Other People's Money: The Evolution of Dealing with Financing Execution Risk in LBO & Strategic Mergers

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Having started my legal career in 1980, I had the pleasure of watching the modern M&A boom grow into a huge practice area, at the same time I was developing from a young inexperienced associate to a now grey-bearded practitioner. Those exciting 1980's also brought with it the birth of Private Equity—differentiating from strategic transactions in perhaps the greatest extent by the fundamental need for other people's money.

In those early years, from the 1980's to roughly 2005, the dichotomy between PE deals and strategic deals where one corporation bought another was reflected in large part in their approaches to financing conditionality. Generally, strategic buyers used their own balance sheet and did not have a "financing condition" enabling them to walk away from the deal if they did not have the money to close (except with very few exceptions where the acquisition might be very material relative to the size of the buyer), and the strategic buyer would be subject to specific performance requiring it to close the deal and be liable for damages if it did not close, based on a negotiated but relatively customary package of conditions. While the strategic buyer may well choose to obtain financing for the transaction, they had a high level of assurance in receiving it, and it was the buyer's risk to do so.

On the flip side, the classic PE model would have almost all purchase obligations be in a newly created shell company, and require other people's money based on the credit of the acquired company to make the deal happen, using a combination of equity from the PE firms' investors and debt placed on the target company at closing in a combination of bank loans and high yield bonds. While the deals would provide for specific performance, throughout this period the contracts had a financing condition relieving the PE purchaser from the obligation to close if the debt financing was not available at closing, predicated on a recognition that without the other people's money, the deal just could not occur. Remarkably, throughout this period there were very few failures for deals structured this way to close as a result of financing, based in large part on the critical importance to the PE sponsors' reputation of getting the deals done.

In 2005, with the $11 Billion SunGard Data Systems sale to a PE consortium, the PE structure began to evolve away from the use of financing conditions. The target board there felt uncomfortable with the exposure and wanted something more. But with that change got ushered in a new paradigm for financial conditionality, but not necessarily less risk. In return for the elimination of the financing condition, the paradigm from 2005 to 2007 became no more specific performance against the PE buyer, and while the absence of the financing condition meant the buyer might be in breach of the purchase agreement if it could not close due to a lack of financing, the contracts effectively precluded <u>any</u> claim for damages other than the collection of a so-called reverse break-up fee of approximately 3 percent (generally reciprocal with the target company's fiduciary break-up fee), and the buyer entities were still shell companies backed by a limited guarantee of the PE sponsor to pay the reverse break-up fee if required.

While the impact of a financing failure would now carry a monetary cost, interestingly, in that early era, the remedy limitations and reverse break-up fee covered even non-financing breaches by the buyer, providing theoretical optionality to the buyer beyond just failure of financing. This would come to haunt sellers with the financial meltdown that occurred in late 2007/2008. That period experienced an unprecedented number of broken PE deals (at least 24). Oddly, while the failure of financing post-SunGard came with a stated cost, the presence of the reverse break-up fee effectively priced the optionality of the deal in the eyes of the players, and under the stress of that period, legitimized deal failures to a far greater extent than in the pre-SunGard era.

The intervening 5 years from 2008 saw the conditions for PE recover slowly with the first U.S. PE deal since the recession over $10 Billion not coming until 2013, when we saw both Dell and Heinz at around $20 Billion. The financing conditionality paradigm post-recession held relatively stable for PE deals, notwithstanding the deal dislocation during the recession and early expectations that sellers would demand much less conditionality. Today you generally see what we call the "financing failure model," where specific performance is available to enforce the financing covenants and, if the debt financing is available, to force the buyer to draw down the equity financing and close the deal. If financing is not

available, there is no right to specific performance but buyer will have to pay a reverse break-up fee—now generally at a significantly higher level than in the pre-recession period, with mean levels approaching 7 percent of equity value.

And what of the strategic buyer? Where have the corporations faired in all of this? In 2007 then Vice Chancellor Strine in Delaware questioned the dichotomy between PE and strategic deals in the use of reverse break-up fees and accompanying conditionality in the well-known *Topps Company* case. But instead of PE deals becoming more strategic as many thought at the time, some strategic deals have included financing conditionality and reverse break-up fees, particularly after the lessons of the post-2007 meltdown, with examples like Dow Chemical/Rohm & Haas.

In general, strategic deals remain for the most part "old school", *i.e.*, full specific performance and full damages and no financing conditions. Where the realities of the financing need for other people's money is at a critical enough level, and a strategic buyer is willing to weaken the strength of its bid by including a financing condition of some type, then we will sometimes see a version of financing conditionality utilized in a strategic deal. Sometimes it would be a stated financing condition with a similarly sized fee triggered on its use, sometimes a PE-like financing failure model with a similarly sized reverse break-up fee. A non-comprehensive survey we have done of larger public strategic deals in the last 5 years shows about 13 percent of them having some form of financing optionality.

So, while the tension between the needs of buyers and sellers of necessity focuses on deal conditionality almost as much as deal value, the realities of financing and the variability of economic conditions always require us to be objectively responsive to the need for other people's money.

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This January-February issue is a special one, featuring some of the more prominent members of the M&A bar—tackling different topics as they look forward and looked back. The March-April will continue with this theme, as several more entries will be included in that issue. Looking forward!

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