

Risk Allocation Mechanisms in Merger and Acquisition Agreements

Keywords: M&A, delayed enforcement of acquisition agreement, MAC clause, termination fee, price adjustment mechanism

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Abstract

This article serves as an overview to provide basic knowledge for people previously unacquainted with the field of mergers and acquisitions and the risks of parties involved in M&A agreements. The article provides a thorough review of the risks the parties are exposed to in the time period between signing and closing the transaction and proposes three ways to effectively allocate these risks between the parties, namely Material Adverse Change (MAC) clauses, termination fees and price adjustment mechanisms.

Full Article

1 Introduction

Merger and acquisition (M&A) transactions are usually very complex as they involve the takeover of an entire company with its rights and obligations. The economic value of these deals is also significant – for instance, in the last decade the net worth of major top ten deals rose from more than \$50 billion to \$167.7 billion. Negotiating these kinds of deals requires a lot of specialized workforce as the M&A agreements involve complex economic, fiscal and legal matters. The amount of details that must be settled and clarified in an M&A agreement is enormous and therefore the agreement is often more than 100 pages long. Due to its complexity, the lawyer who advises or takes part in the process of concluding an M&A agreement must be familiar with all the economic and accounting related aspects, as well as other non-legal fields.

The sheer size of the transaction is a reason why these deals require considerable time to finish. Several matters must be negotiated between the parties, but even when the final agreement is established, the enforcement of the transaction can be delayed. A common reason for a delay is the need to obtain competition authorities' acceptance, but also other legal issues can lead to delayed performance of the agreement. The time period between signing and closing the agreement can amount to as much as a year. The problem with this delay is that usually the assets acquired do not have a constant value in time and are subject to change. This matter is further emphasized by the fact that usually such deals include intangible assets and/or goodwill. Therefore, the longer the time period between the signing and closing, the bigger the possibility that the value of the target will change, but the parties are exposed to other risks as well, such as general economic downturn or terrorist attacks. The important question is by whom and how is the target company's ordinary business activity maintained. In addition to that, the possibility of intent to defraud by the other party cannot be disregarded either. All these risks must be allocated between the parties in the M&A agreement.

Therefore, the object for this article is to give a general overview of the reasons for delay between the signing and closing the M&A deal, risks that the parties of the M&A deal are exposed to, and also to provide three main mechanisms to allocate these risks. The aim is to provide basic knowledge to students with no special knowledge in the M&A area, but who are keen to get familiar with the topic. The first chapter of the article concentrates on the reasons for delay between the signing and closing the agreement and takes a closer look at the risks the deferral of closing involves. The next three chapters present three principal ways to allocate risks between the parties – the material adverse change clauses, termination fees and price adjustment mechanisms. The article provides an overview of what is a MAC clause and how is it used, and also deals with the problems related to drafting the clause. Termination fee, as one of the most negotiated parts of the agreement, has several implications to look closer at as well – these aspects are explained and their general economic background is introduced. Price adjustment mechanisms are complex systems that involve a lot of accounting principles and methods. These must be well considered when concluding a

price adjustment clause in the agreement, as disputes over price adjustments may easily emerge. Whenever possible, all three methods are accompanied with tips and suggestions to consider when drafting an M&A agreement. The issues in the article are handled on a general international level, although the common law system and US court practice of have had an impact on this work.

Within the frame of this article it is not possible to go in depth with each of the topics, thus the article does not intend to discuss all the possible aspects related to the presented risk allocation mechanisms. Neither does the article cover the use of pre-contractual agreements and other contractual terms, such as closing conditions and representations and warranties, which are also often used to allocate contractual risks.

2 Need for Risk Allocation in M&A Agreements

2.1 Delay in Closing the Acquisition

The problem of deal risk in business combinations is well-known in the law of contracts.¹ The difficulty is in the interim period between signing and closing.² There can be several reasons for a delayed performance: for example, the performance of the parties simply takes more time to complete (e.g. building a house). However, a company acquisition is merely a transfer of property and a payment of consideration that, in its nature, could be effected simultaneously with entering into an agreement³ and is often used for instance in Germany.⁴ If there is no time gap between signing and closing the question of risk allocation never arises,⁵ but it is rarely the case. Usually the reasons for non-simultaneity of signing and closing are legal.⁶

Commercial and limited liability company laws play the main role in causing a delay. There are three ways to acquire a business of another: a) a stock

1 Miller 2009a, p. 2016.

2 Miller 2009b, p. 99–204, p. 107.

3 Freund 1975, p. 149–150.

4 Beinert 1997, p. 136.

5 Miller 2009a, p. 2016.

6 *Ibid.*

purchase; b) an asset purchase; and c) a merger under state law.⁷ The majority of the deals are structured as mergers under state law⁸ and usually state law requires shareholder approval for these agreements. For example, in member states of the European Union, laws concerning mergers are harmonized with the EU Council Third Directive where Article 7 states that a merger agreement must be approved by the shareholders in the general meeting.⁹

Although arranging a shareholder meeting takes time, a far longer delay may be caused because of competition issues. State law may require approval for the proposed merger or acquisition from relevant authorities. As an example: concentrations that take certain dimensions must be approved by the European Commission,¹⁰ and as the recent Sun Microsystems acquisition by Oracle Corporation has shown, getting the necessary approvals can take several months.¹¹ In the USA receiving consents from Federal Trade Commission or the Department of Justice can take more than a year.¹² Some additional approvals might be needed when a merger takes place in certain industries. It is the case for instance when banks merge.

Sometimes closing the acquisition takes time because third parties' interests have to be taken into account – a party to a business combination may need to seek consent of its own contractual party. For example, when a company has a factory on a lease, it should be examined whether an approval from the owner of that estate is needed. These kinds of contractual clauses protect the counterparty from ending up in a contractual relationship with a party that is other than the one originally contracted.¹³ In this situation there are two possibilities: seek the consent of the counterparty or closing the transaction without the consent (also known as “*close over*”). The decision is

7 Kling & Nugent 1992, § 1.02.

8 Miller 2009a, p. 2017.

9 Third Council Directive 78/855/EEC concerning mergers of public limited liability companies.

10 Council Regulation (EC) No 139/2004 on the control of concentrations between undertakings.

11 EU press release IP/10/40. EU Commission started its investigation on 3th September 2009 and concluded that the transaction would not significantly impede effective competition in the European Economic Area on 21th January 2010.

12 Miller 2009a, p. 2021.

13 *Ibid.*, p. 2023.

obviously made depending on the costs and benefits of the possible course of action.¹⁴

As mentioned, there are several reasons for non-simultaneous signing and closing of the agreement. The delay is not a threat *per se*, but it represents a considerable risk because the business situation at closing can differ from the situation at signing. At signing both parties voluntarily enter into the agreement and therefore, at least at the time of signing, the parties must believe themselves to be making a good deal.¹⁵ However, as the length of the interim period between signing and closing increases, the profitability for a party to close the deal may change as well.

2.2 Risks of the Parties in a Delayed Closing

The risks of the parties created by a delay in closing the deal are diverse. There is always a considerable risk to lose significantly in transaction costs that have accrued in calculating the accurate offer of the target if the acquisition finally is not closed. Moreover, a bidder can lose the opportunity to profit from another strategic merger.¹⁶ However, the buyer is not the only one exposed to risks, as the seller may also lose significantly when the deal is not closed. These different types of risks parties are exposed to can be divided into four groups as set forth by *Robert T. Miller*:

Systematic risks can be changes in broad economic or market factors affecting firms generally. Such factors include, among other things, changes in financial, credit, debt, capital, or securities markets; general changes affecting the industries or lines of business which the party operates; changes in law; changes in Generally Accepted Accounting Principles (GAAP); changes in political or social conditions; acts of war, terrorism or natural disasters.¹⁷ There is usually very little either party can do to prevent these kinds of risks or even cushion the long-term effects of these risks.¹⁸

14 *Ibid.*

15 Miller 2009b, p. 162.

16 Levy 2002, p. 1363.

17 Miller 2009a, p. 2071.

18 *Ibid.*, p. 2074.

Indicator risks are connected to the company itself and the company can take measures to avoid them. These risks are for example not meeting the internal projections or estimates by industry analysts, or change in the value of the shares in the market.¹⁹ However, changes in these matters do not certainly mean that there is a risk.²⁰

Agreement risks are such as attrition of employees or loss of customers arising from the announcement of the agreement.²¹ In that case the employees might fear that the merger has adverse consequences on them personally and seek a new job; there is also the risk that competitors will exploit such situation to increase their market share.²²

Business risks are those that arise in the ordinary course of the company's operations, such as loss of important customers or sales due to competitive pressure, cyclical downturns in business, large tort liabilities arising from the company's operations, problems rolling out new information and accounting systems, and product defects along with resulting recalls and product liability claims.²³

Another risk from the buyer's point of view is a competing bid made by another company. In a typical scenario, one company places a bid on the target and the bid is accepted. The two entities reach a final agreement on the terms of the acquisition, but prior to the closing of the transaction, a third company offers a higher bid for the target company.²⁴ *Richard S. Ruback's* study has shown that the second bidder is usually the winner.²⁵ Although the study is almost 20 years old, the risks are the same – as the second bidder does not need to make large investments to find out the target's price and has thus an advantage of making a better offer. Therefore the initial bidder has the risk of losing capital invested to make the initial offer and thus a strong incentive to avoid the materialization of such a risk.

19 *Ibid.*, p. 2007.

20 *Ibid.*, p. 2085.

21 *Ibid.*, p. 2007.

22 *Ibid.*, p. 2087.

23 Miller 2009a, p. 2089–2090.

24 Levy 2002, p. 1367.

25 Ruback 1983, p. 141, 147. The research analyzes rivalry among bidders in the acquisitions market for two different objective functions: stockholder wealth maximization and management welfare maximization.

Sometimes the success of the acquisition may depend on early efforts to facilitate integration, because the merger is motivated by the potential post-closing synergy. Thus the companies might start integrating the businesses immediately after the signing. This is important in industries that experience rapid technological change.²⁶ In the abovementioned situation the cost of non-closure of the deal can be quite significant to both parties – the seller needs some guarantees that the buyer will close the deal and not walk away with the information revealed in the integrating or due diligence process.²⁷ These risks are quite high in industries where human capital and technological know-how are critical inputs and where technological change is rapid.²⁸

During negotiations the buyer wants to have maximum protection against business changes while the seller seeks to limit its liability.²⁹ Usually this is not possible and the risk will be allocated between the parties to reach a more equal outcome. However, if the risk is not set on the acquirer, the seller wants to limit the outs for the buyer as much as possible, in order to keep the buyer committed to the transaction and protect itself from the negative exposure that a broken deal could create.³⁰ Therefore parties to the merger or acquisition use different kinds of contractual methods to allocate these risks. Some of the most important methods to allocate the risks are MAC clauses, termination fees and price adjustment mechanisms. These are discussed below in detail.

3 Material Adverse Change Clauses

MAC (material adverse change) or often named as MAE (material adverse effect) are conditions used in merger and acquisition agreements for allocating risks between the parties during the interim period between the signing and closing of the contract. MAC clauses are complex and are negotiated thoroughly, because MAC permits the buyer or the seller not to close the transaction after signing. Usually they distinguish various kinds of risks to

26 Gilson & Schwartz 2005, p. 337.

27 *Ibid*, p. 337–338.

28 *Ibid*, p. 340.

29 Grech 2003, p. 1501.

30 Hall 2003, p. 1064.

the parties' business and allocate them between the parties, with many exceptions and exceptions to exceptions.³¹ A typical term would permit the buyer not to close the transaction on the post-execution occurrence of "any change, occurrence or state of facts that is materially adverse to the business, financial condition or results of operations" of the seller (i.e., the "target").³² There are opinions that MAC should be preferable to MAE³³, but mostly MAC and MAE are used interchangeably³⁴ and there is no big difference between them.

3.1 Definition of a MAC Clause

In merger and acquisition agreements MAC clauses are used in several places: in the definitions part, in the representations and warranties sections and in the closing conditions.³⁵ A MAC definition is needed to understand the meaning of MAC, because in the other sections of the agreement only the acronym MAC is used. Therefore we usually find the meaning of MAC in the definitions part; the fairly standard description goes as follows³⁶:

"Material Adverse Change or Material Adverse Effect means any change, effect, event, occurrence, state of facts or development which individually or in the aggregate [has resulted] [[would reasonably be expected to] [could] result] in any change or effect, that is **materially** adverse to the business, condition [(financial or other)] [, prospect] or results of operations of the Company and its Subsidiaries, taken as a whole; provided, that none of the following shall be deemed, either alone or in combination, to constitute, and none of the following shall be taken into account in determining whether there has been or will be, a Material Adverse Change or Material Adverse Effect: (A) any change, effect, event, occurrence, state of facts or development (1) in the financial or securities markets or the economy in general, (2) in the industries in which the Company or any of its Subsidiaries operates in general, to the extent that such change, effect, event, oc-

31 Miller 2009b, p. 104.

32 Gilson & Schwartz 2005, p. 331.

33 Adams 2004, p 18–19.

34 Cheng 2009, p. 568.

35 *Ibid.*

36 Quintin 2008, p. 278–279.

currence, state of facts or development does not disproportionately impact the Company or any of its Subsidiaries or (3) resulting from any Divestiture required to be effected pursuant to the terms of this Agreement or (B) any failure in and of itself by the Company to meet any internal or published projects, forecasts or revenue or earnings predictions (it being understood that the facts or occurrences giving rise or contributing to such failure may be deemed to constitute, or be taken into account in determining whether there has been or would reasonably be expected to be, a Material Adverse Effect or a Material Adverse Change”).

This definition has several elements worth looking at:

1. Has, would, could. Usually the buyer likes to use as wide a MAC definition as possible to involve any adverse effects. This could be achieved by using the modal verb “could” in MAC definition instead of “has” or “would”. Using “could” involves all possible alternative courses of events that could lead to MAC occurring. So all adverse effects are involved, no matter how remote. “Would” is middle ground and defines the MAC as something likely to happen. The purpose of “Has” can be to restrict the grounds for MAC – it simply states that when invoking to MAC, the event must have occurred.³⁷ In agreements “would” is perhaps the most commonly used.³⁸

2. Prospect. In general usage, prospect means “chances or opportunities for success”. Therefore using “prospect” in MAC definition means that the favored party can trigger MAC when there is a change in chances or opportunities for success. The counterparty is not happy to add “prospect” into the agreement, because it involves the future. For example adding “prospect” in high-tech deals can be fatal because the future is not often predictable, but on the other hand it is inevitable in deals that involve biotechnology.³⁹

37 Adams 2004, p. 16–17.

38 Quintin 2008, p. 280–281.

39 Adams 2004, p. 35–36.

3. Material. Materiality is the main issue in the MAC litigations and therefore it will be discussed in the interpretation part.

4. Target definition. The seller usually wants the adverse effect to be measured on the basis of its aggregate impact on the target, not in an isolated fashion. For example: “the Company and its Subsidiaries, taken as a whole”.⁴⁰ From the buyer’s standpoint it would be better to measure it separately to allow opt-out if the interesting subsidiary deteriorates, even though having no serious impact on the corporation.

The definition of MAC is referred to in the closing conditions and in the representation and the warranties sections of an agreement and thus the MAC definition is only as important as the operative clauses that convey its meaning. MAC can be triggered in two totally different contexts, one favors the seller, the other favors the buyer.⁴¹ Usually the closing condition has a requirement that the seller’s or the buyer’s representations and warranties set forth in previous sections shall be true and have not suffered MAC.⁴² If the defined MAC is applied in representations and warranties, the following is quite common: *since January 1, 2008, no events or circumstances have occurred that constitute, individually or in the aggregate, a MAC.*⁴³ Another example: *neither the Seller nor the Target is party to any litigation that would reasonably be expected to result in a MAC.*⁴⁴

3.2 Exceptions to MAC

Exceptions to the MAC are important as they serve to limit the scope of the MAC provision by shifting liability to the buyer or seller (depending on the structure of the deal) should one of the exceptions arise.⁴⁵ Like in the definition above, exceptions to the MAC are possible and actually quite common – 70% of all the deals contain a carve-out.⁴⁶ It is also stated that

40 Quintin 2008, p. 281.

41 *Ibid*, p. 279.

42 See e.g.: Asset purchase agreement between Sonic Solution and Roxio Inc, p. 57.

43 Elken 2009, p. 305–306.

44 *Ibid*.

45 Grech 2003, p. 1490.

46 Nixon Peabody LLP (2008), p. 7.

the current financial crisis has made exceptions more buyer-friendly.⁴⁷ Exceptions are assumed to be very important in deals that involve companies where technological know-how is a crucial input or the company is exposed to information leaks that could aid competitors, customers and suppliers, or where the declines in stand-alone value are essential in case the deal fails.⁴⁸ Usually the exceptions concern a change in the economy or business in general; change in the conditions that prevail in the target's industry, unless the change has a disproportionate impact on the target; change in securities markets; change in trading price or trading volume of the Company's stock; change in interest or exchange rates; change in the legal environment or a change in the interpretation of laws or regulations; or acts of war or terrorism.⁴⁹ The choice of course depends on the needs of the parties and their bargaining powers.

An interesting solution is available in the UK, where MAC clauses in public transactions in mergers and acquisitions agreements may not contain MAC exceptions, since the UK regulation prescribes the circumstances when a condition may or may not be invoked.⁵⁰ A transaction is considered to be public when the target company's securities are traded in a regulated market in the UK.⁵¹

3.3 Interpretation Issues

The main issue in litigations that concern the MAC has usually been whether the adverse change is of sufficient magnitude to count as a material adverse change within the meaning of the agreement.⁵² The materiality is often not defined by the parties in the agreement, and even when it is, the definition is often too vague.⁵³ Therefore the materiality is often a matter of dispute, although the case law is not favorable for triggering the MAC clause – courts have set the bar rather high before a buyer may be allowed to back out of a transaction using the MAC clause.⁵⁴ Courts in the US for example use

47 Nixon Peabody LLP (2008), p. 3.

48 Gilson & Schwartz 2005, p. 340.

49 Nixon Peabody LLP (2008).

50 McDermott Will & Emery 2007, p. 4.

51 The Takeover Code 2009, at A3-A7.

52 Miller 2009b, p. 100.

53 Cheng 2009, p. 574.

54 Quintin 2008, p. 284.

several techniques to interpret whether a MAC has occurred or not, because the text of the MAC offers usually limited help to determine it.

Firstly, the courts in the US tend to be fact intensive. Courts will delve into the facts surrounding the creation of the agreement, the parties' actions while the agreement was in effect, and the parties' actions after the agreement was terminated, and use the results to interpret the MAC. Since all the facts surrounding a merger or an asset acquisition will be included in the court's analysis, it would be reasonable for parties to act in a manner they want to have on record. This means that the parties of the agreement should treat one another with respect and act *bona fide* during the transaction.⁵⁵

Secondly, when ambiguous language is used, courts will interpret it rather from the seller's point of view. The buyer usually wants to use broad language defining the MAC to protect itself from any harm the target company could suffer. The Delaware Chancery Court in the US found in shareholders' litigation against IBP Inc that the MAC clause seemed to allocate all the risk of negative events to IBP, but the court found it difficult to conclude that the parties meant to include every negative event, no matter how great or small. Thus the court used external evidence to determine the meaning of the clause. However this solution could lead to a result that is not consistent with the intent of parties. Therefore, when the parties meant to include all the negative events, it should be expressly stated in the MAC clause.⁵⁶

Thirdly, courts tend to emphasize external facts. They often use external facts to interpret the MAC clause – i.e. the external factors that were outside the control of the parties. Therefore the target company should carefully negotiate the language of the MAC clause to exclude external factors or conditions outside its control.⁵⁷ Finally, the court takes into account the size of the adverse change in question. The size of the adverse impact is critical to the court's determination of whether a MAC has occurred or not. The event must be substantial compared to the size of the deal. Also the seasonality and the temporary declines in earnings are often taken into account deter-

55 Hall 2003, p. 1080–1082.

56 *Ibid*, p. 1082–1084.

57 *Ibid*, p. 1084–1085.

mining the materiality.⁵⁸ Courts in the US also make a difference between strategic investors and financial investors – latter ones are more favored in the cases of MAC interpretation.⁵⁹

4 Termination Fees

4.1 Economic Background for Termination Fees

Termination fee (quite often known as “break-up”, “bust-up”, “cancellation” or “good-bye” fee)⁶⁰ is a sum of money paid by the seller to the potential buyer of a business in case the agreed transaction fails to close for reasons set forth in the acquisition agreement.⁶¹ The acquisition process can be complicated⁶² and therefore lawyers, accountants, investment bankers and other highly-paid professionals may be needed to advise on the deal.⁶³ All this increases the costs of the deal and therefore, a termination fee can be used as a measure to allocate the risk of losing investments made for making the initial bid to the seller.

It must be noticed that there are slight differences in different legal systems concerning termination fees. In civil law systems the termination fee is usually in a form of contractual penalty, but in common law systems the contractual penalty is not allowed by law and the termination fee usually refers to a clause in the agreement that enables opt-out from the agreement when the termination fee is paid. Below the common law system is examined more closely, but the same principles often apply to the civil law systems as well.

Consider the following as an example of the importance of the termination fee: Bidder A makes a bid of \$100 million on a target company and an agreement is concluded but without a termination fee for the seller. Then comes bidder B and bids \$105 million. The target will terminate the agreement and bidder A loses its investments made to investigate the amount

58 *Ibid*, p. 1086–1087.

59 Quintin 2008, p. 283–284.

60 Samet 1996, p. 133.

61 *Ibid*, p. 132.

62 Some examples of the difficulties: Easterbrook & Fischel 1996, p. 164–165.

63 Samet 1996, p. 133.

of the correct bid, whereas the bidder B prevails in the bidding and has a free ride on some of the expenditures of bidder A. The difference between A's and B's offer is \$5 million. Now let us observe the situation with a \$3 million termination fee: if the target terminates the agreement with bidder A, then the seller must pay \$3 million as a compensation for A. In this case bidder B does not only outbid bidder A, but also adds the termination fee to the bid. Therefore the change between the offers of A and B is now \$2 million and contrary to the first situation, A does not stay with empty hands.⁶⁴ It can be stated that the main role of the termination fee is to compensate the expenses the failed bidder carried to make the initial bid, as without any reimbursement mechanisms potential buyers might not consider taking part in the bidding at all. It is also suggested that the fee is meant to compensate the losses incurred during the delay between making the bid and closing.⁶⁵ What should be considered when drafting a termination fee clause in the merger and acquisition agreement is specified below.

4.2 The Seller's Incentives to Draft the Termination Fee Provisions

The termination fee provisions do not only serve as the advantage of buyer, as also the other party may use these provisions to allocate their risks. The seller may have several reasons to agree to have a termination fee in the agreement. Firstly, termination fee provision can be necessary to attract a serious bidder by showing that the seller is receptive to the bidder's offer and willing to proceed with the negotiations in good faith.⁶⁶ Secondly, the target's board can preserve its fiduciary duties to its shareholders at a known cost. The termination fee also enables the target to examine other offers without losing the credibility or deterring the initial offer.⁶⁷ Therefore the termination fee can be seen as an "exit" clause for the board of the target to negotiate with another bidder in order to satisfy their fiduciary duties to the stockholders.⁶⁸

64 Sneirson 2002, p. 581–582.

65 Wachtel 1999, p. 587.

66 Swett 1999, p. 357.

67 *Ibid.*

68 Quintin 2008, p. 276.

Interestingly, the target company's directors might have motives to use the termination fee in a way that supports not the shareholders' interests, but their own. From the target's directors' point of view the acquisition probably ends with them losing their jobs and therefore they have an incentive to request for a counter-offer of a cheaper price but with them staying at their position, or instead make the acquisition impossible by requesting too high a price. Either way, it is not in the interest of the shareholders but the members of the board. Therefore the members of the board can be made liable for losses if they infringe their fiduciary duties.⁶⁹

Termination fee in an agreement can be used as a tool to support the board's intention – setting a high termination fee may force the shareholders to approve an acquisition agreement in order to avoid the payment of the termination fee.⁷⁰ However, the business judgment rule is used in the US to determine whether the board can be made liable for the losses shareholders have suffered: if the directors acted on an informed basis, in good faith, and without self-interest, the board's decision is sound.⁷¹ The board is expected to solicit the best possible offer for the shareholders and if the termination fee disables others' opportunity to make bids, it can be declared void in US courts.⁷² This board obligation is referred to as “Revlon duties” because it was determined in the case *Revlon v. MacAndrews & Forbes Holdings*.⁷³ Therefore, while drafting termination fee provisions, a lawyer must also consider the board's fiduciary duties in order to make a valid provision.

4.3 Size of the Termination Fee

Although the parties may agree a termination fee as high or small as they want, the amount of the fee is often the source of dispute after the agreement is signed and respectively, courts of the US may lower its size. Courts have taken into account considerations such as the sheer size of the termination fee as a total amount or percentage of the deal size, the amount of the

69 Wachtel 1999, p. 617.

70 *Ibid*, p. 618.

71 Swett 1999, p. 359.

72 *Ibid*, p. 364.

73 *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, (Delaware Supreme Court, 1986). In that case the board of the target company used a break-up fee as a measure to make a deal with a preferred buyer in an auction process where the other buyer would have paid more for the target.

fee relative to the benefit to shareholders, as well as the size of the parties of the acquisition and the need for the protection measures for the parties, among others.⁷⁴ The court is likely to investigate whether the termination fee is inserted to the agreement in a one-on-one negotiation or in an action situation.⁷⁵ To prevent possible disputes later it would be wise to make clear that the board of the target's company understands the economic impact of the termination fee on potential competing bids.⁷⁶ As a consequence, termination fees usually amount from 1 to 5% of the transaction value,⁷⁷ as the higher ones bear the risk of non-enforcement.⁷⁸ According to Delaware courts, as small a percentage as 3% is not considered reasonable by itself, and other circumstances must be considered as well.⁷⁹

4.4 When Is the Termination Fee Triggered?

When drafting a termination fee provision not only the size of the fee must be agreed on but also the circumstances when the fee must be paid. Although the amount of the fee gets most of the attention during the negotiations,⁸⁰ defining the events that trigger the payment of the fee are more important from the author's point of view, as a higher fee should be favorable if there is only one event that triggers the payment, compared to a situation where there is a smaller fee to be paid but more circumstances that might trigger the payment. There are various events that may trigger the termination fee⁸¹, such as if the transaction is not closed by the seller because it accepted another offer; the target company's shareholders do not approve the acquisition agreement; or when the acquirer terminates the agreement because the target breaches the representations, warranties or covenants.⁸² Sometimes it might be useful to state that the termination fee must be paid in case of an automatic termination of the agreement, when the deal was not closed on a "drop dead" date.⁸³

74 See generally: Laster & Haas 2007.

75 Kramer & Slonecker 2000, p. 13.

76 *Ibid.*

77 Levy 2002, p. 1366.

78 Gilson & Schwartz 2005, p. 336.

79 It has been stated for example in the court case of *La. Mun. Police Employees' Ret. Sys. v. Crawford* 2007.

80 Glover 2002, p. 14.

81 See generally e.g. Glover 2002.

82 Glover 2002, p. 21.

83 Glover 2002, p. 14, 18.

Termination fee can be designed to have two tiers that will be triggered by two different events and if both events exist, both fees must be paid. As an example, *Bell Atlantic Corporation* and *NYNEX Corporation* had the termination fee in a merger agreement broken down into two parts: first part provided that the party would be required to pay \$200 million if there were a competing acquisition offer for that party, a failure to obtain shareholders' approval or a termination of the agreement. The second tier represented a payment in amount of an additional \$350 million when the competing transaction was consummated within eighteen months of the termination of the merger agreement.⁸⁴

4.5 Termination Fee as Liquidated Damages

In the US and the UK contractual penalty is prohibited.⁸⁵ Instead they use a similar legal construction called "liquidated damages". These contractual clauses place an obligation to the parties to pay a sum of money in case one party breaches the agreement.⁸⁶ Liquidated damages need three conditions to be fulfilled in order to be valid: a) it needs to be intended to function as a damage, not as penalty; b) the amount of the damages is difficult to calculate or unpredictable; c) the amount agreed on must be reasonable.⁸⁷ Therefore it is important to make a difference between the termination fee used as a contractual clause enabling a party to back out of the deal, and the termination fee that is intended to be used as liquidated damages in case the agreement is breached, while the latter is based on another standard. Drafting termination fees as liquidated damages can be used to bypass the application of Revlon duties and the business judgment rule, and therefore it has its own advantages.⁸⁸

4.6 Reverse Termination Fee

Recent years have introduced a new termination fee clause where the buyer pays the termination fee – a so called "reverse break-up fee".⁸⁹ It is used

84 Wachtel 1999, p. 590.

85 See e.g. Calleros 2006.

86 Law Library – American Law and Legal Information 2010.

87 *Ibid* and Swett 1999 as from the acquisition viewpoint.

88 Swett 1999, p. 343.

89 Quintin 2008, p. 276–277.

mainly by private equity funds (PEF) as an option to opt out from the deal for reasons such as when the finances are not available any more.⁹⁰ The deals where the PEFs are parties are structured differently from the deals where strategic investors are the buyers. The PEFs do not bear the risks at the same level with the strategic investors and therefore they need an option to back out of the deal when the circumstances change. One way the PEFs are using to minimize the risks is to distance themselves from the deal and use a shell company, provided with guarantees from the PEF to pay the reverse termination fee or the price of the target when the conditions precedent are satisfied.⁹¹ These agreements are also drafted in a way that enables no specific performance. Thus avoiding possible damage claims when the deal is not closed and leaving the reverse termination fee as a sole remedy to the seller.⁹²

5 Price Adjustment Mechanism

The acquisition agreements often contain purchase price adjustment clauses as a measure of risk allocation. A purchase price adjustment clause allows changing of the purchase price according to the change in value of the target during the interim period between signing and closing the acquisition agreement. Usually the value of the company changes due to business operations in their ordinary course, but the buyer might also need protection against the seller “looting” the company after the price has been determined.⁹³

The purchase price adjustment mechanisms are generally based on the working capital or net assets of the company.⁹⁴ Although the mechanism can be made using a net book value, tax liabilities, shareholders' equity, cash expenditures, net debt, net worth, cap-ex spending or number of customers as a benchmark. According to a survey that studied 43 publicly-filed purchase agreements entered into since January 1, 2003 with a transaction value in excess of \$50 million, and which contained purchase price adjustment provisions other than working capital, none of the purchase price adjustment

90 Kaye & Hinds 2009, p. 5.

91 Griffin 2009, p. 7.

92 *Ibid.*

93 Adel 2006.

94 Freeland & Burnett 2009c, p. 12.

mechanisms were used in more than 10% of the surveyed transactions.⁹⁵ However, the less used are often combined with the mechanisms that are based on working capital, outstanding debt being the most used.⁹⁶

Price adjustment mechanisms are used when there is a fundamental agreement between the parties as to the value of the target, but which is subject to change when the closing of the deal is placed in the future.⁹⁷ One intention of purchase price adjustments is to ensure that the seller is motivated to conduct the business between signing and closing in a way that is in the long-term interest of the buyer rather than the short-term interest of the seller.⁹⁸ These clauses combine both accounting and legal principles and therefore give ground for conflicts during the negotiation, drafting, interpretation and enforcement phase⁹⁹ and are often considered to be the most frequent source of post-closing disputes between parties to private company acquisitions.¹⁰⁰ It is examined below, whether purchase price adjustment clauses should be inserted in the agreement and if so, how they should be drafted.

5.1 Should Price Adjustment Clauses Be Inserted into the Acquisition Agreement?

As the price adjustment mechanism can work against both parties of the agreement, they should be carefully considered before being inserted into an agreement. According to *Mark B. Tresnowski*, at least four questions should be asked before adding price adjustment clauses into the agreement:¹⁰¹

1. Do you have a “closed system”¹⁰² in the acquisition agreement? In that case the parties usually do not need a working capital adjustment. Basically the need for a price adjustment mechanism exists when the seller can or wants to manipulate the working capital and cash before closing. When the value of the target cannot decrease,

95 Sinha & Elsea 2004, p. 18.

96 See generally Freeland & Burnett 2009c.

97 Walton & Krieb 2005, p. 8.

98 Freeland & Burnett 2009a, p. 9.

99 Tresnowski 2004, p. 14.

100 Freeland & Burnett 2009a, p. 9.

101 Tresnowski 2004, p. 17–18.

102 “Closed system” refers to the situation where the agreement does not contain elements whose value is subject to change in time.

then there is no need for purchase price adjustment clauses, because it probably raises the purchase price.

2. Can you defend a one-way adjustment provision? In that case you have nothing to lose and it will make sense to add it to the agreement, especially if you have an “open system”¹⁰³ in the acquisition agreement. But on the other hand you need to have a good negotiation position in order to insert a one-way adjustment provision, particularly considering the fact that working capital tends to increase over time.

3. If you are destined to have a two-way adjustment provision, in which way do you expect working capital to go in the ordinary course between signing and closing?

4. Is there a minimum level of working capital that the target business needs to operate efficiently? If there is and it is not present at closing then the buyer needs some more funding and that means that the actual purchase price is bigger than mentioned in the agreement.

Considering the answers, the buyer may find it desirable not to raise the issue of a purchase price adjustment provision in the agreement and rely solely on the representations, covenants and warranties of the agreement. In case the buyer wishes a price adjustment mechanism to be inserted in the deal, many aspects must be considered beforehand.

5.2 Object of the Measurement

The case law in the US has shown that it is to the seller’s disadvantage when assets subject to adjustment are mentioned broadly in price adjustment clauses.¹⁰⁴ As the price adjustment mechanism must provide a certainty to the parties of the possible outcome, general accounting principles (e.g. GAAP)¹⁰⁵ are just not precise enough for purchase price adjustments.¹⁰⁶

103 “Open system” refers to the situation where the agreement contains elements whose value is subject to change in time.

104 Freeland & Burnett 2009b, p. 13.

105 GAAP is a principle driven accounting system used in the USA. The problems concerning GAAP are similar to other principle driven accounting systems as well.

106 See generally: Freeland & Burnett 2009b

Roughly half of the agreements that had a working capital adjustment clause measured it using some variation of the standard GAAP definition of the “current assets minus current liabilities”.¹⁰⁷ Broad wording and therefore ambiguous meaning creates misunderstandings between parties and thus buyers might consider assets as part of working capital while the seller does not. For example, in *Mehiel v. Solo Cup Company*¹⁰⁸ court case in the US, the seller defined its Maryland facility as an “asset held for sale”, which is a current asset, because the seller intended to sell it. But when the buyer calculated the post-closing working capital, the \$5.6 million factory was not included because the buyer decided to hold it as a long term asset.

Therefore it is suggested to draft precise components of working capital in the price adjustment mechanism. One example is to include: 1. cash, 2. accounts receivable, 3. inventory and 4. prepaid taxes; and take off: 1. trade payables and 2. accrued expenses.¹⁰⁹ The same authors believe that the practice of enumerating the balance sheet components that will be included or excluded in working capital adjustments continues even at a higher level, because the GAAP gives no certainty of the outcome with respect to the purchase price adjustment mechanism.¹¹⁰

As all the necessary information is derived from the target’s latest financial statements and the earning trends reflected therein,¹¹¹ a problem may emerge in the assessment of whether the target’s statements are concluded in a way agreed upon. The aim of the buyer is that the pre-closing balance sheet is concluded in conformity with GAAP, but the seller would like to have the balance sheet drafted as it had been drafted before. Thus the purchase agreement will usually guarantee that pre-signing and post-closing balance sheets must be prepared consistently and in compliance with GAAP.¹¹² However, sometimes the buyer finds that the pre-closing balance sheet does not comply with GAAP and therefore, the buyer is not able to conclude a final balance sheet which is at the same time consistent with the pre-closing balance

107 Freeland & Burnett 2009b, p. 12.

108 *Mehiel v. Solo Cup Co.*, 2007.

109 Freeland & Burnett 2009b, p. 13.

110 Freeland & Burnett 2009c, p. 20.

111 Walton & Krebs 2005, p. 9.

112 Freeland & Burnett 2009a, p. 12.

sheet and in accordance with GAAP.¹¹³ In that case, the outcome of the price adjustment is uncertain and may depend on the circumstances.¹¹⁴ Therefore it is suggested to use the following wording in the price adjustment clause: “The final balance sheet is prepared in accordance with GAAP, applied consistently with the target company’s prior accounting practices to the extent such practices are in accordance with GAAP.”¹¹⁵

5.3 The Importance of Precise Language

Although purchase price adjustment provisions are seemingly quite simple, vague wording in price adjustment provisions can cause disputes not only in the measurement metrics but also in the arbitration and dispute resolution parts. Therefore precise language is very important in drafting the relation between price adjustment and indemnification.¹¹⁶ If the relation between them is not clear, it can cause uncertainty of the result as the *Westmoreland Coal v. Entech*¹¹⁷ case in the US has shown. In the case the seller had concluded a pre-signing balance sheet that was not in conformity with GAAP and therefore the buyer wanted adjustments in the purchase price. The seller advocated that it was a matter of the indemnification and the dispute should be settled in court instead of using the arbitrator as the acquisition agreement designated in case the price adjustment dispute would arise. The court’s analysis showed that it considers the acquisition agreement in its entirety and does not concentrate solely on the price adjustment clauses and therefore, the interplay between price adjustment clauses and indemnification part of the agreement must be made clear in order to grant a foreseeable result.

At the same time the methods that are used to evaluate the assets must be clearly defined. There are many methods that can be used to assemble a balance sheet and the result will be the same, although these methods may give different results when you compare certain accounts. GAAP provides many different principles and methods for accounting and thus, using general ref-

113 *Ibid.*

114 *Ibid.*, p. 12-13.

115 *Ibid.*, p. 13.

116 Freeland & Burnett 2009b, p. 13.

117 *Westmoreland Coal Co. v. Entech, Inc.*, 2003.

erence to the GAAP in price adjustment clause may lead to a dispute after closing. This uncertainty of outcome may work against both parties.¹¹⁸ As an example of difficulties, in *Twin City Monorail v. Robbins & Myers*¹¹⁹ case in the US, the parties had agreed to use the methods provided by GAAP for evaluating the inventory. However, as the GAAP enables the use of several methods, the buyer had the firm opinion that LIFO (last in, first out) was the right one to use while the seller advocated for FIFO (first in, first out), which made a difference of \$700,000. Therefore in the agreement it should be precisely drafted what method to use and sometimes it can be as easy as: “inventory will be valued at the lower of cost or market, using the LIFO method of valuation”.¹²⁰

Concluding the price adjustment clauses, a lawyer should also consider, for example, how much authority will be given to the arbitrator. Does the arbitrator solve disputes only concerning the accounting matters or all the matters with regards to the price adjustment?¹²¹ Also, it must be considered when the price adjustment should be delivered to the seller. If the agreement states that the seller should be given no more than 15 business days after the buyer has received all *necessary documents*, then these documents must be stated as well.¹²²

6 Summary

Mergers and acquisitions are complicated transactions. M&A agreements tend to be large and complex documents in which the parties allocate the risks associated with the deal. There are many contractual mechanisms that enable the parties to allocate risks as agreed.

The MAC conditions enable the allocation of the risks between the parties using the “material adverse change” as an indicator for opting out of the agreement. Exceptions to the MAC are possible and quite common. A lawyer, drafting a MAC clause in the agreement, should make clear whether

118 See generally: Freeland & Burnett 2009a and Freeland & Burnett 2009b.

119 *Twin City Monorail, Inc. v. Robbins & Myers, Inc.*, 1984.

120 Freeland & Burnett 2009a, p. 14.

121 Freeland & Burnett 2009b, p. 13.

122 *Ibid*, p. 14.

material adverse change must have taken place, would take place or could take place in order to enable the party not to close the deal. Also, it must be considered whether changes in the company's prospects can be a reason for triggering the MAC. As the main issue in litigations that concern MAC clauses has usually been whether the adverse change is of sufficient magnitude to count as a material adverse change within the meaning of the agreement, the parties must clearly stipulate when the change is material enough. Parties must also agree whether the adverse effect is to be measured on the basis of its aggregate impact on the target or in an isolated fashion, not taking its subsidiaries into account.

A termination fee is a sum of money paid by the seller to the potential buyer of a business in case the agreed transaction fails to close for reasons covered in the acquisition agreement. The termination fee clauses therefore protect the buyer's investments made during the negotiations and after signing. Recent years have introduced the usage of reverse termination fee – in that case the buyer pays the agreed amount of compensation if it decides not to close the deal. As the termination fee has a great impact on the party who is obliged to pay it, it is often under dispute in courts. Concluding a termination fee in the M&A agreement, a lawyer should consider how big the termination fee should be – if it is too high, the courts can lower it. In order to avoid disputes, it would be wise to state it clearly in the agreement when the payment of the termination fee is triggered. If the termination fee is concluded in the agreement as a liquidated damage, then in order to be a valid provision in the common law jurisdiction, some additional requirements must be considered as well.

A purchase price adjustment mechanism allows the changing of the purchase price according to the change in the value of the target during the interim period between signing and closing the acquisition agreement. As the price adjustment mechanism can work against the party who insisted to add it into the agreement, the need for the mechanism must be considered well beforehand. Although the price adjustment mechanism is a good way to ensure the seller is motivated to operate the business between signing and closing in a way that is in the long-term interest of the buyer, rather than the short-term interest of the seller, many aspects must be made clear

before agreeing to include the price adjustment clause into the agreement. It is suggested to define the object of the measurement precisely in order to avoid later disputes. Precise language is very important at drafting the relation between price adjustment and indemnification and the methods that are used to assess the assets must be clearly defined as well.

All abovementioned methods enable lawyers to draft a agreement with relevant risk allocation between the parties, although every method has its own issues to consider in order to achieve a result that is both suitable and predictable for the client. Probably the simplest way to manage at least some risks is to use a termination fee clause in the agreement which enables the buyer or the seller to get a specified amount of cash in case the other party ends or breaches the agreement. MAC clauses are suitable in agreements when economic or market factors may affect the value of the deal dramatically, and where the risks must be somehow allocated between the parties. However, in cases where the value of the company's assets varies seasonally or there are other reasons the value of the company might change, price adjustment clauses are used to define the process of pricing and thus enable an adequate result for both parties. Quite often all of these methods are used together in the agreement, and the recent financial crisis is probably a reason why these mechanisms will have a growing importance in M&A deals.

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