KING & SPALDING

CRISIS PRACTICE

Coronavirus

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M&A Purchase Price Considerations in the Context of COVID-19

Much like everything else in the world, M&A transactions must adjust in order to account for the impact of COVID-19. Arguably the most important feature in any M&A transaction is the purchase price. Set forth below are several practical ways for parties to reach a successful agreement regarding the purchase price despite coronavirus-related uncertainty.

POST-CLOSING PURCHASE PRICE ADJUSTMENTS

Most acquisition agreements contain provisions allowing for adjustments to the purchase price after closing, particularly in the form of net working capital adjustments. Net working capital adjustments work by allowing the parties to "true up" the net working capital component of the purchase price, which is typically estimated at the time of closing, with the actual amount of the target company's net working capital at the time of closing calculated after the closing date. While determining and negotiating the mechanics of the net working capital adjustment, given the impact of COVID-19 on most (if not all) businesses, parties should ask themselves the following questions:

- Given the impact of COVID-19 on the target company, how should "target" or "peg" net working capital be determined? For example, taking an average of net working capital over the last twelve months may not be the best measure.

- When is the closing expected to occur? What impact will the timing of the closing have on net working capital? For example, parties may expect the prospects of a target company to be better if closing is expected to occur in three to six months as opposed to one month.

- Has a review of the impact of COVID-19 on the target company's working capital been undertaken? If so, what was the result of that study? Buyers now have the benefit of observing how a target company has been impacted over several months in the coronavirus world, and any company going through a sale process should be prepared to provide those results.

- How will parties determine inventory levels after closing? It is not unusual for an acquisition agreement to contain a requirement for the performance of a physical inventory in connection with the determination of net working capital. Given the impact of COVID-19 (and social distancing), is taking a physical inventory even possible? How will the parties deal with obsolete inventory?
- Consider whether the response times for providing the post-closing information (and any response thereto) in order to calculate the exact net working capital amount is adequate or if it is likely that more time will be needed.
- Is a collar on the purchase price adjustment to minimize dramatic swings during the crisis appropriate? Parties can incorporate a ceiling (an upper limit to any positive adjustment amount) and/or a floor (a limitation on the negative adjustment amount) to limit the risk for either or both parties.
- How will the parties take into account any loans that a target has received under the CARES Act and the Paycheck Protection Program ("PPP")?

EARNOUTS

Given the impact of COVID-19 on the business of many companies, it is becoming even more common for buyers and sellers to have a disconnect on the perceived value of a business being bought/sold. How can parties bridge this valuation gap to get to a deal? Earnouts may provide that bridge and are becoming particularly important, and increasingly more common, in acquisition agreements in the context of the COVID-19 outbreak, when the future performance of a business is especially hard to predict. Earnouts are payments with respect to a target company that are contingent on the target achieving certain post-closing milestones, which are often tied to revenue or EBITDA targets. For example, if a target company achieves revenue of a certain amount during the year (or two) following closing, the buyer agrees to pay the seller additional consideration as part of the purchase price. This contingent consideration serves as a risk-allocation mechanism whereby the buyer and seller can bridge the gap between different expectations for the performance of the target business post-closing.

Given the uncertainty regarding business operations going forward, with the potential for rolling stay-at-home orders and social distancing measures for an extended period, the parties to an M&A transaction must pay even more attention to how an earnout is structured. Set forth below are areas to pay particular attention to when drafting an earnout provision:

- How will the target business be operated post-closing, including with respect to any limitations on how the business will be run after closing in a COVID-19 environment that could necessitate significant changes? How can the seller be assured that the target business will be operated post-closing in a manner to maximize the possibility that the earnout will be paid?
- How will the milestones be set, including both in terms of the appropriate threshold amount(s) and the timing of the measurement date(s)?
- If there is more than one possible earnout payment, how will the parties manage failure to attain a threshold in one year vs. overperformance in another year? Will pro-ration or catch-up payments be permitted?
- What accounting methodologies will apply to the target company post-closing for purposes of the earnout? Will it be the accounting methodology used by the target company pre-closing or the accounting methodology used by the buyer post-closing?
- How will the parties treat any PPP loans received by the target company and the forgiveness thereof?
- What happens if the target company is sold during the earnout period? Does the new buyer assume the earnout? Does the first buyer have to pay all of the earnout at the closing of the sale to the new buyer?

BUYER STOCK

Buyers can pay the purchase price in an M&A transaction to the seller in the form of (i) cash (which can be obtained by the incurrence of debt), (ii) stock of the buyer or (iii) a mixture of both. Due to COVID-19, debt markets are tighter, and many potential buyers are hoarding cash until their own operations and the economy as a whole return to some level of stability and predictability. Given these factors, buyers may find it favorable to use stock as consideration for an acquisition in lieu of cash. From a seller's perspective, the buyer's stock provides upside potential if the buyer's value increases post-closing, as well as the potential for tax advantages over an all-cash acquisition. It is important to engage tax advisors/specialists when considering stock versus cash consideration, and the parties should consider the appropriate share valuation method (fixed, floating or hybrid) to address stock price fluctuations between signing and closing, particularly given the recent extreme market volatility. Determining the appropriate value for stock consideration will depend on the buyer's prospects (including today in the context of coronavirus), so the seller should consider its expectations for the buyer's stock when negotiating the purchase price in a transaction involving stock consideration.

DISTRESSED SALES

While the CARES Act has made certain changes to U.S. bankruptcy law that distressed companies can evaluate and consider, many companies may be better off pursuing a distressed sale instead of bankruptcy. The valuation of intangible assets such as intellectual property (e.g., patents, brands and know-how) may have dropped significantly as a result of COVID-19's impact, particularly with respect to distressed targets, which may present an opportunity for a tax efficient transaction and a more attractive purchase price. Depending on the company's asset composition, it may be better to structure the deal as an asset sale instead of a stock deal (or vice versa). These considerations will certainly impact the purchase price and may present options to a target company feeling cornered by the difficult economy, so it is imperative to engage qualified restructuring and tax advisors to advise in these situations. Buyers with available resources will also want to be equipped to take advantage of the opportunities in the market to acquire distressed targets at values well below pre-COVID-19 levels.

CONCLUSION

COVID-19 has made it even more difficult to value target companies, which is why post-closing purchase price adjustment mechanisms and earnouts are increasingly helpful tools to enable buyers and sellers to reach an agreement and consummate a transaction. Parties should not forget to consider buyer stock as an alternative to cash for the purchase price payment in these volatile times. Further, distressed sales may present new opportunities and options for buyers and sellers alike.

For more on how COVID-19 is impacting ***other provisions of acquisition agreements*** *beyond the purchase price, see our Client Alert titled, "COVID-19's Impact on Acquisition Agreements and M&A Deal Processes."*

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