M&A board considerations for acquirors

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This is part one of a series focusing on current M&A trends, opportunities and challenges.

Mergers and acquisitions always raise fundamental issues for boards of directors of companies doing the acquiring. In this era of COVID-19, there are additional issues and challenges for boards to address, as well as more uncertainty associated with the range of potential outcomes.

This article highlights a number of matters that boards of directors should consider when looking to undertake an acquisition. Future articles in this series will consider board matters from the perspective of potential target companies and companies in financial distress.

Framework

As always, boards must consider M&A opportunities in light of their fiduciary duty to act honestly and in good faith in the best interests of their company, and their duty of care to exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances. The pandemic does not change this, but it does add a number of new risks and other considerations for the board to consider in the course of its deliberations. A number of these are discussed below in more detail.

Strategic fit

Some business enterprises that were previously healthy and not potential M&A targets will inevitably become targets due to the effects of the pandemic. While a number of industries have adjusted well to reduced economic activity, or even seen their businesses thrive, others have been hit hard and some companies may be for sale at a much-reduced price. These sorts of acquisition opportunities can seem too good to pass up, but the board must consider whether this is indeed the case. Does the transaction fit with company strategy? Will it foreclose taking advantage of more strategic opportunities?

Target assessment and due diligence

One of the things that has changed since the initial COVD-19 lockdown is that the pandemic has gone from being an unexpected event with unexpected consequences, to being a fact of life that everyone has to deal with.

From an M&A perspective, much of the initial discussion among M&A practitioners was around whether the pandemic, and the government and other responses to it, triggered material adverse effect (MAE) or material adverse change (MAC) clauses in acquisition agreements. While those questions are still being answered as various agreements are litigated or otherwise resolved, there is now a different environment as COVID-19 and its effects are more apparent. Accordingly, in assessing M&A targets boards will need to consider, among other things:

- How vulnerable is the target to the pandemic as it continues? How well has it adapted?
- To what extent is the target, either directly or indirectly, dependent on government support programs for its continued financial health?
- Assuming the pandemic dissipates, as a result of a vaccine or otherwise, what are the prospects – for better or worse – for the target's business?

Having made an outside assessment of a potential target, the normal process is for the acquiror to test its analysis by conducting due diligence. The pandemic has made this more difficult in many respects. While virtual data rooms are the norm, there are often items that do not exist in electronic form and need scanning first before they can be uploaded to the data site. This requires people to be physically in offices in order to find and scan documents. With many offices still not fully open, this process can take longer and be less reliable than it was pre-pandemic.

Obviously, physical inspections of assets and face-to-face meetings with management of the target may not be as easily performed because of the difficulties associated with travel and physical distancing. Also not to be forgotten are that some of these same issues may apply in relation to third parties that are critical to the target business. For example, discussions with key customers or suppliers, and financing or joint venture parties may be more difficult to carry out, not to mention dealing with key shareholders with whom it may be desirable to enter into a lock-up agreement.

Representation and warranty insurance was being used increasingly in Canada prior to the pandemic, and this trend has continued. While insurance may be one way of reducing risk in the current environment, it is also true that the providers of insurance now address COVID-19 in their policies and underwriting process. If the insurer is not comfortable with the level of due diligence the acquiror has been able to conduct, it is unlikely to provide insurance to cover the risk.

Accordingly, depending on the situation and the nature of the target business, boards will need to consider whether they are willing to accept a higher degree of risk in relation to their assessment of the target.

Deal terms

As noted above, when the COVID-19 pandemic began, there was much discussion around whether MAE or MAC clauses were triggered. Related issues were whether a particular target had complied with its obligations to carry on business in the ordinary course from the time of signing the purchase agreement until closing, and to deliver a closing certificate that its representations and warranties given at signing were still true at closing. There have been a number of lawsuits in relation to this issue, the Cineplex/Cineworld dispute being the highest profile case in Canada, and the LVMH/Tiffany's case being one of the most recent in the U.S. If judicial decisions result from some of these cases, they will no doubt be of assistance in interpreting MAE and MAC clauses in future.

In the meantime, MAE and MAC clauses are now being tailored to address COVID-19 and related risks. Boards will need to consider what will fall within the meaning of material adverse effect or change, and what carve-outs to those definitions will apply. A seller is likely to argue that the effects of COVID-19 are now well-known and understood, such that any consequences flowing from the disease and responses to it are not material adverse changes, but reflect the current state of the world.

An acquiror may be willing to accept a certain amount of risk in this regard, but may argue that consequences that hit the target disproportionately hard, and out of line with other companies in the target's business, should still be considered materially adverse so as to trigger an MAE or MAC clause. Given that courts have been notoriously reluctant to allow buyers to walk away from deals on the basis of material adverse change clauses, acquirors may not be able to take much comfort from such nuanced provisions. Nevertheless, the negotiation around allocation of risk is important for a board to understand.

Similarly, boards need to understand provisions relating to the operation of the target business during the interim period between signing and closing. With many businesses not operating how they normally would, carrying on business "in the ordinary course" may have a different meaning. There may be implications for employee relations, customers, suppliers and leases, for example. While purchase agreements have generally allowed targets to carry on business in the ordinary course and required acquiror consent for actions outside the ordinary course, the range of permitted actions may be subject to more negotiation as targets will want the freedom to respond to pandemic-related issues, while acquirors will want to be involved in those responses. The path to a successful closing may depend on how the parties manage these interim period issues.

Finally, the pandemic has made timing of acquisitions more uncertain, and deal terms may need to be more flexible. For example, the Competition Bureau has indicated that there may be delays in its processing of merger reviews, as have other competition and anti-trust authorities around the world. Acquisitions that are to be effected by way of plan of arrangement require court approval and, while courts are adapting to the COVID-19 world, scheduling the necessary hearings (even if by way of video conference) may be delayed. The parties must be prepared to deal with this uncertainty.

Other issues

Pricing: Of course, if a low market price makes a target attractive to potential acquirors, it is likely to be just as unattractive to the target. Persuading a target to transact at a lower valuation may be a challenge, unless the target is financially distressed. Financial distress raises other issues, which we will discuss in a later instalment of this series.

Even if the target board can be persuaded that the proposed price should be accepted, shareholders may be difficult to convince if they are looking at taking a loss on the sale of their shares. Bids during the pandemic run the risk of being labelled “opportunistic”, which implies taking advantage of a temporary situation to buy at an artificially low price. The challenge, then, is to demonstrate that the offer price is the best shareholders can hope for in the foreseeable future. At the same time, as pandemic fatigue sets in, it would seem there is less risk for acquirors being perceived as unduly taking advantage of the current situation, but instead being seen as part of life getting back to normal.

Payment: A related issue to pricing is how that price will be paid. While a share exchange may be attractive to target shareholders who believe better times are ahead and that receiving shares as consideration will allow them to participate in a recovery, for targets in a distress situation, cash may be the only acceptable consideration. If cash is being paid, the acquiring board will need to consider the sources for that cash. If financing is required, the ability of the acquiror to obtain such financing, whether debt or equity, on terms and within a time frame that fits with its acquisition plans must be factored in.

Accumulation: Potential acquirors may wish to consider accumulating shares in a target if they believe the market price does not reflect underlying value. Even if they don’t pursue an acquisition, there may be value realized in a recovery of the target’s stock price. In Canada (assuming there is no existing takeover bid outstanding), it is possible to acquire voting or equity shares of a public company without making public disclosure until a holding of 10% is reached. There are a number of rules that apply should a decision to proceed with an acquisition be made, including pre-bid integration and insider trading rules – which are beyond the scope of this article – but would need to be considered by a board before proceeding with an accumulation strategy.

Conclusion

While acquiror directors’ duties and responsibilities in M&A have not fundamentally changed, the considerations that must be taken into account as a result of COVID-19 are evolving as the world lives with and adapts to the pandemic. It will be up to boards of directors to view M&A opportunities in that context and make decisions in accordance with their fiduciary duties and standards of care.

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