THEY'RE REAL AND THEY'RE SPECTACULAR: THE 2009 PRIVATE M&A TARGET DEAL POINTS

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They're Real and They're Spectacular: The 2009 Private M&A Target Deal Points

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The recently released 2009 Private Target M&A Deal Points Study (the "Study"), together with the several other companion ABA Deal Points studies that are now available, continues the theme of providing deal lawyers with highly-practical market benchmarks on commonly negotiated M&A issues. Produced and published by the M&A Market Trends Subcommittee of the ABA's Mergers and Acquisitions Committee (the "Market Trends Subcommittee"), the Study is a veritable mother lode of data points guaranteed to please even the most jaded member of the deal community.

This article will highlight "the standards" (*i.e.*, earnouts, indemnification survival, baskets, caps, etc.) as well as some new data points. These data points are, of course, only a very small sampling of the increasingly comprehensive range of way-cool market metrics now contained in the Study. As is our custom, we will assume that the reader has a more-than-pedestrian-knowledge of the M&A practice arena.

The Study Sample

The Study analyzed 106 publicly available acquisition agreements that were filed with the SEC by public buyers of private targets in transactions which closed in 2008. Staying with prior years' middle market focus, the transaction values again ranged between $25 million and $500 million. As in the past, the final Study

CONTINUED ON PAGE 4

Content HIGHLIGHTS

Complete Table of Contents listed on page 2.

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Table of CONTENTS

Editorial Board

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February 2010 ■ Volume 14 ■ Issue 2

From the EDITOR

The Shareholder Battlefront

The new senator from Massachusetts, surprise victor Scott Brown, may help stall or even kill what until recently had seemed to be a sure thing. No, not new healthcare legislation, but federally-enforced "say on pay" proposals as part of corporate governance reforms.

Last December, the House approved a financial reform bill (on a party-line vote) that included an advisory vote provision. However, reformers have had less luck in the Senate, where legislation introduced by Banking Committee Chairman Sen. Christopher Dodd, which includes a pay vote mandate, is now foundering for lack of cross-party support. Brown's election, which denies the Democrats a filibuster-proof majority, further decreases the Senate bill's chances. Dodd (who recently said he will not run for re-election) has said he remains optimistic the legislation will pass in some form.

The irony, of course, is that "say on pay" continues to grow with or without federal enforcement. Just recently, Edison International, ConocoPhillips and State Street all agreed to conduct advisory votes on executive compensation, according to RiskMetrics. Edison will now hold an annual advisory vote, starting at its April 22 meeting, following a 51.3% vote in 2009 in favor of a proposal from shareholder activist John Chevedden. ConocoPhillips has committed to hold its first pay vote next year while State Street will hold a pay vote at its 2010 annual meeting.

RiskMetrics said that 41 U.S. companies now have agreed either to hold voluntary advisory votes or have already done so, including Pfizer, Goldman Sachs, Prudential, Microsoft, and Yum Brands. And more companies will likely bow to the inevitable this year. RiskMetrics estimates that pay-vote proponents (including pension funds, labor unions and shareholder activists) plan to file about 100 "say on pay" proposals in 2010. By comparison, 76 such proposals went to a vote in 2009, averaging 45.6% support, including 24 majority votes, RiskMetrics found.

New developments

Our February issue features the return of a popular feature at *The M&A Lawyer*: the Private Target Deal Point Study, by Wilson Chu, from K&L Gates, and Larry Glasgow, from Gardere Wynne Sewell. The latest Study analyzed 106 publicly available acquisition agreements filed with the SEC by public buyers of private targets in transactions which closed in 2008. Keeping with the middle market focus of previous surveys, transaction values again ranged between $25 million and $500 million.

Expect to discover many interesting findings. Here's one example: "When we first tracked MAE carveouts in a predecessor study in 2000, we found that carveouts were included in MAE definitions 25% of the time. Since 2000, carveouts have increasingly crept into the MAE landscape to the point where 79% of the 2008 deals with a definition of MAE included one or more MAE carveouts in that definition," Chu and Glasgow write. "As it appears that resistance is futile (to reject MAE carveouts in the first place), buyers have increasingly focused on negotiating carveouts to the carveouts (how sweet it is!), which is consistent with the Study's finding that 78% of the deals-with-MAE-carveouts subset included one or more "disproportionate effect" carveouts."

Also, Peter Lyons, Beau Buffier and Jessica Delbaum at Shearman & Sterling LLP offer a detailed survey of the changing antitrust landscape. As the authors write, "With a new administration in the U.S., a newly appointed E.C. competition commissioner, the emergence of the new Chinese merger control regime, and general market uncertainties, sellers are currently much more concerned about certainty of closing and regulatory uncertainty in particular has become a key focus."

CHRIS O'LEARY

MANAGING EDITOR

CONTINUED FROM PAGE 1

sample excluded deals involving bankruptcies, reverse mergers, and other deals deemed inappropriate for inclusion in the data set.

The Study is the work product of a large and diverse group of experienced M&A lawyers (over 50 lawyers from a multitude of law firms/companies) drawn from the East Coast, West Coast, Wall Street, Main Street, in-house, big firms, and boutique firms (*see* Study slides 2-5 for a listing of the Study's working group members). One of the core strengths and the resulting integrity of the Study (like others of the sister ABA Deal Points studies) derives, therefore, from the diversity of analytical perspective and judgment that such a large, varied, and experienced working group brings to the table.

Conservative Hockey Sticks

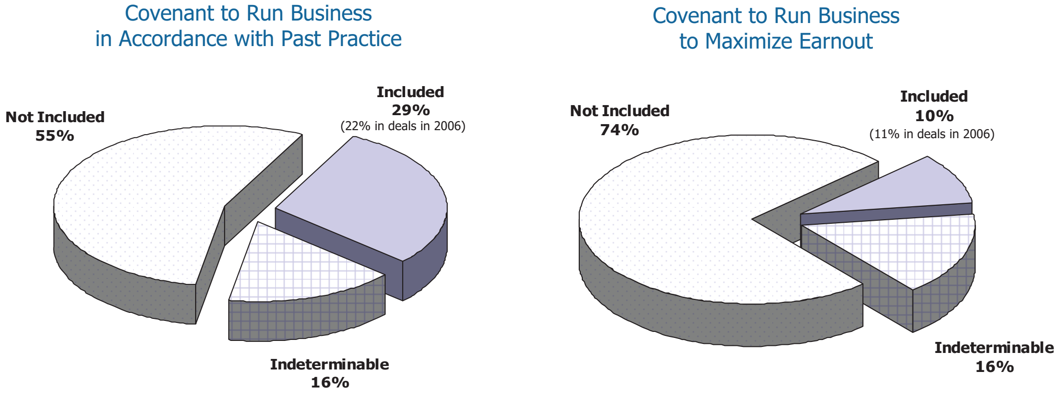
In the shadow of pesky market conditions, like credit crunches and looming subprime meltdowns, dealmakers faced ever increasing challenges to bridging the valuation gap between the buyer's price and the seller's expectations, the latter being based, of course, on the seller's "conservative hockey stick" projections. Anecdotally, in the current difficult deal environment where creativity is a necessity, you'd expect to see more earnouts being negotiated and baked into deals. So how did earnouts fare in 2008? The Study found that the "incidence" of earnouts increased by over 50% (29% of 2008 deals vs. 19% of 2006 deals). At first blush, you might think a "WOW!" would be in order, but with the relatively small number of 2008 deals a "WOW!" may be a little premature. In any event, this is certainly a deal point to pay close attention to in the future. The use of "incidence of earnouts" is perhaps a Freudian slip, because "incidence" is a term often used when measuring risk, and while an earnout may make business sense, the practical challenges of crafting the Holy Grail of earnouts (*i.e.*, one that precisely aligns interests and predicts how to resolve every single future scenario that may occur during the earnout period) could make matters more "risky" than "business."

Setting aside the challenges of crafting the correct earnout metrics (*see* Study slide 20 for the metrics on the metrics), there is likely no ground more fertile for risky business than how the parties are supposed to conduct business during an earnout period. Negotiating these operating covenants involves balancing the freedom of a buyer to run the business for which it just paid a king's ransom with the seller's desire that operations be conducted in a manner that guarantees full payment of the back-end loaded purchase price. The Study continues to track two such covenants, one on the buyer's conduct of the business "consistent with past practice" and the other "in a manner to maximize the earnout." In both cases, the Study did not find any meaningful change from the 2006 deal sample with regard to the number of deals with earnouts that included these covenants (29% of the earnout subset in 2008 deals included a "past practice" covenant and 11% of the earnout subset in 2008 deals included a "maximize earnout" covenant).

Financial Provisions

Earnouts –
Buyer's Covenants as to Acquired Business

(Subset: deals with earnouts*)



* Two deals that included an earnout contained a provision authorizing Buyer to operate the business in its own best interest.

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2009 Private Target Study, slide 22
Release Date 12/23/09

February 2010 ■ Volume 14 ■ Issue 2

The flipside is that a significant percentage of deals are silent on this issue. So did the buyer dodge a bullet by going silent? Maybe not, especially in light of a case like the recently-decided *Sonoran Scanners, Inc. v. PerkinElmer, Inc.*[1] in which the court found that, under Massachusetts law, an acquisition agreement contained an implied covenant requiring a buyer to use reasonable efforts with respect to an earnout provision. Not scary enough (if you're on the buy-side)? Then, you may want to read the *Horizon Holdings* case[2] in which the 10th Circuit, applying Delaware law, invoked Delaware's implied duty of good faith and fair dealing to find that a trier of fact could reasonably conclude that the buyer and the seller—**had they actually thought about it**—would not have included provisions permitting the buyer to engage in the alleged bad faith actions designed to frustrate and impair realization of the seller's earnout. The lesson here would appear to be that, to avoid being on the losing end of a whack-a-mole game by going silent, a buyer may be better served by proactively and specifically addressing its freedom to operate the business during the earnout period.[3]

One additional point the Study analyzed, which happens to be a new data point for the Study, was whether a buyer was successful in including a disclaimer of fiduciary duties with respect to the earnout. The Study found that only 6% of the deals-with-earnouts subset included such an express disclaimer. Given the possibility, and also the likely ambiguity, of state-law implied duties of good faith and fair dealing, perhaps a buyer's disclaimer of earnout related fiduciary duties is worth considering? But then, of course, the question turns to whether such a disclaimer is against public policy.

My Carveout Is Bigger Than Your Carveout

And so the game continues in the world of material adverse change/effect negotiations. When we first tracked MAE carveouts in a predecessor study in 2000, we found that carveouts were included in MAE definitions 25% of the time. Since 2000, carveouts have increasingly crept into the MAE landscape to the point where 79% of the 2008 deals with a definition of MAE included one or more MAE carveouts in that definition. As it appears that resistance is futile (to reject MAE carveouts in the first place), buyers have increasingly focused on negotiating carveouts to the carveouts (how sweet it is!), which is consistent with the Study's finding that 78% of the deals-with-MAE-carveouts subset included one or more "disproportionate effect" carveouts.

Deals Completed In	Deals With MAE With Carveouts
2008	79%
2006	74%
2004	80%
2003	51%
2002	28%
2001	26%
2000	25%

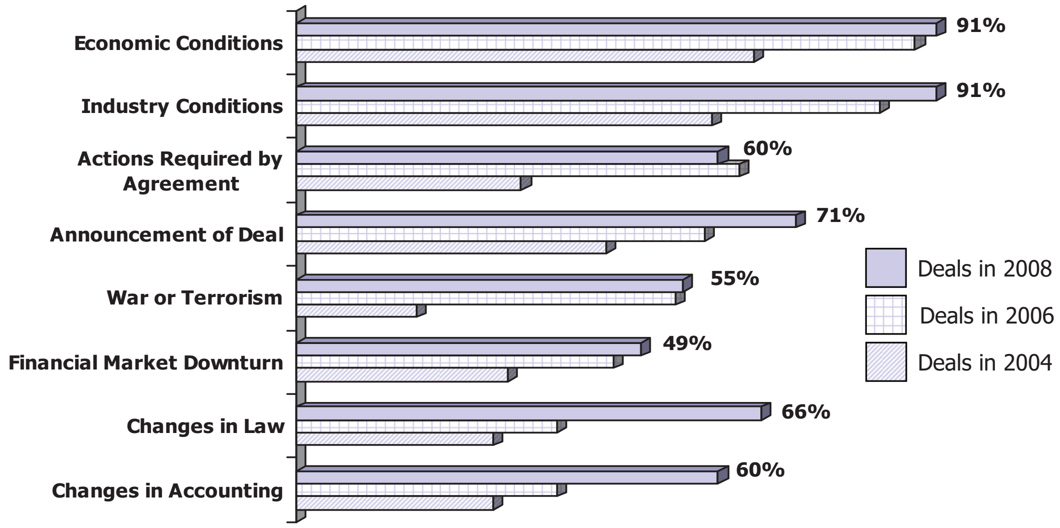
In the post credit crunch era, we were treated to spectacular deal-deaths that turned on whether an MAE had or had not occurred, with most cliffhangers turning on what's *not* a MAE due to the existence of a so-called MAE carveout. From *Sallie Mae* (change in law carveout) to *Genesco* (failure to meet projections carveout) to *Hexion* (premature reliance on disproportionate effect carveout to industry conditions carveout), it's all about the carveout. So, armed with the Study's findings that "common" carveouts such as economic or industry conditions are being included with increasing frequency, it looks like lawyers will continue contributing to the demise of the broadly-written MAE,[4] notwithstanding Vice Chancellor Strine's wishful thinking:

> **"[a] contrary rule [to reading broadly-written MAEs as a backstop against unknown events] will encourage the negotiation of extremely detailed 'MA[E]' clauses with numerous carve-outs or qualifiers. An approach that reads broad clauses as addressing fundamental events that would materially affect the value of a target to a reasonable acquiror eliminates the need for drafting of that sort."[5]**

Pervasive Qualifiers

Definition of "Material Adverse Effect" – Carve Outs

(Subset: deals with MAE definition with carveouts)



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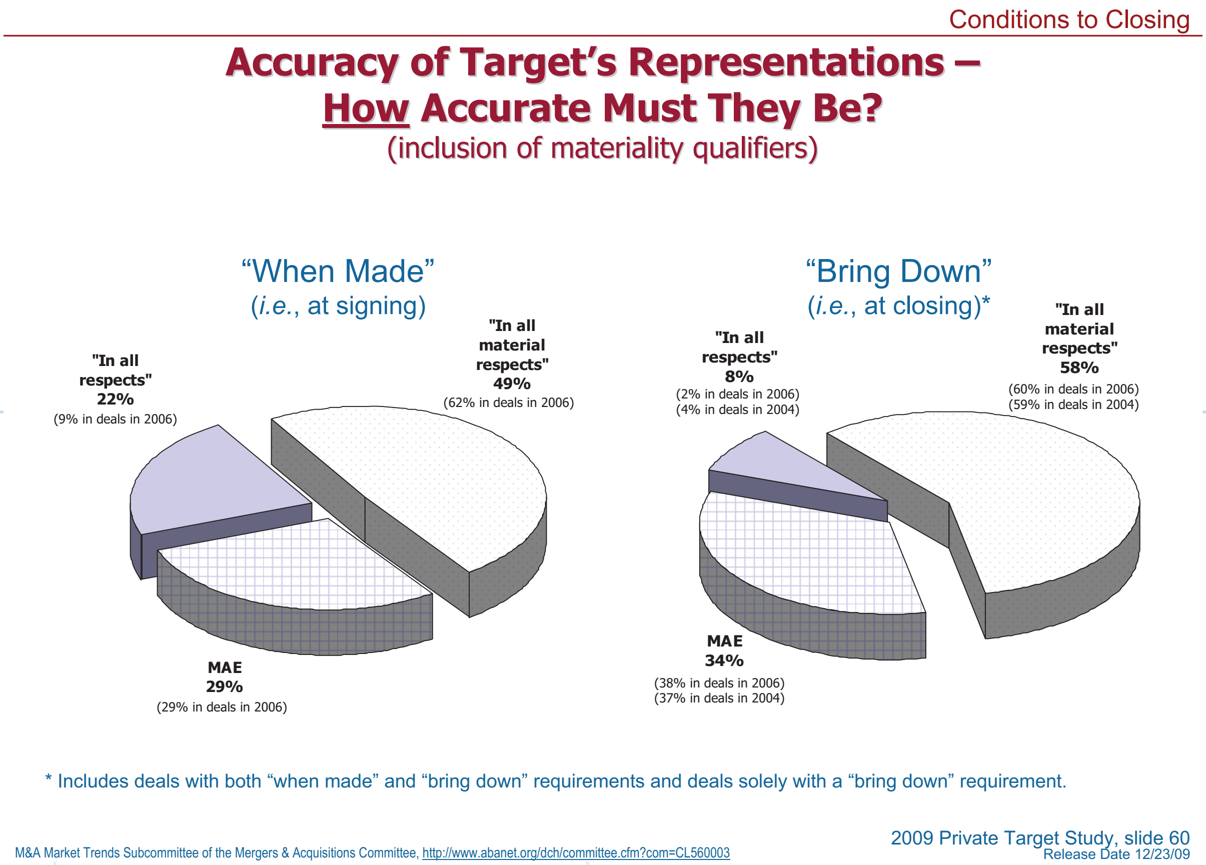
2009 Private Target Study, slide 35
Release Date 12/23/09

February 2010 ■ Volume 14 ■ Issue 2

More Carveout *Creep*…

A new data point in the Study looks at carveouts to the so-called bring-down condition (which requires that the seller's representations and warranties be accurate at closing). As in previous studies, this Study tracks "how wrong could the seller be?" by analyzing materiality qualifications to the accuracy of the seller's representations and warranties. Despite 2008 swinging toward a buyer's market, the needle really did not move much from the 2006 deal sample, with 92% of the deals including some form of a materiality qualifier (58% of 2008 deals being qualified "in all material respects" and 34% being subject to an MAE qualifier).



While materiality qualifiers were virtually universal in the context of bring-down conditions, there are nonetheless instances when it may be reasonable for a buyer to require 100% accuracy of one or more of the essential representations. For example, if you're buying stock of a closely-held business, do you really want to close if you're only getting "materially all" of the outstanding shares (notwithstanding a post-closing indemnity right)? While "bring-down carveouts" are limited only by one's imagination (and bargaining power), the Study decided to put a toe in the water by examining the "capitalization representation bring down carve out" data point, and found that the capitalization representation was carved out from the prevalent materiality qualifier 32% of the time in 2008 deals.

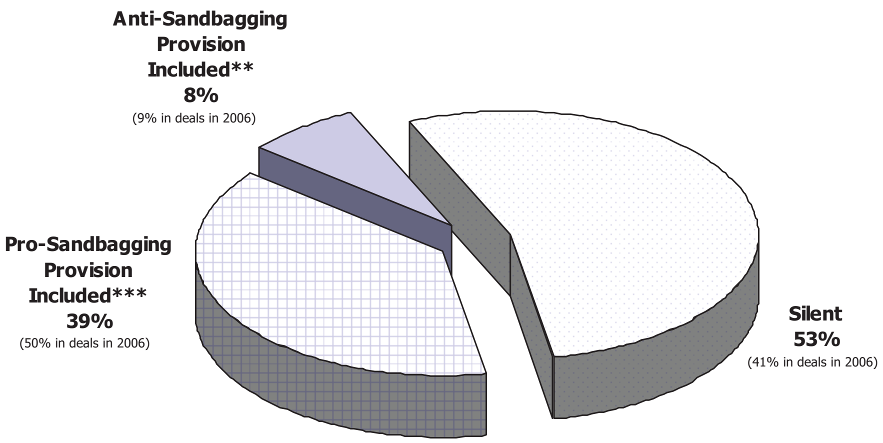
With carveouts continuing to creep in, will bring-down condition negotiations go the way of the increasingly complex and tedious MAC negotiations? Or will practitioners prefer a more streamlined and uncluttered bring-down condition (preferring to ding the seller on the back-end with an indemnity claim)? One thing's for sure, the Market Trends Subcommittee looks forward to chronicling this epic struggle for the heart and soul of this "Mother of all Closing Conditions."

Is it Sandbagging or is it BOB?

The answer to that question is: "It depends on which side of the deal you're on." A cautious seller would submit that the buyer shouldn't have the right to bring a claim for a breach that the buyer was aware of before closing or, to put it a little less subtly, the right to "sandbag" the seller. The buyer, on the other hand, is interested in getting what it paid for…as in the "benefit of the bargain" (or, as we refer to it, "BOB"). Lawyers going down the path of one of these provisions (whether pro- or anti-sandbagging in nature) are likely teeing their client up for an evidentiary fight that, while perhaps lucrative for someone's litigation team, is not likely to be much of a business development tool for the lawyer deal team, as they watch the beleaguered client being subjected to Watergate-era (and sadly modern-era) questions of "What did you know and when did you know it?" The Study found that 39% of 2008 deals contained pro-sandbagging (a.k.a. BOB) provisions (compared to 50% of 2006 deals), that 8% of 2008 deals contained anti-sandbagging provisions (compared to 9% of 2006 deals), and that 53% of 2008 deals were silent on the subject (compared to 41% of 2006 deals). If there is a trend in these percentages it would appear that parties are setting aside sandbagging provisions all together and are, instead, going silent on the subject. At first glance, the "go silent" approach might appear to be a reasonable compromise because no one gets their way. Right? Well, not so fast, because, depending on applicable state law, "going silent" may actually be a "win" for the seller because of standards of fair play (including notions of reliance) that are imposed on buyers by courts in this arena.[6]

Indemnification

"Sandbagging"*



* Disregards one deal with a hybrid provision that allows sandbagging for constructive knowledge, but prohibits sandbagging in the event of actual knowledge.

** Includes one deal in which Buyer represented it was not aware of any breach without further reference to effect on indemnification rights, as Seller should have a reciprocal counter-claim if Buyer makes a claim based on a previously-known breach.

*** For purposes of this Study "pro-sandbagging" is defined by excluding clauses that merely state, for example, that Target's representations and warranties "survive Buyer's investigation" unless they include an express statement on the impact of Buyer's knowledge on Buyer's post-closing indemnification rights.

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2009 Private Target Study, slide 76
Release Date 12/23/09

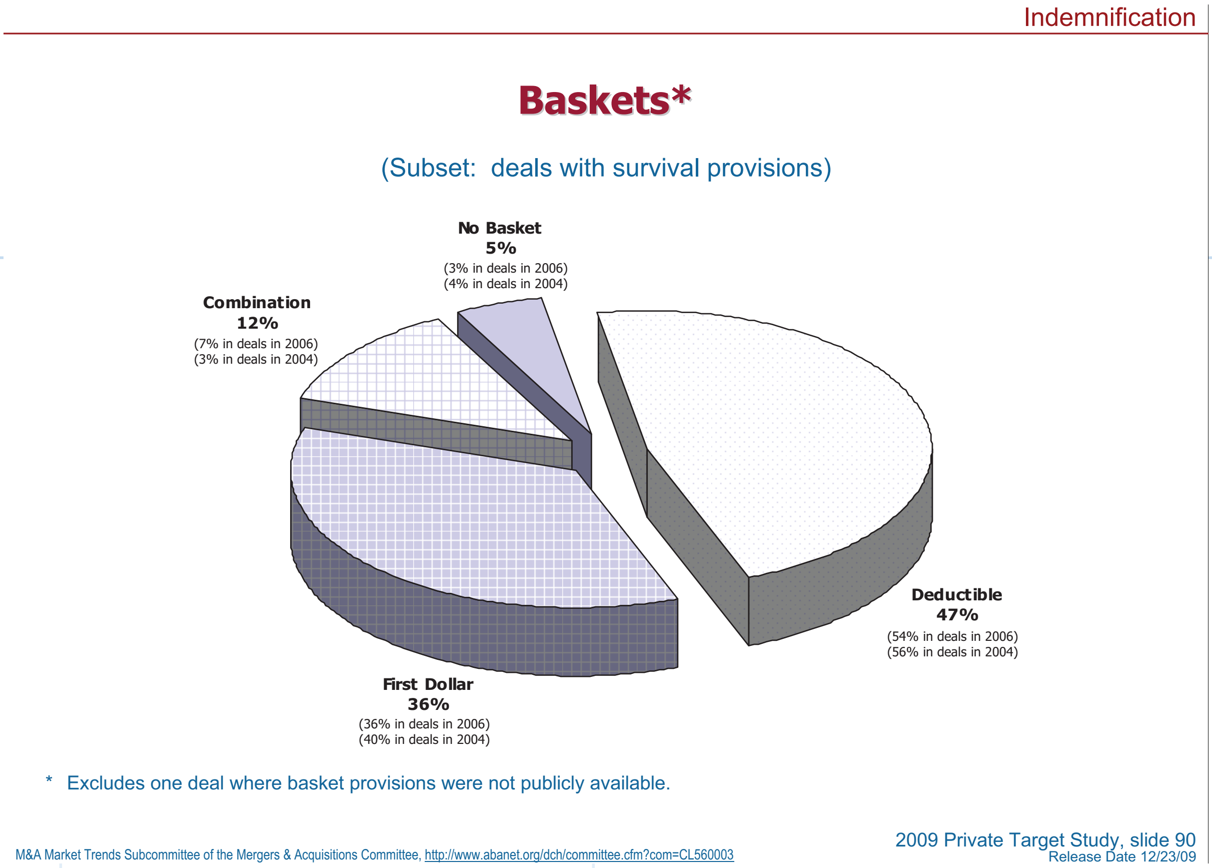
BOB Swapping?

One of the most important caveats about "uses and abuses" of the deal points studies is that the data points generally do not take into account the customary tradeoffs inherent in deal negotiations. The Study takes another first step towards benchmarking the "fuzzy logic" behind the negotiated deal by analyzing the correlations between sandbagging, full disclosure, and non-reliance provisions. Sadly, due to space limitations in this article, we are not able to delve into the "strategeries" associated with trading one or more of these provisions for another. Suffice it to say, that it's not uncommon to swap a BOB for a non-reliance provision—and so on (*see* Study slides 81-83).

February 2010 ■ Volume 14 ■ Issue 2

The Cocktail Party Favorites—Indemnity Baskets, Caps, and Survival Periods

Because you love it and can't get enough of this stuff, the Market Trends Subcommittee again analyzed indemnity baskets and caps. The Study found that an overwhelming percentage (95%) of 2008 deals had indemnity baskets (*i.e.*, quantified materiality hurdles to Buyer's right to indemnification), reflecting virtually no change from the percentages in the 2006 and 2004 deals. So, what was market for baskets for 2008 deals? The Study found that only 5% of 2008 deals had no basket, while 47% were of the "deductible" variety (compared to 54% in 2006 deals and 56% in 2004 deals), 36% were of the "first-dollar" variety (identical with the percentage of 2006 deals and down from 40% in 2004 deals) and, in what you could refer to as the principal growth area in the wonderful world of baskets, the Study found that 12% (compared to 7% in 2006 deals and 3% in 2004 deals) were attributable to the "double-trigger" or "combination" baskets (*i.e.*, where both deductible and first-dollar components are involved).



The following table summarizes the findings regarding the size of baskets, as a percentage of the purchase price for 2008 deals, with a comparison to 2006 deals and 2004 deals:

Size of Basket	½% or less	>½% to 1%	>1% to 2%	>2%
2008 Deals	44%	45%	9%	2%
2006 Deals	62%	28%	8%	2%
2004 Deals	40%	49%	7%	4%

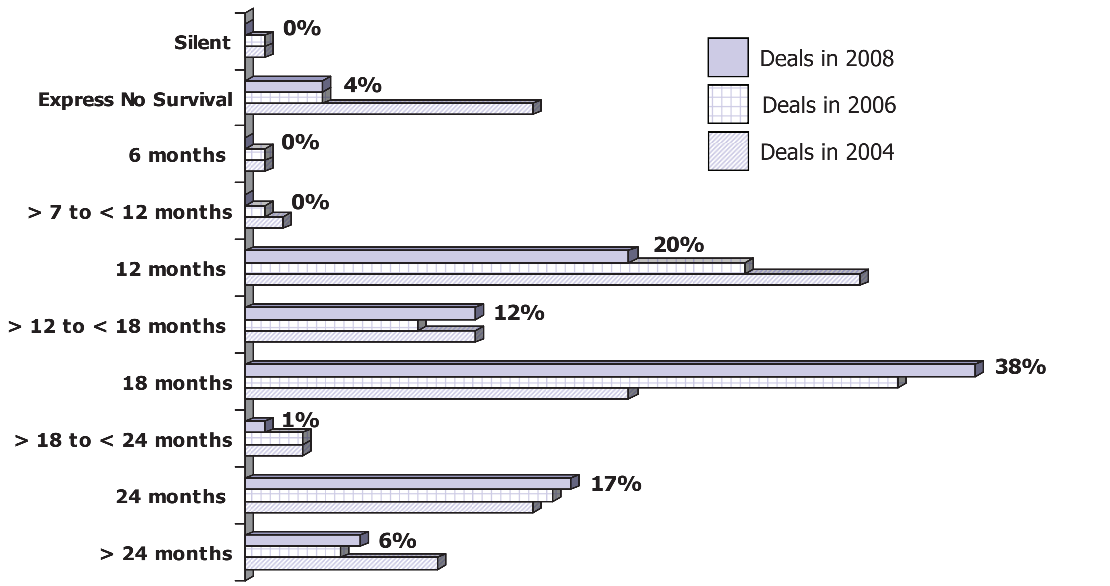
The Study's finding that 89% of the baskets were 1% or less of the deal's purchase price continues to refute those who would insist that baskets are typically much higher, but it's important to remember that the appropriate percentage depends largely on the size of the deal in question.

In a review of 2008 deals with indemnity caps (*see* Study slide 100), the Study found that only 5% of 2008 deals had a cap equal to the purchase price (compared to 9% in 2006 deals and 6% in 2004 deals). In fact, 43% of the 2008 deals within the caps subset are grouped between >10% and 50% of the purchase price (compared to 39% in 2006 deals and 53% in 2004 deals). If you include caps of 10% or less, then the percentage of deals with caps of 50% or less of the purchase price jumps to 91% (compared to 86% in 2006 deals and 96% in 2004 deals). As usual, readers are reminded that this deal point is particularly sensitive to the nature of the Study's sample (*i.e.*, public companies buying private targets where the buyer's stock could often be in play as a component of consideration).

As in past years, the Study analyzed just how long after the close of a deal a buyer had to assert a claim for indemnity against the seller. As you can see in the graph below, the most frequently occurring "survival" periods showed up in the 12 to 18 month range with an aggregate of 70% 2008 deals occurring in that range. This is a virtual dead heat with the 2006 deals, where the aggregate of the 12 to 18 month range was 69%. As in prior years, the length of the survival period appears to be correctly geared to allowing the buyer at least one 12-month audit period to assimilate the acquired business.

Indemnification

Survival/Time to Assert Claims*
(generally)



* 2% of the deals had survival periods equal to the applicable statute of limitations.
** These periods apply to most representations and warranties; Certain representations and warranties may be carved out from these periods in order to survive for other specified periods.

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2009 Private Target Study, slide 85
Release Date 12/23/09

Where Can I Get a Copy of the Study?

The Study is available to ABA M&A Committee members, without charge, at http://www.abanet.org/dch/committee.cfm?com=CL560003 or you can email either of us (wilson.chu@klgates.com or lglasgow@gardere.com). Please remember that, from time to time, the Subcommittee may release updates and supplements to the Study (including, a planned supplement that analyzes whether financial sellers get a better—or worse—deal than the Study's general population). So the best way to make sure that you have the most recent version of the Study (and the other Market Trends Subcommittee studies) is to sign up for Update Alerts on the Market Trends Subcommittee website.

NOTES

1. 585 F.3d 535 (1st Cir. 2009).
2. *O'Tool v. Genmar Holdings, Inc.*, 387 F.3d 1188 (10th Cir. 2004), *aff'g Horizon Holdings, LLC v.*

February 2010 ■ Volume 14 ■ Issue 2

Genmar Holdings, Inc., 244 F. Supp. 2d 1250 (D. Kan. 2003).

3. In fact, the Study found only two deals in which the buyer had an express right to operate the business in the buyer's own best interest.
4. For an excellent overview of the state of MAE negotiations, *see* Stephen M. Kotran, *Hey MAC – Where Are You Headed?* http://uscorporate.practicallaw.com/9-386-4019?q=kotran&qp=&qo=&qe=.
5. *In re IBP, Inc.*, 789 A.2d 14, 68 (Del. Ch., 2001).
6. See Robert F. Quaintance, Jr., *Can You Sandbag? When a Buyer Knows Seller's Reps and Warranties Are Untrue,* The M&A Lawyer, vol. 5, no. 9 (West Legalworks, NY, NY) (Mar. 2002).

Strategic Deals Require Strategic Thinking: Antitrust Provisions to Consider in Negotiated Transactions

BY PETER D. LYONS, BEAU W. BUFFIER AND JESSICA K. DELBAUM

Peter D. Lyons is a partner in Shearman & Sterling LLP's M&A Group; Beau W. Buffier is a partner in Shearman & Sterling LLP's Antitrust Group; and Jessica K. Delbaum is an associate in Shearman & Sterling LLP's Antitrust Group. The authors are grateful to Cody Wright, Timothy Haney, Karina Lubell, and Bradley Janssen (each with Shearman & Sterling LLP) for their research assistance and analysis of the data. Contact: PLyons@Shearman.com or BBuffier@Shearman.com.

Antitrust considerations play a critical role in many negotiated transactions, affecting numerous aspects of the deal, including timing and the scope of the acquisition. With a new administration in the U.S., a newly appointed E.C. competition commissioner, the emergence of the new Chinese merger control regime, and general market uncertainties, Sellers are currently much more concerned about certainty of closing, and regulatory uncertainty in particular has become a key focus. Merger control regimes exist in more than sixty-five jurisdictions,[1] many of which, if certain filing thresholds and jurisdictional elements are satisfied, require parties to make a merger control filing and obtain approval for their transaction prior to closing. In strategic transactions involving major competitors, regulatory approval may entail the parties having to divest assets or offer other remedies to obtain clearance. Consequently, effective and efficient representation in mergers and acquisitions requires early consideration of antitrust issues.

Unless the parties are confident that antitrust issues will not be a significant factor, counsel for both parties, as an initial matter, should obtain background information regarding the products (or services) being acquired/sold and perform a preliminary analysis of antitrust risk (ranging from procedural filing and timing issues to analysis of substantive overlaps), preferably with input from the appropriate businesspeople. Once each party's antitrust counsel has completed its internal, initial competitive assessment, whether the respective counsel should discuss their views of the transaction's antitrust risk (as well as the feasibility of any proposed remedy) is often a major tactical consideration. The Seller usually wants to resolve the antitrust issues as soon as possible. The Buyer's counsel, however, may want to delay discussing antitrust issues with Seller's counsel for strategic reasons; namely, avoiding having to commit to accept any antitrust risk before the Seller has committed significant time and energy toward negotiating the transaction (and thus become more enthusiastic about the merits of a deal). However, in other cases, having the discussion upfront enables both parties to make informed judgments about the impact of a number of contract provisions and hopefully avoids needless posturing about hypothetical risks. The greater understanding gained through this process should allow each party to better determine whether to expend their negotiating leverage on antitrust related points or to save it for other issues.

This article discusses several of the key antitrust-related provisions contained in merger and acquisition agreements in strategic deals. In particular, it addresses antitrust clearances as a precondition to closing, risk allocation provisions (including reverse breakup fees), covenants regarding cooperation on antitrust matters, and "ticking" fees. Several other provisions that may be impacted by antitrust considerations are also briefly discussed.

Antitrust Conditions Precedent

Both parties typically want to close the deal as soon as possible after signing to ensure that market conditions do not impact the negotiated purchase price and to realize their respective benefits of the bargain. Although both the Buyer and the Seller typically want to close quickly, other conflicting interests may lead to disagreement as to the jurisdictions in which antitrust approvals or clearances should be obtained prior to closing. For example, the Seller faces the often not insignificant risk that its business will deteriorate in the period between signing and closing, in part from customer and employee defections due to uncertainty. The Seller typically is interested in receiving the consideration as soon as possible to avoid any number of risks that could intervene and cause the transaction to be delayed or abandoned. Accordingly, the Seller typically wants to limit the number of antitrust approvals that are conditions precedent to closing. In contrast, the Buyer usually wants assurances that a governmental authority will not oppose the transaction after the Buyer has paid the Seller the purchase price and tends to want a more extensive list of jurisdictions that will be closing conditions. For example, the Buyer may want to include approval from a jurisdiction it deems advisable or appropriate, even if not legally required, such as from a jurisdiction with a voluntary merger control regime.

Prior to signing, the parties may not have had access to all the relevant data (and people) to make a definitive assessment of which countries require pre-closing approval (or clearance) of the transaction. Generally, any assessment requires at a minimum the revenues of the parties broken down by jurisdiction based on the location of the customer. Market share estimates are also needed for some jurisdictions. As a threshold matter, parties typically can exclude any country in which the target had *de minimis* turnover in the most recent calendar year. Counsel should also inquire as to whether the parties have any particular jurisdictional sensitivities regarding either the Seller's retained business or the Buyer's business; for example, a party may always notify its acquisitions in a specific country because of concerns about potential spillover effects (*e.g.*, very significant sales or the importance of the government to the Buyer's or the Seller's other lines of business). To the extent failure to obtain pre-merger approval may result in criminal penalties in a jurisdiction,[2] counsel should, in addition to considering the jurisdictional nexus, also inquire as to whether either party has any assets or personnel at risk in the jurisdiction.

There is rarely disagreement about including U.S., E.U., and Canadian antitrust clearances as a closing condition, if these jurisdictions require the transaction to be reported prior to closing. China recently revised and bolstered its merger control regime; similarly, it is anticipated that India will implement a merger control regime. Conditions precedent that require antitrust clearance from China and India have the potential to extend significantly the time between signing and closing, as these jurisdictions can have lengthy review periods.

For the many other jurisdictions with merger control regimes, the approach as to whether, and how, to list them as closing conditions varies. The three typical approaches are for the parties: (1) to stay silent as to other jurisdictions; (2) to specifically list each additional jurisdiction (often in a schedule); or (3) to limit the additional jurisdictions to those that are (a) required by law; (b) would prohibit the consummation of the transaction; or (c) that if not obtained (i) would result in a criminal violation; or (ii) are, or would be, reasonably likely to have a Material Adverse Effect.[3] The Material Adverse Effect may be measured with respect to the Buyer and/or Seller or to the combined company assuming that the proposed transaction proceeds.

A thorny issue could arise if the parties elect not to include as a closing condition a country with low jurisdictional thresholds (*e.g.*, Ukraine or Pakistan) and in which they have no assets or sales, and that country objects to the transaction prior to closing. If all the conditions precedent are satisfied, could the Seller force the Buyer to close, or would a U.S. court accept a Buyer's argument that closing the transaction would be illegal under the local law? Would a U.S. court really find that the parties cannot close the transaction in contravention of, for example, Ukrainian law, when there is no relevant nexus between the transaction and the Ukraine and where the Ukraine arguably has been aggressive in extending its jurisdictional reach beyond international norms?

Another difficult issue can arise when a large, and potentially competitively problematic, transaction

February 2010 ■ Volume 14 ■ Issue 2

is reportable in some jurisdictions, such as the E.U., but, for technical reasons, is not reportable in others, such as the U.S. Unlike many non-reportable transactions, which frequently sign and close on the same day, thereby obviating the need to have a separate antitrust condition precedent, in the foregoing scenario, the parties will not be able to close immediately. The U.S. antitrust agencies, the U.S. Department of Justice ("DOJ") and the Federal Trade Commission ("FTC"), may investigate a proposed acquisition even if no filing under the Hart-Scott-Rodino Act of 1976, as amended ("HSR"), is required, and an E.C. investigation may increase the risk of a DOJ or FTC investigation. Accordingly, if the Buyer thinks there is a meaningful risk that the DOJ or FTC will investigate the transaction, it may want to provide for such a possibility in the closing conditions. The Buyer typically would prefer that it not have to close the transaction if a DOJ or FTC investigation is pending, while the Seller typically would prefer the Buyer to have to close the transaction provided there is no injunction preventing it. A compromise position may be a closing condition that the Buyer need not close if an investigation is reasonably likely to issue, coupled with a short outside termination date.

Antitrust Regulatory Approval Covenants: Generally

Parties typically include covenants regarding the efforts they will undertake to obtain antitrust regulatory approvals. The parties generally agree to use some form of efforts—typically, "best efforts," "reasonable efforts," "reasonable best efforts," or "commercially reasonable best efforts." At least under New York law, courts have yet to establish definitive criteria for these different formulations and instead assess the defendant's behavior based on the specific facts of each case.

Although one can easily conclude that a "best efforts" provision is the most stringent efforts provision, there are disparate interpretations of each of the above formulations. Accordingly, the parties often attempt to document the specific obligations required in the "efforts" covenants. Parties, however, may also want to consider whether they benefit from leaving the terms ambiguous rather than risk creating a negative negotiation history that could be introduced as parol evidence in construing an ambiguous term of the contract. For example, if a non-material divestiture were needed to obtain clearance, a Seller might prefer to rely on the ambiguous meaning of "reasonable best efforts" to obtain all required antitrust approvals rather than seek to negotiate for an explicit divestiture obligation and perhaps run the risk of winding up with a provision in the agreement that specifies clearly that the Buyer is not required to agree to make, or to make, any divestitures or accept any kind of operational restriction in order to obtain antitrust approval.

Antitrust Regulatory Approval Covenants: Risk Allocation

In any strategic transaction, a critical question is how the parties will allocate the risk that a governmental antitrust authority might challenge the transaction, including whether the Buyer will have any obligation to propose a remedy to a governmental antitrust authority (or accept a remedy offered by such an authority). If the Buyer does have a divestiture obligation, what is the scope of that obligation? Typical provisions range from remaining silent (relying on whatever general efforts covenant is included relating to obtaining regulatory approvals) to effectively requiring the Buyer to do whatever it takes to obtain antitrust clearance (a "hell or high water" provision) to providing explicitly that the Buyer has no divestiture obligation.

The parties also may agree to a variation on the obligation depending on the circumstances. For example, the Buyer's divestiture obligations may be limited to: (1) certain product lines; (2) a revenue cap (although this raises the potential that the Buyer would be obligated to divest an unexpected asset); or (3) a materiality cap.

Buyers often express the concern that an explicit divestiture obligation (including the ultimate divestiture obligation, a hell or high water) not only may increase the likelihood of the DOJ or FTC issuing a Second Request because it indicates that the parties see a potential problem but also may alter the Buyer's bargaining power vis-à-vis the government agency. These concerns are often referred to as the "road map" problem. The degree of risk depends on how obvious the parties think the potential antitrust issue is likely to be. For example, when Boston Scientific made its unsolicited bid for Guidant in 2006, it included a detailed divestiture commitment in its initial bid, reasoning that the potential overlaps were almost certain to be obvious to both the FTC (which had ordered a divestiture for the then-pending Johnson & Johnson—Guidant transaction which Boston Scientific was trying to top) and Guidant's Board of Directors and shareholders. Boston Scientific concluded that the advantage in making a specific divestiture offer in gaining the support of Guidant's Board and shareholders far outweighed any road map concerns.

In our experience, hell or high water provisions are unusual in strategic transactions and even specific divestiture obligations are not the norm. To provide additional color, we searched publicly-available sources, such as Google, PR Newswire, Competition Law360 and Securities Mosaic, to identify transactions that received an HSR Second Request in 2008 or 2009, with the assumption that parties to those transactions likely had been aware ex-ante of antitrust risk. This list was supplemented with transactions that were subject to a DOJ or FTC consent decree or preliminary injunction. These searches yielded 54 transactions.[4] Of these 54 transactions, 29 had publicly available transaction agreements, which we then reviewed. We identified only one agreement (or less than 5%) that contained a hell or high water provision and eight that contained some form of a specific divestiture obligation (*e.g.*, a revenue cap).[5]

Historically, some parties have avoided putting the explicit terms of a divesture obligation in the base transaction agreement. Instead, interpretations of the regulatory approvals efforts have sometimes been included either in a side letter memorializing counsels' conversations or in a joint defense agreement ("JDA"). Properly written, the side letter or JDA does not amend the terms of the merger agreement and does not constitute a part of the merger agreement, but rather it memorializes the parties' joint understanding of the appropriate antitrust defense of the transaction, and may include tactical points such as the timing of any settlement offers and the scope of any divestiture or other settlement agreement to which the parties might agree in the face of pending or threatened litigation. Depending on how the parties draft the provisions (and other issues), they will need to consider the scope of any disclosure that needs to be made under the securities laws or in any privilege log that may need to be submitted with any regulatory filings.

Reverse Breakup Fees

Parties also may seek to allocate antitrust risk by providing for the payment of a reverse breakup fee by the Buyer if the transaction fails to close on antitrust grounds. A critical issue with reverse breakup fees is identifying the appropriate triggering conditions; potential antitrust triggers include the failure of the HSR condition precedent by the agreement's outside termination date, the failure to satisfy non-U.S. clearance condition(s) as of the outside termination date, or the transaction being preliminarily (or permanently) enjoined by antitrust authorities. For moral hazard reasons, a reverse breakup fee typically is not payable if the Seller failed to discharge its obligation under the regulatory covenants. Similar to divestiture commitments, a reverse breakup fee may be perceived as a signal of antitrust issues to governmental agencies. While a reverse breakup will not provide the government a "roadmap" to a specific remedy, the existence of a significant reverse breakup fee may give the government significant leverage in any negotiation of remedies.

In our experience, antitrust-triggered reverse breakup fees are rarely used. In light of the not insignificant probability that (i) the Seller's business will deteriorate prior to closing, and (ii) any subsequent acquisition price would be lower than the Buyer's, it would seem that the Seller would almost uniformly prefer a divestiture commitment to a reverse breakup fee, which effectively evolves into an option for the Buyer. In addition, a Seller may be reluctant to accept a reverse breakup fee because of a concern that a court would treat the reverse breakup fee as an appropriate measure of liquidated damages in the event of, for example, the Buyer's breach of its regulatory covenants. A possible exception to this exists when the parties cannot articulate a clear remedy to the potential antitrust issue. To minimize the likelihood that the Buyer is able to treat the reverse breakup fee as an option, the Seller typically would include a contractual right to seek specific performance or damages if the Buyer intentionally breaches the agreement by failing to use the requisite level of efforts to obtain antitrust clearance.

We utilized the FactSet Mergers database, also known as MergerMetrics,[6] to analyze further the relevance of antitrust-triggered reverse breakup fees in strategic transactions. For a transaction to be included in the MergerMetrics database: (1) the target company must be incorporated in the U.S.; (2) the target company must be publicly traded; and (3) the acquirer must own less than 50% of the target at the time the deal is announced and must be seeking

February 2010 ■ Volume 14 ■ Issue 2

to acquire 100% of the target's equity. Within this database, we searched for deals announced between January 1, 2005 and December 31, 2009 in which the merger agreement was publicly filed. We limited the search to deals with a transaction value of $500 million or greater and excluded financial and hostile buyers.[7] There were 375 transactions that met these criteria. Of the 375 transactions, 121 contained reverse termination fees, and only 32 of those reverse termination fees had antitrust triggers. In other words, of the 375 deals in our sample, only 8.5% had antitrust-triggered reverse breakup fees. The average antitrust-triggered reverse breakup fee was 5.84% of the transaction's value and the median was 3.92%.[8] These figures support our hypothesis that antitrust-triggered reverse breakup fees are highly unusual.

We also reviewed the regulatory covenants of the 32 transactions in our sample that had antitrust-triggered reverse breakup fees. Of those, three, or fewer than 10%, had both an antitrust reverse breakup fee and a hell or high water provision to obtain antitrust regulatory approval. This low percentage is consistent with our hypothesis that antitrust-triggered reverse breakup fees may be disfavored because of the threat that the fee would be treated by the courts as the measure of damages for a breach of the hell or high water provision.

Regulatory Approval Covenants: Other Provisions

In addition to the risk-shifting provision discussed above, the typical acquisition agreement also includes a number of other antitrust-related provisions. For example, in which jurisdictions must the parties make merger control filings and under what timetable? The answers to the former question may be different than the jurisdictions listed in the antitrust condition precedent.

Frequently, agreements provide that the parties will make their respective HSR filings, if required, within a defined number of business days (often 10) after signing. Filings for other jurisdictions, such as the E.U., may take significantly longer, so the parties usually agree to make these filings as promptly as practicable. The Seller in particular may want to include a provision that the parties agree not to take any action that will make antitrust approval more difficult (*e.g.*, the Buyer will not acquire a business that competes with the Seller's prior to closing).

Another important consideration is what obligation the parties will have to coordinate their dealings with government agencies. For example, do they agree that they will not have any substantive meetings or conversations with government agencies unless the other party is present? Do they agree to provide each other (or their counsel) with advance notice and an opportunity to review any communications and submissions (subject to applicable law and privilege)? Particularly where the Buyer has agreed to a risk-shift provision, the Buyer usually will want more control over the government agency process. In addition, Buyers sometimes resist an obligation to share information with the Sellers regarding settlement offers.

These regulatory approvals covenants also may establish the parties' obligations to litigate in the event of a challenge. The obligation may be imposed on the Buyer alone or on both parties. The obligation may be to litigate through a final, non-appealable judgment or something less. The obligation may also differ if the plaintiff is a governmental authority or a private party. The Seller's counsel will want to ensure that a decision by the Buyer to litigate does not relieve the Buyer of its divestiture obligation (if there is one).

In addition to the above covenants, the Seller may want to include several provisions to facilitate closing the transaction as quickly as possible. A provision regarding the timeframe in which the parties will respond to any Second Request that may be issued is one such provision. Another such provision is an agreement that neither party will withdraw its merger control filings, extend any waiting periods or enter into a timing agreement without the consent of the other party.

Ticking Fees

So-called "ticking fee" provisions provide another means of motivating the Buyer to move quickly. Such a provision obligates the Buyer to pay interest on the purchase price if the transaction does not close by a specified date. Interest typically would not be payable until some specified period of time has elapsed and may increase over time. For example, if the closing occurs more than 120, but less than 150, days after the signing, the interest rate may be 6% per annum and might increase 1% per month thereafter.

Data suggest that the use of ticking fees is exceedingly rare, at least in deals involving public U.S. targets. A March 2009 study by MergerMetrics found that just over 1% of transactions in its database contain ticking fees.[9] In our reverse termination fee examination above, of the 375 deals in our search, only four (or 1.07%) contained ticking fees. Such fees ranged from between 6% and 8% of the transaction value, per annum. The fee increased in only one transaction, the acquisition of ADVO, Inc. by Valassis Communications, Inc., starting at 6.75% per annum and increasing by 0.1% per month thereafter.[10]

Additional Potential Antitrust Issues in Agreements

Although beyond the scope of this article, below are brief summaries of other potential antitrust issues that may arise in transaction agreements.

Pre-closing ("ordinary course") covenants. Ordinary course covenants are designed to protect the value of the assets/business the Buyer is purchasing and typically restrict certain actions the Seller can take in the pre-closing period. Covenants that are too restrictive can amount to "gun jumping" in violation of the HSR Act or to a potential problem under Section 1 of the Sherman Act. The DOJ and FTC do review agreements' ordinary course covenants and may pursue an enforcement action if they think the covenants are too restrictive.[11] Potentially problematic covenants include those significantly restricting the Seller's: (i) pricing or discounts offered to customers; (ii) current and future R&D projects; (iii) planned capital expenditures and capacity expansions; (iv) ordinary course hiring decisions; and (v) ability to execute key competitive strategies.

Non-competition covenants. Under the common law, generally, covenants that are reasonable with respect to the: (i) restricted activity; (ii) geographic scope; and (iii) duration will be enforced if necessary to protect the goodwill of the assets or business being purchased or to protect against the disclosure of confidential information. If "ancillary" to the sale of a business or asset, non-competes are generally lawful under the rule of reason. If the restriction is not ancillary, it may be found to constitute a horizontal agreement not to compete in violation of Section 1 of the Sherman Act. Potentially problematic non-compete provisions include bilateral non-competes (*i.e.*, each party agreeing not to compete in a certain area) and restrictions on products/customers/areas unconnected with the business being sold.

Representations and Warranties. Transaction agreements typically include Buyer and Seller representations and warranties regarding, *inter alia*, "consents and approvals" and "no conflict." The consents and approvals representation need not necessarily mirror the closing conditions. For example, the closing conditions may only include antitrust clearance from the U.S. and E.U. but the representation may have a broader formulation. The "no conflict" representation typically provides that the execution of the agreement and consummation of the transaction will not conflict or violate any order, writ, injunction, decree, statute, rule or regulation. Usually, there should be at least a carve-out for antitrust consents.

Drop-Dead Date. In deciding upon a date after which either party may terminate the agreement (a so-called "drop-dead date"), the parties should consider whether it provides enough time to obtain the expected antitrust approvals. Oftentimes, parties will elect to have a relatively short drop-dead date that provides for an extension (typically +90 days) in the event all closing conditions have been satisfied except for the antitrust regulatory closing condition.

Material Adverse Effect. If the Seller is concerned that its business is likely to deteriorate significantly during a prolonged antitrust review, Seller's counsel should be careful that the Buyer cannot use the material adverse effect provision to avoid any divestiture commitments or to avoid payment of reverse breakup fees.

Conclusion

Given the number of provisions that involve antitrust considerations and their potential impact on the transaction, the parties and their advisors are well-served by conducting antitrust due diligence early in the process and by carefully considering potential antitrust issues when initially drafting and negotiating agreements.

NOTES

1. *See* Global Competition Review, Getting the Deal Through: Merger Control 2010 (2009), *available at* http://www.gettingthedealthrough.com/books/20/merger-control; Global Legal Group, The International Comparative Legal Guide

February 2010 ■ Volume 14 ■ Issue 2

to: Merger Control 2010 (2009), *available at* http://www.iclg.co.uk/index.php?area=4&kh_publications_id=124.
2. *E.g.,* Canada, Greece, and Ireland.
3. *See, e.g.,* Whirlpool Corp., Agreement and Plan of Merger among Whirlpool Corp., Whirlpool Acquisition Co., and Maytag Corp. (Form 8-K), at § 7.01(b) (Aug. 22, 2005).
4. Although many companies disclose the receipt of a Second Request, particularly public companies, which must disclose material information, Second Requests are not public and therefore the FTC and DOJ likely issued more than 54 Second Requests in 2008 and 2009. For example, we know that in FY 2008 (October 1, 2007 through September 30, 2008), the FTC and DOJ issued 41 Second Requests. *See* Fed. Trade Comm'n Bureau of Competition and Dep't of Justice Antitrust Div., Hart-Scott-Rodino Annual Report Fiscal Year 2008, *available at* http://www.ftc.gov/os/2009/07/hsrreport.pdf.
5. *See, e.g.,* Pfizer Inc., Agreement and Plan of Merger among Pfizer Inc., Wagner Acquisition Corp., and Wyeth (Form 8-K), at § 6.3(d) (Jan. 29, 2009).
6. http://www.mergermetrics.com.
7. Specifically, we excluded deals classified by MergerMetrics as involving any one of the following features: (i) a tender offer; (ii) a short-form merger; (iii) a management buyout; (iv) a leveraged buyout; (v) a going private transaction; (vi) a special purpose acquisition company acquirer; (vii) a financial buyer; or (viii) a club deal.
8. The maximum, 39.81%, was in Monsanto Company's acquisition of Delta and Pine Land Company, a transaction that the Antitrust Division of the Department of Justice had challenged previously. The minimum, 0.11%, was in CapitalSource Inc.'s proposed acquisition of TierOne Corporation and just covered expenses.
9. Jim Mallea, Research Spotlight: Tick, Ticking, Ticking Fees.... (Mar. 31, 2009), https://www.mergermetrics.com/pub/rs_20090331.html.
10. ADVO, Inc., Agreement and Plan of Merger among Valassis Commc'ns, Inc., Michigan Acquisition Corp. and ADVO, Inc. (Form 8-K), at § 2.01(c) (Jul. 5, 2006), as amended by Amendment No. 1 to Agreement and Plan of Merger among Valassis Commc'ns, Inc., Michigan Acquisition Corp. and ADVO, Inc. (Form 8-K), at § 2 (Dec. 20, 2006).
11. *See United States v. Computer Assocs. Int'l*, 2002-2 Trade Cas. (CCH) ¶ 73,883 (D.D.C. 2002); *see also United States v. Qualcomm Inc.*, 2006-1 Trade Cas. (CCH) ¶ 75,195 (D.D.C. 2006).

To Change or Not To Change: Should Sponsors Modify Management Equity Due to the Market Downturn?

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Management equity is always at the front and center of any private equity acquisition since it aligns the economic interests of the private equity sponsor and management after closing and rewards management for their commitment to the success of the portfolio company. The effect of the economic downturn on management's expectations with respect to their equity has ranged from modest disruption of this traditional incentive alignment structure at some portfolio companies to complete devastation at others. This article explores how private equity sponsors are dealing with (or not dealing with) the changed financial return expectations of the management of certain portfolio companies.

Background

Nearly all private equity sponsors favor management equity programs consisting of a combination of some form of purchased equity and some form of "free" equity. The purchased equity, often funded from proceeds to management in the transaction or effected through the rollover of existing target equity, is intended to ensure that management's economic fortune is tied to the private equity sponsor's success through the risk of losing capital actually invested. "Free" equity accompanies the purchased equity and is essentially a form of carried interest, providing management with the opportunity to earn a return disproportionate to their cash investment as a reward for providing services to the portfolio company during a successful investment period.

Although this framework is generally consistent across private equity sponsors, there is significant variation from sponsor to sponsor and, sometimes, from deal to deal. For example, the purchased equity may or may not be the same class of equity purchased by the private equity sponsor, or loans to management to purchase equity may be permitted or disfavored. Free equity may consist of appreciation rights (such as options, stock appreciation rights or partnership profits interests) or full-value awards (such as restricted stock or restricted stock units), and may be subject to vesting based on performance or continued service (or both). For performance-vesting awards, goals may be keyed solely to an exit, or to ongoing financial metrics such as EBITDA, or other performance criteria. The effect of a termination of a holder's employment may differ from sponsor to sponsor, and calls on the management holder's equity (and, less often, puts) may or may not be triggered by a termination of employment. Transfer restrictions may lapse on an initial public offering or may continue after the offering until the private equity sponsor has largely exited the investment.

The economic downturn has disrupted the return models with respect to management equity in many deals, in some cases significantly. In particular, some deals that closed at the height of the private equity boom from 2005-2007 are now facing the prospect of, potentially, sharply lower returns than were anticipated at the time of closing. In addition, it is possible to likely that private equity sponsors will be forced to stay invested in certain of their deals for much longer than the normal 5-7 year investment period. The question that follows from this changed landscape—sometimes raised independently by a private equity sponsor and sometimes forced on a sponsor by management—is whether any changes should be made to the management equity program as a result.

Doing Nothing in the Downturn

Of the two alternatives to dealing with management equity in the current economic downturn—doing nothing and doing something—doing nothing has been the most common course to date. The following reasons are typically offered for maintaining the status quo:

- When considering whether to grant new awards, a private equity sponsor may be unwilling to increase the dilution of its interest caused by additional management equity.
- When considering whether to reprice options or otherwise adjust outstanding awards, the private equity sponsor may be concerned with the reaction of limited partners of the fund or, if the portfolio company is public, of the public shareholders.
- The private equity sponsor may not wish to treat management of a portfolio company uniformly with respect to any of the possible adjustments, and the prospect of making changes to some, but not all, employees' equity may be sufficiently disruptive that no changes are made. Similarly, some sponsors may be concerned about a domino effect from treating one portfolio company differently from another similarly situated portfolio company, although this has been seen as a lesser concern to date.
- As we have seen over the past year, markets do eventually recover, at least in part, and a private equity sponsor may be unable or unwilling to predict a recovery and may be wary that changes will result in a windfall if the recovery happens sooner, or more robustly, than expected.
- More generally, the private equity sponsor may view management equity changes as fundamentally inconsistent with the message that the private equity fund and management should participate together in both good and bad times.

Doing Something

Sometimes, however, a private equity sponsor views doing nothing as the wrong answer. This view is most often the result of the sponsor having concluded that existing equity held by a management team does not provide a sufficient incentive for the management team to remain focused on increasing the value of the portfolio company and to continue moving (no matter how slowly) toward an exit. In particular, where a sponsor views a management team as fundamentally solid but as having been swept up in the downturn by general market forces, changes to a management equity program may be more readily embraced. Other reasons, such as the costs of replacing a management team, the desire to avoid further deterioration in the portfolio company's business or the need to deal with a management team or individual managers with particular leverage, are also offered as reasons to make changes.

Changes to management equity programs considered by private equity sponsors range from tweaks to radical surgery. Although the following changes are most often considered, the diversity of portfolio companies, sponsors and management teams makes it unlikely that identifiable trends will develop.

New Grants of Free Equity. New awards are most common, probably because of their simplicity. Although new awards increase the dilution caused by management equity, the private equity sponsor may feel reasonably comfortable after modeling the dilution and expected return from the old awards and the new awards. Full value awards, such as restricted stock and restricted stock units, are often perceived as a more desirable form of free equity for these new grants—from the sponsor's perspective, because a lower number of full value awards are granted (when compared with stock options), and, from management's perspective, because full value awards continue to have an intrinsic value even if the value of the underlying stock falls after the grant date. Vesting in these new awards need not follow the same vesting principles as the prior awards, and applying performance vesting to a full value award is not uncommon. Requiring an additional cash investment as consideration for these new awards is uncommon.

Repricing of Options. Stock options continue to be the most prevalent form of free equity, and sponsors may consider whether to reprice underwater options. For private portfolio companies, a "straight" repricing—that is, the reduction of the exercise price to the new, lower fair market value—is a reasonably straightforward exercise. More complicated repricings, such as a reduction in the number of option shares in addition to a change in the exercise price, may require participant consent and, for a public portfolio company, may require compliance with the SEC's tender offer rules. Public portfolio companies may also need shareholder approval of a repricing under NYSE or Nasdaq corporate governance rules, and institutional shareholder reaction should be considered (even if the private equity sponsor ultimately controls the shareholder vote). In the past, repricings presented significant accounting risk if done incorrectly (which resulted in having to wait six months and one day to effect a repricing); under the current accounting rules, only the incremental cost of a repricing must be reflected in the portfolio company's financial statements, and as a result a repricing can typically be effected without significant accounting complexity or risk.

Resets of Performance Vesting and Related Adjustments. For awards subject to performance vesting, sponsors may consider resetting the performance goals to match the new expectations of the portfolio company's performance. For example, if existing EBITDA or cash flow metrics are hopelessly obsolete, the realignment of incentives through new EBITDA or cash flow metrics may make sense. Alternatively, a private equity sponsor may consider adopting completely new performance metrics to match a portfolio company's new outlook—for example, preservation of cash or compliance with debt covenants may, in the near term, be a more compelling performance metric than exit value. The *quid pro quo* for these changes may include re-setting requirements for continued employment, so that the sponsor can be reasonably assured that the portfolio company's management team will remain in place.

Cash Awards. Some private equity sponsors may wish to provide relief to management but also decide that they are unwilling to tinker with their customary methods of providing management equity. For these sponsors, it may make sense to consider a long-term cash incentive program. If structured correctly, such a program can be self-funding by predicating the awards to management on the direct or indirect generation of cash to pay those awards. Cash awards in the current downturn may also (rightly or wrongly) be perceived by a management team as more valuable than additional equity. These awards would normally be subject to medium-term performance-vesting goals rather than vesting on an exit. With respect to annual bonuses, some private equity sponsors are providing for shorter (*e.g.*, quarterly or semiannual) performance periods so that performance goals can be reexamined and refined over the course of the year in light of ongoing business volatility.

What About Liquidity?

Although the economic downturn has extended the investment horizon for some private equity sponsors in some portfolio companies, discussions about changes to management equity have to date generally not gone so far as to cover the possibility of providing a management team with the opportunity to exit its investment more quickly than the private equity sponsor. Exceptions to this general rule are, and should be, rare—a manager exiting before a sponsor exits (other than in the obvious cases of termination of employment or following an initial public offering) should be viewed as a fundamental change in the private equity model of management equity. In addition, the sponsor runs the potential risk in this situation of appearing to reward failure with liquidity. One example for which an exception may be appropriate is a selling founder nearing retirement age who was never intended to remain with the portfolio company past a normal investment horizon. It is also conceivable that some sponsors could offer partial liquidity outside of a public offering as a reward for satisfying performance goals, although probably not for a portfolio company that is a reasonable candidate for an IPO.

What Next?

It remains to be seen whether an economic recovery reduces the pressure on private equity sponsors to make changes to management equity programs at their portfolio companies. That may be the case, but an economic recovery will also likely lead to a more robust hiring market, which in turn may give members of management more leverage to demand improvements in their position. Additional pressure may also be placed on management equity if the recovery is delayed or in the event of another downturn.

Sweat the Small Stuff: Acquisition Agreement Terms to Which Target Companies Should Pay Closer Attention

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In the heat of negotiating the financial terms of an acquisition—the purchase price, earn-outs, the mix of cash and acquirer stock that will constitute the acquisition consideration—a target company's management and its lawyers sometimes neglect a number of important provisions in the acquisition agreement and acquisition-related agreements. Failing to address these matters can result in the target's and its stockholders' disappointment with the target's attorneys and sometimes the acquisition as a whole, even when the target and its stockholders have gotten a good deal.

1. **Ownership of the target's legal files.** Where the acquirer is purchasing the target's entire business, whether by merger, stock sale or asset sale, some thought should be given as to whether the target's acquisition-related legal files should be included in the sale. The acquirer may object to it, but there are two important reasons why the target, either directly (where the target survives the acquisition as an independent entity) or indirectly (through a stockholder representative or its stockholders), should retain ownership of these files.

First, if established early in the process (*e.g.*, at the letter of intent stage) that the target's successors in interest will retain ownership of the files and that the confidentiality of the target management's communications with the target's lawyers will thereby be preserved, this will promote necessary candor between the target's management and its lawyers to make appropriate disclosures and identify and address significant legal issues during the acquisition process. Second, the target's successors in interest may need the acquisition-related legal files in the event of a dispute related to the acquisition agreement, such as a purported breach of the representations and warranties or a disagreement over the interpretation of the terms of an earn-out. The target's successors in interest cannot rely on the discovery process to recover these files. In fact, if the target entity survives the acquisition as a subsidiary of the acquirer, the files may be protected by attorney-client privilege in favor of the post-acquisition target entity! The target should also consider if its successors in interest should retain any legal files not related to the acquisition.

2. **Selection of the stockholder representative.** Where the target does not survive the acquisition as an independent entity, a stockholder representative is oftentimes designated to look after the interests

February 2010 ■ Volume 14 ■ Issue 2

of the target's stockholders. In fact, the acquisition agreement in such transactions many times gives the stockholder representative the exclusive right to bring action on behalf of the target's stockholders, thereby barring other parties from taking legal action on behalf of the target's stockholders. The role of the stockholder representative is especially important where the acquisition contains an earn-out. It is the stockholder representative's duty to ensure the acquirer fulfills the terms of the earn-out and other post-closing obligations.

The target usually assigns the role of stockholder representative to one or more members of its management or board of directors. It is generally a challenge just finding someone willing to take on the responsibility. However, the process should be one of selecting an individual or individuals best situated to take on the role, bearing in mind that the stockholder representative will need to act quickly and consistently and may sometimes be at odds with the acquirer. Following are some options to consider.

If the target selects multiple individuals to bear the burden of stockholder representative, it can be beneficial to create a corporation or limited liability company owned and managed by such individuals to act as the stockholder representative. Equityholders and management are shielded from the liability of such entities provided that corporate formalities are met. And although acquisition agreements oftentimes release the stockholder representative from liability in fulfilling its obligations as stockholder representative in good faith, the extra liability shield provided by such an entity can help convince individuals to accept the responsibility of serving as the management of the stockholder representative entity and give them the peace of mind to effectively make decisions. In addition, corporations and LLCs provide a framework for equityholders and management to make decisions. If properly set up, the possibility of deadlock among the equityholders and management of the stockholder representative entity can be minimized.

It can be advantageous to appoint a single individual as the stockholder representative. By doing so, the target does away with the possibility of inaction due to disagreements among multiple individuals, and one would think that an individual stockholder representative should generally be able to make decisions more quickly and consistently than multiple individuals. However, the weight of being the sole individual stockholder representative can be oppressive and may lead to inaction. If opting for an individual stockholder representative, the target needs to choose an individual who has demonstrated the ability to make hard decisions. Note that a single individual can serve as stockholder representative through an entity as well, to take advantage of the liability shield.

Finally, whether the target appoints a single or multiple individuals, and whether these individuals serve as stockholder representative directly or through an entity, the target must anticipate conflicts of interest. Will any such individual be employed by the acquirer post-acquisition? If so, the target must determine whether this conflict will prevent the individual from effectively carrying out his or her duties. What if such an individual later goes on to found a company with technology suspiciously similar to that of the target? The acquisition agreement should contain a mechanism to allow the target's stockholders to replace the stockholder representative generally, including in the event of such a conflict of interest. If the stockholder representative is an entity, the charter documents of the entity should have a mechanism for its stockholders and/or management to be replaced in the event of such a conflict of interest.

3. **Funding the stockholder representative's activities**. Even if an acquisition closes smoothly, the stockholder representative will incur expenses following the closing in carrying out its duties. Some of these expenses will be basic, such as the costs incurred in exchanging telephone calls, facsimiles and correspondence (including FedEx charges) with stockholders. However, other expenses will be more specialized and more expensive. The stockholder representative will generally need legal services in its continued dealings with the acquirer, to help to respond to stockholders' legal questions and with other acquisition-related matters. It may also need accounting services to prepare or review balance sheets necessary for post-closing consideration adjustments and, if applicable, earn-out metrics. And, in the event of a dispute that leads to litigation, the stockholder representative will need legal, accounting and a myriad of other services.

A portion of the closing consideration should be held back to cover the stockholder representative expenses described above. If applicable, the stockholder representative should be entitled to hold back a portion of the earn-out consideration to cover expenses. In both cases, any unused funds can be remitted to the stockholders. Such provisions are generally included in the acquisition agreement.

In the event of litigation, the stockholder representative will need funding of a much larger magnitude. Whereas $100,000 might be a generous sum to fund the stockholder representative's other activities, it can constitute a mere drop in the bucket in terms of the costs of a serious litigation matter. In order to address such a possibility, the stockholder representative and the stockholders should enter into a stockholder representative agreement that allows the stockholder representative to draw funds directly from the stockholders. That is not to say that the stockholder representative will have carte blanche. A portion of the funding can be guaranteed (*e.g.*, up to $1,000,000 in the event of litigation related to the acquisition agreement), with additional funding requiring certain conditions or the approval of a majority or supermajority of the stockholders. In addition, where there are some stockholders with small ownership interests, the stockholder representative agreement should give the stockholder representative the option to defer or waive entirely smaller or *de minimis* contributions, lest the stockholder representative end up spending too much of its time chasing after and collecting small checks.

4. **Anticipating the post-acquisition legal needs of the target's successors in interest.** Where the target entity survives the acquisition as a subsidiary of the acquirer, the target's pre-acquisition lawyers continue to owe certain fiduciary duties to the post-acquisition target entity. This is true even when the post-acquisition target entity terminates the engagement of its pre-acquisition lawyers at closing, as is generally the case. However, it is almost always desirable for the target's lawyers to continue to provide some services following the acquisition to the stockholder representative or directly to the target's stockholders. In order to undertake such a representation, the target's successors in interest need to obtain a conflict waiver from the post-acquisition target entity and the acquirer as its parent. Such conflict waivers can be drafted directly into the acquisition agreement. The target should consider this issue prior to closing and arrange to receive necessary conflict waivers from the post-acquisition target entity and the acquirer at closing. In fact, in order to ensure continuity of legal services, it is advisable that the target's successors in interest enter into an engagement letter with the target's pre-acquisition lawyers at closing.

5. **Identifying the escrow agent and negotiating the terms of the escrow agreement.** In many deals, escrow agents are entrusted with paying out the merger consideration to the target's stockholders. However, the escrow agent is generally engaged by the acquirer, and the target and the stockholder representative are oftentimes not made parties to the escrow agreement. In such an arrangement, the escrow agent has very little incentive to provide excellent service to the target's stockholders.

The target should require the acquirer to identify its escrow agent early in the process so that the target can conduct diligence with respect to the escrow agent prior to entering into the acquisition agreement or escrow agreement and make objections to the escrow agent if necessary. Admittedly, it can be difficult to convince an acquirer to change its escrow agent. And it is nearly impossible to negotiate such a change where the acquirer is a public company, part of the acquisition consideration is acquirer stock and the acquirer wants to use the exchange agent for its stock as the escrow agent. The exchange agent is ideally situated to act as escrow agent.

In addition, the target should require that it (where it survives the acquisition as an independent entity), the stockholder representative or someone else with the vested interests of the stockholders be made a party to the escrow agreement and negotiate the escrow agreement so that the target's stockholders are ensured prompt payment of the acquisition consideration. Such prompt payment is particularly important where the target stockholders are receiving registered securities of the acquirer as part of the acquisition consideration. In a volatile market, a few days' delay can result in drastic depreciation of securities' value and materially diminish a stockholder's realized pay out.

6. **Address treatment of employees in the acquisition agreement**. Employees are oftentimes one of the target's most valuable assets. Although the target and acquirer can spend a significant amount of time negotiating the employment, noncompetition and other agreements for key employees, many times very little of the negotiation addresses the rank-and-file employees beyond which are being retained, who will want to know if their compensation and benefits and their day-to-day routines will change. Uncertainty can hurt their morale and productivity.

February 2010 ■ Volume 14 ■ Issue 2

If possible, the target should ensure that the acquisition agreement covers basic terms regarding the employees, such as: when employees will be notified if they are being retained; how and when retained employees' salaries will be set; what benefits the employees will receive from the acquirer; whether employees will become immediately eligible for such benefits (or if there will instead be a gap in coverage); and what credit, if any, the acquirer will give to the employees with respect to seniority for their service to the target. There are various other steps that can be taken with respect to retained employees to help ensure a smooth transition and maintain morale and productivity, but most of these lie outside the acquisition agreement and are therefore outside the purview of this article.

By addressing the six issues above, a target company's management and its lawyers can help ensure that a good deal does not come to be perceived as a bad one by the target's stockholders.

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