GETTING M&A DEALS DONE IN THE COVID-19 ERA

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The novel coronavirus (COVID-19) pandemic has resulted in many unforeseen challenges for Canadian businesses as they struggle to adapt to the impact of COVID-19 on their operations. It is unsurprising then that we have seen a significant disruption in merger and acquisition (M&A) markets, as deals have been put on hold or abandoned as a result of this uncertainty, and many fewer new deals have been proposed. Valuations are uncertain and financing may be difficult to obtain.

For buyers and sellers intent on completing their pre-pandemic announced deals or looking for new opportunities in these uncertain times, the reality of COVID-19 has introduced new considerations for getting the deal done. We anticipate that these (and other) COVID-19-related considerations will continue to have a significant impact for the foreseeable future. The principal considerations are discussed below.

1. **Due Diligence: It takes longer and new (and evolving) issues take priority**

COVID-19 has impacted deal due diligence in many ways.

First, parties should anticipate that due diligence will take longer than what was "normal" prior to the Spring of 2020. Whereas the availability of online data rooms and electronic files means that there has been little immediate impact on legal due diligence, business diligence that typically is undertaken may be substantially delayed or interrupted because of governmental measures such as forced business closures, restrictions on in-person interactions, international or provincial travel restrictions, or other constraints on a target's operations. This could have a significant impact if site visits or specialized inspections are required as part of the diligence process.

For example, environmental assessments that may require experts to travel and conduct on-site testing may take longer than normal as a result of COVID-19-related restrictions. The process and timeline may be further complicated if the people or services involved are located in different jurisdictions subject to different public health restrictions. To that end, parties may want to specify necessary diligence requirements and timelines in their letter of intent or similar document early on in the process. Parties must also consider whether the conventional terms for exclusivity periods and non-disclosure agreements are still appropriate or if they should be adjusted when diligence will likely take longer, resulting in deals moving slower.

In addition to due diligence taking longer to complete, certain aspects of a business are more important to examine in light of COVID-19. While suppliers, customers and employee matters have always been key areas of diligence, these may require deeper examination in the COVID-19 era. For example, assessing the continuing viability not just of the contractual relationships with critical suppliers and customers, but also of the suppliers and customers themselves may be necessary. Similarly, some buyers may wish to examine more closely a target's workplace practices and policies to ensure they do not violate public health requirements in such a way that could trigger enforcement actions or create concerns with employees about the safety of working conditions.

Information Technology may be another area of increased focus, especially where targets work in or provide services to customers in regulated industries with unique data security requirements. In such circumstances, diligence may be needed to determine whether a target's current IT infrastructure and work-from-home arrangements have or will jeopardize the target's cybersecurity obligations or otherwise create issues with the target complying with the terms of its commercial agreements with third parties.

Now more than ever it is critical to ensure that buyers also closely diligence the effectiveness of a target's business continuity planning and its response to the COVID-19 pandemic. This should include an examination of a target's existing response to the pandemic and any forward-looking plans. How the target has weathered the current crisis may showcase strengths and weaknesses in continuity planning and of management. For example, diligence in this area may reveal a target's potential liability related to mass lay-offs that were initiated as an emergency measure in response to the pandemic or its ability (or inability) to quickly and effectively respond to a second wave of COVID-19 infections.

Buyers looking to utilize representation and warranty insurance ("**RWI**") must also be mindful of whether their insurers have specific diligence expectations in the COVID-19 era. For sign-then-close deals that are already in the interim period, RWI providers will likely expect to see continued diligence by buyers regarding the impact of COVID-19 on a target's operations and ask more detailed questions on bring-down calls prior to closing.

RWI providers are still adjusting to the risks posed by COVID-19. To-date, RWI providers generally have proposed broad COVID-19 exclusions for RWI policies. As a result, we have not seen quoted prices for these policies jump, but exclusions of this kind only increase the importance of buyers' due diligence to identify, assess, and price in risks. We expect insurers will be increasingly willing to review COVID-19 coverage for deals on a case-by-case basis taking into consideration the facts and circumstances of each target and the particular deal.

2. **There is more uncertainty in evaluating the target, which complicates purchase price negotiations**

The uncertainty created by COVID-19 has created unique challenges for determining target company

valuations. Historic EBITDA, which often is used to value private companies, and post-closing purchase price adjustments based on closing date net working capital might not be appropriate tools to value a target in the current environment because buyers and sellers may have difficulty determining whether historical financial performance is a good measure of current and future value of the target.

To manage such inter-party risks, we have seen buyers and sellers in recent transactions increasingly rely on earn-outs or deferred-consideration mechanisms. These do not necessarily need to be tied to traditional targets such as revenue or even profits. For example, an earn-out could be tied to the target returning to some normalized working capital levels within a specified period of time. Indemnities are another mechanism that can be used to address pricing uncertainties regarding a business' ability to return to or continue normal operations. For example, a specific indemnity tied to the potential loss of a major customer or supplier due to COVID-19 can be put in place. For greater security, this could even be backed by funds placed in escrow.

Alternatives to cash payments may also be appropriate and can be a tool to achieve consensus to get the deal done. The use of the buyer's shares as consideration may also allow parties to reach an agreement on price, especially if the buyer and target are companies of similar size and/or operating in similar industries. However, we note that this option could give rise to potential securities law considerations and liquidity issues for the sellers post-closing.

3. **Deal terms: They're evolving to respond to and mitigate COVID-19-related risks**

(a) Representations and Warranties

In light of the government measures taken to limit the spread of COVID-19, many Canadian businesses were (and have been) forced to close or significantly reduce their businesses activities for many months. While provinces continue to move through their individual reopening plans, business must continue to be mindful of the force majeure provisions in their commercial agreements. If counterparties have not already trigged these terms, the continuing nature of the pandemic and the potential for rapid regulatory changes means that circumstances could arise that might permit an important customer or supplier to trigger a termination right in their contract with the target. The potential for the collapse of supplier and customer relationships can pose significant risks to parties at any stage of an M&A transaction. Sellers should consult with counsel to determine the potential impact of COVID-19-related force majeure events on any representations and warranties (or breaches of the same) in purchase agreements related to customers and suppliers.

Buyers' traditional reliance on representations and warranties as a backstop to their due diligence means they too must pay special attention to these terms. COVID-19-related changes during an interim period could substantively change the facts underlying buyers' diligence and may significantly impact their risk assessment of a target. Buyers should discuss with counsel the potential impacts of different changes and their rights and

remedies under a seller's representations and warranties in the purchase agreement.

Focusing on suppliers, customers, and specific supply chain issues (e.g., disruptions in inventory) should be top of mind for buyers and sellers. Sellers may seek to limit broad representations regarding the status of their customers and suppliers and narrow their disclosure to customers or suppliers that have provided notice of termination due to an inability to perform. Buyers, on the other hand, may seek to expand representations related to customers and suppliers, including disclosure of customers or suppliers who have provided notice of force majeure events related to COVID-19.

Consideration should also be given to the impact of COVID-19 on other typical representations and warranties, such as: labour and employment matters (e.g., layoffs and potential COVID-19-related health and safety claims); compliance with laws in a rapidly changing regulatory environment; and specific financial impacts of COVID-19 on accounts receivables and a target's bad debt expenses.

(b) **Covenants**

"Typical" interim period covenants require targets to operate the business between signing and closing in a manner that is consistent in nature, scope and magnitude with the past practices of the company – or a company that is in the same line of business as the target – but many things about operating in the COVID-19 era are not business as usual.

During an interim period, buyers and sellers should be having frank and ongoing discussions regarding mitigating measures or other steps to maintain business operations as close to normal as possible. And, for deals signed while the pandemic is occurring, the impact of the pandemic must be taken into account because it will affect the baseline "ordinary course" of operations as of the date the M&A agreement is signed. Whereas buyers want to ensure that what they acquire on closing is what they bargained for, sellers have and will continue to face unique challenges under these circumstances as government orders and the pandemic itself may force them to take bold actions to rescue their businesses, such as unusually high draws on operating lines of credit or continuing long-term layoffs.

Going forward, sellers will need to consider what flexibility they will require during an interim period to continue operating their business in the changing face of the pandemic. For example, sellers may require the flexibility to accept emergency government funding or access extended credit on operating lines of credit, waive notice periods or even grant other relief to major customers or suppliers in the face of force majeure events without having to obtain the buyer's approval. Buyers and sellers should also consider whether the purchase agreement should include a mechanism that would allow the buyer and seller to jointly develop an action plan to tackle the challenges posed by COVID-19.

(a) **Material Adverse Change Provisions**

In this new and uncertain reality, buyers and sellers must pay even more attention to the "Material Adverse Change" ("**MAC**") – also known as "Material Adverse Effect" – provisions in their purchase agreements, or any MAC-related definitions. These may be critical sources of relief from performance obligations under purchase agreements if regulatory or commercial factors drastically change. These provisions are intended to address changes that affect an entire industry or the economy as a whole, not just a specific business, so they will be one of the first places a buyer or seller will look if they are running into trouble.

That being said, Canadian jurisprudence related to MAC clauses is not well established so it is difficult to speculate on the availability of these provisions as a contractual remedy in the current crisis, unless the provisions clearly contemplate that the pandemic, or a worsening of the pandemic, could be a basis for termination or another remedy under the agreement. Parties should not be overly reliant on these terms for protection under these circumstances. Any analysis on the potential applicability of MAC provisions will turn on the specific wording of the provision, together with the factual circumstances in which the buyer and seller find themselves.

We expect that MAC carve-outs for epidemics and pandemics will become increasingly common subjects of negotiations until market standards begin to emerge.

(b) **Closing Conditions**

Besides MAC provisions, parties should also consider the impact of COVID-19 on other closing conditions and whether COVID-19 specific closing conditions are appropriate for their transactions. For example, a buyer might want the ability to terminate the M&A agreement if a significant customer is lost as a result of COVID-19 or another similar public health emergency. Any such COVID-19 closing conditions would obviously be specific to the target's industry and operations, to the parties' business priorities or other considerations and in doing so could function similarly to MAC provisions. However, spending the time to draft new, COVID-19 specific conditions may be desirable if it can provide more certainty for the parties than relying on pre-pandemic standard or even just traditionally structured closing conditions.

(c) **Regulatory Approval and Third-Party Consents**

In response to the COVID-19 pandemic, the Canadian government has significantly increased its scrutiny of foreign investments using its national security review powers. An April 2020 Policy Statement indicated that investments in the health care sector and investments involving critical supply chains would be examined carefully (as detailed in our earlier bulletin). To ensure the availability of adequate time and resources for the review of potential national security issues, the Canadian government has now also temporarily extended three

significant time limits under the *Investment Canada Act's* national security provisions. The extended time limits are discussed more fully in another bulletin that we published on August 12, 2020.

In addition, many businesses and government offices have continued operations on skeleton staffs or by working from home, forcing government agencies and private entities to focus on critical functions due to workforce shortages. Such arrangements can slow down deals where regulatory approvals and third-party consents are required.

Parties should anticipate that transactions may require longer interim periods than normal to close. While we are seeing an increasing amount of activity across the provinces, the patchwork of rules across jurisdictions (and even within them) as well as the potential for renewed restrictions mean that parties should continue to keep this in mind as they plan their timeline for deal completion. Buyers and sellers need to be more flexible with respect to drop-dead dates for transactions than they were pre-COVID-19. For example, tolling language could be included in purchase agreements to allow for extended closing timelines where all closing conditions are satisfied, save for regulatory approval or material consents.

(d) **Limitation Periods**

In response to the COVID-19 outbreak, courts across Canada either closed or significantly curtailed their activities. At the same time, many provinces, such as British Columbia and Ontario, released emergency orders suspending statutory limitation periods and deadlines (with a few exceptions) for varying periods of time.

These orders have sweeping implications for parties' access to judicial remedies (including additional delays to proceedings as courts begin to re-open), but they do not affect contractual agreements between parties. This means that if a purchase agreement specifies an indemnification procedure and time requirements for making indemnity claims, then the parties to the agreement likely have to stick to its terms when asserting their claims. However, there may be factual scenarios that impact such matters and parties should seek qualified legal advice with respect to the enforcement of any rights and remedies under a purchase agreement in light of these circumstances.

Our team of experts is closely monitoring the evolving COVID-19 situation. To learn more about COVID-19 and how it may impact your business, please visit our *COVID-19 Resource Centre* or contact any member of our Business Law Group.

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A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against

making any decisions based on this material alone. Rather, specific legal advice should be obtained.