

**Checklist**

# **Pandemic M&A Letter of Intent (Annotated)**

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# Pandemic M&A Letter of Intent (Annotated)

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**Editor's Note:** This checklist identifies issues for buyers to consider as they negotiate letters of intent (LOIs) for mergers and acquisitions (M&A) deals being contemplated during the Covid-19 pandemic.

## Transaction Structure

### **Consider structuring the transaction as an asset acquisition.**

- If viable, a buyer should consider using an asset acquisition structure in order to assume only specified liabilities of the target business. This will require a thorough analysis of successor liability laws, but may provide another line of defense from liability for a buyer.
- A target business may be subject to potential liabilities uniquely arising as a result of the consequences of Covid-19 that are best left behind as retained liabilities of the seller. Consider the following:
  - Certain companies scrambling to survive the economic shutdown may engage in risky or ill-considered employment-related decisions. A buyer may wish to consider the following issues when evaluating the payroll, hiring, furlough, and termination practices of the target business:
  - Whether the target business has complied with notice requirements under the Worker Adjustment and Retraining Notification Act (WARN Act), and any corresponding state law, for furloughs, terminations, or reductions in hours of its employees
  - Whether the target business has made timely payments of any owed wages (or accrued vacation, if applicable) to employees upon termination

**Comment:** In California, for example, an employee is entitled to a final paycheck on his or her last day of employment. If an employer fails to make such payment, the terminated employee is entitled to a full day's worth of pay for each day that the employer delays payment up to a maximum of 30 days. This issue would be ripe for class action treatment for a target business that engages in mass layoffs and fails to meet its obligations under applicable law:

- Whether the target business has properly managed furloughs, hours reductions, and/or pay reductions for exempt employees and continues to maintain its exemption status
- Whether the target business has used discriminatory selection criteria in deciding which employees to furlough or layoff (e.g., laying off older workers or workers with caregiving responsibilities)
- Where the target business has offered severance to employees in exchange for a release, whether such separation agreement complied with all applicable laws and contains enforceable releases.
- If the target business has obtained a loan through the Paycheck Protection Program (PPP Loan Program) under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), but is subsequently found to have failed to satisfy the eligibility requirements for the loan (despite certifications to the contrary made in the application) or used loan proceeds for impermissible purposes, the target business may be subject to fines and penalties (including significant criminal penalties) and lose the ability to obtain forgiveness for amounts otherwise eligible for such treatment.
- The target business may have failed to perform its obligations under a contract due to supply chain issues, employee unavailability during the economic shutdown, or other reasons, and not be excused from performance, whether by virtue of an effective force majeure clause or otherwise. Depending on the materiality of the contract, a buyer may elect to exclude the contract

(and the liabilities thereunder) from the acquired assets, or otherwise only assume post-closing obligations under the contract.

## Purchase Price

### **Consider requiring tailored post-closing purchase price adjustments or earn-outs to offset operational uncertainties.**

- The impact of Covid-19 may make it difficult for parties to develop reliable projections to value a target business or to establish “normalized” working capital and other financial targets.
- A buyer should consider negotiating tailored “earn-outs” and other post-closing purchase price adjustments to account for changes in the performance of the target business due to the impact of Covid-19.
  - For instance, earn-out periods could begin at a later date following the closing and extend for a longer period if “operational normality” of the target business is not expected to resume or be measurable until sometime after closing (e.g., consider providing that the earn-out period will begin six months or more after the closing of the transaction or the official lifting of the relevant shelter-in-place order).
  - For a target business that has obtained a loan under the PPP Loan Program, the treatment of the loan will depend on, among other things, whether (a) the target business has used the funds according to the PPP Loan Program terms, (b) the target business is entitled to forgiveness of some or all of the loan, (c) a loan forgiveness application has been presented to the lender but has not yet been determined, and (d) the loan (or a portion thereof) has already been forgiven by the lender (with any amounts not forgiven being subject to the note's original terms).

A target business's eligibility for a loan under the PPP Loan Program is determined at the time of application. Upon the expiration of the eight-week period following the funding of the loan, the target business may apply for loan forgiveness after which the lender has 60 days to determine what portion of the loan, if any, will be forgiven. If loan proceeds are used for unauthorized purposes, the Small Business Administration (SBA) will direct the target business to repay such amounts, and civil and criminal penalties may also be imposed if such funds were fraudulently obtained.

Given that the terms of the PPP Loan Program lack clarity, and that the SBA has not yet issued any guidance on loan forgiveness requirements for PPP Loan Program lenders, a buyer should continue to monitor SBA guidelines and resources to evaluate the treatment of such loans.

- A buyer should consider treating the outstanding portion of such a loan like other indebtedness and as a deduction when determining the purchase price at closing, perhaps with an agreement to pay the seller at a later date to the extent that any portion of the loan is subsequently forgiven.
- If proceeds from the loan remain to be utilized following the closing and loan forgiveness is not a certainty, a buyer should consider deducting the loan like other indebtedness when determining the purchase price payable at closing and escrowing funds to pay to the seller if and when a portion of the loan is actually forgiven. Of course, the seller will seek to impose post-closing obligations on the buyer to ensure that the buyer takes all necessary action to facilitate loan forgiveness, such as requiring loan proceeds to be used for only permitted purposes and submitting an application for loan forgiveness.
- If such a loan has been forgiven in full prior to the closing, then the buyer should consider whether to escrow a portion of the purchase price equal to the amount forgiven if there exists any uncertainty as to whether the target business properly qualified for the loan and satisfied the requirements for forgiveness of the loan.
- If the target business has defaulted on its rent or other obligations, the buyer should consider treating such defaults as deductions when calculating the purchase price at closing, or alternatively as a part of the working capital adjustment mechanism.

- The CARES Act provides that net operating losses (NOLs) incurred in 2018, 2019, and 2020 may be carried back to the previous five taxable years and such losses may generally offset 100% of taxable income. A seller of corporate stock is customarily entitled to receive tax refunds for pre-closing tax periods. Thus, a buyer should seek to ensure that tax refund provisions allow the buyer to carry back any post-closing NOL of any target corporation to pre-closing tax periods and be entitled to retain any federal and perhaps state income tax refund attributable to such NOL carryback.

## Representations and Warranties

### **Consider requiring more robust representations and warranties.**

- A buyer should consider the advisability of tailored representations and warranties, including representations with respect to:
  - Whether the target business has obtained or applied for a loan under the PPP Loan Program and satisfied the eligibility and certification requirements at the time of application
  - The collectability of accounts receivable
  - Compliance with state and county shelter-in-place orders or any loan programs the target business participates in under the CARES Act, including restrictions on the use of funds borrowed under such loan program
  - The maintenance of safe and acceptable working conditions, including disclosures regarding positive cases of Covid-19 among employees of the target business
  - Privacy and cybersecurity, particularly regarding the implementation or expansion of remote work programs
  - Compliance with Covid-19 specific requirements for extensions and delays in intellectual property (IP) registration prosecution (e.g., whether Covid-19 directly caused delay, as required by some jurisdictions)
  - Insurance coverage, including business interruption coverage and whether such coverage would allow recovery for losses resulting from operational disruptions caused by Covid-19
  - Compliance with employment laws, specifically with respect to the furlough or termination of employees, or reductions and modifications in compensation or employee benefits
  - Compliance with supplier and vendor contracts, including whether the target business or its counterparty has sought excuse from, or an accommodation to, performance under such contracts, whether based on force majeure clauses or otherwise
  - The sources and availability of raw materials and inventory
  - Whether the target business has satisfied Employee Retirement Income Security Act of 1974 (ERISA) obligations in regard to benefit plans subject to ERISA in connection with Covid-19

### **Consider requiring specific indemnification obligations of a seller to backstop exclusions from representations and warranties insurance (RWI).**

- RWI policies generally do not cover matters that are known to the insured, and insurers may specifically exclude pandemic impacts from coverage. However, there may be cases in which an RWI carrier decides to not exclude, but rather narrow Covid-19 effects. A buyer should expressly allow for specific indemnification obligations of the seller for matters excluded from negotiated RWI policies.
- A buyer should expect greater scrutiny and increased diligence by insurers during the RWI underwriting process. Although present circumstances will make it difficult to conduct site visits and diligence on real property, warehouses, factories and the like, RWI carriers may allow for virtual site visits.

## Interim Covenants

### **Consider requiring additional, tailored interim operating covenants.**

- A buyer should consider the need for situation-specific interim covenants requiring the seller, among other things, to:
  - Obtain buyer consent prior to the taking of certain actions such as conducting mass layoffs or applying for a loan under the PPP Loan Program
  - Comply with the requirements of the WARN Act and comparable state laws, particularly with respect to employee furloughs or terminations, and pay or hours reductions
  - Keep safe working environments and proper remote working and self-quarantine policies
  - Obtain buyer consent prior to invoking a force majeure clause
  - Obtain buyer consent before implementing “returning to work” orders
- A buyer should give special consideration to the covenant requiring a seller to operate the target business in the ordinary course as this may prove especially difficult moving forward. A seller may seek the inclusion of “commercially reasonable efforts” or a similar standard of conduct, but a buyer instead may negotiate specific exclusions to the covenant and perhaps specify a timeframe for determining what constitutes “ordinary course” that pre-dates the economic shutdown.
- Similarly, a buyer should consider requiring a seller to provide notice under specified circumstances, including in regard to, delays or slowdowns in customer payments, disruptions in supply chain, shelter-in-place orders affecting the target business, or new positive Covid-19 cases among employees (subject to the Americans With Disabilities Act (ADA), the Family and Medical Leave Act (FMLA), and applicable privacy laws).
- A buyer should consider requiring periodic (perhaps even weekly) financial reports and key performance indicators to monitor the financial condition of the target business.
- Care should be given to ensure that requirements in this regard do not give rise to “gun jumping” or pre-merger integration under the U.S. Department of Justice and Federal Trade Commission guidelines.

## Closing Conditions

### **Consider the need for enhanced closing conditions.**

- A buyer may experience increased difficulty in securing favorable debt and/or equity financing to complete acquisitions. As such, we expect the incidence of so-called “financing outs” and “due diligence outs,” which for many years had fallen out of favor, to increase.
- As an alternative to a broad-based due diligence out, a buyer may seek “mini-MAEs” as closing conditions, such as minimum closing cash requirements, minimum “impacted employee” census requirements, minimum inventory requirements, and limits on outstanding payable balances (perhaps based on the amount and age of outstanding payables), to address operational and cash flow uncertainties related to Covid-19 and its broader economic effects.

## Exclusivity Period and Approvals

### **Consider extending the duration of the exclusivity period in the LOI.**

- Current circumstances may make it difficult for parties to schedule site visits and in-person meetings, attain necessary funding, and obtain proper buyer approvals, particularly at the board of directors’ level. We expect a buyer to seek exclusivity periods that are 30-45 days longer than historical exclusivity periods, coupled with built-in extension triggers to account for unexpected changes due to federal, state, or local mandates.

- A seller may take longer to populate data rooms or to respond to inquiries and due diligence requests during the exclusivity period. Accordingly, a buyer should consider requiring the exclusivity period to commence when the data room is substantially populated by the documents and information requested by the buyer rather than the date of the LOI.
- For transactions involving real estate, inquiries to local authorities regarding zoning permits and use approvals may take longer to resolve. Additionally, in jurisdictions where local recorder's offices are closed—and recording of a deed is delayed until after closing—title companies may require a seller to issue an indemnity to the title company for matters which arise between the date of closing (evidenced by the seller's execution of the deed) and the date of recording (once the recorder's office reopens).

**Consider delays in obtaining the required regulatory approvals and third-party consents.**

- The outbreak caused state and federal government offices and regulatory agencies to be shut down or short-staffed, making it difficult for parties to obtain the necessary approvals needed for their transactions. For instance, at the time of publication, the Federal Trade Commission's Premerger Notification Office was only accepting electronic premerger notification filings under the Hart-Scott Rodino Antitrust Improvements Act of 1976 and may not grant early terminations at the rate it did prior to the Covid-19 outbreak. Parties seeking other third-party consents and assignment or change of control approvals should also expect similar difficulties or delays.
- A reorganization, merger, or change in ownership or business structure of the target business without lender approval may trigger default provisions under the terms of a PPP Loan Program note. A buyer should carefully review the terms of the note and ensure that proper approvals are requested and obtained prior to the closing of the transaction.
- A target business may not be able to obtain an estoppel certificate or landlord consent for purposes of the transaction if the target business has defaulted on rent payments.

## Material Adverse Effect

**Consider tailoring the Material Adverse Effect (MAE) definition to account for the impact of Covid-19 on the target business.**

- A buyer should consider including the effects related to Covid-19 in the MAE definition, perhaps limited to effects that have a disproportionate impact on the target business as compared to other industry players. Courts may be reluctant to find an MAE relating to a decline in the target business due to Covid-19 if such decline (a) lasts only for a few months (i.e., is not “durationally significant”), (b) does not adversely affect the long-term prospects of the business, or (c) is felt equally across the industry.

## Due Diligence

**Consider preparing detailed due diligence questionnaires and request lists tailored to assess the impact of Covid-19 on the target business.**

- A buyer should carefully consider how the outbreak has or might affect the target business and expand its due diligence with respect to these matters, including evaluating, for example:
  - Existing insurance policies and coverages
  - Supply chain risks
  - Distribution risks
  - Ability to perform under material contracts
  - Workplace health and safety procedures (e.g., implementation of social distancing and other hygienic measures)

- Remote working practices for employees
  - Privacy and security policies and data-protection and privacy law non-compliance issues caused by adoption of emergency and/or urgent remote working and other technology solutions
  - Delays in prosecution of IP registrations and enforcement of IP rights against infringers
  - Emergency protocols and contingency plans
  - Compliance with the ADA, FMLA, and other employee privacy laws (e.g., handling of employee medical information, including with respect to employees who may have tested positive for Covid-19)
  - Tax issues raised by the conduct of the target business and changes in law in response to the economic shutdown
- If the target business has obtained a loan under the PPP Loan Program, a buyer should request from the seller (a) evidence of the target business's eligibility to participate in the loan program, including internal and third-party analyses and assessments regarding eligibility; (b) copies of the original loan application and certifications made by the target business, as well as the application to the PPP Loan Program lender for loan forgiveness; and (c) detailed summaries of how the target business spent the loan proceeds, particularly during the covered period.

***Consider the rights and obligations of the target business and its counterparties under material contracts, particularly with respect to force majeure and termination provisions.***

- Special care by a buyer will be required to assess risks associated with non-performance of contracts by a target business or its vendors. While a force majeure clause may excuse performance by the target business or its vendors, such clauses are contractual provisions and should be assessed carefully to determine whether pandemics, quarantines, national or local emergencies, stops in production, labor stoppages or slowdowns, industrial disturbances, or similar unforeseeable events did or would excuse nonperformance by the target business or its vendors.