M&A Building Blocks

Negotiating Representations, Warranties & Material Adverse Change / Effect Clauses

The topics of discussion for this building block are foundational to corporate commercial transactions. Our intention is not to focus on all of the various potential provisions which could be included in a particular M&A transaction agreement but rather, at a high level, discuss certain key elements to these agreements and considerations which should be in mind throughout the drafting and negotiating process.

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Key Issues/Process Points

1 Representations and Warranties

Representations and warranties are statements made by a party to a contract to induce another party to enter into such contract. Representations and warranties disclose material information about the parties to the contract and the business or assets being sold and are intended to supplement a contracting party's due diligence. In certain cases, breaches of representations and warranties may be grounds for indemnification claims or may permit parties to unilaterally terminate contracts.

The nature of the appropriate representations and warranties to include in a purchase agreement varies based on the nature of the transaction, the relationship between the parties and the parties' appetites for risk. Buyers tend to require broader representations from sellers in share sales because buyers become indirectly responsible for all liabilities of the acquired company, whereas representations given by sellers in asset sales are often narrower and focussed on the specific assets and liabilities being acquired.

More extensive representations and warranties regarding the business or assets being sold shift transaction risk to sellers and leaner representations and warranties shift risk to buyers. Representations and warranties may be limited by materiality, knowledge of certain persons, a particular time period or disclosed exceptions. Such limitations alleviate some of the transaction risk from sellers and shift it to buyers. Contrarily, buyers may seek to shift transaction risk to sellers by seeking a "full disclosure" representation from the sellers representing that no representation, warranty or information given by the sellers contains an untrue fact or omits a fact.

Sandbagging is a critical issue to be considered by parties when negotiating representations and warranties. Sandbagging occurs when a buyer knows that a seller breached a representation, warranty or covenant, but nevertheless proceeds to close the transaction, and then seeks indemnification from the seller. Inclusion of sandbagging provisions is also an exercise of risk allocation between the parties. A buyer will want to include provisions that permit sandbagging in a purchase agreement, so as to encourage complete disclosure by the seller, enable the buyer to rely on the representations and warranties and discourage the seller from burying the buyer in disclosure. On the other hand, a seller will want to include provisions that prohibit sandbagging so as to encourage the buyer to raise concerns during the diligence process rather than after closing and thereby shift some of the transactional risk to the buyer.

In private transactions, parties typically recover losses suffered due to a misrepresentation or breach of warranty by making an indemnification claim against the party in breach. When drafting, it is therefore important to consider monetary limitations to indemnities, including maximum recoverable amounts and claim thresholds, and the period of time for which representations and warranties should survive. Representations and warranties are only enforceable for the period that they survive and to the extent of any monetary limitation. Indemnification provisions are not practical in public company transactions, since it is not feasible to require individual shareholders of public companies to satisfy claims.

Alternatives to indemnification provisions, mostly used in private transactions rather than public transactions, include (i) the buyer holding back a set portion of the purchase price until specific conditions are met; (ii) the buyer paying a portion of the purchase price to a third party escrow agent, who will hold such funds in trust until certain conditions are satisfied; and (iii) parties purchasing representations and warranties insurance policies. Indemnification, holdback, escrow and insurance provisions are favourable to buyers in that they give buyers certain rights of recourse against sellers (or the insurer) if there is a breach of warranty.

2 Material Adverse Change Clauses

Material Adverse Change (MAC) clauses are found in many commercial agreements. In an M&A context, transactions are often conditioned on the absence of material adverse changes. The objective of a MAC clause is to protect the buyer from adverse changes between signing and closing that make the target company substantially less attractive and thus materially change the bargain between the contracting parties. For the buyer, the inclusion of a MAC provides an ability to walk from the deal if the deal fundamentally changes. A seller who accepts the inclusion of a MAC in the agreement will want to limit the circumstances under which the buyer can terminate and will look to provide remedies in the event of a wrongful termination. The most common ways a MAC provision is used in an M&A agreement are as a condition to closing (i.e. the absence of a MAC), as a representation of the target that no MAC has occurred, and as a specific termination event.

As with the negotiation of representations and warranties, the negotiation of a MAC clause is an exercise in risk allocation. In an M&A context, a MAC definition that is broadly worded will provide the maximum protection to the buyer against unforeseen circumstances. To mitigate the risk of a broadly worded MAC being used to easily escape from a transaction, target companies typically seek to negotiate carve outs or exceptions to the application of a MAC to protect the target against events which are outside the target's control (such as macro-economic changes, changes in laws, acts of war or terrorism, etc.) and to protect the target against transaction specific events (such as an adverse market reaction to the transaction or specific matters disclosed to the buyer during due diligence). Inevitably, there is considerable discussion and negotiation between transacting parties as to the scope of a MAC clause. However, as will be discussed below, given how MAC clauses have been interpreted by courts, buyers should not rely on a MAC as an easy mechanism to escape from a transaction. Where a buyer has concerns it wishes to protect itself against, it is recommended that these be addressed in the agreement through specific representations or as conditions to closing. The inclusion of a MAC clause should never be viewed as a substitute for detailed representations and warranties or as a means for the buyer to conduct less than comprehensive due diligence of the target.

3 The Interpretation of MAC Clauses

While jurisprudence in Canada related to the interpretation of MAC clauses in the context of M&A transactions is limited, there are some useful guidelines. Courts have typically concluded that a subjective standard overrides an objective standard of interpretation of MAC clauses. As such, materiality is to be assessed by reference to the particular circumstances reasonably expected to influence the buyer's decision to complete an acquisition. The use of extrinsic evidence such as the level of sophistication of a buyer and its advisors and prior knowledge of or non-reliance upon a material adverse change by the buyer would preclude the application of a MAC clause to terminate a contract. Moreover, short term changes, regardless of materiality, will not suffice to trigger a MAC. Conversely, unless a MAC clause is limited to internal events, external events which are not within the control of the target can also be MACs.

IBP, Inc. v. Tyson Foods Inc. (2001, Delaware) is the leading U.S. case on MAC clauses. By requiring a very high standard of materiality, the case imposes an onerous burden for buyers to persuade a US court that a MAC has occurred. Of particular significance is that this case was in the context of a public M&A transaction and has had a persuasive influence in Canada and the UK. The standard of materiality adopted by the Delaware Court only considered "the longer term perspective of a reasonable acquirer". In particular, the MAC clause should only serve as a backstop to protect the buyer from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner which should be measured in years rather than months. Therefore, "short-term hiccups" in quarterly earnings would not suffice. Similar to certain Canadian case law, the Delaware Court indicated that buyer's remorse does not trigger a MAC.

In conclusion, while the interpretation of traditional MAC clauses generally favours sellers, the threat of litigation may prompt parties to renegotiate the purchase price or other deal terms.

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