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COVID-19 and private mergers & acquisition

March 26, 2020

COVID-19, classified by the World Health Organization as a pandemic, has disrupted the lives of billions of people and wreaked havoc on the world economy. It has also introduced significant uncertainty into the private M&A market. While some deals are being delayed or canceled, others have been placed on the agenda. These include businesses that adapt well to the changing consumer demands during the outbreak, as well as ones that have become stressed or distressed because of it. Given the rapidly changing business and regulatory environment, common agreement terms must be considered in light of the COVID-19 response. In this article, we highlight a few COVID-19-related legal trends that are emerging in negotiating private M&A deals.

Pricing mechanisms and deferred payments

Pricing mechanisms were already heavily negotiated and dispute-prone before COVID-19. Now they are under even more scrutiny. The sellers in a strong bargaining position may prefer a locked boxed pricing mechanism, which fixes the final purchase price based on the financial statements of the target business on a set date before the signing of the purchase agreement. The locked boxed mechanism potentially allows the economic risk of the business to be transferred to the buyers even before the closing date, and even before the COVID-19 outbreak, if desired.

The buyers, on the other hand, will gravitate towards a more traditional post-closing purchase price adjustment mechanism, where the purchase price is trued up to the state of the target business as of closing. In other words, the sellers will bear the economic risk of the target business between signing and closing. However, the COVID-19 crisis may result in abnormal inventory levels and unusual numbers for accounts receivable and payable, which can lead to the uncertainty and potential for disagreements in the adjustment calculations.

In terms of valuation, the sellers may predictably take the position that the fundamentals of the target business are unaffected by the COVID-19 crisis. The buyers could in turn suggest deferring the payment of a portion of the purchase price with earn-outs. Because the earn-outs are contingent on the target business's performance post-closing, the parties share the economic risk of the business during the earn-out period. Setting the earn-out targets, however, may involve business people taking on the role of an epidemiologist, making predictions on how long the outbreak will actually last.

Timing of transaction and buyer's financing

From a timing standpoint, the buyers and the sellers should take into account that because of COVID-19, third party consents and governmental approvals may take longer to obtain. If the purchase agreement sets an "outside date" when the closing conditions must be met or the deal may be terminated, the parties should expect a slower timetable and agree to a longer interim period than they otherwise would.

It may also take longer and become harder for the buyers to obtain third-party financing to fund the purchase price. In anticipation, the buyers may want to have a "financing out" condition, allowing it to walk away from the deal with no penalty if financing fails. The seller, on the other hand, should consider negotiating a reserve break fee. It is also advisable to examine more closely the financial wherewithal of the buyer and, if appropriate, request an escrow for deferred purchase price payments and a guarantee from the buyer's parent.

Due diligence and representations and warranties

For the transactions that are at the due diligence stage, COVID-19-related concerns will be front and center. Has the COVID-19 crisis caused or likely to cause any material breach in the commercial agreements? Are there force majeure clauses that excuse non-performance? Do the agreements cap liabilities? The buyers will also want to look more closely at the target's supply chain, insurance coverage, counterparty risks, IT systems, business continuity plans, and remote working arrangements. The sellers should appreciate the buyers' sensitivity and proactively gather information on COVID-19's impact the target business and the measures taken to counteract.

We may also see COVID-19 specific representations and warranties in the purchase agreements, as well as more extensive pre-closing disclosure updates from the sellers. The sellers will want to seek coverage under appropriate knowledge and materiality qualifiers, resist forward-looking representations and warranties, and carve out breaches or inaccuracies known to the buyers before closing from its indemnity obligations. The buyers, on the other hand, have an added incentive to push for a holdback of purchase price to secure payment of indemnity claims, as well as purchase price adjustments.

Material adverse effect between sign and close

The regulatory environment and the market conditions are fast evolving during the COVID-19 crisis. Parties that enter into a purchase agreement may find that the target's business varies drastically from the signing date to the closing date, which interim period can sometime last months. A common closing condition in a purchase agreement is that there is no "material adverse change" or "material adverse effect" (MAE) on the target business. This condition may allow remorseful buyers to walk away without penalty in situations like we are seeing today with impact that COVID-19 is having on businesses.

The definition of MAE is generally set out in the purchase agreement. Whether the negative effects the COVID-19 response may have on the target business will allow the buyer to walk away depends on the language used to define the term, the law governing the purchase agreement, and the specific effect the outbreak has had on the target business.

There is limited case law in Canada regarding what constitutes an MAE, and as a result, the parties should endeavor to draft the MAE definition as clearly as possible. The MAE definition typically refers generally to any effect or change that may be "materially adverse" to the target business, and then provides a list of exclusions. Such exclusions may include effects that are the result of “epidemic”, “pandemic”, and “disease outbreaks”, or more generally, “general economic conditions”, “conditions generally affecting the industry”, and “any changes in applicable laws”. These exclusions allow the sellers to make a case that wide-spread events that adversely impact the target business, and that the target business may have no control over, would not constitute an MAE and thus, would not permit a buyer to walk away from closing. In response, buyers, typically insist on limiting the exclusions to situations where the target business is not disproportionately affected by the particular event, compared to others businesses “in the same industry”.

What we have seen in this COVID-19 crisis is that epidemics may have significantly different impacts on businesses in different jurisdictions. Buyers limiting the exclusions should consider what “peer group” should be used for comparing to the impact on the target business and will want to ensure that the target business is only compared to the appropriate peers, including considering the geographical location of those peers.

Ordinary course of business during interim period

The purchase price of a business is generally agreed upon based, in part, on a buyer’s analysis of the target business’s financial statements and historical performance. This analysis is conducted and the purchase price agreed upon at the time of signing the purchase agreement, prior to the closing date when the target actually changes hands. To preserve the value of the target business in the meantime, purchase agreements include covenants that require the seller to operate the target business in the ordinary course during the interim period between signing and closing.

These interim covenants may require the target not to pledge any of its assets outside of the ordinary course, not to terminate or change the compensation of any employees, and not to make any capital expenditure over a certain monetary threshold without the buyers’ consent. However, in response to the COVID-19 outbreak and governmental recommendations, we are seeing companies taking significant actions which could generally be agreed to be outside of the ordinary course – but which may be in the best interests of the company. For example, we are seeing companies lay off employees, refinance debt obligations, and negotiate amendments to material contracts in order to cope with the ramifications of the outbreak.

Drafting interim covenants during the COVID-19 outbreak, parties must consider how to balance the sellers’ fiduciary obligations to the target business to respond swiftly to the current volatile environment and the buyers’ interest in ensuring the responses do not result in any erosion of the target’s value. The sellers may not be able to seek the buyers’ consent at every turn and competition laws may prevent the parties from coordinating or working together on planned responses if they are in similar industries. More flexible operating covenants during the interim period may be necessary to allow for the prudent COVID-19 measures.

These are some of our general observations in negotiating private M&A transactions during the COVID-19 crisis. As the business and regulatory environment surrounding COVID-19 continue to develop, additional concerns or issues may arise. As every deal making situation is fact-specific, this articles is intended as a starting point. For a further discussion, we encourage you to reach out to a member of our team.

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