



# Impact of COVID-19 on Mergers and Acquisitions Deals

New Laws, Economy, Changed Ways of Doing Business Force Attorneys to Reevaluate All Aspects of Transactions

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**H**istory will remember 2020 as the year the coronavirus wreaked havoc across the world. Despite a brief pause at the outset of the COVID-19 pandemic, middle-market companies and advisers adapted quickly and had a remarkable year engaged in mergers and acquisitions (M&A) transactions. While to some extent the transactions represented “business as usual,” COVID-19 impacted all aspects of M&A transactions.

Valuation methodologies of target companies changed to discount for declines in business and allocation of risk, among other changes. The industry coined the new financial metric “EBITDA+C” (earnings before interest, taxes, depreciation, amortization, and coronavirus), and buyers expanded due diligence requests relating to employment and benefits and COVID-19 compliance and required additional post-closing escrows. Banks, landlords, vendors, and customers experienced their own impact from COVID-19, compounding delays and transaction complexities. The United States Small Business Administration and United States Department of the Treasury published and continually updated their guidance and rules<sup>1</sup> related to the Family First Coronavirus Response Act, as amended by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), the Paycheck Protection Program codified in 15 U.S.C. 636(a)(36) (PPP), the Consolidated Appropriations Act, 2021, and other relevant government acts.<sup>2</sup>

Many COVID-19 affected companies found themselves changing their M&A plans: seeking alternatives to traditional M&A, adding additional liquidity to bolster balance sheets, pausing or abandoning transactions, or changing sector focus. COVID-19’s impact on a company’s operations and financial health ultimately must be resolved in the transaction documents. As with all deal terms, buyers and sellers will negotiate each obligation and liability relating to COVID-19. Purchase agreements must address the status and disposition of PPP loans, furloughed and terminated employees, remote employees, representations and warranties relating to compliance with PPP loans and state and federal directives, and new indemnification obligations and escrows. This article focuses on COVID-19’s effects on pre-M&A operations, the due diligence process, and changes to purchase agreement provisions from the perspective of a seller of a middle-market target company.

### **Company Operations**

Depending on the company’s line of business and ability to pivot, COVID-19 has either led to further success or decimated the business. Many companies found themselves needing to update their employee handbook to update or implement a work-from-home policy and create new in-person rules for social distancing and wearing face coverings in the office. Companies updated their business technology and cybersecurity compliance<sup>3</sup> and applied for PPP loans to cover anticipated short-falls in payroll.

### **Employees and benefits**

Remote employees pre-COVID-19 may not have been directly impacted, but their in-office colleagues, vendors, suppliers, customers, and the business itself most certainly have. If the business changed its benefits or policies, there are compliance issues that must be considered and addressed. The needs of employees and businesses needed to be balanced: emergency paid sick time or leave,<sup>4</sup> protection in the workplace, flexibility, reduction in benefit plans, expense reimbursement policies or other company obligations, cost of personal protective equipment (PPE), cost of lost



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productivity, and cost of “inefficient” use of space for proper social distancing. Each of these decisions impacted the safety of employees, but also the company policy making process, due diligence process, and allocation of risk and liability provisions of the purchase agreement.

### ***Policies and Compliance***

As state and federal government guidance progressed, companies needed to maintain compliance with their existing benefits policies, existing contractual relationships, and new COVID-19 related policies. Companies had to or should have evaluated any notice provisions under applicable law,<sup>5</sup> benefit plans regarding changes, and any contractual relationships that were at risk. Prior to the pandemic, material adverse change and force majeure provisions in commercial contracts did not always include pandemics and epidemics. For example, any reduction to 401(k) plan matching contributions may have required advanced or prompt notice to employees. Other operational changes may have warranted a Worker Adjustment and Retraining Notification Act (WARN Act) analysis.

### ***PPP Loans***

In addition to complying with state directives related to physical operations and changes to benefit plans and policies, companies needed to align their operations with the requirements of the PPP to qualify for a loan under the PPP which might be forgiven, or other funding, such as an Economic Injury Disaster Loan or state-level loans such as the New Jersey Economic Development Authority program.<sup>6</sup> The SBA outlined the parameters of the PPP loan program, which limited the interest rate and the complexity of the loan terms, among other things. Lenders scrambled to set up their loan applications, forgiveness applications, and other forms to partici-

pate in the program.

From the perspective of a target company, sellers typically deliver the target company on a cash-free and debt-free basis. That means that sellers are entitled to retain company cash, and buyers will not assume any of the debt, on the company’s balance sheet. Sellers pay off debt at or prior to closing, or otherwise retain the liability.

PPP loans are simply another form of debt which buyers will not ordinarily assume in a transaction. However, due to the nature of the PPP loan terms and opportunity for forgiveness, sellers often do not pay off PPP loans prior to closing. The purchase agreement must address the mechanics and disposition of the PPP loan if it is not repaid or forgiven prior to closing. Attorneys drafting purchase agreements must carefully consider how PPP loans are characterized and defined, including whether they are included within the definition of “indebtedness.” While the outstanding PPP loan technically is company indebtedness, sellers anticipating full forgiveness should seek to avoid the PPP loan affecting the purchase price or other deal metrics. On the other hand, fully or partially repaying the PPP loan is a realization of the debt and buyers must be made whole either by a reduction in the purchase price or other adjustment. The purchase agreement will also include company representations and warranties that the company has complied with the CARES Act and 15 U.S.C. § 636(a) of the Small Business Act relating to business loans, including, without limitation, the company’s proper use of PPP loan proceeds, as well as indemnification for liabilities relating to the PPP loan.

If a company has satisfied the SBA requirements for loan forgiveness, namely, maintaining employee and compensation levels, spending PPP loan proceeds on payroll costs and other eligible expenses, with at least 60% of the

proceeds spent on payroll costs, then the company may submit a forgiveness application for full or partial forgiveness of the PPP loan. Processing the forgiveness application may take several weeks or longer. The lenders have 60 days, and the SBA has 90 days, to review applications.

From the cash due at closing, in addition to purchase price adjustments, transaction expenses, and other escrow requirements, the buyer will deduct an amount equal to the outstanding PPP loan balance and deposit it into escrow at closing, pending the final disposition of the SBA. The PPP escrow amount may or may not be held in the same escrow account as the adjustment escrow or indemnity escrow and may or may not be subject to fees, interest, and deductions for any unforgiven amounts or other loans, such as EIDL. Upon the SBA’s determination of forgiveness, any indebtedness under the PPP loan that was not forgiven will be released from escrow to the PPP lender in satisfaction of such unforgiven indebtedness, and any remaining PPP loan escrow amount will be released to the sellers.

### ***Due Diligence***

#### ***Financial Due Diligence***

The main metrics for pricing a deal is how much has the company recently made, and what is the company projected to make in the short-term and middle-term. These metrics are based on changes to income from customers, the number of customers, cost of goods sold and deferred revenue, or in short, as one example, earnings before interest taxes, depreciation, amortization, based on historical financial statements (EBITDA). However, dealmakers now need to price in the impact of COVID-19, or EBITDA+C, on all the above. Adjusted EBITDA, another financial metric, could also account for lost revenues and profits; however, it is difficult to be exact in

defining what was specifically lost due to COVID-19, or if there were other factors in play. Common EBITDA adjustments include special projects or one-time settlements. Common 'C' additions to EBITDA include employment changes, supply chain cost increases and disruptions, loss of revenues and profits, and other declines related to COVID-19. Changes to customer volume, volume per customer, economic terms in a contract, among other factors, all impact earnings and the company's balance sheet. Some company customers have declared bankruptcy or ceased business altogether, further impacting the company's bottom line. The buyer's tax and finance advisers will require a clear picture of all such changes and how they will impact the existing relationships with customers, suppliers, and vendors going forward.

#### ***Employment and Benefits Due Diligence***

COVID-19 not only decreased profits and increased business costs, but also increased due diligence costs. Access to employees and on-site reviews are critical to deals. Additionally, due diligence requests pertaining to the impacts of COVID-19 became the primary inquiries of buyers. Buyers sought answers to whether the company modified, increased, or reduced compensation or benefits for any employees, modified or reduced employee hours, or conducted layoffs or furloughs as a direct or indirect result of COVID-19. If the answer to any of the foregoing is yes, then the buyer conducts more extensive diligence to ensure compliance with laws and guidance, many of which, such as FFCRA and the CARES Act, are new. Even more broadly, buyer's counsel can shift compliance<sup>7</sup> diligence onto sellers related to state and federal guidelines, including the aforementioned laws, such as tracking employee COVID-19 reactions, handling stay-at-home orders,

posting and distributing notices during to FFCRA company policies, employment changes, state compliance issues based on new locations of employees working from home, safety policies,<sup>8</sup> WARN Act and notices to benefit changes.

In a typical M&A transaction, the company makes several representations and warranties relating to employment matters, such as the number of employees on its payroll and contractors engaged, terminations of key employees, mass layoffs or closures, and material changes in compensation or benefits. The disclosure schedules attached to the purchase agreement provide details and context for any changes outside the ordinary course or exceptions to the representations and warranties.

Due to COVID-19, in 2020, not unlike recessions and other unstable periods, companies were more likely to take extraordinary protective, reactive, and precautionary measures. Companies closed offices, terminated and furloughed employees, and reduced or deferred compensation. In response, buyers began requiring new representations and warranties in M&A purchase agreements to provide a complete picture of COVID-19's impact on the company's workforce, including changes in employment and payroll taxes. Sellers addressed most material changes in employment matters in the disclosure schedules, to disclose to buyer the employees' pre- and post-COVID-19 workplace location, changes in benefits and reduction of compensation, and lists of terminated and furloughed employees.

One consequence of company employees suddenly working remotely due to COVID-19 is unexpectedly having employees living in different states. Whether due to personal, financial, health, or family reasons, many employees moved across state lines in 2020. Depending on the state, and whether

the move is intended to be permanent or temporary, different legal issues arise. Companies must determine in each state their new obligations with respect to sales tax, payroll tax, and corporate and business registrations. The purchase agreement and disclosure schedules address and resolve these new compliance obligations.

#### ***Operational Due Diligence***

In addition to the above enhanced employment diligence, buyer's counsel is also enhancing operational and corporate governance due diligence. Buyers want to make sure that clients, suppliers, and other third parties material to the business are operating under a valid contract, no exceptions, reductions, cancellations, or otherwise have been implemented. On the other hand, buyer's and investor's counsel want to know that the company has not experienced any other delays, disruptions, or interruptions that has or will negatively impact or impair the company from satisfying any of their performance obligations under any contract. On top of typical diligence, there has also been a focus on force majeure clauses and other rights of parties related to performance issues. This enhanced due diligence process not only stems from counsel, but also from the increased use of representations and warranty insurance (RWI), which increases the teams of lawyers reviewing company operations. RWI also leads to more fulsome diligence and disclosures by way of fulsome representations and warranties in the purchase agreement.

COVID-19 and related government acts also impact other aspects of the deal besides diligence and the purchase agreement. For example, effective Oct. 2, 2020, the SBA provided lenders with a procedural notice outlining required procedures for loan forgiveness for an entity that is undergoing a change of ownership.<sup>9</sup> Prior to Oct. 2, 2020, some

lenders were hesitant to provide consent to a change of control, and deals were held in limbo as they wait for lender internal processes to review an ever-growing bank of guidance. Now, with clearer guidance, lenders can expedite the process on their end, without SBA consent.

## Conclusion

COVID-19 has had a tremendous impact on economies, businesses, and people's lives in the United States and across the world. It is no surprise that M&A and corporate attorneys and advisers must reevaluate and reconsider every aspect of a transaction in light of the effect of COVID-19 on their clients, and their clients' customers, employees, and vendors, as well as all those of all parties to a transaction. ☞

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## Endnotes

1. On March 27, 2020, the CARES Act was signed into law. For more on the CARES Act, see "Coronavirus Aid, Relief, and Economic Security Act (CARES Act) – S.3548," available at: [olenderfeldman.com/sba-documentation-checklist-and-paycheck-protection-program-treasury-guidance-update/](https://olenderfeldman.com/sba-documentation-checklist-and-paycheck-protection-program-treasury-guidance-update/). For more on interim final rules and guidance in early April, see (1) "SBA Documentation Checklist and Paycheck Protection Program Treasury Guidance Update April 3, 2020," available at: [olenderfeldman.com/sba-documentation-checklist-and-paycheck-protection-program-treasury-guidance-update/](https://olenderfeldman.com/sba-documentation-checklist-and-paycheck-protection-program-treasury-guidance-update/); (2) "Paycheck Protection Program Loans Update April 8, 2020," available at: [olenderfeldman.com/paycheck-protection-program-loans-update-april-8-2020/](https://olenderfeldman.com/paycheck-protection-program-loans-update-april-8-2020/); and (3) "Paycheck Protection Program Second Interim Final Rule Summary – April 16, 2020," available at: [olenderfeldman.com/paycheck-protection-program-second-interim-final-rule-summary-april-16-2020/](https://olenderfeldman.com/paycheck-protection-program-second-interim-final-rule-summary-april-16-2020/).
2. For more on the PPP and other related programs, acts, and guidance, see [olenderfeldman.com/category/covid-19](https://olenderfeldman.com/category/covid-19), and more specifically: (1) "PPP Loans: Whether to Keep Your Loan or Send It Back?" available at: [olenderfeldman.com/ppp-loans-whether-to-keep-your-loan-or-send-it-back/](https://olenderfeldman.com/ppp-loans-whether-to-keep-your-loan-or-send-it-back/); (2) "Paycheck Protection Program June 19, 2020 Interim Final Rule," available at: [olenderfeldman.com/paycheck-protection-program-june-19-2020-interim-final-rule/](https://olenderfeldman.com/paycheck-protection-program-june-19-2020-interim-final-rule/); (3) "Paycheck Protection Program Flexibility Act of 2020," available at: [olenderfeldman.com/paycheck-protection-program-flexibility-act-of-2020/](https://olenderfeldman.com/paycheck-protection-program-flexibility-act-of-2020/).
3. For more on data privacy and security, see "Data Privacy & Security Check-Up (the other 'PPP') – Working From Home During COVID-19," available at: [olenderfeldman.com/data-privacy-security-check-up-the-other-ppp-working-from-home-during-covid-19/](https://olenderfeldman.com/data-privacy-security-check-up-the-other-ppp-working-from-home-during-covid-19/).
4. For more on this, see "Back to School and 'Paid Child Care Leave' Under FFCRA," available at: [olenderfeldman.com/back-to-school-and-paid-child-care-leave-under-ffcra/](https://olenderfeldman.com/back-to-school-and-paid-child-care-leave-under-ffcra/).
5. For more on FFCRA notice requirements, see "Updated Guidance on Notice Requirements and Furloughed Employees under the Families First Coronavirus Relief Act," available at: [olenderfeldman.com/updated-guidance-on-notice-requirements-and-furloughed-employees-under-the-families-first-coronavirus-relief-act/](https://olenderfeldman.com/updated-guidance-on-notice-requirements-and-furloughed-employees-under-the-families-first-coronavirus-relief-act/).
6. For more on the NJEDA program, see "NJEDA Providing Loans and Grants to Small Businesses Impacted by COVID-19," available at: [olenderfeldman.com/njeda-providing-loans-and-grants-to-small-businesses-impacted-by-covid-19/](https://olenderfeldman.com/njeda-providing-loans-and-grants-to-small-businesses-impacted-by-covid-19/). For an overview, see "SBA Loans for Small Businesses Impacted by Coronavirus (COVID-19)," available at: [olenderfeldman.com/sba-loans-for-small-businesses-impacted-by-coronavirus-covid-19/](https://olenderfeldman.com/sba-loans-for-small-businesses-impacted-by-coronavirus-covid-19/).
7. For more on PPP loan compliance, see (1) "If You Are Seeking a Loan Under the CARES Act, Compliance is Key," available at: [olenderfeldman.com/if-you-are-seeking-a-loan-under-the-cares-act-compliance-is-key/](https://olenderfeldman.com/if-you-are-seeking-a-loan-under-the-cares-act-compliance-is-key/); (2) "Paycheck Protection Program (PPP) Frequently Asked Questions Regarding Spending Loan Proceeds," available at: [olenderfeldman.com/paycheck-protection-program-ppp-frequently-asked-questions-regarding-spending-loan-proceeds/](https://olenderfeldman.com/paycheck-protection-program-ppp-frequently-asked-questions-regarding-spending-loan-proceeds/).
8. For more on workforce reintegration planning and safety, see "COVID-19 Workforce Reintegration Planning," available at: [olenderfeldman.com/covid-19-workforce-reintegration-planning/](https://olenderfeldman.com/covid-19-workforce-reintegration-planning/).
9. For more on this, see "PPP Guidance- Loan Forgiveness and Change of Ownership," available at: [olenderfeldman.com/ppp-guidance-loan-forgiveness-and-change-of-ownership/](https://olenderfeldman.com/ppp-guidance-loan-forgiveness-and-change-of-ownership/).