

SHEARMAN & STERLING_{LLP}

Lessons Learned from Key Deals

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Overview

Introduction

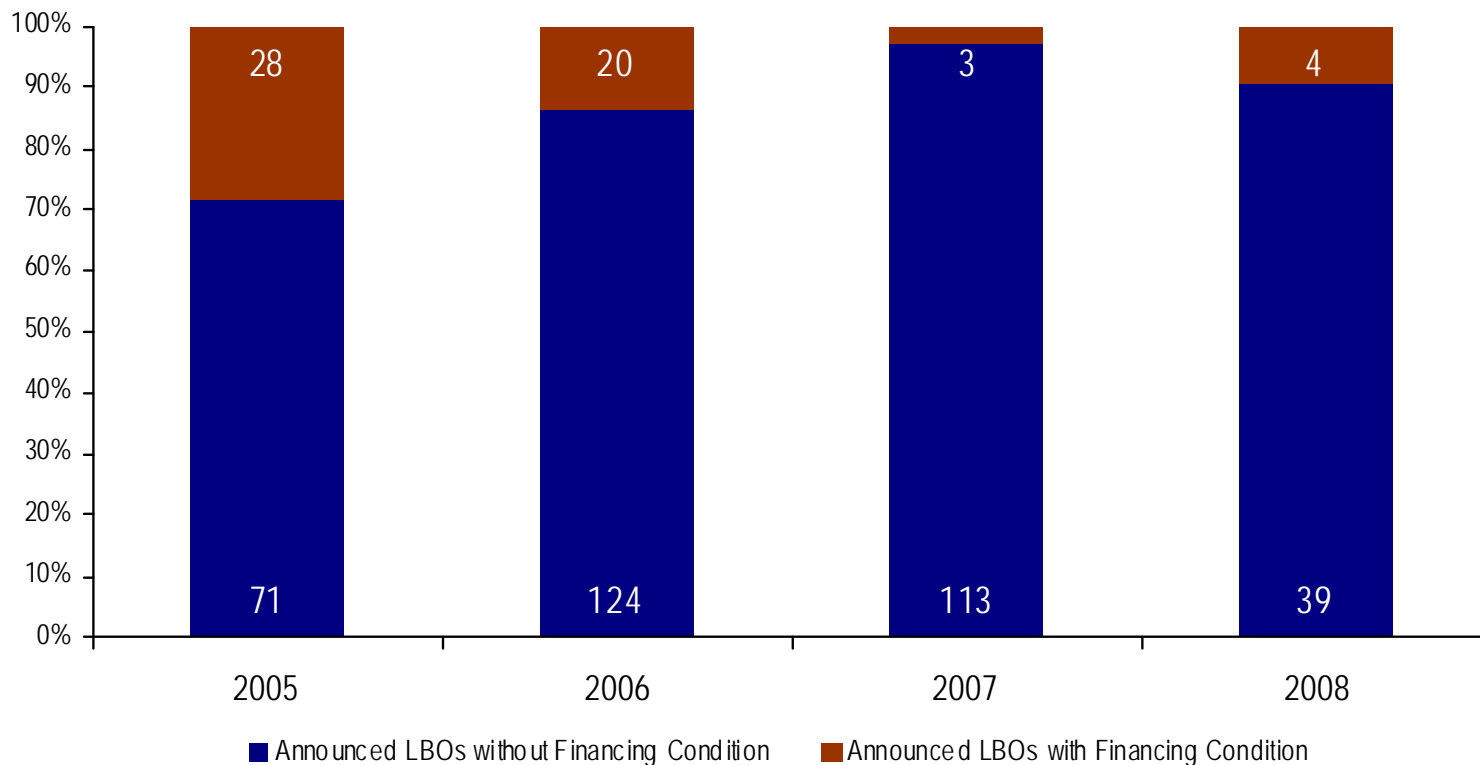
Deal Structure and Terms

Where Deals Go From Here

Lessons Learned

Introduction: Financing Conditions

Prior to 2005, targets in private equity deals generally shared the risk with sponsors that financing would be unavailable at closing. Financing conditions permitted sponsors to walk away without penalty if financing was ultimately unavailable. However, as competition for transactions increased and financing became more readily available, targets had enough leverage to refuse to accept financing conditions and favorable financial terms made sponsors more willing to acquiesce



Introduction: Reactions to Market Changes

Prior to 2005, in light of financing conditions coupled with no reverse break-up fees, targets were left with no recourse against sponsors if financing could not be obtained

As the number and size of private equity transactions increased beginning in 2005, and private equity buyers sought to compete with strategic buyers, sponsors were forced to make their transactions more similar to those of strategic buyers and to give up their financing conditions, instead offering target companies a reverse break-up fee as their sole and exclusive remedy. In the heady markets that prevailed between 2005 and 2007

- Target companies were willing (and even happy) to accept the limited recourse
- In a market where financing was readily available and competition for deals was high, target companies did not fear private equity sponsors walking away from deals
- Reputational damage in an active market was deemed a powerful deterrent to failed transactions

In fact, target companies were more focused on ensuring *they* could get out of deals if a better offer came along, as was evidenced by the introduction of “go-shop” provisions

Introduction: Reactions to Market Changes

The trade-off between financing conditions and a limited form of recourse seemed to work in a robust market, but stopped working when the financing markets ground to a halt

The implicit understanding of how private equity sponsors would behave could no longer be relied upon

The troubled deals of late 2007 and 2008 have brought to the forefront what are often seen as contract “boilerplate” provisions:

- Termination
- Specific performance
- Dispute resolution
- Governing law and venue for disputes
 - Symmetry of law and venue for all transaction documents (*i.e.*, merger agreement and financing commitments)

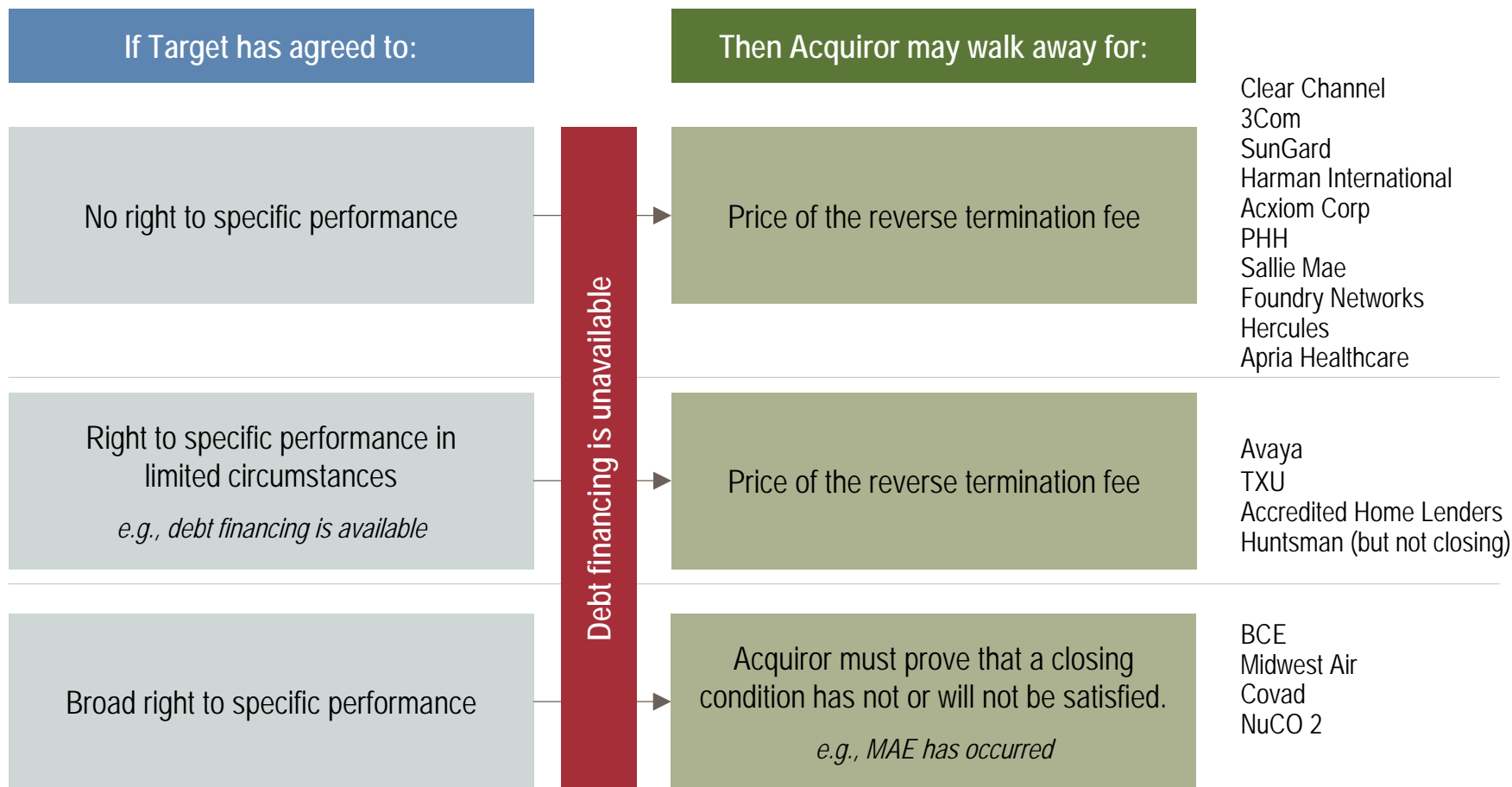
Introduction: Factors at Play

Factors influencing the outcome of recent private equity transactions include:

- Significant curtailment of finance availability
 - Most challenging credit markets in recent history
 - Banks willing to risk breach rather than fund into significant loss positions
 - Aided by limited recourse (payment of reverse break-up fee often less than embedded financing loss)
- Market volatility and financial performance of industry in which target participates
- Diminished concern on the part of acquirors generally and sponsors in particular about reputational damage from broken deals
- Target's appetite for litigation
 - Differing levels of available remedies, especially specific performance
 - Target's concern regarding collectibility of agreed-upon premium (*Con Edison v. Northeast Utilities*)

Deal Structure and Terms: Current Deal Structures

In recent years, the following deal structures have been used most frequently:



Deal Structure and Terms: Reverse Termination Fees

Common Approach

Acquiror agrees to pay a reverse termination fee if it breaches the agreement and such breach gives rise to a failure of a condition or it otherwise fails to close the transaction

This gives the acquiror a pure walk away right if it pays the fee

Two-tiered Approach

Acquiror agrees to pay:

- one reverse termination fee if acquiror fails to close because the debt financing is unavailable
- a second higher termination fee if acquiror fails to close but the debt financing has or will be funded
- (3Com Corp)

This gives the acquiror a pure walk away right only if it pays the higher fee

Liability Cap Approach

Acquiror agrees to pay a reverse termination fee if acquiror fails to close because the debt financing is unavailable

If the acquiror breaches the agreement in other circumstances, it agrees to be liable for damages up to a capped amount (the "liability cap")

(Michaels Stores; Goodman Global; Acxiom; CDW Corp; Bright Horizons, Getty Images)

If the buyer walks away in circumstances where the debt financing is available, its liability is capped at a higher amount than the amount of the reverse termination fee or uncapped (Huntsman)

- Uncapped liability approach only practical where acquiror is sufficiently capitalized

Deal Structure and Terms: Reverse Termination Fees (cont.)

Size of the fee

- Usually the same amount as the target's termination fee (typically, 2% to 4% of the transaction value), although there have been a number of transactions in which the reverse termination fee has been significantly greater than the company termination fee (Getty Images, Goodman Global and Michaels Stores); 2% to 4% fee does not reflect appropriate pricing if deal is a true option

Disincentive to walking away?

- From the sample of transactions we surveyed, it was inconclusive as to whether the size of the reverse termination fee impacted the deals' success or failure, taken as a whole

Effectiveness of the two-tier structure

- Target needs to ensure that there is no gap between the conditions in the merger agreement and the conditions in the debt commitments to avoid the debt financing being "unavailable"

US/ Delaware law implications

- Delaware courts permit a target's board of directors to approve a "break-up" fee as a deal protection device. Delaware courts will review the size of the fee to ensure the amount of the fee does not preclude an alternative transaction
 - Delaware courts will typically approve of a break-up fee in the 2-4% range
- Acquirors that pay a "reverse break-up" fee will not be subject to similar judicial scrutiny; amount merely a contractual matter

Deal Structure and Terms: Reverse Termination Fees (cont.)

Who pays the fee?

- Target wants to avoid any third parties (for example, financing sources) paying the fee because this would make it easier for an acquiror to walk away; Sponsors may want financing sources to “share the pain”

Deal Structure and Terms: Material Adverse Effect

- The definition of MAE has again hit the spotlight - because most LBO acquisition agreements did not include a financing condition, the MAE has become acquirors' primary "escape route"
- Successfully asserting an MAE is a challenge, given the customary language used to define material adverse effect and the limited, and relatively unfavorable (from an acquiror's perspective), judicial interpretation of that language
 - Case law MAE interpretive issues:
 - "durationally significant" (*IBP v. Tyson*)
 - MAE an "uncertain notion" - litigation result must be discernible (*Frontier Oil v. Holly*)
- In the recent Huntsman case (discussed below), Vice Chancellor Lamb reminded the corporate world at large that Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement
- Recent Delaware decisions confirm the view that target companies will prefer to have Delaware law as the governing law, and Delaware as the venue for all disputes
 - The Court of Chancery's posture with respect to MAE claims is clearly target company-friendly
 - The Court of Chancery will act quickly in responding to transactional disputes

Deal Structure and Terms: Material Adverse Effect (cont.)

- One clear trend over the last several years has been the ability of target companies to include a number of exceptions to the standard MAE definition. These exceptions often include:
 - Changes in general economic, financial market or political conditions
 - Changes generally affecting the industry or industries in which the company operates
 - Changes in applicable laws or accounting standards
 - Acts of terrorism or war
 - Failure by the company to meet any published analyst estimates or expectations or internal projections or budgets
 - Changes in the price or trading volume of the company's stock
 - Changes resulting from the announcement or pendency of the transaction; and
 - Changes resulting from the company's compliance with the terms of the acquisition agreement
- Important for acquirors to make clear that with respect to certain of these exceptions the underlying causes of such events are not excluded from determining whether an MAE has occurred
 - Often, disproportionate impact on a target company can be an MAE (issues regarding application thereof - *SLM Corp v. Flowers*)
- Huntsman and Genesco: Threshold question is whether an MAE has occurred

Deal Structure and Terms: Material Adverse Effect (cont.)

- Since the credit crisis began in early August 2007, there has been little change in the drafting of MAE provisions, which, on the whole, continue to include multiple exclusions
- However, three transactions have addressed particular concerns of the acquiror during the period between signing and closing
 - In Deb Shops, Goodman Global, and Getty Images, the closing conditions of the acquiror included a minimum EBITDA requirement for a period or periods following or ending after the signing date
 - As lenders exert greater influence on borrowers, lenders may revert to including an MAE provision in loan documents. As such, targets must ensure that the MAE provisions are the same in all transaction documents
- In Radiation Therapy, changes in general conditions that have a materially disproportionate adverse effect on the industries in which Radiation Therapy operates (not just on Radiation Therapy) constitute an MAE for the purposes of the closing condition (prior example: travel industry after September 11)
- Strategic acquirors may currently find a less competitive deal environment and may be seen as more attractive partners than financial sponsors
 - Accordingly, strategic acquirors may be able to narrow MAE carve-outs or add defined MAEs or termination rights
 - Alternatively, as lenders seek more stringent MAE provisions, strategic acquirors that are not dependent upon third-party financing may be able to differentiate themselves by agreeing to MAE definitions that provide greater certainty to targets

Deal Structure and Terms: United Rentals Litigation

Specific Performance Provision

- Specific performance section of the merger agreement expressly permitted URI to enforce performance by Cerberus of its financing covenant and to require it to consummate the transaction
- However, the provision was subject “in all respects” to the provisions of one of the termination sections of the merger agreement, which provided, among other things, that in no event, whether or not the merger agreement has been terminated, will the buyer be subject to liability in excess of the reverse termination fee and in no event will URI “seek equitable relief or seek to recover any money damages” in excess of such fee

Delaware Court’s Decision - December 2007

- The language of the merger agreement presents a direct conflict on two provisions which renders the agreement ambiguous
- Extrinsic evidence does not clearly show that URI’s interpretation of the agreement (that the two sections can be reconciled on the basis that the termination provision limits equitable remedies other than specific performance) represents the common understanding of the parties
- Under the “forthright negotiator” principle, the subjective understanding of one party may bind the other if the other party knows or has reason to know of that understanding - because the evidence showed Cerberus understood the agreement to preclude specific performance and URI knew or should have known of this, Cerberus’ understanding binds URI, and Cerberus was entitled to specific performance

Ambiguous drafting may, at times, be seen as beneficial; however, if a specific remedy is desired, such position must be clearly communicated to the other side and boilerplate provisions must be carefully reviewed

Deal Structure and Terms: Genesco Litigation

Genesco and Finish Line Merger – The banks participate in a settlement

- \$1.3 billion leveraged strategic merger. In August 2007, Genesco reported Q2 net earnings loss of \$4.2 million (a 170% decrease from previous year's Q2) after which Finish Line claimed it was not required to close the transaction because Genesco withheld key financial data that would have predicted such losses. One month later Genesco (a Tennessee-based company) filed suit seeking an order for Finish Line to close the deal. One of the three defenses asserted by Finish Line (an Indiana-based company) was the occurrence of an MAE
- During the trial, on almost every issue where the judge had to judge credibility of Genesco or Finish Line witnesses, the Tennessee judge found Genesco witnesses to be more credible
- In December, the Tennessee Court decided, among other things, that although a MAE had occurred (the lowest earnings in ten years, lasting for a significant amount of time, and affecting the financing of the transaction), the circumstances fell within the carve-outs to the MAE provision (*i.e.*, Genesco's decline was due to general economic conditions such as higher gasoline, heating oil and food prices, housing and mortgage issues, and increased consumer debt loads and was not disproportionate to others in the industry)
- Conclusion: Finish Line was required to specifically perform the agreement and close the merger; however, consummation was subject to the resolution of the UBS (financing source) solvency lawsuit filed in NY
- On March 3, 2008, Genesco, Finish Line and UBS entered into a settlement agreement pursuant to which:
 - The merger agreement and the UBS financing commitment were terminated
 - UBS and Finish Line agreed to pay Genesco (i) \$175 million in cash and (ii) Class A shares of Finish Line common stock equal to 12.0% of the total post-issuance Finish Line outstanding shares of common stock
 - The Class A shares of Finish Line will be remitted to Genesco's shareholders as soon as reasonably practicable following the registration of these shares by Finish Line

Governing law and venue are important

Deal Structure and Terms: Alliance Data Systems Litigation

Alliance Data Systems ("ADS")/ Blackstone

- May 17, 2007 → Two special purpose companies affiliated with the Blackstone Group, agreed to buy ADS for \$6.4 billion. Neither Blackstone nor the related fund was a party to the merger agreement.
- Because ADS owned a bank, the transaction required approval from the US Office of the Comptroller of the Currency (the "OCC"). The OCC refused to grant its approval absent a commitment by Blackstone and several of its affiliated companies to give assurances to the OCC that they would provide any extra capital and liquidity that the bank might need.
- Blackstone would not agree to the OCC's demands. The merger was not completed in the timeframe provided for in the merger agreement, and the Blackstone entities purported to terminate the agreement.
- ADS brought suit in the Delaware Chancery Court claiming a breach of the merger agreement by the Blackstone entities as a result of the failure to reach an agreement with the OCC and seeking to recover the \$170 million termination fee provided for in the merger agreement
- The court granted the defendant's motion to dismiss, finding that there was no breach by the Blackstone parties of the merger agreement, and no obligation on their part to force Blackstone to enter into an agreement with the OCC:
 - Vice Chancellor Strine noted in his decision that Delaware law respects corporate formalities, absent a basis for veil-piercing, recognizing that the wealth generating potential of corporate and other limited liability entities would be stymied if it did otherwise. He also confirmed that the implied covenant of good faith and fair dealing is a "backstop" to the agreement of the parties, and "not an exception to the rule that courts will alter the terms of a bargain sophisticated parties entered into willingly because a party now regrets the deal."

Deal Structure and Terms: Huntsman Corporation Litigation

Huntsman Corporation

- After outbidding Basell, Apollo Management LP (through Hexion Specialty Chemicals) agreed to buy Huntsman for ~\$10.6 billion
- Not structured as a typical sponsor transaction
 - Antitrust “hell or high water” clause
 - Reasonable best efforts to consummate financing
 - Huntsman entitled to specifically enforce the covenants in the agreement (other than to close)
 - Hexion required to sue the banks in the event of a breach
- Uncapped damages in the event of a “knowing and intentional breach”
 - Damages calculated as aggregate consideration that would have been paid to Huntsman stockholders (a ConEd provision)
 - Difference between \$28 plus “ticking fee” and current trading price

Deal Structure and Terms: Huntsman Corporation Litigation (cont.)

Litigation timeline:

- May 9, 2008 → Huntsman reports a 37% decrease in operating income for Q1 2008 from Q1 2007
- June 18, 2008 → Hexion files a lawsuit in Delaware against Huntsman alleging that it is not required to complete the merger because an MAE has occurred (due to the decline in Huntsman's financial condition) and that the combined company would be insolvent
 - Huntsman counterclaimed that Hexion knowingly and intentionally breached the merger agreement by failing to use its "reasonable best efforts" to obtain financing; trial was set for September 8th
- June 23, 2008 → Huntsman files a \$3 billion fraud lawsuit in Texas against Apollo (and its partners) alleging that Apollo misrepresented the price it was willing to pay in order to get Huntsman to terminate its contract with Basell
- July 2, 2008 → Huntsman extends the drop-dead date from July 4th until October 2nd
- July 18, 2008 → shareholder files a proposed class action suit against Hexion and its executives claiming that Hexion damaged Huntsman investors when it did not publicly disclose its concerns about purchasing Huntsman
- August 28, 2008 → Apollo/ Hexion rejects a proposal by shareholders, including Citadel Investment Management and D.E. Shaw, to provide at least \$500 million in additional financing to help Apollo/ Hexion finance the transaction

Deal Structure and Terms: Huntsman Corporation Litigation (cont.)

Delaware Court's Decision – September 29, 2008

- No MAE had occurred
 - MAE should be measured in terms of whether a company has suffered a material deterioration measured against its past performance, and whether the deterioration is likely to cause substantial long-term effects on the earning power of the company
 - Huntsman had experienced year-over-year decreases of 19.9% to adjusted EBITDA and 73.3% to EPS beginning the month prior to signing
 - These results, while disappointing, were not compelling as a basis to claim an MAE
 - Carve-outs to MAE definition not examined as MAE has not occurred as a threshold issue
 - MAE is a very narrow “out” under Delaware law
 - Merger agreement: MAE must be measured against historic performance rather than projections created pre-signing; no reliance on forecasts
 - Projections explicitly carved out of company representations and warranties
- Hexion had knowingly and intentionally breached the merger agreement (including implied covenant of good faith and fair dealing) by releasing insolvency opinion and failing to communicate concerns to Huntsman
- Order: Hexion must use reasonable best efforts to take all actions necessary, proper or advisable to consummate the merger
- Damages: If Hexion chooses not to close where all preconditions to closing have been met, it will remain liable to Huntsman for uncapped damages not limited by the \$325 million reverse termination fee if its refusal to close amounts to a breach of the agreement
- Conclusion: Huntsman is entitled to specific performance of all covenants other than closing

Deal Structure and Terms: Huntsman Corporation Litigation (cont.)

Response to Delaware Court's Decision

- Hexion filed appeal against the Delaware Court's decision
- Huntsman sued banks in Montgomery County, Texas alleging conspiracy, tortious interference and other claims (September 30th)
 - Lawsuit seeks specific performance and damages
 - Trial set for May 11, 2009
- Banks refused to fund transaction, citing insolvency of combined company (October 28th)
 - Closing scheduled for October 28, 2008 failed to occur
- Hexion sued banks in New York, seeking specific performance of commitment letter (October 29th)
 - Trial set for January 2009
 - Huntsman not a party to Hexion's New York suit against the banks
 - Commitment letter expired on November 1, 2008; New York court refused to extend expiration

Proving an MAE in Delaware is very difficult

Deal Structure and Terms: Huntsman Corporation Litigation (cont.)

Recent Update

- December 14, 2008 - Huntsman entered into a Settlement Agreement and Release with Hexion and other Apollo affiliates
- Upon an aggregate payment of \$1 billion to Huntsman (\$425 million in cash, purchase of \$250 million of Huntsman's 7% Convertible Senior Notes and \$325 million termination fee), the parties agreed to take all necessary action to obtain the dismissal with prejudice of (i) the lawsuit in Delaware, (ii) Huntsman's lawsuit against Apollo (but not the Banks) in Montgomery County, Texas and (iii) Apollo's and Hexion's lawsuit against Huntsman in New York state court
- Hexion agreed to seek leave to withdraw its claims in New York against the Banks (other than claims related to a termination facility with the Banks under an existing commitment)
- May 2009 – Texas Judge rules against Banks motion to dismiss Huntsman's common law fraud and tortious interference claims against the Banks clearing the way for a possible jury trial in Texas in June 2009

Deal Structure and Terms: Governing Law

While governing law is important for substantive reasons (*e.g.*, shareholder approval requirements – which may become particularly important if we see an increase in activist hedge funds or institutional investors), the venue for disputes under agreements can be an influential factor if a deal ends up in litigation

- Genesco – Tennessee Law (merger agreement); New York Law (commitment papers)
- Clear Channel – Delaware Law; Texas suits for “tortious interference”
- Penn National Gaming – New York Law, but forum in Court of Common Pleas of Berks County, Pennsylvania
- Huntsman – Delaware Law (merger agreement); New York Law (commitment papers); Texas Law (suits against Apollo for tortious interference and fraud in the inducement)

Alternative Dispute Resolution

- US courts (particularly those in Delaware and New York) will commence expedited hearings to allow for transactions to close within reasonable time periods
 - Delaware proceedings generally most expedient
- Transaction dynamics may be such that arbitration, which can often allow for significant time to elapse (*i.e.*, 30 days to choose an arbitrator), may be more appealing

Rohm and Haas v. Dow Chemical Company

- ❑ Definitive Agreement signed July 10, 2008 (shortly after Huntsman litigation was commenced)
 - Highly competitive auction – all participants were strategic buyers
- ❑ Merger Agreement very favorable to ROH
 - No financing condition
 - Narrowly drafted material adverse change definition
 - Agreement allowed ROH to seek specific performance (including obligation to close)
 - Dow agreed to antitrust divestitures up to agreed limits
 - No third party beneficiaries provision
 - No specific provision allowing damages based on consideration paid to ROH stockholders
- ❑ Litigation:
 - Dow anticipated \$9 billion in financing for deal from joint venture with Kuwaiti petrochemical company; Kuwaitis refused to perform in late December 2008.
 - Dow sought (unsuccessfully) to negotiate changes to the deal.
 - Dow informed ROH it could not close the ROH deal on the scheduled closing date in late January 2009.
 - ROH sued for anticipatory breach in Delaware Chancery Court on January 26, 2009 and sought specific performance. Trial was set for March 9, 2009.

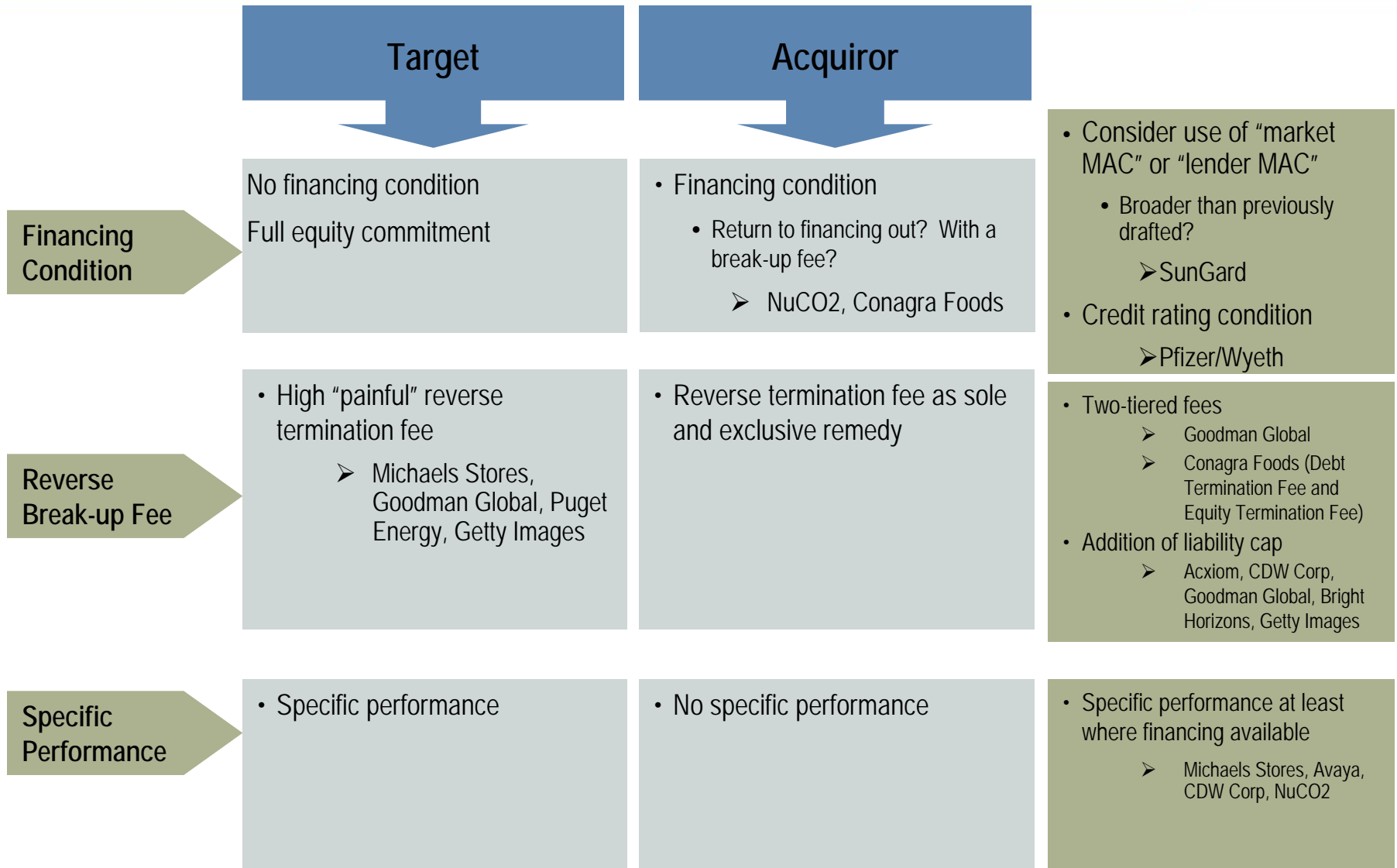
Rohm and Haas v. Dow Chemical Company

- ❑ Primary issue: whether court should order specific performance of the merger
- ❑ Chancellor Chandler: Never a right to specific performance; always within the discretion of the Court to grant (scheduling ruling)
- ❑ Delaware law: Courts generally will hold parties to contractual stipulation that the parties will have no adequate remedy at law in the event of breach; but no absolute right to specific performance.
- ❑ ROH Argument
 - Contract specifically called for specific performance
 - Monetary damages were in fact inadequate – ROH outlined the special harms
- ❑ Dow argument: Specific performance was not proper because of harm to post-acquisition combined entity
 - Balance of equities argued against granting of specific performance
 - Possibility of immediate default on bank loans

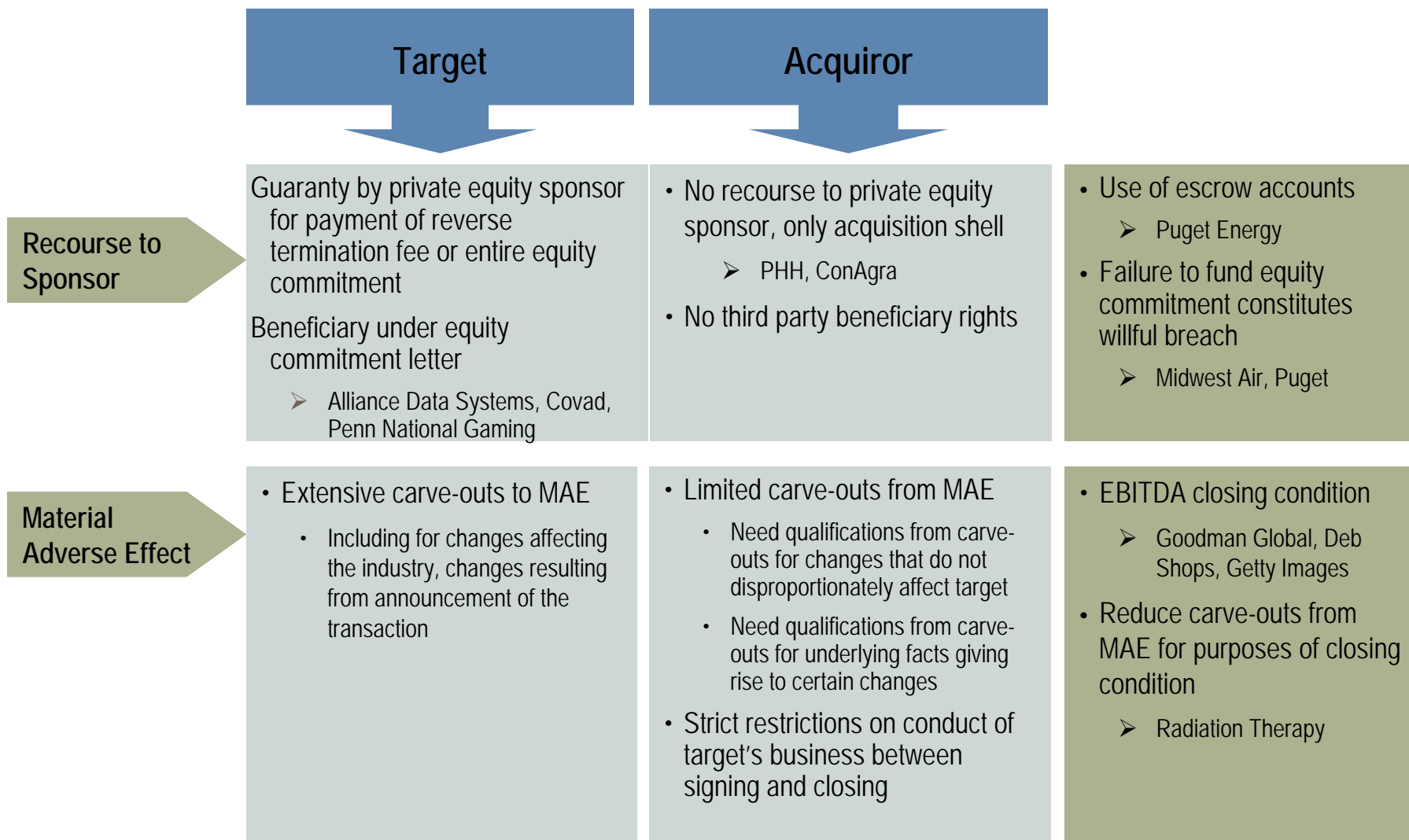
Rohm and Haas v. Dow Chemical Company

- ❑ If specific performance is not appropriate, what is the measure of damages?
- ❑ Dow argument: ROH not entitled to damages suffered by shareholders because of no-third-party-beneficiary clause (*see Consolidated Edison, Inc. v. Northeast Utilities*, 249 F. Supp. 2d 387 (S.D.N.Y. 2003)) and negotiating history
- ❑ ROH argument: Delaware would not follow *Con Ed*
 - *In re IBP, Inc. Shareholders Litigation*, 789 A.2d 14 (Del. Ch. 2001) assumed that shareholder expectation damages would be appropriate
 - Clause barring third-party beneficiaries does not necessarily exclude all third-party beneficiaries (*see Amirsaleh v. Board of Trade of the City of New York*, 2008 WL 4182998 (Del. Ch. Sept. 11, 2008))
- ❑ Outcome
 - Case settled on the first day of trial
 - Closing deferred to April 1, 2009
 - Significant shareholders agreed to invest \$3.0 billion of cash proceeds in newly issued Dow Preferred Stock (effectively changing deal into a 65% cash / 35% stock transaction)
 - No substantive issues decided

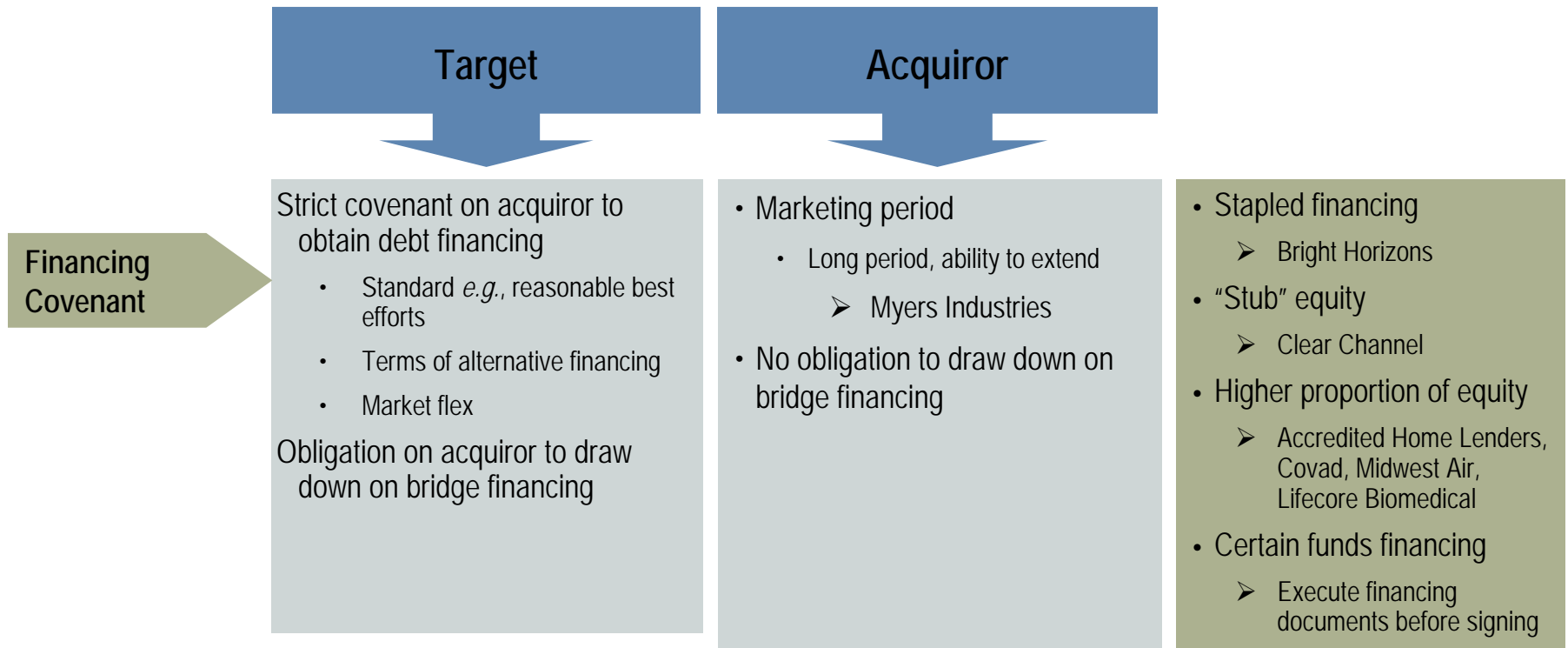
Where to From Here



Where to From Here (cont.)



Where to From Here (cont.)



Lessons Learned

1. Drafting matters
 - Specific performance
 - Dispute resolution
 - Choice of law/ forum
 - MAE definition
 - Establishing an MAE is very difficult – the *Huntsman case* confirmed the high standard required to establish a MAC, and the *Genesco case* confirmed the effectiveness of the typical carve-outs
2. The distinction between risks associated with private equity acquirors and strategic acquirors may be greater than previously
 - Era of presumed good behavior on the part of private equity sponsors appears to be over
 - Target companies may have to calculate how much they should discount private equity bids
 - There may be an opportunity for well-financed strategic acquirors in light of reduced private equity competition
 - Dow shows may also be risks related to strategic deals. Many strategic deals now mimic PE reverse termination fees
3. Financing risk may be reallocated between sellers and buyers
 - Strategic acquirors may get financing conditions in financed deals
 - Sellers may insist that sponsors commit to finance transactions with all, or a significant portion, of equity
4. Definitive credit agreements and not just debt commitment letters may be negotiated prior to signing in financed deals
 - Eliminates any ambiguity in banks' commitment

Lessons Learned (continued)

5. Tender offers may have a role in private equity transactions
 - If transactions are financed with 100% equity, then a tender offer could be used to acquire control, which would, among other things, limit the length, and therefore utility, of a “go-shop” provision (but see, *Lifecore Biomedical*)
6. Litigation may play a larger role in transactions
 - Courts may play a role not previously needed because of sponsors’ reluctance to risk their reputation by walking away
 - Ambiguity in merger agreements will face more scrutiny in challenging deal environment