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M&A Targets Today: Seeking Deal Certainty in an Uncertain Environment

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Following two years of significant activity, the M&A market in 2008 has set up quite differently. In the first quarter of this year, M&A market activity declined more than 51%, year over year.[2] The financing markets, which remain constrained following the deterioration in the credit availability that began last summer, present a meaningful hurdle to the M&A market, with a large backlog of "signed deal" debt remaining on the books of the investment banks that committed to fund bridge financing. Despite federal and regulatory intervention and the ability to insist on terms that are more "lender friendly" than at any point during the recent run in M&A activity, debt financing sources appear reluctant to finance new deals.

In light of these (and other) developments, most private equity buyers, after having played a dominant role in recent deal activity, have stepped to the sidelines or walked away. The market for large M&A deals ($5 billion+) has evaporated,[3] and in recent months, credit pressures have seriously eroded the M&A market for smaller deals.[4] Although some strategic bidders have "flexed their muscle" by pursuing opportunistic transactions,[5] overall deal activity is running at a fraction of the pace set in 2006 and early 2007 (perhaps reflecting both the lingering impact of the credit crunch and overall concern about macro-economic conditions).

Dozens of buyers (particularly, but not exclusively, private equity buyers) have added to the market malaise by walking away from signed deals. Highly publicized litigation arising out of a series of "busted" deals has renewed focus on MAC clauses, "best efforts" covenants, the availability of specific performance and on whether the existence of a "reverse termination" fee provides a meaningful incentive to close or merely leverage to renegotiate.

In this environment, it seems appropriate to pause and ask how, if at all, the state of the current M&A market should affect a target board's decision to entertain or pursue a sale transaction. Should "deal certainty" be the board's predominant concern in this market, or are there other, perhaps equally important, factors for the target board to consider?

Getting Started—Considering Whether to Entertain or Pursue a Sale

Whenever a proposed transaction involves a sale or change of control, the directors' duty (without regard to whether the M&A market is roaring or whimpering) is to obtain "the best transaction reasonably available for the corporation and its stockholders."[6] Whether a deal represents "the best transaction reasonably available" is contextually specific—it requires the court to consider both the information upon which the directors based their decision and whether the directors' actions are reasonable *in light of the circumstances then existing.*[7]

In view of this standard, it is reasonable to ask—in light of the current state of the M&A market—what information should a target board consider when deciding whether to entertain or pursue a sale? Put another way, should the prevailing market conditions require the directors to approach sales transactions differently than in the past or to ask different questions? While any well-run sales process will have certain common touchstones (for example, the consideration of strategic alternatives, reliance upon financial and legal advisors, examination of competitive pressures, etc.), a contextually specific analysis by a target board might consider, among other things, the following questions and issues:

- *Is this the right time to sell?* If a more vibrant M&A market is likely to create a more competitive bidding scenario, should the target delay the sales process? Are the financial advisors able to provide any guidance on the state of the market and the expected timing of a market turnaround?
- *Will market conditions prevent an effective post-signing market check?* A target sometimes opts to pass on a pre-signing market check and instead negotiates for the right under the terms of the acquisition agreement to perform a post-signing market check (for example, through the use of a "go-shop" provision). If the M&A market is floundering, will the post-signing market check provide the target board with reliable evidence sufficient to assess the fairness of the initial bid? Alternatively, does the financial advisor's analysis as to the availability and likelihood of other bidders provide sufficient comfort to the target board?
- *Is a competitive bidding process the answer?* Under Delaware law, a target board has reasonable discretion in structuring a sale process.[8] In some cases, a competitive bidding process may present certain negatives that might mitigate against using such an approach.[9] However, in light of the current market, are those negatives outweighed by the benefits afforded? Absent a healthy M&A market, the market may be expected to return to more buyer-friendly (and financier-friendly) transaction provisions. If so, then will a "competitive bidding" situation, by generating more bidder interest, provide the target with sufficient leverage to negotiate more seller-favorable provisions?
- *Has the target considered non-traditional funding sources?* In transactions where financing will need to be obtained, target boards may wish to seek further information concerning the availability of non-traditional financing sources (such as sovereign wealth funds, SPACs and overseas buyers).
- *Has the target board built a record that supports its decision to entertain or pursue a sale?* It is important for the target board's legal advisors to document the board's discussions and analyses promptly and carefully. Target boards and their advisors should anticipate that the plaintiffs' bar will challenge the sale transaction and raise questions concerning the board's consideration of the market environment issue.

Re-Evaluating "Standard" Deal Structures and Terms

The recent litigation over troubled transactions has reminded practitioners that the structure of the transaction, as well as the words contained in the acquisition agreement, really do matter. In light of the recent, and in some cases, continuing, litigation over MAC clauses, pre-closing covenants and remedies contained in signed acquisition agreements, target boards and their advisors may want to reassess accepted norms in structuring and documenting transactions and question whether these accepted norms and structures continue to make sense. Questions that target boards and their advisors might want to ask when reevaluating these provisions and structures include:

Deal Structures

- Should targets be more reluctant to enter into transactions with "shell companies" of private equity buyers? Does the private equity fund's equity commitment and its obligation to pay a reverse termination fee under certain circumstances create a sufficient incentive to close?
- What steps can target boards take to manage more effectively issues relating to financing contingencies? For example, should targets seek to require specific performance from the buyer (and, in the case of a private equity transaction, the private equity fund) to enforce the financing commitments? Should targets seek to require that the buyer has fully negotiated credit documents at the time the transaction is signed? Should targets have the right to require buyers to reconfirm publicly their commitment to close (where the failure to do so might permit target to terminate early and trigger payment of the reverse termination fee)?
- Why is the transaction structure different for a strategic buyer and, in light of recent events, does that dichotomy make sense?

- In a transaction with a strategic buyer, does a two-step structure (*i.e.,* a tender offer followed by a merger) provide more deal certainty than a one-step merger?
- Should targets seek to require that all disputes arising out of a signed deal be heard in one forum and that the target and all the buyer parties (including the funding source(s)) submit to jurisdiction in that forum?

Definition of "Material Adverse Effect"

- Does the inherent ambiguity of this definition provide buyers with an opportunity to force either a price renegotiation or a negotiated termination of the transaction simply by asserting a MAC?
- If so, then are there ways a target may reduce the buyer's leverage? For example, will the interests of the target be better served if the acquisition agreement specifically (and more expansively) defines what constitutes a material adverse effect and also includes such items as a closing condition, rather than reverting to the definition of a material adverse effect?

Pre-Closing Covenants

- Has the target provided for sufficient flexibility in the acquisition agreement to address post-signing issues that may call into question the willingness of the buyer to close the transaction? If not, what additional flexibility should the target seek?
- Does the buyer have both the right to "hold the target" in the transaction and, after developing a case of buyer's remorse, the ability to "drag its feet"? If so, for what contractual protections should the target board bargain in such a situation?
- Does the target board have sufficient flexibility in the acquisition agreement to comply properly with its fiduciary duties in connection with calling and holding the stockholder meeting?
- How has the agreement affected the target board's ability to respond to unsolicited offers? Does the agreement purport to contractually limit the target board's ability to communicate with stockholders or its ability to change its recommendation?
- What does the covenant to use your "reasonable best efforts" to complete a transaction mean? Are a strategic buyer's "reasonable best efforts" any different from the "reasonable best efforts" of a private equity buyer? If so, how should the agreement address this difference?

Remedies

- When the buyer is relying on the cash flow of the target to fund the acquisition debt, will the remedy of specific performance alone adequately protect the target's interests? What remedy should be available if specific performance is not available?
- How may a target increase the certainty of closing? Is the answer to bargain for a larger reverse termination fee and/or a fulsome specific performance right? Will a buyer agree to a larger reverse termination fee and if the buyer does, will it provide sufficient incentive for the buyer to perform and/or cause its financing sources to perform?
- Is an uncapped "damages" provision an adequate remedy for the target? Does it make sense for a target actually to request that remedy, given the evidentiary issues, litigation costs and extended litigation overhang such a damage action poses for a target and its ongoing operations? How comfortable can a target board get with the ability of a court to calculate damages in that context?

Preparing for the Deal Announcement—Further Considerations

Even after the parties agree on the terms of a deal and enter into an acquisition agreement, the target board faces an unsettled market in which factors outside the acquisition agreement may put at risk the certainty of closing. In that environment, the target board has a number of factors to consider, including:

Activist Stockholder Resistance

With the rise of stockholder activism, the target company's effectiveness in communicating to the marketplace the reasons for, and the advisability of, entering into a sale transaction has taken on increased significance. In recent years, stockholder resistance (or the possibility thereof) has endangered or killed a number of announced deals and consequently represents a significant concern for deal lawyers.[10] In particular, hedge funds and activist stockholders now routinely exert their financial influence to press for improvement in the terms of announced deals. Increasingly, hedge funds and others are utilizing complex financial instruments or derivatives to magnify the pressure they may exert on the target company's shares and the deal.[11] Despite the downturn in M&A activity, practitioners should expect stockholder resistance to continue and perhaps increase.

As a matter of good deal practice, target boards and their advisors should be prepared to meet stockholder resistance and activism with a host of measures, including:

- Developing a communications strategy for "selling the deal" to the market and to the target company's stockholders following the announcement. Targets should strongly consider the involvement of public relations personnel and proxy solicitors as part of the deal team prior to announcing the signed transaction, as recommendations by RiskMetrics/ISS and Glass Lewis and media coverage of the announced transaction are important drivers to obtaining stockholder approval of the transaction in today's marketplace.[12]
- Regularly scheduled meetings before and after the announcement of the deal among investor relations personnel, the proxy solicitors, the investment bankers, the deal lawyers and the public relations firm should help maintain open communications and a consistent message, and allow for prompt responses to developments in the media and the public markets from pressure exerted by third parties.

Litigation

In today's deal practice, legal challenges by stockholders, competing bidders, disgruntled partners and others are commonplace. Shortly after the announcement of a M&A transaction (sometimes within hours), it is not unusual for lawsuits challenging the decision-making process of the target board to be filed by multiple plaintiffs in multiple jurisdictions. Over the past nine months, another trend has surfaced—the "enthusiastic buyer" on the announcement date who, distressed by an alleged downturn in the target's business or deteriorating financing terms, quickly becomes a "less than willing buyer" with a serious case of heartburn. To prepare for either possibility, target boards should consider a number of prophylactic measures, including:

- Early involvement of litigation counsel experienced in fiduciary duty and deal litigation in the deal process. In addition to providing an opportunity for litigation counsel to assist in developing the best record for anticipated the litigation, early involvement of litigation counsel also allows them to respond promptly to any litigation and defend the target board's actions.
- Engage in negotiations with the understanding that at a later date a court may be asked to interpret the meaning of each (and every) provision of the acquisition agreement. Where possible, drafting should eliminate all ambiguity. When ambiguity is unavoidable (or desired), counsel should carefully document the negotiations between the parties and the parties' understanding as to the intent of various provisions. (Careful notetaking during these negotiations may help develop a record for the target to defend its various positions in any subsequent litigation where the court has found the language to be ambiguous.) Documentation alone, however, may not be enough to carry the day. If buyer's counsel has articulated an interpretation of a particular provision that is at odds with target counsel's interpretation of the same provision, then target's counsel must build a record demonstrating that the target understands the provision to hold a different meaning.[13]

Even in the challenging M&A market, motivated buyers and targets represented by qualified and able advisors can navigate the problems presented by this troubled deal environment. Targets should consider whether these changed circumstances require them to reassess prior deal norms and whether new approaches will be required to address the particular problems posed by the current market environment.

(Endnotes)

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[2] According to Thomson Financial, announced U.S. M&A deal volume for the first quarter of 2008 declined 51.1% over the same period in 2007, the third consecutive quarterly decline. Leveraged buyouts driven by private equity firms declined 89.6% in the first quarter of 2008 as compared to the same period in the prior year. Thomson Financial, *Mergers and Acquisitions Review: Worldwide M&A Falls 24% to US $730 billion—Lowest Quarter since 3Q06* 1 (First Quarter 2008), http://www.thomsonreuters.com/content/PDF/financial/league_tables/ma/2008/1Q08_Financial_Advisory.

[3] According to Thomson Financial, during the first quarter of 2008, the value of worldwide private equity sponsored M&A transactions approximated $81.3 billion, the lowest levels since the third quarter of 2005. Only one transaction over $5 billion has been announced since July 2007, compared to 32 deals over $5 billion announced during the first seven months of 2007. *Id.*

[4] See "Credit Crunch Slowing Middle-Market Deals," The Deal.com, May 1, 2008.

[5] Consider, for example, Microsoft's offer for Yahoo! and Electronic Arts' pending tender offer for all the shares of Take Two Interactive.

[6] M.A. Morton & R. Houtman, *Go-Shops: Market Check Magic or Mirage* (May 2007), http://potteranderson.com/assets/attachments/Potter_Anderson_Go-Shops__rev.pdf, citing *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del.1986) (finding that once directors have decided to sell control of the company "[t]he directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company").

[7] *Paramount Communications, Inc. v. QVC Network Inc.*, 637 A.2d 828, 45 (Del. Ch. 1993) (emphasis added). If directors have made a "reasonable decision" and selected a reasonable alternative, then the Delaware courts will not second guess the board's decision (even if subsequent events cast doubt on the wisdom or accuracy of the board's determination). *In re MONY Group Inc. Shareholder Litigation*, 852 A.2d 9, 20 (Del. Ch. 2004).

[8] *See Leonard Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989) (stating "there is no single blueprint that a board must follow to fulfill its duties").

[9] Many boards, for justifiable reasons, may find the benefits of confidentiality outweigh the benefits of a competitive bidding process, particularly if the target has leverage with respect to the buyer. However, in a competitive environment, seller boards may be able to obtain more seller-favorable terms than in a single bidder context. While sole bidder transactions may contain the ability of the target board to negotiate a transaction without continued public scrutiny and, depending on the context, rely on a post-signing market check, one could expect that the "seller favorable" deal terms enjoyed during the recent highs in M&A market activity may be absent from such a process, given the lack of competition in the bidding and negotiation process with the potential buyer. Compare that to a situation in which the seller does a full or limited market check, inviting a number of bidders and thus creating competition on price as well as deal terms.

[10] For example, the proposed acquisition of Reddy Ice Holdings, Inc. by GSO Capital Partners LP was publicly opposed by Shamrock Capital Advisors, Inc., which owned 5.4% of the outstanding shares of Reddy Ice at the time of the announcement. In addition, the proposed acquisition of Lear Corporation by American Real Estate Partners, L.P., an entity controlled by Carl Icahn, was publicly opposed by Pzena Investment Management LLC, which owned a 10.1% stake in Lear at the time of the announcement. Neither transaction was ultimately consummated.

[11] *See* Henry T. Hu and Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions,* 156 U. Pa. L. Rev. 625 (2008) and *2008: The Year of the Activist Hedge Fund, Deal Lawyer* (March-April 2008) http://www.deallawyers.com/Newsletters/Blur-2008_MarApr.pdf.

[12] In cash transactions where financing is not required and prompt governmental approval is relatively assured, targets should consider structuring the sale transaction as a two-step structure, with a first-step tender offer followed by a second-step merger. Such a structure presents a more prompt path to closing and reduces the influence of proxy advisory firms.

[13] *See United Rentals, Inc. v. Ram Holdings, Inc.*, C.A. No. 3360-CC (Del. Ch., Dec. 21, 2007) (discussing the "forthright negotiator principle").