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What's Market in Canada, eh? A Comparison of Two Canadian Private Target M&A Deal Point Studies

To help find a reasonable middle ground or to resolve a thorny point of negotiation in a share or asset purchase agreement, clients often will ask their merger and acquisition ("**M&A**") lawyer: "What's market"? But the view of one deal lawyer may be different from the view of another, and it will be influenced by the lawyer's own experiences, clients, and negotiating acumen.

In 2008, the Mergers & Acquisitions Committee of the American Bar Association, Section of Business Law published its first Canadian Private Target M&A Deal Points Study[1]. That Study was the first-ever report on key deal terms in Canadian private company M&A agreements and became an instant must-have tool for M&A lawyers, as it provided very useful, objective insights into Canadian market practice. The M&A Committee has since published private target deal points studies on a bi-annual cycle, with the most recent study being released in late 2016 (the "**ABA Study**").[2] The five studies, produced over a 10 year period, include historic trend information as well as useful comparisons of trends in Canadian and US deal

[1] 2008 Canadian Private Target Mergers & Acquisitions Deal Points Study, https://www.americanbar.org/content/dam/aba/administrative/business_law/deal_points/2008_Canadian_Private_Target.authcheckdam.pdf.

[2] 2016 Canadian Private Target M&A Deal Points Study, https://www.americanbar.org/content/dam/aba/administrative/business_law/deal_points/2016_can_private.authcheckdam.pdf. John Clifford chaired the working group of Canadian M&A lawyers who produced the 2008, 2010 and 2012 studies and has remained actively involved on the working groups for subsequent studies.

practice (the ABA M&A Committee produces similar studies on US private target M&A deal points).

And now there is a new tool available to Canadian deal lawyers. In early 2017, Practical Law Canada issued its inaugural report titled "What's Market: Legal Trends in Canadian Private M&A" (the "**Practical Law Study**"). Like the ABA studies, the Practical Law Study reports on trends in deal points in agreements for the purchase of Canadian private company targets. While similar in approach and content, there are notable differences in the reports. In this bulletin we discuss some of the key trends reported in the Practical Law Study and highlight some of the differences reported in the ABA Study.[3]

Overview of the Study Samples:

The deal points reported on in the ABA Study are derived from M&A deal documents filed on Canada's System for Electronic Documents and Analysis and Retrieval (SEDAR) filed by Canadian reporting issuers who purchase private companies. The 2016 ABA Study reports on deals that were signed in 2014 and 2015.'

The study sample for the Practical Law Study was much larger and more current. Practical Law looked at deal documents filed on SEDAR as well as deal documents filed by US public companies on the US Securities and Exchange Commission's Electronic Data Gathering, Analysis and Retrieval System (EDGAR) that were governed by the law of a Canadian province. This resulted in a more robust study sample of 150 agreements, compared to only 101 agreements in the ABA Study. The Practical Law Study reports on deals that were signed in 2015 and 2016.

Both the ABA and Practical Law studied only those agreements where the purchase price was C$5 million or more. The highest purchase price in the Practical Law Study was C$2.6 billion whereas the largest transaction reported on in the ABA Study had a purchase price of C$4 billion. 52% of the deals surveyed by Practical Law had a

[3] This bulletin also makes specific references to previous ABA Canadian Private Target M&A Deal Points Studies, released in 2012 and 2014 (the **"2012 ABA Study"** and the **"2014 ABA Study"**, respectively).

purchase price of C$50 million of less. This is materially more than the ABA Study, which reported that 41% of the deals it reviewed had a purchase price of less than C$50 million. However both studies reported that about two-thirds of deals were valued at C$100 million or less. Clearly, the "mid-market" in Canada is much less than the United States and elsewhere.

Notably, 46% of the deals reported on by Practical Law were asset transactions (43% were share deals, with the balance (11%) being amalgamations, plans of arrangement or some combination of assets and shares). In the ABA Study, only 28% were asset transactions. This is important because the larger number of asset deals in the Practical Law Study may skew some of the reported trends, since, for example, purchase price adjustment mechanisms and some of the representations and warranties typically included in a share deal may not be relevant or appropriate in an asset transaction.

These similarities and differences in the studies are more particularly set out in the chart below.

Overview of Deals Analyzed

	ABA Study	**Practical Law Study**
Number of Deals	101 (64 in 2014, 37 in 2015)	150 (91 in 2016, 59 in 2015)
Deal Size	Range (C$) $5.7M to $4B <$25M – 29% $25M-50M – 12% $50M-100M – 22% $100M-500M – 30% >$500M – 7%	Range (C$): $5M to $2.65B <$25M – 39% $25-50M – 13% $50M – 100M – 14% $100M – 500M – 21% >$500M 13%
Form of Deal	Asset: 28% Share: 71% (includes amalgamations and plans) Mixed: 0%	Asset: 46% Share: 43% Mixed: 4% Merger: 7%
Form of	All cash: 55%	All cash: 57%

Consideration	All stock: 6% Mixed: 39%	All stock: 16% Mixed: 27%
Nature of the Parties – Principal Buyer	Corporate: 87% Private Equity: 10% Financial: 2% Entrepreneurial: 2% Indeterminable: 0%	Corporate – 95% Management – 1% Private Equity – 1% Not disclosed – 4%

The three principal industries in which the target operated in the deals reported on by Practical Law were oil and gas, metals and mining, and services. Natural resource deals accounted for just over one-third of the deals and over half of the service deals related to natural resources (drilling, oilfield services, etc.). Of the deals reported on in the ABA Study, the three principal industries of the targets were chemical and basic natural resources, oil and gas, and industrial goods and services. Natural resources accounted for 17% of deals and oil & gas accounted for 16% of them.

Deal Terms

Indemnification Provisions

Indemnification is a contractual remedy and risk allocation mechanism that the parties to an acquisition agreement negotiate to address certain post-closing issues and losses. The studies' findings on several of the highly negotiated indemnification-related provisions are discussed below.

Survival Periods:

The survival period in an M&A agreement is the time during which the parties may assert a claim for indemnification for an incorrect representation or warranty (or breach of covenant in some cases). The duration of the survival period is a key issue in almost all private M&A transactions. Buyers generally prefer long survival periods to ensure recourse regardless of when an issue arises. Sellers naturally want a shorter period.

It is not common for general survival periods to be more than 24 months, and both the Practical Law Study and the ABA Study

reported that 18 months is the most frequent period. This is not surprising since 18 months enables a buyer to conduct the business through one complete financial year and related audit cycle, which typically is enough time to uncover any significant issues with the business.

However, there are notable differences in the periods reported in the studies.

Survival Periods

	ABA Study	**Practical Law Study**
Less than 12 Months	0%	2%
12 months	19%	26%
> 12 to < 18 months	5%	2%
18 months	32%	27%
> 18 to < 24 months	2%	n/a
24 months	25%	20%
Other (>24 months or silent)	17%	23%

Notably, many agreements reported on by both the ABA and Practical Law had a 12 month survival period. Overall, although most transactions have a general survival period of between 12 and 24 months, looking back at prior ABA studies the shorter 12 and 18 month survival periods appear to be on the rise and are most prevalent, which is consistent with US practice.

Indemnity Baskets:

An indemnity basket is a threshold amount of certain types of losses that a party must incur before it is entitled to any indemnification from another party. The following types of indemnity baskets are common in M&A transactions:

The ABA Study reported that deductible baskets were found in approximately 41% of deals, which is comparable to the 35% (of deals that included an indemnity provision) reported on in the Practical Law Study. The use of deductibles in Canada has grown; deductibles were used in only 14% of deals reported on in the 2012 ABA Study and 36% in the 2014 ABA Study. This trend is more consistent with the U.S., where the use of deductibles is prevalent.

The Practical Law Study reported that over 40% of the deals surveyed which included an indemnity provision used tipping baskets, compared to 45% reported in the ABA Study. This is down and is the corollary to the trend of greater use of deductibles. Tipping baskets were used in 59% of deals reported on in the 2012 ABA Study and 50% in the 2014 ABA Study. In both the ABA Study and the Practical Law Study, a partial tipping basket was used in the agreements less than 10% of the time.

The ABA Study reported that 72% of all deals with indemnity baskets had a basket equal to or less than 1% of the total deal value. This is materially different than the findings by Practical Law, which reported that only 42% of deals had a basket equal to or less than 1% of the purchase price. However the Practical Law Study included in its calculation deals which did not have any indemnity provisions (which accounted for 20% of the reported deals). Presumably, if those deals had been excluded from the denominator in the calculation, Practical Law would have reported a materially greater number of deals that has baskets equal to or less than 1% of the purchase price. In our experience, the basket often falls somewhere between a transaction value of 0.5% to 1.0%.

Indemnity Caps:

An indemnity “cap” is the upper limit of a party’s financial obligation to indemnify another party for its losses in the event a representation or warranty is untrue or a covenant is breached. When negotiating an indemnification cap, a seller will want the lowest cap possible, while a buyer will seek a high cap or no cap at all. Carve-outs, such as for breach of fundamental representations, are usually subject to an increased cap, or no cap at all.

Caps as a percentage of deal value were similar as reported in the two studies. The ABA Study reported that 23% of the agreements containing survival periods set the cap at the purchase price, while the Practical Law Study reported that the purchase price was the cap in 21% of deals surveyed (noting that 15% of deals did not include an indemnity provision. If these deals had been excluded, the reported 21% would have been higher). These results show that caps tend to be much higher in Canada than in the U.S., where a cap equal to the purchase price is unusual.

It is otherwise difficult to compare the caps as a percentage of purchase price data in the two studies. The ABA Study reports that:

Indemnity Caps as Reported by the ABA

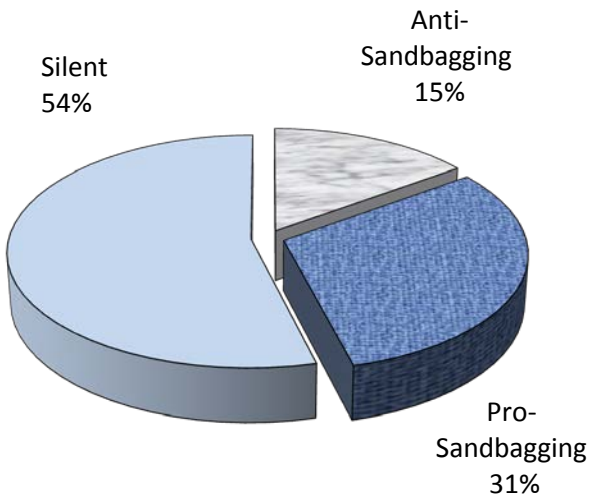
Percentage of Deals with Indemnities	Cap
18%	10% or less of the purchase price
27%	more than 10% but less than 25% of the purchase price
23%	more than 25% but less than 50% of the purchase price
9%	more than 50% but less than 100% of the purchase price
23%	purchase price

Practical Law, on the other hand, reports its percentages as a percentage of total deals, and reports that 15% of deals did not include an indemnity provision and that the information in 24% of deals was redacted. As a result, information for 39% of deals is not taken into account. So, while the Practical Law Study reports that the indemnity cap was less than 25% of the purchase price in 21% of all deals surveyed, it does not report a percentage only of those deals which included an indemnity provision and for which information was available.

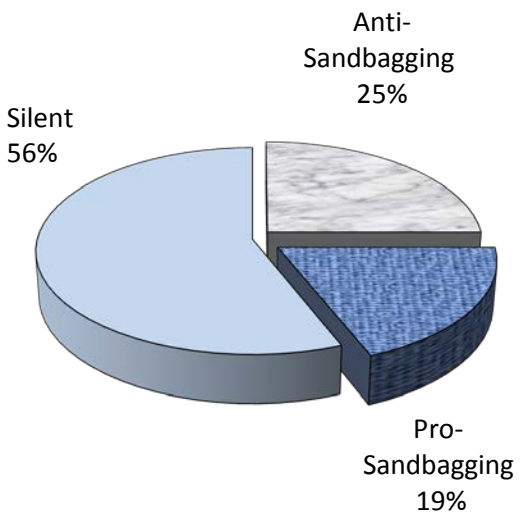
Sandbagging:

Buyers in private company M&A transactions often want to include a "pro-sandbagging provision" to expressly preserve their right to bring indemnification claims against the seller for breach of a representation, warranty or covenant, even if the buyer knew about the breach before closing and proceeded with closing the deal anyway. In other words, the buyer could decide to complete the acquisition knowing about a specific problem, and then proceed to "sandbag" the seller for recourse post-closing. Sellers often try to exclude the sandbagging provision or include an anti-sandbagging provision which limits the buyer's ability to seek recourse in respect to matters which the buyer knew about at closing.

Frequency of Sandbagging Provisions



ABA Study



Practical Law Study

As reported in the ABA Study, pro-sandbagging clauses were included in 31% of deals, up markedly from prior studies (15% in the 2014 ABA Study and 24% in the 2012 ABA Study). The Practical Law Study reports that pro-sandbagging provisions were included in only 19% of the deals surveyed. In contrast, anti-sandbagging clauses

appeared in 25% of the agreements reviewed by Practical Law and 15% of the deals reported on in the ABA Study.

No Canadian court has considered whether a buyer can sue and recover its losses for breach of a representation if it knew of the breach when it closed on the transaction. The prevailing view of commentators is that a buyer can recover absent unusual circumstances, so in effect silence is equivalent to an express pro-sandbagging clause. The ABA Study reported that 54% of deals surveyed were silent on the point (down significantly from prior years) and Practical Law reported silence in 56% of deals.

Escrows and Holdbacks

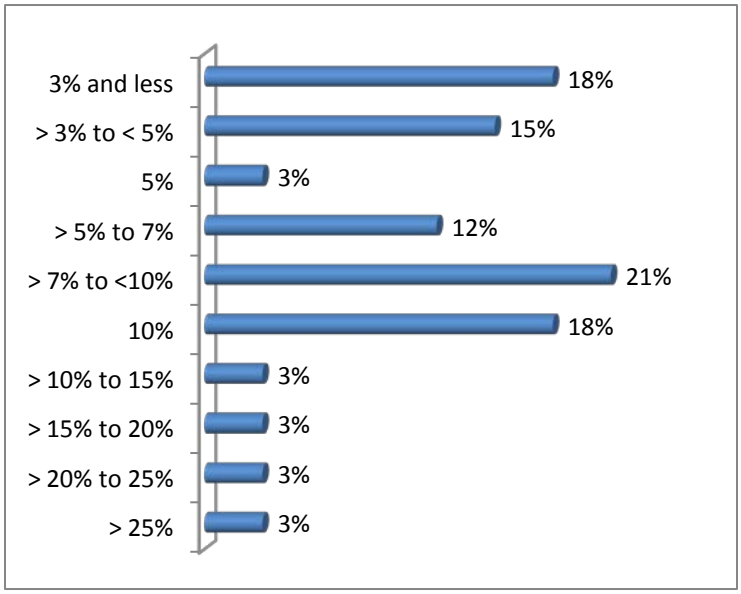
Escrow funds are often held by a third party escrow agent and distributed in accordance with the terms of an escrow agreement to satisfy any adjustments to the purchase price in favour of the buyer and/or indemnification claims made by the buyer against the seller. Similarly, a holdback is a mechanism used by the buyer to withhold payment of a portion of the purchase price at closing until a future condition is satisfied. The amount of the escrow or holdback and whether the amount is to be the sole source of indemnity for any incorrectness in or breach of a representation or warranty or breach of a covenant can be a key negotiation point in private M&A transactions.

The Practical Law Study reported that almost 40% of the deals surveyed included an escrow or holdback as a protective measure for the buyer, with both measures more prevalent in share deals (41%) than in asset deals (23%). Of the deals that had an escrow, the escrow in 44% of those deals was for indemnification claims and in 21%, the escrow was for purchase price adjustments (Practical Law reported that “several deals” made use of escrows for multiple purposes, but it did not report which percentage of deals had an escrow for both indemnification and purchase price adjustments.) The ABA similarly reported that 43% of deals which included a survival provision had an escrow or holdback. The ABA Study did not report on the purpose of the escrow.

Interestingly, the use of escrows is much more prevalent in the United States where, according to ABA reports, about 75% of private target deals make use of an escrow.

A point of interest is the difference in the studies in the value of the escrow as a percentage of the total value of the deal. The Practical Law Study reported that, of the 50 agreements which included an escrow, the escrow amount on average was 21.2% of the transaction value, with the median amount being 10.3%. This is markedly different from the deal point reported by the ABA. According to the ABA Study, of the deals with determinable escrow/holdback amounts, the average escrow amount was 8.3% of deal value, and the median amount was 7.3%. Helpfully, the ABA Study also includes specific breakdowns of escrow amounts as a percentage of deal value:

Escrows as a % of Deal Value (ABA Study)



Representations and Warranties

Representations and warranties are factual statements typically made about the shares, assets, and business that are being purchased, and the liabilities that are being assumed. They provide disclosure to a buyer and are a means to allocate risk about unknown matters between the parties.

Compliance with Laws

In a "compliance with laws" representation, the seller represents and warrants that the business has been conducted in compliance with applicable laws. Points of negotiation often centre around the period covered (i.e. current or past compliance) and exceptions or limitations to the representation (such as for environmental matters, which often are dealt with in a unique representation). The representation is sometimes qualified by knowledge or materiality.

Both the ABA Study and the Practical Law Study reported that substantially all deals include a compliance with law representation (ABA Study – 96%; Practical Law Study – 87%), and in only a relatively small percentage of deals is the representation qualified by knowledge (ABA Study – 13%; Practical Law Study – 25%). Looking back at information provided in prior ABA studies, it is clear that the frequency of use of knowledge qualifiers changes over time and is inconsistent year-over-year (5% in the 2014 ABA Study; 23% in the 2012 ABA Study), but consistently the qualifier appears in a small minority of agreements.

Full Disclosure

A full disclosure representation serves as a catch-all safety net for the buyer. A typical formulation of the rep is a statement by the seller that the agreement does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements contained in the agreement not misleading. Both studies report that a full disclosure representation is included in only about one third of deals (ABA Study – 36%; Practical Law Study – 33%). The historic ABA studies show that the inclusion of the rep has declined in recent years (was 45% in the 2014 ABA Study; 52% in the 2012 ABA Study), and that the more recent Canadian practice is converging with US deal practice.

No Undisclosed Liabilities

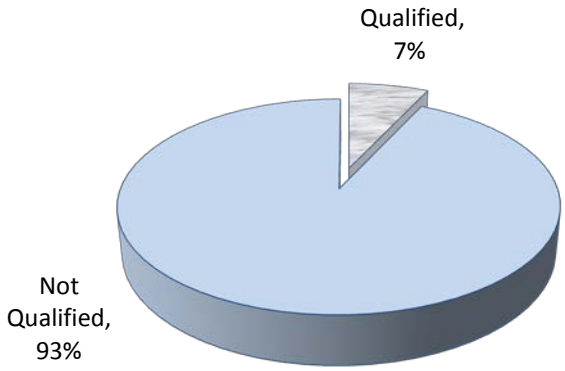
There are several formulations of a "no undisclosed liabilities" representation. A buyer-favourable formulation states that the target company has no liability except for liabilities reflected or reserved against in its balance sheet and liabilities incurred by the target in the ordinary course of its business since the balance sheet

date. A more seller-friendly formulation will limit the rep to liabilities of the nature required to be disclosed in a balance sheet, since businesses often will have liabilities that are not reported (and not required by accounting standards to be reported) in the financial statements.

According to the Practical Law Study, 63% of deals included some form of no undisclosed liability representation. This is markedly lower than the 85% of deals reported in the ABA Study. The difference may reflect that the Practical Law Study included many more asset purchase agreements. Often an asset buyer can more confidently identify and quantify the specific liabilities that it is assuming and thus will not need the protection of a broad no undisclosed liabilities representation from the seller.

The ABA Study helpfully also reports on the frequency by which a no undisclosed liability representation is qualified by knowledge. Practical Law did not cover this deal point in its study.

How often is the Rep Qualified by Knowledge?
(ABA Study; not reported by Practical Law)



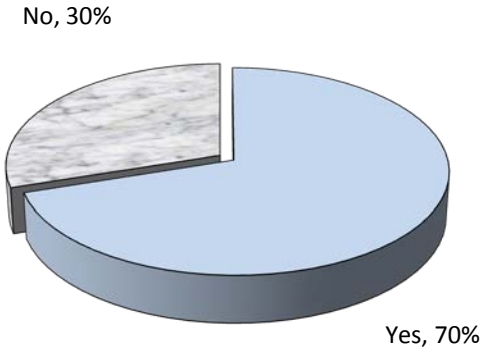
Post-Closing Purchase Price Adjustments

Many M&A agreements include a mechanism for the parties to determine a financial metric – such as working capital of the business – as of the closing date and make adjustment payments post-closing if the actual working capital is more or less than a target amount.

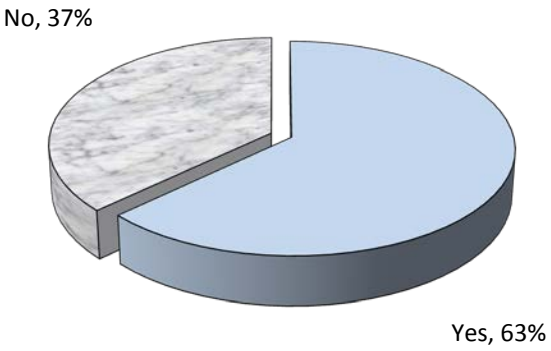
Adjustments may also be calculated on other pre-determined financial metrics or earn-outs, which are conditional on future performance of the business being acquired.

The ABA Study and the Practical Law Study both report that purchase price adjustment mechanisms are included in about 70% of deals. Helpfully, Practical Law reports that the frequency of purchase price adjustments is about the same in both assets deals and share deals.

Did Agreement Contain Purchase Price Adjustment Clause?
(as reported by Practical Law)



Asset Purchase



Share Purchase

The ABA Study reported that 83% of adjustments were made on account of working capital, notably more than the 58% reported by Practical Law. The lower frequency reported by the Practical Law Study may again be attributable to the greater number of asset deals included in the Practical Law Study, where working capital typically is not relevant to a buyer.

Both studies reported that a similar number of deals - about 45% - included adjustments based on multiple metrics. The ABA Study reported that debt metrics were found in 27% of deals, while the

Practical Law Study reported that debt metrics were found in at about 20% of deals. Both of these figures represent an increase from the 2012 and 2014 ABA Studies, both of which reported that debt was an adjustment metric in only 11% of deals.

Observations

The addition of the Practical Law Study to the resources available to Canadian deal lawyers is welcome, and it provides a useful comparison and is a good supplement to the ABA studies.

But both studies should be read and used carefully, with a good appreciation of the basis for the reports – for example, the fact that one-third of the agreements included in the Practical Law Study are for asset deals, which may affect the aggregate deal points reported – and their context. The underlying agreements reviewed for both studies are filed by public companies who purchased a private company. Hundreds of deals get done every year by private parties (including private equity firms) and the agreements for those deals are never filed, so we do not have the benefit of knowing "what's market" for those deals. And of course final deal terms will always be influenced by the relative bargaining position and leverage of the parties, and the increased use of rep and warranty insurance is expected to affect the many of the key terms in M&A deal documents.

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