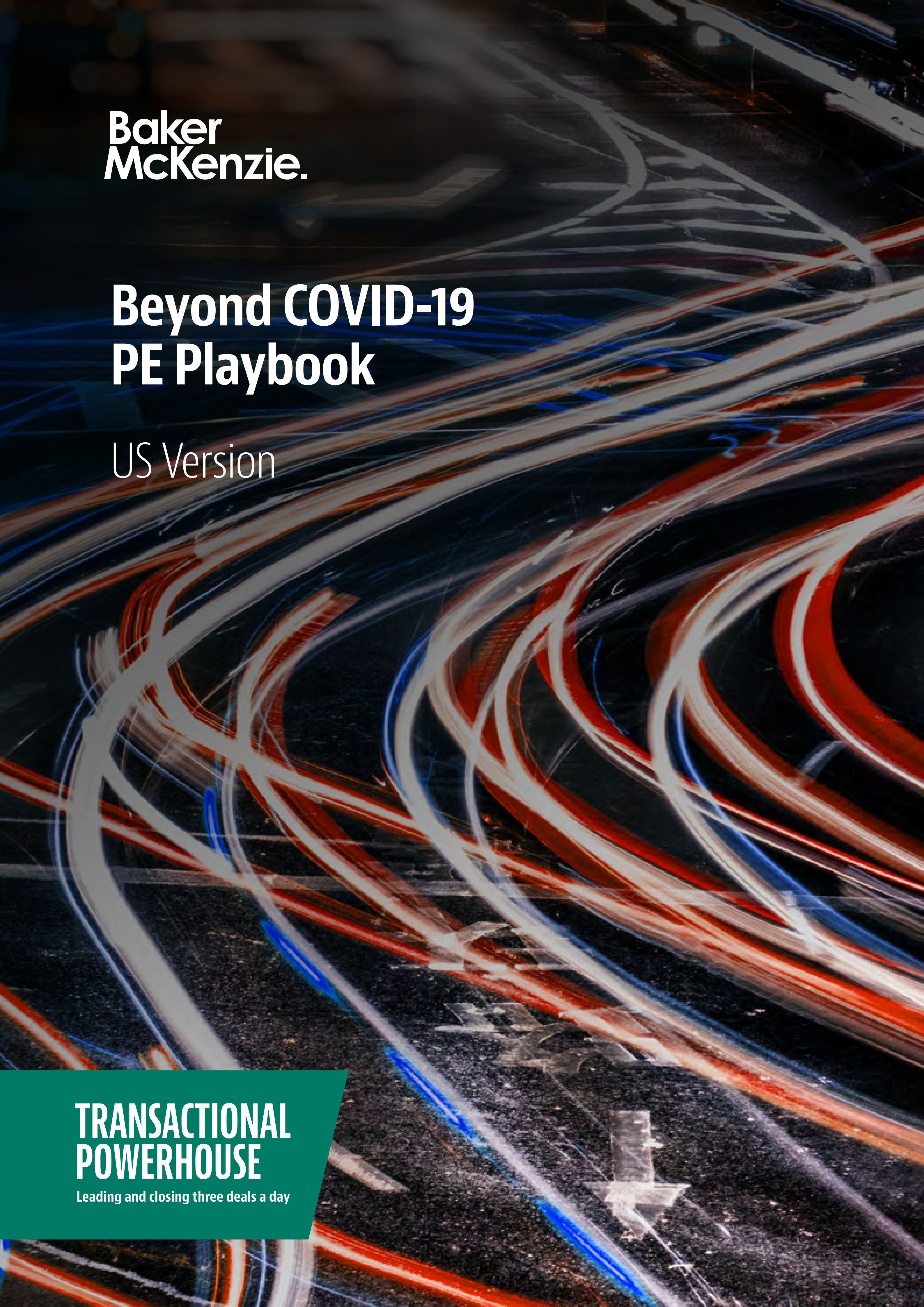
Baker McKenzie.

Beyond COVID-19 PE Playbook

US Version



TRANSACTIONAL POWERHOUSE

Leading and closing three deals a day

Contents

1

Distressed M&A

Distressed M&A

Any downturn tends to produce a surge of distressed M&A opportunities and the current crisis will be no different. Investments in distressed companies follow a different set of rules to "normal" M&A transactions, bringing additional complexity in terms of the stakeholders involved and deal structuring, as well as a particular set of challenges for due diligence and buyer protections.

Structuring considerations

- **A complex cast:** Restructurings often entail a broad range of protagonists - the equity, senior debt, junior debt, bilateral country debt providers, trade creditors, unions, government(s) and management. Understanding early on where the value breaks, who is driving the deal, conflicts of interest, and who can spoil a deal, are critical. Where distressed funds are involved, be aware that their tactics and strategies can differ significantly from those of traditional buyout houses.

- **Cram-down/process:** Cramming down out-of-the-money creditors and/or equity will be the critical catalyst as to how a restructuring is framed. Techniques vary from country to country, and there may be scope to avail of more debtor-friendly legal systems. Due process is not just a sell-side issue. Buyers need to ensure the restructuring is fair and completed in accordance with the terms of existing agreements and the law to avoid claims and/or the deal being unwound. Court sanctioned restructurings may provide legal comfort. It would be rare for the "sell-side" to provide any meaningful indemnification from claims from crammed-down creditors, so paying special attention to the detail of the restructuring plan and its efficacy will be critical.

- **Loan-to-own strategies:** Credit funds are well-versed with taking positions in capital structures as part of a loan-to-own strategy or otherwise. Even where their fund terms permit investment into debt or mezzanine securities, many buyout funds have stayed clear of such structuring although there has been in the recent years increasing activity in the sponsor backed loan-to-own debt deals. As we enter a period of greater financial strain on business, PE should remain open-minded and creative about more structured deals to achieve control, especially with new opportunities to refinance debt burdened businesses. Having a clear view on the possibilities under the existing credit facilities, capital structure sensitivities and endgame is critical.

Facilitating a distressed deal out-of-court

- **Time pressure:** Sale processes are nearly always on an accelerated basis as insolvency looms. There is often insufficient time for a normal, full due diligence process.
- **Access to information:** One of the biggest challenges for distressed M&A is access to quality information. Promoters of the distressed company have either already been removed or have limited financial upside. In such circumstances, they may not be particularly cooperative and, in the case of historic mismanagement, the information they leave behind may be incomplete and/or poorly organized.
- **Success risk:** Buyers potentially need to commit material resources early in the process in order to address challenging due diligence needs in a fast paced environment; however, given the distressed nature of the target and the many interested parties in any distressed M&A deal, the liklihood of a successful bid may be less clear than in a traditional M&A process.
- **Costs:** In the distressed M&A arena, it is less likely that a seller can absorb or mitigate those costs through break fee agreements or similar. Additionally, obtaining exclusivity (often a prerequisite for a buyer to incur material costs) may be difficult in a fluid distressed sale scenario where seller stakeholders must sell quickly and are seeking to keep all options open.
- **Timeline and certainty:** Sellers/stakeholders likely require a quick sale and may place increased weight on a buyer's certianty to close. Antitrust risk, foreign investment concerns or financing contingencies can derail a bid for a distress asset. Bidders should have committed financing and a clear view of regulatory risk to reduce conditionality and keep to a compressed timetable.
- **Asset deals:** Buyers often prefer an asset purchase transaction in order to limit assumed liabilities, but these are generally more complicated and slower to execute. Asset transactions typically require extensive diligence around transferability of assets, and there is often also a potential requirement for third party consents.
- **Fraudulent transfer risk:** Lack of a robust process in terms of the thoroughness of diligence and the openness to as many bidders as possible may expose a buyer to fraudulent conveyance claims from seller's creditors in transaction structured as asset sales or partial sales. To limit this risk a buyer should consider obtaining a fairness and solvency opinion which may not be feasible given the time and cost constraints. It is also possible to get fraudulent conveyance insurance if the deal has a solvency opinion from a reputable valuation firm and diligence is robust.
- **Rejection of acquisition agreement:** Notwithstandnig the successful negotiation of the acquisition of a distressed target, it is possible that the target would seek bankruptcy protection between signing and closing. Covenants not to delcare bankruptcy are generally not enforceable and the debtor in posesson could reject a pre-bankruptcy purchase agreement unwinding the transaction.
- **Contractual protections:** Sellers are more likely to offer limited (or no) representations and warranties or other contractual protections on the basis that there are known issues and the business is therefore sold 'as is', and/or because the seller itself is facing liquidity and/or solvency issues.

- **R&W insurance:** R&W insurance is often still available in a distressed situation, although certain distressed sellers may not be a good fit for a R&W insurance (such as severely distressed sellers who may not be in a position to support a typical due diligence process or provide typical disclosures). In a distressed situation, a new set of considerations will apply when placing a R&W insurance:
  - insurers will want to understand the factors which led to the target being distressed, and the quality of due diligence will be closely scrutinized (in particular, "internal" due diligence may be problematic, or at least lead to exclusions);
  - the definition of "loss" will need to be carefully considered and agreed up front; and
  - synthetic policies are gaining traction in the context where sellers can't or won't give representations and warranties, especially for businesses in certain jurisdictions and sectors. They can be available even where there is low seller/management engagement (i.e. the lack of disclosure schedules is not fatal) and although pricing tends to be higher than for a "normal" R&W policy.
- **Management incentives:** Finally, as with any buyout, the MIP discussion may create alignment between a PE house and management, which could help facilitate the deal. Be cognizant of the impact of the restructuring on management. Have management lost their investment in the old deal? Can you be creative and replicate that in the new deal (i.e. by providing a company loan to assist management in funding their new equity participation on a non-recourse basis)? This will raise complex tax issues both for the management and the target but if done correctly can be an important enabler for the deal.

Considerations for distressed sales in bankruptcy court

While some of the concerns raised by out-of-court distressed sales (such as the need for robust due diligence) are also present in 363 sales, 363 sales alleviate some of the concerns of out-of-court distressed sales. Most importantly, the buyer in 363 sales acquires the assets free and clear of liens which limits successor liability claims, the bankruptcy court determines that the consideration paid is fair and reasonable which protects against fraudulent conveyance claims, and the contracts can typically be assigned without third party consents. Nevertheless, buyers should consider certain issues that are triggered by 363 sale processes:

- **Stalking horse bid:** The stalking horse bidder has the ability to set the terms of the transaction, including price, assets to be acquired and which liabilities if any will be assumed. The stalking horse bidder will typically have a better opportunity to conduct a thorough due diligence and negotiate deal protections. However, the stalking horse bidder is subject to the risk of being out bid at the auction and may find that competing bidders who are willing to take on a greater amount of liabilities or sign a more seller friendly purchase agreement. While it is typically superior to be the stalking horse bidder, the buyer should consider the added costs and risks associated with taking on this role.

- **Topping bids:** Even if a bidder is not the stalking horse bidder, it is standard that an auction take place before the debtor-in-possession or trustee closes the 363 sale with the stalking horse bidder. A topping bid must be higher than the stalking horse bid plus the termination fee and be made on terms generally as favorable to the bankruptcy estate as the stalking horse bid.

- **Credit bidding:** Secured creditors of the debtor can bid in their debt up to the value of the assets secured by the debt. This creates an opportunity for prospective bidders to acquire secured debt from existing lenders to enhance their bid position in the 363 auction.

- **Costs:** A stalking horse bidder can agree in the purchase agreement the termination fee and expense reimbursement provisions although the court may not approve if these are deemed excessive. Termination fees are typically in the range of 3% of the purchase price.

- **Contractual protections:** The sale of a debtor's assets in a 363 sale is usually made on an "as is" basis. Buyer will typically not have any post-closing recourse against the debtor.

- **R&W insurance:** In a Section 363 asset sale process numerous post-closing risks that would ordinarily be covered by R&W insurance are mitigated or eliminated as part of the court sanctioned process. However, R&W insurance is often still available for post-closing risks that are not extinguished through a court process (e.g., product liability, regulatory and compliance issues).

The "failing firm" defence: an opportunity for PE?

PE bidders should also be aware of the opportunity that the downturn may bring for add-on deals of distressed businesses, which were previously considered too hard due to antitrust reasons. A number of antitrust regimes have a 'failing firm' concept (generally a business facing bankruptcy with reorganization being unrealistic), whereby in certain circumstances an alternative framework will apply for assessing the merger and the antitrust authorities may allow the transaction to proceed despite underlying competitive concerns. The objective in these situations is to prevent the business of the 'failing firm' from exiting the market altogether. These deals are rare and highly fact-specific but may offer opportunities, both for add-on creativity and PE intervention where such deals are proposed by others and PE can show itself as an "alternative purchaser".

In the US, the relevant framework for the DOJ to assess a failing firm scenario is:

(i) the allegedly failing firm is unable to meet its financial obligations in the near future;

(ii) it would not be able to reorganize successfully under Chapter 11 of the Bankruptcy Act;

(iii) it has made unsuccessful good faith efforts to elicit reasonable alternative offers (above liquidation value) that would keep it in the relevant market and pose a less danger to competition; and

(iv) absent the acquisition, it would exit the relevant market.

The same general considerations govern "failing division" defenses, which allow a healthy company to sell one of its divisions despite potential competitive concerns.

The "flailing firm" defense, by contrast, applies when one of the merging parties, while not on the verge of bankruptcy, is a "weakened competitor." That weakened state suggests that it cannot compete effectively in the future, thereby rebutting the implication of high market shares and the presumption that a merger will have anticompetitive effects.

Both the "failing firm" and "flailing firm" defenses typically face high hurdles for winning approval and it is yet to be seen whether the agencies will reassess given the current climate.

2

PIPEs

PIPEs

COVID-19 has forced everyone to talk about liquidity relentlessly. Many listed companies may have fixed their immediate liquidity needs but will need more funding going forward. This likely means that, alongside the usual secondary capital raising structures, we will start to see more PIPEs (private investments in public equity), which should give rise to opportunities for PE funds. The US has seen a significant number in the first five months of 2020 - over 500 PIPEs raising nearly $30 billion.

Why now?

- Many companies have reacted quickly and taken steps to reduce overheads and to preserve or create liquidity, drawing down on revolving credit facilities or putting in place new working capital facilities. Others have tapped the equity markets. However, early movers may have had an advantage while the window was open; the "equity story" of second movers may face greater scrutiny and shareholders may be less willing to fund traditional secondary offerings in the future.

- Dry powder is at record levels and valuations of listed companies are currently at a historic low point in many sectors.

- PIPEs can be put in place quickly and without requiring public disclosure that a transaction is imminent (which could have a significant effect on the stock price) - they frequently have short timetables and are often structured in a way that avoids the need for shareholder approval or a prospectus. The sale is typically conditioned upon the filing of a resale registration statement and approval by the SEC declaring the registration effective.

- PE investors can acquire equity in target companies that need liquidity at attractive valuations at a discount to market which, when added to already depressed valuations in current climate, creates an opportunity to book gains similar to those in an LBO.

- In a PIPE deal, investors have an ability to get close to a potential take private candidate where the target board would not approve a sale at current market valuations.

- PIPEs have for many years been a common feature of the US market, where pre-emption rights are not a default feature of corporate laws on new share issues.

- They are also relatively common in some European countries, with the notable exception of the UK. However, there are some signs in the UK that the tough stance institutional investors have taken on pre-emption rights (and the vocalized desire for issuers to respect these) may now soften, given the unprecedented demand for liquidity expected in certain sectors.

- There is no one-size-fits-all PIPE transactions as creative investors will look at legal and regulatory parameters and look to structure around them, (e.g. combination of common stock, convertible preferred equity and (convertible) debt, or quasi-debt) and investors may start to participate alongside traditional institutional shareholders in further equity issuances.
- A PIPE may be combined with an M&A deal - as part of an acquisition of assets from a listed company, a PE buyer could agree to make a separate PIPE into the seller. There has also been an upswing in PIPEs in the parent entity with an option to carve out part of the business after conducting diligence.

Key issues

- **20% rule:** Nasdaq and the NYSE require listed companies to seek shareholder approval for certain issuances of 20% or more of the common stock. Some of the stock exchange requirements, particularly as they relate to convertible securities, are quite complex. Both exchanges have exemptions from the shareholder approval requirement for issuers that face financial hardships requiring prompt access to capital, although it is limited in scope and requires prior approval from the respective stock exchange.
- **Shareholder approval for charter:** Issuers need to ensure they have sufficient authorized shares in their charter documents to complete the transaction. Even if an issuer is not required to obtain shareholder approval under stock exchange rules, amendments of a company's charter to increase the authorized shares would typically require shareholder approval.
- **Market resistance:** Although PIPEs have been prominent in the US and in some European countries (especially in the healthcare and technology sectors) they have not traditionally been a common feature of the UK market. This is principally due to the importance the UK investor community attaches to pre-emption rights and the regulatory and customary restrictions that have been placed on listed companies preventing the hasty issuance of shares for cash in a manner that would excessively dilute existing shareholders.
- **Lack of PE interest:** Historically, interest from PE investors in PIPEs has been limited, due to some or all of:
  - incompatibility with PE's traditional control model;
  - the fact that LPs can access listed company investments through mutual funds;
  - investment restrictions in fund terms; and
  - concerns about the means and timing of any exit.
- **Discount restrictions:** Listing rules in Europe commonly restrict issuances at a discount - 10% is a common threshold (other than with shareholder approval) whereas there are no such restrictions in the US.
- **Take private rules:** Stakes secured via PIPE deals could lead to eventual take-private transactions. In the US, PE funds investing in PIPEs need to be cognizant of the take private rules which apply in a subsequent buyout if they are affiliates of the target after the PIPE. Takeover rules in European countries will require a mandatory offer if the PIPE investor becomes interested in shares carrying 30% or more of the voting rights of the company as a result of the transaction. No such rule applies in the US, although a significant PIPE could trigger a change of control.

- **Information sharing:** While an issuer might share some limited due diligence materials with a prospective investor, as a general rule, the issuer must not share "material non-public information" (in the US) or "inside information" (in Europe) with a potential PIPE investor.
- **Investor rights:** Anti-dilution rights, veto rights and rights to information are not common in the UK and are generally resisted by issuers, whereas they are common in the US and other European markets. However, there may be more flexibility for investors if the instrument subscribed comprises convertible debt.
- **Lock-up:** Issuers commonly seek to subject PIPE investors to a lock-up for a period of time. In the US, in the absence of registration rights (to secure liquidity for the underlying securities), a PIPE investor must generally hold the securities for 6 months. In the UK and a number of other European markets, 6 - 12 months is common. Issuers may seek a "standstill" from the PIPE investor, e.g. an undertaking not to buy further shares in the market or launch a takeover offer for an agreed period of time after making the PIPE investment, again, subject to limited exceptions (e.g. if a third party makes a takeover offer).
- **Exit:** For any investor, there will remain some uncertainty over how the investor will ultimately exit, as the larger the stake, the larger the overhang in the issuer's stock. This should be manageable, just as PE investors are able to sell down post-IPO.

Minority Investments

Naturally, liquidity concerns arising from COVID-19 are not limited to the public sector. Privately held companies that have solved their immediate liquidity needs may also require additional funding going forward. In circumstances where the debt markets are not accessible, shareholders in private companies are increasingly open to significant, but non-control, investments from new partners. Such investments present a variety of challenges for buyers more accustomed to transacting for control. In this chapter, we highlight some of these challenges, together with key issues to consider in structuring minority investments.

Key issues

- **Specialised PE interest:** While certain PE funds, particularly those with an institutional pedigree in the venture or small-cap space, specialise in making minority investments, many upper mid-market and bulge-bracket PE firms have stayed clear of such investments for a range of reasons, including some or all of:
  - incompatibility with the traditional control model;
  - investment restrictions in fund documents; and/or
  - concerns about the means and timing of any exit.
- **Existing shareholder rights:** It is critical at the outset of any discussions to understand the composition of the existing shareholder base and their ability to block a potential transaction. For example, whether existing shareholders have veto rights under the shareholders agreement and/or constitutional documents, or rights to pre-empt or participate in any new issuance by the company. The identity of the remaining shareholder(s) can often impact the discussion around control and liquidity, as founder shareholders often have different sensitivities than corporate or financial sponsor shareholders.
- **Structure of the transaction:** Parties should consider whether the transaction should be structured as a primary investment in new shares of the target company, or whether any of the existing shareholders will be taking money off the table as part of the transaction.
- **Economic rights:** Minority investments are typically structured with a liquidation/dividend preference. The preference shares may be convertible into common shares (where the value of the as-converted common exceeds the value of the preference), or may be participating preferred (where the preference shares participate on an as-converted basis in distributions that remain after payment of the preference). If the preference shares are convertible, key issues are the conversion price, whether conversion is optional only or (after a certain period) mandatory, and anti-dilution protection.

- **Governance rights:** PE sponsors making material minority investments often require significant governance rights. In addition to board seats and extensive information rights, sponsors will typically expect to receive a broad set of negative control rights in the form of board and/or shareholder vetoes. Such rights may be static, or could include 'springing' rights, whereby the sponsor obtains additional affirmative control rights in the event of continued underperformance by the business (e.g. the ability to replace the CEO). The negotiation on governance will likely form part of a broader discussion around the investment style and approach of the PE investor; convincing the company (especially if it is founder or family owned) that a new investor will be the right "fit" and will allow sufficient management autonomy can be key.

- **Liquidity:** PE sponsors must retain an ability to create liquidity and return proceeds to their investors at some stage. The nature and timing of these rights are often the most contested features of any minority investment. Outcomes may include:

  - a lock-up period during which all investors are restricted from selling shares without consent;

  - a subsequent right for an investor to sell its own shares in the company, subject to rights of first offer/refusal and tag-along rights for the other parties;

  - drag-along rights enabling shareholders holding above a certain threshold to force an IPO or sale of the company after a defined period and/or if a minimum return threshold is exceeded; and

  - put rights for the minority investor to be bought out by the company or other shareholders.

  Minority investors will need to weigh practical considerations alongside their legal rights to liquidity, e.g. how effective is a drag-along right if the business is still led by a founder and when it comes to it s/he is not prepared to get behind a sale process? Will the company/other shareholder have the funds to satisfy a put option, or does this need to be coupled with a right to force a sale to a third party if they default?

- **Other considerations:** Other key topics include the nature and scope of warranties received by the investor, the ability for the investor to recover from the company and/or existing shareholders in case of breach, and the parties' right to participate on new issuances.

3

Going private transactions

Going private transactions

Recent falls in equity markets will mean that many listed companies may appear attractively priced, for a period at least. With significant levels of dry powder available to financial investors and potential delays to at least some private M&A processes, we expect the focus on going private transactions to increase during the next phase of the cycle. Going privates create a different set of challenges for bidders more accustomed to private company acquisitions. This chapter includes a reminder of some of those challenges, as well as some specific issues to consider in light of the current crisis.

Potential challenges in the shadow of COVID-19...

- **Pricing:** While depressed market valuations make going private transactions more attractive to PE buyers, those same market pressures make pricing such transactions all the more challenging, particularly in the hardest hit sectors. Target boards and key shareholders may find it difficult to assess "value" and/or may be unwilling to engage with bidders that they perceive to be opportunistic. Current volatility in stock markets will exacerbate the risk that a jump in share price will kill the bid.

- **Due diligence challenges:** Lack of market guidance on earnings and delay in publishing audited financial information may place greater importance on due diligence, but at a time when lock-downs and travel restrictions will make due diligence as well as management meetings and presentations more challenging.

- **Focus on financial statements:** Extra care will be needed around financial statements in the offer documentation as they may not adequately reflect financial condition in quickly deteriorating business which can enhance potential disclosure concerns.

- **Government intervention:** Going private transactions face an increased risk of government intervention as a result of COVID-19, with several European governments already announcing measures to protect potential targets against opportunistic takeovers and UK considering such measures. Where intervention is likely, this may affect the timetable and require conditionality in the offer. Bidders should be ready to enter into negotiations with government authorities to give undertakings as to conduct of business post-offer.

...as well as all the usual challenges associated with going private transactions

- **No price adjustments:** In a public company acquisition all cash consideration is usually paid to the target shareholders in full at or shortly after the closing. Earn-outs, escrows, holdbacks, working capital adjustments and other unique pricing formulations, all of which are customary in private company deals, are rare in public company transactions. With limited built-in pricing adjustments and limited recourse against the shareholders, the buyer's front-end due diligence is of utmost importance.

- **Limited buyer protection:** Once a public company transaction closes, the buyer has no ability to sue the seller's shareholders for breaches of representations and warranties although the buyers are increasingly seeking out R&W insurance in public company deals. The buyer would instead focus negotiations on closing conditions, although due to the pressure to include standardized market terms, a buyer of a public company generally has limited ability to inject unique closing conditions that it believes may be appropriate for the transaction (e.g., a tailored MAE definition or certain financial thresholds that must be met).

- **"Market check" and "fiduciary out":** The boards public companies have a fiduciary duty to make sure the sale price is sold is fair and in the best interest of the shareholders which means that a public company sale will always include some form of "market check." The target board is provided by a "fiduciary out" that would allow it to terminate the proposed deal if a superior transaction comes along although the "fiduciary out" often comes with buyer friendly deal protections, such as an opportunity for the buyer to match or beat the superior proposal, what exactly constitutes a superior offer, and whether a break-up fee would be payable to the buyer if the deal is terminated.

- **Disclosure requirements:** The material terms of public company transactions (including the entire definitive transaction contract) are publicly filed with the SEC and provided to all target company shareholders (as part of any tender offer or shareholder vote). This level of required public disclosure can be especially challenging for private equity fund buyers who are experienced in negotiating unique deal terms and keeping those terms private, particularly from competing private equity funds and prospective buyers and sellers.

- **Incentivizing management:** Details of MIP proposals must be disclosed, will need to be the subject of a "fair and reasonable" opinion from the target's financial adviser and may require an independent shareholder vote (if significant in value/unusual in nature). The MIP discussion is therefore often deferred until after the bid; if however relevant manager(s) are receiving substantial proceeds and rollover terms are critical to the deal, this will force engagement on the MIP into the pre-bid phase.

- **Process risk and cost:** Fees and other costs tend to be significantly higher on a going private transaction than in a private deal, without any bidder protection if the bid fails. Even when the public company seller is ready and willing to close on the transaction, the buyer may be unable to do so based on a failure to obtain sufficient acquisition financing or necessary regulatory approvals - in this scenario, the buyer will typically be required to pay the target company a reverse break-up fee..

> The points highlighted in this chapter are approached primarily through a UK lens, in light of the rules of the UK Takeover Code. P2Ps of targets in other jurisdictions will be subject to different rules, albeit with some overlaps.

4

Valuation bridge tools: unlock M&A deals after COVID

Valuation bridge tools: Earn-outs

An earn-out is the traditional solution to bridge a valuation gap between the buyer and seller. In recent times they have been relatively rare, primarily because they are notoriously open to abuse. With unprecedented uncertainty over future business performance in light of COVID-19, and company valuations more subjective than ever, earn-outs may now enjoy a resurgence.

Key issues

- **What is being measured?** The most common metric is EBITDA, but others - either financial or non-financial (or a combination) - may be used, (e.g. net turnover; turnover of certain products/ clients; product development and approval phases (e.g. for healthcare businesses); and retention of certain employees). Turnover-based earn-outs are likely to be more difficult to manipulate than those based on EBITDA. Ultimately the metric being measured should be measurable, not subject to manipulation and ultimately tied to the buyer's view of the value drivers of the business.

- **Getting the definitions right:** Defining the relevant metric(s) as precisely as possible is key. EBITDA is not defined in any accounting standards, so if used this must be very clearly defined in the documentation.

- **Earn-out accounts:** For financial metrics, which will be the relevant accounts and how will they be prepared? Include detailed accounting policies, with early input from accountants. Agree specific adjustments wherever possible and avoid vague or subjective concepts (e.g. "non-recurring items"). If integration will have started, can accounts for the acquired business still be prepared? For financial metrics, consider agreeing a pro-forma schedule with illustrative figures for a past period.

- **Earn-out period:** The earn-out measurement period will rarely be longer than one to two years, after which performance is less likely to be a legacy of the seller's ownership. If the earn-out period starts under the seller's watch (and especially if there is a significant gap to closing), consider measures to protect against artificial inflation of the earn-out pre-closing.

- **A second COVID-19 wave:** Following the current crisis, buyers may be nervous that a "second wave" of COVID-19 and renewed or prolonged business interruption might wipe out earn-out potential. Could parties agree that the earn-out period will be deferred by, say, 12 months following specified COVID-19 triggers, at a reduced participation?

- **Avoiding abuse by the buyer:** Examples of buyer manipulation include:
  - overspending on discretionary areas (e.g. advertising, training);
  - deferring recognition of revenue until after the earn-out period; and
  - redirecting customers/contracts to other parts of the buyer's business.

Seller protections in the documentation might include:

  - negative covenants preventing specified actions during the earn-out period;
  - positive covenants to carry on business in the ordinary course and to promote certain products/services;
  - specific adjustments e.g. to reverse out discretionary overspending (perhaps by reference to an agreed budget) or to add back revenue from contracts transferred to another buyer group entity.

- **Avoiding abuse by the seller:** Where the seller is the owner for part of the earn-out period, it could manipulate the earn-out, for example by offering incentives to customers designed to boost short term revenues or by delaying discretionary costs, to boost EBITDA. Buyer protections in the documentation might include:
  - representations and covenants on ordinary course operation of the business until closing;
  - specific representations and covenants around continuing to incur expenditure and no non-ordinary course incentives/ discounts to customers;
  - specific adjustments.

- **Integration and synergies:** The seller's instinct may be to push for the target to remain isolated from the rest of the buyer's group until after the earn-out period, but the deal economics may not work if the buyer cannot realize synergies. Consider if integration can go ahead and if the parties can agree adjustments to reverse out the impact on the relevant metric (including to add back cost savings from synergies). In practice, extensive post-acquisition integration may force a shorter earn-out period. In some instances it makes sense to structure the earn-out metrics on matters which are measurable regardless of integration, such as software seat licenses or service downloads.

Valuation bridge tools: Vendor financing and equity rollovers

When there is a market correction or liquidity constraint, seller notes tend to surge in popularity. The other alternative to consider is to roll the seller over into the buyer's equity structure. Both of these are more liquidity solutions than value bridge tools, but can help to unlock deals.

Seller loan notes

- These are loan notes representing that portion of the purchase price that the seller is willing to defer.
- Size is typically limited, equating to 10-15% of EV/purchase price at the upper-end, which is unsurprising given the current focus on liquidity.
- It is possible to structure a note as a contingent value instrument, e.g. offset indemnity/other claims.
- The key structuring issue is where the note sits in the capital structure. Seller notes are typically structurally subordinated to any acquisition debt. If it sits above the "banking group" proceeds, it may count as an equity contribution on day one.
- Like any debt instrument, the key terms to consider are:
  - **Coupon:** typically a PIK interest commensurate with junior debt although as income is recognized without cash flow this may have tax consequences to the seller.
  - **Maturity:** subordinated to acquisition debt, seller notes typically attract a long term (10 years), but accelerate/mandatory prepayment on certain events, e.g. change of control.
  - **Security:** usually unsecured.
  - **Other:** typically light touch protections akin to shareholder debt.
- If the seller note is at the level of the debt perimeter, it will likely constitute indebtedness (deductibility of such debt should be addressed); if it is structured as preference equity, it may not.

Equity rollovers

- Equity rollovers have traditionally been common in PE deals where, for example, management (and sometimes institutional sellers) contribute a portion of their consideration to the acquisition newco in consideration for the issuance of equity securities in newco.

- Depending on the jurisdiction of newco, there is likely to be broad flexibility to create bespoke seller equity rights. The seller may hold the same investor strip as the buyer, or the seller's equity can be structured to achieve a wide variety of economic results.

- We have seen sponsors structure seller equity to mimic an earn-out (so once a sponsor has achieved a defined return threshold, the seller receives a portion of any further returns). We have also seen anti-embarrassment provisions where the seller's equity participates at a higher percentage if the sponsor achieves a defined return within a specified period of time.

- Structuring the seller's rollover equity rights to mimic an earn-out in this manner can be very attractive to sellers, both economically (if they get a percentage of distributions instead of a fixed earn-out payment) and because by tying the earn-out to equity value it reduces the scope for buyers to 'game' the earn-out payment (in the manner discussed earlier in this chapter).

- Structuring equity rollovers is highly bespoke and tax sensitive.

- Typical co-investor considerations will be relevant, in particular whether the seller equity is intended to be purely economic, or whether it will provide the sellers with any other rights or minority protections, for example:

  - potential nuisance value/holdout rights under statutes of the relevant target jurisdiction;

  - information rights (contractual or statutory);

  - veto/consent rights (e.g. affiliate transactions, or future issuance valuations);

  - an ability for the seller to transfer its shares or otherwise achieve liquidity independently from the buyer; and

  - rights to participate on future issuances.

Valuation bridge tools: Anti-embarrassment

An anti-embarrassment provision offers a seller protection against being seen to have "left value on the table", by enabling it to claw back part of the (higher) price received on a subsequent transaction involving the same business.

- **When relevant?** Anti-embarrassment (aka "schmuck insurance") is likely to be considered in particular by publicly listed or distressed sellers, for which the pricing of a disposal may come under close scrutiny by shareholders and the financial press following a subsequent exit by its buyer. Anti- embarrassment might be used in situations where the business has not been extensively marketed to third party buyers, on a pre-pack sale by an administrator, or on a rescue or restructuring.

- **Buyer perspective:** Buyers will generally look to avoid offering anti-embarrassment protection unless they consider the prospects of the provision being triggered during the relevant period to be remote. However, as we enter the next cycle, buyers should think more deeply about why anti-embarrassment protection is being requested. Post-Lehman, a number of the early restructurings were set up to provide anti-embarrassment protection to certain out-of-the-money creditors. For example, if senior lenders have forgiven debt in a deal which sees the incumbent equity retaining control, it would be highly embarrassing for the lenders of that sponsor to then realize an exponential return. Upside sharing above certain returns scenarios will help unlock such deals.

- **Duration:** The duration of the anti-embarrassment period will be a key item on both sides. More than one year is unusual for "normal" M&A. In distressed M&A, the period can be much longer.

- **Upside sharing:** Agreeing the split of the additional consideration between the buyer and seller will differ from deal to deal. Parties should consider whether 50/50 is appropriate, and whether it should be fixed or variable over time, with the buyer retaining a greater share of the excess the longer the period since closing.

- **Defining the triggering "transaction/ disposal":** As well as a sale or IPO of the whole group, an aggressive seller may try to catch partial sales (e.g. of a single entity or business division), or even sale and leaseback transactions. Anti-embarrassment by reference to a disposal of "any" entity or division is likely to be strongly resisted by buyers. Defining a partial sale as a sale of assets representing, say, 50% of the group's total revenue may be more acceptable.

5

M&A: The new normal

M&A: The new normal

Few businesses were prepared for a global pandemic and the chaos that ensued. How will this change the way that buyers approach M&A in the near-term?

- **Valuations will be more challenging:** Historically, many businesses have been valued as a multiple of LTM EBITDA. If the LTM numbers have been severely impacted by COVID-19 how do you normalize that? It will be clear that buyers and sellers will have different views around what normalization adjustments are appropriate and the route to recovery (V, U, W, L shaped). These differences may be capable of being resolved through one or more of the valuation bridges considered in chapter 4.

- **Locked Box:** Given uncertainties around target performance, the deals that initially contemplated locked-box mechanics may revert to the more traditional working capital adjustment provision to limit risks in declining working capital for buyers.

- **Ticker:** Where a locked-box is still used, the market is for a daily ticker to apply to the fixed equity purchase price. The daily ticker reflects the projected cash-flows of the business between the locked-box date and the closing date. Where there is much greater uncertainty around a business' performance in the near-term there will be much greater scrutiny and caution around the use of fixed daily tickers. In some deals we have seen mini true-up mechanisms being applied to calculate the actual free cash flows of the business generated during this period.

- **Greater focus on conditionality and gap protections:** There is generally little if any ability to walk away from a larger deal. For deals where there is a meaningful time period between signing and closing, buyers may be concerned about a second wave of COVID-19 (particularly around the usual flu season timing) and what this could mean for the business. This is likely to result in increased focus in the context of conditionality and gap protections:
  - some buyers are likely to push for greater conditionality in particular around MAE walk-away rights. Note that a general MAE is unlikely to afford a buyer a walk away right, as events like pandemics tend to affect all companies in the same industry, and would therefore typically be caught by an exclusion. But a specific MAE that is triggered if there is a material deterioration in earnings/revenue is more likely to be helpful. If a buyer is sensitive to closing in the face of adverse market conditions, they might also 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;
  - buyers will also want to have more focus on interim operating/gap covenants as to how the business will be run between signing and closing. If there is a second wave, what will be the business' strategy to address it? What liquidity management steps should be implemented? Will the new normal include diligence on business pandemic recovery plans akin to current diligence on disaster recovery?
  - 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 a MAE. This trend abated following improved market conditions, but the approach can be considered to provide clarity, particularly for transactions being negotiated during current turbulence.

Foreign Investment Restrictions (FIR)

Some governments are introducing additional FIR measures to protect wider economic and social concerns triggered by COVID-19.

- There is an EU-wide FIR approach calling Member States to consider all options to address potential cases where a foreign investment would create a risk to security or public order in the EU. Some Member States have already made moves here, e.g. Italy and Spain.

- Non-EU countries are also beginning to take a similar stance to protect their own national interests, e.g. Australia and India.

- Even where temporary measures have not been introduced, existing FIR regimes may include discretion for the government to review certain investments with more scrutiny/a more stringent approach, e.g. the US and Korea.

- FIRE is a Baker McKenzie analysis platform which answers 49 detailed questions on foreign investment review regimes across 24 jurisdictions. It is updated in real time and provides a roadmap to regulatory timetables, risks and barriers that can be promptly fed into corporate strategy and planning processes: http://fire.bakermckenzie.com/

6

Debt buybacks

Debt buybacks

In the context of volatile markets, the ability to invest in undervalued portfolio company debt may present an attractive opportunity for sponsors.
Debt buybacks are now a well-established feature in both the US and European bank and bond products.

The opportunity

- For sponsors, buying or funding the purchase of debt at a discount can:
  - improve equity returns by profiting from the discount;
  - improve financial covenant levels of portfolio company borrowers; and
  - support and enhance portfolio group performance.
- For portfolio companies, debt buybacks can:
  - reduce indebtedness at a discount to par;
  - reduce ongoing interest costs;
  - improve leverage and debt service ratios; and
  - increase covenant headroom and corresponding basket capacity.

Key Issues

- A multitude of factors will influence the ability to structure and execute a debt buyback. Key issues include:
  - **Bond instruments:** Repurchases are subject to the terms of the bond instrument as well as securities law considerations (e.g. disclosure, tender offer rules).
  - **Bank debt:** Bank debt purchases are primarily governed by the terms of the loan agreement (e.g. purchase process, disenfranchisement). Regulatory issues are less likely to be a major factor.
  - **Investment rationale:** Buying debt to hold to maturity, as opposed to buying and extinguishing immediately, raises materially different issues (e.g. tax and voting).
  - **Identity of buyer:** Whether the buyer is inside or outside the borrower group has an impact on the treatment of the debt in the hands of the buyer (e.g. financial covenant calculation).
  - **Process:** While the ability to buy back debt in both bank and bond structures is largely aligned, the process varies widely depending on instrument and the buyer (e.g. pro rata or private purchases).
  - **Funding:** Availability and source of funds (e.g. sponsor or portfolio balance sheet cash) for a buyback will impact structuring. Where new sponsor funding is injected, management/co-investor rights (including pre-emption rights) will need to be considered.
  - **Tax:** A number of issues are raised, for example forgiveness of debt purchased at a discount may give rise to a taxable gain in the hands of the borrower.
  - **Equitable subordination:** Subordination upon bankruptcy of related party claims to third party creditors is well established in the US and certain European jurisdictions.
  - **Execution:** Taking into account the various factors in each case, the debt purchase may need to be put into place legally (lender of record), contractually (sub-participation) or synthetically (total return swap).

Practicalities upon execution

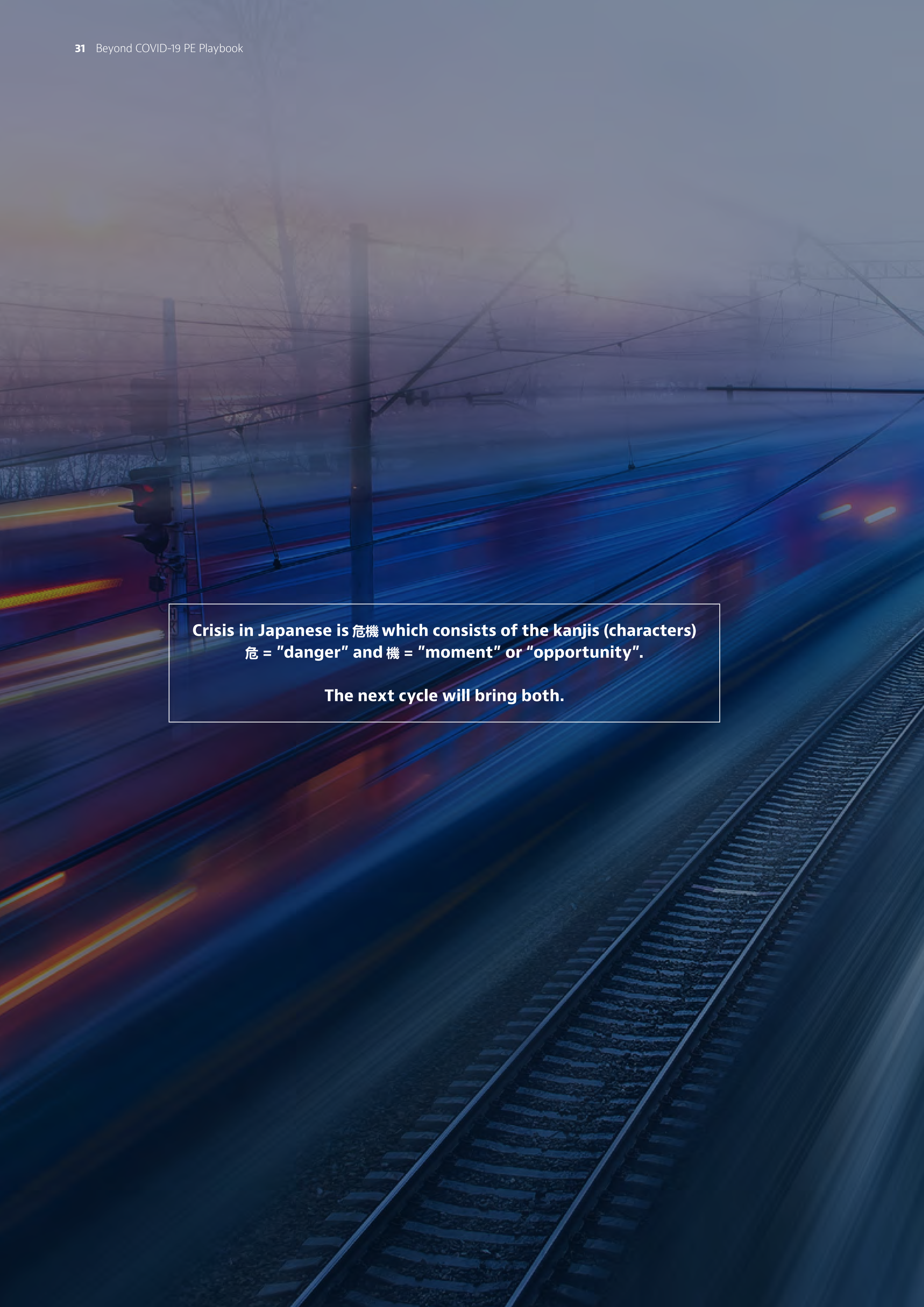
- When a debt buyback transaction moves from the structuring to execution phase the practical steps involved in the process will depend on the debt instrument being purchased.
- Coordination of third parties, such as facility agents and trustees, needs to be proactively managed to ensure documentation requirements and timetables are met.

Bank debt buybacks

- Many credit agreements contain provisions which require the borrower to give lenders equal opportunity to participate in debt buybacks.
- Credit agreements seek to preserve the principle of pro rata treatment by requiring borrowers to buy back debt through a pre-agreed offer mechanism - typically either a "reverse Dutch auction" process or through an open order from the borrower to purchase a fixed quantity from accepting lenders pro rata.
- Sponsor disenfranchisement provisions should be analyzed to determine the extent to which purchases by a sponsor or related party will result in the purchaser becoming excluded from voting.
- There may be instances in which securitization techniques can be employed to navigate prescribed process and voting restrictions, which generally assess affiliation by reference to traditional indicators such as equity ownership and board representation.

Bond buybacks

- The issues that arise in relation to bond repurchases are in large part a function of the need for the issuer to comply with US securities laws.
- Open market or privately negotiated purchases can allow issuers to retire debt quickly and with limited publicity, documentation and cost.
- Issuers should be aware of the need to avoid such transactions amounting to a "creeping" tender offer which would engage the detailed disclosure and offer requirements of US securities laws. The debt buybacks in the US are not subject to the "best price" for all holders rule and, as such, there is flexibility to structure a debt buyback to force the hand of recalcitrant debt holders by making them tender early or risk being paid less later in the process.
- Bond indentures will generally allow bonds to be repurchased.
- Restricted payment provisions in instruments more senior to the debt being repurchased need to be analyzed to determine compliance and any necessary consents from senior creditors obtained.
- The issuer should obtain regulatory advice in relation to its ability to effect repurchases without disclosing inside or material non-public information to the seller.



Crisis in Japanese is 危機 which consists of the kanjis (characters) 危 = "danger" and 機 = "moment" or "opportunity".

The next cycle will bring both.

Contacts

OUR TEAM

Michael Fieweger
Chicago
+ 1 312 861 8232
michael.fieweger@bakermckenzie.com

Andrew Sagor
New York
+ 1 212 626 4562
andrew.sagor@bakermckenzie.com

Mark Mandel
New York
+ 1 212 626 4527
mark.mandel@bakermckenzie.com

Nick Marchica
New York
+ 1 212 626 4426
nick.marchica@bakermckenzie.com

Steven Canner
New York
+1 212 626 4884
steven.canner@bakermckenzie.com

Darcy Down
Los Angeles
+ 1 310 616 5304
darcy.down@bakermckenzie.com

Leading and closing three deals a day

We are a transactional powerhouse providing commercially-focused, end to end legal advice to maximize deal certainty and secure the intended value of transactions. Our 2,500 lawyers combine money market sophistication with local market excellence. We lead on major transactions with expertise spanning banking and finance, capital markets, corporate finance, restructuring, funds, M&A, private equity and projects. The combination of deep sector expertise, and our ability to work seamlessly across each of the countries where we operate, means we add unique value in shaping, negotiating and closing the deal.

bakermckenzie.com