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The Hangover: 2011 in Review and What to Expect in 2012

BY FRANK AQUILA AND MELISSA SAWYER

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As of early November, five of the top six grossing movies of the year were sequels. And 2011 felt very much like a sequel of 2009: familiar characters and similar plot devices. The markets continue to be volatile and many fear that things will not return to normal until after the next presidential election. Others are predicting that European M&A will not make a comeback until many of us have retired. This is our annual survey in which we weigh in on the key trends in the preceding year and make our predictions of what to expect in the year to come.

Just Go (Down) With It: Riding the Down Cycle

In January 2011, we were optimistic about M&A's prospects. Corporate buyers had cash on their balance sheets to do deals. Private equity funds could borrow at historically low rates on borrower-friendly terms and we thought they would come under pressure from their limited partners to deploy committed equity before their funds expired. We speculated that funds would want to crystallize gains by selling interests in portfolio companies. We also expected to see a lot of outbound investments into emerging markets.

Our optimism continued to build during the first quarter of 2011 as several large transactions were announced, including Duke Energy/Progress Energy, AMB Property/ProLogis, NYSE Euronext/Deutsche Boerse and AT&T/T-Mobile.

Unfortunately, things went mostly downhill from there.

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UK Merger Control: Longer, More Costly and Is It Really Still Voluntary?

Companies and their advisers should think twice before deciding not to notify their deal in the UK. If they choose not to notify it, there is a good prospect that the UK Office of Fair Trading will in any event review the deal, perhaps after it has closed, and possibly cause a costly disruption to the integration process.

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Allocating Financing Control and Risk in Sponsored Joint Ventures

As both seller and buyer in a sponsored joint venture scenario are concerned about the terms of any financing, and the impact of those terms on the venture post-closing, provisions designed to incentivize or force the buyer to accept financing upon less favorable conditions are not necessarily favorable to the seller. As a result, sellers will need to explore alternatives to the customary approaches to financing risk allocation.

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From the EDITOR

The Year That Wasn't

"The stage could be set for the long-awaited boom year in 2011." That's how this column began in our November/December 2010 issue. And at the time, a recovery seemed like a sure thing. As Sullivan and Cromwell's Frank Aquila and Melissa Sawyer write in their annual year-end review, as 2011 began, everything seemed in place for an M&A boom. Corporate buyers were flush with cash. Private equity funds could borrow at historically low rates and were facing pressure from limited partners to put equity to work. The emerging markets looked ripe for investment.

And for a time the prediction seemed to hold, as the early months of 2011 were filled with major deals, from Duke Energy/Progress Energy to the union of NYSE Euronext and Deutsche Boerse to the proposed AT&T/T-Mobile merger (which as of press time was close to collapsing).

Then, through the spring and summer, the global economy's tepid recovery stalled, uncertainty grew and deal announcements slowed. The Japanese earthquake, the political chaos of the Arab Spring, the ongoing slow-motion debt disaster in Europe, and political gridlock and continual high unemployment/low growth in the U.S. proved a toxic combination. Some pessimistic analysts predict that if a worst-case scenario occurs in Europe—say an Italian default or Greece leaving the euro—a second recession seems a certainty.

So what can M&A professionals do if the market stays in a lull next year? Aquila and Sawyer note that there are still a number of areas requiring legal attention. For example, determining and reducing FCPA risks remains a critical function for M&A lawyers. The recent *Del Monte* decision is making companies focus far more closely on the role of investment bankers in M&A transactions. The recent *Southern Peru* case shows that courts will continue to put special committees under the microscope, which means that lawyers can help a target ensure that its special committee and sale process are as "bullet proof" as possible.

And as Aquila and Sawyer note, there are still viable areas for merger activity in the new year, despite economic uncertainty. Long-planned break-ups of conglomerates ranging from McGraw-Hill to ConocoPhillips will generate a steady run of spinoff and IPO activity in the new year. The Hong Kong and Chinese markets also remain viable prospects.

In our other review article, Skadden, Arps' Marc Gerber looks at the past year in corporate governance. By contrast to the economic picture, "the state of U.S. corporate governance at the end of 2011 has an initial allure," Gerber writes. Say-on-pay issues seemed relatively under control: "with companies receiving an average of 92% of shares voted in favor, one might conclude that shareholders are happy with executive compensation." And in those companies where investors had voiced concerns about executive compensation, "they expressed those concerns in the say-on-pay votes rather than voting against compensation committee members." A federal court vacating the SEC's mandatory proxy access rule was also a relief for directors.

But directors shouldn't exhale just yet. Gerber notes that 2012 will have its own set of challenges, from new battles on say-on-pay and proxy access to the specter of new Dodd-Frank rules to the revival of an "old storyline—the role of auditors and the relationship between auditors and their audit clients," he writes.

This is the final issue of *The M&A Lawyer* for 2011. Have a happy and safe holiday season. We'll be back early in 2012, a year that one can only predict will be unpredictable.

CHRIS O'LEARY
MANAGING EDITOR

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The Ides of March

The events exerting downward pressure on the markets, and M&A in particular, included the following:

Sweeping unrest and political changes caused massive instability in the Mideast.

The earthquake and tsunami in Japan had an immeasurable human cost, and they also froze the Japanese economy and had an immediate impact on the global supply chain.

European countries (including Greece, Italy and Portugal) teetered on the brink of default. As of the writing of this article, those sovereign debt issues remain very much at the forefront of macroeconomic concerns, with all of the associated currency issues, opacity about the potential impact on financial institutions that hold sovereign debt and a generally dismal economic outlook in Europe. Notwithstanding central bank intervention, the situation is far from being under control. Furthermore, it has become clear that austerity plans were too little, too late. Even if the immediate risks abate, the markets now have more insight into the desperate situation of countries that have rapidly aging populations, early retirement ages and under-funded public pension systems.

In the U.S., we experienced prolonged levels of high unemployment with stagnant demand and consumer malaise. The mounting budget deficit, the inability to "fix" Social Security and Medicare, the political theater over the debt ceiling and the S&P downgrade of U.S. treasuries only exacerbated already extraordinarily volatile market conditions. Investors raced for shelter in gold and commodities instead of debt and equity. Meanwhile, fundamental tensions in mortgage markets and financial institution liabilities that surfaced during the credit-crisis continued to have a chilling effect on the mortgage securitization market, stripping the economy of a much needed lubricant.

Add to that litany of woes a few M&A-specific concerns:

- Regulatory uncertainty, as evidenced by the long wait for the final version of the Volcker Rule and the regulator's negative reaction to the announced AT&T/T-Mobile transaction;
- the public's negative reaction to the prospects of health care reform;
- rumors (that proved to be accurate) of a potential bankruptcy of another airline (American);
- the collapse of MF Global and the resulting fall-out;
- hints of a permanent climate change that could result in repeat Irene-like threats to submerge Wall Street under water; and
- the fact that a single rogue trader can still circumvent a major investment bank's (UBS') fraud protection systems to lose $2 billion dollars in a very short amount of time.

On the other hand, viewed in a more positive light, 2011 could have been a lot worse. Although the market dropped 400 points in a single day, on other days it also traded up hundreds of points in a single hour. Despite the lousy deal-making climate, we still saw some big deals, including Express Scripts/Medco, Google/Motorola Mobility, and BHP/Petrohawk. We also continued to see unsolicited bids, such as Icahn/Clorox, SAB Miller/Foster's Group, and the continuation of the Dollar Thrifty/Avis/Hertz deal. Neither the inflation rate nor the unemployment rate are moving up as quickly as once feared.

Insidious Contagion: Europe's Woes Continue to Sweep Through the Global Markets

What can we expect in 2012? Until the Eurozone sovereign debt mess abates and the U.S. markets settle into a more predictable rhythm, we think 2012 will be a very slow year for deal making. The big bank deals that carried deal makers through the credit crisis probably will not reemerge until after we all get more experience with Dodd Frank. The multitude of small private deals that kept us busy in 2010 are probably going to take longer and be harder to complete given the difficulties of getting financing and uncertainty about business prospects. Leveraged deals, includ-

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ing "going private transactions," will be virtually non-existent until the credit markets reopen.

That being said, there are still a few potential areas of M&A activity.

- Several big conglomerates have announced break-ups that could spur deals, including Tyco, Fortune Brands, McGraw-Hill, and Kraft. We expect to see more of these announcements in 2012 as boards and management teams seek ways to create shareholder value. The deals could be structured as spin-offs or asset or stock divestitures.

- Although the IPO markets are almost completely stalled in the U.S., the Hong Kong, and China markets continue to be very active. Some private companies may start dual-track processes seeking to sell themselves or IPO on one of those exchanges. It is not clear whether the relative exuberance about Chinese listings will continue in the face of recent Chinese government intervention in a failing state-owned bank and increasing scrutiny of the accounting practices of Chinese public companies. However, the economic fundamentals of China as a consumer market and production venue remain enticing to many companies that may be looking to expand their operations or markets.

- Shareholder activists like Carl Icahn and Bill Ackman continued to play big roles in some major M&A activities. It seems they can be counted on to shake things up in a wide swath of industries.

The Dilemma: What Can a Deal Lawyer Do in a Volatile Market?

We think that M&A advisors will find the advisory side of their practice very busy, even while the deal-making side remains relatively stagnant. Companies are spending more on advisors to analyze the economic and reputational risks that can surface during deals. Recently, they have been focused on the following topics, among others:

- *Financial advisor conflicts of interests*. In the wake of the *Del Monte* decision, parties are focusing more closely on the role of investment bankers in M&A transactions. Financial advisor engagement letters are being customized to a greater degree and directors are spending more time building a record of their due diligence of banker's relationships with other parties involved in the deals.

- *Special committees*. Courts continue to scrutinize special committees very closely, as evidenced by the recent *Southern Peru* case. Lawyers can add tremendous value by helping a target to structure a bullet-proof special committee and sale process.

- *FCPA risks*. The recent pick-up in FCPA enforcement activity has made it imperative that buyers fully understand a target's FCPA policies and compliance record. Even for targets with relatively clean FCPA records, buyers need to make sure they can integrate the target in a manner that will allow them to monitor and address any FCPA issues that may arise post-closing.

- *Regulatory approval requirements*. Some might argue that we are experiencing a new era of protectionism. For example, China has signaled that it will apply its competition laws to deals that have a limited Chinese nexus, and the U.S.'s CFIUS continues to review of a broad range of transactions. Further support for this hypothesis has been expressed in some of the commentary that followed the collapse of the NYSE's bid for the TSX, which opened the door for the "Maple Consortium" bid, and by the U.K. Takeover Code amendments that were precipitated by the Kraft/Cadbury deal. Even without applying a pejorative "protectionism" label, we think it is fair to say that cross-border deals are getting increasingly complex. In our view, navigating the interplay of stock exchange rules and regulations across multiple jurisdictions requires more expertise, time and advance planning than ten years ago. While this unfortunately increases costs and delays for clients, it also creates opportunities for rival and

hostile bidders to use technical regulatory requirements to their strategic advantage.

- *Criminal liabilities*. We have been seeing a step-up in SEC enforcement activity against individuals in some very high profile insider trading cases and cases that grew out of the mortgage crisis in 2008. These risks quickly get the attention of very senior executives and deal lawyers are increasingly being asked to weigh in on questions around disclosure requirements, share buy-back timing and trading black-outs, among others.

- *Intellectual property issues*. Over the past four to five years, we have observed a steady increase in high profile litigation over intellectual property issues (as any Blackberry user can attest). Our sense is that both strategic and financial buyers are more alert than ever to the risks associated with imperfect ownership of IP. They are spending more time at the outset of the deal discussing structures to protect their rights in acquired IP and structuring remedies for imperfections in title. This is another area where expertise in cross-border transactions can be particularly helpful, because the menu of available options varies depending on the jurisdictions involved from deal to deal. If the pharma and biotech industry consolidation continues to expand internationally, for example, expertise in patents will be highly valued.

- *Emerging markets*. China continues to buy up commodities and natural resources, especially in Africa and Latin America. Increased investment in those countries could have long-term political and economic impacts. Among other things, over the next decade we could see significant changes in tax policies and the opening of new markets for consumer goods. In 2012, we may see more companies, especially in such businesses as wireless telecom and money transfer, try to establish themselves more firmly in emerging markets to lay the groundwork for future growth opportunities.

- *Innovative M&A closing risk allocations*. In the face of regulatory uncertainty and potentially long timelines for closing, together with unpredictable credit markets, we expect we will continue to see technical innovations in the way in which parties allocate closing risks in deals. Specifically, we may see new ways that parties are "splitting the baby" when it comes to financing risk, reverse break-up fees and specific performance. By the same token, we may see some changes in the traditional package of deal protections, recognizing that any innovations in that particular field will likely get litigated in Delaware Chancery Court.

In Time

Although 2011 has been a disappointment to the deal community, it has not been a completely lost year. What is most important is that buyers, both strategic and financial, have the financial strength and strategic need to make acquisitions. If there is stability in the capital markets and an increase in growth, we should expect to see increasing levels of M&A in 2012. All good things come to those who wait. See you in 2012.

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U.S. Corporate Governance: Fasten Your Seatbelts, Turbulence Ahead

BY MARC S. GERBER

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As directors of U.S. public companies look around, they may see a glass half full or a glass half empty. For many companies, profits are up and they have a large stockpile of cash. On the other hand, the Federal Reserve forecasts sluggish growth and continued high unemployment, U.S. markets zigzag based on concerns over Europe's sovereign debt crisis, the U.S. has its own debt challenges and Occupy Wall Street protesters have a presence in cities around the country and indeed the world.

Looking for good news wherever they can find it, the state of U.S. corporate governance at the end of 2011 has an initial allure. The corporate governance space was dominated by "say-on-pay"—shareholder advisory votes on executive compensation. And with companies receiving an average of 92% of shares voted in favor, one might conclude that shareholders are happy with executive compensation. Relatedly, at companies where investors did have concerns about executive compensation, they expressed those concerns in the say-on-pay votes rather than voting against compensation committee members. And the icing on the cake—in July a federal court vacated the SEC's mandatory proxy access rule. Directors can exhale. Or can they?

In exploring the corporate governance themes that we anticipate will be significant for 2012—and that are likely to cause some turbulence along the way—many of the same storylines of 2011 will continue to unfold: say-on-pay may get more challenging, the battle over proxy access will move to its next phase and Dodd-Frank rulemaking will impose burdens. In addition, an old storyline will be revived—the role of auditors and the relationship between auditors and their audit clients.

Say-on-Pay

In many ways, say-on-pay in 2011 can be viewed as a success. The 2011 votes, however, were just the first steps in a longer, multi-step process. For some companies, the next steps are clear. For many other companies, the biggest risk may be complacency. Having successfully navigated say-on-pay in 2011, companies and boards of directors need to understand how the landscape is changing so that they can continue to be successful in 2012.

2011 Recap

Proponents of say-on-pay expressed, as one of their goals, the desire to achieve greater levels of engagement with companies concerning executive compensation. They were successful. Based on surveys, as well as anecdotal evidence, more companies sought engagement with their institutional investors and many companies went deeper down the list of investors, in terms of size of shareholdings, with whom they engaged.

Engagement also took the form of improved proxy disclosure, with companies using a variety of techniques to articulate in their proxy statements how their executive compensation was consistent with a pay-for-performance policy. In addition to charts and graphs, many companies added an executive summary to their Compensation Discussion & Analysis (CD&A) and some companies created a proxy statement summary that crystallized all of the critical information for shareholders in just a few pages. Another interesting development was the trend of companies, typically in response to negative ISS recommendations on say-on-pay, to publish additional proxy materials to take issue with ISS' recommendations and emphasize the companies' views.

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Finally, when companies viewed it as appropriate, they made changes to executive compensation plans and policies that increased the likelihood of a successful say-on-pay vote. In some cases those changes were adopted early enough to be incorporated into the company's initial proxy disclosure and ISS' initial voting recommendations. In other instances, the changes were made closer to the annual meeting date in reaction to ISS' negative voting recommendations coupled with the feedback companies received from engaging with their institutional investors.

In terms of voting results, based on ISS data, investors heavily supported companies' executive compensation, with an average vote of 92% of votes cast in favor. In fact, only about 40 companies failed to achieve majority support for their executive compensation (with approximately another 170 companies receiving only lukewarm support—more on that later).

The other new vote in 2011 was the "say-on-frequency" vote—a shareholder advisory vote on the frequency of future say-on-pay votes. Based on voting results and company announcements, it appears that the vast majority of companies—approximately 95% of S&P 500 companies and 80% of Russell 3000 companies—will be holding say-on-pay votes on an annual basis.

The 2012 Proxy Season

Every company, regardless of 2011 voting results, will need to evaluate how its executive compensation has changed during the year, how the company has performed and how the company can improve its proxy disclosure and engagement/communication efforts to secure a favorable say-on-pay voting result for 2012.

Another important element in planning for the 2012 say-on-pay vote will be assessing whether and, if so, how the yardstick used by a company's institutional investors and ISS may have changed from last year. Will institutional investors take a harder line in 2012? For ISS and many institutional investors, pay-for-performance concerns were the critical issue in deciding how to vote on say-on-pay. It is noteworthy that ISS is proposing to revise its approach to analyzing pay-for-performance. ISS states that it does not anticipate a change in the percentage of negative say-on-pay recommendations it issues (which was approximately 11% of companies in 2011) but that the set of companies identified as having a pay-for-performance misalignment "may differ somewhat" under its proposed methodology.

In addition to the need for all public companies to refresh their say-on-pay self-analysis and map out their engagement strategy accordingly, there are some companies that are "behind the eight ball" and may need to exert greater effort to achieve a successful say-on-pay vote in 2012. Those companies include the roughly 40 companies who failed the 2011 say-on-pay votes. Beyond those easily identified companies, the more difficult question is knowing the point at which the level of dissent received was meaningful enough that extra efforts should be employed and an explicit response is considered advisable. ISS has noted that 86% of investors who responded to its survey believe an explicit company response is called for if the prior say-on-pay vote received more than 40% opposition, and 72% of investors feel the same at companies that received more than 30% opposition. On the other hand, fewer than half of the issuer respondents believed an explicit response was called for in the case of 30% opposition on the prior say-on-pay vote. In connection with revising its voting policies for 2012, ISS has requested comment on where to draw this line. This debate provides notice to another 170 companies or so (and, in particular, to the members of their compensation committees) that simply getting a majority vote may not be sufficient to satisfy investors when the vast majority of companies are receiving shareholder support for executive compensation at or above the 80% level.

Wherever this line ultimately is drawn, ISS and institutional investors will be asking themselves whether companies below that line, and directors of those companies, have been responsive to investors' concerns. In ISS' proposed policy, it notes that it is looking for "concrete actions" in terms of changes to compensation practices, as well as disclosure of the company's engagement efforts with major institutional investors on

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compensation issues. This ISS proposal dovetails with an SEC disclosure requirement that will apply to most companies for the first time in 2012. As part of the CD&A, companies must disclose whether they considered the most recent say-on-pay voting results and how that consideration affected their executive compensation decisions and policies.

ISS has proposed that the response, or the lack of a response, to a high level of dissent on say-on-pay factor into its voting recommendations not only for the 2012 say-on-pay vote but also for how shareholders should vote with respect to compensation committee members. While there was a significant decline in opposition to directors in 2011, attributed to shareholders' ability to express displeasure over compensation matters in the say-on-pay vote, that decline may turn out to be a one-year phenomenon as compensation committee members standing for re-election will again be subject to high negative votes if they are viewed as unresponsive to investor concerns over executive compensation.

Proxy Access

A significant negative vote for a director—whether arising from a perceived lack of responsiveness to a negative say-on-pay vote or due to other investor concerns—can certainly be a complication many companies would prefer to avoid. That complication could grow exponentially if it heightens the risk that directors will face a short-slate proxy contest the following year. A system of "proxy access" would do exactly that. Proxy access would allow some universe of qualified shareholders (including many who, under the current regulatory structure, are not likely to engage in a proxy contest) to include their chosen director candidates in the company's proxy materials, thereby creating an election contest. As a result, even the threat of a proxy access nomination has the potential to have a significant impact on boardroom decision making.

In August 2010, the SEC adopted a "one size fits all" proxy access rule that would allow a shareholder or group of shareholders holding at least three percent of a company's shares for three years, and nominating candidates for up to one quarter of the total number of board members, to have its nominees included in the company's proxy materials. That rule was challenged by the Business Roundtable and U.S. Chamber of Commerce and vacated by the D.C. Circuit Court of Appeals in July 2011.

The SEC also adopted an amendment to Rule 14a-8 (the shareholder proposal rule) to allow proxy access shareholder proposals. Embracing the notion of "private ordering"—letting boards and shareholders decide what level of proxy access (if any) is appropriate on a company-by-company basis—the Business Roundtable and Chamber of Commerce did not challenge this rule change, and the amendment to Rule 14a-8 became effective in September 2011. Accordingly, the ongoing battle for proxy access shifts from the battlefields of legislation and regulation to the "urban warfare" model of block-by-block, or in this case company-by-company, skirmishes.

Many tactical questions remain unanswered on both sides of the proxy access question. Will the proponents of proxy access shareholder proposals be large institutional investors who submit proposals to a carefully selected handful of companies with perceived poor governance profiles? Or will the proponents be "activist" individuals who submit proxy access proposals to scores of S&P 500 companies seeking to establish a market standard? Will the proposals take the form of binding bylaw amendments or will they be precatory proposals urging boards to adopt proxy access? Will investors only support proposals that closely follow the SEC's three year and three percent parameters or will investors vote for proxy access proposals containing thresholds as low as one year and one percent?

Although it is likely that all or most companies receiving a proxy access shareholder proposal will oppose it (assuming they are unable to exclude it from the proxy statement), a company's response will need to be the result of deliberation after considering the actual facts and circumstances, including the terms of the proposal and the company's shareholder base. Will we see companies propose board-sponsored proxy access proposals with large and lengthy holding requirements?

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It is possible that the answers to many of these questions may take multiple proxy seasons to fully develop. In any event, it appears that proxy access has the potential to become a standard corporate governance shareholder proposal "menu item"—joining topics such as board declassification, shareholders' right to call special meetings, shareholders' right to act by written consent and elimination of "poison pills"—selected by institutional investors, particularly labor unions and public pension funds, to make their presence felt in boardrooms across corporate America.

Dodd-Frank Act

As the Dodd-Frank Act was enacted sixteen months ago and say-on-pay and proxy access were topics addressed in the statute, corporate officers and directors could be excused for believing that all of the rules implementing the corporate governance provisions of Dodd-Frank must be in place by now. Alternatively, for those paying closer attention, it is understandable if they believe rules to implement Dodd-Frank's corporate governance provisions are a perpetual topic of discussion that will never actually happen. The fact that the SEC still has a substantial "to do" list with respect to Dodd-Frank implementation is a function of the significant amount of rulemaking Dodd-Frank required and the complexity of the issues. And even though the SEC is giving due consideration to the many viewpoints expressed on a variety of topics, at the end of the day the SEC's hands may be tied by the language in the statute. Of the various governance-related rulemakings still to come, the three that may have the greatest potential to burden public companies relate to: (1) disclosing the ratio of CEO compensation to median compensation paid to all other employees, (2) clawback policies to recoup executive compensation in the event of a financial restatement (even absent misconduct) and (3) conflict minerals disclosure.

In the case of pay ratio disclosure and clawback policies, the current SEC schedule indicates that rules will be proposed by the end of 2011 and adopted by June 2012. Although those rules may not impact the 2012 proxy season, companies should continue to monitor developments and be ready to comment on the proposed rules. The pay ratio disclosure may result in significant data collection and analysis costs and appears likely to result in disclosure that may appeal to the press and labor activists but be of little use to investors. The clawback policy rules may result in compensation committees and boards of directors losing the discretion they currently possess under most company-adopted clawback policies and require companies to engage in costly and distracting litigation with current or former employees in the event of a restatement where the potential recoupment is far outweighed by the direct and indirect costs of recovering the funds.

The conflict minerals provision of Dodd-Frank represents an attempt to solve a geo-political problem on the backs of U.S. corporations. Rules have been proposed and final rules could be adopted before year-end. As a result, companies may soon be required to determine whether columbite-tantalite (coltan), cassiterite, gold or wolframite are necessary to the functionality or production of their products and, if so, to determine whether any of the minerals used by the company may have originated in the Democratic Republic of the Congo or any neighboring countries. Companies may have to engage in costly and burdensome supply chain due diligence in order to make the necessary determinations and then disclose their conclusions on their websites or SEC filings, disclosure that may be of little or no benefit to investors.

Auditors

When the Sarbanes-Oxley Act was adopted in 2002, reforming the auditor-audit client relationship was viewed as a critical step in restoring investor confidence. A new regulator, the Public Company Accounting Oversight Board (PCAOB), was created and various rules were adopted to strengthen the independence of auditors and of audit committees. So far, auditors have generally avoided becoming the topic of new legislation and regulation in the aftermath of the financial crises that gave us Dodd-Frank.

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The questions for 2012 are whether that is about to change and, if so, how will any changes impact public companies and investors. In August 2011, the PCAOB issued a concept release on auditor independence and mandatory audit firm rotation. As described by the PCAOB, the idea of audit firm rotation has been considered at various points since the 1970s. The PCAOB concept release follows the issuance in October 2010 of a European Commission "Green Paper" entitled "Audit Policy: Lessons from the Crisis" that also explores the role of auditors and their independence, including the notion of mandatory audit firm rotation. Various reports and studies, however, have indicated that mandatory audit firm rotation would impose costs on companies and may cause audit quality to suffer in the early years of a rotation.

The PCAOB also issued a concept release in June 2011 exploring potential changes to the auditor's reporting model, such as requiring an "Auditor's Discussion and Analysis," expanding the scope of the auditor's report and otherwise expanding the auditor's reporting of information outside the financial statements. In addition, the PCAOB recently proposed amending accounting standards to require disclosure of the engagement partner's name in each audit report. Separately, the PCAOB publicly released a previously confidential portion of an inspection report critical of a Big Four accounting firm, the first time the PCAOB has done so.

Although it may be too early to know whether all this activity will result in new regulations, some of the proposals, if adopted, could have a profound impact on audit firms as well as on public companies. Accordingly, companies and audit committees should monitor these developments diligently and be prepared to comment on any proposed rules that they believe would negatively impact the ability of companies to produce high-quality financial statements and other disclosures that can be relied upon by investors.

Conclusions

U.S. companies remain resilient. Nevertheless, the cumulative effects of legislative and regulatory reforms, no matter how well-intentioned, create challenges for companies as they navigate the current slow-growth economy. Add to that the tension between stock market volatility due to macro-economic factors and the potential negative impact on investors' returns, on the one hand, against the imperative to attract, motivate and retain high quality executive talent, on the other hand. And for good measure, mix in the prospect of more challenging say-on-pay votes and the prospect of proxy access. As we enter 2012, fasten your seat beats: there is likely to be turbulence ahead.

UK Merger Control: Longer, More Costly and Is It Really Still Voluntary?

BY MATT EVANS

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M&A lawyers usually include a condition precedent that the deal be filed and cleared in all jurisdictions which require prior filing and clearance. UK merger law operates a so-called voluntary system, whereby merging parties can complete and implement their deal without notifying the authorities. In light of this, many sellers try to insist that deal completion must not be conditional upon UK merger clearance.

The UK Government is currently considering reforming UK merger control, including the possibility of making merger notification mandatory for deals meeting jurisdictional thresholds and forbidding implementation of such deals prior to receipt of UK merger clearance. In theory, this would mark a step change in UK merger control, with important consequences for M&A lawyers and merging companies as regards deal timeta-

bles and costs. In practice, however, the regulator's approach to taking jurisdiction over deals in 2011 raises the question of whether there is already something approaching a *de facto* mandatory notification system in operation.

Companies and their advisers should therefore think twice before deciding not to notify their deal in the UK. If they choose not to notify it, there is a good prospect that the UK Office of Fair Trading (OFT) will in any event review the deal, perhaps after it has closed, leading to potentially costly disruption to the integration process. What's more, the review process under UK merger control has become lengthier and more costly than used to be the case. This should be taken into account when establishing at the outset the likely deal timetable and advisers' fees.

Background to UK Merger Control

Merger control powers in the European Economic Area (EEA)[1] are divided between the European Commission (the Commission) and national competition authorities. As a general rule, the Commission gains exclusive jurisdiction within the EEA over mergers, acquisitions and joint ventures between parties whose annual worldwide and European Union (EU)—wide sales meet the thresholds set out in the EU merger regulation (EUMR).[2] In cases where the EUMR notification thresholds are not met, merging parties must check the national thresholds.

In the UK, the OFT has the power to assess a deal if either the target's annual UK sales exceeded £70 million in the previous financial year (the Turnover Test) or both the acquiring corporate group and the target purchase or supply the same category of goods or services in the UK or part of the UK and between them account for a 25% or more share (the Share of Supply Test). The OFT is under a duty to refer a deal to the Competition Commission (CC) for an in-depth review if it believes it to be the case that a transaction may be expected to result in a substantial lessening of competition.

Unlike most jurisdictions with merger control laws, in the UK merging parties can complete and implement their deal without notifying the OFT. Whether or not a completed deal is notified, the OFT has four months from the date that the deal was made public or, if not publicized, from the date that it was brought to the OFT's attention, in which to decide whether to refer the deal to the CC for an in-depth review. The OFT actively seeks out qualifying deals that have not been notified to it and employs members of staff to monitor national and local press and industry journals for news of deals expressly for this purpose. Where it identifies such deals, it sends a standard enquiry letter to the acquirer asking for information to help it assess whether the Turnover or Share of Supply Tests are met and, if at least one of them is met, the OFT also asks for information typically included in a merger notification.

UK Merger Review Process

From the date of notification, the OFT has a non-binding 40 working day timetable in which to decide whether to clear a completed deal unconditionally, clear it subject to agreeing with the acquirer "undertakings in lieu" (usually a divestment), or refer it to the CC for an in-depth review. Where the OFT reviews a deal that has not yet completed, it is open to the parties to use a notification format which imposes a 20 working day timetable on the OFT (the OFT can, and usually does, extend this by 10 working days).

During the OFT's review, if the OFT has not been able to rule out one or more material competition concerns about the deal within about five weeks, it will decide to hold an internal "case review meeting" (CRM). Prior to the CRM, the OFT will invite the merging parties to an "Issues Meeting" and, in advance of that meeting, will send an "Issues Letter" to the merging parties, setting out the principal arguments in favor of a reference to the CC and summarising those hypotheses the OFT is still considering. The parties will usually prepare a written response to the Issues Letter and may choose to give a presentation at the Issues Meeting.

If the OFT refers an anticipated but not yet completed deal to the CC, the parties may not complete the deal before the CC has cleared it.[3] If the OFT refers an already completed deal to the

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CC, however, then the buyer must hold the target separate from the rest of its businesses. This could involve parachuting in a new management team, who will be financed by, but otherwise independent of, the buyer. This process is almost always costly and highly disruptive to business operations. The hold separate arrangements are usually overseen by a third party "monitoring trustee" appointed by the CC and paid by the buyer. The monitoring trustee must report regularly to the CC on the buyer's compliance with its hold separate obligations. The CC's review period lasts 24 weeks and can be extended by up to eight weeks.

Signs of a More Aggressive OFT Approach Towards Completed Deals

It has generally been the case that if a deal met the Turnover Test but not the Share of Supply Test, acquiring parties were often willing not to make completion of the deal conditional on UK merger clearance. This was because, unless the parties were important actual or potential customers or suppliers of one another, it was unlikely that the deal may be expected to result in a substantial lessening of competition. In such cases, even if the OFT decided to take jurisdiction over the completed deal—whether as a result of a voluntary notification or an OFT enquiry letter—the merger review process would be relatively painless and would not be expected to interfere with the post-completion task of integrating the merging businesses.

Interference from the OFT means, in this scenario, a "hold separate" arrangement. Where a deal has completed before the OFT has cleared it, the OFT has the power to request hold separate undertakings from the buyer (whereby the buyer agrees not to integrate the acquired business into its operations) and ultimately, if the buyer does not agree to this, to impose a hold separate order on that buyer. Historically, the OFT tended to seek hold separate undertakings relatively rarely and generally only in cases where there were preliminary indications of competition concerns arising from the deal. This may be the case if third parties have expressed coherent concerns to the OFT, or if the OFT's own preliminary assessment, often based on the receipt of information from the buyer, indicates that the deal may give rise to competition concerns. The OFT's guidance states that meeting the Share of Supply test (*i.e.*, a combined share of 25% or more) provides a sufficient basis for requesting hold separate undertakings. That said, the OFT used to adopt a pragmatic approach to hold separate undertakings and would often contact the parties' customers to gauge their initial views about the deal before deciding whether there were preliminary competition concerns that merited a hold separate arrangement.

The UK's current system of merger control has been in force since June 2003. Since then, the OFT has typically sought hold separate undertakings in respect of nine to ten completed deals each year. In 2011, however, as of November 2, it has sought hold separate undertakings in 16 cases.[4] This material increase in hold separate undertakings appears to reflect two trends.

Apparent Increase in Asserting Jurisdiction

First, the OFT is asserting jurisdiction over a greater number of completed deals than used to be the case. Senior OFT staff have made it clear to UK antitrust practitioners that they wish to make greater efforts to ensure that deals which may have a negative impact on competition in the UK are not slipping through their net due to a decision on the part of buyers not to make a voluntary merger filing. This approach no doubt reflects a desire on the part of the OFT to prove to the Government that its staff are capable of doing a good job in enforcing UK merger control and should take the lead in any new authority that may be established as a result of the future reform of UK competition law enforcement. As a result, the OFT is sending out more enquiry letters in respect of completed deals than it used to.

An example of this involves the recent acquisition by UK-based real estate services provider Jones Lang LaSalle of a UK competitor, King Sturge.[5] On the one hand, the OFT had jurisdiction on the basis of Turnover Test and most likely also the Share of Supply Test. In respect of the latter, in certain narrow categories of real estate

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services the parties possibly had a 25% share of supply, or slightly more. On the other hand, it would appear from reading the very short clearance decision that had the OFT initially contacted customers and competitors of the merging parties, no-one would have expressed any concerns about the transaction. The OFT has the discretion to take these relatively quick and easy steps before opening a merger investigation, yet appears to have chosen not to do so in this case.

During its merger review, the OFT received comments from over 60 third parties and not one expressed concern about the deal. Moreover, in each of the narrow candidate markets assessed by the OFT during its review, the OFT identified between 10 and 20 or more existing competitors to the merging parties. The UK's "voluntary" system of merger control enabled the parties first to complete the deal and, given that the OFT did not in that case request initial hold separate undertakings, presumably Jones Lang LaSalle was able to commence integrating the two businesses. By asserting jurisdiction over the transaction, however, the OFT will have added significantly to the costs of the deal (a merger filing fee of £90,000 and presumably external counsel fees of several tens of thousands of pounds) when instead, it could have exercised its discretion not to request a filing.

A More Aggressive Stance Towards Buyers Who Have Completed Deals

The second recent trend is that the OFT is adopting a more aggressive stance towards buyers where a deal has completed and not been notified to the OFT. This trend is resulting in the increased use of hold separate undertakings and is illustrated by a recent case involving US firm Ryder Systems Inc (Ryder).

Earlier this year, a UK subsidiary of Ryder providing fleet management and commercial vehicle rental services acquired a UK competitor, Hill Hire plc (Hill Hire). Hill Hire's turnover last year exceeded £70 million, meaning that the OFT could assert jurisdiction over the deal on the grounds that the Turnover Test was met. Ryder chose not to notify the deal to the OFT, but completed it and began integrating the two businesses, as UK law permits. The OFT picked up on the deal and duly sent Ryder an enquiry letter. None of this would in itself have come as a surprise. What is surprising, however, is that the OFT then requested hold separate undertakings. This is surprising because, upon reading the OFT's ultimate clearance decision, it would appear that the Share of Supply Test was barely met, if at all. It is not mentioned as a basis for asserting jurisdiction. It would also appear that the vast majority of the 20 to 30 third parties who responded to OFT questions about the deal did not raise any concerns. In fact, the decision points to just two competitors of the parties raising some general, unsubstantiated concerns.

Against this background, the fact that the OFT sought hold separate undertakings indicates a more aggressive approach by the OFT towards completion of deals between two competitors. This has significant implications for acquiring companies. UK merger control at its simplest is not a cheap process. Filing fees range from a minimum of £30,000 (for deals where the target's annual UK turnover is £20 million or less) to a maximum of £90,000 (where the target's annual UK turnover exceeds £70 million). The notification documentation itself is onerous and firms can expect to incur tens of thousands of pounds in advisers' costs during the merger review process.

A request from the OFT for hold separate undertakings can add thousands of pounds more to the costs. Although the OFT asks companies to use its standard undertakings template and not to amend the wording of that template, it will also consent to derogations from the template. Such derogations will be necessary if integration has already commenced. Derogations need to be negotiated with the OFT, a process which can take several weeks and which uses time and resources which might otherwise be spent focusing on the merger review itself. Corporate counsel should bear in mind, therefore, that the OFT is increasingly seeking hold separate undertakings in respect of completed deals involving businesses whose activities in the UK overlap. This

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should be taken into account when forming an integration timeline.

In light of the OFT's hardened approach towards asserting jurisdiction over completed deals, regardless of the extent to which they may give rise to prima facie competition concerns, it appears that in practice, the UK is moving away from a purely voluntary notification system. As a result, acquirers are more likely than used to be the case to be advised by local counsel to notify qualifying deals to the OFT before they complete.

Merger Clearance Is Taking Longer and Costing More

Two other trends during 2011 of which M&A counsel should be aware are increased timelines for UK merger clearance and a move towards more intensive reviews, which result in greater costs for the merging parties.

Increased Timelines

The OFT's formal review timetables have remained unchanged since June 2003 (20 or 40 working days, depending on notification format). Nevertheless, in practice, UK merger control is taking longer.

First, the OFT is insisting on a longer pre-notification period, during which it takes time (typically one to two weeks, but often longer) to review one or more drafts of the notification and request that additional information be provided before it will start the review clock. Pre-notification remains a shorter period than is usually required for mergers notified under the EUMR (when at least four to six weeks is the norm and often several months), but should nevertheless be built into the deal timetable.

Second—and this is to be welcomed—the OFT has been using the flexibility inherent in its non-binding 40 working day timetable to extend its review period where it considers that it needs a longer period to complete its review. This may in part reflect delays on the part of the merging parties to provide all requested information, but it also demonstrates the OFT's willingness to avoid referring a deal to the CC where its remaining concerns might readily be removed. Two notable cases in recent weeks illustrate this. First, in telecommunications firm Level 3's acquisition of Global Crossing, the OFT's review was extended by just over five weeks.[6] More recently, Amazon's acquisition of rival online bookstore The Book Depository saw its decision deadline moved from August 30th to October 26th.[7] In both deals, the OFT received a number of third party complaints, but both were cleared unconditionally.

More Onerous Review Process

One final notable feature of 2011 UK merger control has been the high proportion of cases that have involved a CRM. Historically, approximately 20% of cases notified to the OFT involve a CRM. In the OFT's current financial year, however (since April 1), 40% of cases in which the OFT has made a decision have involved a CRM. Meanwhile the proportion of deals ultimately referred to the CC has remained consistent with previous years, at some 10%.[8] This dramatic increase in the use of CRMs has material implications for the costs of the merger control process in each case. Reviewing and responding to an Issues Letter and preparing for and attending an Issues Meeting typically adds considerable costs in the form of advisers' fees and makes onerous demands on the time of senior management, some of whom may be expected to attend the Issues Meeting in person.

It is not yet clear why the OFT has had more initial doubts about the deals it has reviewed in 2011 than has been the case in previous years, nor whether this trend is likely to remain in the future. For the time being, however, those involved in M&A transactions should take note that the OFT is adopting a rigorous approach to merger reviews and making considerable demands on merging parties' time and resources.

What Does This Mean for UK Merger Control?

Reform of UK merger control is on the political agenda and changes can be expected in the next one to two years. In the meantime, M&A

lawyers would be well advised to take note that the OFT is aggressively asserting its jurisdiction over transactions that qualify for UK merger control, to such an extent that one might legitimately question the extent to which notification is really voluntary these days. This may make an acquirer think twice about trying to avoid notifying their deal. In particular, if it is important to complete the deal before obtaining UK merger clearance, acquirers should be aware that the OFT may well seek to put a stop to any post completion integration pending the outcome of its review, regardless of whether the deal is likely to raise competition concerns. The deal timetable should also take account of the OFT's new policy of increasing pre-notification discussions before the merger review timetable begins, as well as the possibility that decision deadlines can be and are extended. Finally, all parties to the deal should be aware that UK merger control is becoming a more costly business—but one that increasingly cannot be avoided.

NOTES

1. The 27 Member States of the European Union plus Norway, Iceland, and Liechtenstein.
2. Council Regulation EC 139/2004 on the control of concentrations between undertakings.
3. In exceptional circumstances, the acquirer may seek permission from the CC to complete the deal prior to receiving clearance.
4. Acergy/Subsea 7; Edmundson Electrical/Electric Center; Electruepart/ESpares; Kerry Foods/Headland Foods; Kingspan/CRH Insulation Europe; Lightcatch/Tote; Monaghan Mushrooms/Sussex Mushrooms; PHS Group/Direct Hygiene; PHS Group/Capital Hygiene Services; Princes/canning business of Premier Foods; Ryder/Hill Hire; Shell/Rontec; Silos/CleanCrop UK; Sims Metal Management/Dunn Brothers; Sports Universal Process/Prozone Group; SRCL/Ecowaste Southwest.
5. ME/5083.11, Completed acquisition by Jones Lang LaSalle of King Sturge, decision published on 3 October 2011.
6. Anticipated merger between Level 3 Communications Inc. and Global Crossing Limited, ME/5025/11. The original decision deadline was July 22. The decision was made on August 30.
7. Anticipated acquisition by Amazon.com, Inc. of The Book Depository International Limited, ME/5085/11.
8. Figure correct as of September 30, 2011.

Allocating Financing Control and Risk in Sponsored Joint Ventures

BY DANIEL SEROTA AND NINA MCINTYRE

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A key issue in any merger, acquisition, strategic investment or similar transaction in which a portion of the cash consideration will need to be financed is how to allocate between the buyer and seller the risk that such financing will be available and consummated in time for the closing of the transaction. As a result, certain well-developed provisions are commonly negotiated to address such risk (*e.g.*, financing conditions, efforts to secure financing, reverse break-up fees, etc.). The impact and incentives created by these provisions operate differently in the context of a sponsored joint venture. Since both the seller and the buyer in a sponsored joint venture scenario will be concerned about the terms of any financing and the impact of those terms on the venture post-closing, provisions that are designed to incentivize or force the buyer to accept financing upon less favorable conditions are not necessarily favorable to the seller. As a result, sellers will need to explore alternatives to the customary approaches to financing risk allocation to balance its desire to consummate the transaction with the potential reduction in value of its remaining equity due to the joint venture obtaining financing on less favorable terms than contemplated at the time the transaction was agreed.

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This article proposes three alternatives to the customary risk allocation approaches that may be employed in sponsored joint ventures: (i) buyer and seller agree upon a threshold of acceptable financing terms below which either party has the option to terminate the transaction with or without a reverse breakup fee payable to seller; (ii) buyer and seller agree upon a threshold of acceptable financing terms below which the seller has the option to terminate the transaction with or without a reverse break-up fee payable to the seller; and (iii) buyer and seller agree that if the buyer fails to obtain financing to consummate the transaction on the agreed upon terms, the seller will have the option to provide financing for the transaction or to obtain financing for the transaction from a third-party on terms no worse than agreed upon terms.

What Is a Sponsored Joint Venture?

In a sponsored joint venture, a private equity or strategic buyer (the "sponsor") acquires a portion of a company and enters into a joint venture arrangement with the company's existing owners. As part of the joint venture transaction the sponsor may acquire shares of the company directly or through a newly formed joint-venture entity. The sponsor and the seller agree in the transaction agreement (*e.g.*, a share purchase agreement or merger agreement by which the sponsor makes its initial investment in the company) to enter into a joint venture agreement, shareholders agreement and/or other governing documents which will govern the parties' relationship and the running of the joint venture post-closing.

Special Considerations in Financing Sponsored Joint Ventures

Generally, in the context of any merger, acquisition, strategic investment or similar transaction in which the seller is selling all its interest in an entity or where its remaining interest post-closing will not be significant, the seller is not concerned with the terms of the financing obtained by the buyer other than the conditions to such financing, because the seller is exiting its investment and is concerned solely with ensuring that the transaction closes and that it maximizes the consideration received at the closing. The seller cares that the financing is obtained, but is not concerned with the underlying terms of the financing.

In contrast, in the context of a sponsored joint venture where the seller will continue to hold an ownership stake in the company or newly-formed joint venture following the closing, the seller has an additional incentive that the joint venture receive the best available financing terms in connection with the formation of the joint venture and for positive or negative control and/or limitations on the variations from such terms. Furthermore, depending upon the seller's stake in the venture post-closing, the seller may be incentivized to negotiate for some measure of control over the terms of future financings which may be needed by the joint venture on an ongoing basis.

Another distinction between financings of sponsored joint ventures and of other acquisitions is that in a sponsored joint venture, as in a leveraged buyout, lenders to the joint venture typically look solely to the operations and assets of the target company to secure the acquisition loans. This differs from financings of strategic acquisitions or other acquisitions involving purchase of all or substantially all the equity interest of a target company where the lenders frequently look to the operations and assets of the buyer to secure acquisition financing and to measure the borrower's ability to pay (*i.e.*, looking to assets of both the buyer and the target company together to calculate debt service ratios).

Overview of Issues in Allocating Financing Control and Risk in Sponsored Joint Ventures

When a sponsor agrees to make an investment in a target company and enters into a joint venture arrangement with the existing owners of the company, the determination of whether the sponsor or the seller will have control over obtaining the financing and determining the financing terms and whether the sponsor or seller will bear the risk of a financing failure are significant issues. Major negotiation points with respect to financ-

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ing sponsored joint ventures include (i) which party controls obtaining the financing and to what extent such party has an obligation to obtain the financing, (ii) which party controls the terms and conditions of the financing, and (iii) how the risk of the financing being unavailable at the closing of the transaction is allocated between the sponsor and the seller. The following sections of this article outline key issues that should be considered in apportioning financing control and risk in sponsored joint ventures.

Sponsor Control

If the sponsor has control over obtaining the financing, but bears little or no risk of a failure to obtain financing, for example by having a financing closing condition in the main transaction agreement and with a low standard for the sponsor to try to obtain financing (*e.g.*, good faith efforts), then the sponsor may have opportunities to back out of the deal without suffering any harm. In addition, depending on the terms of the joint venture arrangements, if the sponsor has negotiated for a priority return in any liquidation or distribution (or for a substantial or front-loaded portion thereof) from the company through a conversion waterfall, liquidation preference or other right, then the sponsor might be willing to agree to financing terms that would have a disproportionate effect on the seller's equity value post-closing. The same would be true if the joint venture arrangements have a built-in internal rate of return (IRR) threshold above which the seller will receive a return on its investment in the company. For example, if the sponsor controls the financing and the joint venture arrangements have an IRR threshold which must be reached before the seller participates in any distributions, the sponsor could agree to financing terms that operate to reduce the downside risk for the sponsor that the company will fail to reach the IRR threshold (and the size of such failure) by negotiating for a lower interest rate in exchange for granting the lenders preferred equity kickers or other participation rights starting at the IRR threshold which reduce the seller's potential returns. However, as the seller would not participate in distributions until the IRR threshold was reached, it would not receive a benefit in exchange for the dilutive effect of granting the equity kickers or other participation rights.

Seller Control

In contrast, if the existing owner selling an interest in a company to a sponsor has control over obtaining the financing and the financing terms and conditions, then the seller could agree to financing terms and conditions in order to complete the transaction that might be unacceptable to the sponsor or otherwise detrimental to the company from a business perspective. In such a scenario, the seller's desire to receive the sale price or the need of the company to receive an equity infusion from the sponsor could cause the seller to agree to undesirable financing terms solely to close the transaction. As an example, if the terms of the joint venture agreement provide that the sponsor first will be paid out its capital or an agreed upon return, the seller in controlling or exerting influence over the financing might be willing to agree to a higher interest rate on funds or otherwise to agree to terms of financing which could pose additional costs to the venture, subject to any significant increased fraudulent transfer risk with respect to consideration received by the seller in the form of a distribution from the joint venture at the closing if the changes to the financing result in the insolvency of the joint venture,[1] in exchange for eliminating any equity kickers or other terms which could dilute the seller's return if the applicable threshold is reached.

In addition, since the sponsor is the source of new equity for the joint venture and, unless the seller has a high volume of M&A activity, is likely to have stronger relationships with potential lenders, an approach in which the seller controls the financing negotiations would be strongly resisted by the sponsor and is not part of current market practice. As financing control by the seller is more theoretical and not a realistic market approach, the discussions of allocating financing control and risk below will assume that the party having positive control and an obligation to obtain financing is the sponsor.

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Financing Efforts

Intertwined with the question of which party will control obtaining acquisition financing is the question of whether and the degree to which the party obtaining financing must expend efforts to do so. In almost all cases, the party obtaining financing is required to undertake some level of efforts to put the financing in place. At one end of the spectrum of efforts is an absolute requirement that a party obtains financing or, a more common than absolute requirement, is an obligation to use best efforts. At the other end of the spectrum is an obligation to use good faith efforts to put financing in place. In between are all manner of efforts standards: reasonable best efforts, reasonable efforts, commercially reasonable efforts, etc. As noted above, if the sponsor is responsible for obtaining the financing and is subject to a lax efforts standard, then the sponsor could treat the lax efforts standard as a *de facto* option on its investment in the target, *i.e.,* if the market turns against the investment the sponsor could use the low efforts standard to circumvent a requirement to close the transaction. Furthermore, the sponsor's use of special-purpose vehicles to invest in the joint venture may limit the remedies available to the seller to enforce the sponsor's obligations with respect to financing except to the extent of any guarantees from creditworthy entities.

Risk of Financing Being Unavailable

Similarly, if the sponsor controls obtaining financing but bears little or no risk if there is a financing failure, then the sponsor has a *de facto* option on its investment. For example, if the sponsor controls obtaining financing and there is a low efforts standard and a financing closing condition, the sponsor might plausibly be able to satisfy the low efforts standard and still fail to obtain financing, in particular if market conditions change for the worse between signing and closing, and be able to walk away from the deal without incurring damages. This is especially true if the investment agreement does not impose any material break-up fee on the sponsor to counteract other incentives to walk away from the transaction.

Reverse Break-Up Fees

The impact of the incentives caused by a reverse break-up fee in the context of a sponsored joint venture are different than in mergers, acquisitions, or similar transaction where an entire entity is being sold. In a typical merger, the seller will not be impacted by the terms of the financing following the closing and therefore wants to incentivize the sponsor to obtain financing regardless of the financial terms. In a sponsored joint venture, a seller does not want the sponsor to agree to financial terms for the financing materially worse than those contemplated at signing because any negative impact on the equity value of the joint venture will be shared by the seller. The inclusion of a reverse break-up fee will incentivize the sponsor to agree to obtain financing that negatively impacts the joint venture so long as the sponsor's portion of the lost equity value is less than the amount of the reverse break-up fee. For the sponsor's part, the sponsor does not want the seller to be able to limit sponsor's ability to accept the terms of available financing while the sponsor is also at risk of paying a reverse break-up fee. As such, in negotiating whether to have a reverse break-up fee in sponsored joint ventures (and in evaluating and setting the acceptable threshold for financing terms at the outset), consideration must be given to (i) whether a reverse break-up fee can be crafted that would not incentivize the sponsor to accept financing terms that would negatively impact the joint venture in excess of the agreed threshold, (ii) the extent to which the reverse break-up fee will take into account the sponsor's desire for full control if the sponsor will be required to pay the reverse break-up fee, and (iii) the seller's concern that the sponsor might suggest unfavorable financing terms as a method for getting out of the investment.

Three Proposals for Allocating Financing Control and Risk

As described above, there are a number of perverse incentives created by having either the sponsor or the seller control obtaining the financing (including the extent to which such party is

obligated to obtain the financing) or control determination of the terms and conditions of the financing, in particular where the controlling party bears little risk of the financing being unavailable at the closing of the transaction. To address these incentives, we propose three approaches to workable divisions of financing control and financing risk between the sponsor and the seller in the context of a sponsored joint venture.

Proposal 1: Set Thresholds for Financing Terms Below Which Either Party May Terminate the Transaction

An approach for allocating financing control in the context of a sponsored joint venture is that the parties could agree in advance to a threshold of financing terms below which one or both parties have the option to terminate the transaction. The financing threshold might be based upon the commitment letters that the sponsor has obtained, if any, including any flex terms, permitted deviations if the original financing is not available or, if there is not a firm commitment letter in place, be determined by the parties setting forth specific thresholds of acceptable terms, including ranges of total financing amounts either individually or in the aggregate for term loans and revolver facilities, the highest permissible interest rates applicable thereto, leverage ratios, which assets will serve as collateral, relative obligations of sponsor/seller as guarantors of the debtor entity under the facility, and the scope of covenants applicable to the debtor entity. Preferably, the thresholds would be unambiguous. It should be noted, however, that if the investment agreement is required to be publicly disclosed (including the terms regarding the financing thresholds) the parties should consider the impact on negotiations with lenders if explicit thresholds (rather than the more traditional materiality standards) are disclosed.

This threshold setting approach tempers, but does not fully eradicate, the potential negative incentives created by giving a sponsor control over the terms of the financing. This approach might be improved by imposing a meaningful efforts standard on the sponsor to avoid inadvertently granting an option on the investment if the financing market sours between signing and closing. To further moderate the sponsor's control over financing, the investment agreement might provide that specific performance as an available remedy to the seller if financing is available on terms equal to or better than the agreed upon threshold, but the sponsor fails to close. The seller could be granted the right to specifically enforce the equity commitment or the sale under the investment agreement and the sponsor could covenant to enforce its rights under the debt commitment letter and not to take any action which would materially negatively impact the ability to obtain financing at or above the agreed upon threshold. Likewise, the potential negative incentives of sponsor control could be mitigated by providing that a reverse break-up fee is payable by the sponsor to the seller if either of the sponsor or the seller terminates the agreement due to a financing failure. A reverse break-up fee might also be triggered only as a result of termination of the transaction by the sponsor. However, if a reverse break-up fee is payable *only* upon sponsor's termination for a financing failure and if financing satisfying the threshold is not available, the seller will attempt to avoid being the party that terminates the transaction (because no reverse break-up fee would be due) and the sponsor will also attempt to avoid being the party that terminates the transaction (because a reverse break-up fee would be due) and both parties will instead be incentivized to wait for the other to terminate first.

Proposal 2: Financing Threshold for Seller Only

One approach for allocating financing risk would be to provide the seller with the right to terminate the investment agreement if the final terms of the financing obtained by the sponsor are worse than a threshold of financing terms agreed to by the parties in connection with entry into the investment agreement. The option of the seller to terminate if the financing does not meet the agreed upon threshold could be accompanied by a reverse break-up fee paid by the sponsor to the seller upon termination of the agreement as a result of a financing failure. By only allowing

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seller to terminate if financing is not available at or above the agreed upon threshold, the risk approach may be more balanced. As efforts clauses are difficult to police, this approach creates additional incentive for the sponsor to use the efforts it can to seek financing above the threshold as seller may choose to have the transaction move forward with less favorable financing if no better options are presented. In this approach, seller's counsel will need to carefully review the equity commitment letters to make sure that terms of the financing or changes thereto are not a condition to funding and that the seller can cause specific performance of the funding if the conditions to the joint venture are satisfied or waived. As with Proposal 1, this approach could be improved and further reduce the financing risk for seller by granting the seller the right to specifically enforce the equity commitment or the sale under the investment agreement and by requiring the sponsor to covenant to enforce its rights under the debt commitment letter and not to take any action which would materially negatively impact the ability to obtain financing at or above the agreed upon threshold.

Proposal 3: Seller Option to Provide Financing if Sponsor Financing Fails

A third approach to allocating financing control and risk is that the parties agree that if the sponsor fails to obtain financing for the transaction, then the seller has a right to provide financing for the transaction itself on terms agreed to by the parties in connection with entry into the investment agreement or to secure from a third-party lender financing on no worse terms than those agreed to by the parties. The parties would need to agree up front if such alternative seller financing terms would be based upon the commitment letter entered into at the time the investment agreement is executed or some other criteria and whether any adjustments would be made to compensate the seller for agreeing to provide seller financing in place of the cash it would receive at closing and/or the presumption that unavailability of financing consistent with the original commitment letter is due to the terms of such commitment letter not providing sufficient flex to match market pricing as of the closing or the period shortly prior to closing. This approach could be implemented in combination with a reverse break-up fee to the seller if the seller does not elect to provide financing.

While this third approach provides for the most deal certainty for the seller, the use of seller financing may present significant downside to seller depending on its objectives. Seller financing delays and/or reduces the liquidity the seller would receive in the transaction. The seller will have additional capital and risk tied to the joint venture until such time as the debt matures or is redeemed, if applicable. Furthermore, the seller will need to consider any accounting or regulatory impact that would arise as a result of providing seller financing to the joint venture.

Conclusion

Unique issues arise in the allocation of financing control and risk in sponsored joint ventures because the seller is concerned not only that the financing be obtained, but also that the terms of the financing do not disproportionately harm its continuing equity interest in the venture. For this reason, sponsors and sellers should consider novel approaches to the division of financing control and risk in negotiating sponsored joint ventures to address the seller's special concerns in this context, including (i) defining a threshold of acceptable financing terms below which either party has the option to terminate the transaction with or without a reverse break-up fee payable to seller; (ii) providing the seller (and possibly the sponsor) with the right to terminate the transaction coupled with or without a reverse break-up fee payable to the seller if financing is not available above the agreed upon threshold; and (iii) providing the seller with an option to provide financing for the transaction, or to obtain financing for the transaction from a third-party on terms no worse than agreed upon for seller financing.

NOTES

1. *See, e.g., Geltzer v. Mooney (In re MacMenamin's Grill Ltd.)*, Adv. Pro. No 09-8266 (RDD) 2011

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(Bankr. SDNY April 21, 2011). In *Geltzer*, the United States Bankruptcy Court for the Southern District of New York held that the safe harbor in Section 546(e) of the Bankruptcy Code did not apply to a small, private LBO transaction where the transaction posed no systematic risk to the stability of financial markets. The court held that the transaction, involving the payment of $1.15 million in loan proceeds by a financial institution to three non-insider shareholders to fund the acquisition of their stock in an LBO, did not fall within the safe harbor of Section 546(e) and exempt the payments to shareholders from avoidance under the Bankruptcy Code. In so holding, the court acknowledged that that application of the safe harbor may be implicitly tied to the value of the securities transaction being challenged and the number of shareholders involved. However, many courts have reached the opposite conclusion, *i.e.* that Section 546(e) would exempt private payments to stockholders in leveraged transactions. *See, e.g., Kaiser Steel Corp. v. Pearl Brewing Co. (In re Kaiser Steel Corp.),* 952 F.2d 1230, 1240 (10th Cir.1991) ("Given the wide scope and variety of securities transactions, we will not interpret the term 'settlement payment' so narrowly as to exclude the exchange of stock for consideration in an LBO."); *In re QSI Holdings, Inc.*, 571 F.3d 545, 550-51 ("nothing in the text of §546(e) precludes its application to settlement payments involving privately held securities"); *Brandt v. B.A. Capital Co., LP (In re Plassein Int'l Corp.)*, 590 F.3d 252, 258-59 (3d Cir. 2010), cert. denied 130 S. Ct. 2389 (2010); *Contemporary Indus. Corp. v. Frost*, 564 F.3d 981, 987-88 (8th Cir. 2009) (payments that shareholders received in exchange for their stock during leveraged buyout were within safe harbor of Section 546(e)); *Official Committee of Unsecured Creditors of Nat'l Forge Co. v. Clark (In re Nat'l Forge Co.)*, 344 B.R. 340, 367-70 (W.D. Pa. 2006) (stock redemption); *Official Comm. of Unsecured Creditors v. Fleet Retail Fin. Grp. (In re Hechinger Inv. Co.)*, 274 B.R. 71, 87 (D. Del. 2002); *Official Comm. of Unsecured Creditors of The IT Group, Inc. v. Acres of Diamonds, L.P. (In re The IT Group, Inc.)*, 359 B.R. 97, 100-102 (Bankr. D. Del. 2006).

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