Cassels

Navigating Uncertainty: Legal Trends in Share Purchase Agreements for Private Equity in the Face of Market Volatility

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In an M&A environment that is uncertain, dealmakers are employing creativity in an attempt to bridge gaps around valuations and assuage concerns about diligence findings.

Based on our internal survey of recent transactions, and an assessment of legal trends shaping purchase agreements (drawing on statistics from Practical Law's annual survey (October 17, 2023), the ABA Private Target Mergers & Acquisitions Deal Points Study (December 18, 2023) (the ABA 2023 M&A Study), and GF Data's Private Equity Mid-Market Overview (3Q 2023; Spring 2024)), we note the following developments.

Practical Law's survey reviewed 23 purchase agreements signed in 2023 and 74 purchase agreements signed in 2022, providing insights into the private merger and acquisition environment in Canada. Complementing this, the ABA study analyzed 108 publicly available acquisition agreements for transactions executed and/or completed in 2022 and the first quarter of 2023. Together, these studies offer a comprehensive overview of current market practices and emerging trends in purchase agreements within the private M&A sector.

Cash Dynamics in Share Purchase Agreements: A Return to Normal

In many ways the results of Practical Law's survey reflect a return to pre-pandemic trends. Notably, consideration in 45% of the purchase agreements included in the survey took the form of 'all-cash' transactions (in contrast to 'all share' deals or combined 'cash-share' deals), an increase of 14% year-over-year. Our analysis of the 23 purchase agreements signed in 2023 also confirms the preference for cash consideration. Among these, 12 were 'all-cash' transactions, two were 'all-stock', and nine involved a mix of cash and share consideration.

This trend is indicative of a much-anticipated regression towards the mean, as Practical Law's pre-pandemic surveys have historically revealed that consideration in transactions is predominantly 'all-cash'. It also reflects the well-documented phenomenon that PE firms continue to have record levels of dry powder. As market dynamics continue to shift to conditions marked by the increasing cost of capital, inflation, and geopolitical volatility, many funds have amassed vast amounts of capital. In addition, vendors of 'A-level' companies insist on all-cash deals: the most sought after businesses have more leverage in negotiating purchase price and other relevant deal terms.

The Strategic Role of Escrow and Holdback Provisions for PE Investors

Practical Law's statistics highlighted a shift in the approach to risk mitigation. Among the 23 agreements signed in 2023, six agreements included some escrow or holdback mechanisms, representing approximately 26% of the total agreements. This marks a slight decrease from the previous year, when Practical Law's annual survey indicated that 35% of agreements signed in 2022 included either an escrow or a holdback provision. To further understand the broader market trends, the ABA 2023 M&A Study offers additional insight. It reports that of the 108 agreements analyzed, 53% included an escrow or holdback mechanism, while 47% did not.

These trends reflect the ever-important role of protecting against undisclosed liabilities that may arise after closing by employing a holdback or escrow arrangement. They also reflect an important characteristic of the current M&A market for PE: it is a buyer's market. Buyers prefer to proceed with a holdback, ideally, as doing so provides maximum control over the funds (in contrast to instances where funds are held by a third-party escrow agent). Generally, our internal survey underscores the observation that most deals include an escrow or holdback provision.

Risk Mitigation Strategies: The Due Diligence Process, Indemnification, and Representation and Warranty Insurance

Due Diligence

The COVID-19 era was characterized by urgency in M&A, as transactions were closing with ever-increasing speed. While historically, buyers were typically granted 90 days of exclusivity, the due diligence process during 2020-2022 was abridged to less than 30 days in some cases.

Markets have since retreated to pre-pandemic trends. An internal survey of Cassels private M&A lawyers revealed that due diligence periods in 2023/2024 are approximately 21-49% longer compared to those in 2021/2022. Further, we have noted that deals are taking longer to close and the diligence process is often more detailed (specifically in areas like legal, financial, and cybersecurity).

Indemnity Caps

According to data collected by GF Data in their Mid-Market Overview of Spring 2024, indemnification caps surged in Q4 2023, reaching an average of 26.7% of Total Enterprise Value across all deal sizes. According to GF Data, this figure is the highest quarterly average GF Data has tracked, reflecting concerns/risks in the market.

GF Data notes the following indemnification caps by deal size:

TEV (millions)	1Q, 2023	2Q, 2023	3Q, 2023	4Q, 2023
10-25	23.3%	29.1%	15.9%	27.2%
25-50	19.0%	9.3%	8.6%	21.4%
50-100	32.7%	9.5%	37.1%	30.5%
100-500	6.2%	N/A	3.2%	23.0%
Total	22.3%	20.5%	16.1%	26.7%
N=	44	23	32	35

Source: *GF Data (Spring 2024)*

Representation and Warranty Insurance

We continue to see significant negotiations in the mid-market around the interplay between Representation and Warranty Insurance (RWI) and the standard survival and indemnity provisions. Based on our internal survey, the standard survival period for non-fundamental representations and warranties, where there is no RWI in place, ranges from 18 to 24 months from closing.

Our RWI expert, Matthew Stephen, has noted the following: where RWI is employed, the RWI policy will typically provide a three-year survival period for non-fundamental representations and warranties, irrespective of whether the survival period for the same representation/warranty in the purchase agreement is shorter than three years. In this sense, the RWI policy will offer enhanced coverage by extending the survival period. Further, while three years is the standard survival period offered by RWI insurers, longer survival periods are available for additional premiums and buyers will have strategic reasons to seek longer survival periods in the purchase agreement.

Matthew has also noted that RWI can help make the negotiations related to survival periods between buyers and sellers less contentious. From the buyer's perspective, where RWI insurance is obtained, a buyer's main recourse for a breach of general business representations is typically under the RWI policy. Conversely, from the seller's perspective, where RWI is obtained, a seller's exposure is typically limited to 50% of the original retention amount in place under the RWI policy for the first 12 months from the closing date and following the expiry of this 12-month period, the original retention amount under the RWI policy typically reduces or 'drops down' by 50%. From the first anniversary date of closing, the seller's obligation to contribute to the RWI retention typically therefore ceases. As a result of this reduced exposure, a seller will likely advocate less stringently for a shorter survival period.

Unlocking Value: The Strategic Role of Earn-Out Structures

Earn-out structures, which played a significant role in the survey of 2022 transactions (28%), continued to be a notable element in deal-making in 2023. Among the 23 agreements reviewed in 2023 by Practical Law, six featured earn-out structures, accounting for 26% of the agreements. This prevalence is further substantiated by the ABA 2023 M&A Study, which found that 26% of the 108 agreements analyzed also included earn-out structures. These figures highlight the sustained importance of earn-out structures in today's M&A market, particularly in bridging valuation gaps, managing transaction risks, and introducing flexibility in competitive bidding scenarios. Consistent with trends seen in 2021 and 2020, the most prevalent earn-out metrics continue to be EBITDA, revenue and development milestones.

Including such a provision continues to be of importance for PE investors as doing so minimizes financial risk considerably, as the total purchase price to be paid is based on the seller's future performance rather than solely projections. This feature is ever important in the current landscape, where we are witnessing an enhanced focus on risk in the financial markets.

Conclusion: Adapting Strategies for Private Equity in Shifting Market Dynamics

The trends observed underscore the adaptability and strategic foresight of PE buyers in crafting comprehensive purchase agreements in a challenging market. The resurgence of holdbacks, the strategic use of earn-outs and RWI, and the delicate negotiation dynamics around cash dynamics reflect a concerted effort by private equity parties to strike a balance between risk and opportunity in an increasingly volatile market.

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