

Practical Canadian M&A Advice During the COVID-19 Outbreak

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Introduction

As the novel coronavirus (COVID-19) pandemic continues to impact global commerce, businesses and their advisors have been forced to consider a range of issues, many of which, like the virus, are novel, in order to address their current and post-pandemic business needs. The Canadian M&A and capital markets landscape is not immune from this reckoning, as COVID-19 has affected, and will continue to affect, many of the key deal provisions typically included in definitive transaction agreements and associated M&A documentation.

Certain types of transactions have been more affected than others during the pandemic and, in some cases, terminated entirely, with industry type and stage of transaction often playing key roles in determining a given transaction's prospect of success. Regardless of industry, COVID-19 has likely stirred increasing anxiety for those that have already entered into definitive transaction agreements as to how the prior drafting of those agreements will withstand the pressures of the virus; while for those that are still in the negotiating stage, COVID-19 has likely impacted the manner in which such parties and their advisors are negotiating key deal provisions. Whether in the pre-signing or post-signing stage of an M&A transaction, COVID-19 is sure to impact how most transactions ultimately develop. This article will focus on some of the most critical components of, and well-known provisions in, typical Canadian M&A documentation and which we have observed receiving additional consideration during the COVID-19 pandemic due, in part, to the realization that these provisions could have significant consequences that extend well beyond the lifespan of the virus.

Purchase Price - Bridging the Gap

Negotiation Stage

Determining a purchase price under a purchase agreement is typically the most negotiated element of any M&A transaction. While purchase price calculations can take many forms, the majority of purchase agreements involving any relatively sophisticated target business will typically include certain vendor incentive provisions or price adjustments. Purchase price negotiations will not get simpler during the COVID-19 pandemic. While the transacting parties may be agreeable to looking back to certain historical, pre-COVID-19, data to determine the base purchase price in a purchase agreement, determining certain financial milestones to be achieved by a target business at closing or post-closing in connection with calculating earn-out payments, or similar purchase price adjustments, may become significantly more challenging during the pandemic. Current/future operational disruptions to target businesses are likely to diminish the utility of historical averages in order to calculate the quantum of any future earn-out payments. As such, vendors, purchasers and their advisors may wish to incorporate bespoke quantitative pricing mechanisms that carve-out the results of a target business during certain periods prior to signing from being included in a current working capital figure in the context of an earn-out calculation or, similarly, delay the commencement of the results of a target business during certain periods from being included in such calculation.

Similar to how COVID-19 may impact earn-out payment calculations, the pandemic is also expected to have a material impact on purchase price adjustments, such as a working capital adjustment. Purchasers and their advisors may wish to spend additional time and resources considering how the COVID-19 pandemic has affected the target business's working capital target in circumstances where that business

has experienced significant business disruptions prior to signing. Extended disruptions to the target business prior to signing may artificially decrease a working capital target, particularly in cases where the period during which current working capital is calculated is relatively short so as to normalize, and incorporate into the current working capital calculation, lower historical working capital figures than the target business would typically achieve. A lower working capital target could result in a purchaser paying an inflated working capital adjustment post-closing. Conversely, if the target business has not yet experienced significant business disruptions in connection with the pandemic, then vendors and their advisors may wish to consider how the target working capital figure is to be calculated in light of potential future disruptions to the target business.

Both in the case of earn-out payments and working capital adjustments, vendors, purchasers and their advisors may wish to consider how assistance from new government relief programs will impact the calculation of the contemplated payments. For instance, how should the benefits of the Canada Emergency Business Account or Emergency Wage Subsidy impact a target company's balance sheet post-closing and, as a result, affect the calculation of earn-out milestones, working capital targets and related payments? These issues should not be ignored during negotiations. Agreeing upon applicable adjustments to determine such calculations post-closing are sure to be more difficult and time-consuming and, as such, it may be prudent for the transacting parties to take time to consider these issues in the drafting stage. Alternatively, the parties may prefer to avoid incorporating earn-out payments and/or purchase price adjustments into definitive transaction agreements entirely or consider acquiring a lesser equity percentage of the target business with options to purchase additional portions of the enterprise in the future.

Post-Signing Stage

With respect to amending a purchase price after signing, it may prove difficult to have both sides mutually agree to any significant amendment, likely a decrease, particularly in the context of a fixed purchase price; however, the transacting parties may wish to consider this option during the COVID-19 pandemic if it would facilitate the completion of the transaction. Any amendments may also need to be communicated to certain third parties, such as lenders, representation and warranty insurers or regulators, which the transacting parties and their advisors will want to be mindful of during any purchase price negotiations.

In addition, the effect of business disruptions on the ability of a purchaser to operate a target business post-closing may reduce the likelihood of the business achieving certain milestones and, as a result, adversely affect the likelihood of a vendor being paid an earn-out and/or a purchase price increase in connection with achieving a certain working capital target. As noted above, the impact of assistance from new government relief programs on the normalization of working capital post-closing may also be a contested issue post-signing. All of these factors could have a significant impact on the ultimate consideration paid under a purchase agreement. The transacting parties may wish to amend any earn-out and/or purchase price adjustment provisions by reducing certain thresholds, extending financial milestone time horizons, incorporating the benefits of government assistance programs into working capital calculations or by increasing the base purchase price and eliminating any earn-out and/or purchase price adjustment entirely. Amendments of this nature are likely to be highly contested.

Due Diligence - Different and Delayed Investigations

Negotiation Stage

Conducting meaningful due diligence prior to signing a definitive transaction agreement is expected to be more difficult and time-consuming during the COVID-19 pandemic, particularly if certain materials must be provided by third parties. The pandemic has affected the time associated with due diligence as well as the format of diligence investigations.

With respect to timing, conducting a thorough diligence investigation will take longer than in the normal course, which all parties should be cognizant of when approaching the negotiating table and beginning to draft definitive transaction agreements. Although electronic data rooms have been standard for Canadian M&A transactions for some time, diligence investigations involving third parties, in particular, are expected to take an extended period of time. For example, government or third-party approvals or search results, such as real property title and/or bankruptcy searches, can be expected to take longer than in the normal course. In addition, physical inspections of a target business's operations or those of integral suppliers

and/or customers may simply be impossible during the pandemic. Diligence relating to the scope and depth of a target business's operations and policies can also be expected to be more comprehensive than in the normal course and vendors should be mindful of this well in advance of commencing the diligence process. As a result, the transacting parties may need to adapt to different forms of diligence, including video-conferencing, or adjust the drafting of certain due diligence-related provisions in order to complete a transaction.

With respect to determining the quantum of the purchase price during the pandemic, vendors, purchasers and their advisors will need to consider the reliability of certain financial models and outlooks typically relied upon to determine a purchase price in the normal course. Depending on the nature of the target business, these types of models and outlooks may no longer be appropriate, particularly in the shorter term, as such models and outlooks will likely be prepared based on certain assumptions relating to past performance of the target business pre-COVID-19. In the context of M&A involving publicly-listed entities, a purchase price calculation relying heavily on certain trading price metrics may also need to be reconsidered, as market uncertainty associated with the COVID-19 pandemic has resulted in significant volatility from one trading session to the next, which could result in an insurmountable valuation gap among vendors and purchasers. Reasonableness among the transacting parties will be more important than ever during this crucial stage of an M&A transaction throughout the COVID-19 pandemic.

Post-Signing Stage

Similar to during the negotiation stage, conducting meaningful due diligence during an interim period is expected to be more difficult and time consuming during the COVID-19 pandemic. As such, the transacting parties may wish to consider waiving the termination date of certain diligence periods or amending the applicable agreement in order to allow the parties to produce and review the diligence documentation necessary to complete the transaction. Traditional interim meetings between the transacting parties and important third parties may similarly be delayed, conducted by way of video conference or cancelled entirely as a result of the pandemic. Vendors, purchasers and their advisors will need to be flexible in these circumstances and begin considering whether they can accept the waiver of certain diligence conditions, or delivery of certain materials/documentation post-closing, in order to complete the transaction.

Material Adverse Change/Effect - Addressing the Expectation of the Parties

Negotiation Stage

Vendors, purchasers and their advisors should carefully consider the language used to define certain commonly used terms in M&A documentation during the COVID-19 pandemic, including the typical definition of "material adverse change" (MAC) (or "material adverse effect"). The definition of MAC is particularly important where an interim period is provided for and certain representations and warranties need to be correct at the time of closing - in addition to at the time of signing - and where certain intervening events must be avoided such that there are no MACs on the target business prior to closing.

Vendors, purchasers and their advisors may wish to consider qualifying certain representations and warranties, or the definition of a MAC itself, with carve-outs for events that could be attributed to COVID-19. MAC definitions that exclude the effects of a "pandemic", or COVID-19 explicitly, or "acts of God", to the extent that such events, changes or circumstances do not have a disproportionate impact on the target business, may be also appropriate. With respect to definitive transaction agreements that have not yet been signed, it may prove difficult for a purchaser to claim that the impact of the COVID-19 pandemic constitutes a MAC since the virus will already be well-known and its impact, at least initially, on the target business likely established. This argument was recently asserted by a TSX-listed Canadian mining company that had its bought deal securities offering pulled by its underwriter in mid-March pursuant to a typical "disaster-out" provision after the signing of the definitive underwriting agreement. While a court is yet to opine on the merits of the miner's legal position, the deal was nonetheless aborted. Had the underwriting agreement included a more specific "disaster-out" provision that explicitly excluded the effects of COVID-19, which it could have based on when such agreement was signed (March 11, 2020), then the deal would have likely gone ahead. We believe that this line of reasoning can similarly be applied to MAC clauses.

Post-Signing Stage

Depending on the nature of the target business, the transacting parties may wish to amend certain definitions or representations and warranties in a purchase agreement in order to reduce the potential impact of the COVID-19 pandemic on a transaction. Vendors, purchasers and their advisors may wish to amend the language relating to certain bring-down representations and warranties at closing, such that a MAC that resulted after signing relating to COVID-19 does not unnecessarily derail a transaction. If amending a definitive transaction agreement would prove too cumbersome, the transacting parties may wish to begin preparing their respective arguments as to why COVID-19 has, or has not, resulted in a MAC in the context of their particular transaction. When considering such arguments, the parties must first look to the specific wording of the particular MAC, as there can be significant divergence as to how the definition is drafted. For example, some MAC definitions may include references to the “outlook” or “prospects” of the target business as also being subject to the definition, as opposed to current business operations, in which case it may be more difficult for vendors to argue against the occurrence of a MAC.

Purchasers looking to terminate a transaction by asserting a MAC in connection with COVID-19 may, subject to the wording of the definition, wish to endeavour to prove that the pandemic has had a “disproportionate” effect on the operations of the target business as compared to some other control group, such as the particular target business’s industry as a whole. Conversely, vendors looking to complete a transaction by disputing a MAC claim during the pandemic may wish to assert that, subject to when the definitive transaction document was executed, the widespread effects of COVID-19 could not have been contemplated by the transacting parties at the time of signing and, therefore, incorporating the impact of the pandemic on the target business into the definition of MAC would not reflect the intentions of the parties at the commencement of the transaction. While the wording of a MAC definition, and, to a lesser extent, the nature of the target business, is sure to impact how vendors, purchasers and their advisors prepare these types of arguments, transacting parties would be wise to prepare sooner rather than later in the event that it becomes necessary to formally assert their positions.

Interim Covenants - Changes in the World Between Signing and Closing

Negotiation Stage

Satisfying certain interim covenants may be more difficult and time-consuming for both vendors and purchasers during the COVID-19 pandemic. As such, vendors, purchasers and their advisors should consider the extent to which fulfilling certain standard interim covenants may be affected by COVID-19. Specifically, the transacting parties may wish to consider how the target business will be able to operate in the “ordinary course” during the pandemic so as not to be offside the typical vendor covenant requiring that the target business be operated in the ordinary course prior to closing.

It is almost certain that any target business in Canada will, at least to some degree, be unable to operate in the ordinary course during the COVID-19 pandemic. Site shutdowns, social distancing and border closures will impact how virtually any business can operate, if at all, and transacting parties will need to be flexible if they intend to complete their transaction. In addition, interim covenants requiring the parties to obtain certain third-party and regulatory consents or achieve certain levels of financing may also need to be reconsidered, as obtaining such consents and/or financing may prove to be challenging, and certainly slower, during the pandemic. For example, many government offices and banks are operating on reduced hours, which is likely to impact the ability for necessary consents, such as consents relating to the assignment of a government grant or bank loan, to be obtained in a timely manner. Vendors and their advisors may wish to caveat “ordinary course” operational covenants with specific language carving-out any disruptions attributable to COVID-19, while purchasers may wish to consider allowing for extended time periods during which certain covenants may be completed. Flexibility will be integral to drafting a definitive transaction agreement that can sustain the impacts of the pandemic.

Post-Signing Stage

As noted above, some degree of business disruption as a result of COVID-19 will almost certainly occur. As such, the transacting parties may wish to consider amending certain operational covenants of the vendor with specific language carving-out defaults or MACs to the operations of the target business attributable to the pandemic (see *Material Adverse Effect/Change - Addressing the Expectation of the Parties* above).

The extent to which a business disruption is actually attributable to COVID-19, and whether such disruption is a direct or indirect result, will likely be a highly-contested amendment as vendors will surely want to incorporate broad disruption language, while purchasers will conversely want to incorporate more specific language. In addition, covenants requiring the parties to obtain certain third-party/regulatory consents or certain levels of financing may also need to be amended or waived entirely depending on the nature of the target business and financial position of the purchaser. Again, the flexibility of the transacting parties and desire to complete the transaction will likely be key factors in determining whether a transaction is ultimately completed during the COVID-19 pandemic.

Representation and Warranty Insurance

The impact of the COVID-19 pandemic on representation and warranty insurance (RWI) policies in M&A transactions could be significant. Purchasers and their advisors should likely contact their RWI providers well ahead of negotiating any new deals, as standard policy exclusions may be significantly expanded as compared to what may have been “the norm” prior to the COVID-19 pandemic. Expanded exclusions may be on the horizon and could severely impact the drafting of indemnity provisions by potentially attributing additional risk to the seller even if RWI is purchased for the particular deal, which, in turn, could affect purchase price mechanics.

Due to the current uncertainty relating to how and when the COVID-19 pandemic will evolve, purchasers and their advisors may also experience RWI providers insisting on broader exclusions at closing in cases where there is an interim period, while accepting more standard exclusions in the shorter term at signing. The extent that RWI insurers are involved in due diligence or bring-down due diligence is also likely to increase during the COVID-19 pandemic. While it is too early to determine precisely how RWI providers may adjust their operating practices in light of the pandemic, it is clear that some change is inevitable. As such, vendors, purchasers and their advisors should consider whether RWI is truly necessary under a given definitive transaction agreement and whether obtaining such insurance would be prohibitively expensive or burdensome to completing the transaction. Flexibility and a mutual desire to close is likely to ultimately determine the fate of any transaction that the applicable transacting parties intend to complete during the pandemic or its aftershock.

Our Capital Markets Group will continue to monitor the effects of COVID-19 on the Canadian capital markets and M&A landscapes and provide additional guidance as the situation develops.

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