The impact of COVID-19 on M&A transactions

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With COVID-19 shaking up the global economy, it is clear that M&A activity has been, and will continue to be, impacted. In Canada and the U.S. a number of previously announced deals have already been shelved and it is possible that more deals will continue to fail as companies focus on ensuring they have sufficient cash reserves and access to debt for the foreseeable future. At the same time, deal activity has not completely dried up and some market participants are continuing to pursue transactions, in many cases finding opportunity in the chaos.

For market participants choosing to proceed with M&A transactions during this unprecedented time or for those with previously signed deals, they will undoubtedly need to re-evaluate deal terms and contemplate a wide variety of unique risks and challenges. In this article, we have identified some key issues that parties to M&A transactions should consider in both the public and private M&A context.

Pricing considerations and purchase price adjustments

At the outset, purchasers will need to reflect upon target valuations, as many industries are experiencing significant uncertainty with respect to short-term and long-term revenue and earnings expectations. To address this, purchasers may want to consider structuring purchase price payments to include performance-based purchase price mechanisms, such as earn-outs, in order to reflect more accurately the state of the target company post-closing. It would be prudent for vendors considering these mechanisms to ensure that the purchase and sale agreement contains post-closing covenants addressing, among other things, the operation of the target business by the purchaser and vendor audit rights.

Additionally, both vendors and purchasers will need to consider whether or not customary purchase price adjustments still work. The impacts of COVID-19 on a target's working capital, for instance, will mean that typical working capital adjustments may no longer suffice. Purchasers will also need to assess if fixed pricing arrangements such as locked box mechanisms are too risky given the current environment.

Acquisition financing

Purchasers relying on financing to fund an acquisition will need to ensure they have consistent and open dialogue with their lenders regarding the impacts of COVID-19 on their ability to secure funds. As COVID-19 continues to disrupt the cash flows and solvency of various businesses, financial covenants in lending arrangements are likely to become more onerous and/or purchasers in certain industries may find it difficult to obtain deal financing. On the other hand, vendors will want to scrutinize the financial health of potential purchasers and consider whether additional protections are needed, such as parental guarantees, to ensure the purchaser is able to fulfill its payment obligations under the purchase and sale agreement.

Due diligence and representations and warranties

Due to social distancing and the closure of businesses throughout the world, due diligence in the COVID-19 environment presents numerous challenges for parties to M&A transactions. Site inspections and employee meetings may now be impossible, populating data rooms could be challenging if employees cannot access office files, target forecasts and projections may no longer apply and timelines to complete due diligence may need to be extended. To address some of these challenges, purchasers in particular will want to undertake COVID-specific due diligences processes. This will include ensuring that due diligence extends to business continuity and operations, insurance, supply chain risk, solvency risks, employee claims regarding COVID-19 accommodations, and risks pertaining to material contracts and the ability of counterparties to terminate or suspend their obligations due to the existence of *force majeure* clauses or similar termination provisions.

COVID-19-specific or COVID-19-modified representations and warranties may also be needed in the purchase and sale agreement to address issues discovered during the due diligence process and changes in the target's financial position and operations. The form these will take will be industry specific, however, some areas of concern likely include layoffs or terminations of employees, insurance, customers and suppliers, the ability to collect accounts payables, loss of customers and the ability of parties to perform material contracts. Parties will also need to consider the extent to which the vendor or target company will be able to satisfy bring-down representations and warranties at closing time and how potential carve-outs of those bring-downs might look, including revised benchmarks for ordinary course operations (as discussed further below).

Parties contemplating representation and warranty insurance should pay close attention to whether or not COVID-19 pandemic related losses are excluded from coverage. Purchasers can also expect that insurers will require heightened due diligence focused on the effects of COVID-19 on the target, and will scrutinize the purchase and sale agreement for representations and warranties that may be affected by the pandemic. Insurers will also ask specific questions during bring-down underwriting calls about the impacts that COVID-19 has had on the target during the interim period.

Material Adverse Effect and Material Adverse Change provisions

Material Adverse Effect (MAE) and Material Adverse Change (MAC) provisions have generally been quite difficult to rely upon as a reason to terminate an M&A transaction,

as the courts have leaned towards upholding transactions. These provisions are intended to address unforeseen events that have a material and adverse impact on a target company's value and often did not reference pandemics or epidemics as a carve out pre-COVID-19. Although a purchaser may be able to rely on a MAE/MAC provision that was drafted pre-COVID-19 (and does not reference pandemics or epidemics) to terminate, to do so will generally require the purchaser to show that the language that commonly excludes broader economic conditions from being an MAE/MAC does not extend to the impact of COVID-19. This analysis is fact specific and depends on the nature of the target company's business, the specific language in the MAE/MAC clause and how the target company was impacted in comparison to others in the target's industry. In these cases, much debate will undoubtedly centre on what constitutes a comparable peer group for the target, whether the effects are significant in both duration and impact and whether or not there was any knowledge of the potential impact at the time the purchase and sale agreement was signed.

Recent examples include, in Canada, CanCap Group Inc.'s purported termination of its purchase of Rifco Inc. (before the Alberta Court of Queen's Bench) and, in the U.S., the high profile attempt by Sycamore Partners to exercise its right to terminate its purchase of Victoria's Secret from L Brands (before the Delaware Court of Chancery). Each involve an attempt by the purchaser to rely on the MAE provision contained in the purchase and sale agreement arising from the impact of COVID-19 on the target's business. Given the general lack of caselaw on this subject, both cases will undoubtedly be followed closely by those in both the business and legal communities.

Going forward, vendors and purchasers negotiating a purchase and sale agreement will want to consider adding language to their MAE/MAC provisions to directly address how COVID-19 risk will be treated. For example, parties will want to consider if the impacts of COVID-19 should be specifically excluded or whether a benchmark for losses sustained by the target business will be set that, if surpassed, would allow a party to rely on such MAE/MAC to terminate.

Regulatory issues

Because of COVID-19, purchasers and vendors should prepare for longer transaction timelines and expect delays in the processing of regulatory approvals between signing and closing. M&A transactions in Canada often require approvals such as *Competition Act* review, *Investment Canada Act* review and stock exchange approvals. Due to COVID-19, however, various agencies have indicated that review timelines may be slower.

Some regulators have also stated that certain M&A transactions may face elevated review. For example, the Government of Canada recently announced that certain foreign investments into Canada will be subject to enhanced scrutiny in an attempt to prevent opportunistic investment behaviour that may flow from depressed valuations caused by COVID-19. The focus of this enhanced scrutiny is expected to be: (i) Canadian businesses related to public health or implicated in the supply of critical goods; and (ii) acquisitions by investors that are owned, subject to influence by, or even closely tied to foreign states. Pre-COVID-19, parties generally assumed that the national security review process under the *Investment Canada Act* (although it varied), could take at least 200 days to be completed. Although at this time deadlines applicable to the commencement of the national security review process have not changed, if

significantly more reviews are to be conducted due to enhanced scrutiny of certain types of transactions, the review process may take longer going forward.

For a more detailed analysis of the recently announced *Investment Canada Act* measures, see the BLG publication "Government announces "enhanced scrutiny" of foreign investments as a result of COVID-19".

Interim operating considerations

During the interim period between signing and closing, customary interim operating covenants typically require that the vendor operate the target company in the "ordinary course" in accordance with past practices and refrain from proceeding with certain actions without the purchaser's consent. In the current COVID-19 environment, however, vendors may find it challenging to comply with these obligations. Purchasers and vendors will need to work together to negotiate appropriate interim period covenants that allow the target company sufficient flexibility to respond to the unique and fluid conditions currently facing businesses, while at the same time adequately protecting the value of the business for the benefit of the purchaser. Purchasers should consider additional protections to address COVID-19-related risk including, among other things, covenants relating to liquidity, working capital and potentially elevated interim period reporting. Vendors will want to ensure that such covenants are not so strict that they all but guarantee the vendor will be in breach of them.

Termination rights, outside dates and closing delays

It can be expected that closing conditions such as routine third party consents, shareholder approvals, regulatory approvals and bank financing may take longer and may be harder to obtain in a COVID-19 environment. Accordingly, termination rights and break fees will require added attention from both vendors and purchasers. The parties will need to consider how to allocate the risk of these potential delays and how the risk of failure to meet certain closing conditions is allocated between the parties and for what length of time. Certainly, the "outside date" provision will take on added importance as a result.

Deal execution and closing procedures are also likely to experience delay due to social distancing requirements, among other things. To address this, parties will want to begin planning well in advance of closing, particularly if original signatures are required, and, to the extent possible, will want to consider electronic closings and the exchange of electronic signature pages.

Conclusion

The effects of COVID-19 on the economy and on M&A transactions are rapidly evolving. BLG's M&A lawyers regularly counsel purchasers and vendors involved in high profile M&A transactions and are available to assist with any questions you may have regarding the effects of COVID-19 on your M&A transaction.

For more information about COVID-19 and its impact on your business, please visit BLG's COVID-19 Resource Centre.

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