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Highlights from the Latest American Bar Association Deal Points Study

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Canadian Private Target M&A – Deal Points Study: Including Transactions from 2020, 2021 & 2022

For the first time in seven (7) years, in an important development for Canadian dealmakers, the ABA published its Canadian Private Target M&A Deal Points Study (the Study) in February 2025. The Study analyzes transactions executed in 2020, 2021, and 2022 and is the first ABA Canadian private M&A deal points study since the 2018 edition. The Study analyzes 83 definitive agreements executed between 2020 and 2022 involving Canadian private targets purchased or sold by public companies. The Study excludes transactions having a value of less than C$5,000,000. The Study is a leading resource in answering a strategic and basic transaction question: "what is market?"

The Study is a useful tool for M&A advisors in that it offers data on various terms negotiated in a definitive agreement. This summary of highlights select trends in Canadian private M&A noted in the Study with respect to: (i) representations, warranties, and covenants; (ii) post-closing purchase price adjustments and earnouts; and (iii) indemnification provisions. It is noted that the Study provides more fulsome and detailed discussions on each of the aforementioned trends, as well as many others not covered by this summary.

Representations, Warranties, and Covenants

The Study provided that the use of a *"No Undisclosed Liabilities"* representation increased to 88% from 79% in the 2018 edition. Further, the use of a *"Full Disclosure and/or 10b-5"* representation increased to 43% from 38% in the 2018 edition. Although this trend sees an increase in the allocation of risk shifted to vendors, the risk is often mitigated by including knowledge qualifiers in the definitive agreement. New data shows the use of additional representations including: *"Me Too," "Cyber Security,"* and *"Privacy,"* as parties seek to allocate and mitigate risks associated with misconduct, data collection and privacy breaches.

In M&A transactions, unknown target liabilities are typically addressed in different ways throughout the definitive agreement. A *"No Undisclosed Liabilities"* representation is one of the principal representations in a definitive agreement pursuant to which the vendor and the purchaser allocate the risk of unknown target

liabilities between themselves. A *"No Undisclosed Liabilities"* representation may take various forms, but generally involves the vendor making statements to the purchaser certifying as to the absence of target liabilities that are not otherwise identified or disclosed (whether addressing specific liabilities or referencing all liabilities). The purchaser typically desires that the vendor make an unqualified *"No Undisclosed Liabilities"* representation to the greatest extent possible in the definitive agreement. Specifically, the purchaser wants to ensure that the representation includes minimal exceptions and covers the maximum universe of reasonable potential liabilities.

One representation and warranty that the purchaser often requests is commonly referred to as a *"Full Disclosure and/or 10b-5"* representation. This name is a reference to the United States Securities and Exchange Commission's Rule 10b-5, promulgated under Section 10(b) of the United States *Securities Exchange Act of 1934*. Clause (b) of Rule 10b-5 makes it unlawful, in connection with the purchase or sale of any security, to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading." Most *"Full Disclosure and/or 10b-5"* representations track this language at least in part. Depending on who you ask, the *"Full Disclosure and/or 10b-5"* representation is either a completely innocuous representation intended to backstop the other more specific representations and warranties in the definitive agreement, or it is a "catch-all" that can be very dangerous to the vendor. For this reason, vendors should be very cautious about including such a representation in a negotiated definitive agreement.

With respect to interim period covenants, the Study noted the inclusion of *"No Shop/No Talk"* provisions which increased to 82% from 64% in the 2018 edition – of this subset, only 12% of transactions contained an express *"Fiduciary Out"* for the board of directors of the vendor. A *"No Shop/No Talk"* provision is a protection afforded to most purchasers that would prohibit the ability of the target to solicit alternative offers. The *"Fiduciary Out"* exception allows the target to consider an alternative offer that would maximize shareholder value. The *"Fiduciary Out"* exception tends to limit the alternatives and makes the parties contemplate and specifically define what makes an alternative offer "superior" to the current offer in the definitive agreement. As such, the expected inclusion of *"No Shop/No Talk"* and *"Fiduciary Out"* provisions tend to be negotiated between the parties during the letter of intent stage to ensure the purchaser and the vendor are in agreement in respect of their inclusion in a definitive agreement and are further refined and settled upon in respect of the parameters of such provisions in the definitive agreement.

New data shows that 47% of transactions precluded the vendors (or their principals) from competing with the target or the acquired business or from soliciting employees and customers of the target or purchaser after closing with the use of a *"Non-Compete/Non-Solict"* provision. This restrictive covenant is usually included at the request of the purchaser to protect its investment. Although the enforceability of a *"Non-Compete/Non-Solicit"* provision can be challenging in an employment context, the provision tends to be enforceable in a commercial context if its terms are reasonable in scope, duration and geographic area, as determined by a court of competent jurisdiction. This was most recently reaffirmed in the recent Ontario Court of Appeal case, *Dr. C. Sims Dentistry Professional Corporation v Cooke*, 2024 ONCA 388.

Post-Closing Purchase Price Adjustments and Earnouts

The Study notes a 25% decline in post-closing purchase price adjustment provisions, from 79% in the 2018 edition to 54%. 64% of post-closing purchase price adjustments were based on more than one metric, with working capital being the primary metric. Preparation of the closing date balance sheet is increasingly completed by the purchaser, up to 78% from 59% in the 2018 edition. Post-closing calculations are often prepared in accordance with Generally Accepted Accounting Principles (GAAP) (55%) or in accordance with GAAP consistent with past practices of the target (36%). In M&A transactions, a purchase price adjustment is a mechanism in the definitive agreement that adjusts the final price based on the target company's financial condition as at closing, protecting both the purchaser and the vendor from unforeseen changes between valuation and closing.

A typical post-closing purchase price adjustment is the *"Net Working Capital Adjustment"* provision in a definitive agreement. For example:

- if the purchase price, without adjustments, is C$35,000,000 and includes C$2,000,000 of working capital held by the target on the date the definitive agreement is executed;
- the target operates in accordance with past practice, and, on closing, the target holds C$1,500,000 of working capital;
- the purchaser prepares and delivers to the vendor a closing date financial statement, demonstrating all of the assets and liabilities of the target as of the closing date and, therefore, a shortfall of C$500,000 in the working capital of the vendor; then
- the post-closing purchase price adjustment, usually on an upward or downward dollar-for-dollar basis, would provide a mechanism to return C$500,000 to the purchaser to make the purchaser whole.

The inclusion of these types of provisions is not intended to allocate risk between the parties as much as it is meant to keep the parties as close to the true purchase price and valuation of the target as of the date of execution of the definitive agreement. If there was excess working capital in the example above, the provision would operate to deliver the excess working capital to the vendor.

Parties may be unwilling to spend the extra time and expenses associated with preparing and reviewing closing date financial statements and instead may be more inclined to have certainty with respect to the purchase price and the operation of the business in the interim period (for example, by maintaining agreed upon levels of inventory).

The Study noted that transactions with earnouts have increased to 31%, up from 18% in the 2018 edition. The most common earnout period was between 18 to 24 months. Of those transactions with earnouts, 28% used a revenue/turnover metric, 14% used earnings before interest, taxes, depreciation, and amortization

(commonly referred to as *EBITDA*) and 17% used a combination of the two metrics. In M&A transactions, earnouts are a contractual arrangement where a portion of the purchase price is contingent on the acquired business achieving specific performance targets after the transaction closes, acting as a bridge for valuation gaps and aligning interests between the purchaser and the vendor. Most earnouts tend to include additional incentives for management to encourage sustained performance or growth well after the transaction closes. Drafting a clear and well thought out earnout mechanism is crucial to avoid post-closing disputes. In addition to how the earnout is calculated and by whom, parties may consider adding terms to the definitive agreement that obligate the purchaser to perform or refrain from taking certain actions post-closing (for example, to continue to operate the business consistent with past practice, and to refrain from re-branding a certain popular product, which may affect revenue).

Indemnification

"Sandbagging" or the right of an indemnified party to seek indemnification regardless of whether it had knowledge of a breach of a representation, warranty or covenant before closing, is also covered in detail in the Study. 18% of transactions included an express *"Sandbagging"* provision, down from 34% in the 2018 edition. Only 8% of transactions had an express *"Anti-Sandbagging"* provision, down from 12% in the 2018 edition, while 10% of transactions had an express *"Pro-Sandbagging"* provision. In everyday language, *"Sandbagging"* means to conceal or understate the strength of one's position to gain an advantage over a competitor. The term applies in the M&A context when the purchaser learns of a breach of a representation, warranty or covenant before closing but says nothing about it until the transaction has closed – at which point it brings an indemnity claim pursuant to the definitive agreement. An *"Anti-Sandbagging"* provision is vendor-friendly as it limits the purchaser's post-closing remedies for a vendor's breach of a representation, warranty or covenant if the purchaser had knowledge of such breach prior to closing (typically through knowledge gained pursuant to the due diligence process).

Most survival periods (or the time to assert claims under an indemnity provision) range from 12 to 24 months (23% at 12 months, 19% at 18 months and 26% at 24 months). Less than 7% of all transactions had indemnification periods longer than 24 months. The Study notes that certain fundamental representations and warranties, such as those in relation to ownership of the securities or assets being acquired by the purchaser, may be carved out from the survival period and last indefinitely.

The use of a *"Deductible"* in an indemnification provision has increased to 46% in the Study, up from 32% in the 2018 edition. 49% of transactions reported the purchase price as the maximum amount that can be claimed under the indemnity provisions in the definitive agreement, up from 24% in the 2018 edition, offering more protection to purchasers.

In an M&A transaction, a *"Deductible"* provides that an indemnifying party does not have an obligation to indemnify the other party until the amount of the losses suffered by the indemnified party exceed a certain

threshold, which is the *"Deductible"*. For example, a vendor may be obligated to indemnify the purchaser if the aggregate losses from the claims exceed CAD$300,000. If the purchaser suffers losses of CAD$400,000, then the vendor will be obligated to indemnify the purchaser for the delta of CAD$100,000. This shifts some of the risk to the purchaser and encourages the purchaser to mitigate their losses in any potential indemnity claims.

The Study found the use of representation and warranty insurance (RWI) to be low (approximately 15% or 13 of the transactions studied). This is expected given that transactions with a lower value are unlikely to include a RWI policy. In those transactions where RWI was obtained, it was most common that the purchaser and the vendor both covered the expenses for obtaining the RWI policy on a 50/50 basis. In 31% of the transactions that included an RWI policy, there was an express obligation on the purchaser to pursue claims under the RWI policy. The vendor typically looks to reduce the risk of being on the hook for an indemnification claim. The definitive agreement often mandates that the purchaser pursue a claim *via* the RWI policy first, rather than allowing the purchaser to choose the claims procedure at the purchaser's own discretion, mitigating the vendor's risk. According to the ABA's 2023 Private Target Mergers and Acquisitions Deal Point Study (the United States Study), RWI is an increasingly important feature of private M&A transactions in the United States. More than half (55%) of the transactions in the United States Study expressly reference a RWI policy. In Canada, RWI policies are becoming more commonly used in transactions where the target is widely held and recourse against individual shareholders, following closing, is difficult. Although the inclusion of a RWI policy remains less frequent in Canadian private M&A transactions to date, we expect in the coming years that it will become more common practice to include them as the policies become more economically justifiable.

Conclusion

The Study does not include data on every private M&A transaction in Canada as it relies only on public information filed on the System for Electronic Document Analysis and Retrieval (SEDAR+), but it continues to provide valuable insights into the current trends shaping Canadian private M&A transactions. The careful use of post-closing purchase price adjustments and the strategic negotiation of representations, warranties, covenants and indemnification provisions are indicative of the evolving M&A landscape. By understanding and effectively leveraging these elements, parties can navigate the complexities of M&A transactions with greater confidence and success.

According to the Study, Canadian market practice is trending towards convergence with the United States in some respects (for example, including a *"No Undisclosed Liabilities"* representation and a *"No-Shop/No Talk"* covenant), but remains different in others (for example, in the United States, 92% of transactions had post-closing adjustments versus 54% of transactions in Canada). Differences can be due to a range of factors including the different regulatory regimes, applicable corporate and securities laws and as a result of the typically larger size and the nature of the transactions in the United States.

As the market continues to evolve, staying abreast of these trends and best practices is crucial for legal professionals and stakeholders involved in private M&A transactions. With the right strategies and tools, the potential for closing successful and mutually beneficial transactions is greater than ever.

If you have any questions regarding this summary, the Study or M&A transactions generally, please contact the authors or any other members of our Mergers & Acquisitions team.

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.