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DEALMAKING

Expert Analysis

Evolving Agreements Offer Flexibility in Credit Crunch

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While the pace of M&A activity has been subdued, the significance of contractual developments in dealmaking has been pronounced. Over the past year, the difficulty of the credit markets has resulted in significant developments in how practitioners draft cash acquisition agreements for strategic buyers (e.g., corporate buyers seeking to further their strategic objectives). These developments have resulted in such buyers having greater flexibility in deciding not to close, particularly if the reason is financing related. These changes have been especially pronounced in multi-billion dollar transactions where the buyer is dependent on third party financing to effect the proposed transaction. This trend began with strategic buyers utilizing the termination provisions used in private equity deals under which a seller's only remedy if a buyer were to fail to close were a fixed fee from the buyer (i.e., a reverse break fee). In such cases, this reverse break fee structure was analogized to an option or referred to as providing the buyer with "optionality." The practice has, however, now developed beyond the use of the reverse break fee model as utilized in private equity deals. Although there are variations in the benefits of these provisions to prospective buyers, a common element is that they mitigate the risk to a buyer from failing to close due to a financing failure.

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Private Equity Precedent

The optionality used in recent strategic deals was based on a structure used in private equity deals that developed after 2005. Prior to 2005,

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private equity transactions were structured with the private equity firm forming a shell company that entered into the acquisition agreement and undertook the obligations contained therein. There was no risk to the private equity firm, as distinguished from the shell company, other than reputational risk and the theoretical possibility of piercing the corporate veil (i.e., disregarding the corporate entity and treating obligations of the shell company as obligations of shareholder/owner). Further, the acquisition agreement was typically conditioned on the availability of financing (although the shell company often agreed to be subject to the remedy of specific performance pursuant to which it could be required to use its reasonable best efforts to obtain financing). Given that the shell company was without resources, sellers were put in the position of relying on the reputational risk to the private equity firm if its wholly owned shell company breached its obligations as well as the possibility of veil piercing. This latter risk was viewed as remote but the consequences were grave if realized.

Beginning in 2005, the private equity structure utilizing financing conditions as described above was superseded by a reverse break fee structure. This structure arose out of a desire by sellers to eliminate the financing condition and reduce the reliance on the reputational risk to the buyer arising from a breach. Under this structure, a break fee of roughly 3 percent was payable by the shell company for a failure to close, which fee was guaranteed by the private equity firm. This created significant optionality for the private equity firm as it guaranteed the payment of a fixed fee, but the firm was no longer subject to the in terrorem risk of veil piercing or any other liability. Moreover, although there were exceptions, the norm that developed was that even the shell company was not subject to specific performance. This meant that there was no risk that the shell company would sue the private equity firm under the equity commitments or lenders under the debt commitments. Some deals sought to increase the cost to the buyer of failing to close by providing that the private equity firm could be subject to, in addition to the reverse break fee, the payment of damages in excess of a break fee for a willful breach. Those deals were, however, a small minority.

The Dichotomy

As the optionality of private equity deals reached its zenith, the distinction between how private equity and strategic deals were structured became even more pronounced. Historically, strategic deals were structured without a financing condition and with an express provision entitling both parties to specific performance. Moreover, these deals did not provide for either a reverse break fee or a cap on damages. To be sure, there were valid reasons for this dichotomy as the shell company, in contrast to a strategic buyer, had no capacity to "make good" if there were a breach. In addition, the capability of a private equity firm was not analogous to a strategic buyer. While private equity firms had some access to funds through the commitments of their limited partners, any losses arising from a breach would need to be funded through capital calls (subject to any limitations contained in the relevant limited partnership agreements). Nonetheless, practitioners and commentators increasingly took note of this dichotomy. Indeed, Vice Chancellor Strine questioned why this dichotomy exists in the *Topps* decision stating that the factors driving the dichotomy "seem to include both economically rational ones and ones that are less rational."[1]

The extent of broken deals beginning in late 2007 caused dealmakers to reassess the limits of optionality. The best example of the downside of optionality was the sale of United Rentals Inc. where the buyer, Cerberus, unabashedly chose to pay the break fee rather than close, despite the absence of any material problem in the URI business. In order for a seller to avoid URI's fate, the principal provision that would provide greater comfort is specific performance. Specific performance against the shell company, which was relied upon before the advent of the reverse break fee and on occasion thereafter, addresses optionality by virtue of forcing the shell company to enforce its equity commitments against the private equity firm and the debt commitments against the banks. To be sure, there is some uncertainty as to whether the courts will enforce specific performance against banks (i.e., courts of equity may treat lending obligations as a fungible commodity). Nonetheless, any uncertainty over enforcing the obligations of the lenders can be substantially addressed by a three-part linked set of obligations consisting of (i) the commitment papers providing for specific performance against the banks, (ii) the commitment papers granting third party beneficiary rights to the seller and (iii) the merger agreement providing for specific performance against the shell company.

Many practitioners expected that private equity deals would provide sellers with greater certainty following the string of broken deals in late 2007 and early 2008. Despite those expectations and notwithstanding that a path to certainty was available, in the immediate post-2007 environment virtually all meaningfully sized private equity deals continued to rely on the reverse break fee model that was akin to an option for the private equity firm. The uncertainty in the financing markets substantially contributed to the unwillingness of the private equity buyers to accept reduced optionality in their deal structures. Specific performance against the buyer was rarely incorporated into acquisition agreements, not to mention the absence of any bank willing to agree to specific performance with respect to its obligations. Indeed, some agreements added additional conditions, such as a minimum EBITDA condition (generally parallel to the conditions in the bank commitment papers). The most prevalent concession to a desire of sellers for greater certainty was an increase in reverse break fees, with the high end of the range moving from roughly 4 to 6 percent. But even some of the break fees reflected the difficulty of the financing markets as two-tier fees were used with a lower fee if the closing did not occur due to a financing failure rather than a willful failure.

> The nature and extent of the conditions that a seller will be willing to accept will be affected by both the price and pressure on the board to sell. The buyer will be influenced by the relative size of the deal to the buyer, the amount of third party financing and the extent of other bidders.

Since September 2008, there has been little evidence upon which to evaluate the evolution, or lack thereof, of the reverse break fee model used in private equity deals given the lack of private equity deals. Indeed, since September 2008, when Lehman went bankrupt, there has been only a de minimus number of traditional public to private deals for a U.S. target in excess of $150 million that have been effected by a private equity firm.[2]

Duplicated Structure

Beginning in 2008, a number of strategic cash deals began to duplicate the private equity reverse break fee structure. While buyers made the argument of symmetry, the state of the financing markets was the most decisive factor fueling the use of the reverse break fee structure. In addition, dealmakers were aware of Finish Line potentially being ordered by the court to complete its highly leveraged acquisition of Genesco at a time when UBS was equivocal regarding its obligation to fund the acquisition pursuant to its commitment letter. Buyers also benefited from the lack of competition. While many strategic cash deals did not use the reverse break fee structure, a sufficient number of deals, particularly where the buyer was dependent upon a significant amount of financing, were using that structure to signify a trend. In general, there has been significantly more strategic activity than private equity activity because the extent of leverage in private equity deals has made financing more difficult than is typically the case in a strategic acquisition. This was particularly pronounced after the Lehman bankruptcy in September 2008.

In April 2008, the Mars/Wrigley deal became the first strategic deal to be structured with a reverse break fee termination provision as used in a private equity deal. The remedy for any breach was limited to a reverse break fee (approximately 4.3 percent of purchase price); the remedy for specific performance was expressly unavailable. If there were a breach by Mars because the banks failed to fund or for any other reason, then the only liability of Mars was the reverse break fee. Moreover, one should note that the Mars deal was in many respects structured as a private equity deal. The debt commitments incurred by Wrigley were without recourse to Mars and the equity portion was provided by Mars pursuant to equity commitments to a newly formed shell acquisition vehicle. The Mars approach was repeated in the JDA Software/i2 Technologies deal in August 2008. Unlike the Mars transaction, however, the JDA Software deal was terminated after a failed renegotiation and the buyer paid a reverse break fee.

As the application of the private equity model to strategic deals evolved, sellers recognized the difficulty of the financing markets but questioned the appropriateness of full optionality. The rationale for modifying full optionality was that acquisition agreements should be tailored to the difficulty of the financing markets rather than allowing the buyer to walk for any reason. This variation on the Mars/Wrigley model provided that the remedy for a financing failure was a reverse break fee with no specific performance for such financing failure. Other than in connection with a financing failure, however, the standard remedies of damages and specific performance would be available. Examples of transactions that adopted this structure include King Pharmaceuticals/Alpharma, Ashland/Hercules and Brocade/Foundry.

Another variation of optionality did not allow for the remedy of specific performance but provided for unlimited or "capped damages" with a cap at a substantially higher level than a typical reverse break fee. The common link with the other private equity model deal structures was that the buyer could walk away from the deal and only be subject to damages. Examples of deals that used this structure included MidAmerican Energy/ Constellation and AT&T/ Centennial.[3]

A New Paradigm

The conditions that led strategic buyers to adopt the private equity model have continued to persist. The credit markets continue to affect the deal structures for larger deals dependent on third- party financing in two respects. First, buyers remain mindful of the risk that banks will not perform and that the buyer, without being able to obtain specific performance, would be left in a vulnerable position. Second, banks have introduced greater conditionality in their commitments as they seek to limit their syndication risk in the event of post-signing adverse developments. Until banks are willing to take on more financing (or syndication) risk, strategic acquisitions may increasingly require financing conditions (as variations of the private equity reverse break fee model) in cash deals. In addition, the financing problems that arose in the Dow Chemical/ Rohm & Haas transaction and the subsequent litigation and price renegotiation further deterred some buyers in cash deals from agreeing to an acquisition without a safe exit.

In this environment, practitioners have continued to seek a paradigm that balances sellers' desire for certainty, buyers' need to protect against the difficulty of the financing markets and lead lenders' fear of being unable to lay off their exposure. To many, the recent balances struck in the Pfizer/ Wyeth and Merck /Schering-Plough transactions—similar to reverse break fee termination provisions triggered only on financing failure—are appealing models for balancing the risks of financing and non-performance.

In the Pfizer/ Wyeth transaction, the merger agreement contained a financing condition. The exercise of this financing condition by the buyer requires a large liquidated damages payment (approximately 6.7 percent of purchase price). The condition is limited solely to a financing failure due to (i) the combined entity not receiving a specific credit rating or (ii) the occurrence of a material adverse effect. These terms were driven by and identical to the terms of Pfizer's $22.5 billion debt commitment letter which contains parallel conditions to the conditions in the merger agreement. Both parties are entitled to specific performance under the merger agreement. Accordingly, if the banks fail to perform under their commitments, Wyeth can attempt to ensure the financing condition is satisfied by forcing Pfizer to seek specific performance against the banks (e.g., sue the banks).

The Merck/Schering-Plough deal is similar to the Pfizer/Wyeth deal and also contained a financing condition. There is no obligation for Merck to close unless financing is available (technically embedded in the timing of closing provision). The financing condition is more favorable to Merck than the Pfizer formulation as it extends to a financing failure for any reason (not limited to credit ratings threshold or material adverse effect). The broad nature of financing failure was similar to early strategic deals that followed the private equity model. Merck is obligated to pay a fee (approximately 6.2 percent of purchase price) if the financing were not available in full at the drop dead date (after an automatic three month extension). Other than if financing were unavailable, specific performance is available from both parties. In that connection, if the banks fail to perform, Schering-Plough can require Merck to seek specific performance against the banks.[4]

The Merck and Pfizer formulations bear comparison with the private equity model with a reverse break fee for a financing failure. The explicit agreement in the Merck and Pfizer formulations on a financing condition may reduce the likelihood of litigation for failure to close. The use of such a condition may also better characterize the "deal" than a reverse break fee for a breach. As a substantive matter, however, the effect of both the potential new paradigm and the reverse break fee linked to a financing failure are substantially similar.

Conclusion

One should keep in mind, however, that there is no one size fits all for acquisition agreements despite the condition of the credit markets. The nature and extent of the conditions that a seller will be willing to accept will be affected by both the price and the pressure on the board to sell. The buyer will be influenced by the relative size of the deal to the buyer, the amount of third party financing and the extent of other bidders. Both parties will, of course, take into account market conditions and the conditions of the financing markets. The interplay of these factors may result in many bidders continuing to proceed without any form of financing condition while others require some form of reverse break fee or the paradigm reflected in the Merck or Pfizer transactions. The prevalence of those structures in deals dependent on a relatively significant amount of third party financing will, however, continue as long as a breach by banks of their funding obligations remains a reasonable possibility and banks remain unwilling to undertake the kind of syndication risks that was reflected in commitment letters before the credit crisis.

1. *In re Topps Co. Shareholders Litigation*, 926 A.2d 58, 72 n.11 (Del. Ch. 2007).

2. A recent exception to the standard reverse break fee structure is Apax's $530 million acquisition of Bankrate. In this transaction, Apax agreed that the acquisition vehicle would be subject to specific performance and, if specific performance were not available, Apax would guarantee payment of damages capped at the entire purchase price. This transaction, however, is not a traditional leveraged buyout as the deal is funded entirely with Apax's equity commitment and is not dependent on third party financing.

3. New York case law suggests that a seller cannot sue for "lost premium" damages of shareholders on a buyer breach, absent language to the contrary. The reliance on damages as a remedy puts more pressure to specifically provide that seller damages include the loss of premium, although Delaware law is less clear on this issue than New York.

4. Although in each of Merck and Pfizer the buyer was specifically obligated to sue the banks to enforce the equity commitments, a contrary position was adopted in the Brocade/ Foundry deal where the specific performance remedy explicitly excluded the obligation to sue the banks.