M&A Matters
Emerging from COVID-19

Welcome to the second publication in our M&A Matters series tracking notable M&A-related trends and insights. Although the economic turmoil created by COVID-19 continues to dominate the deal landscape globally, New Zealand M&A, at least for now, seems to be operating in a bubble of modified normality. In this publication we take a brief look at some of the key issues to look out for.

Price adjustment mechanisms

Working capital adjustments have long been the purchase price adjustment mechanisms of choice in the New Zealand M&A market.

The highly unpredictable nature of the current trading environment, however, creates challenges for buyers in determining a target's 'normal' level of working capital as part of their financial due diligence. It also increases the chances of unexpectedly large working capital adjustments resulting from unusual working capital movements.

Some solutions

Working capital adjustments should take into account extraordinary and non-recurring items that result from the impact of COVID-19, as well as any increased risks associated with receivables and payables – including potential repayment of amounts received under the Wage Subsidy Scheme. Parties could look to limit their exposure by making any adjustment to the price subject to a floor and/or ceiling amount.

Alternatively, parties could consider using a different pricing mechanism, such as a locked box. While traditionally seen as a seller-friendly construct, a locked box delivers price certainty to both parties in circumstances where the outcome of a working capital adjustment could be difficult to predict.

Buyers should, however, approach a locked box with a degree of caution where there is significant gap between the date of the locked box accounts and the expected date for completion of the transaction. Buyers will also need to ensure that the locked box accounts have taken into consideration any COVID-19 impacts on the target. In some circumstances, a hybrid of a locked box mechanism with adjustments for items more susceptible to uncertainty and fluctuation may be preferable.

Distressed / Rescue M&A

There has not yet been a significant increase in distressed sales, but we still expect that to be a feature of the market as the full economic impact of the pandemic takes effect. We look at some of the ways this may play out in M&A transactions.

Quick and clean exit

Sellers will want to achieve as quick and clean an exit as possible. In competitive processes, the ability to transact quickly (particularly through a lack of regulatory conditions, like Overseas Investment Office (*OIO*) consent could prove more persuasive than the headline price a buyer is willing to pay. A seller may also seek to increase commitment and deal certainty at the outset, for example through a deposit or break fee arrangement.

Sellers will also likely try to limit recourse, which may necessitate an increase in the use of warrant and indemnity (*W&I*) insurance or escrow structures – for example where a portion of the purchase price is retained for the warranty claims period.

However, sellers shouldn't expect to have it all their own way, particularly if there is a swing to a buyer's market similar to that seen after the Global Financial Crisis of 2007-08.

"a locked box delivers price certainty to both parties in circumstances where the outcome of a working capital adjustment could be difficult to predict"

Joshua Pringle

Transactions at an undervalue

If a buyer's market emerges and prices are generally lower, buyers will nevertheless need to ensure the price they pay is at fair market value to avoid any future challenge by a liquidator. Under the Companies Act, liquidators can seek to recover the difference in value for transactions that occurred at an undervalue during the two year period prior to commencement of the liquidation.

Separately, buyers will need to consider reputational risk if they transact at a price that is perceived to be opportunistic or otherwise low. That risk will be higher where the target has received government support.

Directors' duties

Directors of a business in financial difficulty will be strongly focused on their duties under the Companies Act. Although this does not directly impact the buyer, it has the potential to shape the nature of negotiations. This effect will be accentuated if D&O policies are tightened as insurers seek to limit their exposure to COVID-19 related claims.

See also Chapman Tripp's commentary on the Government's COVID-19 insolvency law package, including the temporary "safe harbour" available to directors of companies facing significant COVID-19 generated liquidity problems.

W&I insurance

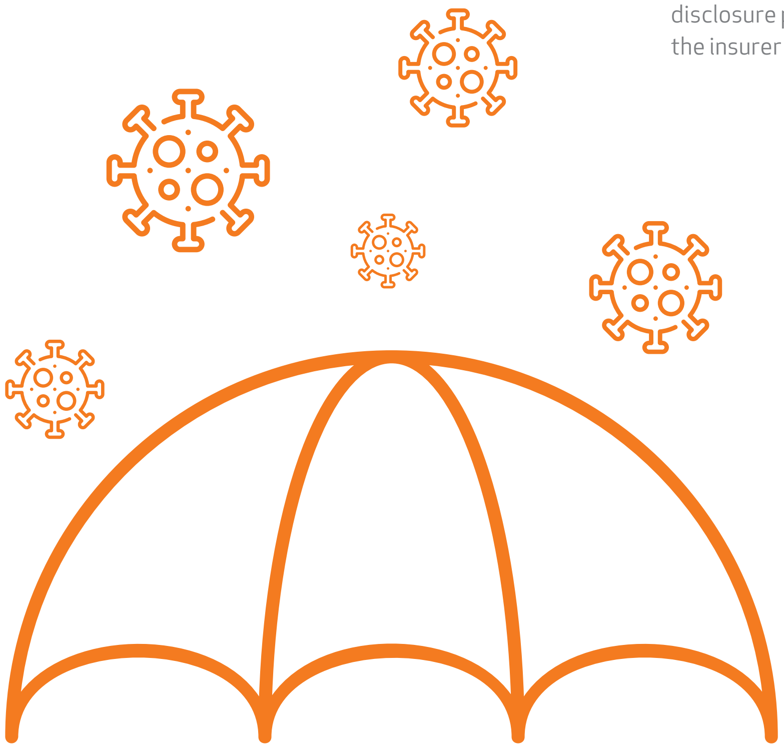
Our recent experience is that W&I insurance underwriters have been more prepared to continue to write policies than perhaps we anticipated, though that could be a result of recent M&A transactions being focused on sectors that have not been badly affected by the pandemic.

Underwriters have capital allocated to their W&I insurance businesses and remain willing to deploy that capital and write policies in the right circumstances.

Further, at least in the New Zealand market, most insurers are showing a willingness to engage on whether a blanket COVID-19 exclusion from the policy is appropriate depending on the target's exposure to COVID-19 risk, which we expect most buyers would have addressed exhaustively in the due diligence process.

Separately, we may see a rise in the use of 'synthetic' W&I insurance policies, particularly in relation to distressed M&A transactions where it may not be possible to negotiate meaningful warranties with the seller(s). Synthetic policies cover a suite of warranties negotiated directly with the insurer, which are set out in the policy rather than in the transaction documents. The insurer will rely more heavily on the quality of due diligence undertaken by the buyer to determine the warranties it is willing to cover, compared to a traditional W&I process where negotiation of the warranties between the buyer and seller remains an important feature.

The price for a 'synthetic' W&I insurance policy will inevitably be higher than for a traditional buy-side policy in normal circumstances, reflecting likely shortcomings in the disclosure process and the higher level of risk being taken by the insurer as a result.



Overseas Investment Regime

New Zealand has joined other jurisdictions in tightening its foreign direct investment rules to protect key assets in distress from predatory purchase by foreign investors.

In June, the Government enacted legislation introducing an emergency clearance process that considers whether relevant transactions raise national interest concerns.

That approach, rather than simply lowering the existing consent threshold, appears to have paid off when compared to the position in Australia, where Foreign Investment Review Board (*FIRB*) decision timeframes have significantly lengthened as a result of reducing their monetary screening threshold for foreign investment to $0. By contrast, the New Zealand emergency clearance process does not apply where consent under the Overseas Investment Act is already required, and is designed to be comparatively quick and simple, with the majority of applications cleared within 10 business days of the notification being made.

Some practical considerations of which parties (particularly buyers) should be aware:

- although more straightforward than a consent application, the 'light touch' notification form requires significant information on the buyer's ownership and control structure and its directors (including copies of passports)
- the form must be completed online and is rigid in its requirements (for example containing character limits on certain responses), which can be challenging for more complex transactions
- a degree of cooperation from the target is required, as target financial statements for the previous two years must be uploaded, and
- as the form cannot be saved once started, it is more efficient to collect all necessary information in advance.

A buyer should either complete the notification and receive clearance before signing or include a suitable condition precedent in the transaction documents. In most cases, we expect a three week window would be sufficient to collect the necessary information, submit the notification and to receive confirmation from the OIO that the relevant Minister has cleared the transaction.

If a transaction involves potential national interest concerns, an additional 30 business day review period applies, which can be extended once by another 30 business days. National interest considerations will apply most acutely where the buyer is a foreign government investor and/or the target operates a strategically important business.

As an inherently political tool, the national interest test could potentially be used in respect of transactions which are seen as opportunistic acquisitions at an undervalue (e.g. as a result of the impact of COVID-19 on the target business), though we're not aware of any transaction having been blocked on this basis to date.

The emergency regime is subject to periodic review by the Government, and will be unwound when the effects of the pandemic no longer justify its continuation. At this stage, we expect it will remain in place at least until the end of this year.

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Luke Bowers

Ongoing impact of COVID

In our first M&A Matters **publication**, we looked at the immediate impact of COVID-19 on due diligence, interim period covenants, conditionality and material adverse change clauses, price protection, warranties and indemnities, W&I insurance, and regulatory and enforcement considerations.

For the most part, those impacts are ongoing. However, we note that:

- practical challenges for due diligence in relation to domestic transactions are no longer a significant concern, given New Zealand's largely virus-free status, but remain in play for overseas investors, and
- in addition to the areas we previously outlined, due diligence should include:
  - key counterparty conduct during and since the lockdown, including whether those counterparties have been and are complying with their obligations, and
  - the target's entitlement to and/or compliance with the Wage Subsidy Scheme and other relevant government assistance programmes.

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