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Shifting the Risk: an Evolving Approach to Financing Contingencies in LBO Acquisitions

Reverse Termination Fees and/or Equity Sponsor Guarantees in lieu of the Traditional Financing Out

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One of the more interesting developments last year in private equity sponsored leveraged buyouts was the shift—from the sellers to the sponsors — of the debt financing risk. Last year saw a number of highly publicized deals in which the sponsors relinquished the traditional right to walk away from an acquisition if the debt financing was unavailable at closing on the expected terms. Instead, the sponsors agreed to pay a "reverse termination fee" and/or guarantee the payment of a capped amount of the seller's damages resulting from the buyer's failure to close. This evolving approach to financing contingencies—which has developed for the reasons discussed below—is likely to continue in the current year.

In this article, we first briefly describe how private equity sponsored LBOs are structured and the "traditional approach" to financing contingencies. Second, we provide an overview of the general elements of this evolving approach, followed lastly by our concluding observations about the two approaches and considerations for sponsors, sellers and their advisors in evaluating those approaches.

Structure of Private Equity Sponsored LBO's

The same basic framework has long been employed in LBO transactions.

Shell Buyer. Traditionally, sponsors have acquired companies through newly-formed acquisition vehicles. These so-called "shell buyers," instead of the sponsors themselves, typically act as the buyer under the acquisition agreement. Accordingly, the target company and its sellers (and we use the term "sellers" to refer to both the target and its owners) do not have contractual recourse to the sponsors for breaches by the shell buyer.

Equity and Debt Commitment Letters. To fund the purchase price for a leveraged buyout, the shell buyer draws on equity financing commitments obtained from the sponsors and debt financing commitments obtained from lenders. Under a standard equity commitment letter, the sponsor is obligated to fund the equity commitments if, but only if, the shell buyer's closing conditions under the acquisition agreement have been satisfied. In other words, if the acquisition agreement included a debt financing condition and the contemplated debt financing were not available at closing, the shell buyer would have no obligation to close and the sponsor would have no obligation to fund its equity commitment.

Under a standard debt commitment letter, the lenders' funding conditions can be more expansive than the shell buyer's closing conditions under the acquisition agreement. Lenders, with lower expected returns than equity sponsors, have naturally tended to accept less risk. This gives rise to the possibility that the shell buyer is obligated to close the acquisition (absent a debt financing condition in the acquisition agreement) but the lenders are not obligated to lend it the required funds. This "mismatch" in acquisition closing and debt funding conditions presents significant execution risks in acquisitions.

Incremental Debt Funding Conditions. Some examples of incremental lenders' funding conditions that create a mismatch with the closing conditions in the acquisition agreement are:

- no material adverse change (MAC) in the target company, where "material adverse change" is defined in the debt commitment letter differently than in the acquisition agreement;
- no material adverse change in the financial markets;
- compliance with specified financial measures (such as a maximum pro forma leverage ratio or a minimum amount of EBITDA);
- no discovery of new information that is inconsistent with information previously provided to the lenders; and
- completion of definitive documentation and delivery of customary closing items (such as security interests, title insurance and legal opinions) in each case that are satisfactory to the lenders.

Also, debt commitment letters often contain "market flex" provisions that permit the lenders to change the pricing, reduce the size and alter other terms of the contemplated debt if market conditions deteriorate.

As a consequence of the mismatch of conditions and market flex provisions, the availability of debt financing on the expected terms can be outside the control of the parties to the acquisition. So the critical issue arises: who bears that risk, the sponsors or the sellers?

The Traditional Approach to Financing Contingencies

Sellers' Risk. More often than not, it has been the sellers that have borne the financing contingency risk. Traditionally, the acquisition agreement would contain the following provisions:

- a closing condition that the shell buyer has obtained funds under the debt financing contemplated by the debt commitment letters (or alternative debt financing on terms not less favorable to the shell buyer than the debt commitment letters);
- a representation and warranty of the shell buyer on matters concerning the equity and debt commitment letters that were delivered at signing of the acquisition agreement (such as their validity and enforceability and that the shell buyer has no reason to believe that the funding conditions will not be satisfied);
- a covenant of the shell buyer to use a defined level of efforts (whether reasonable best efforts or commercially reasonable efforts) to obtain the contemplated debt financing; and
- a covenant of the sellers to cooperate with the shell buyer in connection with the contemplated debt financing.

Under this approach, if the contemplated debt financing is unavailable despite the shell buyer having used agreed upon efforts to obtain it, the shell buyer is not obligated to close and the sellers have no further recourse against either the shell buyer or the sponsors.

Sponsor Downside Protected. Without the debt financing condition, the shell buyer would be in breach of the acquisition agreement, and exposed to damage claims brought by the sellers, if it failed to close as a result of the failure of the debt financing. While the shell buyer may not have the wherewithal to satisfy a damage claim, it is quite possible that the sellers could collect damages from the sponsor under "corporate veil piercing" or other equitable theories. What's more, that measure of damages—typically the difference between the deal price and the target's value at the time of breach—could exceed the amount of equity capital the sponsor was prepared to commit to the transaction. Finally, the sponsors as repeat players in the acquisition business could suffer grave reputational harm if they were viewed as trying to hide behind a shell buyer that was in breach of its obligations.

An Evolving Approach to Financing Contingencies

New Environment. Last year saw a distinct shift away from the traditional approach for perhaps four reasons. First, with large pools of capital intensively competing for limited acquisition candidates, heated auctions became increasingly common. Moreover, financial sponsors are frequently competing head-on with healthy strategic bidders able to commit to an acquisition with no financing contingencies. Second, because sponsors generate significant deal flow for debt financing sources, they wield enormous clout with lenders. As a result, sponsors have been better able to significantly narrow or even effectively eliminate the incremental lender conditions to funding, narrowing the mismatch with the acquisition conditions. Third, sponsors have enjoyed a frothy financing market that has emboldened their willingness to assume the financing contingency risk. Fourth, sponsors may perceive a benefit in the new approach because their exposure is defined and/or capped. Effectively, they obtain an option on the acquisition (albeit highly priced) permitting them to walk away or limiting their downside exposure should they elect not to close based on an assertion that a "material adverse change" has occurred at the target.

Some notable leveraged buyouts announced in 2005 where the sponsors assumed the financing risk include:

- the acquisition of SunGard Data Systems, Inc. led by Silver Lake Partners, Bain Capital, The Blackstone Group, Goldman, Sachs & Co., Kohlberg Kravis Roberts, Providence Equity Partners and Texas Pacific Group (approximately $11 billion equity value);
- the acquisition of The Neiman Marcus Group, Inc. led by Texas Pacific Group and Warburg Pincus & Co. (approximately $5.1 billion equity value);
- the acquisition of Wyndham International, Inc. led by The Blackstone Group (approximately $1.4 billion equity value); [Note to readers: Paul, Weiss, Rifkind, Wharton & Garrison LLP represented Wyndham in this acquisition.]
- the acquisition of Insight Communications Company, Inc. led by The Carlyle Group (approximately $710 million equity value);
- the acquisition of The Hertz Corporation led by Clayton Dubilier & Rice, The Carlyle Group and Merrill Lynch Global Private Equity (approximately $5.6 billion equity value); and
- the acquisition of Town & Country Trust by Morgan Stanley and Onex Corporation (approximately $800 million equity value).

In each of these transactions, the shell buyer assumed the debt financing risk and, in many cases, agreed to take down its lenders' bridge loan commitment at the end of a specified marketing period if the contemplated high yield bond offering was not completed by that time. Under the evolving approach seen in these transactions, sellers have direct recourse against sponsors for the shell buyer's breaches up to a specified maximum amount, and in some cases the sponsors agree to pay a "reverse termination fee" to the sellers as liquidated damages if the debt financing is unavailable. These sponsor guarantees and reverse termination fees typically are the sellers' sole and exclusive remedies, and quite often sellers agree to waive their ability to seek specific performance or pursue other equitable remedies (including corporate veil piercing). We describe in turn each of these elements in more detail.

1) No Financing Condition. These transactions no longer include a debt financing condition for the shell buyer's benefit. As a result, it is the sponsors and not the sellers that bear the risk that the contemplated debt financing will not be available at the closing. In some instances (most notably in SunGard), the acquisition agreement contains a "no Market MAC" or "no Lender MAC" closing condition in lieu of the traditional debt financing condition, but these conditions have been defined so narrowly as to be rendered almost useless. In SunGard, the no Market MAC and no Lender MAC conditions permitted a walk-away only in the most cataclysmic of circumstances, such as a general suspension of trading on the NYSE for three or more consecutive business days or lenders providing at least 25% of the contemplated debt financing were declared insolvent.

2) Prompt Drawdown of Bridge Loan Commitment. The second element of the evolving approach is the obligation of the shell buyer to complete the high yield debt offering that invariably is a component of the financing plan within a specified marketing period or else draw down its bridge loan commitment to close the acquisition. While under the traditional approach the shell buyer may have had until the so called "drop-dead date" of the acquisition to market and complete the high yield debt offering before it is required to draw down its bridge loan commitment, under the evolving approach the shell buyer may be required to do so a significant amount of time before the drop-dead date.

3) Limited Recourse to Sponsor. The evolving approach—of which there are three varieties—always incorporates a capped sponsor guarantee and, sometimes but not always, a "reverse termination fee" payable under different circumstances. These two provisions expressly serve as the sellers' sole and exclusive remedy for the shell buyer's failure to close the acquisition. The existence of the capped sponsor guarantee provides the sellers with contractual recourse against a solvent entity without need to resort to proving equitable theories to reach the sponsor.

a) ***Debt Receipt Failure Fee.*** The first variation of sponsor recourse under the evolving approach involves what we call the "debt receipt failure fee." Neiman Marcus and Hertz implement this variation. Under this approach, the shell buyer is required to pay the sellers a reverse termination fee as liquidated damages if the sellers terminate the acquisition agreement because the shell buyer breached its obligation to close <u>solely</u> due to the failure to receive the contemplated debt financing. The debt receipt failure fee is accompanied by a sponsor guarantee of the shell buyer's obligations under the acquisition agreement that is capped at an amount greater than the amount of the fee. The sponsor guarantee covers not only the obligation to pay the fee but also an amount of damages (up to the cap) arising from other breaches by the shell buyer of its obligations under the acquisition agreement. These additional breaches may include the failure of the shell buyer to use the defined level of efforts to obtain the contemplated debt financing.

Where the target is a public company, the amount of the debt receipt failure fee typically equals the termination fee payable by the target if its board exercises its fiduciary out. For instance, in Neiman Marcus, the debt receipt failure fee payable and the fiduciary out termination fee each equaled $140.3 million, or approximately 2.8% of the equity value of the transaction. Where the target is not a public company (such as in the case of a division of a public company), there is no fiduciary out termination fee to mirror so the amount of the debt receipt failure fee is determined by negotiation. For example, Hertz involved a debt receipt failure fee of $125.0 million, or approximately 2.2% of the equity value of the transaction. Similarly, the cap, or the maximum amount of liability under the sponsor guarantee, also is determined by negotiation and can vary greatly from deal to deal. In Neiman Marcus, the cap was $500 million, or approximately 9.8% of the transaction's equity value, whereas in the Hertz acquisition, the cap was $300 million, or approximately 5.4% of the transaction's equity value.

b) ***Walk-Away Fee.*** The second variation of sponsor recourse under the evolving approach involves what we refer to as the "walk-away fee." SunGard adopts this variation. In it, the shell buyer is required to pay the seller a reverse termination fee as liquidated damages if the seller terminates the acquisition agreement for <u>any</u> material breach by the shell buyer (including <u>but not limited to</u> a breach by the shell buyer of its obligation to close the acquisition due to the failure to obtain the debt financing). In SunGard, the amount of this walk-away fee was equal to the termination fee payable by the target company if its board exercised its fiduciary out ($300 million, or approximately 2.7% of the transaction's equity value). As is the case with the debt receipt failure fee, the walk-away fee also is accompanied by a sponsor guarantee of the shell buyer's obligations under the acquisition agreement. Unlike the debt receipt failure fee, the sponsors' liability under the sponsor guarantee is capped at an amount equal to the amount of the walk-away fee for <u>all</u> breaches by the shell buyer (not just those arising solely from the failure to receive the debt financing). In practical terms, the sponsors in SunGard had the option to walk away from the transaction for any reason upon payment of a $300 million fee.

c) ***No Fee/Capped Damages.*** The third variation of sponsor recourse we refer to as the "no fee" variation. Under this approach, which was used in Wyndham and Insight, there is no debt receipt failure fee or other reverse termination fee payable by the shell buyer under any circumstances. Rather, there is a sponsor guarantee which covers damages up to a specified cap amount arising from breaches by the shell buyer of its obligations under the acquisition agreement. Accordingly, the sellers are not guaranteed the payment of a liquidated, sum-certain amount but rather have to prove actual damages suffered as a result of the breach. Like the debt receipt failure fee approach, the maximum amount of liability under the sponsor guarantee in this variation is also determined by negotiation, and is subject to great variance. In Wyndham, the cap was $275 million, or approximately 19.6% of the transaction's equity value; in Insight, the cap was $10 million, or approximately 1.4% of the transaction's equity value; and in Town & Country, the cap was $200 million, or approximately 25% of the transaction's equity value.

4) Sole and Exclusive Remedy. Each of the approaches described above includes an expressed limitation on remedies available to the sellers. Invariably the acquisition agreements will provide that payment of the debt receipt failure fee or other reverse termination fees and/or performance under the capped sponsor guarantee is the sole and exclusive remedy of the sellers against the shell buyer and its sponsors. Often the sellers also are prohibited from seeking specific performance to require the shell buyer to complete the acquisition.

Conclusion

Obviously, the sellers in the current market for leveraged buyouts have been insisting on implementing the evolving approach in order to provide for greater deal certainty. Indeed, the evolving approach provides real, less-conditional recourse to credit-worthy entities which should enhance the sponsors' incentive to ensure completion of the acquisition. But the evolving approach also grants sponsors a walk-away option capped at a sum-certain (albeit often times an expensive sum-certain) amount. Moreover, because this evolving approach fixes or caps the cost of that option, it arguably removes the reputational taint that otherwise could result if a sponsor failed to complete a transaction. Finally, as the case law interpreting "material adverse effect" and "material adverse change" makes it more difficult for buyers to assert a walk-away right based on adverse occurrences in the seller's business, sponsors may be attracted to approaches that cap their exposure should they wrongfully assert that an MAE or MAC has occurred. Sponsors may view this as an attractive trade-off depending on the size of the fee and/or cap.

Whether the evolving approach will gain momentum over the traditional approach in leveraged buyouts remains to be seen. Our sense is that the vast majority of acquisitions in 2005 by private equity firms continued to utilize the traditional approach to financing contingencies. Indeed, we have yet to see the evolving approach utilized in an acquisition where the required debt financing could not be obtained (although we know of at least one case where sponsors using the debt receipt failure fee approach chose to significantly reduce the size of its high yield debt offering and close the acquisition with a significantly different capital structure). If a true disaster were to unfold, sponsors may begin to have second thoughts about accepting the debt financing risk. Even short of a disaster, sponsors may begin to find the debt markets too choppy to navigate consistently. When the additional costs that could be borne before sponsors would be better off terminating the acquisition and paying the fixed fee is made transparent to high-yield markets, sponsors may reconsider the benefits that the traditional approach—with all of its uncertainties—provides a transaction.