

# The New World Of Leveraged Buyout “Deal Protection”

by Overton Thompson III and Ryan D. Thomas

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**Within a year, the market for leveraged buyout deals, especially those with private equity, has gone from a flood to a drought. This has left some boards wrestling with what had seemed sure deals that now are drifting away, or even falling apart. How can a board protect both pending deals and the interests of shareholders?**

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In early 2007, the insatiable demands of the capital markets provided private equity buyers the ability for the first time to be competitive with strategic buyers on price. This created a “buyer frenzy” for sellers with attractive assets and gave these sellers tremendous bargaining power.

Merger agreements negotiated during this period were often light on seller representations, but heavy on provisions that increased certainty of closure. Sellers negotiated limited closing conditions and numerous carve-outs to the traditional “material adverse change” clause in their merger agreements. This made it difficult for buyers to escape from the deal due to a material change in the seller’s business.

**When buyer’s (or banker’s) remorse sets in, a variety of strategies are used by buyers to force a renegotiation of the deal terms, or even to force termination of the deal.**

In many cases, deal closings were not conditioned on the buyer obtaining financing, even though the buyer needed it to close. Likewise, buyers could obtain “covenant lite” financing commitments, with attractive pricing and minimal conditions.

In mid-2007, however, the market for the debt generated by these deals all but evaporated as a result of the subprime credit crisis. Banks were left with the option of trying to offload the debt at a significant

loss, or holding it on their balance sheets (possibly even incurring borrowing costs). Either option could require the banks to recognize accounting or actual losses that dwarfed the fees they stood to earn on the deals.

Simultaneously, the subprime market collapse and its ripple effect on the economy hit many sellers’ future earnings prospects. This led to several clashes between buyers/banks and sellers, who often had diametrically opposed interests.

On the one hand, sellers and their boards had negotiated high-premium deals that were no longer available in the current market. On the other, the deals were often no longer profitable for the buyers and their banks, at least not on the terms originally agreed to. Numerous deals have since been cancelled, including:

□ Cerberus Capital’s purchase of United Rentals, Inc.—terminated for payment of reverse termination fee after Cerberus Capital prevailed in a lawsuit for specific performance.

□ JC Flowers’ purchase of SLM Corp. (Sallie Mae)—terminated after Sallie Mae sued to collect the \$900 million reverse termination fee and JC Flowers claimed a material adverse change.

□ Lone Star Funds’ purchase of Accredited Home Lending—consummated, but at a reduced price by agreement of the parties.

□ Silver Lake and Value Act Partners’ purchase of Axiom—terminated for payment of reverse termination fee without litigation after Silver Lake and Value Act Partners claimed a material adverse change.

□ GSO Capital Partners LP’s purchase of Reddy Ice Holdings, Inc.—terminated for payment of reverse termination fee after failed efforts to renegotiate

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the deal terms.

□ KKR and Goldman Sachs Capital Partners' purchase of Harman International Industries, Inc.—terminated in exchange for convertible debt investment without litigation after KKR and Goldman Sachs claimed a material adverse change.

□ GE Capital Solutions and Blackstone's purchase of PHH Corp.—terminated for payment of reverse termination fee without litigation after banks were unwilling to provide financing under the original terms.

□ The Finish Line, Inc.'s purchase of Genesco Inc.—terminated after Genesco prevailed in a claim for specific performance but the bank contested solvency of the combined company.

When buyer's (or banker's) remorse sets in, a variety of strategies are used to force a renegotiation of the deal terms, or even termination. Some of the more typical strategies are discussed below.

□ *Asserting a material adverse change.* Unhappy buyers and lenders may claim a "material adverse change" (MAC) in the seller's business. Most merger agreements contain a MAC clause, which gives the buyer a potential escape hatch if the seller's business is materially and negatively affected before closing.

Essentially, the MAC is designed as a backstop against all matters not addressed by the representations and warranties. Case law generally indicates this must be a significant, unanticipated adverse change in the target's business that affects its long-term earnings potential. It has proven to be a high standard for buyers to meet.

**Material adverse change claims by buyers have proven effective in bringing sellers back to the table, given their inherent uncertainty, expense and distraction for the seller.**

Sellers also frequently "carve out" specific matters from even being considered in the MAC clauses, such as "general economic conditions." This further dilutes the potency of a MAC claim. Thus, the MAC will generally be of far less utility as a potential buyer

"out" than a specific closing condition on financial performance.

In the Accredited Home Lending and HD (Home Depot) Supply transactions, MAC claims proved effective in bringing the seller back to the table. Even where specific performance is available, buyers may threaten MAC claims, given their inherent uncertainty, expense and distraction from a seller's perspective. MAC claims also may be asserted by buyers (regardless of merit) to give them a public "excuse" for walking away from the deal.

Finally, a buyer will also seek to find potential covenant breaches, and the seller's actions will be scrutinized closely in hopes of finding a cost-free buyer "out."

□ *Asserting fraud-based claims.* Buyers and lenders may allege claims of fraudulent inducement. Typically, a buyer alleges that the seller misrepresented or concealed the company's true financial condition, or other material facts regarding the company. More than one buyer has also argued to a judge that the parties should not be compelled to merge because the management teams can no longer get along following contentious litigation that included fraud claims by the buyer. Though fraud is a difficult case to prove, it should be anticipated in "anything goes" merger litigation, especially where the contractual ability of the buyer to terminate is limited.

□ *Attempting to pay the reverse termination fee.* Many leveraged buyout merger agreements let the seller end the agreement for a "reverse termination fee." Historically, these are between two and four percent of the deal price (sometimes higher for "willful" breaches—such as walking away with financing available). The reverse termination fee, when drafted as a sole remedy, is effectively an "option" in the event that the buyer changes its mind after signing.

This structure is common in private equity buyouts and was agreed to in the United Rentals, Acxiom, Sallie Mae, and Harmon transactions, among others. Some leveraged deals do not include reverse termination fees, but instead contain "specific performance" provisions (such as in the Genesco deal).

Some remorseful buyers seek to voluntarily pay the

reverse termination fee in an effort to avoid the risk of losing MAC litigation. This occurs even where there may be “reputational” risk (once considered the gold standard in the days of financing conditions).

□ *Delay tactics.* Another strategy to get sellers to renegotiate is to *threaten* (but not file) a MAC claim, while stalling closing efforts. Buyers can even refuse to cooperate in the completion of the financing required for closing (the “pencils down” approach). This gives the buyer time to look for an alternative out, allows time for market/business conditions to further deteriorate, and can place the burden on the seller to file a lawsuit for specific performance of the merger agreement.

This can help the buyer by placing the burden of proof at trial on the seller. If the losses from closing the deal will be significant (and potentially greater than potential damages for breach), lenders may even refuse to close the deal without threatening a MAC.

□ *Going directly to shareholders.* Finally, some buyers will “go to the media” to press their case. This happened in the Accredited Home Lending and Sallie Mae cases. In these cases, the buyers publicly disclosed lesser offers in response to their MAC claims. This was done in hopes of attracting shareholder support to pressure the sellers to come to the table.

**In a broken deal, the target company generally sees its stock price drop, and may suffer reputational harm and lose key employees and business.**

A broken deal can have dramatic consequences for the seller. If a target corporation exits a failed transaction, its stock price generally drops lower than the merger price (and often the pre-deal trading price). The target company may also suffer reputational harm. The company may have lost key employees, and may be challenged to regain business momentum after being in a state of limbo during the uncertainty over its future.

In most cases, the target has been constrained

in its business activities pending the merger. The company will also need to regain the confidence of long-term and growth-oriented stockholders and the analyst community, and to reestablish and promote its long-term business plan.

Given these and other risks, the strategic decisions a board makes along the way are critical in trying to save the deal, or mitigate the fallout from the deal failure. Remember, you just approved a transaction providing for a substantial premium to your shareholders. They will be closely watching your every move to see if you are vigorously protecting the deal or otherwise acting in their best interests.

A selling company’s board should not only understand the protections and remedies of the merger agreement, but should understand if there are any contractual uncertainties or ambiguities. If a MAC claim is threatened, understand whether the claim is legitimate or whether a “carve out” may apply under the facts.

If a fraud claim is presented, are there strong “no-reliance” and “integration” provisions limiting the seller’s representations? A less than stellar contract, or an “option deal,” may hamstring a board’s flexibility, limit recourse and drive a seller to the bargaining or settlement table sooner than preferable (and with less leverage).

Assess the buyer’s and banker’s true objectives and allegiances. What are their actual motives? Do they want out, or are they saber rattling for renegotiations? Which player is pulling the strings? Does the deal still make strategic sense for the buyer? Is the deal costing the banks money? Does the buyer have extra leverage with the bank?

If the bank is causing trouble and the buyer still wants to close the deal, join forces with the buyer and strategize to put the maximum pressure on the bank. The bank and buyer versus the company, on the other hand, means having to fight the battle on multiple fronts.

Try to save the deal without litigation. Lawsuits rarely yield a completely satisfactory result. They also significantly distract the company and its managers from operating the business. If a problem arises with your transaction, work with the company’s

advisors to formulate a strategy for saving the deal without resorting to litigation, and navigate issues as they arise.

**Try to convince a balky buyer that it is in their best interests to align with the seller, not with the bank.**

Try to convince the buyer it is in their best interests to align with the seller, not the bank. Stress the importance of avoiding mudslinging, and encourage management not to hint that the deal may not work due to inability to work together following closing.

Also, be aware of other circumstances that could affect strategy. For example, once the shareholder vote has been obtained, there could be less flexibility to renegotiate the deal. Thus, even the decision of whether to delay the shareholder vote will require a thorough assessment. Finally, renegotiations can be done privately without market scrutiny. However, there could be fallout from decisions implemented, particularly if the market views the seller as having the upper hand.

Understand the potential for success in litigation. The strength of your legal positions and contractual remedies will be a guiding factor in each strategic decision, particularly in determining if litigation is a realistically successful option. If there is a likely outcome, could it be achieved without resorting to litigation?

Merger litigation is inherently uncertain given the imprecise nature of the MAC clause by design. Even if you win a MAC claim, specific performance may be expressly excluded as a remedy for the seller (the “option deal”). Thus, risk of losing the MAC claim may weigh against suing in lieu of negotiations. If it is not excluded, but the contract is silent on specific performance, the buyer may successfully argue that there is an adequate remedy at law (damages).

Even where the contract expressly mentions specific performance, a buyer (or banker) may ultimately prevail as a practical matter if they can successfully show the financing will not be available by its terms. Fraud claims may also be challenging

for the seller to defend. At the least, the buyer may successfully argue an “unclean hands” defense to specific performance.

**Merger litigation is expensive, distracting and often gets ugly and personal, with “scorched earth” tactics. Still, be willing to file a lawsuit if it becomes necessary or appropriate.**

Know when to pull the trigger on litigation. Merger litigation is expensive, distracting and often gets ugly and personal with a buyer’s “scorched earth” tactics. Still, do not allow your desire to avoid it to stand in the way of filing a lawsuit if it becomes necessary or appropriate.

Above all, move swiftly and decisively in order to avoid the cloud of uncertainty over the employees, shareholders, and other constituencies. Delay generally favors the buyer and its banks and increases the odds a MAC or a covenant breach may occur. Commitment letters typically have expiration dates that mirror the drop-dead dates in the merger agreement.

Even if you are not certain of prevailing, a reasonable case may still merit filing a lawsuit to call the buyer’s “bluff” and increase your chances of maximizing the settlement value (these cases are most often settled before the actual trial). In a lawsuit, the court will likely view quick, decisive action as evidence of the strength of your position, and may be skeptical if you waited too long to file. In addition, your adversaries will question your confidence if you allow them to stall indefinitely.

Finally, damages calculations are challenging and uncertain with little practical precedent to guide the courts. Only specific performance can fully make your shareholders whole. Thus, if your deal provides for specific performance, suing for it may be the preferable course. Conversely, attempting to recut a deal prior to trial can be appropriate if your defenses are uncertain, rather than risk losing the case on the merits and letting the buyer walk without payment.

Get the best advice possible. Engage strong investor

relations and proxy advisory firms to help win the PR battle with your shareholders. Have your investment bankers involved in the strategic decisions, particularly if renegotiation or settlement talks begin. Understanding the “fairness” of any recut transaction will be critical. Hire litigation attorneys experienced in merger litigation and who understand the issues and complexities unique to these cases.

A MAC claim is largely a question of fact. Thus, in defending one, good experts are critical. Invest in the best talent you can find. Avoid experts for hire with unproven track records and seek out those with genuine practical experience who can credibly testify first hand about the issues in question. Credibility of certain experts, for example, strongly influenced the judge in the Genesco litigation.

Be sure your company continues compliance with covenants in any merger agreements. Do not give the buyer an escape hatch by breaching a covenant pending the litigation.

Know when to settle or renegotiate. As events unfold, your strategy may change. Keep your options open and know when to throw in the towel. Consider the costs and risks of continuing the litigation, the likelihood of success at trial, and the practical ability to force a closing if the debt commitment is terminated or expires.

Weigh the potential insolvency of the combined entity, the uncertainty of the timing and amount of court damage awards, and the actual willingness of the buyer to close at the deal price or even lower. Finally, consider the publicly expressed views of your shareholders, and the adverse effect of protracted litigation on the company’s employees and business.

Of course, the best time to avoid issues with failed deals is at the start. There are several things a seller’s board can insist on *before the deal gets signed* to help add certainty in an uncertain market.

*Insist on clarity of terms.* Most states, including Delaware, give great deference to freedom of contract. However, the court in the United Rentals case displayed little appreciation for “conscious ambiguity.” Fight for your protections and remedies up front, and insist that your lawyers leave no ambigu-

ity on key issues such as remedies and termination rights.

*Limit conditionality in debt commitment letters.* The fundamental issue that the merger agreement cannot control is the actual availability of the debt financing at closing. Solvency conditions to funding may be unavoidable. However, require the buyer to resist other conditionality, such as “market MACs” and other lender-favorable covenants that must be satisfied at closing. If necessary, a limited marketing period is reasonable to allow the bank an opportunity to off-load the debt.

*Know the track record of the buyer and its banker, and assess the practical risks outside of the contract.* Prior actions may be a good indication of future actions if the going gets rough. Consider this if weighing between multiple offers and any discount for execution risk.

With a strategic buyer, consider if the buyer can afford the company without the debt financing. Consider what is happening in the financing markets. Weigh solvency risks and, potentially, requiring a solvency opinion at signing.

Finally, for a strategic buyer (and even financial buyers with portfolio companies in overlapping industries), consider regulatory risks. Even look at “political” risks if the buyer is foreign controlled or a sovereign investment fund.

### **Resist giving buyers an ability to walk out of a deal on the “cheap” compared to the potential damages resulting from a broken deal.**

*Insist on an “election of remedies” construct and substantial reverse termination fees.* The United Rentals, Acxiom, and Harmon cases offer a clear illustration of the need to carefully assess the “option” deal prior to signing. This includes assessing the certainty of closure and/or potential discounts for offers, which may not contain the option feature. Require the ability, at seller’s election, to make the buyer specifically perform its obligations to seek the debt (or alternative) financing, or terminate and receive damages.

Whether or not the deal is technically an “option deal,” insist on substantial reverse termination fees. Resist giving buyers an ability to walk out on the “cheap” compared to the potential damages resulting from a broken deal.

□ *Insist that the equity and debt commitment letter provide for specific performance remedies, name the seller as an express third party beneficiary and require the buyer to use its best efforts to obtain the financing.* For specific performance to be a practicable remedy, there should be an unbroken chain of obligations and a clear right for the seller to request a court to force the buyer to push the financing through with its best efforts. The merger agreement can bind the seller to close. However, the deal certainty is undercut if there is no clear mechanism to compel the banks to close (or for the sellers to sue them to close).

□ *Carefully consider the conflicts if “staple financing” is used.* If your financial advisor will also be lending to the buyer to finance the transaction, carefully consider how this inherent conflict of interest could affect “execution” risk. Not only could your banker decide to protect its balance sheet above your interests, but the conflict could deprive you of a key fact witness in any resulting litigation with the buyer.

□ *Insist on limited conditions and narrowly drafted MAC clauses with numerous carve outs.* Never give the buyer more outs than absolutely necessary with-

out recourse. Resist conceding specific conditions relating to financial performance (for example, based on minimum EBITDA levels at closing). Remember, a successful MAC claim or assertion of failure of a condition lets the buyer walk without payment of damages.

□ *Ensure continuity of management during the process.* Confirm that appropriate change in control protections are in place to help ensure key managers remain with company.

□ *Minimize board member exposure for personal liability.* Be mindful that, in a transaction, the board’s fiduciary duties do not end with announcement of the deal. In addition, directors may face heightened scrutiny of their decisions and process in approving an all-cash leveraged buyout deal. A board is thus required to secure the best deal reasonably available.

Running a reasonable, fair process is also important. Make every effort to maximize “deal certainty” on the front end, or else consider discounting a bid subject to conditionality or other execution risk. Negotiate the best, and the clearest, contract that you can—ambiguity of remedies will not help your case. Also, understand the “deal risk” (the risk that the deal will not close) prior to execution, both contractual and practical risks, and discount the value of the bids accordingly. The board should also always confirm the adequacy of its D&O policies prior to executing a transaction agreement. ■

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