The M&A LAWYER

November/December 2008 ■ Volume 12 ■ Issue 10

A Series of Unfortunate Events: How 2008 Changed M&A and What It Means For the Year Ahead

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Unrelenting negative news has made 2008 an *annus horribilis* for the deal community. In the wake of the subprime mortgage meltdown and the resulting liquidity crisis, financial institutions are disappearing or changing form at an unprecedented rate, the capital markets have struggled to remain functional, governments and central banks around the world are expending hundreds of billions of dollars to limit the long term damage, and the average investor has lost faith in the markets.

Given the daily doom-and-gloom emanating from the financial pages, should M&A lawyers simply pack it in and head to the beach to join their mortgage-backed securitization and leveraged finance colleagues? Absolutely not. M&A activity levels will undoubtedly be down across the board yet again in 2009, but challenging and interesting deals will nevertheless be plentiful. While predictions are always difficult to make during times of such great uncertainty, we will attempt, to our reputational peril, to read the tea leaves.

M&A In a Time of Deleveraging. The financial, legal and economic landscape has changed in a truly fundamental way over the last year. These changes are likely to have a direct impact on the pace, size and type of deals we will be working on in the year to come. Private equity funds may not be dead, but they will certainly continue to hibernate through at least the first half of 2009. Deal financing will be tight and we are likely to

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One Year Subscription ■ 10 Issues ■ $444.00
(ISSN#: 1093-3255)

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see more stock-for-stock deals. Strategic deals, especially cross-border deals, will predominate. It also is probable that investment from Asia and the Middle East will increase. Unsolicited and hostile takeover activity will abound, as will distressed asset sales and broken auctions. Industries that depend heavily on financing will continue to consolidate. We are already seeing this with the roll-up of regional banks into the larger money center banks, and we should expect to see numerous deals in the energy and power sectors.

Cleaning-up the Fall-Out. There will continue to be fall-out from the "irrational exuberance" that preceded the credit crisis and the plunge in the equity capital markets. We will likely see more than a few tortious interference cases. The courts will undoubtedly be faced with several more opportunities to interpret MAE clauses and the availability of specific performance remedies. Some of this fall-out will generate new work—renegotiations of existing deals as well as fire-sales and divestitures following broken deals. We will also see more derivative suits against directors and more shareholder class actions, resulting in even more guidance about the contours of directors' fiduciary duties in times of financial distress. In reaction to this phenomenon, we may well see a further "expertization" of corporate boards, with more individuals with industry or finance expertise serving as directors.

Restocking the Defensive Line. Many financially healthy companies will find themselves vulnerable to hostile takeovers as a result of low stock prices that do not reflect the intrinsic value of the business enterprise. This will be an appropriate time for these companies to reevaluate their defensive postures. After a decade of shareholder activism resulting in shareholder resolutions to eliminate poison pills and classified boards, and establish majority voting rules, we are beginning to see a resurgence of the adoption of defensive measures. Such measures have grown more sophisticated, as we have seen with the advent of advance notice bylaws that focus on derivative positions. We will also see more targets becoming cautious about conducting pre-signing market checks that could thrust them into *Revlon* mode. Given the current low equity valuations, we expect that companies may opt to employ the "just say no" defense with increasing frequency.

The Tide Has Turned. Gone are the sellers' markets of 2006 and the early part of 2007. Auctions and other "strategic processes" in 2009 are likely to be much less competitive. We will see lower deal multiples, and buyers will have more say over the manner in which sales are conducted and the terms of acquisition agreements. Some buyers will demand exclusivity agreements as a condition of submitting a bid, and many buyers will reject long standstills. The sheer number of closing conditions is likely to grow while the scope of MAE carve-outs is likely to shrink. We may see break-up fees inch upward and more attempts to use voting agreements and crown-jewel options. Also, we will see buyers less willing to accept "hell-or-highwater" risk with respect to regulatory approvals on transactions (this is particularly true with a new administration in Washington).

Searching for Blue Light Specials. M&A in 2009 will be less about acquiring crown jewels or levering up already successful businesses, and more about finding diamonds in the rough, making bolt-on acquisitions and finding partners for strategic expansion. If we see any private equity deals at all, these deals are likely to involve small, strategic investments rather than the huge leveraged acquisitions of whole companies such as First Data, HCA, TXU and others in 2006 and early 2007. We will likely see more acquisitions of divisions and business lines as companies focus on their core businesses. Strategic alliances and joint ventures will also be back in vogue. The contractual techniques we use will change accordingly. Smaller deals will require shareholders agreements, joint venture agreements and asset purchase agreements rather than public company cash merger agreements. Instead of talking about fiduciary outs, financing conditions or reverse break-up fees (the language of *United Rentals* and *Huntsman*), we will be talking about earn-outs, indemnities and survival periods. We may need to be creative in finding ways to defer payments, or make payments contingent on future performance, and we will all have to develop better techniques to address the risk of counterparties' becoming insolvent.

Beggars Can't Be Choosers. Emerging markets are suffering as much or more than the U.S. economy in the current environment, but we will continue to see an influx of investments from stable non-U.S. economies. We have already experienced this development

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with the significant investments from China and Japan in U.S. financial institutions, and the active participation of sovereign wealth funds from Singapore and the Middle East in infrastructure projects and other deals. This trend will continue and will likely move into blue-chip industries that are sagging under the weight of slowing consumer demand and rising legacy costs.

For deal lawyers, the proliferation of cross-border deals will require an aptitude for dealing with comparative law issues and a solid understanding of U.S. securities laws as they apply to non-U.S. issuers. Issues like the reconciliation of financial statements prepared using disparate accounting principles, structuring incentive plans for employees without using SEC-registered equity, and familiarity with Exon-Florio and other laws that apply uniquely to non-U.S. buyers will be critical. Deal lawyers will need to pay careful attention to sequencing regulatory approval processes across multiple jurisdictions, addressing political and reputational risks under global scrutiny and bridging the divides between common law systems and civil law systems.

Shaking the Money Tree. In the past, lenders were so eager to participate in deals that they often relied on the buyer's due diligence and projections. The ever popular "covenant lite" commitments afforded the lenders very few "outs." In 2009, even as the credit markets start to ease and financing begins to become available for deals, lenders will impose more stringent requirements. They will charge more for commitment letters and extract a higher return. They will want to perform more detailed due diligence, and they will demand greater protection from changes in the underlying economics of the deal. The great debate over whether lenders should be permitted to rely on legal due diligence reports provided to the buyer will be subsumed by discussions of the tension between the time lenders require to perform their own due diligence and the need to get a deal announced before a leak occurs. In light of this tension and the higher cost of borrowing, strategic buyers increasingly will choose to finance transactions by issuing their own equity (or, perhaps, public debt). We will see more stock-for-stock deals and, as deal lawyers, we will spend a lot of time with investment bankers debating "fixed versus floating" exchange rates, collars and mutuality of contract terms. We will also have to be prepared to advise clients about private placements and SEC registration.

Race To the Finish. Given the recent volatility in the markets, everyone is a little gun-shy about letting deals hang out there for too long. We will see enormous pressure to close deals as quickly as possible after announcement. We may also continue to see sizeable deal spreads between signing and closing while the markets "price in" the risk deals that will not close. The SEC's best price rule amendments have lived up to their expectations and re-sanctioned the use of tender offers as an effective technique to get deals done quickly, so we expect to see more tender offers in 2009. Deal lawyers may also find themselves under tremendous pressure to get proxy statements and regulatory applications filed within days, rather than weeks, of announcing transactions. Lawyers with regulatory expertise will increasingly be called upon to try to structure transactions such that approvals are not required, and to avoid second requests and other extended waiting periods.

Paying the Piper. In the face of intense congressional scrutiny of executive pay in the wake of the Bear Stearns and Lehman debacles, recruiting and retaining successful managers increasingly will present challenges. For deal lawyers, these issues already consume a considerable amount of energy and time, especially for deals in service industries where a target's human capital can be its most valuable asset. Every deal lawyer already needs to be able to help spot accounting and tax issues arising from change in control plans, because a failure to identify a 280G issue or a 409A issue could have wildly expensive consequences for the surviving company in a transaction and/or its employees. In the current climate, deal lawyers also need to be proactive in thinking about how executive compensation and retention programs need to work after a deal has closed. Many companies are struggling to make their forecasts and 2008 performance bonuses for senior executives will be at the low end of their range. As a result, in 2009, it will be essential to the long-term success of the combined company to consider implementing deferred compensation plans and retention packages for key executives.

Scarlet Letters. Scandals arising from financial reporting practices are bound to follow on the heels of the market slow-down. Much as the problems at Enron, WorldCom and Tyco emerged in the wake of

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the bursting of the tech bubble, so should we expect to see more financial restatements, whistle-blowing and other compliance issues in the near future. We can expect that M&A buyers' due diligence will dig deeper than ever before into validating targets' intrinsic value. Deal lawyers will need to be prepared to advise clients about the potential pitfalls of acquiring a company that is in the midst of, or heading towards, a restatement, and the impact the restatement process can have on preparing an S-4 registration statement or even simply preparing an accurate valuation. We will also see more companies that are the subject of SEC investigations or struggling with their auditors to obtain a clean audit opinion.

Conclusion. M&A did not die in 2008 and will not be dead in 2009. Rather, deals will be different from what they were in the boom days of 2006 and 2007. Deal lawyers will need to be especially versatile and nimble in 2009 if they are to successfully guide their clients through the plethora of obstacles required to achieve desired transactions. We may have to file away our standard forms and start borrowing techniques from other practice areas. From an intellectual perspective, 2009 will be an interesting and challenging year for deal lawyers, filled with opportunities for creativity. As Samuel Langhorne Clemens might have said, the demise of M&A has been greatly exaggerated.

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