M&A MATTERS

CHAPMAN TRIPP

DEAL-ING WITH COVID-19

The COVID-19 pandemic has created a climate of extraordinary uncertainty. In this note we discuss some of the key legal considerations for parties looking to undertake M&A in this shifting landscape. Welcome to the first publication in our new series – *M&A Matters,* where we share notable trends and insights on key legal and regulatory issues affecting M&A.

DUE DILIGENCE

Restrictions on inspections of facilities and in-person management meetings, as well as the difficulty of populating data rooms where physical files cannot be accessed, will make due diligence a more drawn-out exercise than usual. To the extent buyers are still able to carry out legal due diligence, we recommend a slight shift in emphasis, with a focus on a few key areas which we delve into below. In some cases, physical access may be so critical that transactions need to be made conditional on satisfactory physical diligence occurring within a certain period.

Supply chain

If the target is primarily a supplier, contractual diligence should focus on the extent to which the target can continue to perform, the target's rights to suspend performance, and counterparties' termination rights for non-performance. Buyers should investigate both the scope and effect of any force majeure clauses (see our note on these here) and whether the target has taken appropriate action under them, including by giving required notices to counterparties. The converse will apply where the target is dependent on suppliers who may be looking to suspend their own supply obligations. Buyers should also be on the lookout for minimum volume or take or pay clauses, particularly where they relate to goods which are usually fast-moving or perishable.

Business continuity/disaster recovery planning

Most targets will have already largely implemented their BCPs by now – it will be crucial to look into how effective these have been, the impact of these plans on the target's ability to carry on business as usual, the extent to which the business has been affected by supply chain disruptions, and what plans are in place in case the situation worsens further.

Employment contracts and health and safety

The pandemic has brought employment issues into sharp relief (some of which we have discussed in our note here). Buyers should look into how the target is complying with its obligations to employees under health and safety legislation, as well as in relation to any employees who are unable to perform their duties due to the current "alert level 4". It would also be prudent to look even more closely than usual at annual leave, holiday pay, sick leave and redundancy entitlements, as the unfortunate reality is that these are becoming actual and not merely contingent liabilities as the crisis rolls on. The target's entitlement to government subsidies should also be carefully assessed; eligibility should not be assumed.

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JOSHUA PRINGLE, PARTNER

Data protection/privacy
With more employees working remotely, buyers should investigate the measures that are in place to ensure that business critical information and personal information pertaining to customers remain secure and confidential.

Insurance
Buyers should consider the extent to which the target's existing insurance policies (e.g. business interruption insurance) will cover losses caused by COVID-19 – as any new policies will no doubt expressly carve this out, particularly for sectors that are most exposed to the effects of the pandemic.

INTERIM PERIOD COVENANTS

Is it still appropriate to include a general obligation to operate the target business in the "ordinary course" or "consistent with past practice" between signing and settlement? Sellers will want flexibility to react to the challenges posed by the pandemic, and it will generally be in buyers' interest to give such flexibility. However, as always care needs to be taken to ensure the right balance is struck.

Some specific drafting considerations include:

- to what extent sellers should be able to take anticipatory rather than purely responsive actions in relation to the pandemic (and the scope of any discretion in this regard),
- whether there should be specific, positive obligations to maintain relationships with specified suppliers or customers and retain specified employees or classes of employees,
- whether such obligations should be absolute or obligations to use best or reasonable endeavours only, and
- whether there should be express exceptions from interim covenants in order to comply with applicable law – and what exactly "law" means in this context, given the response to the pandemic encompasses a variety of regulatory bodies (for more on this, see our note here).

At a practical level, it has become even more important for buyers and sellers to keep communication lines open, for sellers to proactively approach buyers for consent to take action where such consent is required, and for buyers to promptly consider and respond to such requests. In our view, this is not a situation where the adage that it's "better to ask for forgiveness than permission" applies.

CONDITIONALITY AND MATERIAL ADVERSE CHANGE CLAUSES

In addition to a material adverse change/effect condition, and regulatory approval conditions where applicable, buyers should consider including specific conditions precedent in sale and purchase agreements in relation to matters such as:

- compliance by the target with its banking covenants,
- retention of key customer or supplier contracts/relationships, and
- retention of key employees/classes of employee.

Pre-pandemic, our relatively seller-friendly market meant that sellers were often able to resist the inclusion of MAC conditions; there may well be some buyers who are now regretting having made that concession. Having said that, MAC conditions are in fact fairly complex beasts to draft and apply – far from the transaction-killing silver bullets buyers may believe them to be.

When negotiating a MAC condition, or assessing the application of an existing MAC, parties should consider the following, backward-looking (i.e. undertaken at the time the MAC would be triggered) step analysis, assuming the MAC in question is intended to follow, or follows, the usual New Zealand market practice for such clauses:

1 *Has there been a material adverse effect on the target (or, depending on drafting, will there be/is it likely that there will be such an effect) which arose after the date of the SPA?*

2 *If so, does the relevant event fall outside a list of exceptions in the clause? These tend to be somewhat broadly defined, but often include:*

- general or industry-wide economic, financial, regulatory, legal or political conditions,
- war, terrorism, armed hostilities, "calamity" or other international or national emergency,
- natural disasters, acts of God or "other force majeure events", and
- less commonly in the New Zealand market, epidemics, pandemics and other health crises (sellers will obviously be looking to carve out pandemics, or COVID-19 in particular, from MAC clauses going forward).

3 *If an exception does not apply, does a requirement that the relevant event has had a disproportionate effect on the target business apply (either as a condition for falling outside an exception, or as a general proviso)?*

4 *If so, did the event have such disproportionate effect? This limb could be critical, given the broad impact of the pandemic on economic activity.*

There are many different ways of formulating the various elements of a MAC clause, and difficulties can arise in relation to determining:

- the timing of the occurrence of the relevant event relative to the date of the agreement (given the COVID-19 pandemic is an on-going event, we see a high potential for timing-related disputes),
- whether the impact is in fact material (more difficult where the MAC clause does not include objective standards such as specified decreases in earnings or value), and
- the "peer group" against which the question of disproportionate impact is to be assessed.

In drafting new MAC clauses we suggest specificity with respect to these and other key elements will be critical, although for some parties there may still be an attraction towards ambiguity in particular circumstances.

Purported terminations in reliance on MAC clauses will be a key area for disputes and litigation in the near future. Buyers that are considering invoking such clauses would be wise to take legal advice from an early stage, to manage correspondence and avoid foot-faulting.

It's also worth noting that "backdoor" MAC termination rights may be available, either by inclusion of a financing condition (facility documents will almost certainly include their own MAC conditions) or by providing for termination rights for warranty breaches arising prior to settlement.

PRICE PROTECTION

The unpredictable nature of the pandemic means that it is no longer sensible to value businesses based on an earnings multiple, without some sort of true-up to reflect the "new normal". This is likely to contribute to the inclusion of a range of mechanisms in sale and purchase agreements, including:

- earn-outs (which have fallen out of favour somewhat in recent times, and are also a mechanism ripe for disputes), and
- claw-backs based on actual earnings (potentially supported by an escrow/ retention amount or vendor loan).

WARRANTIES AND INDEMNITIES

Buyers should seek robust warranty coverage in relation to matters such as:

- sufficiency of inventory/working capital,

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JEREMY GRAY
SENIOR ASSOCIATE

- no disruptions to supply chain,
- collectability of receivables and payment of accounts payable,
- no breach of contract or notice of termination, and
- solvency and compliance with financing covenants.

Given the ever-evolving challenges currently being faced by businesses, sellers will be more reluctant than usual for warranties that are given at signing to be given again at settlement (without the right to disclose against them). This reluctance may inevitably go to the price a buyer is willing to pay.

W&I INSURANCE

With respect to the W&I market, brokers are telling us that at this stage they expect W&I policies will continue to be written, insurers having not yet flagged a significant change in their appetite for insuring M&A transactions. Having said that, we would expect that:

- insurers will shy away from transactions in the most severely impacted sectors (e.g. tourism and hospitality) or businesses which are dependent on a supply chain from badly affected countries,
- COVID-19 specific underwriting procedures (focussing on high-risk areas such as supply chain, employment/health and safety and business continuity related warranties) are likely to add time and complexity to the relatively streamlined underwriting processes to which we have become accustomed, and potentially require the use of specialist consultants to support these new diligence requirements,
- insurers will seek to carve out warranty breaches/loss arising from COVID-19 from coverage in their entirety – the extent to which this will become "market" remains to be seen, but parties and brokers should seek to narrow any such exclusions to the maximum extent possible, and
- insurers may not offer "new breach" cover for warranty breaches arising during the period between signing and settlement (or the cost of such cover may become even higher) – this could be a particular issue for deals conditional on regulatory approval, and therefore subject to longer interim periods.

In short, we think W&I insurance may no longer be the elegant solution it once was (especially in terms of providing sellers with a clean exit), and we are likely to see a decrease in insured transactions and an increase in escrow/retention arrangements as a result, or possibly a greater number of "mixed" transactions, where insurance is taken out but sellers retain significant liability for uninsurable risks.

REGULATORY AND ENFORCEMENT CONSIDERATIONS

Buyers and sellers should note that regulators, including the Overseas Investment Office, Commerce Commission and Financial Markets Authority, are currently adjusting to working from home, but so far we have not noticed any delays to processing timeframes as a result of this, and anecdotally regulators appear to be taking a more facilitative approach. Regardless, sellers should be seeking longer periods in sale and purchase agreements for satisfaction of regulatory conditions, and mechanisms to extend where necessary, to be on the safe side.

Notably, the Australian Foreign Investment Review Board (FIRB) recently announced that the financial threshold below which overseas investment would not require consent is temporarily being reduced to zero, in a move "designed to protect Australia's national interest as we deal with the economic implications arising from the spread of the coronavirus". The

equivalent threshold in New Zealand under the Overseas Investment Act is NZ$100m, subject to certain exceptions. The statutory deadline for FIRB to complete screening has also temporarily been extended from 30 days to six months. Buyers and sellers, and their advisors, should be conscious of this when considering Australasian transactions, and alive to the possibility that similar restrictions could be imposed here, although as yet there is no indication of this.

Parties wishing to enforce contractual rights (for example, seeking orders for specific performance where a counterparty has failed to settle a transaction) will have to grapple with potential delays in the Courts, which are only open for "priority fixtures" such as criminal and family matters while we are at alert level 4. We expect that this will result in mediators and arbitrators looking to fill the void in relation to resolution of commercial disputes. Parties should strongly consider including arbitration clauses in sale and purchase agreements so that any disputes can be resolved promptly.

LOOKING TO THE FUTURE

Presently M&A is in lockdown, much like all of us, although we are aware of a few deals still being allowed out for exercise.

However, taking into account factors such as:

- private equity firms that are sitting on significant uncalled capital (noting the potential impact of existing portfolio company recapitalisations) and who are therefore capable of structuring less leveraged deals in a tightening debt market, noting that internationally the best vintages for private equity funds in the last 20 years were 2001 and 2008,
- rationalisation of asset pricing in the equity capital markets (described by many as a correction), and
- an inevitable increase in distressed sales,

the stage is set for an increased level of public and private M&A activity as the full impact of the pandemic becomes more certain.

We see no reason why successful outcomes cannot be achieved, so long as buyers and sellers make appropriate adjustments to their approach to deal making. More than ever, getting the fine details right will be critically important.

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