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## Pre-Closing Covenants and the Pandemic

**Why Interim Operating Covenants Should Get Renewed Attention in the Wake of COVID-19**

*By Joe Castelluccio and Jenna Miller, Mayer Brown LLP*

Interim operating covenants in M&A agreements—i.e., covenants that regulate the business operations of a target company between the signing of a deal and closing—provide important protections to both sellers and buyers. These covenants allow buyers to preserve value in the business they hope to buy and permit sellers to responsibly operate their businesses. At the same time, these covenants need to permit appropriate latitude for the sellers to operate their businesses responsibly and independently of buyer control that would be impermissible under antitrust laws, which prohibit buyers from taking operational control of target companies prior to closing.

In the context of the COVID-19 pandemic, interim operating covenants are likely to see increased attention in pre-signing negotiations and play an outsized role in buyer/seller relations between signing and closing. The pandemic has already caused interim periods to be extended due to the virus's impact on business operations and governmental responses around the world. Even before the outbreak of the novel coronavirus, extended interim periods could arise due to increased regulatory scrutiny of deals for national security and antitrust reasons, among others.

In this article, we will examine some commonly used terms that upon closer examination may not have their intended effect, and we'll also look at some practical tips for pre-closing communications among buyers

and sellers. Lastly, we will also examine how these covenants play out in an event like the current pandemic and suggest ways that buyers and sellers can manage emergent and unexpected risk.

### **Uncertainty About the “Ordinary Course of Business” Standard**

Most M&A agreements include a promise by the sellers that they will operate target businesses “in the ordinary course of business” during the interim period. In order to undertake actions outside of the ordinary course of business, a seller must obtain the consent of buyer. The purpose of this restriction is to give a buyer some certainty that, at closing, it will acquire the business in substantially the same condition as it was when the buyer performed its due diligence and valued the target. If a seller fails to comply with these interim operating covenants, the buyer may have the right to refuse to close the transaction (subject to certain negotiated materiality thresholds).

Even though interim covenants are important for both maintaining the value of the business and ensuring closing, they are sometimes not prioritized in the negotiation process. These covenants are sometimes not viewed as “business issues,” in part because of the broad nature of the “ordinary course of business” language and the fact that the restrictions only apply after signing. After a deal signs, however, parties may find them-

*Statutory Appraisal* →

## Covenants

*continued*

selves considering for the first time what exactly “ordinary course of business” means.

In general, whether businesses are operated in the “ordinary course of business” is a fact-specific determination. Recently, Delaware courts have used an objective standard—i.e., the actions of other similarly situated companies in the industry—to determine whether an action is in the “ordinary course of business.” But this comparison—and the resulting outcome—may be undesirable for both buyers and sellers if the industry standard is not consistent with the practices of the business or the agreed trajectory of the business. And while case law suggests that New York courts may be willing to consider the historical practices of the target in conjunction with industry standard, as discussed below, looking to the past practices of a business may not be helpful for future unknown events.

As an alternative, the parties may seek to clarify the meaning of “ordinary course of business” in the M&A agreement by adding some commonly used qualifiers. For example, the objective “ordinary course of business” standard may become subjective by adding “consistent with past practice.” If qualified in this way, the focus of the fact inquiry would be on how the target operated in the past, rather than an objective industry standard. While using this standard is helpful because it doesn’t apply an industry “standard” that a company may not have actually used in the past, it does not allow for flexibility if there are unexpected events in the future that may require a different approach. These unexpected events are discussed in the last section of this article.

Ultimately, there is unlikely to be a satisfactory answer as to what constitutes “ordinary course of business,” with or without qualifiers, in every scenario that may arise in the interim period. As one approach to address this, during the negotiation process parties should consider the agreed and expected actions of the target business between signing and closing, such as paying regularly scheduled bonuses or incurring capital expenditures costs as outlined in a budget. These agreed items should be scheduled as permitted actions and can provide written comfort that the parties are on the same page—at least with respect to known or reasonably foreseeable events.

Another way to address this issue is to make

the covenant subject to the seller’s commercially reasonable efforts (or other efforts standard). By doing so, the ordinary course conduct that is expected of the seller is covered (assuming seller is already acting in a commercially reasonable manner in operating its business). However, in the event of an unforeseen circumstance (e.g., crisis) where the seller uses commercially reasonable efforts to conduct the business consistent with past practice but is not able to do so (and consequently takes some other action to keep the business running), the seller is not in violation of a flat covenant requiring it to operate the target in the ordinary course of business consistent with past practice. This “commercially reasonable efforts” standard in the general covenant attempts to address the items not specifically addressed by the parties without shifting all risk to the seller.

### **Creating Structures for Efficient Communications Between Parties**

Another approach to addressing concerns with the use of the “ordinary course of business” standard is to script a specific communication pathway in the M&A agreement so parties have a clearly defined process to respond to unexpected events that may require company action.

Unnecessary delays can occur if the M&A agreement lacks specifics on the process for obtaining a buyer’s consent to certain actions, which in turn can limit the ability of seller/target to take quick actions that may be necessary and desirable by both parties. To avoid delays and confusion in the consent process, the parties may consider (1) designating a specific individual at buyer to whom requests for consent should be directed and specifying the appropriate method of contact (i.e. email); (2) placing a specific time limit on the period for 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 buyer cannot unreasonably withhold its consent. Sellers will want to make sure that the processes are not too onerous for them to obtain consent in a timely manner. A buyer will want to ensure that the process allows it 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. To that end, a buyer may want to preserve the right to act in its sole discretion regarding certain types of actions, such as incurring indebtedness.

Outside of this consent process, the parties may also consider establishing concrete communication plans for the interim period, such as weekly calls. These types of recurring touch points allow for open lines of communication between the parties and can be particularly helpful if there are numerous pre-closing workstreams—such as employment matters, third-party consents and regulatory approvals. Parties should be creative in establishing communication plans that tailored to the parties’ needs, the transaction and the industry in which the target operates. These pre-scheduled meetings can be especially helpful if unexpected events arise in the interim period.

### **Responding to Crisis Events Under Interim Operating Covenants**

Whether one believes the current pandemic was unpredictable or not, the fact remains that it has—and will continue to have—a massive impact on well-settled conventions and approaches to issues in M&A (not to mention, daily life and social interactions). In the context of interim operating covenants, this impact will manifest itself differently in agreements that have already signed—i.e., deals that are currently in an interim period—and those that will be negotiated going forward.

#### *Here and Now*

In M&A agreements that have already been signed—and do not expressly allow for a seller to take pandemic-related actions without a buyer’s consent—actions required to comply with law usually do not require a buyer’s consent. In addition, one might argue that a seller already has latitude to respond to situations like this if the M&A agreement contains the commonly seen requirement that a buyer not unreasonably withhold its consent to a seller’s proposed actions. After all, most would agree that it would be reasonable for a company to respond in some way to a public health emergency.

However, there continues to be widespread uncertainty and disagreement as to the most appropriate responses to the outbreak. In that context, it is quite possible that there may not be a unanimous view on reasonable and prudent measures, and equally diverse views on whether a buyer was reasonable in its refusal to consent to any of them. For example, even as the outbreak spread to almost every country on Earth during the month of March and as infections continue to exponentially increase, there continues to be a wide disparity in approaches taken by differ-

ent private companies and local governments as of the date of this writing. As a result, proactive measures proposed by a seller—especially ones that have significant economic impacts—may be deemed unreasonable by a buyer.

In light of this uncertainty, how should a seller proceed if it is faced with a buyer that is unwilling to consent to actions that a seller believes in good faith to be reasonable and prudent in light of circumstances such the current pandemic? While unsatisfying, the answer is that the approach depends heavily on the specific facts and circumstances of the crisis, the company and the transaction. Among the variables a seller must weigh are (1) the nature of the crisis itself, (2) the economic impact of the proposed actions, (3) the possible impact (economic and otherwise) of not taking the proposed actions, and (4) other risk-mitigating devices that may be available if action is taken—e.g., insurance that may cover certain economic damages and/or alternative working arrangements that, while outside the “ordinary course of business,” allow a company to minimize the negative effects of the crisis. In formulating a path forward in this situation, boards of directors and company management will also have to weigh and contrast their duties to employees, shareholders, contractual counterparties and, to some extent, their communities.

#### *Looking Ahead*

In the M&A agreements of the future, established M&A practice may evolve to address at least some of this uncertainty. For example, it seems possible that we’ll begin to see exceptions to these interim restrictions that allow for sellers to take all reasonable and prudent measures to respond to emergent public health emergencies, without a buyer’s consent. One might argue that this is unnecessary if an M&A agreement contains the “not to be unreasonably withheld” language noted above, but for the reasons noted, there’s a sound basis for this additional clarity. Given that these types of emergencies are (hopefully) rare, buyers may not be overly resistant to including an exception like this.

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*Covenants* →

## Covenants

*continued*

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