Private M&A Deal Points 2017: Canada vs. USA

The latest edition of the American Bar Association's Canadian Private Target M&A Deal Points Study (the Canadian Study) was released in late December 2016. It is based on deals signed in 2014 and 2015. As with prior editions, the Canadian Study provides valuable insight on the use of several deal points in Canadian private M&A transactions, the evolution of deal terms over prior editions of the Canadian Study and a comparison with those reported by the ABA's most recent US Private Target M&A Deal Points Study which analyzed transactions completed in the US in 2015 (the US Study). This article highlights some of the findings reported by the Canadian Study and, unless otherwise expressed, does not purport to reflect the personal views or experiences of the authors in negotiating the highlighted deal points or, in any case, of other M&A practitioners at Stikeman Elliott.

The Study Sample

The Canadian Study has a sample size that is comparable to the US Study (although he Canadian Study is over two years). A key difference between the two studies remains the percentage of transactions over $100M. Even with an increase in the proportion of Canadian transactions with values over C$100M, US deals are still typically larger than Canadian deals.

Another key difference between the Canadian Study and the US Study are the target industries. As with prior years, a large percentage of the deals in the Canadian Study are in the natural resources sector (17%), the oil and gas sector (16%) and the industrial goods and services sector (11%). In the US Study, the three largest sectors were technology (19.66%), healthcare (17.97%) and financial services (11.97%).

The Canadian Study sample was mostly obtained from acquisition agreements filed on SEDAR (the System for Electronic Documents and Analysis and Retrieval) maintained by Canadian securities regulatory authorities for reporting issuers, meaning a reporting issuer was involved in the structure of the target, the seller or the purchaser (although it was a "private" transaction) and that the transaction was material for that reporting issuer. For the first time, the editors of the Study also found Canadian law governed agreements on EDGAR (the SEC's "Electronic Data Gathering, Analysis and Retrieval" system). Of course, having a public company involved on at least one end of the transactions could skew results compared to transactions where no public issuer is involved.

Table 1	US Study	Prior Canadian Study*	Canadian Study
Number of Deals	117	60	101
Range of Transaction Values	US $17M to US$5B	C$5.6M to C$5.8B	C$5.78M to C$4B
Transactions Over $100M	65%	31%	37%

* The Prior Canadian Study reports on transactions signed in 2012 and 201

Indemnification

In a private M&A transactions, some of the highly (and hotly) negotiated issues are those dealing with post-closing indemnification. The Canadian and US Studies report on a number of indemnification deal points including the following.

1 | Sandbagging

A sandbagging clause deals with a party's ability to make a post-closing indemnity claim for a breach of a representation, warranty or covenant it knew about prior to closing. Purchasers will often try to include a "pro"-sandbagging clause as it allows them to make such post-closing claims. Sellers will try to include an anti-sandbagging clause which bars purchasers from making claims for matter it knew about prior to closing. The parties may also be silent on the matter, in which case, they are leaving it up to a court to determine whether such damages are recoverable under applicable law. According to the Canadian Study, pro-sandbagging clauses are on the rise (from 15% to 31%) and though silence on the issue still form the majority of deals in the Canadian Study, there is an almost corresponding decrease in the percentage of deals that are silent (from 71% to 54%). The use of anti-sandbagging clauses remained relatively steady (from 14% to 15%). The percentages are comparable to those reported in the US Study, where 35% of deals had a pro-sandbagging clause, 9% of deals had an anti-sandbagging clause and 56% of deals were silent. In other words, it appears that Canadian practice is converging with US practice on this issue.

2 | Survival

Purchase agreements typically specify the time period during which representations and warranties (and sometimes covenants) survive closing. As with the US Study and the Prior Canadian Study, the latest Canadian Study reports that most deals have a general survival period between 12 months and 24 months (83% of deals), with the sweet spot being exactly 18 months (32% of deals).[1] In many cases, a survival period around 18 months will allow buyer to uncover most problems: buyer will have had time to run the business and will be able to perform at least one post-closing audit. Note that most agreements will also carveout certain matters such as taxes from the general survival period.

3 | Indemnity Baskets

Indemnity baskets establish the minimum dollar amount of certain types of losses a party must suffer under the purchase agreement before the other party is obliged to indemnify it. Baskets can be (i) deductible: once a party's losses exceed the amount specified in the agreement, the other party has to indemnify only for losses exceeding the specified amount; or (ii) first dollar: once a party's losses exceed the specified amount, the other party has to indemnify for all losses starting from dollar one. A basket may also be a "combination" of a deductible and a first dollar. Both in the US and Canada, most deals have baskets. However, according to the US Study and the Canadian Study (including prior versions), Canadian and US practices diverge on some points including the size of the basket, with baskets being a little larger in Canada. The divergence on the size of the basket may be explained by the fact that Canadian deal values tend to be smaller than US deal sizes and in our experience, basket size as a percentage of transaction value tends to be greater the lower the purchase price.

Table 2	US Study	Prior Canadian Study	Canadian Study
No Basket	2%	8%	9%
Deductible Basket	65%	36%	41%
First Dollar Basket	26%	50%	45%
Combination Basket	7%	6%	5%
All Baskets (other than combination): Mean as % of T. V.	0.65%	0.87%	1.46% and, if outliers are excluded, 0.98%.
Deductible: Mean as % of T. V.	0.69%	0.73%	2.10 and, if outliers are excluded, 1.15%.
Dollar One: Mean as % of T. V.	0.81%	0.96%	0.81%
Basket as % of T. V.:			
Greater than 1%:	10%	28%	28%
1% to 0.5%:	38%	30%	39%
-0.5% or less:	52%	42%	33%

[1] In the US Study, 86% of agreements have a survival period of 12 to 24 months, with the sweet spot being exactly 18 months (36% of deals) and in the Prior Canadian Study, 81% of agreements had a survival period of 12 to 24 months, with the sweet spot being exactly 18 months (29% of deals).

The Canadian Study showed some anomalies in terms of baskets as a percentage of transaction value. The mean basket was reported as 1.46% when considering all baskets together other than combination baskets, whereas in the two prior studies the percentages reported were 0.87% and 0.51%. The mean deductible was reported at 2.10%, whereas in the two prior studies the percentages reported were 0.73% and 1.0%. The samples included a couple of unusually large deductibles: 5.7%, 10% and 20%. This in our view does not represent market practice. The highest reported basket as % of transaction value in the prior two editions of the Canadian Study was 3.5%. Arguably, a fourth deductible should have also been considered an outlier at 4.2%, but given its proximity to the highest reported basket in the prior studies, it was not referred to as such. If the three outliers are excluded from the calculation, the mean basket is 0.98% of transaction value for all baskets other than combination baskets and the mean deductible is 1.15% of transaction value. Even those numbers are high given the fact that the Canadian Study reports that 72% of transactions have basket that is 1% or less as a percentage of transaction value (with 39% at less than 1% but greater than 0.5% and 33% at less than 0.5%). Perhaps a better indicator is the median value since it looks at the midpoint result and has the advantage of not being affected by any single percentage that is high or low compared to the rest of the sample. The median deductible was reported as 0.80% for all baskets other than combination baskets and the median deductible was reported at 1%. Our experience suggests that a large percentage of baskets (whether deductible or dollar one) lie somewhere between 0.5% and 1% of transaction value.

Another type of basket is known as an eligible claim threshold or a minimum loss basket. An eligible claim threshold will provide that a party is not required to indemnify the other party for an individual claim where the loss relating to the claim is less than a specified amount, the idea being that any claim below the specified amount is not material given the scope of the transaction. According to the Canadian Study, the use of eligible claim thresholds is on the rise (from 27% to 37%). Note that this percentage is comparable to that reported in the US Study (38%).

4 | Double Materiality Scrapes for Indemnification Purposes

Materiality qualifications in representations and warranties may be disregarded either for the purposes of calculating damages only or for all indemnifications purposes (in which case the materiality qualifications in the representations and warranties exist solely for the purpose of closing conditions or to allow the seller to make representations and warranties it could not otherwise truthfully make without a qualification). This is often referred to as a double materiality scrape. The Canadian Study shows that Canadian practitioners are increasingly alert to this deal point: 39% of deals in the sample had a double materiality scrape of one type or the other, compared with only 11% in each of the two prior studies. Of those deals with scrapes, 57% limited the double materiality scrape to the calculation of losses only and 43% of those deals (i.e. 17% of all deals with baskets in Canadian Study) have a true double scrape (i.e. where materiality is read out for all indemnification purposes). It may be that those deals use an eligible claim threshold or a minimum loss basket to deal with materiality for indemnification purposes, though the correlation between these two deal points are not addressed by the Studies. Though the latest Canadian Study does show the start of a cross-border convergence on this deal point, the US Study reports that the use of double materiality scrapes for indemnification purposes is more prevalent in the US where 70% of deals with a basket included a double materiality scrape and 43% of those scrapes were limited to the calculation of losses, meaning that 40 % of deal with baskets in the US Study have a true double scrape.

5 | Indemnity Caps

Purchase agreements may also contain a cap on certain indemnification obligations which sets out the maximum amount a party can recover for losses. The US Study and the Canadian Study indicate that in the US all deals with a survival provision include a cap and in Canada almost all deals with a survival provision include a cap. But caps are still substantially lower in the US. However, as the following table shows, caps are tending to be lower in Canada over the course of the studies. This is consistent with the experiences of the authors.

Table 3	US Study	Prior Canadian Study	Canadian Study
No Cap	0%	10%	8%
Mean Cap as a % of T.V.	13.2%	49%	44%
Median Cap as % of T.V.	10%	40%	30%

6 | Third Party Claims

For the first time, the Canadian Study reports on provisions that apply when a third party makes a claim or brings an action against the buyer or target after closing. According to the Studies, the same deal points are generally used but there are some differences as to the degree to which they are used. The Canadian Study indicates that (i) similar to the US Study, most deals are likely to (a) be silent on whether a buyer can be indemnified for third party claims absent a breach of representation and warranty (98% in Canadian Study and 78% in US Study); and (b) most deals in which the indemnifying party can control the defense of third party claims (being 89% of the deals) include exceptions to the ability to assume such control (69% in Canadian Study and 78% in US Study). The Canadian Study also reports that nearly half of Canadian deals in which the indemnifying party can control the defense of third party claims require the indemnifying party to acknowledge liability first (49% in the Canadian Study compared to 38% in the US Study). Also similar to what is reported by in US Study, most eligible Canadian deals include limits on the ability to settle third party claims (96% in Canadian Study and 90% in US Study). Finally, the Canadian Study reports that the majority of deals with a third party claims provision do not include the following limits on the ability of the defending party to settle claims (i) a requirement to get a complete release (36% in the Canadian Study versus 53% in the US Study) or (ii) a requirement that the relief only involves monetary damages (26% in the Canadian Study versus 49% in the US Study). Nearly half of the deals with a third party claims provision do require written consent before the defending party can settle a third party claim (48% in the Canadian Study versus 38% in the US Study).

7 | Types of Damages/Losses Covered

These deal terms are largely consistent with the US Study and the Prior Canadian Study. According to the Studies (a) silence is the norm with respect to incidental damages and diminution in value; and (b) agreements are equally likely to expressly exclude consequential damages or be silent on that heading. According to the Studies, one difference between Canada and the US remains punitive damages: Canadian agreements are almost equally likely to be silent or exclude punitive damages, whereas most US agreements expressly exclude punitive damages. The higher percentage of agreements that are silent with respect to punitive damages in Canadian deals is likely as a result of punitive damage awards being rare in Canada, and when granted, the awards being smaller.

Table 4	US Study	Prior Canadian Study	Canadian Study
Silent on Incidental Damages	74%	75%	79%
Silent on Diminution in Value	72%	78%	79%
Silent on Consequential Damages	44%	45%	55%
Excludes Consequential Damages	49%	44%	42%
Silent on Punitive Damages	21%	51%	41%
Excludes Punitive Damages	78%	42%	57%

Other Deal Points: Some Big Changes

1 | Pervasive Qualifiers

Pervasive qualifiers, such as knowledge and material adverse effect (MAE), serve as a risk allocation tool. Like the Prior Canadian Study, the Canadian Study shows that most deals still include a definition of MAE that is forward looking, include carve-outs but do not include prospects in the definition. Notable changes, all of which indicate a convergence with US practice, include a large increase in the percentage of deals that (a) include the following

carve-outs to MAE: financial market downturn, war or terrorism and changes in accounting, as well as (b) a large increase in the percentage of deals that have at least one carve-out qualified by disproportionate effect.

Table 5	US Study	Prior Canadian Study	Canadian Study
MAE Defined	99%	88%	87%
MAE is Forward Looking	91%	77%	83%
Prospects Not Included	88%	60%	70%
MAE Definition Includes Carve Outs	91%	83%	77%
If MAE Defined, Includes the following Carve Outs:			
Financial Market Downturn	68%	48%%	76%
War or Terrorism	85%	55%	74%
Change in Accounting	79%	48%	72%
If MAE Defined and Includes Carve Outs, At Least One Carve Out Qualified by Disproportionate Effect	86%	53%	74%

2 | Conditions to Closing

A purchase agreement will include conditions to closing when the transaction does not simultaneously sign and close. If the conditions in favour of a party are not met, that party will have the right to refuse to close the transaction. The Canadian and US studies report on a number of closing conditions, including the condition requiring the target's representations and warranties to be accurate as of the signing date o closing date of the transaction (i.e., a bring-down) and whether double materiality will be "scraped". Double materiality occurs where some of the representations and warranties in the purchase agreement are qualified by materiality and the corresponding condition is also qualified by materiality. Where a double materiality "scrape" is included, for the purposes of the bring-down, the materiality qualifiers included in the representations and warranties are disregarded and only the materiality qualifier in the closing condition applies. Prior editions of the Canadian Study indicated that, contrary to what we saw in practice, Canadian deals often did not have such a scrape. That has now changed. The Canadian Study shows that Canadian deals increasingly have materiality scrapes, both at signing (from 20% in the Prior Canadian Study to 65% in the Canadian Study) and at closing (from 18% in the Prior Canadian Study to 64% in the Canadian Study).

3 | Representations and Warranties

The target's representations and warranties are important as they serve the basis upon which buyer can obtain disclosure, terminate the transaction, or obtain an indemnity. These deal terms are largely consistent with the Prior US Study and the Canadian Study. There were, however, some notable changes regarding the representation on compliance with laws. Like the US Study and the Prior Canadian Study, most deals still include a compliance with laws representation that is not qualified by knowledge. There is a noticeable shift in practice, with respect to reference to present and past compliance, notice of violation and notice of investigation, in most cases showing a convergence with US practice.

Table 6	US Study	Prior Canadian Study	Canadian Study
Includes Compliance with Law Representation	98%	95%	96%
If includes Compliance with Law Representation, Knowledge Qualified	4%	5%	13%
If Includes Compliance with Laws Representation, Covers Present and Past Compliance	37%	62%	50%
If Includes Compliance with Laws Representation, Covers Notice of Violation	77%	36%	56%
If Includes Compliance with Laws Representation, Covers Notice of Investigation	28%	4%	20%

4 | Dispute Resolution

Since, Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP, 80 A.3d 155 (Del. Ch. 2013), a lot of attention has been given to privileged pre-closing communications between target or sellers and their respective legal counsel and what happens if it ends up in the hands of purchaser. In that decision, the court found that, absent language in a merger agreement to the contrary, the privilege does in fact pass to the survivor as a matter of law pursuant to Section 259 of the General Corporation Law of the State of Delaware. In Canada, the Alberta Court of Queen's bench considered a similar issue in NEP Canada ULC v MEC OP LLC, 2013 ABQB 540. Merit Energy Company LLC (Merit) had a subsidiary, MEC Operating Company ULC (MEC) where the court also mentioned that Merit "could have inserted a provision into the purchase agreement under which any rights MEC had to exercise or waive privilege over documents relating to the purchase agreement negotiations would terminate on closing, leaving Merit in sole possession of the privilege. They did not."

Like the US Study, for the first time, the Canadian Study reports on the attorney client privilege carve-out for the first and reports that in only 6% of deals the target's attorney client privilege is expressly reserved by seller compared to 46% in the US Study. We predict that this percentage will rise in future studies.

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The authors were intimately involved with the Canadian Study (and previous Canadian and US studies): Kevin Kyte is Co-Chair of the Canadian Study and Tania Djerrahian assisted him on all aspects.

For further details on these and other deal points, please consult the studies, which are all available to ABA members on the Markets Trends Subcommittee of the American Bar Association's Mergers and Acquisitions Committee website