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THE PRICE FOR GETTING THE DEAL

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As the market for acquisition financing remains expensive and uncertain, prospective buyers and sellers continue to adjust their expectations with respect to M&A opportunities. Minimizing consummation risk and clearly defining the recourse resulting from the failure to close have taken on greater significance in the current environment. While overall transaction volume remains low relative to recent years, opportunities at attractive pricing multiples are increasingly available for buyers.

In order to take advantage of current market opportunities, financial buyers in particular are finding that they must utilize transaction structures other than the traditional leveraged buyout model they have historically favored. Under a typical LBO structure, a sponsor would rely heavily on debt financing to leverage a minimal equity investment, and the sponsor's liability for failure to close the transaction would be limited, typically to a reverse breakup fee representing a small fraction of the transaction value. Sellers who were previously willing to accept consummation risk and limited recourse for failure to close as unavoidable risks associated with entering into a transaction with a financial buyer are today reconsidering this position. Lenders who were previously willing to provide covenant-lite debt financing at extremely aggressive leverage levels to sponsors are no longer willing to do so, with the new norm being more stringent financial covenants and requirements that sponsors have significant "skin in the game."

Many financial buyers who have made investments in this new reality have found they must alter their approach to structuring investments. Today's structures require a financial buyer to view its investment, and management, operational and exit strategies in a different manner. For example, some financial buyers have made investments in entities with a view to avoiding the triggering of change-of-control defaults on such entities' existing debt instruments. In most cases, this requires capping the amount of equity and voting control that the financial buyer may acquire, and thus leaves a financial buyer with a significant economic stake in an enterprise but with less than full control over the business. In some circumstances, if the terms of an existing target's debt instrument so permits, a buyer may be able to purchase a controlling interest in the target's controlling entity, which is not itself a party to the debt instrument, without triggering a change-of-control. Other strategies that are more frequently being employed by buyers to consummate acquisitions without obtaining debt financing are seller financing and "loan-to-own" strategies.

Another trend that appears to be an emerging and popular alternative for financial buyers is the all-equity buyout, or "LBO without the 'L'," as some call it. A seller whose aversion to consummation risk would not otherwise permit it to consider financial bidders in a competitive process may be willing to consider an all-equity backed proposal by a financial buyer. From a seller's perspective, the real value associated with an all-equity-backed bid is the ability to require the buyer to close and pay the full amount of the purchase price if all of the conditions to closing are satisfied.

A brief summary of the recently attempted acquisition of **SumTotal Systems Inc.** by **Accel-KKR** is helpful to understand how those parties dealt with some of these issues. The initial merger agreement for the SumTotal transaction provided that both parties were entitled to specific performance for any breach or threatened breach of the merger agreement, the sponsor guarantee or the sponsor equity commitment letter (including the target's right to cause the acquisition shell to enforce the commitment letter, as long as the conditions to the merger had been satisfied). In the case of the target, its sole remedy was to pursue specific performance, except that if a court declined to award specific performance and instead granted an award of damages, the target would be permitted to accept such award but only if the buyer was not willing to consummate the transaction within two weeks following the court's determination. For the benefit of the buyer, the merger agreement included a material adverse change, or MAC, closing condition and a minimum net cash/indebtedness closing condition.

An even more recently announced pending deal, the proposed acquisition of **Bankrate Inc.** by **Apax Partners**, also relies on a set of sponsor equity commitment letters that fully impose the financing risk on the buyer. As in the SumTotal example, Bankrate is required to seek specific performance if there is a breach by Apax Partners of the agreement. Unlike SumTotal, however, there is no cash/indebtedness closing condition, suggesting that the trend of sellers demanding ever less optionality from private equity buyers is continuing.

Financial buyers willing to consider an all-equity buyout should be aware that deal terms that previously may have been considered nonstarters (e.g., specific performance, full sponsor guarantee of the purchase price and the seller's third-party beneficiary right to enforce the equity commitment) will be subject to negotiation and may even be the threshold concessions necessary to become viable bidders in a competitive auction. This is particularly relevant if the auction is comprised of active corporate or other strategic prospective buyers, whose bids rarely present a target with the type of consummation risk that historically accompanied bids from financial buyers. Critically, buyers who are willing to agree to any or all of these deal terms should ensure that the sellers' remedies are limited solely to specific performance and capped at the purchase price consideration, the theory being that even if a buyer is forced to acquire the target, in the long run, the buyer will find a way to maximize value on the purchased assets, whereas failing to limit the recourse to specific performance could leave the buyer in a situation where it pays monetary damages but does not have the benefit of acquiring the applicable assets. In addition, when possible, the transaction agreement should include a net-debt closing condition so that the equity proceeds will be sufficient to pay the purchase price and satisfy outstanding debt obligations. Furthermore, any payment assurances by the sponsor directly must be subject to "no-recourse" and "no entity veil-piercing" language with respect to the sponsor's investors, limited partners and affiliates. Finally, in structuring an all-equity buyout, the sponsor will need to consider not only traditional exit strategies, but will also need to structure the equity investment and the acquisition vehicles employed in a manner so that interim liquidity events can occur prior to a full exit, such as an equity syndication or a post-closing dividend recapitalization, especially where leverage may be expected to become available as debt markets normalize.

The M&A market will undoubtedly continue to evolve as the freeze in the debt financing market begins to thaw, and the types of investment options available to buyers will increase. However, in the meantime, strong opportunities for attractive investments are available, and financial buyers who are willing and able to structure their investments in nontraditional manners will surely be able to capitalize on such opportunities.

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