SRS ACQUIOM

SPECIAL REPORT

2020 Review: COVID-19 *Impact on M&A Transactions*

by SRS Acquiom

With the onset of the global COVID-19 pandemic, a particularly contentious election season, and questions about whether decades-old deal-terms trends would continue to hold, it is fair to say that the SRS Acquiom dataset is capturing shifts in the ways that M&A deals are conducted, and our team is asking questions that would not have occurred to us a year ago. We have been engaging in productive dialogues with clients and colleagues about what we are seeing in the M&A deal-terms landscape and what we expect to see going forward. This report reflects the unique vantage point of SRS Acquiom over the last several months and offers perspective to those engaged in M&A transactions. It leverages MarketStandard®, our interactive database of deal terms from more than 2,700 deals from across the field of M&A transactions. Except where otherwise stated, this report only includes information as of the end of the third quarter of 2020.

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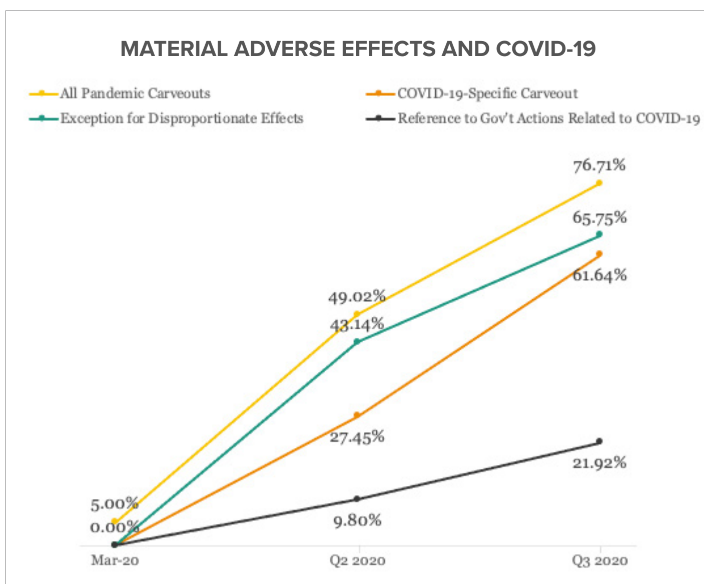
DataSource: SRS Acquiom MarketStandard–the industry's most comprehensive database of private-target M&A deal points. Designed to help deal parties determine "what's market."

New Trends

The Changing Landscape of Material Adverse Effects

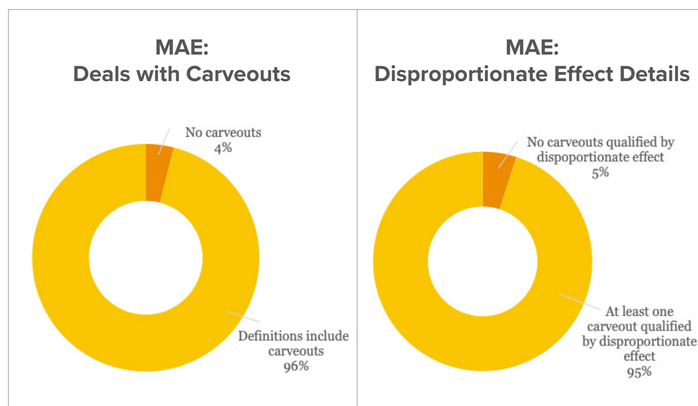
As the reality of the COVID-19 pandemic began to crystallize in early March 2020, SRS Acquiom received a variant of the same question from a multitude of our clients and friends in the M&A community: What were we seeing with respect to Material Adverse Effect (or "MAE") clauses? The answer at that time was "nothing"; it was almost the end of March before the SRS Acquiom data reflected any transaction that explicitly accounted for the pandemic. Our answer has changed considerably since then, so much that we began tracking these matters closely to keep the M&A community apprised of how transactions had changed on an ongoing basis. A full accounting of Q2 2020 showed that almost half of the transactions in which we were engaged included a carveout related to the pandemic, and for Q3 2020, the numbers surged to more than 75%.



Today, the impacts of the early stages of the pandemic are much clearer: The majority of transactions in the SRS Acquiom dataset state explicitly that effects related to the pandemic will not constitute or be accounted for in determining whether an MAE has taken place. The nuances, however, are important:

- Although most deals make specific reference to COVID-19 in the MAE clause (61.64% in Q3 2020), a fair number of transactions only reference "pandemic" or "epidemic" generally. As the pandemic fades, we will continue to note whether these generalized terms remain in deal parties' standard toolkits.
- Some transactions err on the side of being specific to what pandemic-related effects should be included in the carveout, particularly with respect to governmental activity. In Q3 2020, almost 22% of transactions in our data clarified that governmental responses to the pandemic were to be included in the carveout, generally for actions like mandated lockdowns and quarantines.[1]
- Finally, the pandemic-related MAE carveouts in SRS Acquiom data mostly include the counterweight that the pandemic would not be considered an MAE unless the given effect disproportionately affected the target entity as compared to other entities in the same industry. Almost 66% of our transactions included this exception in Q3 (or, specifically, 85% of deals with a pandemic-related carveout included the "disproportionate effects" exception).

The metrics that SRS Acquiom usually tracks—such as whether MAE definitions include carveouts or whether those carveouts are qualified by disproportionate effect—have moved little between 2019 and 2020. To the extent that MAE clauses are changing, those changes appear to be confined to how deal parties are addressing the pandemic.



1 *Almost 5% of transactions in our data explicitly extended this aspect of the carveout to the potential for a declaration of martial law.*

It is fair to say that the ground has shifted in this area of M&A deals, and we anticipate a large majority of M&A transactions in our data will include pandemic-related variations to MAE clauses for the foreseeable future. Whether these changes will persist after the pandemic has faded remains to be seen, but given the relative ease with which a pandemic-related carveout can be included in an MAE clause, we would be surprised if this trend fades, as well.

The Impact of Paycheck Protection Program (PPP) Loans on Transactions

The introduction of the Paycheck Protection Program[2] into the framework of M&A indebtedness terms has yielded both a surfeit of uncertainty and a variety of creative approaches for allocating the risk arising from these loans. In many ways, the post-close treatment of PPP loans in our transaction data mirrors the challenges deal parties have faced in understanding and remaining in compliance with the program. For future deal parties who overcame initial challenges in assessing eligibility and forgiveness requirements, new questions arose regarding two critical items: (1) how to obtain consent from their PPP lender, and (2) how to manage and allocate the risk associated with PPP loan forgiveness in a transaction.

With respect to lender consent, the waters were murky until quite recently. The SRS Acquiom data began to reflect PPP loan issues arising in transactions in mid-Q2 2020, but at the time, some lenders were refusing to consent to mergers. The regulatory road led back to the Small Business Administration (SBA), whose form promissory note for 7(a) loans (including PPP loans) included an event of default upon a change of control without the lender's prior written consent. Under SBA procedures, lenders were required to obtain prior consent from the SBA for change-in-control transactions taking place within a year of disbursement. Although a number of transactions appeared to clear these hurdles, a sizable number of transactions included a PPP loan payoff at close.

The SBA cut some of this red tape on October 2, 2020, issuing guidance[3] that allowed for lender-only approval under certain circumstances: For changes in majority control, lenders could consent to transactions without prior SBA approval if the borrower completed a forgiveness application and placed an amount equal to the outstanding balance of the loan in a lender-controlled interest-bearing escrow account. Since October 2, 2020, the SRS Acquiom data set reflects a number of M&A transactions that appeared to follow this path. We anticipate seeing more as deal parties move through this simplified procedure.

Separately from the question of containing lender consent, we have seen a variety of approaches for managing and allocating the risk associated with these loans. Prior to October 2, we observed that parties:

- **Included the PPP loan amount in the definition of indebtedness for the purposes of a purchase price adjustment.** This approach could complicate the resolution of a purchase price adjustment, but for certain deals this may not pose an issue.
- **Creation of a potential post-closing payment based on the forgiveness amount.** By building the loan amount into the merger consideration and creating a post-closing disbursement of forgiveness amounts, parties avoided the need to set money aside in an escrow account or holdback.
- **Creation of a special escrow account based on the PPP loan balance.**

The latter reflects the most common approach we've seen following the SBA's October 2, 2020 guidance. Notably, however, the requirement for lender-held escrows introduces complications for post-closing payments, as many such lenders may not have significant experience in post-closing shareholder distributions. The retention of an experienced paying agent in these circumstances is recommended.

2 Sec. 1102, CARES Act, S. 3548, 116th Cong. (2020).

3 SBA Procedural Notice Control No. 5000-20057.

Even in circumstances where a forgiveness application was submitted at or near close, questions remain regarding who will control efforts to secure forgiveness (including the submission of supporting or supplemental materials to the SBA). We have seen a variety of approaches here, as well, but the most common approach is buyer control with the requirement of cooperation, review, and consent by a shareholder representative or seller management. This approach likely includes the retention of the target's historical accounting and/or law firm to manage the process, with fees to be paid from a seller expense fund.

As PPP forgiveness applications come due and are evaluated by the SBA in the coming months, we anticipate that we will be able to map our observations onto publicly available data.

Net Operating Loss Carrybacks Under the CARES Act

The CARES Act has significant implications for deal parties during post-close tax preparation—both for deals closed prior to the pandemic and those closed after. These implications arise from a provision allowing corporate taxpayers to carry back net operating losses ("NOLs") up to five years from taxable years 2018, 2019, and 2020.[4] For those target entities with significant NOLs over those periods, this provision is both a boon and a logistical challenge.

Although most deals are silent on which M&A deal party should receive the benefit of pre-closing tax refunds, even those that assign the benefits to the sellers were (pre-pandemic) often not drafted with the potential for an NOL carryback in mind. The question on these pre-pandemic transactions, then, has been how to allocate the costs and benefits to the parties in the absence of a prior agreement.

The team at SRS Acquiom has been able to effectively work with buyers to reach an arrangement on the process, sometimes paying for the tax preparation from a seller-held expense fund and splitting the benefits between the two parties. These arrangements are relatively makeshift given the circumstances but have had fruitful results for deal parties.

4 Sec. 2303(b), CARES Act, S. 3548, 116th Congress (2020).

Since the onset of the pandemic, we have seen M&A deal parties address these issues head-on, with some entailing more requirements for the NOL carryback than others. For M&A deal parties who want to ensure the benefits of this CARES Act provision accrue for the sellers, the following arrangement is suggested:

- Pre-closing tax preparation conducted by the buyer or the surviving corporation, to be paid for via a seller expense fund
- A buyer agreement to not waive any carryback of net operating loss
- A buyer agreement to file an amended tax return for pre-closing tax periods
- An agreement to distribute any refund to the sellers after the refund is received

Sample Language

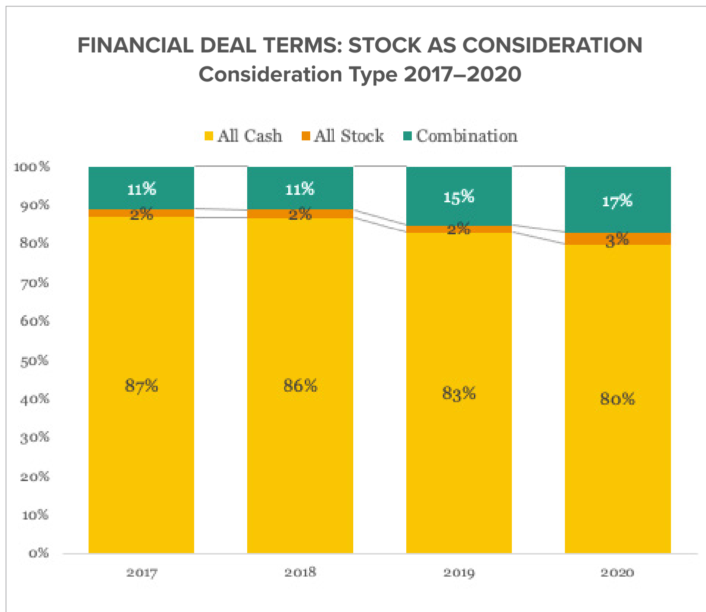
"After the Closing, the Buyer will prepare or cause to be prepared and the Surviving Company shall timely file or cause to be timely filed all income Tax Returns for the Company for taxable periods ending on or prior to the Closing Date that are required to be filed after the Closing Date. Buyer will not (and will not cause the Company to) waive any carryback of any net operating loss, capital loss, or credit on any such Tax Return, and Buyer shall file at the Seller Representative's request an amended Tax Return for a Pre-Closing Tax Period to the extent it would produce a Tax refund."

Financial Deal Terms

Stock as Consideration

From early on in the pandemic, the team at SRS Acquiom anticipated that M&A deal parties would adjust their approaches to merger consideration. This was for a simple reason: The gaps between how buyers and sellers might value targets seemed destined to grow, with adjustments to longstanding practices destined to follow.

That prediction has proven correct. The volume of deals in the SRS Acquiom data set that include a stock component in merger consideration has grown by 3%, though it is notable that this may have been a trend starting in 2019. As of 2020, a full 20% of deals in which we are engaged as the shareholder representative include a stock component, up from 17% in 2019 and 13% in 2018.

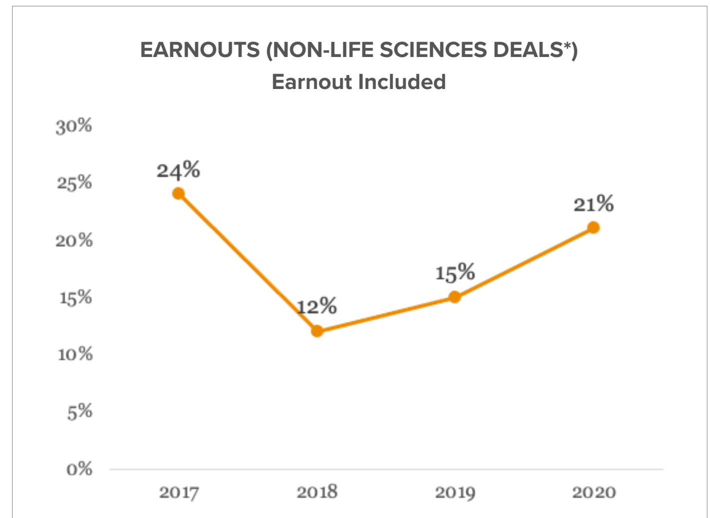


Whether this effect will continue in 2021 is difficult to say. With a good many acquirers working hard to shore up their cash positions in the early days of the pandemic, we may see an excess of cash looking for places to go, reversing this trend. For 2020, however, it is clear that more buyers and sellers than normal looked to stock as a means of building a model for consideration.

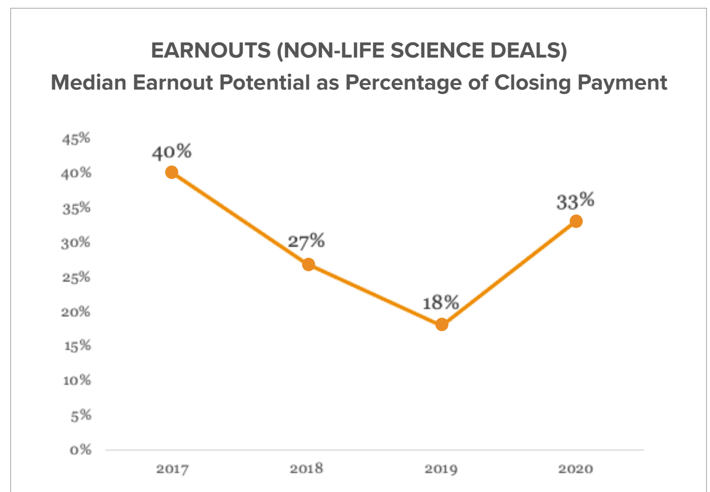
Earnouts

Early in the pandemic, the team at SRS Acquiom predicted we would see an increase in the use of earnout structures, much for the same reason we predicted an increase in the use of stock-based consideration: earnouts help bridge valuation gaps between parties. Ultimately, we did see an increase, and our data on earnouts for 2020 reflects one of the starker trends observed so far this year.

Earnouts have been *more common* for non-life sciences transactions in 2020. This trend has been in place since 2018 (after a reversal in 2017), so the effect cannot entirely be attributed to the pandemic.



The extent to which earnout potential comprises transaction value (measured below as the median earnout potential as a percentage of the closing payment) has also increased. From a figure of 18% in 2019, this measurement has jumped to 33% in 2020. This is not surprising given our general predictions regarding an increase in earnouts in 2020 but does have the potential to generate significant disputes given how much money is tied up in earnouts compared to previous years.



Finally, we are seeing a small but notable shift in the types of earnouts included in our dataset. Over the last three years, the percentage of non-life sciences earnouts based on revenue measurements has decreased from 68% to 58%, while the percentage of such earnouts based on earnings or EBITDA, has increased from 16% in 2018 to 27% in 2020. The increased use of EBITDA-based earnouts is particularly noteworthy from our perspective as a professional shareholder representative, as we tend to find (anecdotally) that earnout disputes are more common with respect to EBITDA-based earnouts than for earnouts based on simpler measurements.

Life Sciences Earnouts

Although the SRS Acquiom dataset does not reflect material differences in how life sciences earnouts are being structured during the pandemic, we have seen significant activity in the space. Specifically, challenges in conducting clinical trials, government-mandated remote-work conditions, workforce illness, and shifting business priorities all have had an impact on the timing and likelihood of parties hitting milestone-based earnouts. Though these impacts are not all in one direction,—buyers, for example, are laser-focused on products with potential COVID-19 applications—the environment for life sciences milestones is far different than we would have predicted at the start of 2020.

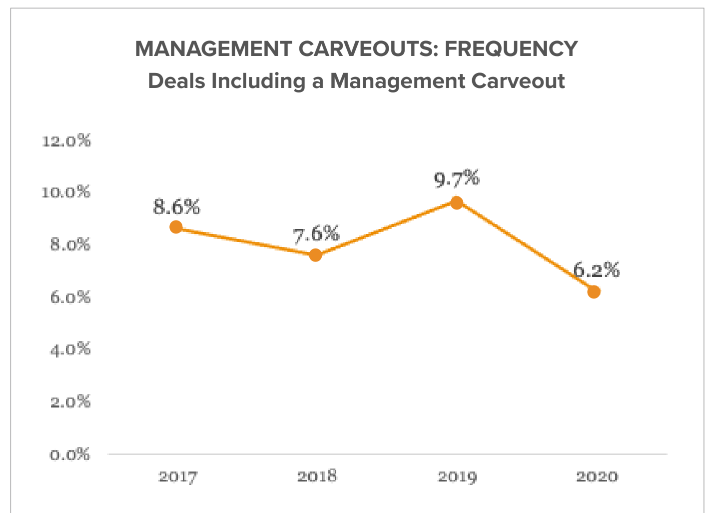
In many cases, deal parties have come to reasonable terms and agreed to amendments to account for these challenges, perhaps reflecting that lengthy, expensive disputes regarding “commercially reasonable efforts” or other covenants would not be practical during the pandemic.

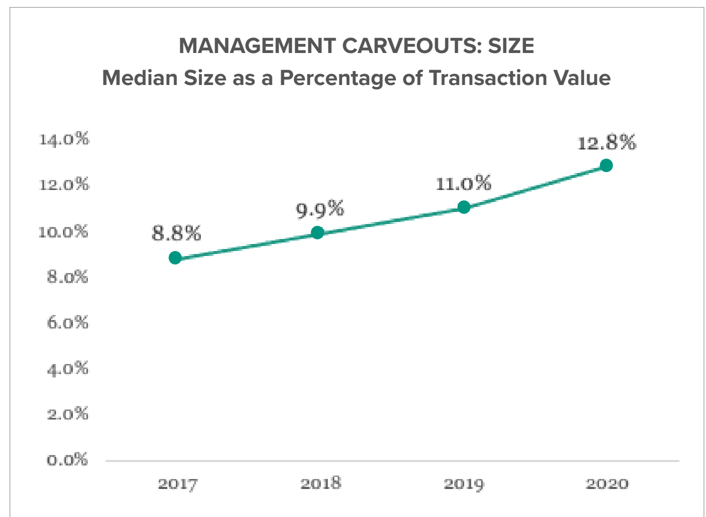
Consideration for Target Employees

Although unclear as to how management carveouts will play out over the long term, 2020 showed both a decrease in the volume of deals that include a carveout and an *increase* in the median size of carveouts as a percentage of transaction value.[5]

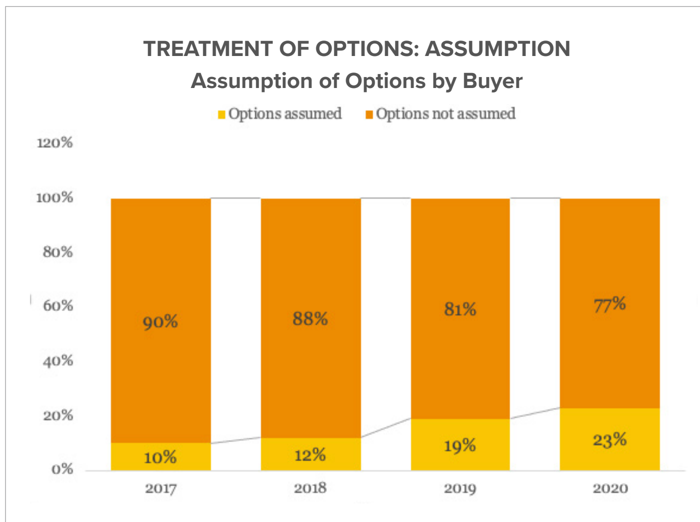
The latter figure represents an ongoing trend since at least 2017. We will be watching this closely to see if valuations have been impacted and note if there are any changes in these trends.

Another notable trend is the extent to which buyers are assuming options post-close. These figures have increased steadily since 2017, and as of the end of the third quarter of 2020, 23% of non-life sciences transactions saw the buyer assuming options post-close.





5 Transaction bonuses, which often differ materially from management carveouts in size and timing of adoption, are not included in this chart.



Other Notable Deal Terms

Representations, Warranties, and Covenants

As a general matter, representations, warranties, and covenants have not undergone significant changes in our dataset since the onset of the pandemic, but we are seeing small shifts toward the use of buyer-favorable terms. For example, the mix of representations regarding undisclosed liabilities that we view to be either buyer-favorable or seller-favorable based on their formulation has shifted slightly to look more buyer-favorable. Additionally, the percentage of deals with representations lacking knowledge qualifiers has become slightly more buyer-favorable (i.e., buyers do not need to demonstrate knowledge on the part of sellers to obtain indemnification for associated losses).

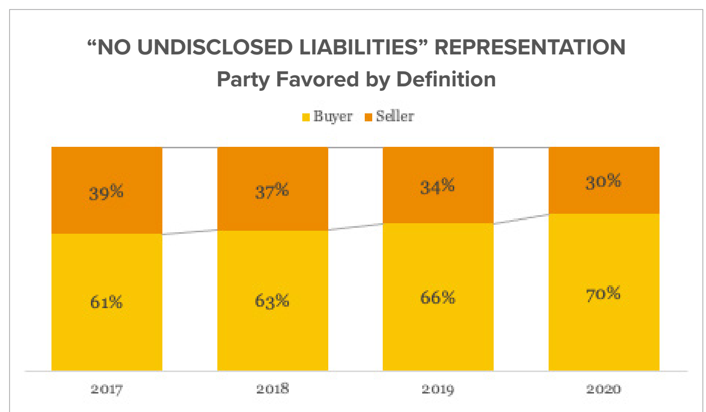
Examples

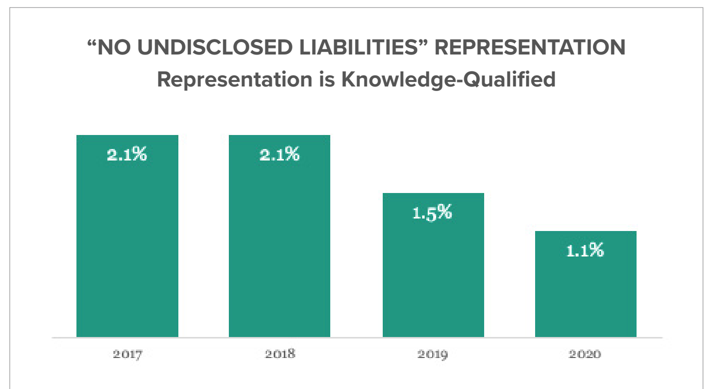
Buyer-favorable formulation

"Seller has no liability except for liabilities reflected or reserved against in the Balance Sheet or the Interim Balance Sheet and current liabilities incurred in Seller's ordinary course of business since the date of the Interim Balance Sheet."

Seller-favorable formulation

"Seller has no liability of the nature required to be disclosed in a balance sheet prepared in accordance with GAAP (or which could not reasonably be expected to have, individually or in the aggregate, a Material Adverse Effect), except for liabilities reflected or reserved against in the Balance Sheet or the Interim Balance Sheet and current liabilities incurred in Seller's ordinary course of business since the date of the Interim Balance Sheet."





Another of our bellwether measurements—the inclusions of "10b-5" and "full disclosure representations"—indicates a small movement favoring sellers. In 2019, for example, 73% of deals contained neither representation. In 2020, that number has grown to 86%.

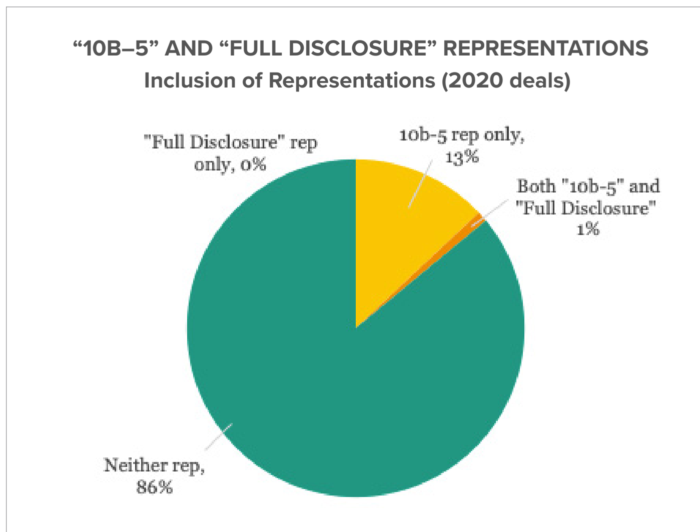
Examples

“10b–5” representation

“No representation or warranty or other statement made by Seller in this Agreement, the Disclosure Letter, any supplement to the Disclosure Letter, the certificates delivered pursuant to Section 2.7(a) or otherwise in connection with the Contemplated Transactions contains any untrue statement or omits to state a material fact necessary to make any of them, in light of the circumstances in which it was made, not misleading.”

“Full disclosure” representation

“Seller does not have knowledge of any fact that has specific application to Seller (other than general economic or industry conditions) and that may materially adversely affect the assets, business, prospects, financial condition or results of operations of Seller that has not been set forth in this Agreement or the Disclosure Letter.”



Finally, we observed a small shift toward seller-favorable representations in “no other representations” and “non-reliance” clauses. In 2019, 59% of deals included both clauses and 24% of deals contained neither clause. Both shifted in favor of sellers in 2020, while the percentage of deals with one or the other changed little:[6]

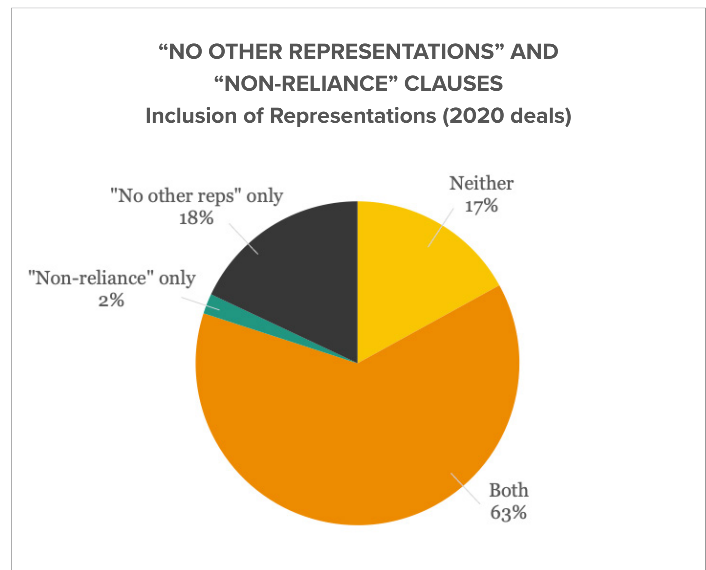
Examples

No other representation

“Buyer acknowledges that Seller has not made and is not making any representations or warranties whatsoever regarding the subject matter of this Agreement, express or implied, except as provided in this Article III.”

Non-reliance

“Buyer is not relying and has not relied on any representations or warranties whatsoever regarding the subject matter of this Agreement, express or implied, except for the representations and warranties provided in this Article III.”



Mixed as they are, it is difficult to draw conclusions about market trend from these factors, though the inclusion of Q1 deals in our dataset may have dampened what buyer-favorable trends that we’ve expected to see arise from the pandemic. Also, note that these effects are quite long term—many date back several years—so it may be the case that the pandemic has not impacted the way that M&A deal parties are thinking about these matters and that other considerations are predominant. Finally, individual representations are including COVID-19 specific items that speak to M&A deal parties’

6 The percentage of deals with only a “non-reliance” clause remained at 2%, while the percentage of deals with only a “no other representations” clause shifted from 15% to 18% from 2019 to 2020.

considerations regarding the pandemic, perhaps reflecting that risk allocation during the pandemic is primarily focused on deal-specific issues rather than broader risk concerns surrounding deals.

For example, it is quite common for the team at SRS Acquiom to see representations regarding a target's workforce—e.g., representations that no employee has been furloughed or laid off, representations that the company has not lost any material customers due to COVID-19-related issues, or representations that the target is in compliance with all COVID-19-related mandates and laws. Additionally, representations related to CARES Act relief are quite common, with parties making robust representations regarding their compliance with any legal requirements related to government relief.

Sample Language

". . . the Company has not closed any facility or operation, instituted any mandatory work-from-home policies, or furloughed any employees in response to the Contagion Event."

". . . no employee of the Company is on a leave of absence, or has requested to take a leave of absence, for a reason related to the Pandemic."

". . . the Company is and since March 1, 2020, has been in compliance in all material respects with all Laws and Governmental Orders respecting COVID-19. . ."

"The Company is in compliance with all Governmental Orders respecting the Contagion Event, including all "stay-at-home" orders or similar directives. . ."

Similarly, except in rare circumstances, we haven't seen broad changes to deal covenants, such as a qualification to "the ordinary course of business" to take into account the impact of the pandemic.

Sample Language

"From the date of this Agreement until the effective time . . . the Company shall not . . . (i) accelerate or delay collection of accounts receivable outside of the ordinary course of business consistent with past practice or (ii) delay or postpone the payment of accounts payable or other liabilities outside of the ordinary course of business consistent with past practice, in each case, except as commercially reasonable in the context of the Contagion Event."

And finally, disclosures are easily mapped against these considerations, with sellers disclosing information one would expect to see related to significant business disruptions.

Sample Language

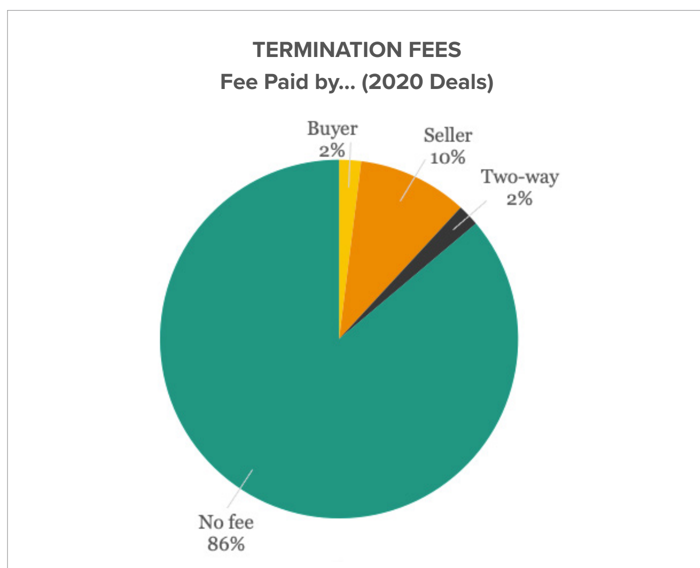
"As of the date of this Agreement, the following customers have informed the Company of the possibility of a material decrease in unit purchases due to the impact of the Pandemic: . . ."

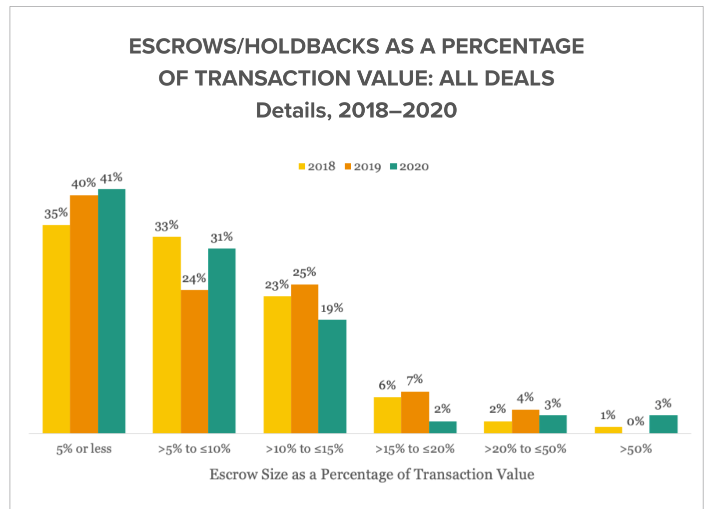
"On March 17, 2020, all employees of the Company were directed to work remotely until further notice."

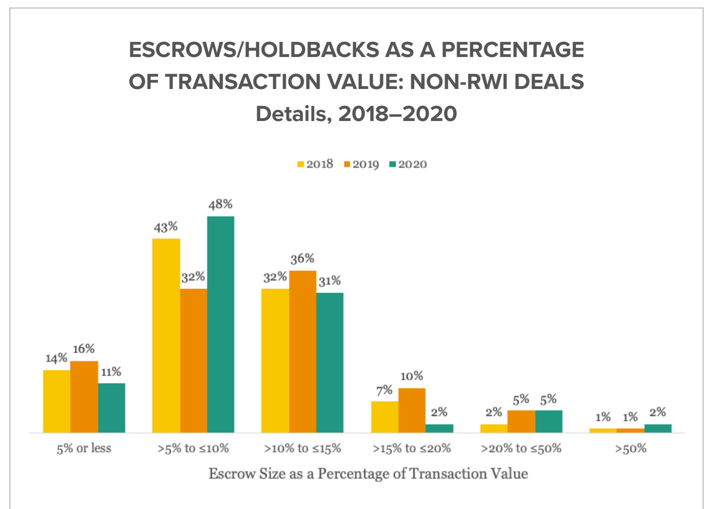
In sum, the SRS Acquiom dataset does not reflect widespread sea changes in the way deal parties are approaching representations, warranties, and disclosures, but rather targeted approaches to specific issues.

A Note on Termination Fees

When the pandemic was ascendant in the spring of 2020, SRS Acquiom was fielding a sizable number of questions with respect to termination fees: Are they more common, and are they getting larger? As of today, the answer appears to be they are no more common than in 2019, and they are somewhat smaller. Median termination fees shrank from 2019 to 2020: for buyers, from 5.5% to 5% of transaction value, and for sellers from 4% to 3.2%.







Post-Close Issues

The team at SRS Acquiom is keenly aware of the role of post-closing disputes in M&A transactions and continues to gather this data. Upon review of our dataset, little has changed. Escrow amounts as a percentage of transaction value has remained fairly stable, even when we remove deals in which the buyer obtained representation and warranty insurance ("RWI").

Although there appears to be a shift from deals with escrows measuring between 10% and 20% of transaction value in favor of escrows measuring between 5% and 10% of escrow value, those figures more closely match the same figures from 2018. It's possible that 2019 was an outlier in this respect, and 2020 is a reversion to practices in prior years.

The SRS Acquiom dataset also reflects similar non-movement in other measures we use to assess how deal parties are thinking about post-close risk allocation. There was:

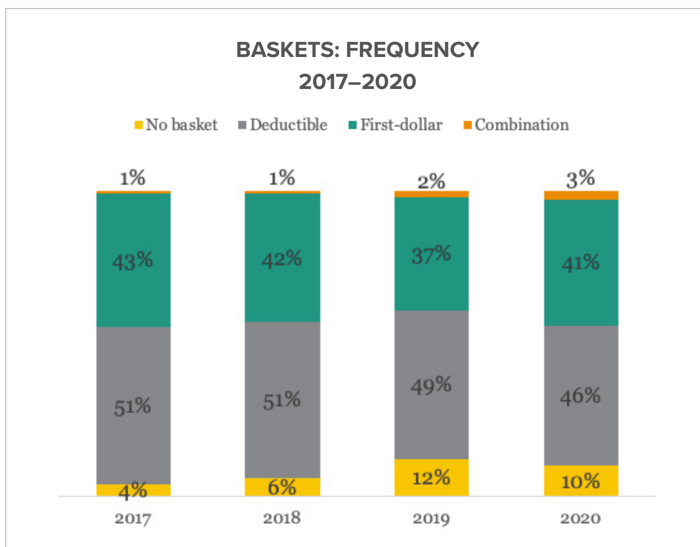
- Little movement in the use of baskets between 2019–2020
- Little movement in the length of general survival periods
- A decrease of the use of "mini-baskets," or individual claim thresholds, but this matches a trend we've observed for several years

Basket Formulations

Deductible:
"Securityholders shall not be required to indemnify Buyer for Losses until the aggregate amount of all such Losses exceeds $300,000 (the 'Deductible') in which event Securityholders shall be responsible only for Losses exceeding the Deductible."

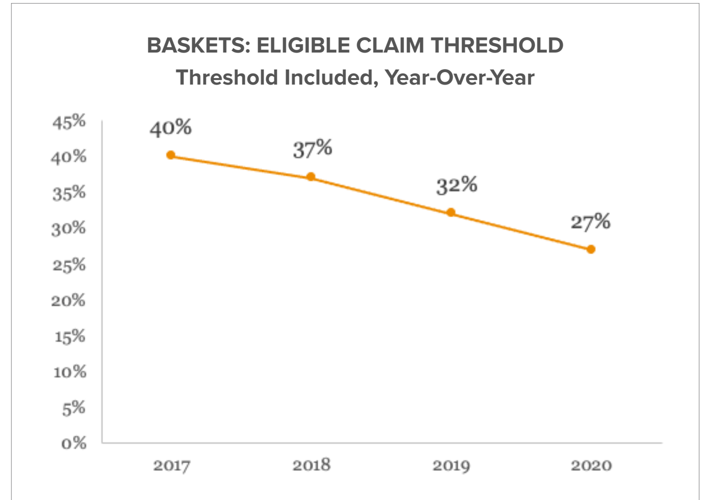
First-dollar:
"Securityholders shall not be required to indemnify Buyer for Losses until the aggregate amount of all such Losses exceeds $500,000 (the 'Threshold') in which event the Securityholders shall be responsible for the amount of all Losses, regardless of the Threshold."

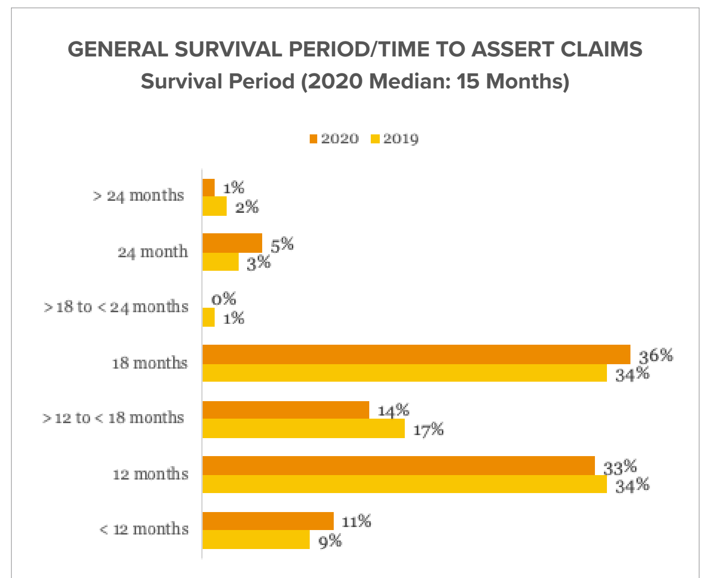
Combination:
"Securityholders shall not be required to indemnify Buyer for Losses until the aggregate amount of all such Losses exceeds $500,000 (the 'Threshold') in which event the Securityholders shall be responsible only for Losses in excess of $300,000 (the 'Deductible')."



Claim Threshold Formulation

"Securityholders shall not be required to indemnify Buyer for any individual item where the Loss relating to such claim (or series of claims arising from the same or substantially similar facts or circumstances) is less than $25,000."

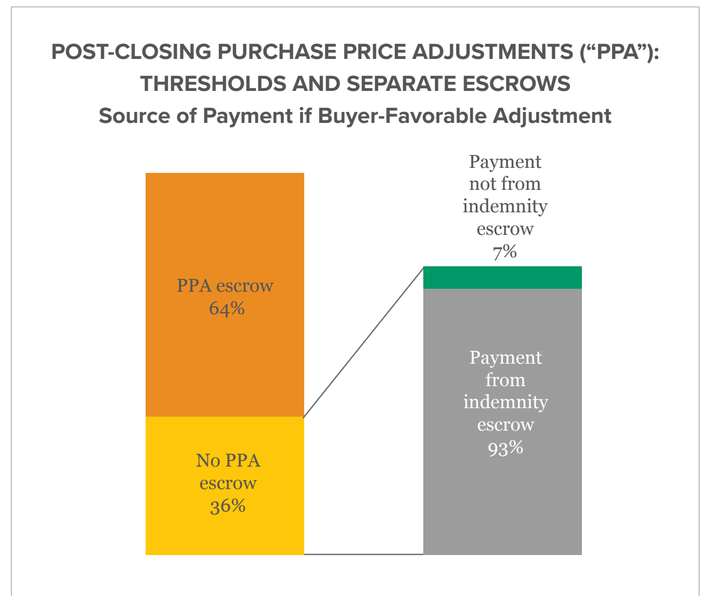




Example Survival Provisions

"**Section 10.1 Survival.** All representations, warranties, and covenants in this Agreement and the Disclosure Schedules and any other certificate or document delivered pursuant to this Agreement will survive the Closing for a period of 12 months."

"**Section 10.5 Time Limitations.** If the Closing occurs, Seller will have no liability (for indemnification or otherwise) with respect to any representation or warranty unless on or before the 12-month anniversary of the Closing Buyer notifies Sellers of a Claim specifying the factual basis of such Claim in reasonable detail to the extent then known by Buyer."



Purchase Price Adjustments

Purchase price adjustments ("PPAs") are a core component of the SRS Acquiom dataset. We pay close attention to PPA trends as we manage and resolve hundreds of PPA processes each year. In 2020, the data we have monitored reflects an ongoing trend that we've seen for some time.

Separate PPA escrows (i.e., escrows that are set aside for PPAs alone, whether there is an indemnification escrow fund or not) continue to grow in use. Indeed, in 2017 only approximately half of deals in the SRS Acquiom dataset included a PPA escrow, but in 2020 that figure is 64%. We believe there are likely two primary causes of this trend: (1) an increased use of RWI for the last several years, leading to a need for separate risk allocation for PPAs; and (2) market recognition that PPA escrows lead to a quicker release of some escrowed funds to sellers in the short term.

Although PPA deal terms do not appear impacted by the pandemic, the team at SRS Acquiom can offer some guidance on how parties might structure the PPA process within their own agreements:

- **Debt Structure and PPP Loan Forgiveness**
  M&A deal parties should carefully consider whether any debt arising out of government relief efforts properly belongs in the PPA process, especially where that debt is not repaid at closing and the parties expect some or all of the debt to be forgiven. It is our view that the timeline for PPP loan forgiveness is a bad fit for the typically brief PPA process. Parties should consider whether other CARES Act-based items, such as payroll tax deferral, might be better handled through general indemnification, tax indemnification, or a separate treatment altogether.

- **Specification of PPA Process Dates**
  With respect to the mechanics of a PPA process, anecdotally, we've seen the typical deadline for a buyer to deliver a final closing statement (usually sixty or ninety days following close) has been more difficult to meet during the pandemic, though it was not uncommon for these to have been delayed pre-pandemic. We suggest parties consider the possibility of delay when negotiating these terms, particularly if the transaction agreement contemplates deeming the estimated closing statement to be final if the final closing statement is not submitted within the prescribed period.

- **PPA Disputes**
  Additionally, in structuring the PPA dispute resolution process, parties should be aware that PPA resolutions–whether negotiated or brought to a formal dispute–tend to be taking longer at this time than in the past, likely due to challenges arising from remote work. Parties may have to be more flexible than anticipated at close to bring these matters to conclusion. The pandemic has not appeared to make parties pursue PPA escrow funds more aggressively, though we thought that might be the case at the outset of the pandemic.

Indemnification

Because indemnification claims often play out over a long-time horizon, we are unable at this time to report significant trends arising from the pandemic. Please keep an eye out for the 2020 SRS Acquiom Claims Insight Report early next year.

Capturing Future COVID-related Deal Terms

With the benefit of observing the M&A market throughout most of 2020, the team at SRS Acquiom has seen how some deal terms and practices have changed markedly–such as pandemic carveouts to material adverse effects clauses and an increased use of earnouts–while others have largely followed past practices. Like most matters related to the pandemic, it will be some time before we can fully characterize what has and hasn't changed. We have found it encouraging to see the M&A community press ahead with transactions while working creatively and flexibly to close transactions during a difficult time. We look forward to capturing future pandemic-related insights from M&A deal terms as reflected in the SRS Acquiom dataset and, as always, we will keep the market apprised of what we find.

SRS Acquiom Contributions by

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About SRS Acquiom

SRS Acquiom offers the most comprehensive platform to help deal parties manage complex financial transactions within mergers & acquisitions and bilateral or syndicated loan deals. Our solutions include paying and escrow agent services, online document solicitation and reporting, professional shareholder representation, and for loan and credit transactions, independent administrative, collateral and sub-agent services. Since 2007, we have helped businesses, investors, lenders, and advisors complete transactions as efficiently and effectively as possible, so they can focus on building strong businesses and maximizing value.

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