Mergers, Acquisitions, Market Turbulence and the Credit Crunch

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The U.S. credit markets started a downhill slide in August of 2007 with heavy losses in the sub-prime lending industry. The ramifications of this downturn, coupled with the looming threat of inflation, led to increased volatility in the equity markets and an overall softening of the economy. This age of economic uncertainty has prompted a re-evaluation of commonly held beliefs and routine practices in the world of mergers and acquisitions (M&A). Corporate leaders and counsel should consider strategic adjustments to structuring and positioning M&A transactions. It is equally essential that associated documentation offer both the most solid legal protections for the client while taking into account the affect of a weakened economy on the deal. It behooves lawyers to fully analyze M&A proposals, monitor pending case law, and revise the related documentation as needed.

Over the past nine months, private equity firms involved in M&A deals have endeavored to negotiate or renege on several high-profile transactions as a result of various factors, including the sluggish markets, lack of financing and poor decision making. Some equity investors, due to inadequate finances, have employed strategic and tactical legal maneuvers to avoid obligations stipulated under M&A transactional documents. In many cases, buyers relied upon financing contingencies and material adverse change (MAC) clauses to circumvent contractual obligations in consummating deals.

In the wake of these developments, transactional lawyers are teaming with their attorney colleagues to gain negotiating leverage by raising the threat of litigation or adverse proceedings to renegotiate transactions or avoid liability under transactional documents. These developments require renewed focus on pre-deal planning and careful attention to drafting to ensure an integrated transaction document that provides maximum flexibility.

MAC CLAUSES

A MAC clause, also known as material/adverse event/effect or MAE clause, is a method for parties to a transaction to allocate risk. When a company agrees to an acquisition, by definition there is a waiting period between the dates of the original transaction agreement and the closing. A MAC clause enables the M&A parties to contractually allocate which party will bear the risk of adverse events which may occur during this interim period. Sellers usually attempt negotiating as narrow a definition as possible to shift as much risk to the buyer. Not surprisingly, buyers often attempt to negotiate as broad a definition as possible to

provide leeway for terminating an agreement if a post-signing, but pre-closing adverse event(s) occurs. The specifics of MAC clauses vary with each M&A transaction and subsequent negotiations are subtle and critical to the successful consummation of the deal.

Parties often define a material adverse effect as "an effect, event, development or change that, individually or in the aggregate, is materially adverse to the business, results of operations or financial conditions of the company and its subsidiaries, taken as a whole." MAC could also be defined to include an "effect, event, development or change" that would affect the ability of the buyer or seller to complete the proposed transactions in a timely manner.

Fraught with ambiguity, these definitions impede negotiations, especially given the current economic climate. A threshold issue that must be addressed is whether the "effect, event, development or change" is restricted to the "business" or applies to other aspects such as seller's results of operations, assets or prospects. Most MAC clause negotiations also include "carve-outs," which define materially adverse events excluded from the definition of a MAC event. A seller's ability to meet earnings projections and changes in the price of the securities of the issuer are common MAC exclusions. Generally, parties negotiate carve-outs to allocate market risk to the buyer and closing risk to the seller for adverse events.

Because buyers will often structure a MAC clause in as broad a form as possible, the inclusion of the clause provides certainty for the buyer. The ambiguity, uncertainty and legal risks of MACs stem from the fact that most are defined in qualitative as opposed to quantitative terms. Additionally there is a lack of reported legal precedents interpreting such clauses.

A buyer-initiated MAC clause does not necessarily insinuate an intention to cancel the transaction. It may indicate a strategic move by the buyer to obtain a price reduction. Buyers may also invoke or threaten to use MAC to curb risks and discourage any legal challenges from the seller.

Due to upheaval in the capital markets, invocation of MAC clauses is now the norm rather than the exception in M&A transactions. Arguably, MAC clauses were initially designed to analyze how well or poorly a company has performed relative to its peers from the date the sale agreement was signed to the closing date. As MAC clauses evolve, buyers seek to expand the scope of such clauses to encompass broader changes in market conditions.

FINANCING CONTINGENCIES

Until the recent credit crunch, financing contingencies were increasingly narrowed or eliminated from M&A transaction documents. The recent tightening and collapse of some credit markets facilitated the need for transactional lawyers to incorporate financing contingencies in M&A proposals.

In many recent cases, buyers relied on the issue of financing, or alleged revocation of financing, as a means for renegotiating and/or terminating transaction documents. As in the case of the invocation of the MAC clause, the reliance on such a legal position, relative to financing contingencies, can well be viewed as an effort to renegotiate the basic deal, terminate the transaction, or invoke a reverse termination fee.

REVERSE TERMINATION FEE

The reverse termination fee provides the buyer a right to abandon a transaction in return for payment to the seller of a fixed fee, generally in cash. These clauses provide sellers with a clear financial and legal remedy analogous to a liquidated damage clause.

BEST EFFORTS AND SPECIFIC PERFORMANCE CLAUSES

In response, many savvy sellers are negotiating and requiring the inclusion of "best efforts" clauses into transaction documents.

Such clauses require buyers use best efforts to enforce debt and equity financing letters. Prudent sellers also employ specific performance clauses in transaction documents requiring buyers close a transaction as specified.

HELL OR HIGH WATER CLAUSES

In the regulatory context, sellers are incorporating "hell or high water" provisions into transaction documents. A cousin of best efforts clauses, these stipulations oblige buyers to insure they comply with regulatory mandates as a condition to closing.

CHARTING A COURSE TO CLOSING

To weather the storm of economic instability across the board, prudent lawyers will keep some of the following suggestions in mind as they work through the M&A landscape:

1. Avoid letters of intent and rely on signed transaction deal documents.
2. Wherever possible, keep things simple.
3. Encourage clients to assemble a qualified team of professionals: attorneys, investment bankers and accountants and to deal with reputable firms and lenders.
4. Review, revise and update boiler plate transaction documents to insure they are relevant to the new realities of the marketplace. MAC clauses, reverse termination fees, specific performance, best efforts, and hell and high-water clauses, cannot be read in a vacuum lest these clauses provide tactical opportunities for renegotiation or open an invitation to litigation. Counsel should not rely on boiler plate forms to document transactions.
5. Avoid complex drafting.
6. Know your client's objectives and goals so they can be set forth in a coherent and cohesive transaction strategy.
7. Communicate with your litigation colleagues and monitor recent case law developments. Transactional lawyers cannot work in a legal vacuum and today's headlines are filled with the details of deals gone bad. The prospect of litigation — something every transactional attorney hopes to avoid — cannot be underestimated. Plan accordingly.
8. Pay attention to the boiler plate provisions. In today's world, venue and choice of law provisions cannot be given short shrift and often carry significant strategic value.
9. Financing documents are critical. Clients and their counsel should request, review and scrutinize closely any commitment and financing letters.

A turbulent market and a liquidity crunch have given rise to new types of litigation surrounding M&A activity. To adapt and protect themselves, many buyers are leveraging a number of new strategies when structuring transactions to avoid subsequent litigation. As is often the case, the best defense is a good offense — know what's happening up front in the market and structure your M&A team accordingly, including your bankers, lawyers and accountants. Prudent selection of your team is critical to crafting the details of the deal and sheltering it from litigation.

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