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Legal Update

Asset Management M&A in the COVID-19 Era and Beyond: A Roadmap

In the early stages of the COVID-19 crisis, the ripple effects of the pandemic and the ensuing economic turmoil have combined to chill the M&A market across most industries. The asset management sector has been no different. The reasons for this are no mystery—business models and valuations in this sector are closely tied to the performance of the capital markets and the value of assets under management ("AUM"). It is easy to see how plummeting markets and increases in volatility would make asset management deals more difficult.

At the same time, some of the pre-pandemic dynamics in this sector suggest that we may see asset manager deal activity recover sooner than M&A in other industries. In this environment, it will be important for parties and their financing sources and advisors to approach deals with a well-developed toolkit for addressing the challenges that will inevitably arise. In this Legal Update, we consider what may lie ahead for asset management M&A and discuss key considerations for deal structuring, addressing regulatory issues, retaining key personnel, and getting to closing and beyond.

Pre-Pandemic Dynamics May Drive Continued Deal Activity in the Asset Management Sector

While COVID-19 has created a "new normal" in many aspects of business, certain trends and dynamics in the asset management industry that were driving strong deal activity before the pandemic have not changed. As a result, these factors could drive a speedy recovery in deal flow after an initial phase of relative inactivity. These potential drivers include the following:

- **Declines in Valuations Could Lead to Opportunities.** Pre-crisis, the years-long bull market and the swift pace of asset manager M&A had led to an upward trend in the multiples buyers were willing to pay asset management businesses. Asset managers with fundamentally sound businesses and investment strategies are still inherently valuable, but market turmoil and uncertainty about when AUM and revenues will recover may lead to a downward adjustment of valuation multiples for these businesses. That, in turn, could generate renewed momentum in deal activity in the sector.
- **Generational Transition.** Since the 2007-2009 financial crisis, generational turnover and manager/founder retirement has been a significant driver of deals in the asset management industry. Managers who are currently near retirement may not have the career runway to postpone

an exit transaction until business conditions recover. This may compel owners to continue to seek exits notwithstanding potentially lower valuations.

- **Digitization of Financial Services.** While most institutional and high-net-worth asset management businesses continue to be people-centric and relationship-driven, technology has and will continue to disrupt and transform the industry. Firms that are behind in addressing this in their businesses may come to market as sellers (to those better utilizing technology) or as buyers (to catch up to the competition).
- **Asset Aggregation Is Still "a Thing."** Prior to the COVID-19 pandemic, asset management businesses were attracting significant levels of private equity investment. Private equity sponsors continue to have capital to put to work and a mandate to do so. Reports from early 2020 indicated that private equity funds were holding approximately $1.5 trillion in "dry powder." It seems likely that a portion of that capital will continue to be directed towards acquisitions of asset managers.

It is also worth noting that, while the effects of the current pandemic are similar in some ways to what we saw in the 2007-2009 financial crisis, no two crises are the same. Some distinctions can be drawn between what's happening today and the situation in 2007-2009. In particular, while declining equity markets and increased volatility certainly played a role in the M&A market slowdown in the asset management sector during 2007-2009, there were other factors at play that are thus far not at play in the current crisis, including a near-total lack of debt financing for deals (due to frozen credit markets) and a crisis of confidence in buyers' ability to diligence advisers (resulting from the discovery of Bernie Madoff's Ponzi scheme). Without those added complications, asset management M&A activity may recover more quickly than expected. That said, the deals that get done first in this environment will have to be able to solve for two factors that existed in both the last crisis and the current one—volatility and challenges in coming to terms on valuation of assets and businesses.

Impact of Volatility and Valuation Challenges on Deal Structure and Terms

Issues relating to asset valuation and uncertainty as to investor behavior are likely to pose challenges to pricing and structuring acquisitions involving asset management businesses until the economic turmoil being wrought by the effects of COVID-19 subsides. In the near term, parties pursuing transactions in the industry are likely to focus in particular on how these issues affect earn-outs and other deferred consideration structures, purchase price adjustments, and closing conditions based on financial metrics.

Complicating factors facing parties pursuing M&A transactions involving asset management businesses in the wake of the pandemic include:

- **Volatile Asset Values.** The fallout from COVID-19 and related governmental restrictions has led to steep drops in the prices of broad swaths of publicly traded securities. At the same time, the fluid nature of the pandemic and the world's response has resulted in extreme volatility in the capital markets, such that predicting with any degree of confidence where prices may be headed over any given timeframe is nearly impossible.
- **Valuation of Illiquid Assets.** Aside from the volatility in the public capital markets, asset managers investing in illiquid markets—such as private equity, real estate, venture capital, private credit, funds-of-private-funds, and the like—have had their own issues determining proper asset valuations. The problems posed by uncertain valuations can cause more headaches for some managers than others. In particular, managers that charge fees based on AUM may face difficulties valuing assets for purposes of calculating their fees, and managers of open-end private funds may also face challenges

in striking a net asset value for the fund for purposes of calculating both redemptions and new subscriptions.

- **Client Withdrawals and Redemptions.** Many firms managing portfolios of liquid securities have faced, or may face, higher-than-usual rates of withdrawals, as some investors become spooked by global events and others require funds to meet expenses. Also, some asset managers of open-end private funds dealing with the challenges of valuing illiquid assets in the current environment have resorted to imposing redemption gates or suspensions. In those cases, there may be large redemption queues accumulating during a period where redemptions are limited or suspended, which could lead to eventual asset outflows that may also damage long-term relationships with investors.

These issues are likely to ripple through structures and deal terms for asset manager acquisitions in the near term. Areas of particular focus are likely to include:

- **Earn-outs.** Deferring some portion of the deal consideration through an earn-out tied to certain performance metrics for the target business is very common in asset manager acquisitions. Depending on the nature of the target business and the type of assets its clients or funds are invested in, earn-outs tend to be tied to changes over some time period after closing in metrics such as AUM, run-rate revenues ("RRR"), profitability, or a combination of the foregoing. These metrics, in turn, are often based on complex calculations that may or may not take into account factors such as client in-flows and out-flows, market movements or other changes in underlying asset values or that may contemplate thresholds above or below which certain changes will not be taken into account. Considerations for earn-outs in asset management deals in the current environment include:
  - It seems likely, given the uncertainties discussed above, that deals that get done in the near term will allocate more deal consideration to the earn-out than to an upfront payment. In addition, given the lack of visibility into how long it may take for businesses to stabilize, parties may be inclined to stretch earn-outs over a longer period of time.
  - Parties should be careful about the extent to which earn-out payments are tied to changes in asset values. Given the volatility in liquid asset prices and the potential uncertainty in the values of illiquid assets, metrics tied to client retention or flows or RRR metrics that disregard changes in AUM based on market movements may be preferable.
  - Parties should be cautious in using metrics that take into account client out-flows if a manager has imposed limitations on withdrawals or redemptions. In those situations, any historical withdrawal/redemption rate may not be indicative of what may come when restrictions are lifted.
  - There will likely be an even greater focus on post-closing buyer covenants intended to support achievement of the earn-out metrics. Sellers will likely push for more control over decisions as to matters such as rate changes or personnel moves that could affect the business given their increased "skin in the game." At the same time, uncertainty about what the future may bring will likely compel buyers to insist on flexibility to manage the business as they deem appropriate as circumstances change.
- **Purchase Price Adjustments.** Many of the issues that are likely to bear on earn-out structuring may also come into play in negotiating purchase price adjustments. Purchase price adjustments in asset management transactions are often tied to, among other things, changes in the same kinds of metrics that are used to calculate earn-outs. Parties should be cautious about tying adjustments to calculations that will be overly influenced by changes in asset values. Changes in AUM based on the significant volatility of liquid assets in the current environment could give rise to surprises. In the

case of businesses managing client accounts or assets invested in illiquid assets, the parties should be as prescriptive as possible about how those assets will be valued for purposes of the purchase price calculation, to the extent variations will be taken into account. Detailed methodologies and agreed-upon illustrative examples of their application will help avoid disputes.

- **Value-Based Closing Conditions.** The challenges relating to asset valuation and volatility and unpredictable client behavior in the current environment are likely to also lead parties to focus on closing conditions tied to financial metrics and client retention. These kinds of closing conditions often interrelate with purchase price adjustments. For example, a purchase price adjustment may have a limit or a collar, but the buyer may be able to invoke a closing condition that's tied to a deterioration not captured by the purchase price adjustment in order to walk away from the deal. As with the considerations for earn-outs and purchase price adjustments, in the near term, parties may favor closing conditions tied to client retention and inflows or outflows or to RRR or AUM metrics that disregard changes based on market movements or underlying asset values.

Elevated Regulatory Concerns in Light of Increasing Compliance Challenges

Even under ideal circumstances, it is essential to conduct thorough due diligence as part of an acquisition to identify any potential regulatory landmines; depending on the nature of uncovered landmines, they could be a reason to walk away from a deal entirely, or the buyer may want to take them into account in pricing the transaction. There are numerous examples of enforcement actions by the US Securities and Exchange Commission brought against acquirers arising out of pre-merger conduct of an acquired company.[1] The current climate has the potential to exacerbate these risks, as asset managers face increasing compliance challenges related to their investments, their personnel, and their compliance framework. In this section, we briefly highlight some of the most significant potential regulatory pitfalls and areas of concern that should be a focus of due diligence and seller representations and warranties in connection with any asset management M&A transaction in the current climate.

- **How Has the Firm Handled COVID-19?** Sellers should expect that buyers will seek information on how the target firm handled (or is handling) complications related to COVID-19. This diligence could include assessment of:
  - Compliance with any "stay-at-home" and "essential business" orders.[2]
  - Effectiveness of the firm's implementation of its business continuity plans and disaster recovery systems. Many firms conduct annual or biannual testing of these plans, but the current work-from-home environment is a true trial by fire. Going forward, looking at enhancements made to these plans stemming from COVID-19 will provide a stark record of the lessons learned through the process.
  - Compliance with supervision requirements in light of remote working.
- **Cybersecurity, Privacy, and Data Protection.** Sellers should expect that buyers will take an interest in how the firm complied with its privacy obligations and data protection policies. Among other things, adherence to any firm policies restricting the use of personal email, text messages, and similar non-business communications for firm business may be put to the test in the work-from-home environment. Sloppy handling of client personal information can easily lead to a data breach that could have significant collateral impact on the firm. Moreover, personnel working from home may be using personal devices that are more vulnerable to malicious cybersecurity threats than in-office computers.

- **Selective Disclosure and Inequitable Treatment of Clients/Investors.** In difficult economic times, asset managers may feel the pinch, but so do many of their clients and fund investors, and these clients and investors often have increased questions and requests for their asset managers. For some managers, in the heat of the moment, when there's a desire to keep a large client/investor satisfied, there's a temptation to provide more information, accommodate more requests, and otherwise provide more special treatment than they would under normal circumstances. However, this can be a trap for the unwary, as this kind of inequitable treatment, without proper disclosure, could lay the groundwork for a future enforcement action or private litigation. Sellers should expect that buyers may wish to carefully assess any special accommodations—whether in the form of advance notice of actions the manager may take; selective, supplemental reporting regarding valuations or liquidity; redemption or withdrawal rights from private funds; or other actions—and assess whether they comport with existing disclosures to clients/investors and other obligations under applicable law.
- **Valuation and Redemption Practices.** Given the considerations relating to illiquid assets in some funds and portfolios noted above, where such assets are involved, sellers should expect buyers to evaluate the target's valuation practices to look for material weaknesses in the firm's valuation process, assess compliance with the firm's valuation procedures, and confirm proper authority and disclosures around any use of gates or redemption suspensions for open-end funds.

Retaining Key Individuals in Uncertain Times

In nearly all asset manager acquisitions, it is critical for a buyer to retain executives, relationship and portfolio managers, and other key individuals. These individuals are the foundation of a robust asset management business; they are the key to maintaining and growing existing client relationships, attracting new clients, and successfully managing investments. Ensuring stability in the team provides reassurance to clients of an acquired business that service will remain consistent despite the transaction. This will be particularly important in the coming months as clients' concerns will likely be compounded by the ongoing uncertainty flowing from the COVID-19 crisis. Buyers typically implement incentives to encourage the retention of key individuals for a period of several years following a transaction, often through a mix of equity or equity-based compensation and time- or performance-based retention bonuses.

Buyers will need to carefully consider the structure of any retention bonuses to ensure that they provide an incentive for key individuals to remain employed following closing and that performance-based bonuses are designed to incentivize desired performance while taking into account the impact of COVID-19 on the business and its investments. For example, a buyer may consider using relative investment performance, rather than absolute investment performance, as a performance bonus criteria. Buyers may also consider giving more weight to metrics that are less dependent on market performance but still important to the business, such as client retention or AUM retention.

The use of equity compensation to incentivize key individuals may also change during the COVID-19 crisis. Stock options, in particular, may have greater appeal as a long-term retention tool because the recipients see value from stock options only if the value of the stock increases as compared to the grant price. Options granted during COVID-19, when the stock values of many companies are depressed, have great upside potential. Recipients who remain with their companies over the long-term (as options are often exercisable for a period of up to 10 years) will have tremendous opportunities to create value for the company, the shareholders, and themselves. Of course, in an asset management business, many of the key individuals also have an equity stake in the business, and these

individuals may be asked to roll over a portion of their equity in connection with the transaction. Even if the deal value is depressed, rollover equity may provide another source of retention value and a way to further align the interests of key individuals with those of the buyer. While key employees often want to liquidate all or a significant portion of these investments, in a down market, they may welcome the opportunity to remain invested in the business with the hope of selling at a higher price later, when the market improves.

Some Considerations for Getting to Closing and Beyond

Even in the best of circumstances, the time period between signing a transaction and closing can be tense. The target must continue to manage its business and respond to unexpected issues while ensuring it complies with pre-closing operating covenants under the acquisition agreement. At the same time, the parties will be working together to plan for the often complex task of integrating the acquired business after closing. With the added uncertainty of the impact of COVID-19 on the economy, public health, and the target business, this tension is likely to be elevated. Even smaller acquisitions of asset management businesses typically require a delay between signing and closing in order to allow the target to obtain client or other consents and, in some cases, regulatory approvals. In the current environment, when negotiating deal terms, sellers are likely to be focused even more keenly on their ability to respond to the ongoing crisis during the pre-closing period, and on certainty of closing, while buyers are likely to be concerned about guarding against any deterioration in the value of the target business after signing.

The fallout from, and uncertainties created by, the COVID-19 crisis are likely to lead buyers and sellers pursuing asset management deals in the near term to focus particular attention on the following areas: (1) interim covenants regarding the operations on the business, (2) closing conditions and (3) planning for integration of the target business. Considerations in these areas include:

- **Operating the Target Business and Responding to Unexpected Events. In** general, M&A agreements typically require the buyer's consent in order for the seller to take actions outside of the ordinary course of business between signing and closing or to take a variety of specified actions during the pre-closing period. As the vast impacts of COVID-19 unfold, it is clear that asset managers are operating in an environment that is anything but ordinary. Asset managers, like many other businesses, will likely continue to face new and evolving challenges in the coming months. These may relate to issues ranging from compliance challenges and personnel difficulties to client management issues and novel investment decisions. Although most M&A agreements provide that buyer's consent to an otherwise prohibited action cannot be unreasonably withheld, given the widespread uncertainty and disagreement as to the most appropriate responses to the outbreak at all levels, it is quite possible that buyers and sellers will disagree as to appropriate steps for the seller to take in response to a particular issue, with little clarity as to whether a buyer's refusal to consent is reasonable.

  Parties should consider trying to anticipate and address these uncertainties where possible, particularly given that asset management M&A transactions in the near term may require a longer-than-usual period between signing and closing due to likely delays in obtaining client and other consents and regulatory approvals. For example, sellers may want to include exceptions to interim restrictions that allow them to take reasonable and prudent measures to respond quickly to COVID-19-related issues without the buyer's consent. Buyers may be sympathetic to such exceptions but will likely be resistant to broad exceptions and seek to limit a seller's leeway to specific situations. Parties may also want to prescribe specific communication pathways in the acquisition agreement so

there is a clearly defined process to respond to unexpected events that may require company action. To avoid delays and confusion in the consent process, parties may consider streamlining the process for obtaining buyer's consent by, for example, (1) designating a specific individual at the buyer to whom requests for consent should be directed and specifying the appropriate method of contact (e.g., by email), (2) placing a specific time limit on the period for the buyer to consider and respond to the request for consent (such as 2-3 business days), (3) providing for "deemed consent" by the buyer if it does not respond within the prescribed time period, and (4) providing that the buyer cannot unreasonably withhold, delay, or condition its consent. At the same time, buyers will want to ensure that the process allows them enough time to internally review requests, particularly for buyers with internal bureaucracies and/or with respect to requests that may impact the future value of the business. Outside of the consent process, the parties may also consider establishing concrete communication plans for the interim period, such as weekly calls, to allow an opportunity to get ahead of emerging issues.

- **Crafting Closing Conditions in the Current Environment.** In a typical M&A deal, closing conditions linked to the target business are generally focused on materiality, including with respect to the accuracy of representations and warranties, compliance with covenants, and whether a "Material Adverse Effect" or "MAE" has occurred. Using these standards in closing conditions for an asset management acquisition, however, often will not capture issues signaling a decline in the value of the target business, especially in the era of COVID-19. In particular, Material Adverse Effect definitions typically establish a very high bar for a buyer seeking to not close. Applicable US law may not deem a short-term deterioration in the business, even if it is very substantial, to be a material adverse effect. Further, Material Adverse Effect definitions often specifically exclude effects related to matters such as pandemics, general financial or economic conditions, or fluctuations in capital markets. In other words, if COVID-19 fallout causes material deterioration in a target's business prior to closing, it is very possible such deterioration will not be considered an MAE, such that the buyer would not be able to rely on a "no MAE" closing condition to get out of the deal. Accordingly, buyers will likely be better off focusing on specific closing conditions which are tied to the metrics driving the valuation of the target business, such as those discussed above. For example, parties may want to focus on client retention through a condition that requires seller to deliver consents from a certain percentage of clients or clients representing a certain percentage of AUM, as compared to a baseline. Such a metric would be more resistant to market fluctuations than, for example, a condition requiring retention of a specified absolute amount of AUM.
- **Preparing for a Business Combination in a Work-From-Home Environment.** Many business combinations experience unexpected difficulties after closing, during the integration process. Remote working and other restrictions on normal operations resulting from the COVID-19 crisis are likely to make the integration process even more difficult in the near term. In an effort to ease this additional integration burden, parties should be more thoughtful and prescriptive than usual regarding the integration of the target business both in the pre-closing planning period and following the closing. Issues to be mindful of include:
  - Due to remote working issues or facility closures or restrictions, there may be instances where a buyer will need the seller to provide certain post-closing transaction services it might not have otherwise required.
  - Where post-closing transition services are contemplated, longer service periods may be warranted.
  - On-boarding personnel may be more complicated with new hires and HR personnel alike not able to come into the office and with background checks and other necessary steps likely taking

longer. Parties should work together to identify these issues and agree on an approach that will avoid potential delays.

- Parties will need to be careful about transferring client records in accordance with compliance policies while personnel are working remotely.

These and other considerations warrant proceeding even more carefully with integration planning than usual. Buyers should focus on the pre-closing access provisions of the acquisition agreement to ensure that they have the ability to conduct integration-focused due diligence prior to closing and to access key personnel to assist with integration planning. Such rights will help the buyer to troubleshoot problems in the integration process and sachieve transaction efficiencies more quickly after closing.

As with so much of what's going on in the world today, the trajectory for M&A transactions in the asset management industry is not clear. There are, however, reasons to think that we may see deal flow recover in the sector sooner than in other areas. As market participants begin to consider how to get deals done in the face of the challenges posed by COVID-19, being thoughtful about the issues discussed in this article should serve them well.

If you wish to receive regular updates on the range of the complex issues confronting businesses in the face of the novel coronavirus, please subscribe to our COVID-19 "Special Interest" mailing list.

And for any legal questions related to this pandemic, please contact the authors of this Legal Update or Mayer Brown's COVID-19 Core Response Team at FW-SIG-COVID-19-Core-Response-Team@mayerbrown.com.

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Endnotes

[1] *See, e.g.*, https://www.sec.gov/litigation/admin/2014/34-73183.pdf and https://www.sec.gov/litigation/admin/2019/34-85249.pdf.

[2] See our "Essential Business" resources.

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