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COVID-19 considerations for life sciences M&A

Introduction

The coronavirus disease 2019 (COVID-19) has significantly disrupted most businesses around the world but life sciences companies in particular have been thrust into the limelight both in relation to vaccination, treatment and related efforts and the challenges of continuing to provide healthcare services. This will provide opportunities as well as challenges and it is expected to lead to increased M&A activity in the sector. M&A in the life sciences sector has been more resilient to past recessions than other sectors and this is expected to be the case for the current recession, particularly as it has been directly caused by a health event. It may take a while for M&A activity to pick up, as businesses are focusing on stabilising and crisis-response in the near term, but the Stephenson Harwood life sciences team is already advising clients in the area.

This note sets out some COVID-19 considerations for M&A which are specific to the life sciences sector. General COVID-19 M&A considerations will also apply.



Tom Page

Partner, corporate

T: +44 020 7809 2021

E: tom.page@shlegal.com

1. Purchase price structures and adjustments

- 1.1 Valuing a life sciences business has always presented its own challenges but the uncertainty created by COVID-19 has exacerbated these, even for businesses which may benefit from it. Clearly there will be opportunities for life sciences companies but there will also be increased competition. Although the response to the impact of the virus and its novel nature is attracting vast amounts of investment and has sped up trials processes, the standard risks, particularly in the medicine development sector, continue to apply including the cost and time to achieve regulatory approval and to establish profitable commercialisation of product.
- 1.2 This will continue to have an impact on valuation provisions in acquisition documentation. Often a life sciences acquisition will involve an element of deferred consideration, typically with milestone payments becoming due upon the occurrence of specified events, backed up with a commercially reasonable endeavours undertaking from the buyer. There is likely to be greater weight placed on such deferred, rather than up-front, consideration in the COVID-19 context and the conditions attached are likely to increase. Commercially reasonable endeavours clauses, the precise wording of which is usually subject to intense negotiation, are likely to include specific obligations if the target's products are COVID-19 related.

- 1.3 Paper consideration may become rarer due to share price volatility and general demand for cash. Clearly raising finance may be more difficult, though for listed buyers the equity markets have held up, with a steady flow of secondary fundraising having taken place since the pandemic started to affect the UK¹.
- 1.4 There are particular considerations when the seller is in a distressed situation and specific advice should be sought.

2 Conditions, pre-completion undertakings and material adverse change clauses

- 2.1 Life sciences acquisitions often have a split exchange and completion due to the need to obtain regulatory or other third party consents to a change of control. COVID-19 related delays may be experienced in relation to obtaining regulatory consents, for example approval for the transfer of marketing permissions and merger control clearance may take longer to obtain². It may also take longer to obtain consents from contractual counterparties due to capacity but also the greater scrutiny that decisions are subjected to in challenging times. This means the period between exchanging the purchase agreement and the buyer completing the purchase of the target is likely to be extended. This, combined with heightened uncertainty, means the provisions dealing with the "gap period" are likely to be the focus of greater attention.
- 2.2 The period between exchange and completion is normally governed by an undertaking from the seller in the SPA to operate the business "in the ordinary course" pending completion together with a list of actions that the target cannot take without buyer consent. The meaning of "the ordinary course of business" has become unclear since the outbreak of COVID-19. Buyers are likely to seek greater precision in the drafting of such clauses, perhaps with specific examples set out in the transaction documents.
- 2.3 Buyers may also push to have more operational control over the target in the period between exchange and completion or for greater joint contingency planning. Note that this would need to be subject to competition law compliance to ensure "gun-jumping" risks are managed. The tendency over the past few years has been to have lighter interim covenants to avoid gun-jumping but there may be more willingness to accept such risk in the new circumstances. For example buyers may seek reinforced rights in case of material events such as outbreak of epidemics or pandemics.
- 2.4 Clearly in the case of a life sciences target whose value depends on the development of COVID-19 and its impact, the response of management may be critical to a buyer. At the least, buyers are likely to seek greater information rights in relation to COVID-19 (although competition law is relevant here too).
- 2.5 Material adverse change clauses which allow a buyer to pull out of a transaction in the event of a "MAC" have historically been drafted on a general basis. Such clauses are now likely to be more precisely drafted and be subject to greater negotiation. Both parties are likely to want to refer specifically to COVID-19 scenarios, and it is generally thought that the more precise such clauses are, the greater the chance of them being held to be enforceable by the courts (there is limited UK case law in this area). Again, where the value of the target is more directly linked to the pandemic, greater focus is likely to fall on MAC clauses. In the case of transactions which are subject to the UK City Code on Takeovers and Mergers, the Panel has demonstrated its unwillingness to allow bidders to invoke MAC conditions in relation to COVID-19³.

3 Due Diligence

- 3.1 Additional focus in due diligence is likely to be important to buyers, particularly on the target's exposure to the economic and operational implications of COVID-19. The following may be particularly relevant to life sciences companies:

¹ See re AIM company fundraisings during COVID-19 <https://www.shlegal.com/insights/equity-fundraising-considerations-for-aim-companies-during-covid-19>

² Competition authorities around the world, including the Commission and the CMA, have released alerts in relation to delays to merger filing reviews and have encouraged companies to delay making filings where possible

³ See Takeover Panel statements in May 2020 re offer for Moss Bros Group plc

- 3.1.1 the use of government grant or aid schemes, and their terms going forwards;
 - 3.1.2 the terms of any collaboration between life-sciences companies in relation to a COVID-19 vaccine or treatment. This would normally give rise to anti-trust considerations but authorities, including the European Commission and the Competition and Markets Authority ("CMA"), have relaxed the rules on this⁴;
 - 3.1.3 potential for approval for reimbursement / compliance with pricing regulations for COVID-19 related products, depending on their stage of development;
 - 3.1.4 business continuity arrangements;
 - 3.1.5 COVID-19 related disputes;
 - 3.1.6 employment – a greater emphasis on the use of furlough schemes, redundancy programmes, flexible working arrangements and numbers of people "shielding" who do jobs they cannot do from home or are in higher risk environments, e.g. lab-based jobs⁵; and
 - 3.1.7 compliance with data protection and privacy laws if the target is involved in the collection, process or generation of data for COVID-19 (e.g. track and trace).
- 3.2 Given the travel restrictions there may be difficulties in carrying out physical inspections, on-site visits or management presentations as part of due diligence. Physical data rooms are unlikely to be viable. Sellers may undertake vendor due diligence.

4 Warranties

- 4.1 COVID-19 is likely to lead to increased pressure from buyers in relation to warranties and indemnities. The areas referred to above in paragraph 3 on due diligence should also be considered when drafting warranties. Buyers are likely to argue for repetition of warranties at completion. Sellers may argue that COVID-19 related warranties should be "boxed" so claims cannot be brought under general warranties.
- 4.2 There has been increased demand for warranty and indemnity insurance, particularly from non-traditional buyers in the life sciences sector. Terms for such insurance have traditionally been harder to reach for life sciences acquisitions, given the complexity and high-risk nature of the sector. The dearth of deals since COVID-19 began to affect M&A markets has led to insurers offering competitive terms but some have also been mandating a COVID-19 exclusion in their policies and requiring more detailed due diligence.

5 Tax

- 5.1 Although a detailed look at the tax considerations for life sciences M&A is beyond the scope of this article, buyers should consider the following points to arise from COVID-19⁶:
 - 5.1.1 targets which are loss making (which is likely to apply to early-stage life sciences companies) – although in principle a UK buyer can carry forward trading losses to a later period indefinitely, this is mitigated by certain restrictions including as to the amount of carried forward losses that can be used in each period, where there is a major change in the nature or scale of the business bought or where a business is bought for its tax loss attributes. There is currently no indication that these rules will be relaxed for Covid-19 related losses. However similar rules elsewhere (e.g. in the U.S.) have been relaxed, so this may change. If so, the impact on corporate cash-flows and deal-pricing could be significant;

⁴ See <https://www.shlegal.com/insights/antitrust-impact-of-covid-19-on-life-sciences>

⁵ See <https://www.shlegal.com/insights/how-to-practise-safe-working-in-labs-and-research-facilities>

⁶ See re general M&A COVID-19 tax considerations: <https://www.shlegal.com/insights/m-a-recovering-from-covid>

- 5.1.2 deferred consideration – as described above, life sciences acquisitions are usually structured to involve some form of deferred consideration, most commonly by way of milestone payments where certain contingencies are met. Sellers are generally taxed up front for such payments, with the ability to claim a refund if they are not in fact made. An alternative is to “roll-over” into shares or loan notes. Such roll-over consideration must always be structured carefully, having regard to the tax status of the buyer and sellers, as the tax rules are complex and there are potential pitfalls for both parties. The ideal structure for a transaction involving set, but contingent, milestone payments may differ to that for a deal with deferred consideration, the amount of which is unascertainable at the time of completion, for example. More generally, deferred consideration may be less appealing to sellers in times of share price volatility and demand for cash;
- 5.1.3 changes to the tax regime – the UK has applied certain relaxations to the tax regime in response to COVID-19 and appropriate due diligence should be undertaken on a target’s tax affairs where such changes apply. There are a number of uncertainties, however: for example small- or medium-sized life sciences companies claiming R&D reliefs may cease to qualify if they have also received a loan under the Coronavirus Business Interruption Loan Scheme (CBILS) or the Bounce Back loan scheme as they are classed as state aid. A business claiming payable credits under the SME scheme or the R&D Expenditure Credit (RDEC) regime will have to show it had not ceased to be a going concern at the times of claim and payment. HMRC has not yet provided guidance on how this interacts with the relaxation in accounting reports ongoing concern status during the Covid period; and
- 5.1.4 employment taxes – buyers should seek to verify through due diligence that tax calculations in relation to furloughed employees and implementation of salary waivers have been made correctly.

Conclusion

M&A in the life sciences sector is subject to its own particular considerations relating to COVID-19 as well as those affecting other sectors. From a legal perspective, this will result in increased focus on the main transaction documents, particularly in relation to milestone payments, commercially reasonable endeavours obligations and interim covenants, together with increased due diligence. However, this is unlikely to dampen activity in a sector which has come to prominence as a result of the pandemic.

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Contact us



Alexandra Pygall

Head of life sciences and IP

T: +44 20 7809 2137

E: alexandra.pygall@shlegal.com



Anthony Clare

Partner, corporate

T: +44 20 7809 2326

E: anthony.clare@shlegal.com



Andrew Edge

Partner, corporate

T: +44 20 7809 2102

E: andrew.edge@shlegal.com



Marta Isabel Garcia

Partner, competition

T: +44 20 7809 2141

E: marta.garcia@shlegal.com



Dan Holland

Partner, technical operations

T: +44 20 7809 2108

E: dan.holland@shlegal.com



Naomi Leach

Partner, licensing & digital health

T: +44 20 7809 2960

E: naomi.leach@shlegal.com



Tom Page

Partner, corporate

T: +44 20 7809 2021

E: tom.page@shlegal.com



Anne Pritam

Partner, employment

T: +44 20 7809 2925

E: anne.pritam@shlegal.com



Maryanna Sharrock

Partner, tax

T: +44 20 7809 2191

E: maryanna.sharrock@shlegal.com



Hilary Barclay

Senior associate, tax

T: +44 20 7809 2332

E: hilary.barclay@shlegal.com

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