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ARTICLE

Mergers & acquisitions considerations for target boards

This is part two of a series focusing on current M&A trends, opportunities and challenges.

The global COVID-19 pandemic has had a significant impact on financial markets. Many businesses were (and some still are) closed on a temporary or permanent basis, causing stock market volatility. At the beginning of the pandemic, we saw markets tumble and many companies lose considerable value in their market capitalization, and, in some cases, in the actual value of the company. While the markets rebounded as the pandemic progressed, with a second wave upon us, COVID-19 is once again negatively affecting the markets broadly and the stock prices of individual companies.

As we continue to adjust to the realities of living with COVID-19, for at least the foreseeable future boards of directors of public companies will face numerous challenges. One such challenge is being prepared for potential offers to acquire the company. In discharging their duties, directors have a fiduciary duty to act honestly and in good faith in the best interests of their company, and are subject to a duty of care to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. These duties are heightened when considering whether to accept offers to acquire the company. COVID-19 does not change these duties, but it does create new considerations for boards in discharging their duties.

This article highlights a number of matters that target boards in Canada should consider both in preparing for potential offers, and in negotiating acquisitions if an offer is made. Our previous article in this series considered matters from the perspective of the acquiror board. Future articles will consider board matters from the perspective of companies in financial distress.

M&A preparedness

Boards of public companies should be prepared for potential offers to buy the company. If a company has been negatively impacted by COVID-19, it may be more likely to receive unwanted offers. Therefore, it is important that a board be prepared to respond. Set out below are a number of things boards should consider in relation to M&A preparedness:

- Impact of COVID-19 on value. While some companies have been able to get back to some kind of business as usual, many continue to feel the effects of the pandemic. For a target board negatively impacted by COVID-19, one of the challenges will be to determine the prospects for their company's business and its current value. From there, they must decide whether it is best to resist opportunistic acquisition offers in hopes of better times or to accept an offer that may be all that stands between the company and potential bankruptcy or other hardship. Some of the key considerations in this regard are:
  - How has the company adapted to the pandemic?
  - Is the company in an industry that has or will reopen, or is it part of an industry that will be closed fully or partially for the long term? If so, will they be able to adapt and survive?
  - Are there government support programs available? If available, will these programs carry the company through to better times?
  - Assuming the pandemic will ease at some point, will the target business be able to get back to business as usual following the pandemic or be impacted forever?

- Know the company and any vulnerabilities. The board should be aware of any vulnerabilities to a takeover. Are there non-COVID-19 matters affecting the share price? Is a downturn in the market devaluing the stock price? Are there any internal issues with management or within the board?
- Understand fiduciary duties. Directors should have a clear understanding of their fiduciary duties and the heightened responsibility in the face of an offer to acquire the company. It is important that board members understand their duty is to the corporation, they should consider the interests of all stakeholders and, while maximizing price is often a key consideration, it is not the board's number one duty like it is in the United States.
- Know the shareholders. Directors should know who its largest shareholders are and understand their motivations. Is the shareholder base made up of long-term holders or those looking for quick returns? Do shareholders align with management? Do any activists own stock? If not already underway, a company's IR department should be in communication with key shareholders and should keep the board up to date with respect to who the large shareholders are, their current views on their investment in the company and of any significant changes to the company's shareholder base.
  Will shareholders be receptive to an offer that may be below pre-pandemic pricing? Shareholders of a company affected by the pandemic may consider a bid for the target to be "opportunistic." The challenge for a board in such a situation is to satisfy shareholders that the offer price is the best they can hope for in the near future.
- Takeover defenses. Directors should be up to date as to market practice with respect to takeover defenses and relevant rules. In particular, boards should consider whether it would be prudent to adopt a shareholder rights plan or "poison pill" in advance of any potential offer or in the face of an offer. When considering whether to adopt a poison pill, boards should be mindful that with the amendments to takeover bid rules that came into effect in 2016, and, in particular, the 105-day bid period, poison pills are not used as often as in the past.
- Be aware of potential white knights. While it would be unusual to conduct a market check when a company is not in play, a board may wish to get a sense of potential suitors from their financial advisors as part of M&A preparedness. Some issuers will have open, regular dialogue, including due diligence access under an NDA, with a limited number of entities as part of their M&A strategy.
- Preparing for an M&A process. If a company is put into play, things will move quickly and companies that have to get started from ground zero will have a hard time catching up. This may be particularly true during COVID-19, where remote working is common and things may take longer to get organized. To get prepared, companies can take a few steps to be ready to engage in an auction or other market check should the need arise. Steps that can be taken include having:
  - a standard NDA ready;
  - an online data room ready for access; and
  - legal, financial and proxy advisors engaged.

Deal terms

In addition to commonly negotiated provisions in M&A deals, such as deal protections, parties engaging in M&A deals during the pandemic will need to be mindful of a few additional provisions or process-related matters:

- Special committees: In certain transactions, for example where there may be conflicts of interests or insider participation, it is clear that a special committee is appropriate. In other deals, particularly if an issuer has a large board, boards strike a special committee to take the lead on an M&A transaction, as a smaller committee may be able to more swiftly respond to an offer. With the impacts of COVID-19, companies may find they are better able to respond to offers through smaller special committees rather than the full board.
- Form of consideration: A target board, where possible, should consider the form of consideration it will accept.
  If a target's share price is depressed due to COVID-19, a board may feel its shareholders would prefer a share exchange to continue with their investment in the company and wait for the benefit of better times that may be coming, or the benefit from the depressed value of the offeror's stock.If the consideration is shares of the offeror, the board will need to make sure it can conduct appropriate due diligence and many of the challenges of assessing its own value will apply in assessing the value of the offeror. For example, how is the offeror affected by COVID-19? Are any COVID-19 effects short term? Will the offeror fully recover from the effects of COVID-19? If cash is being paid, the target board will want to be comfortable that the price is not opportunistic and the acquiror has the cash on hand or can clearly obtain financing.
- Force majure. Many agreements contained generic *force majure* language pre-pandemic. However, during, and even post-COVID-19, companies will want to negotiate clearly thought out provisions as to what constitutes a *force majure* entitling the acquiror or target to walk away from a deal. What happens if either party cannot meet their obligations to suppliers, customers or other key parties? What if either party cannot continue with negotiations? What happens if key members of management or the board get COVID-19? While there is no right answer to these questions, boards will need to consider these questions when negotiating definitive agreements.
- Material adverse effect (MAE) clauses. When the pandemic began, there was much discussion around whether it triggered MAE clauses drafted pre-pandemic. Not surprisingly, there have been a few lawsuits in relation to this issue. The Cineplex/Cineworld dispute is the highest-profile one in Canada, and the LVMH/Tiffanys case is one of the most recent in the U.S. While judicial decisions, including from these cases, will provide assistance in interpreting MAE clauses, many parties to M&A deals are now expressly addressing COVID-19 in MAE clauses. In drafting COVID-19 exceptions to an MAE, targets may argue that the effects of COVID-19 are no secret, so it is a risk the acquiror must take on. An acquiror, on the other hand, may be willing to accept some COVID-19 related risk, but may argue that if the target is disproportionately affected, that should trigger an MAE.
- Interim covenants. Between signing and closing, target companies are typically required to operate the business in the "ordinary course." COVID-19 has affected how most businesses operate, so care must be taken to consider the effects of COVID-19 when agreeing to operate "in the ordinary course." Targets may want a blanket exception to enable them to deal with COVID-19 operations. This may not be palatable to acquirors, who will want some control over interim operations and may only agree to targets having limited ability to adjust operations to respond to pandemic-related issues, with anything more significant requiring acquiror consent.
- Timing – court proceedings/outside date. For a variety of reasons, the pandemic has made timing of acquisitions less certain. For example, the Competition Bureau has indicated there may be delays in its processing of merger reviews, as have other competition and anti-trust authorities. While courts have been adapting to life with COVID-19, in the early days of the pandemic, they shut down and could do so again during a second wave. As the vast majority of Canadian public company acquisitions are done by way of a court-approved plan of arrangement, court scheduling could affect timing. We have advised targets to include allowances in definitive agreements for additional timing to obtain court-required documents in the event of COVID-19 related delays, as well as extensions of outside dates for similar events.

Takeaway

As COVID-19 continues to be present and affect how business is done, public company boards must be mindful of the effects that it may have on their company. Boards whose companies are impacted negatively by COVID-19 should be ready for potential offers, and be ready to determine how, and whether, to proceed with such offers in accordance with their fiduciary duties.

If you have questions or concerns about mergers & acquisitions during COVID-19, reach out to your BLG lawyer or any of the key contacts listed below.

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