g., impact on EBITDA, are the clearest indicators of adverse changes, courts are demonstrating a willingness to consider strategic benefits and risk profiles when assessing the materiality of adverse change. In *Akorn*, for example, the court referenced an 86% decline in EBITDA amongst other relevant circumstances referred to above, and upheld the MAE. By comparison, in *IBP*, the court found that a 64% drop in a beef producer's quarterly earnings as a result of a severe winter followed by a return to performance in line with prior years' results did not constitute a MAE.

Akorn is a 246-page decision that painstakingly reviews a detailed and lengthy post-trial factual record, but certain issues are likely to be particularly relevant. For example:

- How severe and durationally significant is the negative effect? And, how much is that effect related to the industry as a whole, generally allocated to the buyer, or the specific target company, generally allocated to the seller?
- Does the target company or the buyer have any evidence of wrong-doing or bad faith, such as:
    - Compliance problems? In *Akorn*, the courts found "overwhelming evidence of

widespread regulatory violations and pervasive compliance problems."

o Failure on the part of the buyer to diligently comply with its contractual obligations?

In *Channel*, where no MAE was found, the court believed that buyer Boston Scientific displayed a "lack of good faith" and that the buyer was "looking for a way out of its deal." The court's analysis focused on the fact that Boston Scientific did not generate a "single scrap of paper" assessing the impact of fraud by an executive on marketing of a new product, noting that the lack of any such documentation "casts doubt on the bona fides of the termination decision."

How to Limit Risk in Ongoing Contract Negotiations

When negotiating acquisition agreements, parties should specifically address how the current volatility affects the transaction. Buyers in particular should expressly provide if there are any risks arising from the outbreak that they are not willing to take in the form of express conditions.

Research the specific basis for making or responding to any MAE claim. Although it appears potentially obvious, because the determination of whether an MAE has occurred is highly contextual and will be evaluated against the specific language of and exclusions from the negotiated MAE definition, the facts of the particular company, the metrics related to such facts and the exact time period at issue will be critically important in assessing risk related to MAE claims. In addition, the parties should understand how COVID-19 affected other companies in the target's industry, and the extent to which the impact on the target may or may not have differed.

- *MAE definition changes.* In the short timeframe since the outbreak, parties are expressly addressing the 'elephant in the room' in multiple contractual provisions. Most directly, on the sell-side we are seeing more specific exclusions of pandemics, epidemics and COVID-19 in the definition of an MAE. We are also seeing similar express exceptions in force majeure clauses and express waivers of the doctrines of frustration and impossibility. Finally, there is significant resistance from sellers to include prospects and financial performance in the MAE definition, and buyer attention to the inclusion of carve-backs for disproportionate effects on the particular business.

- *MAE — market outs.* In particular, if a buyer is sensitive to closing in the face of adverse market conditions, they might consider including specific financial performance triggers relating to macro-economic or target-specific measures, e.g., Nasdaq or some other index falls more than a specified percentage, or specific EBITDA thresholds applicable to the target. Moreover, to lessen risk, buyers can try to expand the package of interim covenants in a purchase agreement, for example, include restrictions on borrowings, management of the workforce or plant shutdowns, which if materially breached would allow the buyer to terminate the purchase agreement, without liability.

- *Case law responsive definitions.* As courts are unlikely to account for post-closing synergies in determining whether an MAE has occurred, and the definition of durational significance is uncertain, buyers may consider negotiating to include express references to synergies or limitations on durational significance in the MAE definitions.

- *Reverse termination fees, quantified MAEs.* Reverse termination fees, payable by a buyer if the deal falls through, may become more common as ways to provide negotiated outs in the face of uncertainty. They are an existing market concept and as such have the advantage of clear and well thought out precedent. For example, following the previous financial crisis, some agreements started to include specific dollar thresholds that qualified as an MAE. This trend abated following improved market conditions, but the approach can be considered to provide clar-

ity, particularly for transactions being negotiated during current turbulence.

- *Adjust outside dates.* Given the uncertainties around how quickly any regulatory approvals may be obtained and that financing may now take more time, the parties may consider extending outside dates or including a provision in the purchase agreement for extensions based upon regulatory authority slowdowns or shutdowns. Longer outside dates may, however, impact the proof required to show a sufficiently durationally significant MAE.

- *Locked box deals troublesome for buyers.* Given uncertainties around target performance, we may see deals that initially contemplated locked box mechanics revert to the traditional working capital adjustment provision to limit risks in declining working capital for buyers. We also are seeing a new layer of negotiations to establish working capital targets since historic levels, a typical benchmark, may be less relevant.

By thoughtfully considering these and other factors, within the construct of contractual interpretation, parties can actively mitigate risk and more likely achieve their respective transactional goals.

Does Special Committee Approval Protect a Transaction Involving a Conflicted Board Majority?

By Steve Haas, Partner of Hunton Andrews Kurth LLP

In a recent case, the Delaware Court of Chancery held that a transaction in which a majority of the directors had a conflict of interest (a "conflicted board majority transaction") could still be subject to the business judgment rule if it was approved by a special committee of disinterested and independent directors. The special committee, however, must be in place from the outset of the transaction.

Court of Chancery's Opinion

In *Salladay v. Lev,* the Court of Chancery addressed a conflicted board majority transaction that was approved by a special committee.[1] Three of the six directors on the company's board were allegedly interested in a merger based on a variety of allegations, including that (i) they or their affiliates were rolling over "substantial portions" of their equity in the merger; (ii) one of them (the chairman and chief executive officer) received severance compensation and entered into an 18-month consulting agreement with the acquiror; and (iii) in connection with the merger, two of them exchanged existing notes held by the company for new convertible notes on more favorable terms.

In ruling on the defendants' motion to dismiss, Vice Chancellor Glasscock wrote that the standard of review for approving the merger, as a conflicted board majority transaction, was entire fairness unless the merger was approved by a special committee[2] or by a majority of fully informed stockholders under the Corwin doctrine.[3] He also held that the defendants had the burden of invoking either doctrine.

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1 C.A. No. 2019-0048-SG (Del. Ch. Feb. 27, 2020).

2 See also *In re Trados Inc. Sholder Litig.,* 73 A.3d 17, 55 (Del. Ch. 2013) ("The decision not to form a special committee had significant implications for this litigation. The Merger was not a transaction where a controller stood on both sides…. If a duly empowered and properly advised committee had approved the Merger, it could well have resulted in business judgment deference."); see also *Frederick Hsu Living Tr. v. ODN Holding Corp.,* 2017 WL 1437308 (Del. Ch. Apr. 14, 2017) ("If the board delegates its full power to address an issue to a committee, then the judicial analysis focuses on the committee. A decision made by a disinterested, independent, and informed majority of the committee receives business judgment deference."); *In re PNB Hldg. Co. S'holders Litig.,* 2006 Del. Ch. LEXIS 158, at *3-4 (Ch. Aug. 18, 2006) ("In this conflicted situation, the [] directors are bound to show that the Merger was fair… or to point to the presence of a cleansing device, such as approval by a special committee of independent directors or an informed majority-of-the-minority vote, in order to justify review under the business judgment rule.").

3 See *Corwin v. KKR Holdings LLC,* 125 A.3d 304 (Del. 2015).

In examining the effect of the special committee in this case, Vice Chancellor Glasscock borrowed from controlling stockholder jurisprudence under *Kahn v. M&F Worldwide Corp.,* which held that a special committee must be in place from the outset of the transaction.[4] This is sometimes referred to as the "*ab initio*" requirement.

Vice Chancellor Glasscock reasoned that "[t]he acquirer—as well as any interested directors—must know from the transaction's inception that they cannot bypass the special committee." "Even in a non-control setting," he continued, "commencing negotiations prior to the special committee's constitution may begin to shape the transaction in a way that even a fully-empowered committee will later struggle to overcome."

Applying this rule,[5] the Court of Chancery held that the company's special committee was not in place "before any substantive economic negotiations began." Among other things, the plaintiff alleged that the following events occurred prior to the formation of the special committee:

- the acquiror met with two of the interested directors to "provide an overview of the Company and its financing needs, outline in broad terms how an acquisition of the Company might be approached, and gain an understanding of the [acquirer's] intentions";
- the company and the acquiror entered into a confidentiality agreement and "began a detailed due diligence process";
- the acquiror's investment banker discussed the transaction with an interested director;
- one of the interested directors told the acquiror to "base an offer on the 'independent value' rather than the trading price" of the company's stock, and "effectively told" the acquiror that the board of directors "would be receptive to an acquisition offer of $3.50 to $4.00 per share; and
- the acquiror and the company continued discussions for an additional week.

The plaintiff further alleged that the acquiror's first bid was $3.50 per share—i.e., at the bottom of the range suggested by the interested director—and that the final per share price was just below the midpoint of the range.

Based on these allegations, the court held that it was reasonably conceivable that "these discussions prior to the Committee's []constitution essentially formed a price collar that 'set the field of play for the economic negotiations to come.' " This was so even though, according to the company's disclosure, the interested director informed the acquiror that he did not have authority to negotiate and was offering only his personal view.

Conclusion

Salladay confirms that a conflicted board majority transaction can be reviewed under the business judgment rule if it is conditioned on the approval of a special committee. This includes related-party transactions that are not submitted for stockholder approval.

By applying the *Kahn v. M&F Worldwide* framework, however, *Salladay* makes clear the importance of process in forming and empowering a special committee at the outset of a transaction. Interested directors and potential counterparties to corporate transactions should be aware of this ruling, which indicates that some preliminary discussions with interested directors may deprive them of the business judgment rule's protection in litigation.

As the court noted, the *Corwin* doctrine similarly would have resulted in business judgment rule review. That is, outside of the controlling stockholder context, a transaction that has been

4 See *Kahn v. M&F Worldwide Corp.,* 88 A.3d 635 (Del. 2014).

5 See also *Flood v. Synutra Int'l, Inc.,* 195 A.3d 754 (Del. 2018); *Olenik v. Lodzinski,* 208 A.3d 704 (Del. 2019).

approved by a fully informed and uncoerced vote of a majority of disinterested stockholders will be reviewed under the business judgment rule.[6] Here, however, the court found that the stockholders were not fully informed when approving the merger.

Finally, *Salladay* contributes to the post-*M&F Worldwide* case law governing controlling stockholder transactions. Specifically, its treatment of the *ab initio* requirement and what it deemed to constitute substantive economic negotiations may be instructive in future freeze-out mergers and other controlling stockholder transactions.

A Dealmaker's Guide to Post-COVID-19 Purchase and Sale Agreements

By Matthew T. Simpson, Partner, and Bethany Hickey, Associate, of Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C.

As the global COVID-19 pandemic continues, M&A activity has slowed considerably, with buyers and sellers taking a "wait and see" approach to the markets. When dealmaking eventually resumes, and for those few deals that nevertheless continue during the pandemic, dealmakers should update their purchase and sale agreements to account for the impact of COVID-19 on target companies and the new dealmaking environment.

To assist dealmakers in this task, we convened a firm-wide interdisciplinary team to propose a drafting guide for purchase and sale agreements in the post-COVID-19 era.

With an eye toward making this material as accessible and user-friendly as possible, our format tracks that of a typical stock purchase agreement, marching through key considerations in the order in which they typically appear. We take an industry-agnostic approach as we expect much of our analysis will apply across industries, and while we have endeavored to be comprehensive, these considerations are by no means exhaustive, and are subject to change as the pandemic progresses and the dealmaking environment changes in response.

Deal Economics

Consideration. Except for those few targets that come out of the pandemic on top, expect buyers to reduce purchase prices and shift a portion of the consideration to post-closing (e.g., earn-outs) or to incorporate forms of non-cash consideration (e.g., stock consideration, seller notes).

Working Capital Targets. Buyers and sellers will need to work with their financial advisors to confirm the appropriate time periods for the calculation of working capital targets and any COVID-19-related adjustments.

True Up Procedures. Given expected adjustments and the fluidity in targets' financial operations, consider requiring sellers to deliver the estimated numbers more than just a few days prior to closing to allow buyers more time to review the estimates. Buyers should push for a seller obligation to make available to the buyer all information necessary to review the estimates, and a right for the buyer to approve such estimates, subject to a reasonableness standard, or, alternately, a right to propose changes to the estimates that the seller(s) must consider in good faith. Additionally, consider extending the post-closing true up period to allow the buyer more time to review the estimated

6 See *Larkin v. Shah,* 2016 WL 4485447, at *1 (Del. Ch. Aug. 25, 2016) ("In the absence of a controlling stockholder that extracted personal benefits, the effect of disinterested stockholder approval of the merger is review under the irrebuttable business judgment rule, even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors.").

working capital numbers.

Escrows. Buyers should consider pushing for increased working capital escrow amounts to account for the variability in the financial operations of the target and the potential that true ups will be more significant.

Accounting Principles

Financial terms (working capital target, EBITDA, etc.) should be drafted taking into account any short- or long-term changes that were made to the target's standard accounting practices in response to the pandemic (for example, treatment of government funds received in connection with the COVID-19 response (grants, bailouts, etc.)). Expect buyers to push for adjustments to EBITDA to exclude COVID-19-related unusual revenue and gains, and sellers to seek to adjust EBITDA to exclude temporary and non-recurring costs.

Representations and Warranties

COVID-19 Disclosures. To avoid parsing out the impact of the pandemic on each representation, expect sellers to argue for broad COVID-19-related disclosures, with buyers resisting any such broad disclosures.

Capitalization/Ownership of Equity. Confirm ownership rights and whether any defaults/foreclosures have occurred during the pandemic that might affect ownership or transferability of equity.

No Violation. Given the increased risk of financial stress and proactivity of contract counterparties to adjust contracts that are now considered off-market, confirm all required consents and notices are appropriately scheduled, including those relating to any CARES Act loans or other contracts signed during the pandemic. For transactions that are priced lower than pre-COVID-19 pricing, also consider whether the target validly authorized the transaction and any risk relating to breaches of fiduciary duties (Revlon, etc.).

Financial Statements. Confirm with financial advisors that any extraordinary measures taken during the pandemic were properly accounted for in compliance with GAAP (or other applicable standards). Expect buyers to require sellers to schedule any material deviations from GAAP and/or the target's standard accounting principles.

Accounts Receivable/Payable. Expect additional scrutiny to the target's accounts receivable and payable, in particular any AR and AP deferrals and write-offs. Sellers should also be prepared to schedule and defend bad debt reserves.

Absence of Certain Changes. Sellers will have multiple new disclosures related to this representation, including, for example, those related to:

- Changes in lines of business (for example, a distillery that pivoted to manufacturing hand sanitizer during the pandemic);
- Supplier/customer changes;
- Reductions in force ("RIFs") or temporary shutdowns;
- Write-offs and AP forgiveness;
- Draw-downs on revolvers;
- Changes in accounting methodology or cash management practices;
- Insolvency proceedings;
- Government orders; and
- Tax extensions.

Environmental Matters. Phase I and other environmental inspections require onsite visits. Work with environmental consultants early in the process to identify their operating limitations and expected timelines.

Real Estate. Work with title companies early in the process to identify operating limitations and expected timelines. Additionally, confirm that any improvements to facilities (e.g., reconfiguring manufacturing facilities for COVID-19-related manufacturing) were done in compliance with all regulatory and contractual obligations.

Employment, Labor and Benefits. COVID-19 is impacting nearly every element of employment, labor and benefits representations and warranties. When drafting a purchase agreement, consider the target company's compliance with, among other things:

- Governmental telework, shutdown and sick leave orders;

- Disability laws (for example, in the event an employee is particularly susceptible to COVID-19 and requires alternative work arrangements in the absence of a governmental order to do so);

- Family leave laws (for example, in the event an employee's family member is particularly susceptible to or has already contracted COVID-19);

- Occupational safety requirements to keep employees safe from contracting COVID-19;

- For those industries that went into "overdrive" (such as online marketplace websites (e.g., Amazon) and medical facilities), overtime laws;

- Discrimination and privacy laws (for example, an employer cannot ask employees about their health conditions or whether they have had contact with individuals of certain ethnicities);

- Where plan asset values of multi-employer defined benefit pension plans have declined in line with market changes, whether contributions have been made in response to the foregoing in accordance with pension plan rules and credit agreements;

- If the target issued any equity-based compensation during the pandemic, consider whether FMV determinations made prior to the pandemic are still valid (i.e., whether a new 409A valuation is required);

- If RIFs were undertaken in response to the pandemic, whether they were done in accordance with law, whether severance obligations have been discharged and whether any WARN Act concerns exist; and

- During the pendency of the pandemic, many collective bargaining agreements were renegotiated; expect representations and warranties to the effect that such renegotiations complied with applicable labor laws.

Taxes. The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) passed by Congress includes several changes to tax laws.

Pursuant to the CARES Act, employers are permitted to defer the employer portion of social security (6.2% on employee wages) for the remainder of 2020, which deferred portion is required to be paid over the following two years.

Some companies are also eligible for social security tax credits under the CARES Act. Buyers should require the target to represent what credits the target has used. The buyer should also be indemnified for improperly used or miscalculated credits by the target.

Insurance. Confirm whether insurance coverage was available for any COVID-19-related losses (political risk insurance, civil authority coverage, D&O, EPLI, etc.) and related waiting periods (many policies have waiting periods of several months). Additionally, identify whether insurance proceeds for COVID-19-related losses are properly owned by the seller(s), or, alternately, belong to the buyer, and draft appropriate mechanisms to allocate ownership of the proceeds accordingly.

Material Contracts. The pandemic will place considerable stress on the target's material contracts. Confirm that all such contracts are in full force and effect, that there is no breach thereunder by any party thereto and that no counterparty has threatened to cancel the contract or implement a material reduction related thereto. Also, be sure to include any new contracts entered into during the pandemic/

outside of the ordinary course of business, including any government loans or other assistance.

With an eye towards post-closing integration and operation, buyers should review force majeure provisions in material contracts to confirm the target's rights and obligations. If counterparty performance is at risk, buyers should thoroughly analyze the impact of such excuse on the target's business and downstream performance.

Inventory. Inventory with a short shelf life may be outdated or stale if demand was reduced during the pandemic. Expect increased scrutiny on inventory representations and related disclosures.

Information Technology. The target's IT system's ability to handle spikes in telework should be reviewed, including compliance with licenses, sufficiency of infrastructure, data security and compliance with internal policies.

Data Privacy. Expanded remote working makes targets more vulnerable to cyberattacks. Buyers should thoroughly diligence security procedures and practices, as well as test vulnerabilities.

Compliance with Laws/Government Orders. Businesses in otherwise lightly- or non-regulated industries are increasingly subject to emergency orders covering operational shutdowns, telework requirements, manufacturing priorities, etc. Sellers should include these pandemic-related orders in their disclosures, and buyers should diligence the target's compliance with the same.

Supply Chain. Given the supply disruptions resulting from the pandemic, consider whether new representations addressing the target's supply chain and related resiliency matters should be added. Such a representation may cover mapping of the supply chain and statements relating to resiliency. It may also make sense to take a deeper-than-normal dive into supply-chain diligence, for example, to uncover geographic concentration risk.

Buyer Representations and Warranties

In a time of unprecedented market volatility, the risk of buyer insolvency is increased. As such, sellers may want to push more aggressively for a solvency representation. Buyers may be willing to live with a solvency representation to the extent it is qualified by the veracity of the seller representations and warranties, without regard to any materiality or similar qualifiers.

Sellers should also consider more thorough-than-normal seller diligence of the buyer's authority and compliance with laws representations to confirm the pandemic didn't impact the buyer's ability to execute on the transaction.

Interim Period Covenants

Debt Payoff. With closing certainty at higher risk, prepayment notices are more likely to be withdrawn. Existing credit agreements should be reviewed early in the process to ensure that prepayment notices can be sent contingent on the closing.

In a market where lenders are eager to refinance, they may be less likely to permit a payoff letter to be withdrawn unless the credit agreement permits as much. Parties should also consider reaching out to lenders earlier in the process to confirm any changes to their prepayment processes or timelines.

Operating Covenants. Obligations to operate the business "in the ordinary course of business" will need to be reviewed and better defined. Sellers will look for a broad exception that would allow them to respond to the impact of the pandemic on the target's business. Buyers will likely respond asking for oversight/notice of any such decisions.

Specific activities to consider in light of the pandemic include: (i) changing telework arrangements; (ii) expansion of sick leave policies; (iii) extensions of, or requests for, trade credit in amounts or durations not typical for that business; (iv) delays or cancellations of orders

(from either the supplier side, the customer side, or both); (v) operational shutdowns; (vi) increasing capital expenditures related to

enabling remote working; and (vii) amending material contracts.

Information Sharing. U.S. antitrust agencies have identified legitimate reasons for companies to exchange information during a crisis (diligence of compliance programs, integration of COVID-19 response, etc.). Nevertheless, companies should identify legitimate goals for information exchange that are pro-competitive or competitively neutral and ensure that all communications with competitors are limited to what is reasonably necessary to achieve those goals. Further, any such exchange should be voluntary for each company to adopt at its own discretion.

HSR Approvals. Preparing filings may take longer than usual, as management teams are stretched thin responding to the pandemic and required data may not be as readily available. In addition, if there ends up being a backlog of deals to approve, approval processes may take longer, so parties should be prepared to "pull and refile" with more frequency.

Consider extending deadlines for preparing and submitting filings. Also, note that the FTC and DOJ have suspended early termination and require all HSR filings to be made through a temporary e-filing system.

Closing Conditions and Termination Rights

Financing. Given the challenging credit markets, buyers will likely push more aggressively for financing outs. We may see a rise in reverse break fees as a result.

Third-Party Consents. Many businesses are evaluating existing contracts to identify those that are no longer "market" in the post-COVID-19 era. Where a contract is favorable to a counterparty (e.g., many real estate leases), we expect the counterparty to consent to transactions in the hope of maintaining such favorable terms. Where a counterparty believes a contract is off-market against their interest (e.g., certain long-term supply contracts), however, we expect those counterparties to couple any consents with a rebalancing of the terms.

Dealmakers should also be mindful of the fact that contract counterparties may be short-staffed and struggling to work remotely, causing a delay in response times. If the counterparty is in financial distress, lenders may also be involved in ordinary course decision-making, and approvals may take longer.

Outside Date. Given the potential additional time needed to obtain antitrust and other third-party consents, longer "outside" or "drop-dead" dates may be appropriate and consideration should be given to automatic extensions of any such outside or drop-dead date if the delay is related to COVID-19.

Indemnification

Fraud. When markets are down, management teams and sellers often feel increased pressure to deliver value to shareholders. Increased attention should be paid to fraud diligence and recourse.

Limitations of Liability. When dealmaking resumes, we would expect a shift towards more buyer-friendly indemnification terms, in particular for distressed targets. Expect to see buyers resist the pre-pandemic trend towards no-recourse deals and push for more seller "skin in the game."

R&W Insurance

R&W Insurance Underwriting Process. Expect underwriters to focus on COVID-19-related issues and the operation of the target during the pendency of the pandemic. Buyers will need to demonstrate thorough diligence of these topics, and should be prepared to support any judgment calls. Buyers that are repeat customers (i.e., private equity firms and serial acquirers) with

existing relationships with leading brokers and underwriters may fare better than other buyers who are new to the product or whose diligence process is less tested and trusted.

Exclusions. R&W insurers have begun to push for COVID-19-related exclusions, ranging from blanket exclusions for all related losses, to more targeted exclusions focusing on employment and supply chain issues. Buyers should work closely with their R&W insurance broker and legal team to narrow these exclusions as best as possible.

R&W Insurance Policy Pricing/Terms. It is too early to tell what impact COVID-19 will have on R&W insurance pricing. In the short term, given the light deal flow, we may see underwriters compete more aggressively for market share, which could result in decreased premiums. That said, as underwriter balance sheets become threatened and claims eventually increase, we may see premiums drift upward.

Claims Activity. Following the adage that indemnification claims spike when markets drop, we would expect increased claims activity.

Disclosure Schedule Updates. Sellers may push for the right to update disclosure schedules during the interim period in response to pandemic-related changes and events. Note that any such updates will be excluded from the R&W insurance policy and therefore buyers are likely to reject this concept or insist upon any or a combination of purchase price adjustments, walk rights or bullet indemnities for any material disclosures.

Post-Closing Covenants

Employee Benefits. Obligations that the buyer maintain certain employment levels/terms will need to be tailored to reflect ordinary course levels/terms, and not necessarily those levels/terms that were implemented during the pandemic (which may be higher or lower, depending on the industry).

D&O Indemnification. While markets are down, shareholders may seek to recapture value by suing management teams for improperly reacting to the pandemic. Buyers should carefully diligence all target shareholder communications, as well as the target's management response, to see if any such suits are threatened. To minimize exposure, sellers should push for robust post-closing D&O indemnification rights, including D&O tail policies.

Further Assurances/Cooperation. Generally, the open-ended nature of these provisions should be sufficient to cover any post-closing cooperation needs. However, buyers will struggle with the task of integrating a business that has seen considerable disruption as a result of COVID-19, particularly if many or most of the relevant employees are teleworking for the first time. Accordingly, consider whether specific post-closing support terms are appropriate (for example, in a TSA).

Defined Terms

Cash. Consider whether "Restricted Cash" includes government funds received in connection with the COVID-19 response (grants, bailouts, etc.) and whether any other adjustments to the definition of "Cash" are required to account for the pandemic's impact on the balance sheet of the target.

Governmental Authority/Law. Continue to review these definitions to ensure they capture any new laws/regulations and regulatory bodies/committees created in response to the pandemic that might be applicable to, or have jurisdiction over, the target.

Material Adverse Effect. Sellers should consider adding "pandemic," "epidemic" or "COVID-19" to their definitions of Material Adverse Effect. In response, buyers are likely to require that the pandemic not disproportionately impact the target (as compared to the target's industry at large) for the carve-out to apply. Note this is particularly

important in delayed sign-and-close transactions, where the MAE definition is critical for termination rights.

Miscellaneous

Force Majeure. Consider whether a force majeure provision permitting delay of performance of obligations during the pendency of such force majeure is appropriate. If such a provision is included, sellers should try to limit the buyer's ability to delay the closing during the pendency of a force majeure if all other conditions to closing are otherwise met.

Dispute Resolution. Consider the merits of ADR as a more flexible form of dispute resolution over litigation, especially as courts scramble to catch up with months-long closures. For any internal disputes (working capital adjustment disputes, indemnification disputes, etc.), consider expressly permitting video/virtual meetings to allow the continuation of any such proceedings during periods of restricted mobility.

E-Signatures. During the pendency of the pandemic, executive officers may not have regular access to printers/scanners. Accordingly, parties should be flexible and accommodating in permitting use of DocuSign and electronic delivery of documents. Lenders will still likely require wet-ink signatures, but are more likely to close on PDFs and require delivery of originals post-closing.

Rise of the Activist Investor: The Shift from Active to Passive

By Cas Sydorowitz, Global Head of Activism and M&A, Georgeson

Trillions of dollars moved from active management funds to passive funds in the last two decades. Passive investments, including index, mutual and exchange-traded funds (ETF), increased from $220 billion twenty years ago to $7 trillion in 2018, according to Morningstar, Inc. This can make it more difficult for active funds to keep clients, client inflows and investments.

On the other hand, passive funds, such as BlackRock, State Street and Vanguard, have been on the rise with an influx of clients and increased assets under management. The asset management industry — both active and passive investors — has gained momentum, with topical issues such as remuneration, board diversity as well as environmental, social and governance (ESG). Their efforts to hold management teams and boards accountable for their actions and creating sustainable business models are designed to provide the checks and balances, without the need for them to get directly involved in any of the companies in which they invest.

The Rise of Passive Funds and Activist Investors

Active managers, such as T.Rowe, Capital Group, Fidelity and others, are paid to use their skills in stock selection and bottom-up analysis to create a portfolio that will grow over time. They will look at market opportunities as well as sector cycles and then select the specific companies that will create the most value for their own clients. Their fees for this are higher than the passive index funds or the ETFs, some of which don't charge their clients any fees.

The success or failure of these funds is often down to star portfolio managers, such as Mark Mobius or Neil Woodford. When their funds have performance problems or those individuals leave, the clients often follow the portfolio managers out the door. Most ETFs and index funds don't have the same challenges in retaining client assets.

Activist Investors: Creating Shareholder Value and Long-Term Gain

Clients pay activist investors to work on the companies in their portfolio with the goal of creating greater value. With several years of research and a hyper-focused portfolio of 10 to 15 companies, activists host a continual

dialogue with different stakeholders to test and prove their thesis. However, if one of their 10 or so investments is wrong, the underperforming investment will stand out prominently, whereas an active manager may have many underperforming companies, but a balanced portfolio makes up for those underperformers.

The research an activist undertakes to stress test their assumptions enables them to:

- Demonstrate an intimate, in-depth knowledge of the company that is as good as, if not better than, many of the non-executive directors. Those directors are likely allocating two or three days a month to the board and will not have the capacity or time to do the same extensive research.

- Illustrate to other investors how serious the investment is for them and how they have identified the lever that will create value for all shareholders. The activist takes the market, the competitive landscape and other external sources into consideration. They will hire industry experts, law firms, PR firms, research and restructuring firms to provide the best insight and solutions to existing, underlying problems.

One such activist investor, Elliott Management, is notorious for buying shares and pressuring companies into making changes — from mergers and acquisitions to divestitures and electing board members to refresh the board — all to increase shareholder value.

While controversial at times, Elliott Management and its founder, Paul Singer, are playing the long game, seeking the best return on shareholder value. In fact, Elliott's investments yield an annual return of approximately 14% on average.

By contrast, many asset managers have a long-term track record that leaves more to be desired.

In *The Wall Street Journal* Op-Ed on October 19, 2017, Paul Singer wrote, "On a company-specific level, however, with thousands of companies to be evaluated, it is impossible for [index managers] to do the kind of comprehensive financial and operational analysis required to identify corporate situations in need of change. Activist investors can play this critical role."

Since Singer's Op-Ed, index funds have considerably grown their assets under management. Activists will try to engineer the best returns for their investors by continuing to push for companies to create value. Activist investors play a prominent role in the market and are here to stay for the foreseeable future. Activists seek to create value collaboratively and not contentiously.

In the current market environment, stock prices are at a five- to ten-year low creating investment opportunities for shareholders. With this unprecedented global crisis, it is nearly impossible to predict the market let alone the actions of index funds investors. As indices fall, investors may seek to return to active managers.

Or, perhaps, investors and other stakeholders may see long-term benefits in activists as they continue to push companies to create better value.

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