Transaction considerations resulting from the COVID-19 pandemic

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

With positive news with respect to vaccines, there are reasons for optimism that the worst of the COVID-19 pandemic and the corresponding governmental health restrictions may ease in 2021. However, it also seems increasingly clear that this easing is still months away, and that pandemics and other unforeseen crises are a reality that businesses will need to address on an on-going basis in the future, including in the context of M&A transactions.

This article provides a brief overview of a few key considerations for M&A transactions arising from the COVID-19 pandemic.

Previous articles in this M&A series have looked at specific considerations for boards of directors of acquirors, target entities, for companies in financial distress, as well as valuation issues impacting transactions during the COVID-19 pandemic. This article addresses general transaction considerations.

Due diligence

In addition to the practical challenges of completing a due diligence investigation arising from the COVID-19 pandemic as well as the resulting travel and social distancing restrictions (*e.g.* challenges with site visits, physical inventory review and in person meetings with key personnel), the pandemic has also highlighted areas of vulnerability for many businesses. As a result, certain aspects of due diligence have increased in importance, or in some cases, new issues have arisen. Matters potentially requiring heightened due diligence include:

1. **Supply and distribution chain risks** – It is important that any acquiror have a thorough understanding of a target's supply and distribution chain as well as where they could become vulnerable. For example, it is important to understand if a target is relying on any suppliers where there is not a practical alternative source of supply and how they may have been impacted by the pandemic. In the event that a supplier is critical to the target's ability to conduct business and is

not easily replaced, it may be appropriate to conduct diligence on that supplier as well as review diligence conducted by the target when they entered into the supply contract.

2. **Insurance coverage** – Parties should review all insurance policies to understand the scope of any pandemic exclusions or limitations on coverage and review all claims brought against the target and claims the target has made under its insurance policies as a result of the COVID-19 pandemic.
3. **Employment matters** – In addition to traditional labour and employment due diligence, companies will need to understand what steps a target has undertaken to mitigate against the effects of COVID-19 on its workforce, including ensuring employee safety and knowing how to respond if an employee tests positive for COVID-19. Where the target implemented layoffs because of the pandemic or has implemented austerity programs, such as across the board wage or hour reductions, these should be reviewed to confirm compliance with employment laws and to determine their impact on employee benefit plans or insurance. Finally, it is also important to understand which employees are required to be physically present at the workplace and which are permitted to work remotely. As the COVID-19 work-from-home restrictions abate, it will become increasingly important to understand return-to-work policies and how the target intends to re-integrate personnel on site.
4. **Government grants and loans** – During the COVID-19 pandemic, many businesses received government assistance such as the Canada Emergency Wage Subsidy and Canada Emergency Business Account non-interest loans. It is critical to understand what grants or loans were received or applied for and to ensure the target has complied with and has properly accounted for them. Finally, there are reputational issues related to accepting government assistance that should be considered. For example, stories in the media have recently targeted entities paying out dividends to shareholders, bonuses to executives or using funds to buy back shares after receiving government grants. Even if these actions are technically legal, they may result in unwanted negative press for an acquired business.
5. **Material contracts** – All contracts should be reviewed in light of business disruptions resulting from the pandemic. Where parties have been unable to perform their obligations under material contracts, it is important to understand whether a target has agreed to modify or waive provisions of its material contracts, and whether such modifications or waivers may affect the ability of the target to enforce the contracts. Review of representations and warranties to see if current circumstances exist that may allow for the termination of a material contract or raise the risk of a breach or default of the contract is also important.
6. **IT systems and data security** – Diligence of a target's IT systems has become even more important as businesses have been forced to increasingly rely on their digital platforms because of remote working. This has stretched the capacity of IT systems and often made them more vulnerable. A detailed review of the target's data security and privacy of information processes and monitoring should be undertaken.
7. **Debt covenants** –It is important to understand the target's debt covenants and whether there is a risk of non-compliance, including as a result of business interruptions during the pandemic. Many credit agreements contain financial covenants based on EBITDA calculations that might permit certain unusual, extraordinary or non-recurring expenses incurred in connection with the COVID-19 pandemic to be added back. These provisions should be reviewed in order to understand any caps on these add backs and whether any costs may cease to

be eligible in the event they become permanent costs of doing business after the pandemic. Even in situations where the purchaser is paying out the target's debt and putting its own debt facilities in place, an understanding of how COVID-19 has affected the target's debt covenants can assist in implementing new banking arrangements.

Given the rapid rate of change and uncertainty the COVID-19 pandemic has created, depending on the length of the interim period between signing of the definitive agreement and closing, the purchaser should also consider whether robust bring down due diligence is also required prior to closing and, if so, incorporate these terms into the purchase agreement.

Drafting and negotiating the acquisition agreement

While the pandemic has not changed the fundamental structure of negotiating and drafting an acquisition agreement for an M&A transaction, a few provisions of these agreements have been specifically impacted by the pandemic.

Purchase price considerations

Earn-outs

As set out in the previous installment of this series, Valuation Issues & Nil Premium Transactions, the uncertainty resulting from the COVID-19 pandemic has exacerbated the valuation tension that already exists between buyers and sellers. One potential solution to this is the use of earn-out clauses. Parties to M&A transactions have generally tried to avoid using earn-outs as they are complicated and are one of the most common areas of dispute following the completion of transaction. However, they can be a useful tool for bridging valuation gaps, especially when uncertainty (such as that created by the COVID-19 pandemic) makes it difficult to forecast future profitability.

Purchase price adjustments

Purchase price adjustment clauses should be carefully considered in the context of the pandemic. For example, sample calculations agreed to prior to signing can help to ensure each party understands how particular expenditures or receipts will affect the purchase price. Sellers will want to be cautious with such adjustments, and may seek to negotiate a cap as to the amount the purchase price can be decreased, as government restrictions imposed because of the pandemic could dramatically affect the adjustment mechanism.

MAE/MAC clauses

In the early days of the pandemic, questions immediately arose as to whether COVID-19 and the related government responses could be characterized as a Material Adverse Effect (MAE) or Material Adverse Change (MAC) and, if so, whether parties to transactions that were not yet closed would be able to terminate their agreements in reliance on an MAE or MAC clause. An Ontario court has recently provided guidance on the ability to use MAC/MAE clauses to terminate an agreement, generally and in the

context of the COVID-19 pandemic. BLG's analysis of the decision in *Fairstone Financial Holdings Inc. v. Duo Bank of Canada can be found here*.

Notwithstanding the *Fairstone* case, companies will still need to pay close attention to MAC/MAE clauses as their interpretation will always turn on the specific facts and language used in the definition of MAC/MAE and related carve-outs.

Another option to provide certainty is not relying on an MAE/MAC clause at all, but to consider including specific closing conditions to address particular COVID-19 or other risks instead. Where a specific closing condition is not met, the purchaser will have the option not to close without having the heavy burden of proving an MAE/MAC has occurred.

Interim period covenants

The uncertainty and rapidly changing landscape the COVID-19 pandemic has created has resulted in additional risk for both parties arising during the interim period between signing of the definitive agreement and closing. Accordingly, parties will want to try to limit the duration of the interim period. A further risk is that if the parties are utilizing representation and warranty insurance (R&W insurance), any known breaches will likely be excluded from coverage.

Parties will want to review the interim period covenants contained in the definitive agreement carefully to ensure that:

- The interim period is as short as possible;
- The covenants are capable of being complied with in the current pandemic; and
- The covenants give the target business the flexibility to respond quickly to rapidly evolving developments.

In particular, parties should pay attention to the covenants to provide access and to operate in the normal course.

Access and inspection

Agreements typically require that sellers provide purchasers with access to their premises and their personnel. Parties should ensure it is made clear that this is subject to restrictions and limitations imposed by governments in response to the pandemic. Sellers may wish to clarify that employees will not always be available in person and that web conferencing or phone access is acceptable.

Operations in the normal course

Agreements typically restrict the ability of the target to take any actions during the interim period that are outside the normal course without the prior consent of the purchaser. However, this requirement may result in the target entity not being able to act in a timely manner to protect its business, its personnel or its customers in response to the pandemic or another unforeseen crisis. In addition to ensuring there is good communication between the parties, the seller might seek to include exceptions allowing the target to respond unilaterally to pandemic developments. The purchaser would want

the pandemic exceptions to be as narrow as possible and to include a requirement for the seller to notify the purchaser of the actions taken immediately.

Another alternative may be to amend the definition of “ordinary course” to include any actions taken or omitted to be taken because of COVID-19, provided the actions are reasonable and necessary to protect the health and safety of the business’ employees, customers or other third parties, or to protect the business and financial condition of target entity.

The *Fairstone* decision mentioned above also addressed alleged breaches of the target‘s covenants to operate its business in the normal course during the interim period. The Court rejected these allegations and held that where businesses take prudent steps in response to an economic contraction, consistent with prior behaviour and that do not impose long-term obligations on the purchaser, this should not seen as outside the normal course.

Closing and related matters

Other matters for parties to consider while completing an M&A transaction include:

1. **Financing** – Purchasers that must rely upon acquisition financing may face additional challenges because of the volatility in the equity and debt markets, and may face challenges in obtaining more traditional bank acquisition financing. As we entered the second half of 2020, however, financing challenges appeared to ease and current low interest rates may make leveraged acquisitions more appealing to purchasers. While purchasers may want to try negotiating a financing out, if financing is not certain, sellers will want to push back on any such ask. A compromise may be a finance out with a reverse break fee payable to the seller if the transactions does not close as a result of a failure to finance, to ensure the seller’s expenses and lost opportunity costs are covered. Both parties will want to ensure that the conditions in any commitment letter in respect of financing are as limited as possible and parallel the conditions in the definitive purchase agreement.
2. **Third party approvals and outside date** – Although most businesses and governments have found ways to operate remotely in an effective manner, the pandemic may result in slower turn around times in obtaining third party approvals. Accordingly, parties will want to ensure that the outside date for completion of the transaction is either far enough out to ensure that approvals can be received, or is appropriately flexible in the event any third party approvals are not received.
3. **Physical closing mechanics** - Physical distancing means that physical closing may not be possible and that a virtual closing may be the only option. Virtual closings are done via electronic exchange of signature pages and there are tools available, which BLG utilizes, to fully implement virtual closings,.
4. **Indemnities** - The parties will want to review the indemnity section in light of the current COVID-19 landscape and determine if the standard indemnities for breach of covenants or if warranties are sufficient. If there are specific risks created by the pandemic, it may make sense to include a specific indemnity to address potential losses arising from that risk. For example, if due diligence determined a key customer may be able to terminate their agreement with the target as a result of breaches resulting from the pandemic, the purchaser may

request a specific indemnification from the sellers for losses resulting in the event that agreement is terminated. Purchasers should also consider if a portion of the purchase price should be escrowed to ensure that funds are available in the event of an indemnification claim and if a higher cap may be appropriate if a specific risk with a potential large loss is identified. Sellers will want to push back on indemnification provisions by adding exclusions to any sandbagging provisions to ensure that they exclude claims or losses resulting from known COVID-19 losses.

Conclusion

While the COVID-19 pandemic has caused disruptions to all aspects of life, including M&A transactions, BLG is still seeing robust M&A activity occurring, with deal volume increasing in the last half of 2020 and into 2021. While there are new considerations that need to be addressed in completing transactions in a post-COVID-19 environment, BLG is well positioned to assist its clients in ensuring M&A transactions are completed successfully.

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