

# Changing M&A Deal Terms in Changing Times

November 17, 2010

*Presented by:  
Mark O. Henry  
Kelly Luongo Loving*

# About the Speakers

- Mark O. Henry serves as chair of the firm's mergers and acquisitions practice group. His practice focuses on representing private equity groups and other financial investors in complex leveraged buyouts and dispositions and other investment and financing transactions. He has extensive experience structuring, negotiating and documenting equity and asset acquisitions and dispositions, senior secured and mezzanine debt investments and other preferred and common equity investments, often in the context of leveraged acquisitions, and on intercreditor issues among all layers of capital structures. Mr. Henry also represents both public and private strategic acquirers and sellers, and advises public companies in securities offerings and on general securities matters. Mr. Henry is both a Certified Public Accountant and a Certified Management Accountant.
- Kelly Luongo Loving's practice covers a range of commercial transactions with a focus on mergers and acquisitions, private equity investments and general corporate law. She has represented a variety of public and private companies in acquisitions and dispositions, including strategic acquirers and sellers and private equity sponsors and has also represented parties in joint ventures and other partnerships. Ms. Loving has advised businesses in a variety of other commercial and corporate matters, including organizational issues, shareholder and operating agreements, board matters and corporate governance issues, employment arrangements, minority shareholder issues and significant commercial contracts.



# Current Deal Environment

- Although credit is still tight, there is money to do deals, particularly strategic acquisitions
- Some pressure to close deals before December 31 because of changes to capital gains tax

# Some Good News for Sellers

- Sellers that have been sitting on sidelines waiting to sell are wading into the market
  - Good quality companies are generating a lot of interest from buyers
  - A few successful auction processes over the last several months
  - Good sellers can aggressively negotiate agreement terms and decent multiples

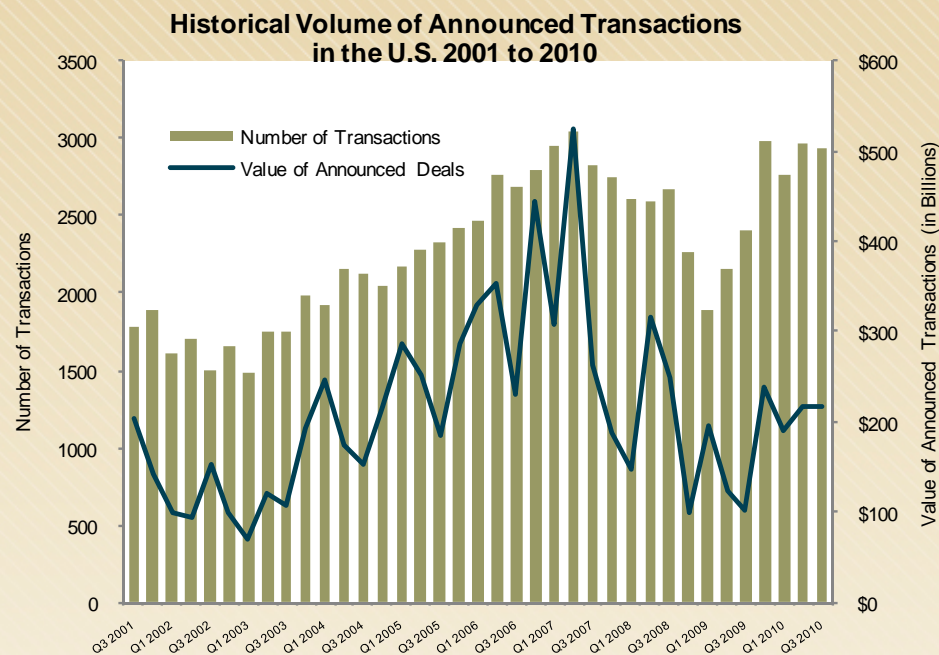


# Mixed Messages for the Future

- Ray Groth, Managing Director, Fennebresque & Co.
  - Many indications that increased deal flow may be around the corner
  - Significant cash balances at corporate level (\$1.6-\$1.8 trillion on balance sheets of S&P 500) and because of general economic conditions, potential for internal corporate growth is limited
  - Private equity funds (especially mid-tier firms) mostly on sidelines in 2008 and 2009 and have commitments for capital with 5-7 year expirations
  - Look for more hostile M&A activity – valuations low, cash is available and many companies without traditional defenses in place
- Recent financial press about businesses shelving M&A plans because of deterioration in confidence and uncertain future outlook
  - Waited out election, nervous about second dip in market

# Current Deal Environment

- Increase in deal activity and increased interest in doing transactions; volume returning but size is down



Source: Capital IQ



# Deal Process

- Focus on pre-deal analysis and due diligence
  - Leave no stone unturned
  - Running a disciplined process
  - Balance between detailed approach and management distraction
- Buyers willing to slow down the process to understand/value issues that are identified
  - Address significant issues with upfront reductions to purchase price instead of through indemnity provisions
- Buyers looking abroad – increased enforcement of FCPA, anti-money laundering rules and OFAC regulations
  - Some bona fide purchaser protection if do your diligence upfront

# Deal Structure

- Companies operating under pre-2007 credit agreements with favorable terms
- Focus on structuring deals to avoid the need for consents/waivers from lenders
- Joint venture structures
- Seller financing
- Earn-out structures



# Deal Terms

- Emphasis on Deal Certainty – simultaneous sign/close if possible
- Reverse Termination Fees
- MAE clauses heavily negotiated
- Price and closing certainty biggest focus but indemnity provisions remain important; trending towards more buyer-favorable terms

# History of Reverse Termination Fees

- Played significant role in private equity acquisitions starting in 2005
- Newly formed shell companies as buyers and increased use of leverage
- With easy access to credit and increased competition for deals, traditional “financing outs” were abandoned
- Emergence of RTFs coupled with a bar on specific performance



# Standard Termination Fees

- Seller pays fee to Buyer if deal is not completed usually because of 3<sup>rd</sup> party bidder
- Public Company Transactions
- Amount Limited by Board Fiduciary Duties

# RTFs and Strategic Deals

- Reverse termination fees are increasingly common in strategic deals
- Address uncertainty of financing and mitigate other potential risks that may arise in difficult economic climate
- Lack of available buyers has allowed buyers to shift some closing risk to sellers
- Buyers seek flexibility to get out of a bad deal



# Types of RTFs

- **Option Style Fees** - Buyer can walk for any reason upon payment of a fee; No specific performance remedy
- **Hybrid Fees** – RTF is the sole remedy under certain circumstances (i.e. financing unavailable despite best efforts to obtain) but Seller can get specific performance for other types of breach
- **Two Tiered Fee Structure** – Buyer pays one fee conditioned upon a specific set of triggers and a second higher fee conditioned on another broader set of triggers. May or may not include limited specific performance rights.

# Common RTF Triggers

- Buyer's breach of reps, warranties or covenants
- Termination in connection with a competing transaction for the Buyer
- Changes in Buyer's Board Recommendation
- Deal not consummated (for any reason)
- Failure to obtain financing
- Failure to obtain Shareholder Approval /Hold a shareholder meeting
- Failure to obtain regulatory approval



# Focus on Antitrust Risk

- Increased antitrust scrutiny
  - Focus of Obama administration, particularly healthcare industry
  - New horizontal merger guidelines
  - Excess capacity at DOJ because of slowdown in economy
- RTF for failure to get HSR approval
- Indemnity for costs associated with second request
- Consider duty of buyer to obtain approval (obligation to divest, use reasonable best efforts etc)

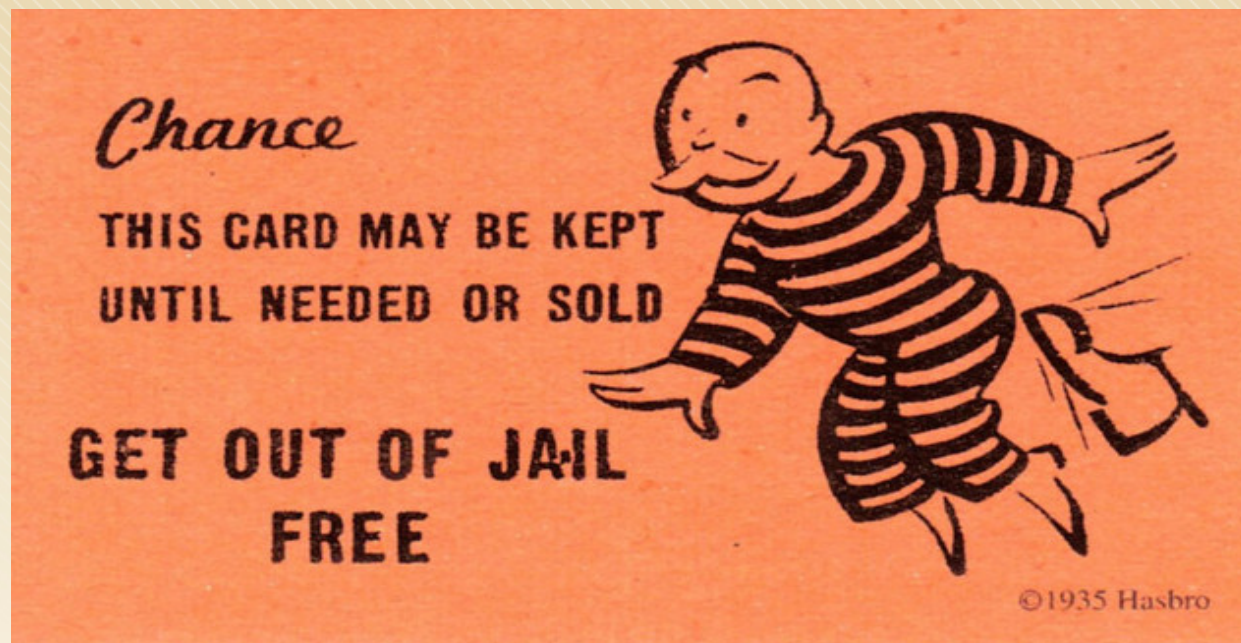
# M&A Financing Recent History

- 2005-2006 – Golden Age of Leverage
  - Increased allocations to private equity cause a frenzy to put money to work
  - Defaults are low and banks compete to fund deals
  - Senior leverage up to 3.5-4.0x
  - Total leverage up to 6.5x
  - Total valuations up to 10.0x
- Summer 2007-Summer 2008
  - Large deals start to fall apart
  - Middle market holds up somewhat



# M&A Financing Recent History

- Fall 2008 – credit dries up almost entirely; continues into 2009
- Exception – signed commitment letter



# M&A Financing 2009

- Few deals get done
- Leverage Multiples Down = Valuations Down
  - Leverage 2.0-2.5x (or lower)
- Pricing Up (Senior Debt LIBOR + 500bps)



# M&A Financing Current Trends

- Deals are getting done, but deal size down



- Otherwise its

- Total leverage back to 5.0x (maybe more)
- Pricing back down

# Financing Commitments

## When Required

- Smaller deals without regulatory issues = simultaneous sign and close
  - much simpler
  - straight to complete credit documents
- Gap between signing and closing = often requires financing commitments (and more complex M&A agreements)



# Financing Commitments

## What You Get

- NY Law – 3 types of agreements
  - Agreements to agree (mere proposals that are completely unenforceable)
  - Type I – actual agreements not yet completely reduced to writing (final agreements in everything but name only); *specific performance remedy for breach available*
  - Type II – agreements to negotiate (preliminary agreements on certain terms including a commitment implied in law to negotiate in good faith toward a final credit or other terms); *specific performance remedy for breach not available*

# Financing Commitments

## What It Was

- Market MAC - “The Commitments of [The Bank] hereunder are subject to: (i) the absence of any material adverse change or material disruption in the loan syndication, financial, banking or capital markets that, in the judgment of the Lead Arranger, would impair the syndication of the Senior Credit Facilities ...”
- Business MAC – typically referenced a material adverse change without exceptions
- “Flex Provisions” – structure, conditions, terms



# Financing Commitments

## What It Became

- Market MAC - gone
- Business MAC – identical to the MAC condition in the acquisition agreement
- “Flex Provisions” – very limited

# Financing Commitments

## Current Trends

- Market MAC – still gone
- Business MAC – still matches acquisition agreement
- New objective conditions (aligned in both credit documents and acquisition documents):
  - Minimum closing EBITDA
  - Solvency
  - Credit rating (Pfizer financing for Wyeth acquisition contingent on Pfizer credit rating; \$4.5 billion reverse break fee)



# Financing Commitments

## Current Trends

- Lenders more involved in acquisition documents (and involved earlier in the process)
  - MAC definition (no Buyer has ever won)
  - Sole remedy = reverse break fee
  - No specific performance
  - Venue (NY or DE)
  - Waiver of jury trial
  - Third party beneficiary provisions
- Collision Course
  - Sellers want certainty of close





# Dow Chemical/Rohm & Haas (2008)

## Not Just a Private Equity/LBO Issue

- July 10, 2008 – Dow Chemical signs definitive merger agreement to acquire Rohm & Haas at \$78/share
- The acquisition of Rohm and Haas is a defining step in our transformational strategy to shape the “Dow of Tomorrow” – a high value, diversified chemicals and materials company, creating the largest specialty chemicals company in the United States with a leading global position in performance products and advanced materials. - Andrew N. Liveris, Dow chairman and CEO



# Dow Chemical/Rohm & Haas (2008)

- Financing (\$15.3 billion Purchase Price):
  - \$4 billion convertible preferred from Berkshire Hathaway and Kuwait Investment Authority
  - \$9.5 billion in expected cash from joint venture with Petrochemical Industries Company of the State of Kuwait (Rohm & Haas deal not contingent on these proceeds)
  - \$13 billion backstop “bridge” debt financing from bank group led by Citi, Merrill Lynch and Morgan Stanley (1 year loan – signed loan agreement on September 8)

# Dow Chemical/Rohm & Haas (2008)

- No Financing “Out”
- MAE Condition
  - Unusually restrictive definition that explicitly excludes adverse effects (i) “generally affecting the specialty chemical industry or the segments thereof in which [Rohm and Haas] and its Subsidiaries operate” or (ii) “generally affecting the economy or the financial, debt, credit or securities markets, in the United States or elsewhere.” (The carve-out extends even to adverse effects that disproportionately affect Rohm and Haas.)



## Dow Chemical/Rohm & Haas (2008)

- December 28, 2008 – Kuwait informs Dow it will not close on the joint venture – Dow stock drops from \$19.34 to \$15.32
- January 23, 2009 – deal gets final regulatory approval
- January 26, 2009 – Dow tells Rohm & Haas it will not close; Rohm & Haas stock falls from \$65.82 to \$57.10; Rohm & Haas sues

# Dow Chemical/Rohm & Haas (2008)

- Closing on bridge financing would have potentially lowered Dow's ratings to junk status
- “Dow remains interested in discussions to find a solution to complete the acquisition of Rohm and Haas, but recent events have made closing untenable at this time.”
- Note what this does not say – no clear right to terminate/refuse to close



# Dow Chemical/Rohm & Haas (2008)

## Settlement

- Deal closed
- Bridge loan extended for one year; \$8 billion in additional bank financing for the second year
- \$2.5 billion investment in perpetual preferred stock by Rohm & Haas family trust

# Private Equity LBOs – Management Terms

## Roll-over Investment

- Management is expected to invest in the Company
- Sources of Investment
  - Existing equity
  - Existing options/incentive equity
  - Change of control bonus payments
  - Out-of-pocket cash
- Size of Investment: a meaningful stake (50% of proceeds)
- Terms: same “strip” of securities as private equity buyer



# Private Equity LBOs – Management Terms

## New Incentive Equity

- New option pool of 10-15% of fully diluted equity
- Vesting
  - Time component (25% per year for four years)
  - Financial component (i.e. IRR hurdle)
- Exercise price: fair market value
- Trend towards LLC holding companies and use of profits only interests

# Private Equity LBOs – Management Terms

## Put and Call Rights

- Sponsors often require call rights upon termination of employment
  - Pricing may depend on reason for termination
- Management is almost always prohibited from selling equity; may ask for a put right based on time or certain types of terminations (usually not successful)



# Private Equity LBOs – Management Terms

## Other

- Subject to “drag-along” rights
- Noncompete agreements
- Employment agreements (severance)



**Mark O. Henry**  
**704.377.8128**  
**mhenry@rbh.com**

**Kelly Luongo Loving**  
**704.377.8397**  
**kloving@rbh.com**