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Debt Financing Risk Allocation in US Sponsor-Led Acquisitions: A Short History and Primer

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Deal terms governing financing risk in financial acquisition agreements in the US have undergone a transformation since the mid-2000s. This article traces this history and highlights recent developments based on a review of publicly announced deals in which financial sponsors were the purchasers.[1]

I. Background

Prior to 2005, financial sponsors, more often than not relying on debt financing to partially fund their acquisitions, typically required a "financing out" – a provision making the availability of debt financing a condition to their obligation to consummate the transaction. In exchange, sponsors' acquisition vehicles would agree to take the measures reasonably necessary to secure the debt financing and draw on it at closing and target companies had specific performance rights to enforce this covenant against the acquisition vehicle.

Sponsors were obviously content with this structure as it afforded them a contractual exit, but target companies eventually grew concerned that, given that the buyer was invariably a sole purpose affiliate of the sponsor with no balance sheet to back up its promises, they had no real leverage against the buyer beyond the sponsor's potential reputational risk.

By 2006, as leveraged deal size and volumes increased, the financing out approach began to disappear. At the same time as boards of public targets had grown increasingly uncomfortable with the structure's legal and practical uncertainty, financial sponsors became more willing to part with the financing out as they sought to compete more aggressively with strategic buyers and because of the decreased risk of failed debt financing given the robust boom-time credit markets.[2]

At the same time, as much as sponsors were interested in competing with strategic buyers during this time, they were not willing to replace the financing out structure with the decidedly target-friendly approach to allocating financing risk generally common to strategic deals[3] – full specific performance rights awarded to the target, no financing out and full uncapped exposure to damages for breach. Sponsors required some form of contractual assurance that they would not be forced to consummate a transaction without the availability of debt financing or be subject to a damage award the amount of which was uncertain. The reverse termination fee ("RTF") emerged to fill the void.

In general terms, the RTF requires the would-be buyer to pay a pre-determined fee to the target should the deal fail to close. This was

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1. Acquisition agreements between private parties are not the subject of this article, but it may be noted that such agreements have generally evolved in the same way as deals with public targets regarding financing risk and the use of the RTF provision.
2. *See* Afra Afsharipour, T*ransforming the Allocation of Deal Risk Through Reverse Termination Fees*, 63 Vand. L. Rev. 1161 (2010) at 1185-1190 and Kevin A. Rinker and Shelby E. Parnes, *Something old, new, borrowed and blue*, The Deal Magazine, July 29, 2009, http://www.thedeal.com/magazine/ID/028836/community/something-old,-new-borrow-and-blue.php.
3. *See* Rinker and Parnes, *supra* note 2.

a welcome substitute to the financing out from the perspective of the sell-side because it guaranteed at least a minimum amount of compensation upon buyer termination. The RTF was also palatable to sponsors given that it was structured to cap liability at an amount significantly less than what even the equity check in the deal would have been.

However, it seems (albeit in hindsight) that insufficient thought went into the pricing of the fee during the first wave of RTFs from late 2005 into 2007. The RTF was commonly arbitrarily set to mirror the customary termination fee which is payable by a public target to a suitor after it terminates their agreement in order to accept a superior proposal. The upper limit for these termination fees is roughly 3.5% of deal value for the judicially-determined reason that target boards cannot agree to a break-up fee so large as to deter competing and potentially more lucrative bids. RTFs, in contrast, do not raise such concerns and therefore do not require the same limitation in size.

Moreover, during this period, many target boards conceded the right to specifically enforce transactions in exchange for the RTF.[4] Under this structure, known as the "pure option" model, targets had to trust that buyers would at least make a good faith attempt to secure all the necessary financing and close because, in fact, the pure option RTF common to many transactions at the time effectively allowed sponsors to terminate a transaction at will upon payment of a relatively small fee.

Apparently, target boards had sufficient faith in financial buyers at this time because it was thought that these buyers, as repeat players, would not compromise their reputations by willfully walking away from deals and forfeit the RTF.[5] At least initially, it seems that sponsors were indeed reluctant to exercise the RTFs built into their acquisition agreements, electing instead to terminate on other grounds.[6,7] Once one sponsor broke the ice by successfully employing the RTF to walk away from a $4 billion deal for a mere $100 million fee in November of 2007, the provision suddenly became a viable option for sponsors involved in overvalued deals. At least 6 large leveraged deals announced in 2007 were ultimately terminated by sponsors tendering an RTF to the target. In several deals that survived, sponsors used the RTF as leverage to renegotiate the original agreement.[8]

Typically, sponsors alleged the inability of their lenders to syndicate the debt financing as a justification for exercising, or threatening to exercise, the RTF. Furthermore, in at least one deal terminated upon payment of the fee, it seems that debt financing was not even at issue.[9] Ultimately, whether or not lenders were prepared to follow through with their commitments, it is fair to say that during the height of the financial crisis, many sponsors were thankful for the availability of the RTF.

In hindsight, it seems that boards of public targets had overestimated the influence of market pressures on sponsors to close deals during the crisis. And even though the RTF was designed to add a monetary disincentive to deal breaking, public targets simply seem to have gotten the calculus wrong – the downside of potential future investment losses associated with closing deals based on boom-time valuations outweighed the possibility of bad publicity in the minds of many sponsors, and sponsors considered the payment of a reverse termination fee under 3.5% to walk away in a new and unkind reality a relative bargain. Indeed, given their facilitative role in the rash of broken deals during the crisis, it was widely speculated – erroneously, as it turned out – that RTFs would disappear entirely.[10]

II. State of Play

A. Prevalence of the RTF

The RTF structure is indeed alive and well. Out of the 20 financial deals financed with debt signed between November 4, 2011 and July 14, 2012 that we sampled, each with a deal value of at least $100 million, 19 make use of the RTF provision.[11] Clearly, public targets have been willing to tolerate RTFs notwithstanding the

4. *See* Afsharipour, *supra* note 2 at 1189 and Rinker and Parnes, *supra* note 2.

5. *See* Matthew D. Cain, Steven M. Davidoff and Antonio J. Macias, *Broken Promises: Private Equity Bidding Behavior and the Value of Reputation*, AFA 2012 Chicago Meetings (March 2012), at 2-3, available at SSRN: http://ssrn.com/abstract=1540000 or http://dx.doi.org/10.2139/ssrn.1540000.

6. *See* Steven M. Davidoff, *Gods at War: Shotgun Takeovers, Government by Deal and the Private Equity Implosion* (Hoboken, New Jersey: John Wiley & Sons, Inc., 2009) at 78.

7. In addition, it is possible that sponsors refrained from exercising the RTF, at least initially, because it was not clear how courts would react to the use of the provision as formulated.

8. *See* Davidoff, *supra* note 5 at 100, *and see generally* at 84-103.

9. *See* Stephen Grocer, *The Goldman Sachs No-Fault Divorce*, WSJ Deal Journal Blog, http://blogs.wsj.com/deals/2007/12/12/the-goldman-sachs-no-fault-divorce/.

10. Afsharipour, *supra* note 2 at 1192.

11. In addition to the RTF, several deals in the sample include an expense reimbursement fee which is sometimes left uncapped.

acrimony associated with these provisions during the financial crisis. Given that sponsors continue to demand flexibility, and targets continue to desire deal certainty, the resilience of the RTF suggests that it may simply be the best mechanism through which to reach a compromise.

B. Size of the Fee

The RTF structure may have survived the financial crisis, but not without undergoing a transformation. The most obvious aspect of the provision in dire need of a change was the size of the fee. By all accounts, the fee did not function as an adequate disincentive to deal breaking at its pre-crisis size. Moreover, the consensus today is that the RTF should take into account the approximate cost to be incurred by the target associated with a failed transaction. This includes the loss of key employees, customers and other third-party relationships as a result of putting the company up for sale, as well as the stigma attached to a spurned target. Indeed, our sample reveals that today's RTFs[12] generally cluster between 4% and 6% of deal value, with some outliers above and below this range.

C. Two-Tiered Fees

Another innovation that came about likely in the attempt to discourage deal breaking within the RTF structure was the development of the "two-tiered" RTF. Typically, under this formulation, two separate fees are employed, each with a different trigger – one fee, at a lower amount, becomes payable upon the occurrence of a debt financing failure, and another fee, at a higher amount, is payable upon willful breach.

The two-tiered fee seems thoughtful in theory, but it has proven a rare occurrence in today's market, only appearing in two deals in the sample. Targets may simply be unwilling to agree to the two-tiered structure given the strong incentive it creates for the buyer to assert the occurrence of a financing failure in order to either qualify for the lower fee or to negotiate for payment of a fee somewhere in between the two poles.[13]

D. Specific Performance

Given that reputational constraints were proven largely ineffectual during the financial crisis, public targets today typically demand contractual forms of comfort. Indeed, targets are awarded rights to specifically enforce the buyer's obligations in 18 out of the 20 deals in the sample. The other 2 deals are in the pure option form, whereby the buyer must pay an RTF upon breach leading to termination but may not be compelled by the target to perform its obligations.

The specific performance formulation used in these deals, however, is a much more limited version than the standard strategic deal model. In each of the 18 deals employing specific performance in the sample, the target is awarded the right to exercise what may be termed "conditional specific performance"[14], pursuant to which the target is awarded full specific performance rights to generally enforce the terms of the acquisition agreement, but the target's right to force the buyer to draw down the equity financing and/or close the transaction is conditional upon the occurrence of certain events, including most notably that the debt financing has been funded or will be funded at the closing. This formulation is generally paired with an RTF enabling the buyer to terminate upon payment of the fee in the event that the debt financing in fact does not come through.

The RTF coupled with conditional specific performance seems to have emerged as the compromise reached by sponsors and targets between the pure option and strategic deal models. Under the conditional specific performance formulation, sponsors need not accept exposure to the full amount of the purchase price, and targets may guard against willful termination by sponsors seeking to avoid investment losses in an overvalued deal. Indeed, the RTF with conditional specific performance seems to address the concerns of both sides.

III. Conclusion

Coming out of the financial crisis, it was clear that the RTF structure – if it was to remain a part of financial transaction agreements – was in need of repair. The size and structure of RTFs in deals signed before the crisis generally left a gaping hole in acquisition agreements through which sponsors could either exit or extract leverage to renegotiate signed deals when market

12. This statement is in relation to single-tier RTFs, as opposed to the two-tiered variety described in Part II, Section C.

13. *See* , e.g., Steven M. Davidoff, *The More Things Change…*, NY Times Dealbook Blog, January 25, 2008, http://dealbook.nytimes.com/2008/01/25/the-more-things-change/.

14. *See Reverse Break-Up Fees and Specific Performance*, Practical Law Company, 2012 Edition, at 7.

conditions soured. In an attempt to tighten these deals in the wake of the crisis, targets have insisted on more expensive RTFs and increasingly negotiate for specific performance rights. Unfortunately, subjecting these acquisition agreements to market disruptions of the magnitude experienced in 2007 and 2008 is the only way to tell whether this approach strikes the right balance between the sponsor's desire for flexibility and the target's desire for deal certainty.

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