KIRKLAND & ELLIS LLP

KIRKLAND **M&A UPDATE**

October 2, 2009

Deal Certainty — The Fallacy of a New Market

Perceived departures from traditional deal structures are largely a reflection of a complex equation of a dozen or so contractual variables that interact with overall deal dynamics, including company-specific and secular market conditions, to produce a deal-specific outcome in the relevant post-crash transactions.

In the aftermath of the economic crisis that began in mid-2007, much ink has been spilled on the lessons learned by buyers and sellers regarding the pitfalls of deal certainty and the development of new paradigms for both financial and strategic buyers. Many assert that in the post-crash M&A market there has been substantial cross-pollination between the traditional deal structures used by those two categories of buyers in the pre-2007 period, with financial buyers being forced to accept deal terms that were once only demanded of strategic buyers and with strategic buyers demanding some of the looser deal commitment terms that previously benefited only financial buyers.

We argue that any attempt to identify a simplified new paradigm or market for basic deal certainty terms is an overly simplistic view of the deal market in these early days of recovery — rather, we believe that the perceived departures from traditional deal structures are largely a reflection of a complex equation of a dozen or so contractual variables that interact with overall deal dynamics, including company-specific and secular market conditions, to produce a deal-specific outcome in the relevant post-crash transactions.

Before outlining this proposition in greater detail, it is useful to briefly trace the history of divergence between deal terms in cash deals for strategic buyers and financial, or private equity, buyers.

Before 2005

Historically, there was a wide divergence between deal models for strategic and financial categories of buyers. Strategic buyers, with the backing of their balance sheets, were expected to commit fully to the completion of an announced cash acquisition backed by a provision providing for a specific performance remedy of the buyer's obligation to close. Sellers were comfortable relying on the potential to obtain such an order of specific performance to force a closing combined with an assumption that alternatively they would be able to collect lost premium in a damages action against a reneging buyer (noting that the validity of this assumption, at least under New York law, proved somewhat tenuous with the 2005 decision in the *Northeast Utilities* case).

By contrast, financial buyers were able to proceed with much looser legal commitment to the completion of a cash buyout. Financial sponsors, whose business model depended on borrowing a significant portion of the purchase price in order to leverage their equity investment, often benefited from the inclusion of a "financing condition" in their purchase agreements, meaning they were able, as a theoretical contractual matter, to walk-away from closing, usually without consequence, in the event debt financing was not available. At the time of signing, the financial buyer often delivered a negotiated debt term sheet and/or a "highly confident" letter from debt financing sources, with such documents providing little if any legal assurance that the debt in fact would be funded. A shell entity created by the financial buyer was the only party to the contract with the seller, meaning that, absent veil-piercing, any specific performance remedy would be largely ineffective.

Sellers accepted the financial buyer's argument that, as a repeat acquiror, the reputational damage associated with it walking away from any deal were so great that the optionality inherent in the deal terms was a negligible risk. With the very low incidence of failed deals, mostly a function of rational deal terms and levels of leverage and available liquidity in the debt markets, the effectiveness of reputational concerns as a constraint on financial buyers was never really tested.

The "LBO Boom" — 2005-2007

With the ascendancy of financial buyers as the key players in the buyout market beginning in 2005, private equity firms quickly deployed their rapidly increasing investment resources in combination with readily available debt financing to complete mega-buyouts featuring purchase prices in the billions, and then tens of billions, of dollars. While the model for strategic buyers remained unchanged, at the instigation of sellers legal remedies quickly bolstered, and then largely replaced, reputation as the main source of comfort offered to sellers by financial buyers as to their commitment to completing their buyout deals. On the surface, financial buyer deals were stripped of some of their traditional buyer-friendly provisions, with the deletion of financing conditions and an insistence on firm debt commitment letters with conditions that paralleled the conditions in the merger agreement. Similarly, sellers appeared to better appreciate the vacuity of negotiating remedies against a shell buyer as was prevalent in the pre-boom structure — instead, they demanded enforceable equity commitments or limited guarantees from the investment funds themselves to back up certain obligations of the shell buyer.

Beginning with trendsetter deals like Neiman Marcus and Sungard in 2005, contracts with financial buyers began to include a "reverse termination fee," which the buyer, backed by the fund commitment or guarantee, would be required to pay in the event the buyout did not close because of either a failure of financing and/or a buyer breach. Sellers believed that they had significantly upgraded their level of deal certainty as compared to the prior reliance on reputational arguments, assuming that a fee in the hundreds of millions of dollars was more than adequate to keep buyers on the straight and narrow.

However, financial buyers were able to reverse some of the impact of this apparently adverse development. Using the argument that, with the addition of a fund commitment or guarantee, the buyout firms needed, for the benefit of their limited partners, to be able to cap the maximum extent of the fund's exposure for a failed deal, the reverse termination fee, or a small multiple thereof, quickly became an absolute cap on the liability of the fund and its affiliates for any and all damages associated with the transaction, including the buyer intentionally breaching the agreement and walking away from the acquisition without excuse. The amount of the reverse termination fee (and, often, the damages cap) tended to mirror the reciprocal break-up fee that buyers demanded from sellers in the event the seller exercised its right to terminate the contract in order to accept a superior topping bid. While guidance from courts limited such seller break-up fees to around three percent because of fiduciary constraints, no such limitations needed to apply to the buyer's fee. Nonetheless, the apparent artfulness of symmetry won out over thoughtful efforts by sellers to distinguish the reasons for, and constraints on, the two fees and therefore their amounts.

While many variations on this construct developed (including, in a few cases, a further reduction in the percentage of the reverse termination fee in some mega-buyouts), the basic structure of a reverse termination fee and cap payable by the buyer for failing to close the deal remained a constant. A herd mentality took hold, and countless buyers and sellers replicated this approach, branding it the new LBO deal paradigm.

It bears mentioning that in a few deals sellers were able to wring a few concessions around the edges of this structure — a limited number of agreements included a specific performance remedy for the benefit of the seller (and therefore an avoidance of the mitigating impact of the liability cap) if the failure of the buyer to close was other than by reason of a financing failure. These admittedly small deviations from the general trend are reflective of the fact that, late in the LBO boom period, a few sellers realized that, in attempting to tighten a seller's legal remedies against a reneging financial buyer, they had unintentionally put a price — and a relatively small one at that — on the ability of financial buyers to simply walk away from a deal if it was no longer appealing.

In setting a contractual right for buyers to walk away upon payment of a negotiated legal penalty, sellers had unwittingly mitigated the reputational stigma that was previously at least a theoretical obstacle to a buyer's walking away from a deal. As the exit of financial buyers from certain deals signed up in the lead-up to the bursting of the LBO bubble shows, sellers had written a mispriced call option on their companies. Cutting through the legalities, financial buyers were in effect agreeing to pay a deferred strike price of about three percent of the target's value for a call option to acquire the company at a fixed price many months after signing. Particularly when compared to both the damage to the target of a failed deal and the potential loss of value that buyers avoided by exercising the option to walk away, the pricing by sellers on the reverse termination fees negotiated during this period looks especially misguided.

The "Bust"

With the sudden deterioration in the credit markets in mid-2007, the shortcomings from a seller's perspective in the boom period private equity buyout model quickly became apparent. Many buyers used the optionality of this structure, as well as, in some cases, other negotiated contractual provisions, to avoid closing (sometimes paying all or part of the reverse termination fee) or to renegotiate a more favorable price. With the deal market all but dead for the second half of 2007 and much of 2008, commentators spent much time dissecting the shortfalls of the models and questioning the bifurcation in deal terms required from strategic buyers and financial buyers. However, the moribund M&A market left little room to test where deal terms were headed and whether contract provisions were going to change in response to the lessons learned. Many predicted that, at the very least, the private equity deal model was dead and buried — never again would a seller rely on reputation or a mispriced option when an LBO firm came knocking with a buyout offer.

The Slow Recovery

As the credit crisis has slowly eased and the general economy improved, there has been a fitful uptick in cash buyout activity. With strategic buyers leading the way, financial buyers have also begun to slowly test the deal waters again. While the sample size has been admittedly limited, commentators have identified a number of general trends in the deals that have been announced. The common view is that there has been a cross-pollination, if not a convergence, of deal terms for these two categories of buyers. In fact, Vice Chancellor Strine of the Delaware Chancery Court questioned the absence of such an overlap in his 2007 *Topps* decision.

As examples, the sale to Nordic Capital and Avista Capital Partners of the ConvaTec business by Bristol-Myers Squibb and the acquisitions of Bankrate by Apax Partners and of Parallel Petroleum by Apollo are cited as evidence that private equity buyers are being forced into the traditional strategic buyer model with funded commitments for the full purchase price backed by specific performance obligations, and reverse termination fees are often disappearing completely.

On the flip side, the introduction of reverse termination fees of varying flavors into strategic deals such as Mars/Wrigley, Merck/Schering Plough and Pfizer/Wyeth (in the case of Pfizer, combined with a limited financing condition that triggers the payment of such fee) are pointed to as evidence of strategic buyers seeking some of the optionality that were the sole province of their private equity counterparts in the pre-bust period.

Of course, a number of deals in each space continue to be done in the pre-bust models, but the high profile departures from the norms described above have prompted breathless assertions of a new paradigm for dealmaking. In particular, the absence of a reverse termination fee in some private equity deals, and, conversely, the introduction of a reverse termination fee into some strategic deals, have been highlighted as presaging a seismic shift in deal models.

Is There Really a New Market?

We argue that the apparent crossovers between the two deal models are not reflective of a sea-change in the way deals are done in each of these two markets. Rather, we believe that these are simply examples of how buyers and sellers, with the breakdowns and lessons of the credit crisis still fresh in their minds, are recognizing that deal models do not exist as binary polar alternatives. Rather than the herd mentality in structuring deal terms in the two silos that was a feature of the overheated market of 2005 through 2007, parties are recognizing that deal terms and models, especially issues of certainty of closing, exist across a wide spectrum between the two poles represented by the pre-bust strategic buyer and financial buyer models. Applying the lessons learned on both sides in the litigious aftermath of the sudden demise of the credit markets, M&A principals and advisers are consciously applying a full range of contract variables that appropriately balance the rights of the parties within the framework of the deal-specific and overall market conditions applying at the time an agreement is struck. Reverse termination fees (or, for that matter, any other deal term) cannot be considered in isolation from the balance of the contract or from the time-specific and party-specific conditions relevant to the transaction at hand.

Without purporting to present an exhaustive list of variables that are factored into achieving an agreed outcome on contract terms, we suggest that the following list of variables is a representative outline of issues that interplay in a manner that is determinative of contractual deal certainty:

- Identity of the buyer as a creditworthy entity, a shell entity or a shell entity backed to a specified limited degree by a more substantial entity
- Extent and terms of financial support such as equity commitments or limited guarantees supporting shell buyers, and ability of, and limitations on, the seller pursuing claims under or outside of such support documents
- Deal structure — tender offer vs. one-step merger and impact on time to closing
- Inclusion of a financing condition
- Tightness of the debt financing commitments
- Inclusion of covenants requiring buyers to enforce debt commitments and rights, or limitations thereon, of seller to specifically enforce those covenants
- Application of a reverse termination fee, and, if so, size, triggers and possible size bifurcation between different triggers
- Terms of the other key conditions to the deal such as the material adverse change (MAC) condition, a company-specific condition tied to minimum EBITDA or debt ratings, or a market criteria such as minimum S&P500 index levels
- Inclusion of language allowing the target to seek to collect on behalf of its shareholders damages for lost premium in the event the buyer reneges on its commitment to close (so-called “ConEd language”)
- Scope and depth of buyer’s commitment to obtain committed financing and/or replacement debt financing
- Circumstances under which specific performance is available as a remedy and interaction between specific performance and damages claim (e.g., order in which remedies must be pursued)
- Inclusion and duration of a marketing period where, after fulfillment of closing conditions, buyer is given a set period to market debt financing
- Selection of governing law and jurisdiction for disputes, including for extra-contractual claims such as tortious interference

Moreover, analysis of the negotiation and outcome of deal certainty contractual terms is incomplete if attempted in isolation from the specific factors applicable to the parties to the transaction and then-prevailing market conditions. The list of possible variables under this heading potentially is even broader than the examples of contractual variables outlined above, but below are a few obvious samples:

- Overall financial market conditions at the time of announcement, including pre-announcement volatility and expectations about post-announcement period
- Availability of debt financing and prevailing borrowing terms
- Existence of competitive auction process for the target
- Target’s “need” to do the deal
- Attractiveness of the negotiated premium to the target
- Absolute and relative size of the purchase price offered by the buyer

Putting this into more concrete terms, one can speculate how the deal term outcomes trumpeted as new paradigms in some of the recent deals would vary materially if some of the variables had been different in the relevant deals.

For example, while Apollo may have been willing to offer a binding equity commitment to support a full purchase price of hundreds of millions in the Parallel Petroleum deal, would a private equity firm be prepared to do so in a multi-billion dollar buyout? Should the level of binding equity commitment be considered in isolation from other deal terms such as price?

Similarly, while Pfizer and Merck negotiated for different forms of financing conditions/terminations coupled with resulting reverse termination fees in their respective mega-acquisitions, would a buyer of that size, or a much smaller seller, even consider such an arrangement in a deal of a more digestible magnitude?

Although often cited interchangeably, parsing the differences between the financing conditions/terminations and related reverse termination fee provisions for the Merck and Pfizer deals only serves to highlight the highly particularized, case-specific drivers of deal certainty terms in today's market. While Pfizer's ability to walk away from the deal based on a financing failure was limited to a situation where a MAC occurred or the combined debt rating was reduced below a specified level, Merck's was of the more traditional variety requiring only the payment of a reverse termination fee for a termination based on the unavailability of financing stemming from any underlying cause. Undoubtedly, these differences are reflective of the complex interaction of many deal-specific elements of each transaction. Perhaps Pfizer's stronger financial position and/or the tighter terms of its debt commitment letters emboldened it to offer a more seller-friendly formulation. Alternatively, perhaps the marginal improvement in credit markets between January 2009 (Pfizer announcement) and March 2009 (Merck announcement), arguably decreasing the likelihood that lenders would renege on signed debt commitment letters, made Schering-Plough more comfortable accepting a broader share of the risk of a financing failure as compared to Wyeth, which insisted on objective criteria as a basis for asserting a failure. Interestingly, the reverse termination fees in each of those deals was in excess of six percent, showing that the inexplicable link to seller fiduciary fees has been broken.

Conclusion

We have laid out our argument that the limited universe of precedent deals in the post-crash deal market does not demonstrate the development of a new market or paradigm for contract terms surrounding deal certainty. Rather, we believe that the evolving deal terms, and migration of deal terms between the two pre-crash models, reflects a more nuanced and thoughtful approach to dealmaking in light of the bitter lessons learned in the aftermath of the crash. Rather than being swept up by a herd mentality, buyers and sellers, and their advisers, in both the strategic and financial buyer markets are expanding their toolboxes in an attempt to reach the "right" answer for the circumstances of their specific transactions. We expect that, for at least some period, the negotiating tactic that so dominated the boom period — "this is how deals are done" — will no longer carry the day and the enslavement to precedent will be diminished.

Perhaps the most relevant and pressing challenge for dealmakers in this new environment is realizing that deal certainty does not exist in a vacuum from other economic terms. While, in retrospect, it is clear that the three percent reverse termination fees and liability caps were mispriced options on the targets, can such a walk-away option in fact be properly priced? Is there a price per share of the target at which something less than traditional strategic buyer-level certainty is a risk that the target's board can responsibly take?

If you have any questions about the matters addressed in this *Kirkland M&A Update,* please contact the following Kirkland authors or your regular Kirkland contact.

David Fox
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/dfox
+1 212-446-4994

Daniel E. Wolf
Kirkland & Ellis LLP
601 Lexington Avenue
New York, NY 10022
http://www.kirkland.com/dwolf
+1 212-446-4884