



New Private M&A Deal Points: Details You Need to Know!

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The latest edition of the American Bar Association's (ABA) *Private Target M&A Deal Points Study* (US Study), based on deals signed in 2016 and the first half of 2017, was released in late December 2017. This article highlights some of the new topics reported by the US Study as well as some of the more traditional topics. Where relevant, this article also compares deal points to the prior edition of the US Study based on transaction completed in 2014 (Prior US Study) and the last Canadian version: the *Canadian Private Target M&A Deal Points Study* (Canadian Study), issued in December 2016 and based on deals signed in 2014 and 2015.

Unless otherwise expressed, this article 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.

New Topics

The US Study includes two new topics (i) buyer power, and (ii) representation and warranty insurance (RWI).

The Buyer's Power

The US Study reports on the buyer's power ratio (BPR) which is determined by dividing the market capitalization of the buyer by the purchase price. Last year, the ABA and SRS Acquiom released a study entitled *Impact of "Buyer Power Ratio" on Selected M&A Deal Terms in Acquisitions of Privately Held Target Companies by Publicly Traded Buyers* (BPR Study) which demonstrated that BPR levels correlate with the level of the buyer favorable deal points (and therefore, negotiation powers). For example, a BPR of less than 10 generally correlates with more seller-favorable terms.

For the sample included in the US Study the average BPR was 12.63 and the median was 8.72, leading to an expectation of more seller favorable trends in deal points. The US Study does not look how individual deal points are impacted by BPR. This data will become more relevant in future versions of the US Study when it can be compared with new BPR numbers.

Representation and Warranty Insurance

While RWI has been available in the Canada and the U.S. since the 1990s, it has really gained momentum in the last 5 years and is now commonly seen in M&A transactions on both sides of the border. Indeed, depending on facts and circumstances, RWI can be a great tactical tool to break a stalemate in negotiations, distinguish a buyer in an auction process and ultimately conclude a transaction. The US Study notes that 29% of deals referenced RWI. Of note, the buyers in the US Study are public companies, meaning mostly strategic buyers, and our practice shows that the use of RWI is more prevalent in deals involving private equity players.

Deal Points Regarding the Policy

There are two types of RWI policies (i) buy-side policies which are purchased for the buyer with the buyer as the main insured and intended to reimburse a buyer for losses attributable to breaches of a seller's representations and warranties; and (ii) sell-side policies which are purchased for the seller with the seller as the main insured and intended to reimburse a seller for losses payable to a buyer for breaches of a seller's representations and warranties. In both types of policies, "known" breaches of representations and warranties, based on the actual knowledge of the deal team, are excluded from the coverage. Also buy-side policies will typically cover the seller's fraud if unknown to the deal team, while sell-side policies will not cover the seller's fraud. Not surprisingly, of the deals that included a reference to RWI, 93% used buy-side policies. Regardless, of the type of policy, it can be paid by any party. According to the US Study, the policy was most often paid by buyer (45%) or both parties (43%).

Another key aspect of RWI is the retention amount (or the deductible under the RWI policy). In Canada, the retention is usually 1% of the target's enterprise value. Not surprisingly, in 88% of the deals that included a reference to RWI, the size of retention was not determinable from the purchase agreement as this normally noted in the policy itself.

Finally, in deals with a delay between signing and closing, a RWI policy can be bound either at signing or at closing. If bound at signing, the policy typically covers breaches that are discovered between the signing and closing and, if bound at closing, it typically only covers breaches that are discovered after closing on the basis that the knowledge of breaches prior to the coming into force of the policy are not covered. In 48 % of the deals that included a reference to RWI, RWI was expressly bound at signing.

Impact of RWI on Deal Points Found in a Purchase Agreement

Covenants and Closing Conditions

RWI has an impact on covenants and closing conditions. If not bound at signing, the binding of a RWI policy at closing will typically be included as a condition to closing in favor of the buyer, this was the case in 50% of the deals that included a reference to RWI. In addition, 58% included some pre-closing covenants related to RWI.

Indemnification

The US study reports on how RWI impacts financial limitations on indemnification. Two common financial limitations on indemnification are indemnity baskets and caps. 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. The US Study shows that RWI does not necessarily impact the type of basket, but does impact its size. In terms of size, the reference to RWI in an agreement generally seems to result in a smaller basket size.

	US Study	US Study - RWI Split	Canadian Study
<i>Deductible Basket</i>	70%	48% without reference to RWI 22% with reference to RWI	41%
<i>First Dollar Basket</i>	26%	22% without reference to RWI 4% with reference to RWI	45%
<i>Combination Basket</i>	2%	All without reference to RWI	5%
<i>All Baskets (other than combination): Mean as % of Transaction Value</i>	0.79%	0.77% without reference to RWI 0.84% with reference to RWI	1.46% and, if outliers are excluded, 0.98%.
<i>Median as % of Transaction Value</i>	0.59%	0.66% without reference to RWI 0.50% with reference to RWI	0.80%
<i>Deductible: Mean as % of Transaction Value</i>	0.59%	0.64% without reference to RWI 0.94% with reference to RWI	2.10 and, if outliers are excluded, 1.15%.
<i>Median as % of Transaction Value</i>	0.58%	0.63% without reference to RWI 0.50% with reference to RWI	1%
<i>Dollar One: Mean as % of Transaction Value</i>	0.81%	1.02% without reference to RWI 0.36% with reference to RWI	0.81%
<i>Median as % of Transaction Value</i>	0.53	0.63% without reference to RWI 0.32% with reference to RWI	0.53%
<i>Basket as % of Transaction Value:</i>			
<i>Greater than 1%:</i>	10%	4% without reference to RWI 1% with reference to RWI	28%
<i>1% to 0.5%:</i>	38%	42% without reference to RWI 8% with reference to RWI	39%

0.5% or less:	52%	29% without reference to RWI 17% with reference to RWI	33%

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 shows that caps are greatly impacted by RWI: the use of RWI correlates with lower caps. In fact, the mean cap with RWI was less than half of that without reference to RWI and the median cap with RWI was a tenth of that without RWI. Of note, in RWI-deals, a common risk-sharing construct with respect to breaches of representations and warranties which has been observed is to split the equivalent of the retention amount under the RWI between seller and buyer, with the basket being buyer's exposure and the cap, seller's exposure.

	US Study	US Study - RWI Split	Canadian Study
<i>Mean Cap as a % of T.V.</i>	13.2%	RWI 14.7% without reference to 5.77% with reference to RWI	44%
<i>Median Cap as % of T.V.</i>	10%	10% without reference to RWI 1% with reference to RWI	30%

Notable Shifts in Traditional Topics

Escrows for Purchase Price Adjustments

The use of purchase price adjustments remains fairly comparable with that reported in the Prior US Study. There is a notable increase in the percentage of deals with a purchase price adjustment that have a separate escrow account for the adjustment (from 25% in the Prior US Study to 45% in the US Study). Furthermore, for the first time, the US Study reports on whether the escrow is the sole source of recovery for the adjustment: it is the sole source in only 11% of deals with a separate escrow for price adjustments.

	US Study	Prior US Study	Canadian Study
<i>Deals with Post Closing Purchase Price Adjustments</i>	86%	86%	72%
<i>Separate Escrow Included</i>	45%	25%	27%
<i>If Separate Escrow, Sole Source for Adjustment Recovery</i>	11%	n/a	n/a

Material Adverse Effect

Pervasive qualifiers, such as knowledge and material adverse effect (MAE), serve as a risk allocation tool. The use of MAE in the surveyed deals remains fairly comparable with that reported in the prior US Study and the Canadian Study. What has changed compared to the Prior US Study is the increase in the use of certain carve outs to MAE in and the US Study: namely, changes in political conditions, force majeure, acts of God and natural disasters as well as failure to meet projections.

	US Study	Prior US Study	Canadian Study
<i>MAE Included</i>	99%	99%	87%
<i>Includes Carveouts</i>	89%	91%	77%
<i>If Includes Carveouts, Type of Carveout:</i>			
<i>Changes in Political Conditions</i>	68%	Unknown but below 50%	n/a
<i>Force Majeure, Acts of God, Natural Disasters</i>	66%	Unknown but below 50%	n/a
<i>Failure to Meet Projections</i>	58%	Unknown but below 50%	n/a

Indemnification Escrow

Most deals in the US Study continue to include an indemnification escrow. However the size of the escrow as percentage of transaction value decreased with roughly a third of the deals with an escrow having an escrow of 3% or less of the transaction value (as opposed to roughly 10% of the deals in the Prior US Study). The shift, which may be at least in part attributable to the greater use of RWI, effectively lowered both the mean and median escrow as a percentage of transaction value.

	US Study	Prior US Study	Canadian study
<i>No Escrow/Holdback</i>	24%	21%	57%
<i>Escrow as a Percentage of Transaction Value:</i>			
<i>3% or Less</i>	32%	11%	18%
<i>Greater than 3% to 5%</i>	12%	18%	18%
<i>Greater than 5% but Less than 10%</i>	28%	32%	51%
<i>10%</i>	12%	9%	18%
<i>Greater than 10% to 15%</i>	15%	23%	3%
<i>Greater than 15%</i>	2%	8%	9%
<i>Statistical Summary:</i>			
<i>Mean</i>	6.66%	9.14%	8.3%
<i>Median</i>	7.00%	7.50%	7.3%

Concluding Remarks

The Studies also include interesting on other deal points. 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.

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