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# M&A and COVID – How COVID has Forced Buyers and Sellers to Re-Think the Allocation of Risk in Contracts

**By: Aaron Baer**

*A year into the COVID-19 pandemic, it's no secret that market volatility has made things challenging for buyers and sellers. While risk allocation between parties has always been a top priority, the pandemic has made it even more important that buyers and sellers address the reality that certain events may materially change the value of a business and the desirability for a buyer or seller to close a deal.*

To best mitigate these risks in M&A transactions, lawyers and clients need to think creatively when negotiating the business deal. In a time where certainty is at a premium, it's so important for everyone to have transparent conversations to make sure that the parties are all on the same page.

**PURCHASE PRICE CALCULATIONS**

It was already challenging to value a private company, but the inherent uncertainty of COVID-19 has made this even harder. It's not easy to predict what the world will look like in the next 7 months, not to mention the next 7 years.

If a company can withstand the challenges of the rest of 2021, they may be incredibly well-positioned for the future. On the other hand, if a company faces significant cashflow constraints and can't buy enough time until the economy re-opens, then the company's potential won't make much of a difference.

We expect patient buyers to find themselves with plenty of interesting acquisition opportunities in the coming year, as we combine the COVID-19 challenges with the ongoing trend of retiring small business owners who don't have obvious succession plans in place.

The ultimate value of a business may vary considerably between the onset of negotiations, the signing of a purchase agreement, and the eventual closing of the deal, What should the agreed-upon purchase price be, and how do you make sure you aren't paying more or accepting less than the company's actual worth?

There's no easy answer, but one thing we're encouraging our clients to do is have more transparent conversations with their counterparty. They are talking out – in plain language – who should bear risks if certain events happen. For example, if a business is forced to shut down due to government changes, then will the buyer be able to back out of the deal? Will the purchase price be reduced? Will it depend on how much revenues are affected and how long any slowdown lasts?

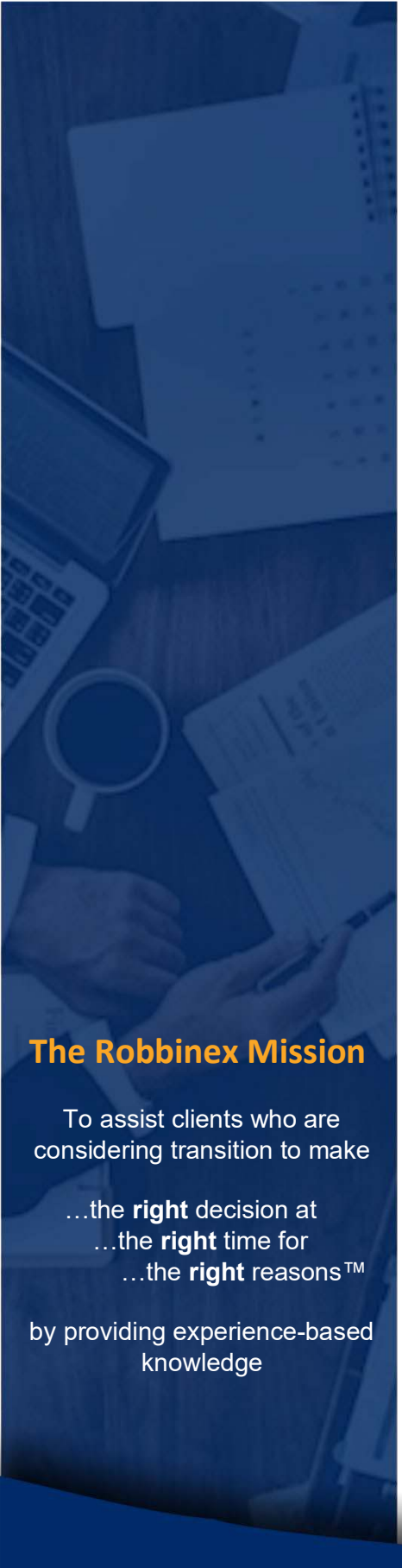
Having these tough conversations can lead to a lot of comfort for the buyer and seller. Rather than fighting over the meaning of certain legalese, they can have a clear, plain-language understanding of who bears what risk. With some clients, we've even started including plain-language charts in letters of intent/purchase agreements so that everyone is crystal clear on how different scenarios will be handled.

**EARN-OUTS**

When a buyer and seller can't fully agree on a purchase price, then an earn-out is a time-tested approach to help bridge that gap. With a typical earnout, the amount of the purchase price paid on closing is fixed, but there are opportunities for a vendor to earn additional post-closing amounts based on certain metrics.

Again, creativity is at a premium here. Traditionally, most earnouts involve some variation of EBITDA. Depending on the nature of a business, we may see revenue used as the main driver.

In a deal we recently re-negotiated on behalf of a vendor, the earnout was over a period of 2 years; however, if certain conditions weren't met (based on the state of the world over that 2 year period), then the earnout period was extended for a further 6 months. That's the beauty of an earnout – it's up to the parties and their advisors to help find a fair, practical solution for everyone.



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To assist clients who are considering transition to make

…the **right** decision at
…the **right** time for
…the **right** reasons™

by providing experience-based knowledge

**PURCHASE PRICE ADJUSTMENTS**

In a typical share deal, there would be a working capital adjustment that takes place post-closing. After all, if the underlying value of a business is $2 million but the company happens to have $500,000 of accounts receivable in the company at closing, then the seller should typically receive some credit for that.

In challenging economic times, it can be tougher for buyers to feel confident that they will be able to collect on outstanding accounts receivable. Whereas they may have accepted certain promises from vendors in the past, those may not be enough now. Again, creative solutions can help bridge the gap.

For example, on a transaction our client (the purchaser) closed in January, they agreed that accounts receivable would be included in the working capital adjustment; however, there was a material purchase price adjustment (down) for every dollar of accounts receivable that weren't collected within 120 days of closing. The seller was, of course, permitted to assist our client with collecting receivables. This way, the parties' interests were aligned, but our client wasn't unfairly penalized by circumstances beyond their reasonable control.

**MATERIAL ADVERSE EFFECT (MAE) and MATERIAL ADVERSE CHANGE (MAC) provisions**

Material Adverse Effect (MAE) or Material Adverse Change (MAC) clauses are often included in M&A agreements. What these terms truly mean – well that's anyone's best guess. There are billion dollar cases currently in progress in both Canada and abroad about the meaning of these phrases. And to make things more challenging, courts have been pretty clear that the meaning really depends on the precise wording used in the purchase agreement. Does that sound like certainty?

Again – rather than leaving things to change, we're advising clients to talk things out and use plain language. Run through the 5 or 10 most likely issues (knowing what we know today) and expressly determine who should bear those risks. Don't put yourself in a position where you're going to spend tens of thousands of dollars fighting over the word 'material'. It's a lose-lose situation that can be avoided with a little foresight.

It's completely fair that a buyer should be able to back out of a deal between signing and closing in some cases, but those circumstances need to be limited. The more parties can agree in plain language about what those circumstances look like, the greater likelihood that you successfully close the deal and avoid the fun of post-closing litigation.

## Bottom Line

COVID-19 has upended our lives, and it's made things more challenging in so many ways. That said, when it comes to buying or selling a business, there are ways that experienced counsel and advisors can help you navigate the potential uncertainty.

When looking for an M&A lawyer, find someone who works on these types of transactions on a regular basis and can help make a challenging experience into something that is a lot more manageable.

## About the Author

**Aaron Baer, Partner at Aird & Berlis LLP**

Aaron is a leading Canadian M&A lawyer who provides himself on providing modern legal advice. An entrepreneur at heart (and on the side), he has helped buy and sell more than 100 companies. Aaron prides himself on providing cost-effective legal advice without sacrificing on quality. Aaron is considered a legal tech expert, and he leverages leading technology tools and processes to ensure that he's providing value to his clients. Aaron isn't afraid of fixed fees, and there's nothing that scares him more than sending a client a bill and desperately hoping that they'll pay it.

Aaron can be reached by email at abaer@airdberlis.com

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