



# COVID-19 Era M&A: State of the Market and Roadmap for 363 Sales

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**Seyfarth Shaw LLP**

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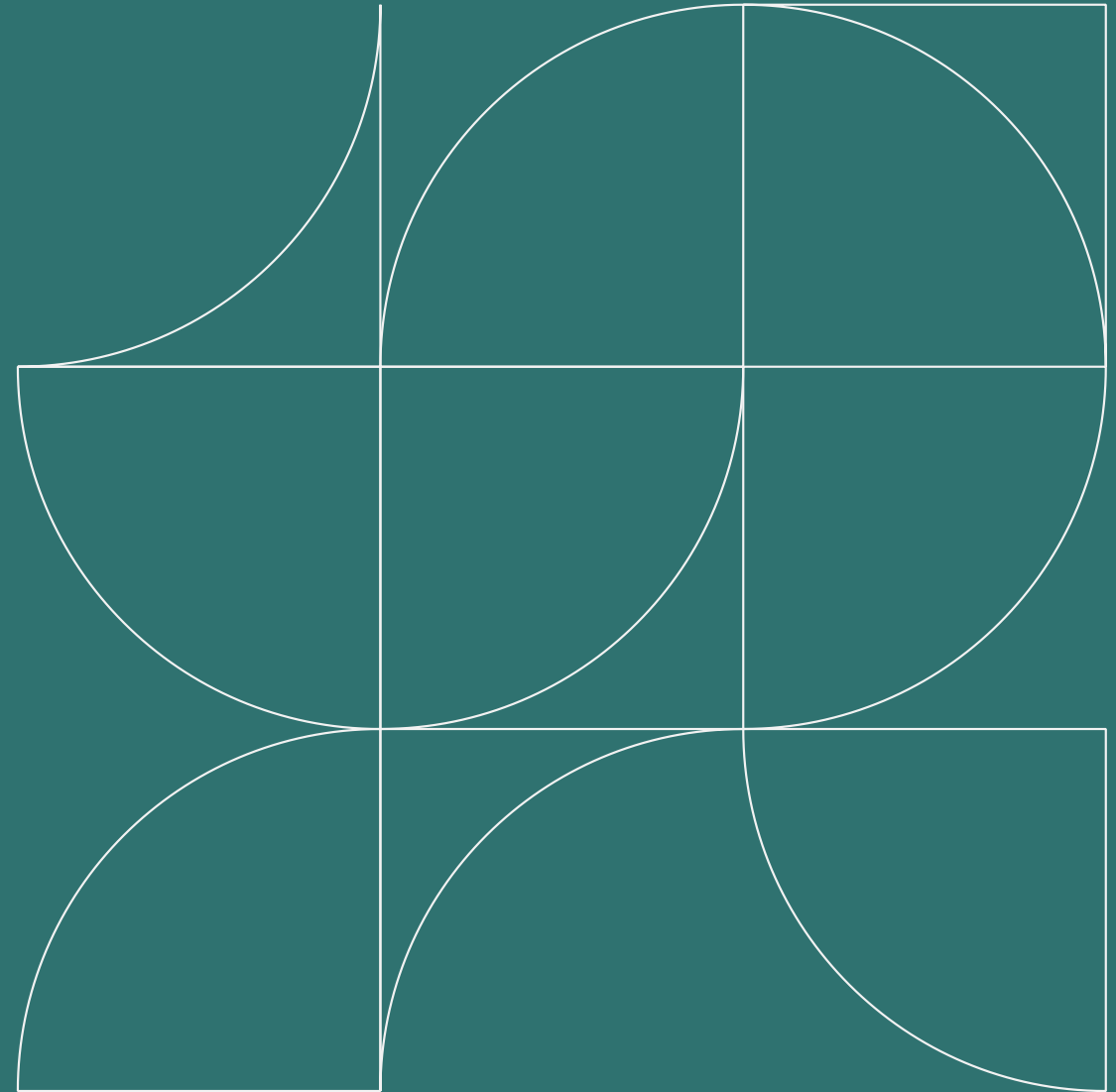
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# Agenda

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- 01** Current State of M&A
- 02** Equity and Executive Compensation Minefields in M&A
- 03** Distressed Asset Sales Under Section 363
- 04** 363 Sale Tax Implications and Other Considerations
- 05** Q&A

# Current State of M&A



# M&A Activity Analysis

## By the Numbers: 1H20

	Deal Volume	Deal Value
North America	↓ 35%	↓ 73%
Global	↓ 33%	↓ 53%

*Source: Baker Tilly, Global dealmakers: North American M&A market update 2020*

## Closer Look at US Private Equity

Through the first half of 2020, US PE dealmakers closed on 2,173 deals totaling \$326.7 billion, meaning deal value was down by nearly 20% compared to H1 2019.

Quarterly figures show an even steeper fall, with Q2 2020 deal value down more than a third from Q2 2019 values.

*Source: Pitchbook, US PE Breakdown Q2 2020*

# So, what does M&A look like during the pandemic?

## Current Deals

- **51%:** “temporary pause” of current deal activity
- **14%:** at immediate deal-stop on all current deals
- **12%:** expediting late-stage deals to a quick transaction closing
- **12%:** intend to proceed to deal closing pursuant to successful renegotiation of valuation or terms
- **11%:** unknown or N/A

## Deal Volume

- **26%:** deal volume for Q2-4 2020 expected to be “substantially reduced”
- **51%:** anticipate remaining on temporary pause
- **23%:** “no impact in 2020 forecast deal volume” or intent to “accelerate”

## Deal Type Objectives

- **57%:** continuing to do strategic revenue growth deals aligned with core acquisition strategy
- But... simultaneously shopping across different deal-types: **49%** looking for distressed company opportunities, **23%** new, non-core tech, solutions, or segments to diversify revenue mix
- **23%:** likely divestitures

**Key challenge ahead:**  
bridging the valuation gap...

*Source: Harvard Business Review/M&A Leadership Council survey of 50 C-level executives and senior corporate development leaders*

# How are deals changing due to COVID-19?

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- Shift from a seller's market to a buyer's market
- Companies that can wait a few years will wait – but a lot don't want to or can't wait (lack of succession plan)
- Face to face meetings harder to do, in-person management meetings are shifting to video conferences (losing the benefit of more personal engagement)
- Generally, deals are taking longer to do – seeing some deal timelines being stretched by more than 60 days...

# How are deals changing due to COVID-19?

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- COVID-19 adding to due diligence:
  - What decisions did you make to cope with the pandemic and why? How did they turn out? How did you treat your employees and vendors? What did you learn, and what would you do differently?
  - What is the seller's supply chain vulnerability, especially to China and other overseas sources? What plans does management have to change the supply chain in a post-COVID-19 world?
  - What additional operating costs are required to operate in a post-COVID-19 world?
  - What plans does management have if the pandemic continues for a longer than expected period?
- Q of E needs to provide insight into how the seller will manage through the disruptions caused by the pandemic with “stress-test” scenarios



# Setting the Stage: Valuation Methodologies and Changing Expectations

## *Three common ways to value target companies:*

- 1 **Multiple of prior 12 months of EBITDA**, which is used for companies with earnings. This is the most common valuation methodology.
- 2 **Multiple of revenues**, most commonly used for software and other technology companies which have been able to build significant sales but are not at the stage of having earnings.
- 3 A “**build versus buy**” analysis, in which the buyer assesses the cost to duplicate the functionality of the seller’s product or technology from scratch, versus the cost to buy the seller and its employee team.

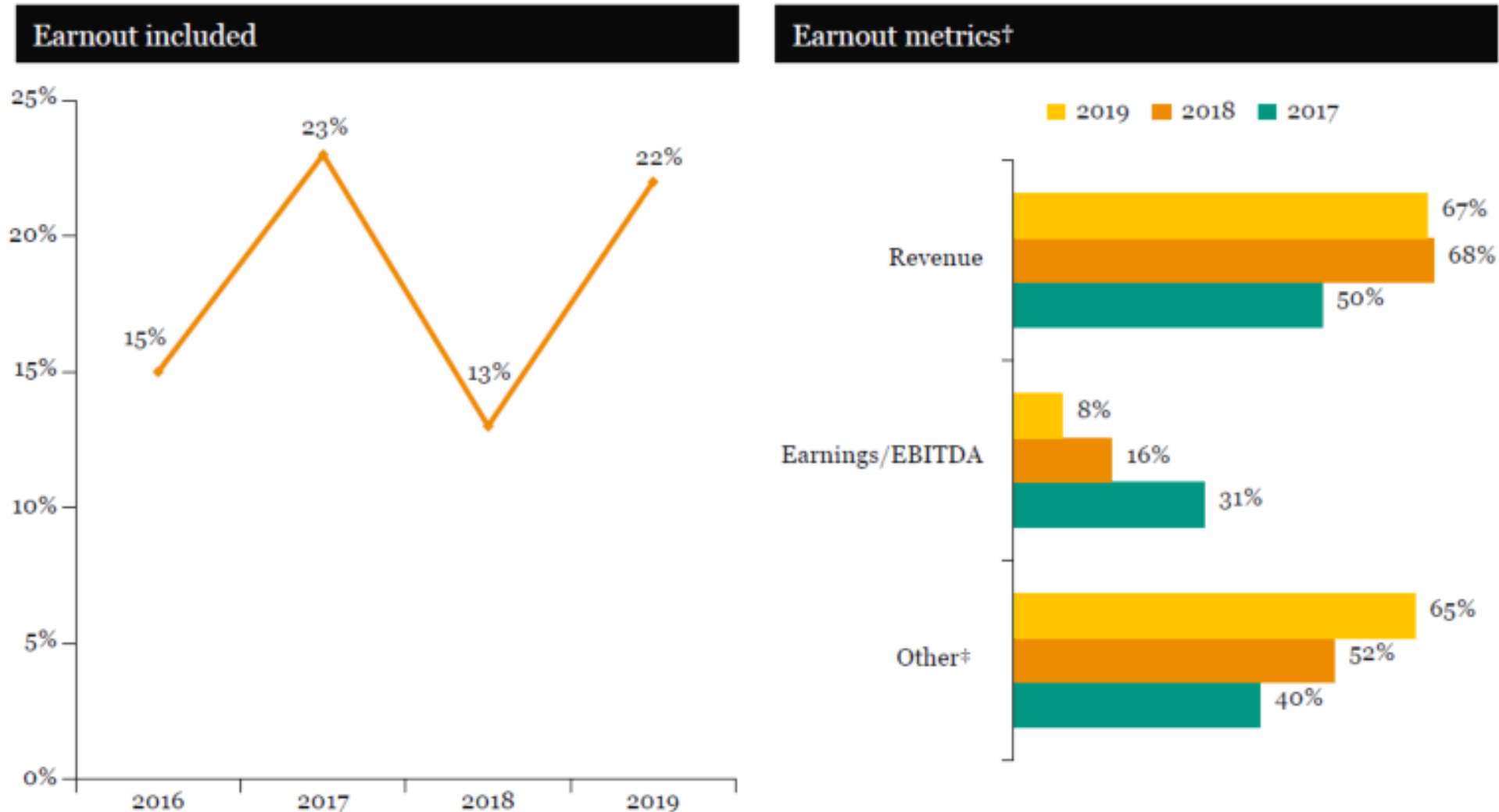
# Reduced Total Purchase Price & Reduced Cash at Closing

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- Companies that are valued as a multiple of earnings or revenues are not worth as much today as they were in January 2020 in the pre-COVID world.
- Particularly attractive companies that were in auction processes in January 2020 with multiple bidders may have received bids of 10X of 2019 EBITDA, with 90%+ of the purchase price paid in cash at closing.
- In the current environment, however, a more realistic multiple might be 8X or 9X of 2019 EBITDA, with only 50% to 60% of the purchase price paid in cash at closing.
- The remaining portion of the purchase price will be contingent, deferred, or subject to an equity rollover.

# Earn-outs, Pre-COVID-19

SRS Acquiom's 2020 M&A Deal Terms Study



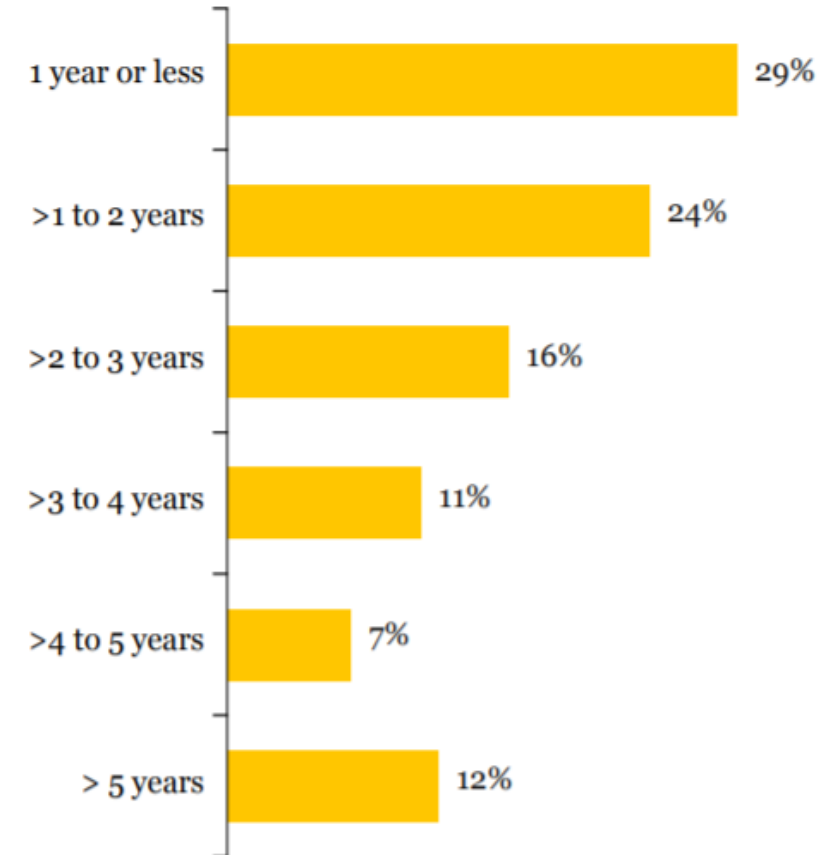
# Earn-outs, Pre-COVID-19

SRS Acquiom's 2020 M&A Deal Terms Study

Median earnout potential as % of closing payment†



Earnout length‡ (2019 median: 24 months)



# Earn-outs, Post-COVID-19

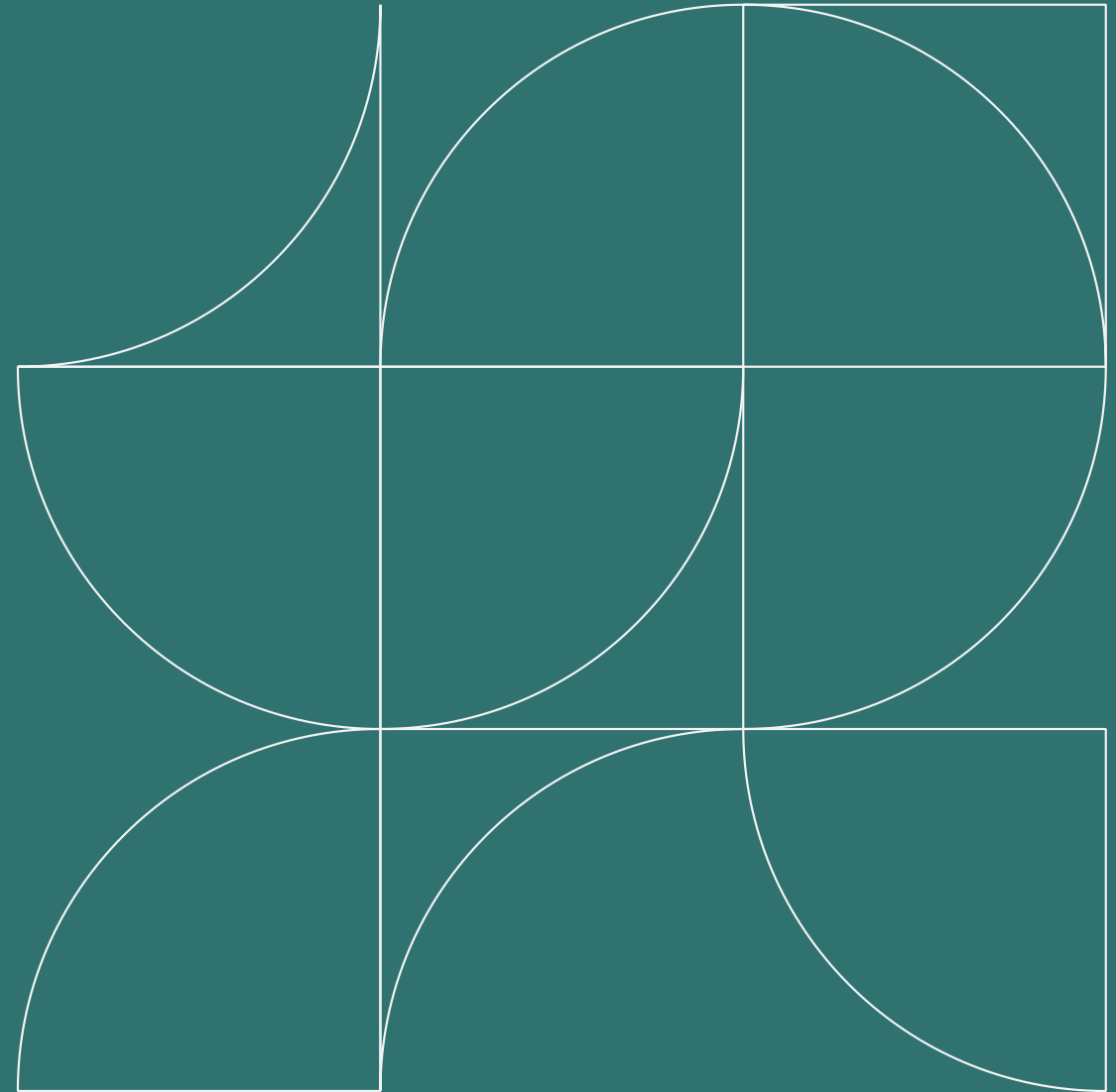
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Earn-outs will become increasingly popular to allocate more risk to the seller for the uncertainty of future performance.

## As a result, these are likely changes for earn-outs:

- Earn-outs will be used in a higher percentage of transactions, from the current approximately 20% to perhaps 30% to 40% of deals, or higher.
- The time period for earn-outs will likely increase from the current median of 24 months to longer time frames. Therefore, allowing for business to “normalize” over time and giving the seller more opportunity to achieve the earn-out.
- The earn-out potential as a percentage of the closing payment can be expected to increase.

# Equity and Executive Compensation Minefields in COVID-19 M&A



# Equity and Executive Compensation Minefields

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Adjustments to executive pay and incentive awards due to COVID-19 may cause unexpected problems for an acquiring company.

- \* Overview

- \* Potential Problematic COVID-19 Adjustments

## Executive Compensation and Annual Bonus

- Company's adjustments of executive compensation could impact or violate other contractual commitments.
- Company's negative adjustments could trigger other rights.
- Adjustments made in one component of executive pay could have impacted executive compensation incentive programs.
- The Coronavirus Aid, Relief and Economic Security Act (CARES Act) provides restrictions on executive compensation and severance for receiving loans from, or loan guaranteed by, the U.S. Department of Treasury.

# Equity and Executive Compensation Minefields

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## Incentive Performance Awards

- Company adjustment to incentive awards or performance goals could trigger legal, tax, accounting, securities and disclosure requirements.
- Compensation Committees may not have discretion to make adjustments to performance targets and may need a plan amendment, if public company, shareholder approval may be required.
- Adjustments of performance based pay awards granted prior to 2017 Tax Cuts and Jobs Act and still outstanding could lose their grandfathered status under IRC Section 162(m) which impacts compensation deductibility.
- Timing for setting and adjustments to performance targets, impact on elective deferrals, violation and taxation IRC Section 409A.
- New performance awards and adjustments to existing awards
  - Delaying or changing the form of the performance the award could trigger compliance with tax issues under IRC Section 409A and securities requirements, if public company.
- Adjustments to targets for performance based compensation
- Changes to performance goals and mid-cycle changes to performance metrics



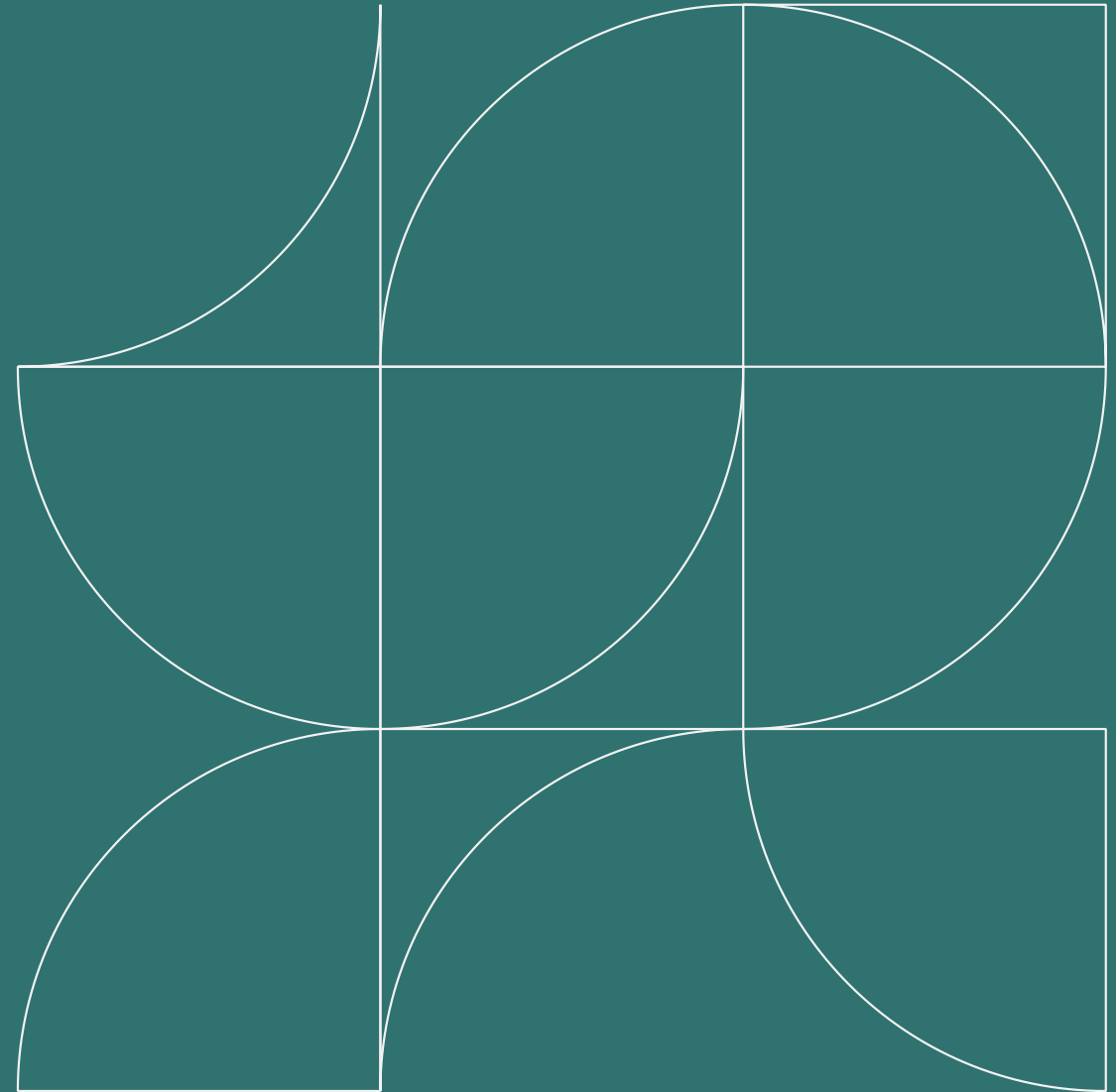
# Equity and Executive Compensation Minefields

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## Stock Options

- Company strategies to address underwater stock options could trigger legal, tax, accounting, securities law and disclosure requirements.
- Compensation committees may not have discretion in plan for action taken such as to address underwater stock options. Action taken may not be allowed under the plan. This could include unilateral cancellation of stock options.
- If public company, adjustments to awards could be required to be disclosed in the proxy statement and other SEC filings. Shareholder approval may also be required to take certain action such as repricing stock options.
- Granting new stock options could be considered a tender offer and have SEC and state law filing requirements.
- Replacements raise valuation issues and can trigger IRC 409A violations
- Strategies to Address Underwater Stock Options
- Potential Risks

# Distressed Asset Sales Under Section 363

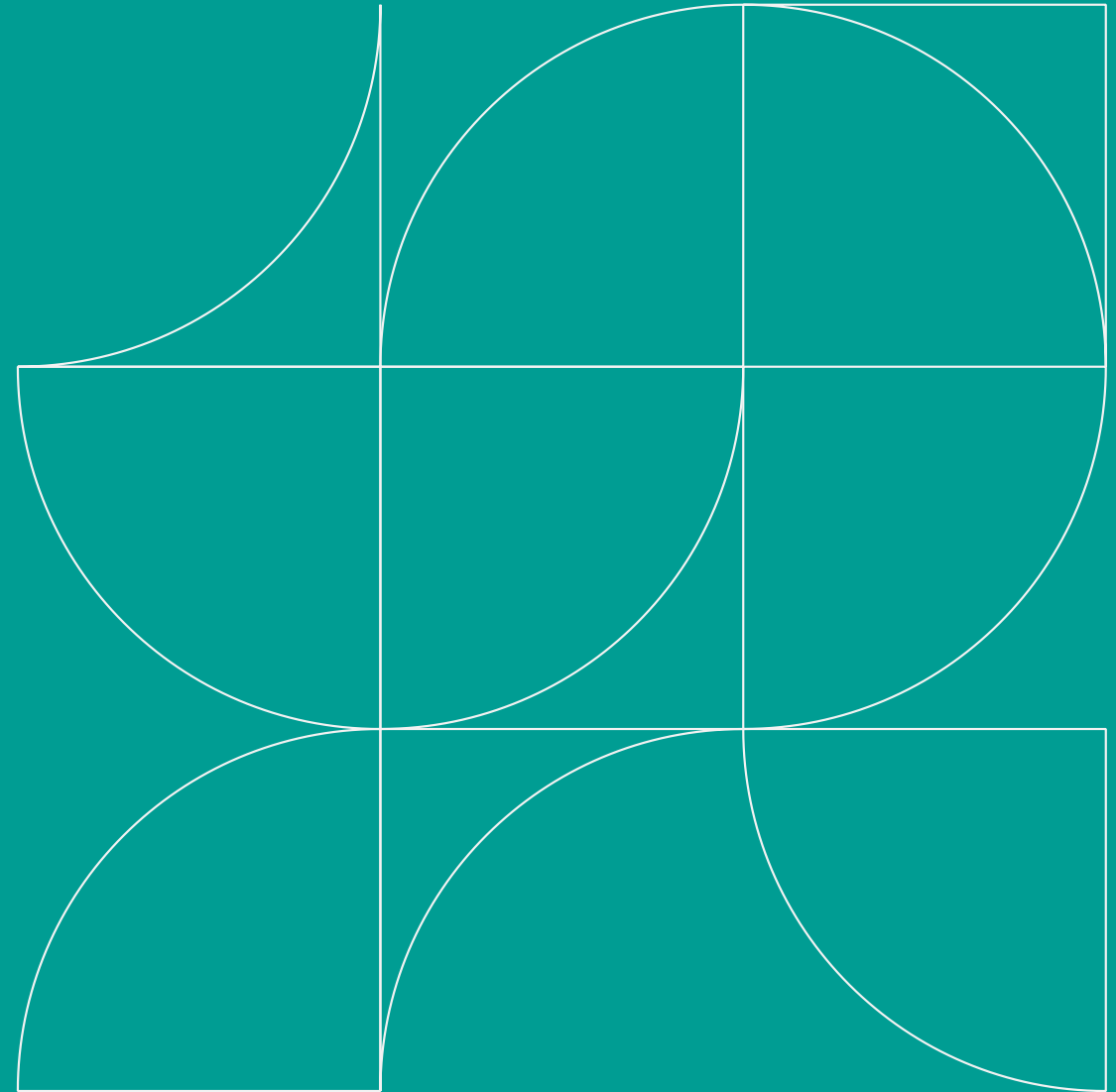


# Setting the Stage

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- COVID-19 impact resulting in vanishing earnings and cash flows, as well as crunched credit and equity markets, are leading to payment and covenant defaults under debt obligations.
- Government funding programs not enough to sustain many businesses.
- **This increasing economic turmoil will likely result in a dramatic rise in distressed M&A activity, including asset sales under Section 363 of the United States Bankruptcy Code.**
- For many strategic purchasers and private equity firms with relatively strong cash positions, financially troubled companies and a new wave of Section 363 auctions will present significant opportunities to purchase assets at discounted prices.
- Section 363 sales come with a number of advantages and disadvantages from the purchaser's perspective as compared private M&A transactions involving “distressed assets” outside of a bankruptcy context.

# Benefits and Risks of Section 363 Sales



# Section 363 Sale Process

A section 363 sale is usually conducted using a two-step marketing process to generate the highest and best offer and generally involves the following key steps:

<b>Stalking Horse Bid</b>	After marketing the assets, the debtor enters into an asset purchase agreement with a prospective buyer offering the best initial bid. The buyer typically acts as a stalking horse, who functions to set the floor purchase price in the auction and to attract other prospective buyers to bid on the assets. In many cases, the deal is negotiated before the bankruptcy filing and the seller files for bankruptcy a day or two after signing the asset purchase agreement.
<b>Notice and Hearing</b>	The debtor must give at least 21 days' notice of the hearing to approve the sale process to all creditors. If there are no objections to the section 363 sale, the court can approve the plan to sell the assets without conducting a hearing. If there are objections (usually from creditors), the court must decide if the sale is in the debtor's best interest.
<b>Auction Sale</b>	After the bankruptcy court approves the sale process, the buyer is usually (but not always) chosen by a court-supervised second auction, to satisfy the requirement that the debtor obtain the highest and best price for its assets.
<b>Sale Order</b>	All of the transaction documents are submitted to the court for approval and the court enters an order authorizing the sale. The sale order is automatically stayed for 14 days, giving any objecting parties time to seek a further stay while they appeal the sale order. Courts can waive or reduce the 14-day appeal period, on request of the parties, if there is a reason to close the sale early.
<b>Appeals</b>	Statutorily moot as to the purchaser if the court makes a factual findings of good faith and sale order is not stayed pending appeal.
<b>Closing</b>	The transaction is generally closed either immediately after entry of the sale order (if the court waives the 14-day stay period) or after the sale order has become final and non-appealable (after expiration of the 14-day appeal period).

# Pros and Cons of Being the Stalking Horse

## PROS

- The stalking horse's bid will set the floor price, and the stalking horse bidder gets to negotiate the terms of the APA
- Have a role in negotiating the bankruptcy bid procedures which will set the timelines for the auction schedule including marketing, due diligence and bid deadlines
- Often able to negotiate break-up fees (commonly between 2% - 3% of the transaction value) to cover anticipated due diligence and professional fee expenses in the event that the stalking horse bidder is not the successful bidder at auction and overbid amounts
- Have more time to complete due diligence than potential purchasers who wait to engage a debtor until formal bid procedures are established

## CONS

- After being selected as the best initial bid—and investing significant time, effort and money in diligence and purchase agreement negotiations—the stalking horse bidder may be outbid by higher and better offers at the public auction stage of the process prior to the bankruptcy court's approval of the sale
- The stalking horse runs the risk of overvaluing the assets with its initial bid – no other bids to compare.
- As an aside, purchasers that decide to “wait and see” (rather than take a stalking horse role) will bear risks associated with a less thorough diligence investigation

## Advantages of 363 Sales

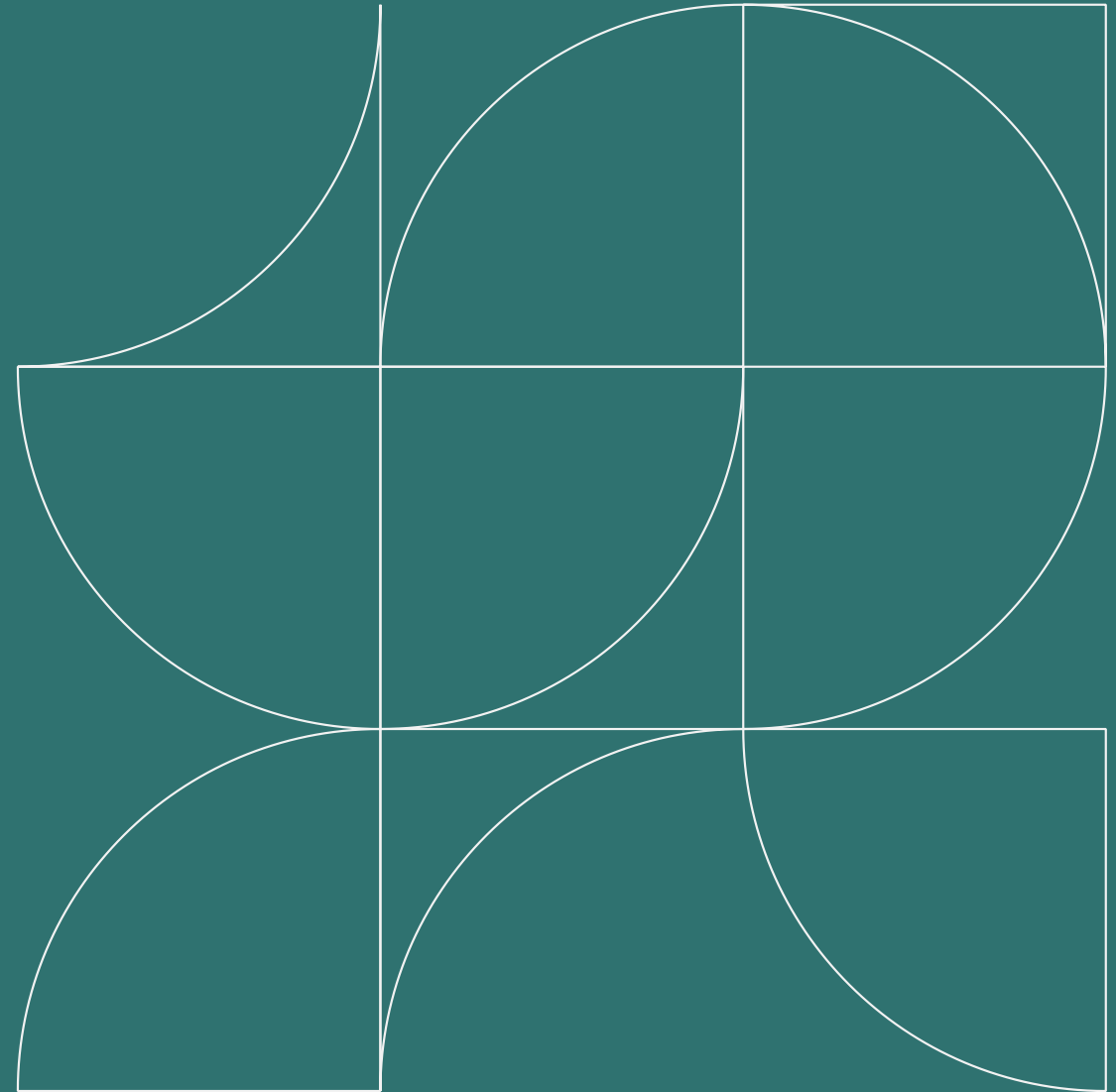
- “Free and clear” of liens, claims and encumbrances
- Fewer consents needed to be obtained (i.e., stockholder and third-party)
- Ability to “cherry pick” contracts
- Protection from fraudulent conveyance claims
- Protection from bankruptcy rejection of transaction agreements
- Bankruptcy automatic stay helps preserve going concern value

## Disadvantages of 363 Sales

- Assets sold “as is, where is”
- Limited representations and warranties
- Limited indemnification rights and closing conditions
- Inability to use deferred/contingent consideration or earn-outs
- Public nature of the transaction
- Potential delays in transaction closing (due to bankruptcy formalities, stakeholder/third-party challenges, and bankruptcy court backlog)
- Note: Can use R&W insurance to fill some gaps in limited post-close remedies



# **363 Sale Tax Implications and Other Considerations**



# 363 Sale: Tax Implications – Sell-Side

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- Background – chapter 11
- Asset sale or “G” reorganization
  - Typically asset sale
  - Occasional Sec. 368(a)(1)(G) reorganization
- Cancellation of debt income (“CODI”) exclusions
  - Insolvency – Sec. 108(a)(1)(B)
  - Chapter 11 bankruptcy – Sec. 108(a)(1)(A)
  - Attribute reductions – Sec. 108(b)
    - Net operating losses and credits
    - Election to reduce basis in assets
    - Timing
      - After the close of the year of the credit bid 363 sale

# 363 Sale: Tax Implications – Sell-Side

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- Other considerations
  - Corporation
    - Sale of US subsidiary
      - Deemed asset sale – Sec. 338(h)(10) election
      - Deferred intercompany gain – Regs. Sec. 1.1502-13
      - Excess loss account – Regs. Sec. 1.1502-19
  - Partnership
    - Abandonment
      - Deemed distribution for reduction in allocation of liabilities
      - Special allocations of debt to partners
  - Withholding on foreign investors
    - Interest withholding on deemed payment to foreign creditors
      - Payment applied against accrued interest first
      - Original issue discount (“OID”) and qualified stated interest (“QSI”)

# 363 Sale: Tax Implications – Sell-Side

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- Other considerations (cont.)
  - State tax impact
    - Apportionment of CODI
    - State conformity to Sec. 108 CODI exclusion
  - Tax filings
    - Liquidating trust and trustee

# 363 Sale: Tax Implications – Buy-Side

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- Asset purchase or “G” reorganization
  - Asset acquisition
    - Purchase price allocation (“PPA”)
      - Purchase consideration
      - Bargain purchase implications
        - Liquidity and planning
        - “Negative” goodwill for financial accounting purposes
    - Attributes do not carryover
  - “G” reorganization
    - Attributes carryover but reduced for Sec. 108 CODI exclusion and any NOL limitation under Sec. 382 ownership change

# 363 Sale: Tax Implications – Buy-Side

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- Successor liabilities
  - State bulk sale matters for indirect taxes including potential unclaimed property
    - Bulk sale notification to be made by creditor
  - Indemnification from debtor or liquidating trust or trustee
    - Language in purchase agreement providing that creditor/buyer is taking assets free and clear of all liabilities not specifically assumed including taxes
- Shareholder and noteholder/creditor
  - Character and timing of losses
    - Shareholder
      - Capital loss unless subsidiary
    - Partner
      - Abandonment of partnership interest
        - Allocation of debts
        - Notification of abandonment

# 363 Sale: Tax Implications – Buy-Side

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- Shareholder and noteholder/creditor (cont.)
  - Noteholder/creditor
    - Gain or loss recognized for difference between FMV of property and its basis in that portion of the claim
    - Bad debt deduction (partially or wholly) – ordinary deduction
      - Sec. 166 for difference between unsatisfied and uncollectible difference between unpaid balance of the claim and its basis
    - Worthless security (wholly)
      - Sec. 165(g) – capital asset
    - Example (1):
      - Creditor holds a \$100,000 secured claim against Debtor with a \$100,000 basis. Debtor bids \$60,000 in a 363 sale to purchase the property in year 1. The property's value is determined to be \$40,000. Creditor has no further recovery on the claim, and the debt is cancelled in Year 2. Creditor recognizes a \$20,000 loss (assuming capital) for the claim-for-property transaction in year 1 (\$40,000 FMV of property less \$60,000 credit bid) and has basis in the property of \$40,000. In year 2, Creditor has a bad debt loss of \$40,000 (\$60,000 credit bid less \$100,000 basis in secured claim). Thus, Creditor has a total \$60,000 loss split between the two years and has basis in the property of \$40,000.

# 363 Sale: Tax Implications – Buy-Side

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- Shareholder and noteholder/creditor (cont.)
  - Noteholder/creditor
    - Example (2):
      - Same as Example (1), but the FMV of the property is determined to be \$80,000. Creditor has a \$20,000 gain (assuming capital) for the claim-for-property exchange (\$80,000 FMV of property less \$60,000 credit bid) and has \$80,000 basis in the property in year 1. In year 2, Creditor has a \$40,000 bad debt loss on the remainder of the claim in year 2 (\$60,000 credit bid less \$100,000 basis in secured claim). Thus, Creditor has a total net loss of \$20,000 and has basis in the property of \$80,000.
    - Accrued but unpaid interest (see below)
- Other Considerations
  - Withholding on foreign investors and inclusion of income
    - Interest – payment applied against accrued interest first
      - OID and QSI



# 363 Sale: Tax Implications – Other Considerations

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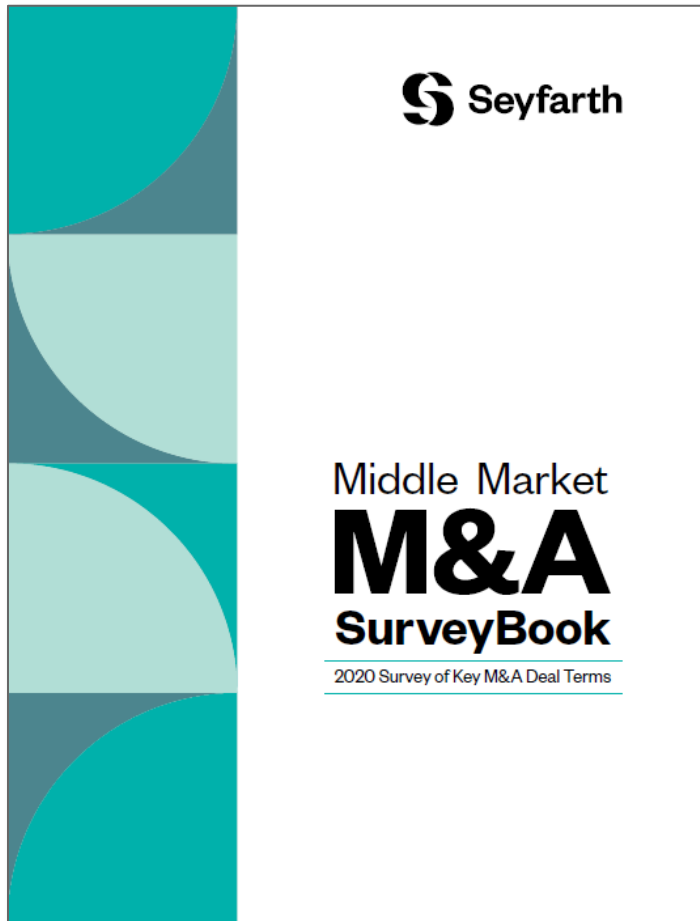
- Other Considerations (cont.)
  - Availability for Sec. 1202 planning?
  - Tax implications of any contingent considerations including deficiency claims
    - Installment sale and losses
- Equity incentive opportunities
  - Profits interests
  - Capital interests
  - Options
- Tax compliance and disclosures
  - Form 8594 – Asset Acquisition Statement
  - Form 982 – Reduction of Tax Attributes Due to Discharge of Indebtedness

**Q&A**

**thank  
you**

# Seyfarth's 2020 Middle Market M&A SurveyBook

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## What's inside:

- Key Indemnity Deal Terms Surveyed
- Fraud Exceptions and Definitions
- Choice of Governing Law
- MAE Provisions in the Wake of COVID-19
- 2020 Hart-Scott-Rodino Act Thresholds
- Navigating Immigration Compliance Due Diligence
- Pension Liabilities post-*Sun Capital*
- CCPA: A New Source of Risk

*Email the Seyfarth presenters for a PDF copy.*