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M e m o r a n d u m

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Negotiated Cash Acquisitions of Public Companies in Uncertain Times

Until the current crises in the financial markets, negotiated acquisitions of public companies had been documented by a form of merger agreement which had evolved into an almost standard “seller friendly” template. This standard model agreement reflected the same factors which contributed to the vibrant M&A activity of recent years: readily available financing, rising stock markets, stable or improving economic and industry conditions, and high levels of confidence in business and financial fundamentals. Combined with the negotiating leverage provided to companies seeking to sell themselves by the generally large and seemingly ever-expanding universe of potential buyers, both strategic and financial, as well as sources of financing willing to assume syndication or underwriting risks, these factors resulted in merger agreements intended to provide sellers with a high level of certainty that a transaction would be completed. With the substantial erosion, if not disappearance of each of the factors underpinning the justification for the standard merger agreement, merger agreements should adapt to the new environment. Therefore, a new paradigm seems likely for acquisitions for cash in which the buyer does not have cash on hand sufficient to pay the acquisition price and any necessary refinancing of seller debt.

The typical pre-crisis acquisition agreement contained the following features highly favorable to selling companies:

- no financing condition – acquirors either arranged committed financing by the time an agreement was signed or were willing to accept financing risk

- limited other closing conditions – generally, required regulatory and stockholder approvals, absence of material adverse changes in the selling company, and accuracy of the seller’s representations as to limited business and financial matters (almost all of which stated that the representations only had to be true to the extent that any inaccuracies would not result in a material adverse impact)

- a material adverse change definition which allocated all but the most seller-specific risk to the buyer (for example, material adverse developments in the general economy or the selling company’s industry which had a comparable material adverse effect on the seller typically would not permit a buyer to cancel the transaction) and did not contain any quantitative standards for determining what constitutes a material adverse change (such as, for example, a specified percentage decline in EBITDA or revenues)

- often, a strong buyer commitment to resolve any regulatory or other obstacles to completing the acquisition
- a "fiduciary out" permitting the seller to accept a more favorable acquisition proposal and a termination or break-up fee of around 2 to 4% payable to the first bidder.

Two modifications to this model evolved as a result of the increasing frequency of sales to private equity firms, the "reverse break-up fee" and the "go shop".[1]

This was the state of the deal world immediately before the credit crises and the accelerating deterioration of economic conditions. Now that the world has changed or, at least, the perception of risk associated with a transaction has dramatically altered, will the merger agreement also undergo a sea change?

Now, it seems likely that the provisions of merger agreements will adapt to the new M&A and financing climate. As the concerns of both buyer and seller change to reflect our expulsion from dealmaker's Eden in which the greatest risk to closing was a topping bid to a world of great uncertainty, the merger agreement will incorporate the resolution of these concerns. Indeed, even after financial markets return to some semblance of normalcy, it should be expected that there will be heightened awareness of risks that were once thought to be extremely remote, if not, once in a lifetime (with the intended frame of reference being the lifespan of Methuselah and not that of a fruit fly), such as the almost complete disappearance of debt financing for even the most credit-worthy borrowers, and abrupt and substantial changes in individual company prospects. Therefore, it should be expected that lawyers, much like generals, will fight the last war and draft agreements to deal with these risks.

Reverse Break-up Fees: In the past, sellers have accepted reverse break-up fees as a financial stimulus to buyers to complete a transaction. In concept, a buyer should complete a transaction in the face of

1 The reverse break-up fee provided for a payment from the buyer to the seller if the transaction was not completed for reasons relating to the buyer, such as lack of financing. Until the market meltdown, PE firms asserted that the reputational risk of not completing an acquisition was too harsh for them not to consummate a transaction and, in fact, almost all deals did close until the past eighteen months. Reverse break-up fees were not new. Strategic buyers sometimes agreed to pay a fee to a seller if antitrust or other regulatory obstacles precluded completion of an acquisition. And in a different era, that of the greenmailer, buyers whose sincerity was questioned sometimes agreed to pay a reverse break-up fee if they did not consummate a purchase. Paul Bilzerian's acquisition of Singer in 1988 comes to mind. A "go-shop" permits the seller to actively solicit potential buyers after the acquisition agreement was executed. It was intended to deal with the perceived conflict of signing an agreement with a private equity firm (which would retain existing management and provide it with equity participation) without contacting other buyers. Absent this apparent conflict, such as in the case of a sale to a strategic buyer likely to dismiss the seller's senior management following the signing of the merger agreement, the agreement would permit a seller only to respond to competing bidders but would prohibit the seller from initiating contact with prospective purchasers. Some contagion of the "go shop" to strategic deals occurred when the seller either did not contact bidders other than the buyer or did not announce that it was pursuing a sale before the execution of the merger agreement.

unanticipated increased costs of financing (or unforeseen conditions to required regulatory approval) if the break-up fee cost is greater than that of the changed financing terms (or regulatory demands). However, the “in terrorem” effect of the reverse break-up fee had been mitigated by the practice of setting the reverse fee at the same amount as the break-up fee payment to the buyer by the seller in the event of a topping bid. Other than simplifying negotiations and a general sense of equity in treating buyer and seller alike, there is no logical basis for linking the size of the two fees. The topping fee is subject to the constraints imposed by courts on deal protection devices. The topping fee must be reasonable in the sense that it will not meaningfully deter competing bids or coerce selling stockholders into accepting a bid. Indeed, in a small number of transactions, the incentivizing purpose of the fee payable by the buyer has been manifest. In those instances, the reverse break-up fee payable by a buyer if regulatory approvals are not obtained have far exceeded the 2% to 4% range of topping fees. In the financing arena, the prior experience with private equity firms was a transaction involving a “shell” company with the payment of the reverse fee guaranteed by the equity firm. The size of the fee in those transactions was driven by business and not legal considerations.

Other than acquisitions subject to regulatory risk, transactions involving strategic acquirors rarely included reverse break-up fees. The strategic acquiror accepted financing risks and subjected itself either to a damage claim (or a specific enforcement action) if it could not complete the transaction. On the other hand, when the acquiror was a private equity firm, the PE firm did not accept the same risk as strategic acquirors. The PE firm did not subject its fund and other portfolio investments to possible damage claims if it were unable to complete an acquisition. Instead, the PE firm would commit a specified amount of capital and guarantee payment of a reverse break-up fee if it did not close. In this way, the reverse break-up fee assumed a new role, that of limiting potential liability of the buyer.

This second function, capping buyer liability, has been incorporated into a number of the strategic acquisitions that have been announced since the turmoil in the marketplace, such as the *Mars/Wrigley* transaction. In effect, if disruptions in financing markets prevent these strategic acquirors from completing necessary borrowings (or completing borrowings on acceptable terms), then they can avoid potentially catastrophic damage claims by paying the reverse fee. In essence, the acquirors can pay for a form of “force majeure” out to their obligation to close.

It seems likely that the reverse termination fee practice of PE deals will become increasingly common in cash acquisitions by strategic parties as a means of allocating financing risk between buyer and seller. It remains to be seen whether the use of the reverse break-up fee by strategic buyers will be confined to the inability to close because of lack of financeability or whether strategic buyers will be successful in obtaining broader “options” similar to those PE firms sometimes obtained in the past. If successful in expanding the scope of the reverse fee, a strategic acquiror could pay the fee in order to avoid consummating the acquisition of a company whose business has deteriorated dramatically even if the deterioration does not constitute a material adverse change. From the point of view of the seller, a reverse termination fee can be an acceptable business resolution of difficult issues. However, the seller must obviously focus on the potential impact of a failed transaction, such as a loss of key customers or employees, the "damaged goods" syndrome, and whether the buyer is adequately paying for its option. If it is clear that a transaction is not being completed because of general market or financing conditions and not seller-specific issues, then the stigma of a sale not being completed is greatly lessened for a seller and its assessment of the cost of a failed transaction may be less than in the past.

(An analogue to the reverse break-up fee is "earnest money" or an escrow. In acquisitions of real estate, even of multi-billion dollar portfolio of buildings, sports teams and, less frequently, private businesses, buyers have deposited a portion of the purchase price in escrow. The deposit is forfeited by the buyer if it does not complete its purchase under specified conditions. Although the functional equivalent of a break-up fee, it seems unlikely that escrows will be used in public company transactions in which the seller has confidence that the buyer has sufficient resources to pay a reverse break-up fee. If sellers request an escrow, they may face an unwelcome request by a buyer that sellers place the breakup or topping fee in escrow as well.)

Financing Availability – Target Company Shareholders as a Source of Financing: In times less ebullient than the recently deceased deal market, buyers sometimes paid the purchase price in part with debt or preferred equity. Underwriting risk was eliminated and selling company shareholders received relatively liquid securities, at least in the case of larger, well capitalized strategic acquirors. Financial buyers also have offered "stub equity" as well as subordinated debt to selling company shareholders in a limited number of past acquisitions. The use of non-cash consideration other than acquiror common stock in future acquisitions to help finance acquisitions may, therefore, be a case of "back to the future". However, the pricing of debt and preferred equity securities in unsettled markets which have little or no appetite for securities of this type presents an issue that did not exist in the past. (In the past, buyer and seller agreed that interest or dividend rates would be set by their financial advisors shortly before closing so that the securities would be expected to trade at par on a fully distributed basis.) Obviously, it may be extremely expensive to price a security to trade at its face amount in extremely volatile trade and illiquid markets. Ceilings on interest or dividend rates may partly address this issue. Perhaps securities may be priced upon execution of the merger agreement. Indeed, the intention may no longer be to assure a short-term valuation at par. Rather, pricing may be based on a more hypothetical normalized market. Alternatively, the security may be viewed as part of an installment sale, in a business sense, and, therefore, contain sinking fund or mandatory redemption provisions. This would provide some prospect of future liquidity for selling company shareholders and might provide a basis for setting a lower coupon rate.

The fragility of financing commitments suggests that non-common equity security may be used not only as part of the initial deal terms but also as a pre-negotiated "backstop" if financing becomes available for an all cash acquisition. Selling companies may prefer to negotiate this backstop at the same time of the all cash acquisition agreement because it may perceive that it has greater leverage before a public announcement that it has agreed to a transaction. In the past, when an acquirer has needed the approval of its own stockholders for a common stock for common stock acquisition, the merger agreement has sometimes provided for the backstop use of acquirer preferred stock or subordinated debt if acquirer stockholder approval were not obtained.

Other Forms of "Seller Financing": With increasing uncertainty attaching to the future performance of selling companies, methods used to bridge pricing differences may become more common. Although most frequently employed in private company transactions, earn-outs can be applied to public company acquisitions. "Contingent Value Rights" or similar securities may also be part of merger consideration and can be tailored to specific situations. Similarly, warrants with cash settlement features also can be structured to provide value to selling stockholders only if certain performance targets are achieved. (A warrant of this type was proposed as part of the unsuccessful settlement discussions in the Sallie Mae dispute.)

Material Adverse Change: Most acquisition agreements provide that, if a material adverse change (MAC) occurs in the selling company's business or financial condition, the buyer can choose not to complete the acquisition without liability. A key aspect of the litigation arising from broken private equity deals has related to whether a MAC has occurred, permitting the buyer to walk away from the deal without penalty, or whether the absence of a MAC requires the PE firm to pay a reverse termination fee. In the past, buyers infrequently focused on MAC clauses in merger agreements. The exceptions largely involved known and relatively short-term risks specific to a target, such as pending litigation, contract renewals with specific customers or suppliers, or late-stage testing of a drug or other new product. Generally, however, buyer psychology in favorable economic times led to business decisions not to jeopardize a deal or antagonize seller management by arguing over risks which were perceived to be extremely unlikely to occur within the short time required to complete the acquisition. Consequently, buyers typically assumed all but the most target-specific risk of business change. Competition from other potential acquirors reinforced this approach. Now, however, the extraordinary has become almost ordinary. For example, if both selling company and industry-wide prospects fall 20% in a single quarter, will a buyer remain complacent that its obligation to close should remain unaffected? With the risk of unpleasant surprises perceived to be much greater and less competition among buyers for a target, it seems likely that buyers will reassess the old practice and, at some point, the change in buyer world view may lead to a paradigm shift in dealing with MACs.

MAC provisions in merger agreements of public companies have rarely included quantitative standards for determining whether a MAC has occurred. Typically, both buyer and seller followed precedent and tacitly understood that the benefit of having a non-traditional and, perhaps, less ambiguous standard was outweighed by the prospect of a difficult and, perhaps, unsuccessful effort to agree on an appropriate standard, such as a 15% drop in quarterly earnings. As the recent decision in the *Hexion/Huntsman* case confirms, this state of affairs favors the selling company because no Delaware court has ever found a MAC to have occurred in the acquisition agreement context.

Buyers may now focus on two different fronts in the MAC negotiating wars. First, they will more closely review the "standard" MAC definition which expressly excludes a lengthy menu of adverse developments and, consequently, allocates most general economic and financial market and geopolitical risks to the buyer. Generally, any ambiguity in the drafting of the MAC definition, which facilitated quick negotiation of an agreement, may give way to greater precision and specificity. Buyers may negotiate more limited exceptions to the definition of a MAC so that the risk of industry-wide business developments, even if not disproportionately impacting the selling company, are borne by the seller. There also may be a more specific risk factor allocation involving particular product lines, profit margins, collection of receivables, and other matters unique to the selling company.

Second, the principals may attempt to quantify a MAC by specifying changes in agreed upon metrics, such as EBITDA, revenues or margins. For example, whether the loss of a customer accounting for 20% of sales constitutes a MAC would be explicit under a quantitative standard but unclear under current MAC definitions.

Related to the effort to clarify MAC definitions is the possible use of additional conditions to the buyer's obligation to complete the acquisition. For example, there can be conditions that EBITDA, earnings or revenue be at least at specified minimum levels for identified time periods before closing. (If financing sources are expected to rely on certain selling company projections, deviations from these projections may be included as a closing condition or be integrated into a financing condition.) Similarly, buyers may insist that they receive certain assurances that key customers or suppliers do not object to the transaction before closing. Whether something similar to the practice of obtaining estoppel certificates in real estate transactions will be imported to public company transactions is questionable. However, buyers often have conditioned their acquisition of investment banking, advertising and high-tech companies on key employees agreeing to remain at their positions following completion of the transaction. A limited number of public company deals have included conditions relating to customer consents or assignment of key leases or licenses.

Express Financing Conditions: When financing sources were willing to assume syndication and underwriting risk (and there were no concerns about the viability of the financing sources), buyers often were able to obtain financing commitments at the time a merger agreement was executed which contained business conditions virtually identical to those in the merger agreement. The buyer could then eliminate the financing condition from the merger agreement. However, variations in financing commitments, such as market flex repricing provisions, exposed the buyer to some market risk.

As noted, some acquirors, including PE firms, relied upon the ability to pay a reverse break-up fee if they did not complete the transaction other than as a result of a MAC or the selling company's actions. In this way, at least a portion of the risk of obtaining financing was transferred to the buyer and the buyer capped its liability to the amount of the fee if financing were unavailable. Moreover, some agreements were drafted to provide the buyer with a more expansive option: it could choose not to complete the transaction and pay the reverse breakup fee. In an environment in which financing risk is widely recognized and few acquirors will be capable of completing an acquisition of substantial magnitude without third party financing, including an express financing condition to the acquisition agreement may be in the interests of both buyer and seller. The buyer will benefit from clarity, having additional time to arrange financing and the opportunity to address its obligations and those of the selling company in connection with arranging or finalizing financing. Rather than subjecting itself to a general "best efforts" or "reasonable best efforts" obligation to raise financing or the ambiguity of phrases such as "commercially reasonable terms", buyers may consider specifying acceptable deviations from either commitment letters or term sheets. Sellers may welcome the opportunity to limit the circumstances under which a buyer may abandon the transaction by paying the reverse breakup fee to only the inability to obtain financing on terms substantially consistent with specified parameters. The optionality that initially appeared in PE deals would be confined to the financing arena. To be sure, the seller would be achieving additional legal certainty but yielding certain of the in terrorem effect.

Buyer Best Efforts Covenants: Agreements usually contain an agreement by the acquiror to use best efforts or reasonable best efforts to complete the transaction. In transactions in which antitrust clearance is an issue, rather than relying on this general standard, the parties often negotiate very specific provisions establishing the standards and limits for divestitures or other actions to which a buyer must agree in order to satisfy regulators.

If financing is an issue, specifying the obligations of the acquiror may be desirable. Absent a provision of this type, disputes may arise about the amount of equity a PE firm must contribute to the transaction if lenders require less leverage. (In fact, this has been a source of contention with lenders in a number of broken PE deals. Additionally, litigation has arisen between a seller and a PE firm over whether the PE firm had to provide a guarantee to satisfy a regulator's concerns about the leverage of the post-acquisition company.) Similarly, changes in the key terms of financing, such as the interest rate, may be required to complete the financing.

When lenders are vigorously competing with each other to finance deals, buyers may accept an obligation to agree to changes in financing terms that is not clearly defined, such as commercially reasonable efforts. However, buyers may now propose more precise standards. In addition, sellers may seek to require buyers to sue sources of financing if these sources refuse to fund (or, alternatively, sellers may ask to become third party beneficiaries with the right to enforce the buyer's financing arrangements). (It should be noted that the parties' allocation of risk for the inability to obtain financing is related to, but slightly different than, the obligations of a buyer to accept changed financing terms. A reverse break-up fee may be payable if the buyer complies with its covenant to use best efforts to arrange financing but the financing is nevertheless unavailable. On the other hand, if the buyer breaches the financing covenant the parties may agree that potential damages are measured differently than by the fee, whether a higher fee or a "benefit of the bargain" damage claim or the right to specific performance. This is a matter for negotiation and was the subject of contention in the recent *Huntsman* case.)

Ticking Fees: The expectation used to be that cash acquisitions which did not entail regulatory issues would be completed between two and four months after the execution of the acquisition agreement. If the buyer were capable of structuring the acquisition through a tender offer, the transaction could close about thirty days after the start of the tender offer.

Buyers may now expect that two to three months may not be sufficient time for its acquisition financing to be completed. If the acquisition agreement contains an express financing condition, the acquiror will have until the "drop dead" date to complete the financing unless specific agreement terms address the financing process. In the past, some PE deals contained provisions specifying the timing of the financing process, particularly if 144A offerings were contemplated. Provisions of this type may become more common.

The principals will need to focus on the timing of the financing activities in relation to the vote of the selling company's shareholders. If the financing is not expected to be completed until well after the shareholder vote, will the acquisition price be increased to reflect the delay by means of an interest factor or ticking fee? Will the parties agree that the deal price reflects an anticipated closing up to a specified number of months after signing, such as six months, and, therefore, no purchase price increase is appropriate unless an extension past this deadline is needed? Will sellers prefer a slightly lower deal price and a ticking fee structure in order to provide the buyer with an incentive to close more quickly?

Fiduciary Outs/Timing of Shareholder Meeting: Generally, the right of selling companies to terminate the transaction in order to accept a more favorable acquisition proposal has expired at the time stockholders of the selling company vote on the acquisition. Merger agreements also required the seller to hold its stockholders meeting as soon as practicable. This meant that proxy materials would be filed soon after execution of the merger agreement and the stockholders meeting would be held within a month or so of SEC "clearance" of proxy materials.

In situations in which regulatory issues were absent and the buyer did not have the right to delay closing in order to finalize financing, the transaction would close shortly after the stockholders meeting. The short time period between the stockholder vote and consummation of the acquisition made the expiration of the fiduciary out upon the stockholder vote largely inconsequential, particularly in a robust M&A and financing environment in which potential bidders with access to numerous sources of financing had a number of months to submit a competing acquisition proposal before the seller's stockholder vote.

There were two exceptions to the virtual concurrence of the seller's stockholder vote and completion of the transaction: transactions involving extended antitrust review or requiring non-antitrust regulatory approvals, such as in banking, utility, or insurance deals, and certain private equity deals in which syndication efforts or 144A marketing were not pursued until seller stockholder approval provided certainty that the financing would be needed and should be priced. In both these circumstance, the practice was still to have the fiduciary out expire upon the stockholder vote. The rationale for this approach was that the selling company would have adequately shopped itself by the time of the stockholder vote, whether as a result of an auction process before execution of the merger agreement, a passive post-signing market check, or a post-signing go-shop process.

In light of changes in the financing climate, in the future buyers likely will seek the right to delay closings past the seller's stockholder vote in order to provide time to complete financing arrangements or to deal with unforeseen disruptions to financing markets. Sellers may reconsider the practice of terminating the fiduciary out before closing in this environment for a number of reasons. First, sellers may argue that their stockholders should not vote upon a transaction if the financing is uncertain. Instead, sellers may contend that stockholders should consider the transaction only when there is a high likelihood it will be completed. (It may be suggested that shareholders will be more likely to approve a sale when firm financing is supporting the transaction. Some stockholders may oppose granting a buyer an "option" on the seller if financing is highly contingent. Of course, the use of a reverse break-up fee to "penalize" a buyer (or to pay for the option) if it is unable to obtain financing will influence a shareholder's decision-making.) Second, the same financial market conditions which lead a buyer to defer closing also may deter potential competing bidders from submitting an alternative acquisition proposal. Extending the fiduciary out until market conditions permit the buyer to firm up its financing may provide competing bidders the additional time to submit credible topping bids. Finally, keeping open the possibility of a competing acquisition proposal until a buyer is in a position to close would conform the functioning of a one-step merger transaction to the effective operation of a two-step structure in which the buyer commences a tender offer and acquires untendered shares in a subsequent merger. A buyer will not purchase shares in a tender offer until it has financing to acquire all of the seller's shares. Until financing is available and shares are purchased in the tender offer, seller shareholders have the ability to evaluate current information and respond to competing acquisition proposals. A seller could argue that a buyer unwilling to employ a tender offer structure because it does not have financing should not place itself in a better position than if it had firmer financing and used the tender offer mechanism.

Force Majeure Closing Conditions: In an era in which one no longer takes the stability of financial and capital markets for granted and the continued viability of lenders is no longer assured, buyers may consider closing conditions relating to "force majeure" events. Whether the occurrence of certain events affecting credit markets or general business conditions, such as a sustained and severe decline in stock indices, are appropriate if a more focused financing condition is included in an agreement may depend upon relative negotiating leverage and specific circumstances.

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The provisions of an agreement providing for a cash acquisition are a product of a number of factors, including:

- the risks lenders are willing to assume and the strength of their balance sheets
- the competitive dynamic among potential buyers of a particular selling company
- the degree of uncertainty relating to closing a seller is willing to accept

The inertial tendency to adhere to customary forms and precedent in documenting an acquisition for cash may be overcome by the tremendous changes in financing and business risks. Most critically, the extraordinary events of the past year have dramatically reduced the ability of lenders to assume "market" risk in acquisition financing. As a result, the negotiating dynamic between buyer and seller must also change to reallocate the risks banks and other lenders no longer will accept. This new dynamic very well may make the negotiating process more difficult and lead to the evolution of forms of agreement more diverse than in the past.

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