

# Do Your Documents Protect Against the Downside?

## Avoiding Potential Issues

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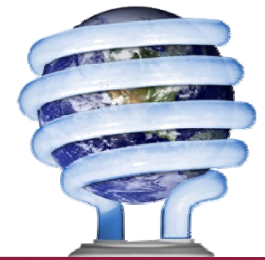
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## Material Adverse Effect Closing Condition

- Does the MAE closing condition sufficiently cover developments that the Buyer believes should allow them to get out of the deal?
  - Courts have been very reluctant to find an MAE
  - MAE should protect the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner

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## Material Adverse Effect Closing Condition

- In the absence of specific language to the contrary, courts will most likely look at three primary factors for determining whether a MAC/MAE has, or has not, occurred:
  - How significant is the adverse effect or change?
  - How long will the adverse effect of the change be felt by the company?
  - Did the Buyer know, or have reason to know, about the event or change before the deal was signed

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## Material Adverse Effect Closing Condition

- If possible, negotiate and draft specific closing conditions/ termination events to address specific, identified risks
  - leave the MAC/MAE for the true unknown risks
  - for example, if the buyer is concerned about the seller's credit rating, access to capital, or cash flow as they might be affected by a worsening economy, specific thresholds can be established as closing conditions
- However, negotiating specific closing conditions can be very difficult to agree upon

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## Material Adverse Effect Closing Condition

- Is the general business, economic and market conditions carveout sufficiently broad?
  - As the seller, it is typical to have a carveout that general economic conditions will not be considered an MAE unless they disproportionately affect the seller
  - Concept is that only developments that impact the seller as opposed to the economy as a whole should constitute an MAE

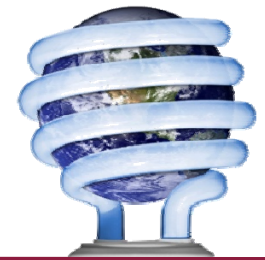
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## Material Adverse Effect Closing Condition

- Consider whether in light of the current economic environment the carveout should be more specific to ensure that general negative economic developments do not result in an MAE

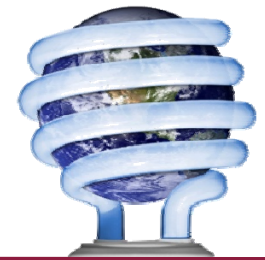
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## Financing Conditions

- A delayed close transaction that requires financing without a financing closing condition
  - How conditional is the outside financing?
    - Does the outside financing have precisely the same conditionality as the transaction itself?
      - More conditional financing can result in obligation to close the transaction without committed financing
      - Historically, difficult to conform the financing conditions to the M&A conditions

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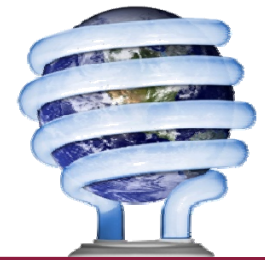


## Financing Conditions

- Most often, financing more conditional than M&A transaction
- Traditional commitment letters have many conditions and potential outs available to financing party
  - Historically, unusual for the financial institution to resort to them.
  - Borrowers therefore usually became comfortable with the conditionality because it rarely mattered



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## Financing Conditions

- M&A World Changed after September 2008
  - Much more frequent for lenders to exercise their outs
  - Borrowers should now pay close attention to the conditionality of financing commitments
- Possible solutions
  - Financing condition to close
  - Break fee in favor of seller – liquidated damages
  - Obtain financing prior to signing

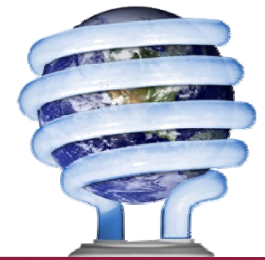
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## Available Funds

- Does the Buyer have the funds available?
  - All cash is not equal – may not have liquidity to pay
- Acquisition agreements often include a representation that the Buyer has sufficient funds available
  - Consider representation stating that the cash is “immediately available”
- Consider covenant or forward looking representation providing that the buyer maintains the required funds in short term treasuries

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## Solvency Rep

- Likelihood that a seller is insolvent has increased substantially in today's environment
- Use of a solvency rep, together with specific recitals detailing that, among other things, a seller is paying its debts in the ordinary course, can significantly enhance a buyer's ability to defeat a claim of fraudulent conveyance
  - Establishes stipulated facts that will undermine any argument for fraudulent conveyance

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## Interim Covenants – “Ordinary Course”

- Consider whether the standard covenant to operate the business in the ordinary course between signing and closing is sufficiently flexible in today’s extraordinary times
- The credit crisis and economic downturn have required many companies to take extraordinary measures that may be implicated by such a covenant

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## Exchange Funds, Escrow Funds and Similar Funds

- What investments should be permitted with the funds deposited in these accounts?
- Historically, common for funds to be permitted to be invested in commercial paper and typical money market accounts – perhaps no longer appropriate
- May be appropriate to limit to short term treasuries and money market funds invested in short term treasuries

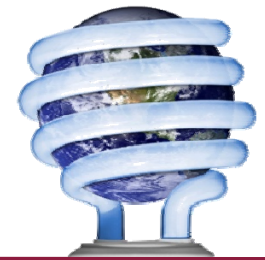
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## Back to Back Contracts

- Often agreements to provide services or products are dependent upon other agreements for inputs
  - Critical that any conditionality in supply agreements is mirrored with precisely the same conditionality in the output agreements
  - Company cannot be in the position where performance is unexcused or the supplies are limited in the underlying supply agreement, but the corresponding obligation to deliver services or products is not equally limited in the output agreement

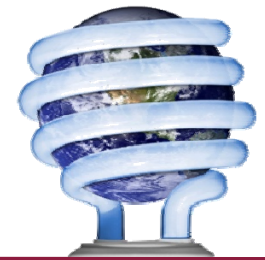
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## Force Majeure

- Force majeure provisions often address inability of business to obtain supplies or labor
- Supply and labor components are often conditioned upon an additional standard, such as “after reasonable efforts by supplier,” or “best efforts”
  - Very important that the standard imposed upon the business is consistent with the efforts and results that the business believes it will be able to obtain in an uncertain environment

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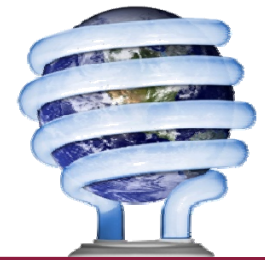


## Force Majeure

- Are there new risks in the industry that should be covered by force majeure?
  - Traditionally strong suppliers may now be questionable
  - Certain inputs may be more uncertain
  - Financing to fulfill obligations may be more uncertain
  - Are any new negative developments now reasonably foreseeable?
- Again, negotiating for force majeure to cover these eventualities may be difficult



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## Financial Covenants

- Historically, companies could typically work with their lenders to work out problems with their covenants in their credit agreements
  - Lenders were often willing to waive the covenants
  - If not, waivers could usually be obtained for modest fees
- Today, more difficult for borrowers to work out covenant issues with their lenders
- In addition, the cost of working out covenant issues with lenders is usually higher

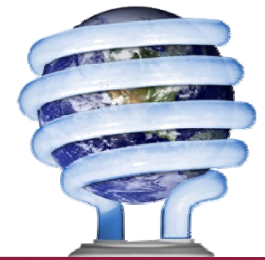
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## Financial Covenants

- Borrowers should carefully analyze how a proposed covenant package impacts their business and their future business plans
- Borrowers should not count on being able to renegotiate the covenant package if any issues arise
- In the past, borrowers often relied on ability to easily work out issues with their lenders, so they did not focus as much on potential issues

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## Financial Covenants

- Borrowers should also carefully analyze a proposed covenant package for what impacts a downturn in their business might reasonably have (“stress test”):
  - Need to ensure that a downturn in business that might reasonably be anticipated does not have a catastrophic effect under their covenants
  - May need to negotiate up front with their lenders what the impact of reasonably anticipated developments may have

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## Capital Contributions in Partnership Agreements and Joint Ventures

- Partnership agreements and joint ventures frequently contemplate additional capital contributions by partners
- The mechanisms usually prescribe what happens if a partner does not make a required capital contribution:
  - Partnership can loan the money on behalf of the partner, to be repaid later
  - Non-contributing partner is diluted if another partner makes the capital contribution

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## Capital Contributions in Partnership Agreements and Joint Ventures

- In today's environment, it is much more likely that a partner may not be willing or able to make a required capital contribution
  - Consider what impact a failure to make a required capital contribution should have
  - Consider whether additional penalties should be assessed
  - Consider whether a non-participating partner should be able to block additional capital contributions

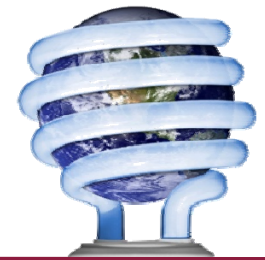
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## Risk Factors

- Companies should consider whether the financial crisis has impacted their risk factors in their 10-K's
- Some risk factors that may be impacted:
  - Effect on the company generally
  - Effect on growth plans
  - Ability to access the capital markets
  - Effect on the ability of customers to pay
  - Effect on the ability of suppliers to perform services

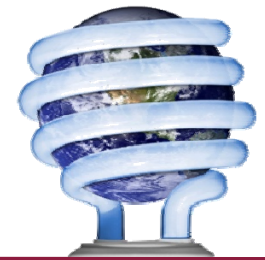
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## Risk Factors

- Risk factors should generally be revised each year to ensure that they are up to date
- Although risk factors are not required to be included in 10-Q's, SEC does require any changes in the risk factors to be included in the 10-Q, so issuers need to consider risk factor disclosure each quarter

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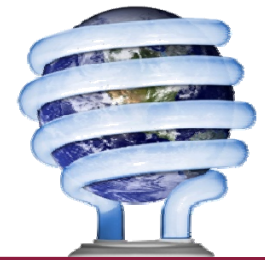


## Poison Pill

- Depressed share prices of many companies have substantially increased the chances of a hostile takeover
- Recent shareholder activism, supported by RiskMetrics (formerly ISS), has greatly reduced the number of companies that have poison pills in place
- Boards should reconsider whether it is appropriate to adopt a poison pill



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## Poison Pill

- The presence of a poison pill may prevent a hostile takeover at a price the board feels is too low, or it may allow the board to better control the process
- Approaches to adopting a point pill:
  - RiskMetrics is generally not opposed poison pills that are approved by shareholders and have sunset provisions in two to three years
  - Also consider having a poison pill on the shelf ready to be adopted if a hostile takeover materializes