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Troubling Signs From Recent M&A Case Law: Forgetful Gatekeepers, Targeted Executives, and Poor Record Building

Please note: The following article is one of several featured in this issue.

A Canadian Perspective: The 2021 US and Canadian M&A Landscape

By Nancy Hamzo, Partner, and Dorna Zaboli, Student at Law, Baker & McKenzie LLP [1]

Q: As we're approaching the end of the first quarter of 2021, what have been the most prominent trends in the Canadian M&A market thus far?

The rebound in M&A activity in the third quarter of 2020 has continued into the first quarter of 2021. Deal flow is a priority for many companies, especially those that performed well and benefited financially from Covid-19. Foreign investor interest in Canadian companies is strong and deal activity has increased across a variety of sectors including energy and Covid-resistant sectors like technology and life sciences.

We are seeing companies focus on scaling their operations and strengthening their balance sheets through consolidations and add-on acquisitions. In Canada, consolidation is happening in several industries, notably, oil & gas, cannabis and technology.

Carve-out transactions have started to increase, driven by both larger organizations looking to focus on their core-businesses and the need to increase liquidity and private equity firms that are carving out units of portfolio entities.

Q: What opportunities and challenges exist for US inbound transactions from Canada?

While Canadian buyers continue to seek acquisition opportunities in the US, the pandemic and related travel restrictions between Canada and the US, has resulted in a significant decrease in outbound transactions from Canada. However, with the rollout of vaccines, there is generally more optimism and confidence, which will lead to increased deal activity from Canada into the US throughout 2021.

The Bank of Canada's low interest rates, which are expected to remain low in 2021, will have a positive impact on Canadian buyers' appetite to

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This interview was conducted by Dorna Zaboli, a student-at-law at Baker & McKenzie LLP in Toronto, Canada. Ms. Zaboli earned her Juris Doctor and Bachelor of Civil Law from McGill University in Montreal, Canada.

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Canadian private equity firms and pension funds have been patiently awaiting opportunities to buy great companies and assets. With government subsidies ending and liquidity becoming a problem for distressed companies, there is likely to be a lot of outbound distressed M&A activity later in 2021 with the US being the largest outbound destination.

Q: What are some of the challenges dealmakers face in the current Canadian and US M&A landscape?

There are a few interesting challenges that dealmakers are facing in the current environment:

- Pricing a transaction has become even more difficult because of Covid-19. Valuations are soaring in almost every industry that has proven resilient to the pandemic or benefitted from the pandemic. Dealmakers have to rethink consideration structures to balance the risk; however, this is not easy given the competition by other potential buyers for high value assets. It is crucial to the future success of the deal to ensure that buyers know what they plan to do with the target business and execute on their overall strategy.
- There is a great deal of liquidity in the market resulting from significant dry powder held by private equity firms, low interest rates, access to financing and IPO activity. This is creating fierce competition for high value target companies, especially those in the technology industry. As a result, we are seeing buyers expedite the due diligence review period, accept deal terms that would not historically be acceptable and generally take on more risk to get the deal done. It is important that notwithstanding the current competitive environment dealmakers focus on their core deal values and deal discipline.
- Globally, foreign direct investment laws and regulations have become a key consideration for dealmakers because of the impact on deal certainty and timing. In both Canada and the US, foreign investors now face increased scrutiny on transactions involving sensitive sectors, such as critical technology, life sciences, transportation and defense. There is a particular focus on buyers who are themselves state owned enterprises or influenced by state-owned enterprises. As a result, foreign state-owned enterprises from China and other countries seeking acquisitions in Canada and the US should anticipate difficult reviews.

Q: What are some lasting practical effects that Covid-19 has had on the drafting and structure of M&A agreements?

- Dealmakers learned lessons related to the negotiation and drafting of certain provisions in M&A agreements because of the pressure the pandemic had on the interpretation of certain contractual provisions.
- Material adverse effect (MAE) definitions are important and dealmakers are now including and accepting specific "epidemic, pandemic or other similar outbreak or health crisis" exclusions in their purchase agreements. One point that is still subject to negotiation is whether to apply the disproportionate impact exceptions to those pandemic exclusions.
- Buyers are considering alternative payment arrangements such as earn-outs and working capital adjustments to address valuation issues. There has been an increase in earn-out provisions in M&A deals and in Canada, we are seeing earn-out periods in excess of five (5) years in certain industries.
- Additional representations and warranties that are specific to the impact of the pandemic on the target's business have started to be included. These representations are intended to address, for example, the adequacy of emergency protocols and IT systems, supply chain risks and delays, customer and supplier termination of agreements, employee related matters and compliance with Covid-19 related loans.
- Buyers and sellers are paying closer attention to interim covenants. The typical commitment for a target company to conduct its business in the "ordinary course" now has parties really thinking through what this means when a company is faced with unprecedented challenges.

Buyers will want to include narrower exceptions and limitations (subject to gun jumping laws), while sellers may prefer to negotiate an efforts standard in operating the business in the ordinary course.

- Because of increased foreign investment scrutiny and a more rigorous regulatory approvals process affecting M&A deals, parties are now working together to include more realistic and longer outside dates or automatic extensions in their agreements.

Q: With the end of the pandemic in sight, what should dealmakers be looking out for with regards to M&A trends for the rest of 2021?

- The pandemic has put focus on our health, economic and social systems on both the national and global levels. Companies, more than ever, will be focusing on building business resilience and in doing that will consider long-term plans while putting sustainability, environmental, social and governance (ESG) programs at the forefront of their priorities. Therefore, ESG will be an increasing issue on transactions and will become a key part of the due diligence review process.
- Distressed M&A will increase, particularly as government subsidies begin to trail off and banks tighten up their lending practices. There will be a lot of opportunities and private equity firms and strategic investors have been waiting patiently to pick up new assets and businesses.
- There will continue to be an acceleration in technology M&A in 2021 driven by many factors including the need for businesses across all sectors to adopt digital technology.
- Carve-out transactions will increase as 2021 continues with companies seeking to focus on their core high value businesses and increase liquidity.
- We will continue to see new laws and greater regulatory scrutiny related to foreign investments; therefore, dealmakers need to prepare for regulatory hurdles and plan accordingly.

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