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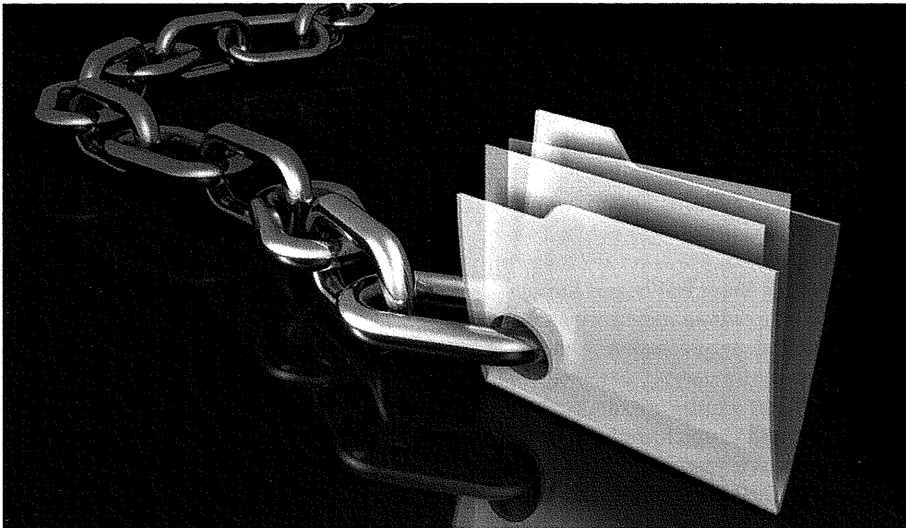
HUSCH BLACKWELL SANDERS LLP

M&A

Deal protection clauses in merger agreements

BY CLAIRE SPENCER



Financial turmoil and deteriorating economic conditions have underpinned a wave of broken M&A deals, which in turn has led to a sharp increase in litigation relating to deal protection. Many of these cases have been quite high profile and led to fears that a dangerous, litigious trend is developing in the M&A market. But this is not necessarily on the cards. Most of the transactions that were financed unrealistically by today's standards have been renegotiated, and new transactions are structured with a more risk-averse outlook. Suggestions that toughening economic conditions will result in more failures may be incorrect. Going forward, buyers, sellers and banks will look to structure their deals with an eye on troublesome areas such as material adverse change (MAC) clauses, specific performance and break-up fees. Ambiguity often breeds litigation, so there are good reasons for tying down the specifics in merger agreements.

Learning from precedent

The last year has seen a deluge of failed M&A deals. One of the main causes has been the shift in market forces. Some deals that were structured to make financial sense a year ago, when debt syndication was easy, look ill-advised now. This is what happened to the private equity firm Blackstone Group when they attempted to purchase Alliance Data Systems. Alliance Data maintains that Blackstone was attempting to delay the transaction's progress to satisfy the "unprecedented and unacceptable requirements" imposed on the transaction by the banks backing it. Frustrated with the delay, Alliance Data is in the process of suing Blackstone for the $170m break-up fee. A similar situation has cropped up for US radio operator Clear Channel Communications, which was on the verge of being acquired by private equity firms Thomas H. Lee Partners and Bain Capital at the peak of the private equity boom last year. As conditions worsened, the six banks involved got cold feet. Unlike the Alliance Data deal however, Clear Channel has joined forces with its prospective buyers, demanding that the banks fund the buyout as agreed last year. At the time of going to press, a resolution appeared imminent, with banks offering to fund the deal at a reduced purchase price of $36 per share, rather than the $39.20 per share offered last year.

Of course, market forces have not been the only problem. Last year, Bain Capital had to refer a deal to the Committee for Foreign Investment in the United States (CFIUS) on the grounds that it posed a threat to national security. Bain, together with China's Huawei Technologies, proposed a takeover of high technology group 3Com, but Huawei's lack of transparency and links to the Chinese government rang alarm bells with members of the House of Representatives. As a result Bain and 3Com volunteered to submit the deal for CFIUS evaluation. Bain pulled out of the deal in mid-March, citing the imminent block by CFIUS as an explanation. 3Com is still pursuing the $66m break-up fee, but Bain has not paid it as yet. No legal action has been taken.

The other main reason for attempted deal abandonment, particularly of late, is the invocation of the MAC clause. This was featured in three high profile cases in the last year, but with very different outcomes. In November 2007, Cerberus Capital Management withdrew from a £7bn deal to buy the tool hire firm United Rentals, due to the company's diminishing prospects. Cerberus had the option to cite MAC, but opted to pay the $100m termination fee – a decision upheld by the Court of Chancery of Delaware. Student loans company Sallie Mae also lost out when potential buyer J.C. Flowers used a MAC clause to get out of its potential tie-in without paying the $900m break-up fee. However, not all MACs are upheld, asserts Scott I. Sonnenblick, a partner in the New York office of Linklaters LLP. "In another deal involving athletics related retailers Genesco and Finish Line, we saw a material adverse change clause rejected on the basis that it was a generalised industry-wide effect in the footwear sector, which was specifically carved out from the application of the material adverse change clause in the acquisition agreement," he says.

This is just a snapshot of the litigious landscape, but it is clear that there is a lot going on in deal protection at the moment. The cases that do not end up in court, or else succeed in quashing MAC invocations, such as Genesco/Finish Line, are generally renegotiated using more reasonable terms. However, it is quite likely that what the market is seeing is an adjustment, rather than a long term trend. "We may see a few more deal protection cases, but the likelihood of a large number is not high," predicts Gary D. Gilson, a partner at Husch Blackwell Sanders LLP. "Parties have been

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aware of the difficult financing situation and operating downturns for some time, and have been factoring them into deal structures. Most of the deals that were caught in the pipeline at the time of the credit crisis and the earnings downturn have cratered or been re-worked," he says. Conditions are tighter, and deals are more difficult to conduct than they were a year ago, but neither of these necessarily means that a rise in broken deals is inevitable.

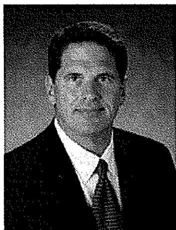
If buyers and banks have learnt anything from recent months, it is that failure to close a deal can result in legal action being taken against them. "If the alternative to closing a transaction would be litigation seeking to force the buyer to ultimately close that transaction, that risk may be outweighed by the perceived loss of value in the transaction that was originally agreed to," adds Mr Sonnenblick. "From a seller's perspective, challenging a buyer may help recover a reverse break-up fee or lost transaction premium, but such litigation can also serve as an ongoing distraction for both management and the market," he warns. Ideally, litigation should be avoided at all costs, and if recent cases have established anything, it is that the whole process should be more carefully crafted. Ambiguous break-up and remedy provisions exacerbate the potential for litigation, so all parties need to ensure that they incorporate an array of possible scenarios before finalising. For instance, reverse break-up fees can work well, but the parties need to understand how they work within a nexus of remedies. Drafting deal protection clauses is never an exact science, but if done carefully, should reduce the possibility of future conflict.

Drafting documentation

Buyers, sellers and investment banks should fully understand and appreciate the drafting process. From the vendor's viewpoint, it is often beneficial to conduct due diligence on the buyer, and the buyer's financing arrangements and sources. Mr Gilson believes that this should occur in auction processes as well as exclusive transactions. "Sellers should get evidence that the entire purchase price has been lined up. Commitment letters should be obtained from each debt provider, and contribution arrangements should be reviewed from each equity source. They should closely examine the conditions to those financing obligations. The seller may need to work with the bidder and the credit and equity providers in order to make these commitments as solid as possible," he suggests. Furthermore, recent cases such as Alliance Data/Blackstone have shown that solidity should not be based on 'best efforts' clauses, which are anything but reliable. The clause states that buyers must use their 'best efforts' to obtain regulatory approvals and take other steps to complete a deal, but there have been wildly varying interpretations of what 'best efforts' actually constitutes.

With specificity as the watchword, it is important to address the construction of MACs, specific performances and reverse termination fees, as these are traditionally the most highly negotiated areas when a merger agreement breaks down. "Each side should go into negotiations with a strategy based on the specifics of that deal," recommends Mr Gilson. "For example, the seller would naturally prefer to eliminate the MAC clause, or to make it as narrow, specific and objective as possible. The bidder would like a MAC clause driven by general future events and earnings. To this end, consider using monetary or revenue benchmarks or earnings percentages where relevant," he says. Both sides should be aware of what will occur if the terms of a clause are satisfied, and these outcomes are by no means uniform. In the Genesco/Finish Line deal, for example, Genesco's drop in earnings technically triggered the MAC clause, but Finish Line still had to complete the deal. Ultimately, the aim is to draft these elements so that no outcome can be second guessed.

If these steps are taken, it seems unlikely that there will be a significant increase in M&A related litigation going forward. Buyers in particular have been changing their approaches to align with market conditions, and have dedicated more time to ensuring that the target has satisfactory near-term operating results. Sellers are taking steps to ensure that financing is fully committed before proceeding with a deal. The increased frequency of M&A litigation has been a concern, but there is nothing to suggest that it will continue indefinitely. By drafting M&A agreements with care, and ensuring that each party knows what they are getting into – particularly in the problematic areas of MACs, specific performance and break-up fee clauses – litigation is ultimately avoidable. Breaking a deal is always an expensive experience, both economically and in terms of reputation and deal flow. Bidders rarely walk away from transactions lightly, and as such will be very careful about committing to deals in the future. ■



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