10 Tips to Mitigate the Risk of Deal Breakups in the Era of COVID-19

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People involved in mergers and acquisitions know there are risks inherent in every deal, including the risk that the parties will spend time and money and then the deal will not close. The only certainty in the COVID-19 world these days seems to be uncertainty. Given this unsettled environment, how can parties proactively mitigate these heightened risks?

Letters of Intent: Typically, letters of intent are not binding on the parties allowing either party to terminate discussions until a binding purchase agreement is executed. This enables the parties to learn more about each the other without obligation (other than confidentiality). However, in this era of increased deal uncertainty, parties could negotiate a binding letter of intent that instead sets out specific reasons the transaction will not go forward. Or, the parties could negotiate and include more of the substantive terms of the transaction into the letter of intent, so there are fewer surprises down the road. While many deal terms depend upon due diligence, often parties have firm expectations regarding some terms at the outset of the transaction, so it can be helpful to confirm there is a meeting of the minds in the early stages.

Exclusivity: The due diligence process may require more time given limitations on travel and in- person meetings. Ensuring the parties agree on the amount of time to be provided for due diligence, and that exclusivity extends for that timeframe or is automatically renewed, can help to eliminate issues later.

Breakup Fees: Breakup fees are frequently used in large transactions involving public companies, but historically have been less common in transactions between privately held companies. In situations of increased uncertainty, the parties could negotiate for payment of a fee, or reimbursement of attorneys' fees, in the event one party decides not to proceed with the transaction.

Earnest Money: Similar in some ways to a breakup fee, real estate transactions have historically included some amount of earnest money committed or paid upfront, with the seller keeping the earnest money in the event that the buyer chooses not to proceed with the transaction. Parties could negotiate for an amount of money to be paid upfront by one or the other party, with some or all of those funds retained by the non-terminating party.

Staged Due Diligence: If the parties stage their due diligence process so

neither party incurs significant fees until there is a commitment to move forward to the next “phase” of a transaction, both parties can reduce risk. Especially given travel restrictions and health concerns during the COVID-19 pandemic, postponing the costs and risks of travel until additional deal certainty is reached can mitigate risks. Having frank conversations before additional time is spent and costs are incurred may help, as might additional written agreements confirming the parties' intent.

Third Party Consents: Although most parties wait to contact third parties for consent until a transaction is relatively certain, under the current circumstances this may not be wise. For example, target companies that have taken advantage of PPP Loans will need bank and Small Business Association consent in order to proceed with most M&A transactions. Landlords are understandably asking more questions about the parties that are assuming leases of their properties. Understanding whether, and on what timeline, such third party consents can be obtained before time and resources are expended is crucial.

Financing: To avoid incurring expenses if a loan is not available, sellers should require a bank commitment letter from buyers—the earlier in the transaction process the better. Although interest rates are low, banks are conducting extensive diligence before providing loans. Seller financing may be an alternative for certain transactions; but this leaves the seller with significant control of the terms of the financing as well as the overall transaction, risking a last-minute change or even a collapse of the deal.

MAC Clauses: Buyers have always required the ability to terminate a deal in the period between signing a purchase agreement and closing in the event of significant changes to the target business, typically known as a material adverse change, or “MAC.” Historically, sellers could rely on the fact that courts have interpreted MAC clauses narrowly, so that very few, if any, events would be deemed to be a MAC. Recently, Delaware courts have indicated an openness to enforcing MAC “outs,” and parties have begun to negotiate COVID provisions as part of MAC clauses. Buyers and sellers will have opposite views regarding whether the effects of COVID should allow a buyer to terminate a pending transaction. One solution is to exclude COVID effects unless the effect on the target's business is disproportionate to other businesses in the same industry, just as is already done with regard to other MAC exceptions such as economic downturns.

Termination Provisions: Most purchase agreements include a “drop-dead” date, the date on which the agreement may be terminated by either party for any reason if the transaction has not closed. Consider an extended time frame for such date, or an automatic renewal, to allow for travel restrictions, virtual meetings with the target's employees, and the other delays described above.

Valuation Adjustment: Sophisticated deal makers always include risk in their calculations of the value of a transaction. In this uncertain environment, transaction valuations may simply need to take the increased risk inherent in the pandemic into account.

In summary, traditional transaction provisions can and should be adapted to address the current uncertainty in transactions. Only time will tell how many deals actually close in the current environment.