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# 11<sup>th</sup> Annual PLI Private Equity Forum

## Fundamentals of Private Equity Investing

Presented by  
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July 12, 2010

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## 1. Overview

- **Following the Credit Crunch**
  - LBO activity down significantly due to reduced access to credit, fund investor resistance to draw-downs and declining values
  - Well-capitalized strategic buyers better positioned to take advantage of certain opportunities
  - Market dominated by investment-grade strategic acquisitions by borrowers with strong cash balances and/or a clear path to the capital markets, and in defensive sectors like health care
  - Despite credit contraction, cash was the exclusive consideration in the majority of large strategic deals
  - Continuing focus on risk allocation
- **Looking Forward**
  - Improved economic outlook
  - Considerable uptick in loan volume, but still anemic by historical standards
  - Expectations for continued improvement in access to capital
  - Cash rich balance sheets
  - Significant private equity "dry powder"

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## 2. How Did We Get Here?

## Traditional Private Equity Structures (pre-2005)

- Sellers bore substantially all of the closing risk
  - Shell companies were sole party to acquisition agreements
  - No direct recourse to sponsors
    - No third-party beneficiary rights for sellers in equity or debt commitment letters
  - Financing conditions allowed buyers to walk away without any risk or penalty if financing was unavailable
    - Financing conditions effectively incorporated broader closing conditions of lenders into buyer's own conditions in acquisition agreement
      - Conditions were generally far broader in lenders' commitment letters (Market outs, etc.)
- Sellers relied heavily on "reputational argument" by private equity firms

## Drivers of Change on the Private Equity Side (2005 – Q1/Q2 2007)

- Eager sponsors looked to put extra capital to work
- Larger deals became possible due to a number of factors
  - Rise of "mega" funds due to increased funds flow into private equity
  - Club deals
  - Attractive debt market
  - Post-announcement syndication and CLO market
  - Equity bridges from debt financing sources
- Strong exit environment
  - Quick leveraged recaps to recoup capital and protect sponsor downside – thereafter playing with the "house's money"
  - Secondary sales to sponsors at attractive prices became more possible with increasingly inexpensive debt
    - Cheap credit enabled ever larger purchase prices
  - Robust IPO markets

## Drivers of Change on the Financing Side (2005 – Q1/Q2 2007)

- Two factors principally drove lenders to agree to increasingly attractive financing terms for sponsors
  - Importance of sponsors to banks' businesses drove greatly increased competition among lenders on price and terms
  - Banks were originators and not long-term holders of the debt
    - LBO lending, related fees and securitization/CLO markets converted originating banks from bearers of credit risk to the "retail" side of leveraged lending
- Accordingly, banks agreed to unprecedented terms in order to procure sponsor business and fees
- Attractive economics of debt terms and greater flexibility afforded by PIK toggle/covenant lite, etc. fueled bidding by sponsors
  - Allowed sponsors to outbid strategics in many cases

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## Post-2005 Private Equity Deal Model

- Closing risk shifted from sellers to buyers
- Financing outs largely disappeared from acquisition agreements
  - Target boards and sellers discounted closing risk in a highly liquid market and relied on "reputational" arguments that were valid historically
  - New model was originally viewed as incredibly target friendly (recall SunGard precedent)
- Reverse break-up fees became commonplace
  - In the absence of meaningful competition from strategic buyers, financial sponsors largely succeeded in limiting "skin-in-the-game" to modest (3+/- %) reverse break-up fees
  - Had the effect of converting merger agreements into option contracts
- Sponsors were generally successful in resisting specific performance yet retained the right to force targets/sellers to close
- Attractive financing terms for sponsors (*i.e.*, PIK toggle, covenant lite, etc.)

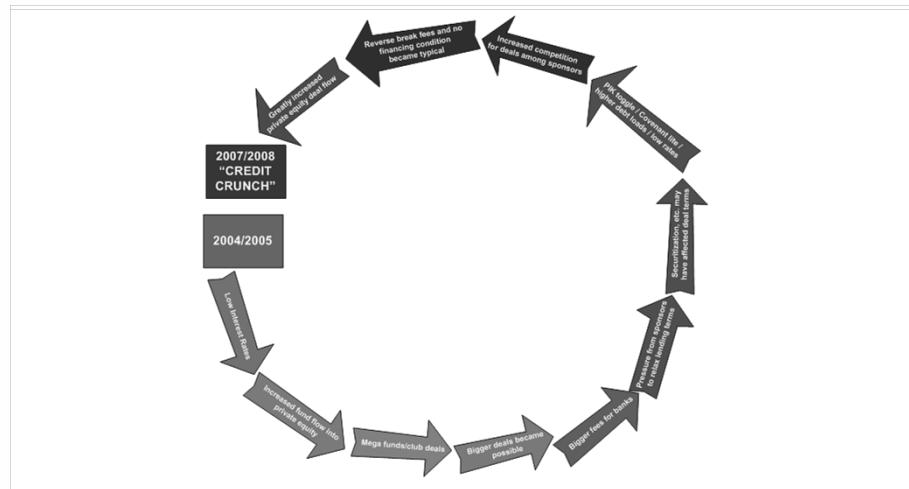
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## Virtuous Cycle for Private Equity Ends with Credit Crunch



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## Financial Crisis Stress Tests Private Equity Paradigm

- Sponsors look for outs to avoid exposure to reverse break-up fees
  - MAC
    - Sallie Mae (JC Flowers)
    - Accredited Home Lenders (Lone Star)
    - Harman International (KKR, GSCP)
    - Genesco (Finish Line)
  - Breach of covenant
    - Harman International (KKR, GSCP)
  - Unacceptable regulatory conditions
    - Alliance Data (Blackstone)
  - Fraud
    - PPG Industries' automobile glass unit (Platinum Equity)

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## Unprecedented Number of Broken or Renegotiated Deals

- Sponsors use their leverage to force sellers into lower prices or walk away with limited downside
  - Negotiate for price reductions
    - Home Depot Supply (Bain, Carlyle, CD&R)
    - Clear Channel's television assets (Providence)
  - Pay reverse break-up fee and walk
    - United Rentals (Cerberus)
    - Acxiom (ValueAct and Silver Lake)
    - PHH Corp. (Blackstone)
    - Reddy Ice (GSO Capital)
  - Allow agreement to lapse
    - Alliance Data (Blackstone)
  - Sponsors with weaker contracts forced to perform/settle
    - Huntsman (Hexion)
    - Dow Chemical (Rohm & Haas) (not PE but analogous)

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## Unprecedented Number of Broken or Renegotiated Deals (cont.)

- Banks try to get out or re-price
  - Refuse to consent to revised acquisition terms negotiated by sponsors and targets
    - Home Depot Supply (JPM, Merrill, Lehman)
    - Reddy Ice (Morgan Stanley)
    - Clear Channel's television assets (Wachovia)
  - Inability to deliver solvency certificate (Finish Line/UBS; Hexion/Credit Suisse and Deutsche Bank)
  - Banks and sponsors have difficulty agreeing to loan terms
    - Clear Channel (Citi, Deutsche Bank, Morgan Stanley, Credit Suisse, RBS, Wachovia) renegotiate to lower price and leverage and improve pricing
  - Leads to assertions of tortious interference by targets
    - Huntsman (Credit Suisse, Deutsche Bank)
    - Clear Channel (Citi, Deutsche Bank, Morgan Stanley, Credit Suisse, RBS, Wachovia)
    - Genesco (UBS)

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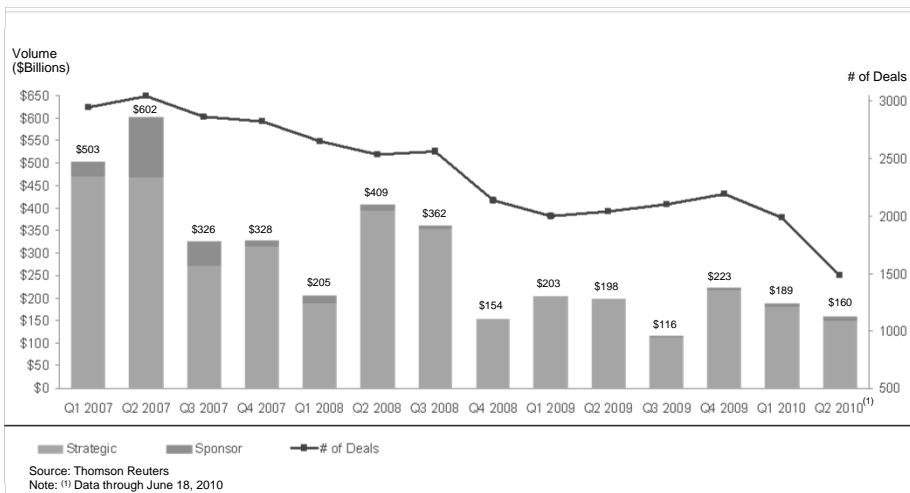
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### 3. Where Are We Going?

## M&A Market Update

U.S. M&A DEAL VOLUME



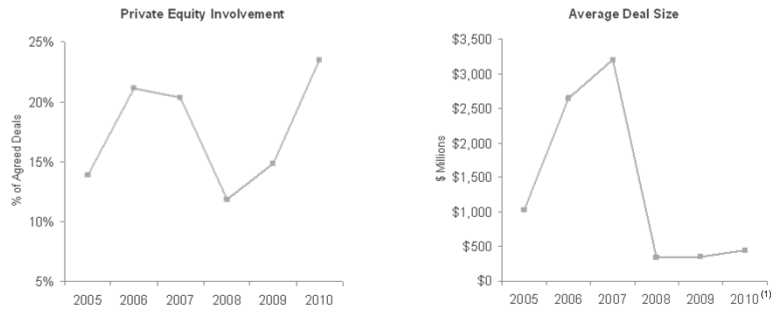
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## The Return of Private Equity?

- Among U.S. deals, financial sponsor transactions accounted for almost 25% of all deals involving U.S. public targets in 2010 to date, the highest level seen since 2005, including during LBO boom
  - However, the overall number and size of deals much lower than during LBO boom



Source: FactSet MergerMetrics. Data based on agreed deals involving full acquisitions of U.S. public companies.  
 Note: <sup>(1)</sup> Data through June 18, 2010

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## The Return of Private Equity? (cont.)

- Trends in the types of deals that got done in 2009/early 2010
  - *Early 2009:* Market was dominated by investment-grade strategic acquisitions, by borrowers with strong cash balances and/or a clear path to the capital markets, and in defensive sectors like health care
    - Private equity sponsors focus on non-traditional deals – e.g. PIPEs
  - *Late 2009/Early 2010:* Material uptick in LBO/sponsor/leveraged financing activity following Warner Chilcott transaction
- Traditional PE exit opportunities constrained by market but green shoots in 2010
  - IPOs: Value of financial sponsor-backed IPOs dropped to \$1.3 billion in 2008 from \$19.5 billion in 2007. But, improved in 2009 to \$4.7 billion and is up to \$5.5 billion as of June 2, 2010
  - Secondary buyouts also severely constrained, but showing some improvement

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## Resurgence of Strategic Buyers

- Sellers (particularly healthy ones) may assign perceived discounts to sponsor's nominal offer price relative to less conditional offers by strategic bidders
  - But note recent strategic deals that follow reverse termination fee construct (see below)
- Sellers will need to balance the financing and walk-away risks presented by sponsors against risks that may be associated with strategic buyers (e.g., antitrust or other regulatory complications)

## Strategic Buyers Adopt Reverse Termination Fee Structure Where Financing Is Essential

- Concern over volatile financing markets and risk that banks will not perform combined with relative negotiating power led a significant number of strategic buyers to negotiate reverse termination fee structures
  - 35% of strategic transactions in 2009 (and 25% in 2010 so far) included a reverse termination fee
  - Deals structured with express financing out paired with payment of reverse termination fee if debt financing failure, as the sole and exclusive remedy in such event
  - In strategic deals, damages for breach (where financing is available) generally uncapped
  - Specific performance (where financing is available) also generally available
  - Size of reverse termination fee higher than pre-credit crunch LBOs
    - From 4% to 7.3% (MSCI/RiskMetrics)
  - However, a majority of all public company strategic transactions in 2009 and 2010 still provided for specific performance against the acquirer following a financing failure

## Select Recent Leveraged Acquisitions by Strategic Buyers

	DATE ANNOUNCED	TRANSACTION VALUE (\$Bn)	DEBT FINANCING (\$Bn)	EXPRESS FINANCING CONDITION	REVERSE TERMINATION FEE (\$mm)/ % OF EQUITY VALUE	TARGET RIGHT TO SPECIFIC PERFORMANCE
Pfizer/Wyeth	Jan-2009	66.8	22.5	Yes, tied to minimum credit rating or MAE	4,500/6.7% <sup>(1)</sup>	Yes
Merck/Schering-Plough	Mar-2009	40.6	8.5	Yes	2,500/6.5% <sup>(1)</sup>	Yes
Roche/Genentech	Mar-2009 (Unsolicited bid)	46.8	39.0	No	No	Yes
Warner Chilcott/P&G	Aug-2009	3.1	3.1	Yes	93/3% <sup>(1)</sup>	Yes
Xerox/ACS	Sep-2009	6.4	3.0	Yes, tied to minimum credit rating or MAE	323/5% <sup>(1)</sup>	Yes
MSCI/RiskMetrics	Mar-2010	1.55	1.38	Yes	100/7.3% <sup>(2)</sup>	Yes
Charles River/WuXi PharmaTech	Apr-2010	1.6	1.25	No	75/4.7% <sup>(3)</sup>	Yes

(1) Fee payable upon termination due to debt financing failure, as the sole and exclusive remedy in such event

(2) Fee payable upon termination due to debt financing failure or inability of parent to agree with lender on terms and conditions in commitment letter, as the sole and exclusive remedy

(3) Fee payable upon termination due to existence of "financial market event"

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## Recent Trends in Financial Sponsor Deals

- Financial Sponsor Deals
  - While there has been a material uptick in financial sponsor deals in 2010, the deals that have been announced are smaller on average
  - Higher equity components as a percentage of total sources (averaging 44%) compared to pre-crisis (33%). Largest LBOs announced post-credit crunch have featured 40-50% of equity commitments
  - Increased buyer focus not just on MAC clauses but on more specific closing conditions designed to manage financing and other business risk (e.g., minimum EBITDA, credit ratings, minimum cash condition and solvency)
- Basic architecture of financial sponsor deals has not changed
  - Buyers are still shell vehicles
  - Financial sponsor deals continue to have no express financing outs, although a reverse termination fee is payable in the event of a financing failure, as the sole and exclusive remedy
  - Monetary damages for breach (where financing is available) are usually capped at the reverse termination fee (although in more recent cases, specific performance was available so long as there was no debt financing failure)
  - However, sellers demanding higher reverse termination fees (between 5 – 10% of equity value and in one case 38% (see GTCR/Protection One) compared to 1-4% pre-2009)

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## Select Recent Leveraged Acquisitions by Financial Buyers

	DATE ANNOUNCED	TRANSACTION VALUE (\$mm)	SPONSOR EQUITY COMMITMENT (\$mm)	EXPRESS FINANCING CONDITION	REVERSE TERMINATION FEE (\$mm)/% OF EQUITY VALUE	REVERSE TERMINATION FEE AS % OF SPONSOR EQUITY	TARGET RIGHT TO SPECIFIC PERFORMANCE
TPG Capital, CPP Investment/IMS Health	Nov-2009	5,900	2,800	No	275/6.6% <sup>(1)</sup>	9.8%	Yes <sup>(2)</sup>
Blackstone/ Birds Eye Foods	Nov-2009	1,400	300	No	40/6.0% <sup>(3)</sup>	13.3%	Yes <sup>(2)</sup>
Apollo/Cedar Fair (terminated)	Dec-2009	2,650	765	No	50/7.7% <sup>(1)</sup>	6.5%	Yes <sup>(2)</sup>
S.A.C. Capital/Airvana	Dec-2009	540	370	No	25/5.2% <sup>(4)</sup>	6.8%	No
Lone Star Funds/Lodgian	Jan-2010	270	Not available	No	No	Not applicable	Yes <sup>(3)</sup>
Thomas Lee/ CKE Restaurants (terminated)	Feb-2010	928	444	No	15/2.5% 31/5.1% <sup>(4)</sup>	3.4%/7.0%	No
Abry/RCN	Mar-2010	1,200	534	No	30/5.3% <sup>(1)</sup>	5.6%	Yes <sup>(2)</sup>
CCMP/Infogroup	Mar-2010	659	344	No	25/5.5% <sup>(7)</sup>	7.3%	Yes
Water Asset Mgmt, J.P. Morgan Asset Mgmt/ SouthWest Water	Mar-2010	427	303	No	13.7/5% <sup>(8)</sup>	4.5%	No
Madison Dearborn/ BWAY Holding	Mar-2010	1,018	296	No	27.5/6.1% 51.1% <sup>(9)</sup>	9.3%/1.7%	Yes <sup>(2)</sup>
Cerberus/DynCorp	Apr-2010	1,500	591	No	100/10% 300/30% <sup>(10)</sup>	16.9%/50.8%	Yes <sup>(2)</sup>

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## Select Recent Leveraged Acquisitions by Financial Buyers (cont.)

	DATE ANNOUNCED	TRANSACTION VALUE (\$mm)	SPONSOR EQUITY COMMITMENT (\$mm)	EXPRESS FINANCING CONDITION	REVERSE TERMINATION FEE (\$mm)/% OF EQUITY VALUE	REVERSE TERMINATION FEE AS % OF SPONSOR EQUITY	TARGET RIGHT TO SPECIFIC PERFORMANCE
GTCR/Protection One	Apr-2010	883	340	No	60/15.2% 150/38.0% <sup>(11)</sup>	17.6%/44.1%	No
Silver Lake, Warburg Pincus/Interactive Data	May-2010	3,400	1,400	No	225/7% <sup>(1)</sup>	16.1%	Yes <sup>(2)</sup>
Thoma Bravo/Double-Take Software	May-2010	257	21.2	No	14.5/6.5% 24.2/10.8% <sup>(12)</sup>	68.4%/114.2%	Yes <sup>(2)</sup>
Providence Equity Partners/Virtual Radiologic	May-2010	294	Sponsor guarantees aggregate value of merger consideration	No	No	Not applicable	Yes <sup>(13)</sup>
Thoma Bravo, Ontario Teachers/SonicWALL	June-2010	748	280	No	60/9.4% <sup>(1)</sup>	21.4%	Yes <sup>(2)</sup>

(1) Fee payable upon termination by company due to failure to close or breach, as the sole and exclusive remedy, subject to specific performance right if debt financing is available

(2) Target right to seek specific performance of equity commitment and close only if debt financing is available and the other conditions to closing have been met

(3) Fee payable upon termination by company due to failure to close by end of marketing period or by either party due to failure to close by end date, as the sole and exclusive remedy, subject to specific performance right if debt financing is available

(4) Fee payable upon termination by company due to failure to close or breach, as the sole and exclusive remedy

(continued)

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## Selected Acquisitions - Notes

*(continued from previous page)*

- (5) In the event of a breach by purchaser, the company must seek specific performance. If a court declines to grant specific performance, damages capped at \$20MM
- (6) Higher fee payable upon termination by company due to failure to close if debt financing is available; lower fee payable upon termination by company due to failure to close for other reasons, in each case, as the sole and exclusive remedy
- (7) Fee payable upon termination by either party due to debt financing failure or by company due to breach, as the sole and exclusive remedy, subject to specific performance
- (8) Company may elect to receive fee or sue for damages up to \$40mm upon termination by the company due to failure to close.
- (9) Higher fee payable upon termination by company due to failure to close or breach; lower fee payable upon termination by either party if the leverage ratio is greater than the maximum permitted.
- (10) Higher fee payable upon termination by company for "Willful Breach"; lower fee payable upon termination by company for failure to close or "material" breach, in each case, as the sole and exclusive remedy
- (11) Higher fee payable upon termination by company due to failure to close if debt financing is available or upon termination by company for "Willful Breach"; lower fee payable upon termination by either party due to debt financing failure or by company due to breach, in all cases, as the sole and exclusive remedy
- (12) Fee payable upon termination (i) by company due to failure to close or breach or (ii) upon termination by either party due to failure to close by end date (and could have been terminated by the Company as set forth in (i)). Higher fee payable if debt financing is available, buyer commits a "Willful Breach" or any condition to funding in the commitment letter has not been satisfied; lower fee payable upon termination for other reasons.
- (13) In the event of breach by purchaser, specific performance is the sole and exclusive remedy. If a court declines to grant specific performance (and grants an award for damages), the company may enforce the award provided that the purchaser is given the opportunity to consummate the merger within 2 weeks of the court's determination and the purchaser continues to refuse to close.

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## 4. Negotiating Key Contractual Terms

## Conditionality: MAC and Financing Condition

### What are the competing considerations for the parties?

- Seller – wants assurance that the Buyer will show up at closing with the money
- Buyer – wants assurance that the money promised by the lenders will be available if the Buyer has an obligation to close
- Lender – wants to be able to back out of the deal if the loans are not marketable and the Buyer is otherwise obligated to close

**The MAC clauses (in the merger agreement and the commitment letter) and the financing condition (in the merger agreement) seek to balance these various interests**

## Material Adverse Change Condition (MAC)

**Definition: a “Material Adverse Change” occurs when a company experiences any material adverse change or effect on the business, condition (financial or otherwise), assets or results of operations of the company and its subsidiaries, taken as a whole**

- Although a MAC under Delaware law is a very high standard, it is not an academic exercise to draft and negotiate the MAC clause that is included in the merger agreement or loan agreement
- Conditions to closing in purchase agreement include
  - “bring-down” of representations and warranties, including the “no MAC” representation
    - Merck/Schering Plough: Since December 31, 2008, there has not been any Event or Events that has had or would reasonably be expected to have, either individually or in the aggregate, a [Schering Plough] Material Adverse Effect.
  - sometimes, absence of a material adverse change (standalone MAC)
    - Merck/Schering-Plough: “Since the date of this Agreement there shall not have occurred any Event or Events that have had, or would be reasonably expected to have, individually or in the aggregate, a [Schering Plough] Material Adverse Effect.”

## Material Adverse Change *(cont.)*

### What are the components of the definition?

- MAC on financial condition or results of operations (always)
- MAC on business, assets, etc. (almost always)
- MAC on securities (less common)
- MAC on Seller's ability to close (less common)
- Prospective MAC:
  - MAC on prospects (almost never)
  - "would reasonably be expected to have a MAC" (common)

## Material Adverse Change *(cont.)*

### What is typically excluded from the definition?

- changes in financial or securities markets
- changes in law, except when there is a specific change of law risk on the horizon
- changes in industry or general economic conditions
- acts of war, terrorism, or natural disaster
- announcement of the transaction
- changes in GAAP
- failure to meet internal or published budgets (this needs to be captured elsewhere)

**Consider use of a "no disproportionate effect" qualifier**

## MAC *(cont.)*

### **Variations on entities covered by MAC (compare merger agreement and commitment letter)**

- Seller only
- Seller and Buyer (tested separately)
- Combined (trend in commitment papers)

### **Variations on reconciling MAC in Commitment Letter to Merger Agreement**

- Referenced (unusual these days)
- Conformed (often, sometimes with limited exception)
- Non-Conformed (still unusual)

## MAC *(cont.)*

### **Practice pointers**

- If representing seller, ensure that any MAC with a “disproportionate effects” qualifier is measured by the extent to which such effects are disproportionate
- Buyers should try to match the governing law provisions relating to the MAC in the commitment letter to those in the merger agreement

## Financing Condition (aka Financing Out)

- A financing condition gives Buyer an “out” if the financing is not available at closing
  - Rare to have a financing out (that does not require the payment of a reverse termination fee if debt financing is not available), even in this market
- Existence of the condition changes the dynamics of Buyer’s negotiations with the Lender with respect to conditionality in the commitment papers
- Financial sponsor deals in large transactions do not generally contain express financing conditions any more, although if financing is not available, damages generally limited to reverse termination fee. In some more recent cases, however, specific performance was available so long as there was no debt financing failure.
  - More common in middle market deals to have financing conditions
- Express financing conditions have appeared in leveraged deals by strategic buyers although paired with the payment of a reverse termination fee in the event of a financing failure
- Distinction between recent strategic transactions (which do have express financing conditions) and financial sponsor transactions (which do not) can be misleading. Although structured slightly differently, if debt financing is unavailable, the transaction will not close and sellers’ remedies limited to reverse termination fee

### Practice pointer

- Since there are many variations, it is important to ensure that you parse through the various provisions in the agreements to figure out how they all fit together

## Financial Milestones As Closing Condition

**Recognizing that traditional MAC clauses offer limited protection to buyers, some Buyers have succeeded in obtaining specific financial milestones as conditions in acquisition agreement to manage business risk and financing risk in some deals**

- Minimum EBITDA
  - Cedar Fair: “EBITDA (as defined in [Exhibit A](#) hereto) for the Company and its Subsidiaries for the four (4) fiscal quarters ending December 31, 2009 shall not be less than \$311,800,000 (the “[Minimum EBITDA Number](#)”), (ii) Parent shall have received a certificate signed on behalf of each of the General Partner and the Company by the Chief Executive Officer and the Chief Financial Officer thereof certifying to the matters set forth in clause (i) of this [Section 6.02\(f\)](#) and (iii) the EBITDA Review Period shall have lapsed. Without prejudice to the foregoing conditions, the parties agree that EBITDA (as defined in [Exhibit A](#) hereto) for the Company and its Subsidiaries for the three (3) fiscal quarters ended September 27, 2009, was \$312,600,000 based exclusively on, and assuming the accuracy of, the information contained in or used to prepare the unaudited financial statements of the Company filed with the SEC prior to the date hereof (it being understood that if such information is inaccurate or incomplete or there is otherwise any change in such information then EBITDA for such three (3) fiscal quarter period may be different).”

## Financial Milestones As Closing Condition *(cont.)*

- **Minimum cash flow**
  - MSC Software: "The Company shall have at least \$143,000,000 in cash (including the Company Cash Deposit) (the "**Minimum Cash Amount**"), (ii) of such amount of cash reflected in the Cash and Working Capital Statement, an amount of cash equal to at least the Company US Cash Threshold shall be held in United States accounts (including the Company Cash Deposit), and (iii) the Company shall have made the Company Cash Deposit in accordance with Section 2.03. The amounts set forth in (i) and (ii) above shall be reflected in the Cash and Working Capital Statement delivered to Parent by the Company and be certified to as required under Section 6.07."
- **Minimum debt ratings conditions**
  - Allied Waste: "Republic shall have received written confirmation from the applicable agency that, upon the Effective Time, the senior unsecured debt of Republic (including Allied or any Allied Subsidiary to the extent an issuer under the Indentures and after giving effect to any parent or other guarantees required by such agency) will be either (i) rated BBB- or better by Standard & Poor's and Ba1 or better by Moody's, or (ii) rated Baa3 or better by Moody's and BB+ or better by Standard & Poor's."

### **It is not unusual for commitment papers to include a ratings or performance condition**

- **Practice pointer**
  - If representing seller, check whether the milestones are realistic and attainable

## Financing Covenant

### **Buyer agrees to use commercially reasonable/reasonable best efforts to obtain financing on the terms in the commitment letter**

- After giving effect to the "market flex" provisions in the fee letter

### **Buyer is obligated under the commitment papers to assist Lenders with the syndication**

### **Seller agrees to cooperate with the Buyer in connection with the syndication of the loans**

### **Practice pointers**

- Look out for the level of assistance required from Seller
  - If transaction doesn't close, who is responsible for the Seller's costs
- Is Seller required to provide financial information or issue securities prior to closing?
- What level of effort is required by the Buyer to obtain financing?
- Is Buyer required to sue the Lenders for specific performance?
- Look out for minimum syndication periods in the commitment letter (including when the period starts and any blackout dates)
- Look out for "clear market" provisions in the commitment letter

## Reverse Termination Fee – Concept

- Concept: termination fee paid by buyer if the transaction does not close either as a result of a financing failure or a breach by the buyer of its obligations under the acquisition agreement
  - Developed in response to sponsors using shell companies as buyers
  - Lack of financing condition in acquisition agreement
- Financial sponsor guarantees payment of the fee under arrangements that limit additional recourse
- In most cases, payment of reverse break-up fee was the “sole and exclusive” remedy for a breach by buyer of the agreement

## Reverse Termination Fee – Mechanics

### Payable upon termination

#### Trigger events vary

- Occurrence of the “drop-dead” date, if all conditions (other than the financing condition) are satisfied
  - *E.g.*, Pfizer, Merck, MSCI, Xerox
- Failure to close despite fulfillment of closing conditions
- Breach by Buyer

#### Structure of Reverse Termination Fee also varies

- One fee payable if Buyer fails to close for any reason (pure “walk-away” right)
- Two-tier: one fee if the failure to close is due to failure of Lenders to fund. Higher fee if debt financing is available and Buyer fails to close
- Damages cap paired with reverse termination fee: reverse termination fee is paid if debt financing unavailable. If Buyer breaches for other reasons, it is liable for damages, not to exceed a capped amount. (*But see* result in Huntsman/Hexion, where damages were not capped. This provision dramatically shifted the leverage to Seller)
- Specific performance available: reverse termination fee payable if debt financing is not available. If debt financing is available and Buyer breaches for other reasons, Seller may seek specific performance

## Reverse Termination Fee (cont.)

### Practice pointers

- Many variations, so you need to parse through all relevant provisions
  - Is the reverse termination fee the sole and exclusive remedy?
  - Are damages for breach capped or uncapped?
  - How are damages calculated? (*Consolidated Edison* language)
  - Can the Buyer sue for breach or seek specific performance prior to termination?
  - Does the agreement provide for additional remedies for breaches that are “willful and intentional”? Does the agreement define “willful”?
- If reverse termination fee is exclusive remedy, the Lender will seek to ensure that the reverse termination fee is also exclusive with respect to it (see discussion on third party beneficiaries in “Trends in Acquisition Financing” above). Check to make sure that the Lender is a third party beneficiary to this provision.

## Most Deals With Reverse Termination Fees Permit Some Form of Specific Performance

- Deals structured with reverse termination fees were traditionally paired with a general prohibition on specific performance of the buyer’s obligations
  - Rationale is that the reverse termination fee is the sole and exclusive remedy
- By late 2009 – early 2010, most deals containing reverse termination fees permit some form of specific performance
  - If debt financing is available (and other conditions met), to require the equity commitments to be drawn and the deal to close
    - *IMS Health*: “The parties acknowledge and agree that the parties shall be entitled to an injunction, specific performance and other equitable relief to prevent breaches of this Agreement and to enforce specifically the terms and provisions hereof, this being in addition to any other remedy to which they are entitled at law or in equity. Notwithstanding the foregoing, it is explicitly agreed that the Company shall be entitled to seek specific performance of Parent’s obligation to cause the Equity Financing to be funded to fund the Merger only in the event that (i) all conditions in Section 7.1 and 7.2 have been satisfied (or, with respect to certificates to be delivered at the closing, are capable of being satisfied upon the Closing) at the time when the Closing would have occurred but for the failure of the Equity Financing to be funded, (ii) the financing provided by the Debt Commitment Letters (or, if alternative financing is being used in accordance with Section 6.14, pursuant to the commitments with respect thereto) has been funded or will be funded at the Closing if the Equity Financing is funded at the Closing, and (iii) the Company has irrevocably confirmed that if specific performance is granted the Equity Financing and Debt Financing are funded, then the Closing pursuant to Article II will occur.”
    - In *IMS Health*, Seller is a third party beneficiary to the *equity* commitment
    - Recent efforts by targets to gain direct beneficiary rights under *debt* financing letters have increased but have so far been unsuccessful

## Most Deals With Reverse Termination Fees Permit Some Form of Specific Performance *(cont.)*

- In strategic deals, where there is no debt financing failure
  - *Pfizer/Wyeth*: "The parties hereto agree that irreparable damage would occur if any provision of this Agreement were not performed in accordance with the terms hereof and that the parties shall be entitled to seek an injunction or injunctions to prevent breaches of this Agreement or to enforce specifically the performance of the terms and provisions hereof."
  - Agreement contained a financing out, so if debt financing failure, Buyer did not have an obligation to close so no breach.
- Prior to termination, in the event of a breach
- To seek specific performance of buyer's obligation to obtain debt financing, irrespective of seller's right to specific performance in other respects

### Practice pointers

- If the Seller seeks specific performance but a court refuses to grant it, can the Seller seek other remedies?
- If the Seller seeks specific performance does it lose the ability to sue for damages or seek the reverse termination fee?

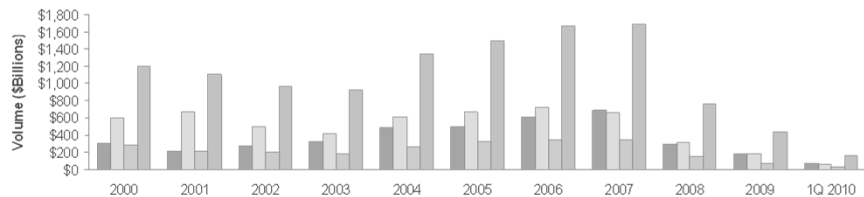
## Absent Specific Performance or a Reverse Termination Fee, Damages Remains an Uncertain Remedy in Public Company Deals

- If specific performance is not available, the focus shifts to how damages ought to be calculated
  - The Second Circuit has ruled that, under New York law, a public company target's stockholders have no right to bring a claim against the buyer for the premium lost by the Company's stockholders if the buyer refuses to close in violation of the merger agreement.
    - See *Consol. Edison, Inc. v. Northeast Utils.*, finding that the merger agreement only created a third-party beneficiary right of stockholders to the merger consideration at the effective time, "if and when the merger happened, not a right to sue to compel completion of the merger or for damages resulting from a party's refusal to merge."
    - Note that in private company deals there will typically be contractual privity between seller and buyer and therefore the damages analysis is different
  - This raises concern that the target itself may not seek to recover its stockholders' lost premium; alternative approaches to address this concern include:
    - Specify the amount as liquidated damages
    - Expressly state that the lost stockholder premium should be included in the calculation of damages (see *Apax Partners/Bankrate, NuCo2/Aurora Management, HireRight/Providence Equity, Charlotte Russe/Advent International*)
    - Expressly state that the company may collect on behalf of the company shareholders, as their agent (see *Entrust/Thoma Bravo, Charlotte Russe/Advent International*)
  - Each alternative raises untested legal issues

## 5. Trends in Acquisition Financing

### State of the Loan Market

- By the end of 2009, there were early signs of a recovery.
- **Loan Volume:**
  - *Early 2009:* There had been a dramatic fall in loan volume.
    - Thompson Reuters LPC: loan issuance fell 55% from 2007 to 2008, and a further 28% in 2009.
    - S&P/LCD: loan issuances fell 71% from 2007 to 2008, and a further 52% in 2009 (excludes amends and extends).
  - *Late 2009/Early 2010:* There was considerable uptick in volume (over half of 2009 volume occurred in the fourth quarter), but still anemic by historical standards. Trend continued in early 2010, including in the form of LBOs (e.g., CCMP/Infogroup) and dividend financings (e.g., Weather Channel).



Source: Thomson Reuters LPC

■ Lev ■ IG ■ Other ■ Total

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## State of the Loan Market (cont.)

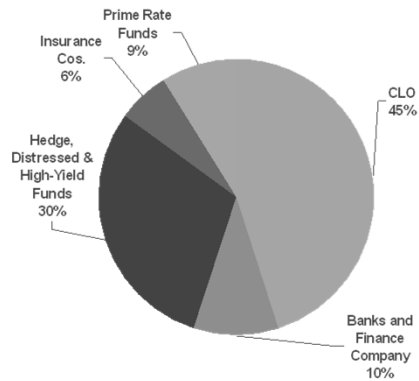
### Buy-side Demand

#### Early 2009:

- The buy side had dramatically changed, with many of the top 10 U.S. lead arrangers in 2007 (JPM, BofA, Citi, Wachovia, CS, Deutsche, GS, Lehman, Merrill and Wells Fargo) having exited the market, modified their form or obtained significant government assistance.
- CLOs had disappeared as buyers of new loans, removing approximately 70% of demand from the market.

#### Late 2009/Early 2010:

- CLOs have been reinvesting cash received from repayments and by late 2009/early 2010 had a 45% share of the institutional lender market. For example, demand for Nalco's oversubscribed \$300MM term loan was driven almost exclusively by CLOs.
- In late 2009 and early 2010, new CLOs began entering the market, though arrangers note challenges in deal execution.



Source: Thomson Reuters LPC

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## Mandate Papers

### Process of Negotiating Mandate Papers

#### Then: Commitment papers had become commoditized.

- Sponsors served up their own form papers with limited tolerance for changes.
- Sponsors served up a grid to be completed relating to economic terms, with extreme pressure to propose no other changes.
- Sponsors provided limited period to banks to negotiate papers, review merger agreement and conduct diligence.
- All typically in the context of competitive auction for a target with its own pressure and timelines.

#### Now:

- Arrangers are more likely to use their own forms of papers, and place more emphasis on preserving certain protections.
- Arrangers insist on time to complete diligence and review merger agreements (and are more aggressive in commenting).
- In competitive situations, lenders who do not use sponsor forms or complete sponsor grid may be viewed as being at a competitive disadvantage:
  - As a practical matter, there may not be another way for borrowers to run a competitive process on a tight timeframe, so we might expect to see more of this type of process if markets continue to improve.
  - However, that should not detract from focus on important provisions.

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## Mandate Papers (cont.)

- There is renewed focus on certain provisions which may once have been thought of as “boilerplate”
  - Expense reimbursement: require expenses to be reimbursed whether or not closing occurs.
  - Indemnities:
    - Focus on carve-outs in addition to willful misconduct/gross negligence. *E.g.* bad faith, breach (or material breach), litigation between commitment parties.
    - Consider whether a final, non-appealable judgment is required before indemnity carveouts are activated.
    - Ensure special, consequential or punitive damages are excluded.
    - Include actions brought by the seller in indemnity, and consider whether this should be express.
  - Governing law:
    - Consider expanding to include any claim, controversy or dispute related to the transaction.
    - MAC to be interpreted in accordance with New York or Delaware law, rather than the law governing the acquisition agreement.
  - Submission to NY Jurisdiction – exclusive or non-exclusive?
- Fees
  - Focus on *when* fees are payable (signing, closing or a combination of each)
  - Focus on how fees are calculated (*e.g.* on commitments at signing vs. commitments at closing, before or after giving effect to flex, etc).
  - Alternative transaction fees vs. rights of first refusal vs. greater fees at signing.

## Conditionality and Flex

- Generally
  - Conditions precedent are typically the most heavily negotiated element of commitment papers for an acquisition financing. They are also dependent on the industry, the credit rating of the borrower, and the intended permanent financing structure.
- Business MAC
  - During the LBO boom, MAC was often defined by reference to the relevant merger agreement condition.
  - *Now:*
    - MAC more likely to be specifically set forth in the commitment papers.
    - MAC definition still typically tracks that set forth in the acquisition agreement, however arrangers are more aggressive in commenting / curbing significant exclusions.
    - Consider modifying MAC where that makes sense (*e.g.* where the MAC in the acquisition agreement contains a carve out for actions taken with the consent of the other party to the acquisition agreement).
    - In strategic acquisitions, coverage of acquirer's condition still a point of negotiation though trend is towards combined MAC.

## Conditionality and Flex (cont.)

- **Market MAC**
  - *Condition:* No material adverse change in credit markets or, if a capital markets financing is backstopped, capital markets.
  - *Then:* Market MACs disappeared from mandate papers, even in the first draft
  - *Now:*
    - Market MACs have not returned to the market despite many predictions to the contrary.
    - Some reasons for this:
      - introduces an unacceptable level of deal uncertainty from buyer/seller perspective;
      - utility of the Market MAC has been called into question (e.g. Solutia);
      - enhanced market flex (below) and premarketing have ameliorated some market risk; and
      - a buyer/borrower may prefer an engagement letter to a commitment letter with a market MAC (and the fees that come with a commitment).

## Conditionality and Flex (cont.)

- **Solvency**
  - *Condition:* Borrower must provide a representation that it is solvent and/or deliver a certificate from CFO as to solvency.
  - *Then:* At times, the only condition was the obligation to deliver a CFO certificate, and the solvency rep would not be a condition to closing.
  - *Now:* Arrangers are much more focused on the solvency condition:
    - Require a separate representation from the borrower (the truth of which is a condition to closing);
    - Solvency certificate to be in form and substance satisfactory to the arrangers (sometimes, a draft form of solvency certificate is attached to the commitment letter); and
    - Third party solvency opinion in appropriate circumstances (e.g. dividend recap).

## Conditionality and Flex (cont.)

- SunGard/Funds Certain
  - *Condition:* SunGard language:
    - prohibits conditions to funding that are not expressly set forth in the commitment letter or in an annex;
    - limits the representations the truth of which are a condition to funding to (i) material representations set forth in the merger agreement and (ii) a limited set of "specified representations"; and
    - limits the actions that are required to perfect security interests and provide guarantees, so long as commercially reasonable efforts have been taken by the borrower.
  - *Then:* SunGard language included in all sponsor deals and pushed for in strategic deals. Very little negotiation.
  - *Now:*
    - Despite predictions that SunGard may be removed from transactions, it is still present in many deals, including many strategic deals.
    - However, more attention is paid by arrangers to some of the limitations in conditionality
      - Collateral requirements should be carefully tailored to the particular transaction
      - Consider expanding the scope of specified representations (e.g., solvency, litigation, information).

## Conditionality and Flex (cont.)

- Ratings or performance based conditions:
  - *Then:* No "minimum ratings" condition; "minimum performance" conditions were rare.
  - *Now:*
    - In some investment grade deals, lenders have insisted on pro forma investment grade rating (NBCU, Merck). Minimum ratings conditions have appeared in some leveraged acquisitions (Spectrum Brands, Bilo)
    - There are more performance based conditions, though they are carefully crafted to offer meaningful protection to the arrangers without disproportionately impacting deal certainty:
      - Conditions that can be cured by the buyer (e.g., replacing part of debt with equity and thus satisfying a debt/EBITDA ratio); or
      - Conditions that buyer and seller are otherwise comfortable can be met.

## Conditionality and Flex (cont.)

- **Terms of the acquisition agreement**
  - *Condition:* Acquisition agreement must be in form and substance satisfactory to the arrangers. Typically deleted prior to signing upon review of the final acquisition agreement.
  - *Then:* Arrangers had very limited opportunity to review and comment on the acquisition agreement. They were asked to defer to sponsor judgment.
  - *Now:*
    - Arrangers are making it clear in early drafts of the papers that the acquisition agreement will not be satisfactory unless it contains the "Xerox language", which includes
      - Limits on the liability of lenders to reverse termination fee;
      - Agreements by seller that all actions brought by it against the lenders to be heard exclusively in New York; and
      - Enforceability of these provisions directly.
    - Arrangers focused on financing provisions of the acquisition agreement, to ensure that sufficient financial information as to the target will be available to enable the permanent financing

## Conditionality and Flex (cont.)

- **No modification to Acquisition Agreement**
  - *Condition:* Acquisition must be consummated in accordance with the approved acquisition agreement without modification.
  - *Then:* modifications/waivers under the acquisition agreement were permitted so long as not "materially adverse" to the lenders.
  - *Now:* Pointing to the experiences during the credit crunch (where some modifications (e.g., price reductions) were arguably not materially adverse) arrangers frequently insist on:
    - no material change (whether or not adverse) (e.g. *Warner Chilcott*); or
    - (more commonly) deeming certain changes (e.g., to price or structure) to be materially adverse (e.g. *Xerox*, *NBCU*).

## Conditionality and Flex (cont.)

- **Market Flex**
  - **Flex:** Allows arrangers to unilaterally modify (within specified limits) the terms of a proposed financing if a successful syndication cannot be achieved with the initial terms.
  - **Then:** Very limited flexibility.
    - Detailed negotiated financial covenants and definitions set forth in mandate papers.
    - Definitive documents required to be consistent with "recent sponsor precedent".
    - Very limited pricing flex – often capped at 25-75 bps.
    - Very limited structure flex – often limited to reallocation of 10-15% of financing among existing facilities.
  - **Now:** Re-emergence of market flex as important protection against market risk.
    - Arrangers are less willing to underwrite detailed covenants or sponsor "forms".
      - May be willing to underwrite cushion to agreed model on financial covenants.
      - May in limited circumstances be willing to underwrite existing agreements.
    - There is greater flexibility to modify structure (1st/2nd lien, mezzanine, amortization)
    - Greater flexibility to modify terms:
      - Call protection (in light of recent repricing efforts, these have become more prevalent)
      - Prepayment conditions (50% equity sweeps, 75% ECF sweeps)
    - Most dramatic change has been to pricing flex.

## Conditionality and Flex (cont.)

- **Pricing Flex**
  - Levels are set significantly higher than expected market-clearing prices.
  - A formulation that has gained popularity:
    - Can flex up to a weighted average cap across all funded debt tranches.
    - Initial cap is a fixed % starting point, increasing by an amount determined by reference to the weighted average increase of certain metrics/indices
    - Increase is weighted based on the amount of senior secured facilities vs. bridge facility/notes.
  - 100% of pricing flex can be issued as OID, sometimes subject to a floor and limits on revolver OID
- **Other flex matters:**
  - Must be able to flex even if flex would not result in a successful syndication. There are several variations of this concept, some of which are more readily accepted by borrowers than others.
  - Successful syndication levels have come down dramatically.

## Syndication

- **Syndication**
  - Arrangers are focused on removing exposure from their books as soon as possible following execution of commitment papers.
  - Arrangers have used the following approaches (among others) to achieve that objective:
    - Increased "tiering": Arrangers maintain flexibility to allocate debt to various tiers and structures that prove appealing to the market at that time.
    - Increased co-arranger discipline in stages of syndication, involving multiple syndication rounds designed to bring down the Arranger's initial commitment.
  - From the Borrower's perspective:
    - This can result in extended deal execution time. Borrower will carefully negotiate acquisition agreement to ensure sufficient marketing periods are built into closing timetable.
    - Borrowers may also be forced to take on greater risk of default by lenders outside the arranger group, and cede control of who can approve waivers etc.
  - Negotiation of the extent to which arrangers can reduce their initial commitments and what, if any, consent rights borrowers have, remains a topic of considerable negotiation.
  - Consider utility of permitting assignments subject to defaulting lender protections.

## Bridge Facilities

- **Bridge Facilities**
  - *Pre-LBO Boom*: Designed and had pricing and terms intended to be unattractive, reflecting both sides' expectation that the bridge facility would not be drawn.
  - *During LBO Boom*: Pricing and terms become more favorable to borrowers:
    - Pricing
      - Not materially different from rest of the capital structure;
      - Step-ups were subject to grace periods;
    - Covenants and terms were based on sponsor high yield terms.
  - *Now*: Although generalizations are dangerous with limited volume:
    - Pricing:
      - Initial pricing is considerably higher and subject to LIBOR floor (though LIBOR floors are starting to recede).
      - Perhaps more significantly pricing (out of the box or through flex or securities demand) can effectively be at the weighted average cap at or shortly after closing.
      - Bridge may step up to the caps automatically or upon exercise of a loan demand.
      - Some traditional bridge concepts (like rollover loans, exchange notes and a separate bridge cap) may be rendered irrelevant.
    - Terms
      - more often mirror the institutional term loan rather than high yield bonds (e.g. include financial covenants);
      - may be secured on a first or second lien basis and debt and restricted payments covenants should be tighter.

## Bridge Facilities (cont.)

- **Securities Demands**
  - *Securities Demands*: Right of the arrangers to require the borrower to issue securities into the debt capital markets to refinance the bridge.
  - *Then*: This right was significantly curtailed.
    - Demand was only permitted after a post-closing holiday.
    - Securities were required to be issued to unaffiliated third parties.
    - Only a limited number of demands were permitted.
    - The applicable indenture required to be based on sponsor form (where appropriate).
    - Subject to minimum maturity and maximum pricing requirements.
  - *Now*: Some of the features we have seen include
    - Investment banks (or a majority of them) can force borrower to issue securities into escrow BEFORE closing.
    - Securities (or demanded loans) can be issued to arrangers.
    - No limit on the number of demands, with no or very low floor on amount that can be demanded at a time.
    - The applicable indenture required to be based on investment banks' form.
    - Terms to be determined by the investment banks based on market conditions, subject only to the weighted average pricing cap.
    - Consequence of failing to satisfy the demand is that the bridge will go to the caps and will trigger a default.

## Bridge Facilities (cont.)

- **Securities Demands (cont.)**
  - Effectively means that arrangers can take securities onto their balance sheet at the weighted average cap prior to closing, and renders the bridge cap and step-ups meaningless.
  - This is proving problematic for some borrowers. Some techniques for bridging the gap between arrangers and borrowers:
    - Require investment banks to engage in reasonable marketing efforts prior to issuing securities demand.
    - Only permit demanded securities to be held by investment banks until after closing, but permit pre-closing demand if sold to third parties.
      - There has been significant pushback from borrowers on pre-closing demands
    - Permit borrower to prepay securities at the issue price (plus accrued OID and interest) for so long as held by the investment banks.
    - Some borrowers have also sought partial relief from prepayment premiums and underwriting fees if the transaction does not close and securities have been issued into escrow.
  - Consider the consequences of failing to satisfy a demand
    - Step up to caps?
    - Payment of rollover/exchange fee?
    - Default?
    - All of the above?

## Return of Frothy Market Features?

- Several features of the LBO boom were considered “off the table” in 2008 and much of 2009:
  - PIK Toggles
    - Borrower permitted to pay interest in kind rather than in cash.
  - Covenant-Lite Loans
    - Do not have financial covenants.
  - General Purpose Accordions
    - Permit borrower to add new tranches to the loan or increase revolving commitments without lenders' consent.
  - Equity Cures
    - Allow sponsor or equity holder to inject equity to cure a financial covenant default.
- However, recent experience suggests that some of these are available in limited circumstances.
  - Covenant lite has arisen in limited circumstances (so far). For example:
    - Pinnacle Foods (add-on term loan)
    - Smurfit Stone (long credit history, low leverage profile, structured and priced to appeal to cross-over investor base)
    - Lyondell (massively oversubscribed).
  - Equity cures are less toxic than they were just 6 months ago.
  - General purpose accordions, subject to a pro forma covenant test that is tighter than the quarterly covenant test have become more common, at least in best efforts transactions.

## New Credit Technology

- Defaulting Lender Provisions
  - *Defaulting Lender*: Lender who fails to fund when required to do so, or is subject to insolvency proceedings, or who defaults generally under other credit facilities (or has a parent that does so).
  - *Consequences*: Defaulting lender is stripped of certain voting and fee rights, and borrower is required to cash collateralize, backstop or reallocate defaulting lenders' exposure.
- LIBOR Floors
  - Given historically low LIBOR levels, floors in the 200 to 250 bps range became common.
  - In recent times, LIBOR floors have begun to retreat to lower (150 to 200 bps) levels, or be eliminated altogether.
- Buyback Mechanics
  - Lenders appear willing to include appropriately crafted non-pro rata buyback mechanics in new loans (e.g., Warner Chilcott).
  - The provisions, which generally include some variation of reverse Dutch auctions, are designed to ensure procedural fairness and to minimize disruption to the normal lender-borrower relationship.
  - There are several variations currently in circulation and terms are starting to become more settled.
- Sponsor ability to buy and hold loans