How COVID-19 has affected global M&A transactions

Jimena González de Cossío Higuera of **Chevez Ruiz Zamarripa** explains how global businesses have been forced to adapt their M&A activity owing to the coronavirus pandemic.

The COVID-19 pandemic represents an unprecedented disruptive event, both in the respect of personal and social relationships, as well as in the operation, management and preservation of corporations. The corporate world has faced an unprecedented challenge in preserving the operation of companies, the health and wellbeing of their employees, maintaining liquidity levels and sources of funding, and balancing the interests of their different stakeholders.

In this context, COVID-19 continues to have significant effects on companies and their operations, including on mergers and acquisitions (M&A), financing, securities market, contractual and commercial agreements. The purpose of this article is to describe in general terms the main impact of the COVID-19 pandemic on M&A transactions.

Renegotiating contracts

The COVID-19 crisis broke out at a stage where businesses were proceeding amid a diverse scenario of M&A transactions, which can be divided into three types: transactions under analysis or in progress; transactions executed and pending closing; and transactions that have been closed and are in process of integration. In this scenario, the valuation, allocation and mitigation of risks in the M&A environment, as well as the analysis of exit strategies for executed transactions pending closing, were the main focus of companies and advisors involved in M&A transactions since early 2020.

Many buyers reconsidered M&A transactions and explored recourses, actions, creative and even aggressive negotiation strategies to renegotiate contract terms or even seek an exit.

Clauses relating to closing conditions or conditions precedent, as well as termination or exit rights, were the main provisions that gave rise to contract renegotiation, and even to numerous lawsuits, due to uncertainty of the effects of the pandemic.

As is common practice, many M&A transactions are structured in such a way that the signing of the contracts takes place at a certain point in time and the closing of the transaction only happens when several conditions have been met, such as obtaining corporate or governmental authorisations, which imply the passage of a certain time and consequently several risks related to the closing of the transaction. In the period between signing and closing, the business or financial condition of the target company may deteriorate to the point where a buyer wants or decides to terminate its purchase obligation on the terms and at the price agreed.

In this context, various clauses have been used in corporate law that aim to allocate risks in the aforementioned transitional period. In general, systemic risks or risks beyond the seller's control are assumed by the buyer, while risks inherent to the operation and management of the business during this interim period are borne by the seller.

MAE and termination clauses

Specifically, in view of the COVID-19 pandemic, there has been much discussion and even litigation at an international level regarding the material adverse effect (MAE) clause. This clause typically gives the buyer the right to terminate a purchase or association transaction prior to closing, upon the occurrence of an event or circumstance that has – as its definition indicates – a material adverse effect on the financial or business condition of the target company.

MAE clauses are intensely negotiated in M&A transactions and are generally designed in two parts. The first part consists of a general definition of events, circumstances or facts that have a negative effect on the business, financial and operating condition of the target, or its capacity to comply with its obligations under the contract. The second part incorporates several exceptions, which generally include acts of god or *force majeure*, natural disasters, war and acts of terrorism, and other similar concepts beyond the seller's control. In addition, such exceptions may or may not include pandemics such as that caused by COVID-19.

Although there is no uniform definition or interpretation of a material adverse event, international precedents define it as a circumstance that significantly affects an entity's earnings potential over a reasonable period of time or over the long term. This concept of time is relevant, since it is assumed that a buyer intends to carry out an acquisition in order to obtain a return in the long term.

Whether or not the COVID-19 pandemic constitutes a material adverse event, under which the purchasers could have an effective exit from the transaction, a detailed analysis of the MAE clause, the exceptions referred to above, as well as the particular impact on the company is required to determine if, in fact, a material adverse effect has occurred.

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Recently, the trend in M&A transactions has been to exclude COVID-19 or other pandemics from such clauses, unless the effects are disproportionate to other companies in the same industry.

Ordinary course of business

From another perspective, buyers in M&A transactions have pursued other exit mechanisms in the face of the prevailing COVID-19 situation, such as invoking a breach of clauses relating to the operation of the company in its ordinary course of business in the period between signing and closing of the transaction.

These clauses are intended to ensure that the sellers do not carry out acts that fundamentally affect the target company's business in the period between signing and closing. As is evident, in times of the pandemic, managers were forced to take actions to preserve the operation and survival of the business, which were not necessarily consistent with the ordinary course and in accordance with past practice.

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The discussion is extensive on this point: some purchasers allege breach of the ordinary course of business operation clause in the sense that the actions taken by management in response to COVID-19 pandemic, materially violate the ordinary course of business clause by departing from the company's operating patterns; while other purchasers point out that the lack of timely decision-making and actions in response to COVID-19 – such as the adoption of operational changes, reduction of personnel or other initiatives – result in the economic deterioration of the company, in contravention of the ordinary course of business clauses. Conversely, the sellers argue that, in a situation such as the prevailing one, the actions taken to address the crisis of COVID-19 are reasonable and within market practices in the corresponding context.

The interpretation and analysis of the aforementioned clauses gave rise to the renegotiation of many transactions, the termination of others and the litigation of some of them.

The trend for structuring and negotiating M&A transactions going forward will be an even more detailed analysis and drafting of MAE clauses, ordinary course of business and other termination clauses and exit mechanisms, including exceptions agreed to by the parties based on the allocation of risks between the parties.

Due diligence processes

It is also important to make a brief analysis of due diligence processes in M&A transactions. In response to the impact of COVID-19, there are certain aspects that warrant special attention in such due diligence processes.

One of them is regulatory compliance. As a result of COVID-19, various provisions have been issued at the federal, state and municipal levels, which have been subject to numerous changes. These provisions include closing of operations, limited or staggered re-openings, health and COVID-19 testing requirements, as well as relevant obligations regarding the use of personal data and confidentiality, which are relevant compliance-related aspects that must be verified in a M&A transaction.

Another relevant aspect in the audit process will be the analysis of the contractual relationships of the target company, the risks arising from the supply chain, as well as the exposure of the counterparties to risks arising from COVID-19. Early termination clauses due to unforeseeable circumstances and *force majeure*, including the requirements to invoke such clauses, MAE clauses as mentioned above and exclusivity agreements that prevent the substitution of suppliers, among other provisions that represent a risk in the continuity or termination of such contractual relationships, should be analysed. Furthermore, it is important to analyse the insurance structure and its respective coverage, specifically including business continuity policies.

With respect to financial agreements, it is essential to analyse and identify breaches or events of default have occurred, including the with respect to obligations to maintain financial and operating metrics or other typical obligations in financing agreements, as well as communications and relations with the company's creditors during the COVID-19 period, should be verified.

There are numerous effects that COVID-19 has had and will continue to have on companies going forward; hence, due diligence processes should focus on the specific industry and the risks surrounding the target company and the third parties involved in its operation.

Without a doubt, the prevailing situation derived from COVID-19 has given rise to a number issues under discussion and analysis around M&A operations, many of which do not have a uniform interpretation and should be assessed based on the agreements among the parties and the factual situations around such contractual relationships.