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"Dealing with Uncertainty in Mergers & Acquisition Transactions"

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Over the last two years, since the nadir of the financial crises, M&A activity has been on the rise. In 2010, total U.S. M&A activity rose to 1,933 deals from 1,116 deals in 2009, an increase of 73%. Thus far in 2011, overall U.S. M&A deal volume remains healthy, with nearly 1,000 closed transactions in the first half of 2011, up nearly 30% from the prior year period. This trend should continue, given the unprecedented amount of cash on the balance sheets of many corporate buyers, limited opportunities for organic growth, the increasing availability of leverage (at historically low interest rates), and the need for hedge funds to invest their so-called "dry powder" or liquidate their portfolio investments as a result of their investment mandates.

Volatility in the marketplace. Nevertheless, significant, ongoing financial concerns remain, led by fears of a European debt crisis, intransigent high unemployment, a glut of foreclosures, the potential for a double-dip U.S. recession, the recent downgrade of U.S. debt, and our seemingly dysfunctional political system. Is it any wonder the markets overanalyze every gesture of Fed Chairman Ben Bernanke and jump at the slightest rustle? Even though U.S. banks today are better capitalized than they were in 2008 and corporations are sitting on unprecedented amounts of cash, and GDP continues to grow (albeit at a slow pace), the credit markets and, hence, the M&A environment remain highly volatile. As a result, there are significant risks in attempting to buy or sell a business under current market conditions. Will the buyer be able to obtain the financing required to pay the purchase price? What if there is another market downturn that negatively impacts the seller's business? Will pre-closing buyer's remorse require renegotiation or termination of the deal? What if the seller hasn't fully disclosed trends or events that will negatively impact the business in the future? How do buyers and sellers hedge their bets and protect their interests?

Negotiating M&A purchase agreements is, at its core, the allocation of risks among the parties to the transaction. A full discussion of the various interwoven and complex considerations that go into that allocation is beyond the scope of this article. Instead, we highlight below five hot topics to which buyers and sellers should pay particular attention as they strike deals in this uncertain environment.

Don't skip the first step. Usually, M&A discussions begin with the signing of a confidentiality agreement (sometimes called a non-disclosure agreement or "NDA"). Too often, the parties gloss over the importance of these agreements, considering them boilerplate, perhaps even signing the form provided by the other party without reviewing it with counsel. If the deal successfully closes, this will likely be a non-issue. But when a party walks away from the negotiation table, a confidentiality agreement may be all the other party has to protect its interests.

Take, for instance, a very recent case out of Atlanta, where Gemini, a private equity firm, signed a term sheet to finance the acquisition by AmeriPark of a competitor (Mile Hi). The term sheet included exclusivity and confidentiality provisions pursuant to which AmeriPark "agree[d] not to discuss this opportunity or reach any agreement with any person or entity regarding financing for this Transaction or the pursuit of any sale or major other financing." During the exclusivity period, AmeriPark abandoned the negotiations and began talks with one of its largest shareholders (Greenfield), who was also the sole shareholder of Mile Hi, eventually completing the acquisition using seller financing and totally cutting Gemini out of the deal. Gemini sued AmeriPark for breach of the exclusivity and confidentiality provisions arguing that the term "any person or entity" was unambiguous and clearly covered Greenfield. The court disagreed, noting that an exception to the confidentiality provision contemplated that the transaction could be discussed with "those in a confidential relationship with [AmeriPark]" and that in any event, discussions with Greenfield should have been anticipated since the proposed Gemini financing contemplated a redemption of Greenfield's stake in AmeriPark.

Regardless of whether you agree with the Court's ruling, the case highlights the need to carefully craft confidentiality agreements. With whom can the parties share confidential information? How is confidential information defined? Are there any exceptions? What are the permitted uses of confidential information? Should the agreement also include, among other things, a non-solicitation provision (preventing the other party from soliciting your employees, customers, vendors, and even shareholders), a standstill agreement (preventing the seller from soliciting other bids or pursuing other sales opportunities during the restricted period), or a provision restricting trading in securities (particularly important if one party is a public company)? Depending on your role in the transaction and the facts and circumstances, you may wish to include an expansive or narrower definition of confidential information, restrict the range of permitted uses of the information, or insist on some or many additional protective provisions.

Once the parties have carefully crafted their NDA, they should be careful not to inadvertently supersede or render it void when they enter into subsequent letters of intent or definitive purchase agreements. Often those agreements include a provision that states "this agreement sets forth the entire understanding of the parties hereto with respect to the subject matter hereof and supersedes all prior agreements among the parties." If the letter of intent or purchase agreement neglects to include, or contains only a perfunctory, confidentiality provision, it may be deemed to have superseded the NDA, leaving the parties without the benefit of the NDA's protections.

Bridging the purchase price gap. There is a natural tension between the value a seller places on its company and how much a buyer is willing to pay for it. This tension is elevated in an uncertain economic environment, when no one knows what tomorrow may bring. An "earnout" is designed to bridge this gap by providing additional compensation to the seller if certain post-closing targets are met.

Over the last few years, earnouts have become increasingly important in M&A transactions. According to JP Morgan, the value of earnouts as a percentage of the total deal value rose to a new high of 41% in 2011, compared with 37% in 2010 and 25% in 2001. This is due, in part, to the uncertain economic environment, but also due to the fact that business valuations are increasing while less debt financing is available to provide the cash to pay such

higher prices. We expect that earnouts will continue to be a significant component of deal compensation, at least in the near term.

Conceptually, earnouts seem straightforward. If the target company achieves certain targets following the sale, the seller "earns" more money. But like so many things, the devil is in the details, resulting in a high degree of pre-signing negotiations and post-closing disputes between buyers and sellers. Parties to M&A transactions are well advised to focus on the details of earnouts during the negotiation process. While the structure of an earnout may vary widely, some of the more important issues to address include:

- earnout targets (these commonly include gross sales, net income and EBITDA, but earnouts can also be based on non-financial targets);
- earnout period (the additional payment could be a one-time event or stretched over multiple years; the period is sometimes tied to an employment or non-compete period);
- structure of the earnout (which could be a fixed amount or based on a multiple, percentage, or some other formula); and
- caps, early buyout provisions, and acceleration provisions (devices to limit the parties' ultimate monetary risks)

In many deals, the focus is on the first three items above, but equal attention should be given to the fourth consideration. A cap sets a limit on the total earnout payable, which is important to protect the buyer if the earnout is based, for example, on a multiple of EBITDA. Particularly in uncertain times, financing for the earnout payment may not be available, or existing loan covenants might create a conflict between the buyer's obligations to the seller and to the buyer's bank. A buyout option generally entitles the buyer to pay a specified amount to satisfy any remaining earnout payment obligations. This may become important, for example, if the buyer decides to sell its business prior to the end of the earnout period, since potential buyers may not be interested in buying a company with future earnout payment obligations, particularly if they are uncapped. Conversely, an acceleration provision generally requires the buyer to immediately pay a fixed earnout amount if certain specified events occur. For example, if the buyer undergoes a change of control after closing, the seller may prefer that a minimum earnout amount be paid immediately rather than undertaking the risks related to business performance under the new ownership.

Hedging the bet. Another way for buyers and sellers to bridge the gap on the purchase price while allowing the buyer to hedge its bet is to provide for a "holdback." A "holdback" is simply the negotiated portion of the purchase price which is placed in escrow at closing and held until the terms of the escrow have been satisfied. Typically, the holdback serves to ensure that the buyer will be able to get a portion of the purchase price returned to it if (a) there is a post-closing purchase price adjustment (*e.g.,* an adjustment based on a requirement that the seller's balance sheet at closing meet certain minimum requirements), or (b) the seller is required to indemnify buyer post-closing (*e.g.,* for claims based on a breach of the seller's representations and warranties contained in the purchase agreement). Any portion of the holdback that is not returned to the buyer generally is released to the seller at the end of the holdback period.

Having an escrow holdback reduces the buyer's risk and, thus, can serve to increase the purchase price to the seller. Of course, the seller is deprived of the use of the holdback funds during the escrow period and the holdback may tend to shift the parties' respective leverage in any post-closing purchase price adjustment or indemnification dispute. Accordingly, the terms of the holdback, including the amount, duration, and specific purpose and terms of the holdback are often heavily negotiated.

According to JP Morgan, based on a study of 250 publicly-disclosed M&A transactions in 2010:

- the median percentage of the purchase price placed into a holdback escrow was 9%;
- the median duration of the holdback escrow was 18 months;
- among transactions in which representations and warranties survived closing, 83% were supported by a holdback escrow to mitigate buyer risk; and
- 24% of escrow agreements called for multiple escrow accounts to be used for distinct purposes (one for general indemnification purposes and the other for purchase price adjustments).

As an alternative or supplement to a holdback, buyers and sellers also may wish to consider representation and warranty insurance. In general, representation and warranty insurance provides buyers with additional risk mitigation, particularly in situations where the holdback is non-existent or relatively small, or where sellers have imposed caps or other limitations on their indemnification obligations. Conversely, sellers may wish to purchase representation and warranty insurance to mitigate their indemnification exposure and as a means to exit their investment cleanly and quickly. For example, a seller may wish to buy insurance so that it knows exactly how much of the purchase price it has available to pay off creditors, limited partners, and other investors, or to enter into another venture, instead of having to reserve a part of the purchase price for indemnification contingencies. While representation and warranty insurance has been around for several years, in the U.S. this insurance product is still rarely used. Still, both buyers and sellers may wish to explore its benefits and costs, particularly in this economic environment.

Negotiating the outs that let a buyer walk from a deal. Generally, once the parties sign an M&A agreement they are bound to close the transaction if the stated conditions to closing are satisfied. Common closing conditions include receipt of financing, third-party consents, and shareholder approval. However, during the pre-closing period (*i.e.,* the period between the signing of the M&A agreement and the closing), there is a risk that some event may arise that materially negatively impacts the business of the seller, a so-called "Material Adverse Event" or "MAE." Examples of MAEs include the loss of the seller's largest customer or a fire, flood, or other *force majeure* event that significantly impacts the seller's operations. Accordingly, most M&A purchase agreements state that one of the conditions to the buyer's obligation to close the transaction is that the seller "shall not have undergone a Material Adverse Event" prior to closing. Because the occurrence of an MAE would allow the buyer to walk from the deal

without being in breach of the agreement, MAE clauses are heavily negotiated between the parties to M&A transactions.

Following the 2007/2008 financial meltdown, MAE clauses have received additional attention in M&A negotiations. Obviously, sellers want to limit the applicability and breadth of the clause, while buyers want to strengthen and clarify their ability to walk away from the deal. Furthermore, during the last few years, these negotiations have been impacted by a series of recent Delaware cases in which the courts consistently have ruled in favor of the sellers and concluded that no event had occurred that qualified as an MAE, as defined in the various purchase agreements at issue. As a result, we expect that buyers will become even more aggressive in negotiating MAE clauses.

Among the concessions that buyers may attempt to obtain from sellers are the following:

- Limiting pro-seller exclusions to the definition of MAE (typical pro-seller exclusions include changes in law or GAAP and general economic downturns that impact the seller's industry as a whole and not the seller individually);

- Shifting the burden of proof to the seller (which requires that the seller establish that no MAE has occurred, or at least that one of the MAE exclusions is applicable);

- Making the MAE forward-looking (by revising the definition of an MAE so that it includes "any event which results *or is reasonably expected to result either before or after Closing* in a material adverse impact on the seller's business, operations, assets, or *prospects*"); and

- Setting the measurement period (so that the determination of whether an MAE has occurred is not judged solely on the long-term prospects of the seller (as the Delaware courts tend to do), but also on the short-term).

Agreeing up front on the penalty for failing to close. Because no deal is guaranteed to close, the parties should carefully consider their remedies should the other party fail to close, whether as a result of a non-willful breach (*e.g.,* the buyer's inability to obtain financing notwithstanding good faith efforts) or willful breach (*e.g.,* buyer's remorse). As was evidenced by the wave of busted deals during the recent financial crisis, this is particularly important to sellers in uncertain economic environments where financing is uncertain and bad economic news can easily spook buyers and their lenders and investors.

Unfortunately, buyers and sellers often fail to pay sufficient attention to the ramifications of a failure to close when negotiating M&A transactions. Perhaps this is because neither party wishes to think about the possibility that the deal may collapse, or perhaps it is because they are focused on what they believe are the bigger issues (like earnouts and holdbacks). Nevertheless, in this volatile market, both buyers and sellers should carefully consider their remedies prior to signing a definitive purchase and sale agreement.

Generally, the remedies available to a seller can be categorized into the following four categories, but these remedies may be combined and modified in several fashions:

- Specific performance (if the buyer refuses to close, the seller can request a court to force the buyer to do so);

- Reverse break-up fee and no specific performance (if the buyer fails to close, the seller is only entitled to payment of a negotiated fee as an exclusive remedy and cannot force the buyer to close or seek any damages; this can be a single fee or a two-tiered fee, with a higher fee payable for a willful breach and a lower fee payable for a non-willful breach);

- Specific performance if the financing is available; reverse break-up fee if the financing fails (the seller has the right to force the buyer to close if financing is available, but if financing is unavailable, the seller's only remedy is a reverse break-up fee); and

- Pure damages (no specific performance and no break-up fee, but instead, if the buyer fails to close, the seller can sue the buyer to recover its expenses and damages, which it must prove).

While there is no absolute rule, the remedies reflected in negotiated M&A purchase agreements tend to vary depending on whether the buyer is a financial or strategic buyer and whether it needs debt financing to fund the transaction. Generally, because most strategic buyers do not require financing to complete a deal (many are sitting on large cash stockpiles), most are willing to sign agreements without a financing condition and to agree to specific performance should they fail to close. Conversely, most private equity/financial buyers require some debt financing to pay the purchase price, and, as a result, demand financing closing conditions and opt for some form of reverse break-up fee for failure to close, instead of specific performance. In either event, with both financial and strategic buyers, of the forgoing four categories of damages, the last (pure damages) is the least common.

Conclusion. In an uncertain economic environment, even the plain vanilla provisions in an M&A transaction are subject to greater scrutiny. The five areas highlighted in this article are among those that require closer attention and provide a means for counsel to use their creativity to help their clients negotiate and, more importantly, close deals in troubled times. While the possibility of unfavorable outcomes cannot be eliminated, by identifying and addressing the risks that are most critical, the parties can reduce the impact of unforeseen circumstances and protect themselves through skillful negotiation of the M&A deal provisions discussed in this article.

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