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Private acquisitions in the United States: market analysis overview

Eric S Williams, Akin Gump Strauss Hauer & Feld LLP

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MARKET OVERVIEW

1. What are the current major trends in the private M&A market?

The effects of the 2019 novel coronavirus disease (COVID-19) on businesses around the world have dramatically impacted private M&A activity since the beginning of 2020. The COVID-19 pandemic accelerated the global recession that many had been predicting for some time, and the impact on the private M&A market has been severe. The onset of the pandemic saw the termination of numerous high-profile public transactions, including:

- Ally Financial Inc.'s USD2.65 billion acquisition of CardWorks Inc.
- The WeWork-Softbank USD3 billion tender offer.

Many private transactions suffered the same fate, and M&A deal flow slowed significantly during the early months of the pandemic.

Some of the deal-making challenges brought on by the pandemic included the following:

- Inability to conduct traditional due diligence evaluations.
- Difficulty forecasting near-term financial performance.
- Reduced availability of debt capital to finance transactions.
- Depressed business valuations that many business owners were unwilling to accept.

The shutdown of global business activity caused financial modelling for many businesses to become significantly less reliable. For many businesses, trailing 12-month EBITDA and revenue are no longer meaningful metrics for valuation purposes, and buyers are forced to rely on short-term financial results in attempting to predict near-term financial performance.

The negative impact on the hospitality, energy, brick-and-mortar retail, and numerous services sectors has been dramatic, with well-known companies such as Hertz, Chesapeake Energy and Neiman Marcus filing for bankruptcy protection. The first few months of the pandemic saw corporate and private equity buyers spending most of their time and effort managing the health of their own companies, shifting their focus from M&A growth opportunities to cash preservation, expense reduction, and survival.

While most businesses have felt the effects of COVID-19, some sectors have weathered the storm better than others. The technology, media and telecom (TMT) and health care sectors have remained relatively active. Difficult market conditions will continue until a vaccine or effective treatment is discovered, but deal activity is beginning to show some signs of life as buyers appear to be shifting their attention back to M&A. Several recently announced transactions are giving M&A professionals reason to hope that the worst may be behind us, such as:

- 7-Eleven's agreement to acquire Speedway from Marathon Petroleum Corp for USD21 billion (Akin Gump advised 7-Eleven in this transaction).
- Teladoc Health's agreement to acquire Livongo Health, in a transaction valued at USD18.5 billion.

2. What has been the level of private M&A activity in the previous year?

Private M&A activity has experienced significant changes over the course of the previous year. Before the COVID-19 outbreak, deal activity was strong, valuations remained high and competition for well-performing businesses was intense. The third and fourth quarters of 2019 continued deal-making conditions that had prevailed for the past several years (high valuations and debt multiples). Heading into 2020, most dealmakers anticipated that there would be a slowdown at some point, but without much clarity on timing and impetus.

COVID-19 was the impetus that very few saw coming, and its impact was immediate and severe. Since the outbreak, deal-making activity slowed significantly, only recently showing signs of recovery. When businesses that were not deemed "essential" were forced to close their doors, business owners spent much of their time reducing headcount, managing expenses, and making plans for the inevitable slow months to come. As time and attention shifted away from M&A strategies, private M&A deal counts dropped significantly.

Some reports indicate that transaction volume in the second quarter of 2020 dropped to its lowest level since 2004, and global transaction value dropped to USD1.1 trillion over the first six months of 2020, compared to USD1.9 trillion over the same period in 2019, a decrease of over 40%. Many of the deals that did close in the early stages of the pandemic involved transactions whose processes started before the onset of the pandemic or involved buyers and sellers that were already familiar with one another.

After months were spent on business preservation, focus now seems to be shifting back to growth opportunities. Interest remains high for businesses that have weathered the storm well and, in some cases, flourished in the current environment. With cash on corporate balance sheets and private equity dry powder at historically high levels, buyers remain eager to deploy capital for well-performing companies. Given the smaller pool of viable acquisition targets currently available, valuations remain high in transactions that are making it to closing.

DEAL STRUCTURES

3. What are the current trends in the structuring of private M&A transactions?

Capital structures have been impacted by:

- Tightening credit markets.
- Forecasting challenges.
- Depressed business valuations.

With banks, and even some non-bank lenders, tightening their belts, many buyers are forced to either write equity cheques that are outsized when compared to deals closed just six to nine months ago, or require sellers to retain a larger ownership percentage of their business or provide seller financing.

In addition to tightening credit markets, valuation challenges contribute to the need for creative transaction structures. Many business owners are unwilling to accept reduced valuations of their companies based on what they may consider a "blip on the radar" of an otherwise well-performing business. On the other hand, many buyers have a sense of entitlement for getting a good deal given current market conditions. For those companies that have experienced a significant increase in their business during the COVID-19 pandemic, buyers are often reluctant to "pay up" out of fear that recent financial performance may not be sustainable.

As a result of current market challenges, many business owners who would ordinarily be ready to sell control of their business are seeking out strategic partners willing to purchase minority positions in their companies, choosing to hold on and wait for improved market conditions. Not surprisingly, buyers willing to make minority investments and serve as a strategic partner to businesses as they navigate these turbulent times are experiencing a greater volume of opportunities than those focused exclusively on buy-out opportunities.

As has been the case for years, the gaps between buyers' and sellers' expectations are often bridged by using an earn-out tied to future financial performance of the target business. While earn-outs must be carefully drafted and are often heavily negotiated, in many transactions they are an effective tool for buyers and sellers to reach agreement on price. With decreased visibility of future financial performance, earn-outs can give both parties some comfort that the consideration paid is a more accurate reflection of true value.

4. What are the current trends in the terms and documentation of private M&A transactions?

With heightened sensitivity to the significant and far-reaching effects of COVID-19 on most businesses, closing conditions and operating covenants in a purchase agreement are being heavily negotiated. Determining which party assumes the risk of another broad-based shutdown and how operating decisions are made in rapidly changing market conditions are frequent points of contention in deal negotiations.

Parties are negotiating the effects of COVID-19 in material adverse effect (MAE) definitions. Many MAE definitions are expressly addressing how COVID-19 and other pandemics are to be treated and what impact they will have on deal certainty. In most transactions, the effects of COVID-19 are carved out as exceptions to MAE definitions, with the rationale being that the effects of the current pandemic are already priced into the deal. One question being asked is the extent to which effects on a business should be blamed on COVID-19. In particular, whether labour shortages, decreases in commodity prices, and supply chain interruptions should be attributed to COVID-19 and therefore excluded from an MAE definition, or whether only the direct effects of COVID-19 on financial performance should be excluded.

Operating covenants typically require target companies to operate in the normal course of business during the interim period between signing and closing. The issue frequently discussed now is how ordinary course of business is to be determined (that is, whether the target company should be required to operate in the ordinary course assuming business as usual in the pre-pandemic period, or whether the analysis should take into account current conditions). Parties are negotiating the level of autonomy the target will have between signing and closing to take actions that may be necessary for survival in the middle of a crisis, for example:

- Changes in compensation and benefits.
- Workforce reductions.
- Reductions to capex budgets.

Buyers naturally want assurances that they have a say in operating decisions before closing, to the extent permissible under anti-trust laws, but sellers are reluctant to agree to covenants that prevent their ability to respond quickly to the pandemic.

Additional time is often required to obtain regulatory and other third-party approvals given the impact on governmental and other business operations amid the pandemic. Consequently, parties are frequently agreeing to a "drop-dead" termination date that is sufficiently far out to allow ample time to obtain all necessary approvals.

Representation and warranty insurance continues to be a popular tool for many buyers, both corporate and financial. However, parties should be aware of new underwriting policies and procedures being adopted by many underwriters in response to the pandemic, including enhanced due diligence review during the underwriting process, which can impact timing. Additionally, underwriters have sought to exclude coverage for pandemic-focused representations and warranties, such as compliance with government-mandated shutdowns and job retention schemes.

Other terms currently being negotiated in M&A transactions include:

- The treatment of payroll taxes deferred under the Coronavirus Aid, Relief, and Economic Security (CARES) Act.
- How to address CARES Act loans that may be forgivable in the future.

With respect to deferred payroll taxes, buyers should consider treating this as indebtedness, since it is a tax liability that will be owed in the future unless there is additional governmental relief.

With CARES Act loans that may be forgivable, the parties need to determine whether these loans should be treated as ordinary indebtedness and warrant a dollar-for-dollar reduction to the purchase price, or whether concessions should be made since at least some portion of the loans may be forgiven in the future.

5. What are the current trends in how private M&A transactions are conducted?

Until the fourth quarter of 2020, most auction sale processes had been shelved completely, or were proceeding at a much slower pace than normal. Traditional transaction timing is being challenged in the current environment. Most buyers are proceeding with significantly more caution in evaluating the pandemic's effect on a target's business and are requiring lengthier exclusivity and due diligence periods, thereby extending the period of time to consummate a transaction.

Most management presentations, and in some cases, facility tours and due diligence examinations, have been taking place virtually. For some buyers, a face-to-face meeting with a management team is a prerequisite to signing a letter of intent and certainly a definitive agreement, but the timing of that face-to-face meeting in the due diligence process depends on the particular facts and circumstances and the parties' relative leverage in the transaction.

Historically, unless a competitive process dictated otherwise, buyers have been reluctant to spend significant time and resources on target company due diligence until a letter of intent or term sheet is signed granting the buyer exclusivity. However, in the current environment, many sellers are requiring buyers to complete more of their due diligence review before committing themselves to deal with one buyer for an extended period of time, in order to better understand the impact of COVID-19 on their business, and finalise more major deal terms than usual at the letter of intent stage (such as closing conditions, MAE definition, and operating covenants).

Demand is high for those companies that have weathered the storm well, or even flourished, in the current environment. Historically high multiples continue to be paid for well-performing businesses in certain sectors. Depending on the nature of the target company's business, in competitive situations many buyers are willing to forego or expedite certain aspects of their due diligence process because winning the deal requires it. Buyers willing to be aggressive on price and timing continue to win competitive processes.

CROSS-BORDER LITIGATION AND ARBITRATION

6. Is it common market practice for a share purchase agreement to provide for a foreign governing law and/or jurisdiction? If so, in what circumstances does this occur and which governing law and/or jurisdiction are common choices?

In cross-border deals, English law is often chosen by the parties to govern the share purchase agreement. For US transactions, share purchase agreements are often governed by the law of the jurisdiction of formation of the target company. However, if the target company is not organised in a jurisdiction with which the buyer is familiar and comfortable, the buyer will frequently require the application of Delaware or New York laws. The well-established body of case law in Delaware and the familiarity with New York law for many buyers provide a certain level of comfort that any disputes are likely to be resolved in a commercially reasonable and more predictable manner.

On occasion, buyers require a target company to convert or reorganise in Delaware or another jurisdiction with which the buyer is comfortable as a condition to closing. Tax, regulatory and contractual issues must be considered when analysing any such conversion or reorganisation. In other instances, the parties may bifurcate governing law so that the agreement is governed by:

- The laws of the jurisdiction of formation of the target company, for certain corporate or statutory purposes.
- The laws of another jurisdiction, such as Delaware or New York, for all other purposes, including validity, interpretation and effect.

7. Is it market practice for an arbitration provision to be included in private M&A documents? Are arbitration clauses enforceable in your jurisdiction? Do local courts respect the choice of jurisdiction in an arbitration clause?

Arbitration provisions, while not necessarily uncommon in private M&A agreements, are not market practice in US transactions. In the past few years, the trend has been for fewer deals containing arbitration clauses. Parties to M&A agreements typically opt for disputes to be resolved through the traditional court system of the applicable jurisdiction and include a jury trial waiver.

The enforceability of arbitration clauses is governed by the relevant state law. For example, arbitration clauses are enforceable in Texas and Texas courts generally respect the choice of jurisdiction in an arbitration clause chosen by the parties. The Texas General Arbitration Act (TAA) is arbitration-friendly, and provides that a court must order parties to arbitrate their claims on a showing that an agreement to arbitrate the claims exists and is enforceable (*Tex. Civ. Prac. & Rem. Code § 171.021*). Only a very limited set of claims are excluded from the coverage of the TAA (for example, workers' compensation benefit claims and claims under collective bargaining agreements).

RECENT DEVELOPMENTS AND PROPOSALS FOR REFORM

8. Have there been any significant recent or proposed legal developments affecting the market that could impact on transactions?

Multiple government stimulus packages, including the CARES Act, have had a positive impact on many businesses, allowing companies that otherwise would have shut down to stay afloat and keep employees on the payroll. With the continued proliferation of COVID-19 around the world, additional stimulus initiatives will be a critical lifeline for many companies.

While the number of businesses filing for bankruptcy protection in the US jumped significantly in the first half of 2020, that number will increase exponentially without additional government assistance. M&A transactions will continue in one form or another. Whether many of those transactions occur within or outside a bankruptcy process will be affected by the governmental stimulus money available to businesses.

The potential for tax rate changes in the near future is likely to impact M&A transactions. With a new administration, many expect an increase in tax rates, including capital gains tax rates, as soon as 2021. Business owners who envision a sale of their company in the next few years may decide to sell in 2020 despite challenging market conditions, to take advantage of lower Trump-era tax rates.

Foreign investment into the US continues to face a greater degree of scrutiny than two to three years ago. In 2018, the federal government expanded the scope of transactions that require review by the Committee on Foreign Investment in the United States (CFIUS). With an enhanced focus on national security, the number of M&A transactions that require CFIUS clearance has increased. For many transactions, the impact of COVID-19 on governmental operations has caused lengthy delays in obtaining clearance.

9. What will be the main factors affecting the market next year, and how do you expect the market to develop?

COVID-19 and its continued impact on the global economy will undoubtedly be the most significant factor affecting the deal market over the course of the next year. Distribution of a vaccine or effective treatment may still be many months away. Until one is available, it is unlikely that M&A activity will return to pre-pandemic levels.

However, deal activity is picking up. With the tremendous amount of dry powder financial sponsors and corporations are eager to deploy, coupled with financial information for the lockdown period becoming available and a sense of a "new normal", an uptick in deal activity should be expected in the fourth quarter of 2020.

As is often the case in election years, the 2020 US presidential election will certainly affect deal activity. Anticipated tax and policy changes brought about by an administration change are likely to drive M&A activity, and may affect the level of M&A activity for years to come.

Practical Law Contributor profile

Eric S Williams

Akin Gump Strauss Hauer & Feld LLP

T +1 (214) 969 2844
F +1 (214) 969 4343
E williamse@akingump.com
W www.akingump.com/en

Professional qualifications. Texas, US, 2001

Areas of practice. Corporate; M&A; capital markets; private equity; special situations.

Non-professional qualifications. JD, Southern Methodist University School of Law