LEGAL UPDATES

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Avoid Ambiguity and Uncertainty to Promote Deal Success, Reduce Risk and Avert Litigation

Service

Mergers & Acquisitions

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In these turbulent economic times, an increasing number of once-promising deals have fallen apart, leaving the parties to pick up the pieces. When buyers, sellers, lenders and investors enter into a transaction, everyone has a stake in closing the deal. To realistically expect to make it to the finish line together, however, parties must now take additional measures when negotiating the terms of a deal. Ambiguities and deficiencies in agreements have turned formerly manageable obstacles into deal breakers and opened the door to litigation. Eliminating as much uncertainty as possible from the start will increase the chances of a successful transaction, and will reduce the risks of a damaging breakup and subsequent litigation.

The recent failures of several high-profile deals illustrate how volatile economic conditions can contribute to the collapse of a deal. Parties have pointed to these conditions to invoke "material adverse change" (MAC) clauses (sometimes called "material adverse effect" clauses), and have cited the inability to secure financing, to excuse their contractual obligations and walk away from deals. The risk of this occurring increases where an agreement lacks specificity with respect to material adverse changes and/or financing obligations. In more stable times, parties may have renegotiated terms or agreed to additional conditions in the interest of closing a deal. Today, however, no one knows what the coming months will bring, so when second thoughts arise, parties are looking for the exit door.

For the remaining parties, the impact of a broken deal can be measured by direct monetary losses related to deal costs, as well as damage to a party's reputation and value of its business. Facing the negative consequences of a failed deal, jilted parties often look to the courts to fill in the gaps of deficient agreements and to force unwilling parties to perform. Even for a prevailing party, however, litigation may be costly due to the distractions from day-to-day management of the business and loss of goodwill.

To avoid these pitfalls, parties must demand greater certainty and transparency with respect to material adverse change clauses and financing conditions. Buyers and sellers will always have competing interests, but these should be considered and balanced in light of the current economic climate. Going forward, companies would be wise to take the steps outlined below.

Perform Adequate Due Diligence

Parties should agree on clear requirements and time frames for all due diligence. In particular:

Sellers should understand how buyers are financing a deal and should know the terms and conditions for financing. Sellers should request and review loan agreements between buyers and lenders and equity arrangements between buyers and investors.

Obligations and expectations regarding on-going financial disclosures by sellers should be clearly set forth in writing.

Parties should discuss solvency issues and determine when and how solvency analyses will be used (if at all) and how they will affect the parties' obligations in a deal.

Negotiate Comprehensive, Unambiguous Agreements

Material Adverse Change (MAC) Clauses

Parties should be reluctant to enter into agreements that lack clear and unambiguous MAC provisions. Although buyers may be inclined to negotiate broad MAC clauses to allow maximum flexibility to exit a deal, if a buyer relies on an ambiguous MAC clause to excuse its performance, the buyer might find itself in litigation to resolve the issue. If the parties negotiate clear and identifiable conditions and parameters for what constitutes a MAC, the level of risk for each party and likelihood of litigation will be reduced. Specifically, companies should consider taking the following steps in preparing MAC provisions:

Establish measurable criteria and objective benchmarks of overall performance, such as EBITDA results.

Consider factors such as current economic conditions in their industry and/or geographic area, industry specific risks and indicators of performance, a party's financial history and results of operations, and other specific factors that the parties mutually agree would be determinative of a material adverse effect.

Test contract language with hypothetical situations involving possible material adverse effects. Parties should look to similar deals that have failed and determine what the result would be under their proposed MAC provisions. By considering such hypothetical scenarios, parties can identify deficiencies and inconsistencies in interpretation and can further refine MAC language, if necessary.

Financing Conditions

Disputes also arise with respect to obligations to obtain financing. A number of deals have failed of late after a key lender or investor backed out, or financial arrangements otherwise fell through. While it may be difficult to prevent these conditions, parties may be able to avoid the additional problem of litigation by addressing financing issues at the outset of a deal. Accordingly, companies should consider the following:

Agreements often provide that buyers shall use "best efforts" to secure financing. Because of the subjective nature of this standard, parties often find themselves in litigation over whether the buyer in fact used sufficient efforts. To avoid this result, parties should negotiate clear and unambiguous terms with respect to a buyer's obligations to obtain financing and agree upon specific actions to be taken by buyers to fulfill such obligations. To do so, parties should know the capital requirements of a deal, the strength and enforceability of third-party financing or investment commitments, acceptable time frames for obtaining financing, and the range of financing terms generally available and acceptable to buyers.

Financing conditions should be tailored to accurately reflect each party's current financial position as well as the economic environment. Today, buyers may need to agree to higher interest rates from lenders and higher breakup fees payable to sellers.

Overall, buyers and sellers must engage in frank discussions about how a deal will be capitalized. They must reach a clear and realistic understanding of how the buyer will go about securing sufficient funds and what will happen if the buyer fails to do so.

Breakup Fees

Mergers and acquisitions always involve the risk of failure. To entice parties to enter into transactions, and to encourage parties to resolve issues that threaten deals, agreements typically provide for breakup fees. Some agreements contain various breakup fee amounts based on the circumstances that lead to a breakup. Often, breakup fees do not apply if a party exits a deal due to a MAC or the failure to meet a financing condition. When, however, MAC and financing provisions are deficient or ambiguous, it is difficult to determine whether a party is required to pay a breakup fee, leading to the possibility of litigation. Consequently, agreements should clearly spell out the situations in which breakup fees will apply, requiring clear MAC and financing provisions when tied to the payment of breakup fees. As with MAC and financing language, parties should consider hypothetical situations to test the clarity and adequacy of proposed breakup provisions.

Forum: Governing Law
Despite every effort to avoid litigation, it is impossible to completely eliminate the risk of ending up in court after a failed transaction. Accordingly, parties should identify a single forum and specific choice of law to avoid multi-jurisdictional litigation. In addition, parties should choose a forum with a judiciary that is knowledgeable in the area of mergers and acquisitions and should choose a governing law that is well-developed in this area.

What This Means To You

In the recent past, parties negotiating a deal were willing to accept ambiguities and silence in agreements in order to get a transaction off the ground. In today's economy, however, parties who fail to take necessary precautions assume greater risks of a breakup and subsequent litigation. While it is impossible to ensure the success of a transaction, parties can increase their chances of closing a deal, and subsequently reduce their risks related to breakups and litigation, by considering and sufficiently addressing the issues discussed above.

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