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RECENT DEVELOPMENTS IN FINANCING-RELATED PROVISIONS IN LEVERAGED BUYOUTS

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During the course of 2005, a number of large U.S. private equity transactions have departed from traditional provisions regarding financing. In particular, each of the leveraged buy-outs of Sungard, Neiman Marcus and Hertz was done pursuant to an acquisition agreement that contained an extremely limited financing condition for the buyer or no financing condition at all. Each agreement also called for the buyer to pay a "reverse termination fee" in certain circumstances if the deal did not close due to a failure of the buyer to obtain the necessary financing.

I. Background

Historically, a notable difference between a strategic transaction and a financial sponsor-led transaction has been the manner in which the definitive documentation addresses the buyer's financing. Strategic transactions involving a company already in the target's business generally do not provide for financing conditions. More typically, the strategic buyer simply represents in the acquisition agreement that it has sufficient funds to pay the cash portion of the purchase price. This type of representation tends to be acceptable to both the buyer and the seller because the strategic buyer often has (and can demonstrate to the seller), or can readily obtain through the normal course of its business operations, the necessary funds to satisfy any cash component of the purchase price. On the other hand, sponsor-led LBO transactions by definition involve significant leverage and sponsors do not maintain significant cash on hand from operations. The leverage typically comes in part from banks in the form of senior debt and in part from subordinated or mezzanine debt raised through the high-yield market. This fundamental difference has resulted in highly negotiated financing-related provisions in LBO acquisition agreements that are less commonly found in the documentation for strategic transactions.

Acquisition agreements in most LBOs done in the United States traditionally have provided that one of the conditions to a buyer's obligation to consummate the transaction is that the buyer has obtained the requisite financing. The buyer's financing condition is

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typically tied to the buyer's receipt of debt commitment or "highly confident" letters from the financing sources. The definitive agreement customarily provides that the buyer has received these commitment letters at the time of signing and also contains a covenant that the buyer will use its reasonable best efforts to obtain the financing on the terms set forth in the commitment letters. The net effect of this traditional model is that a buyer is required to line-up its debt financing at the time of signing, represent to that fact, and employ some level of effort to complete the financing; however, in the event that the debt financing becomes unavailable (for example, because the lending sources decline to fund due to a change in the business or the markets), the buyer does not have any obligation to close and could walk away from the transaction.

Beginning in the 1990s this traditional package of financing-related provisions began to change. One of the first modifications came in the form of equity commitment letters. Private equity funds were not typically themselves parties to acquisition agreements —the acquisition agreement is typically between the seller and a newly formed "shell" acquisition company owned by the fund—so the debt commitment letters did not account for 100% of the funds necessary to complete the transaction. In response to this perceived "gap," sellers began to request that private equity funds sign equity commitment letters in favor of the "shell" company so that the acquisition vehicle had commitments sufficient to pay the entire purchase consideration. Equity commitment letters became an increasingly common part of the LBO landscape and are usually carefully negotiated, including with respect to what if any rights the seller or target company will have to enforce the fund's equity commitment.

A further development in financing packages that emerged in the 1990s was the increased use of "bridge commitments" to back-stop the high-yield portion of the debt financing. As sellers refined their focus on the financing aspect of LBOs in an effort to increase certainty, it became more common for the debt commitment letters to contain this "bridge" component. Sellers sometimes not only look to ensure that the buyer has bridge financing available but also seek to provide in the definitive documentation that the buyer will "take down" on the bridge (which is considerably more expensive for the buyer) in the event that the high-yield offering is not completed when the transaction is otherwise scheduled to close.

One final development of note is the movement of U.S. buy-out funds into the European markets. Financing conditions are not as customary in European LBO practice and in certain instances (*e.g.*, public company acquisitions in the U.K.) are prohibited by regulation. This distinction is furthered by the fact that banks in Europe will sometimes provide "funds certain" at the time of signing, which is not the case with U.S. banks. Over the course of the last several years, banks in the United States in fact have been willing to provide more certain financing terms (although still not to the level seen in U.K. transactions), which has served to mitigate the need for some of the traditional buyer financing protections in U.S. acquisition agreements. At some point this trend may well reverse, in which event we would expect to see buy-out firms seek many of their more traditional financing-related protections.

II. Recent Developments

Several recent, high-profile transactions in the United States have departed even further from the traditional "financing condition" approach described above. In addition to several large real estate company LBOs executed within the last 18 months (including the buy-outs of Extended Stay America, Prime Hospitality, Boca Resorts, Wyndham International and La Quinta Corporation, all of which were $1 billion plus deals), each of the following transactions is noteworthy in how the definitive documentation addressed the financing conditionality inherent in the deal:

- *Sungard Data Systems* (approximately $11.0 billion)—acquired by a consortium of private equity funds including Silver Lake Partners, Bain Capital, The Blackstone Group, Goldman Sachs Capital Partners, Kohlberg Kravis Roberts & Co. L.P., Providence Equity Partners and Texas Pacific Group (announced on March 28, 2005 and completed on August 11, 2005);
- *The Neiman Marcus Group* (approximately $5.1 billion)—acquired by a consortium of private equity funds including Texas Pacific Group and Warburg Pincus (announced on May 2, 2005 and completed on October 6, 2005); and
- *Hertz Corporation* (approximately $5.6 billion)—pending acquisition from Ford Motor Company by a consortium of private equity funds including Clayton Dubilier & Rice, The Carlyle Group and Merrill Lynch Global Private Equity (announced on September 12, 2005 and currently pending completion).

A. Limited or No Financing Condition

In each of these transactions, the buying group agreed to an extremely limited financing condition or no financing condition at all. The Sungard transaction largely followed several of the recent real estate precedents mentioned above and limited the financing condition to a "Market MAC" and a "Lender MAC" (a "Market MAC" occurs, for example, if there is a general suspension of trading for three consecutive days, and a "Lender MAC" occurs, for example, in the event that the lending sources are prohibited from funding due to legal prohibitions or lender insolvency). Each of the Neiman Marcus and Hertz deals contained no financing condition for the buying group whatsoever.

As a result, in each of the transactions, the buyer would be in breach of the agreement if it was unable to complete the financing when all other conditions to closing were satisfied (and, in the case of Sungard, none of the catastrophic events provided for in the Sungard contract had occurred). These agreements generally did provide, however, for the buyer to have an agreed upon time period to raise its financing.

B. Reverse Termination Fee

The buying group in each of these transactions also agreed to a "reverse termination" fee in the event of a failure to close as a result of the buyer not procuring the necessary financing. Under this construct, in the event that all of the other conditions to closing were satisfied and the buyer was unable to complete the financing necessary to consummate the closing, the buyer is required to pay a termination fee to the seller. Moreover, in the case of the Neiman Marcus and Hertz transactions, the buyer potentially could be required to pay further damages above the termination fee in the event that the failure to close did not result from the buyer being unable to obtain the debt financing (such as, for example, the buyer failing to use its reasonable best efforts to consummate the financing, including taking down on the more expensive bridge financing following an opportunity to raise the high-yield debt). The following table highlights the agreed-upon reverse termination fee structure in each of the Sungard, Neiman Marcus and Hertz transactions.

Target Company	*Value of Transaction**	*Amount of "Reverse Termination Fee" Payable by Buyer if Debt Financing Not Obtained*	*Buyer Potentially Liable for Damages Beyond Reverse Termination Fee?*
Sungard Data Systems	$11.0 billion	$300 million (approx. 2.73% of transaction value)	No—Reverse termination fee exclusive remedy
Neiman Marcus Group	$5.1 billion	$140.3 million (approx. 2.75% of transaction value)	Yes—Buyer potentially liable up to $500 million (approx. 9.8% of transaction value) in certain instances where Buyer was otherwise in breach of the agreement
Hertz Corporation	$5.6 billion	$125.0 million (approx. 2.23% of transaction value)	Yes—Buyer potentially liable up to $300 million (approx. 5.4% of transaction value) in certain instances where Buyer was otherwise in breach of the agreement

* SOURCE: Thomson Financial

In addition, the potential obligation to pay these fees will sometimes be supported by a limited guarantee by the private equity funds in favor of the target company or through similar provisions in an equity commitment letter.

It is also important to note that the fees in these agreements have a liquidated damages or liability cap element on the private equity funds' exposure in the event of a broken deal. A buyer's agreement to a fee provision of this nature therefore should not be viewed as a purely one-sided concession by the buyer, because the buyer in this construct can pay a sum certain to walk away from the transaction.

III. Implications

Most U.S. LBO transactions continue to be done with a financing condition. The persistence of this model would seem to indicate that many sellers remain satisfied that, absent financial market dislocations, the buyer will find a way to close the deal in order to avoid the reputational risk from not completing an agreed-upon transaction. Also, the increased willingness of U.S. banks to conform the conditions in their commitment letters to the conditions negotiated in the acquisition agreement has narrowed the seller's risk with respect to the financing condition. Indeed, Sellers should reflect carefully whether, in the particular circumstances of their transaction, the caps on buyer liability which often accompany the removal of the financing condition constitute a more favorable outcome than the retention of the financing condition in conjunction with buyer favorable debt commitment papers. Finally, the transactions discussed in this article all were very large transactions that generally involved significant competition. Consequently, these transactions may be viewed as products of unusual circumstances.

There are, however, factors at work which indicate that the Sungard, Neiman Marcus and Hertz transactions may not be anomalies. In particular, the increased willingness of U.S. banks to conform the conditions of their commitment letters to the conditions negotiated in the acquisition agreement has made the need for a financing condition less acute, although the "funds certain" nature of the financing still is not to the level seen in U.K. transactions and, in any event, the improved terms do not render financing conditions meaningless. Also, large hedge funds have started focusing on LBOs as a supplement (or alternative) to taking minority positions in liquid securities, and in so doing they have shown a willingness to "break the mold" and compete aggressively on contract terms, putting pressure on the private equity buyers to follow suit. In addition, the influence of the European model discussed above, coupled with the increased globalization of M&A activity generally, has to some extent eroded the U.S. approach.

As the last couple of decades have shown, the prevailing deal framework is always subject to evolution, and whether these recent transactions portend a long-term shift, further collapsing the contractual distinctions between a strategic transaction and a leveraged buy-out, will not become clear for some time. At a minimum we will first need to see whether the trend survives some future tightening of debt financing terms or, more significantly, an actual payment by an acquisition vehicle or equity sponsor of a reverse termination fee.