Recent Trends In Limited-Conditionality Provisions

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Law360, New York (January 31, 2017, 4:16 PM EST) -- An important structuring issue in merger and acquisition transactions is whether the buyer or the seller should assume the risk that the buyer will not be able to obtain financing necessary to complete the acquisition. Historically, many buyers were able to negotiate "financing out" provisions in their acquisition agreements (i.e., such that the buyer did not have an obligation to close the acquisition if the financing did not materialize) and, moreover, the acquisition agreements generally incorporated the conditions to funding required under the financing arrangement provided to the buyer. However, sellers began to increasingly focus on buyer acquisition conditionality and their remedies if the buyer failed to close, whether because it was unable to do so due to lack of financing (or for other causes) or for opportunistic reasons.

Over the past decade or so, "financing out" provisions have become increasingly rare in acquisition agreements, especially in private equity-led leveraged buyouts. Moreover, the specific performance remedies available to sellers if the buyer failed to close have become more meaningful, to the point where in some cases sellers require the buyer to close by drawing on all of its available debt and equity commitments if certain conditions are satisfied. Finally, reverse breakup fees (i.e., termination fees payable by buyers to sellers if the acquisition does not close for reasons including unavailability of financing) have become widespread in private equity acquisition agreements. While reverse breakup fees are beneficial to buyers in that they quantify and cap the damages that they can be exposed to if they are sued by the seller for failure to close, they can add up to significant amounts (e.g., 3-5 percent, and in some cases reportedly as high as 10 percent, of deal value).

This trend in the structuring of acquisition agreements, in turn, has created immense pressure on private equity buyers to limit the conditionality under their acquisition financing arrangements in order to maximize the certainty that the financing will be available to close the acquisition and thereby limit their potential exposure to the negative consequences of failing to do so, such as payment of a reverse breakup fee or the seller demanding specific performance. These limited conditionality provisions came to be known as the "SunGard provisions" (named after the 2005 acquisition of SunGard Data Systems by a consortium of private equity firms, which was the first public transaction to contain such limited conditionality). Even though the SunGard provisions represented a significant erosion of the traditional approach to conditionality to funding, these provisions have nonetheless become widely accepted in the market.

The purpose of this article is to examine the evolution of certain aspects of the SunGard conditionality, the extension of some of the SunGard conditionality principles to acquisitions by existing private equity sponsor portfolio companies, and to offer a brief comparison of some of the aspects of limited financing conditionality between U.S. and U.K. transactions. Our article will be focused on private equity leveraged finance, although today high-grade and corporate leveraged acquisition financings often also incorporate some of the SunGard elements.

Specified Representations

Initially, the concept of "specified representations" limited the universe of representations and warranties contained in the credit agreement that were required to be accurate as a condition to funding. Under this formulation, only the failure of the most fundamental representations and warranties (e.g., enforceability, due execution and authorization, margin regulations, etc.) served as a funding block. If any other representation or warranty was not accurate at closing, the lenders would still be obligated to fund, but the failure of such representation or warranty to be accurate resulted in an event of default at closing (a so-called "day two default") and gave the lenders the option to exercise any remedies immediately after closing. This formulation allocated the risk of some more fundamental breaches to the borrower (i.e., buyer) but recognized that some other breaches are not significant enough that they should prevent the buyer from consummating the acquisition and forcing it to pay the seller any reverse-termination fee or, in the most extreme cases, exposing the buyer to a potential lawsuit by the seller.

More recently, some strong private equity sponsors have been successful in negotiating commitment papers where the only representations and warranties in the credit agreement that are actually made at closing are the "specified representations" (funding is still conditioned upon the accuracy of such "specified representations"). This eliminates the "day two default" concept described above and has the effect that some of the representations and warranties contained in the credit agreement are not made at all at initial funding. Those representations and warranties would not be made until the next occasion on which the representations and warranties are brought down under the credit agreement, e.g., when the borrower first utilizes its revolving credit facility after the closing date. Even though this means that a significant portion of the credit agreement representations and warranties may not be made until some point in the future after the initial funding, or at all, arrangers are becoming increasingly accepting of these provisions, although in some cases they will insist that some representations that are not typically included in the scope of "specified representations," such as the accuracy of disclosure, be made on the closing date, although not as a condition to funding. This formulation seems destined to become even more prevalent in "top-tier" private equity sponsor transactions, although it will be interesting to see if arrangers will require that certain "nonspecified representations" that are important from the lenders' perspective be made at closing, with any breaches of such representations resulting in a "day two default."

One potential middle ground between these two competing approaches is requiring the borrower to make all of the representations and warranties in the credit agreement at closing, but permitting the borrower to cure any breaches of "nonspecified representations" during a relatively short post-closing "cleanup" period, subject to certain limitations, in instances that such breaches can be cured. While we have seen this approach taken in the U.S. market before, it is not nearly as prevalent as in the U.K., as described in more detail below.

As far as the scope of "specified representations" is concerned, it is fairly well-established to include representations on organizational existence, power and authority, due authorization, execution and delivery, enforceability, solvency, the absence of conflicts with organizational documents, margin regulations, the Investment Company Act, the Patriot Act, the Office of Foreign Assets Control, and the Foreign Corrupt Practices Act, and creation, validity and perfection of security interests (the SunGard transaction also included a "specified representation" as to the status of the credit facilities as senior debt, but such representation will often not be relevant if the capital structure does not include any subordinated piece). In transactions involving certain specific legal regimes applicable to the target company by virtue of its specific business, it is not uncommon for arrangers to request that a no conflicts with law representation is included, with varying degrees of success.

The most contentious point of negotiations regarding the scope of "specified representations" is often around the Patriot Act, OFAC and FCPA representations. Due to some recent well-publicized government enforcement actions, lenders are very focused on these provisions as a way to mitigate a financial, and perhaps more importantly, reputational, risk that may arise from a possible violation of these provisions. The most common request by private equity sponsors as it relates to these representations is to qualify the FCPA, and in some cases the OFAC, representation by "use of proceeds" of the credit facilities. This has the effect of narrowing the relevant representations (the wording of which can vary significantly) to exclude, for instance, representations as to the borrower's maintaining procedures and policies intended to ensure compliance with the applicable anti-money laundering, anti-corruption, etc. legal regimes. Potential lender liability for FCPA and OFAC breaches is well beyond the scope of this article, but many arrangers have accepted the "use of proceeds" language as adequately addressing the key risks involved. It is worth noting, however, that most arrangers view this as a case-by-case determination based on the due diligence, industry sector and domestic versus international scope of the particular business. The relevant representations in the acquisition agreement are also taken into account. At the end of the day, the "use of proceeds" qualifier may still lead to situations where lenders will be forced to fund a borrower that is in violation of the FCPA, OFAC or other applicable laws, for instance if the borrower used cash from other sources to improperly influence foreign officials. While any risk of actual lender liability in such situations may be limited, the potential reputational risk remains.

Another consideration that comes up in transactions involving businesses with significant non-U.S. operations is that there may be other applicable legal frameworks, in addition to the FCPA, OFAC and the Patriot Act, that may be implicated (e.g., the U.K. Bribery Act of 2010). Since noncompliance by the borrower with such other laws may expose arrangers to similar risks as FCPA or OFAC violations, arrangers will often insist on including compliance with such other laws as a "specified representation." Not surprisingly, many private equity sponsors resist this inclusion, arguing that it goes beyond the scope of what is customarily considered "SunGard." It remains to be seen whether the inclusion of the U.K. Bribery Act or other applicable anti-money laundering/anti-corruption/anti-terrorism laws will become widely accepted in the market, but given the increasingly international nature of leveraged finance transactions and increasing global regulation, one can reasonably expect arrangers to argue for their inclusion as a "specified representation."

Specified Acquisition Agreement Representations

In addition to "specified representations," "SunGard" conditionality limits the universe of representations and warranties made by the target and/or the seller in the acquisition agreement that are required to be accurate as a condition to funding. A typical formulation will limit such representations and warranties to representations and warranties that are "material to the interests of the lenders," but only to the extent the buyer has a right to terminate the acquisition agreement or to decline to complete the acquisition, in each case as a result of a breach of such representations and warranties.

It is the buyer that will ultimately make the determination whether it has a right to terminate the acquisition or to decline to complete the acquisition, and the buyers' and lenders' interests may diverge in instances where the buyer wants to close over an alleged (or even an actual) breach of a representation and warranty that the lenders will argue was material to their interests. Furthermore, acquisition financing commitment letters will typically require that the acquisition be completed in accordance with the acquisition agreement and that the acquisition agreement not be amended or waived (or any consent be given thereunder) in a manner materially adverse to the lenders without their consent. If the buyer waives a breach of a representation or warranty that the lenders will argue was a "specified acquisition agreement representation," it will likely violate such anti-amendment rule and therefore the arrangers will have a conditionality "out" that will permit the arrangers not to fund. This potentially gives lenders fairly significant protection notwithstanding the fact that the termination right lies squarely with the buyer under the terms of the acquisition agreement, although if the lenders were to invoke the anti-amendment rule, an intensive factual investigation may follow.

What about the other representations and warranties made by or on behalf of the seller in the acquisition agreement, namely such representations and warranties that do not create a termination right in favor of the buyer? Depending on how the relevant acquisition agreement is structured in terms of remedies for breaches of such representations and warranties, such breaches may be indirectly addressed in the financing commitment letter by the provisions dealing with purchase price reductions, but, as a general matter, are not likely to trigger a conditionality "out."

The purchase price reduction provisions vary from deal to deal and they are often closely negotiated. Typically, a purchase price reduction will not be deemed material to the interests of the lenders (and therefore will not require the lenders' consent) if such reduction is applied in a manner prescribed in the commitment letter. In many cases, the commitment letter will provide that the reduction will be applied first to reduce the private equity sponsor equity contribution to a certain specified minimum percentage of the entire capital structure (typically in the 25 percent to 40 percent range) and thereafter on a pro rata basis to reduce the amount of the equity check and the credit facilities. While this language is relatively common in strong sponsor transactions, it may create a potential issue for the arrangers because often the expectation at the time that the commitment letters are signed is that, notwithstanding the minimum equity contribution requirement, the actual amount of equity projected to be contributed by the sponsor and any equity "rolled over" by the existing investors (often management) will be significantly higher. Arrangers often view this higher equity check as a material credit matter and, conversely, if the equity check is reduced (as a percentage of the capital structure) this may put pressure on selling down the deal to the syndicate. One way for the lenders to protect themselves in such a situation is to require that purchase price reductions in excess of a certain threshold (say 10 percent of the purchase price) are always deemed material to the lenders' interests no matter how such reductions are applied between the debt and the equity components. While such thresholds were once relatively common, many of the stronger sponsors have been able to eliminate them from their commitment letters, leaving lenders with the risk that the actual equity check may be significantly lower than the level that the lenders initially expected when committing to the financing.

Incremental Facilities and "Limited-Condition Acquisitions"

The limited "SunGard" conditionality began as a set of conditions applicable to initial acquisitions of targets by private equity sponsors. However, in the years after the financial crisis, sponsors began to increasingly utilize their existing portfolio companies to do so-called "add-on" acquisitions. Such add-on acquisitions were typically financed through "incremental facilities" under the portfolio companies' existing credit agreements. Incremental facilities permit the borrower to incur additional indebtedness under its credit agreement, subject to the borrower's compliance with certain conditions, such as compliance with a maximum leverage ratio on a pro forma basis (most incremental facilities will also permit the borrower to incur a certain amount of debt without complying with any leverage test — an incremental starter basket), and so long as there are lenders willing to make such loans to the borrower.

Historically, the incurrence of any indebtedness under such incremental facilities required a full bring-down (i.e., making) of all of the representations and warranties contained in the credit agreement and the absence of any default or event of default at the time of funding under such incremental facilities. Private equity sponsors viewed these conditions as putting them at a disadvantage when competing against strategic buyers or other private equity buyers utilizing shell entities, which would typically get the benefit of full "SunGard" conditionality. As a result, many sponsors were able to negotiate provisions that, in cases of incremental facilities used to finance acquisitions that are not conditioned upon obtaining third-party financing (so called "limited-condition acquisitions"), permitted compliance with just a subset of "specified representations" and allowed the lenders providing such incremental facilities to waive the no-event-of-default condition. It is commonly accepted in the current market that the absence of any payment or bankruptcy event of default may not be waived, but we have recently seen some of the strongest sponsors successfully attempt to give incremental lenders full control over what conditions will be required with respect to any incremental facility.

Moreover, to the extent that an incremental facility in connection with a limited-condition acquisition required compliance with a leverage test or a no-event-of-default condition, credit agreements began allowing such conditions to be tested, at the borrower's election, at the time the acquisition agreement was signed, as opposed to the relevant acquisition closing date. Again, this was designed to create a more level playing field, since compliance with a leverage test is generally not typical in "shellco" private equity sponsor acquisitions. Complying with a leverage test at signing (which is largely in the sponsor's control, for instance through adjusting the amount of incremental facilities to be funded at closing) gave sponsors much greater certainty that they would be able to successfully close on a signed limited-condition acquisition. At the same time, however, it meant that the lenders agreed to assume the risk that the applicable leverage test may not be met at the time of closing, for instance due to the borrower's and/or the target's earnings before interest, tax, depreciation and amortization (EBITDA) declining between signing and closing. This risk can be a significant one, especially in situations where there is a long gap between the signing and closing of the acquisition or in situations where the existing business is declining and the sponsor is using the acquisition as a "Hail Mary" restructuring solution.

In the past few years, the limited-condition acquisition provisions have undergone a rapid evolution, such that the term itself has become somewhat of a misnomer. The applicability of these provisions in strong sponsor transactions has been expanded to all types of transactions, such as acquisitions, investments, restricted payments, asset sales, prepayments of indebtedness, etc., in each case "in connection with" a limited-condition acquisition (or in some, rare aggressive formulations, any permitted acquisition, not necessarily a permitted acquisition that is not conditioned upon obtaining third-party financing). It is now customarily accepted in the top-tier sponsor market that, in connection with any such transaction, the relevant date for determining whether any leverage or interest coverage ratio test is complied with, whether any condition relating to the accuracy of any representations and warranties or the absence of any events of default is satisfied, and availability under any of the "baskets" in the applicable credit agreement is, at the borrower's election, the date on which the definitive documentation for any such transaction is entered into or the date on which irrevocable notice with respect to such transaction is sent (e.g., sending an irrevocable prepayment notice on debt to be repaid). The argument for the expansion of these provisions is that these transactions are inextricably linked with the underlying acquisition itself and should really be viewed as part of the same larger transaction. While that can certainly be true, the somewhat vague "in connection with" language lends itself to differing interpretations and could potentially afford the "limited conditionality" treatment to transactions that are only tangentially connected to the underlying acquisition.

The expansion of the limited-condition acquisition provisions has been taken even further in the past couple of years in the top-tier sponsor market. Today, many transactions in this market provide that after the relevant determination with respect to a limited-condition acquisition has been made, such limited-condition acquisition will be deemed completed for purposes of any subsequent calculation of a leverage ratio test or determination of availability under any of the negative covenants "baskets" (including those baskets that include "grower" components based on a percentage of EBITDA or consolidated total assets). While the actual formulations vary from deal to deal, many of the formulations in essence permit the inclusion of the target's EBITDA and assets for purposes of various determinations under the credit agreement prior to the target's acquisition actually closing. As an illustration of the risks involved, these provisions raise the question as to what happens (as a credit matter) if, for instance, the borrower makes a dividend to its equity holders in reliance on the target's EBITDA or assets and subsequently the acquisition is never completed. Such risks could be especially pronounced in asset-based lending (ABL) transactions, where the financial covenant is commonly tied to a fixed charge coverage ratio (i.e., a ratio of EBITDA to certain fixed charges, such as interest payments, scheduled payments under capital leases, etc.). A fixed charge coverage test is generally viewed as more borrower-friendly and easier to comply with than a leverage ratio test, something that is amplified by the fact that in many ABL transactions, the fixed charge coverage ratio is set at a relatively loose level of 1-to-1. As a practical matter, any breach or potential breach of such test would likely be an indication of financial distress. Therefore, if the borrower were to attempt to boost its EBITDA and fixed-charge coverage ratio in the manner permitted by limited-condition acquisition provisions, this could create a significant credit issue for ABL lenders.

There is one more somewhat unique aspect of "add-on" acquisitions that relates to the absence of the so called "Xerox" provisions from the underlying acquisition agreements. "Xerox" provisions (named for the 2009 deal where such protections originated) came about in response to post-financial crisis litigation in cases such as Clear Channel and Huntsman-Hexion where the sellers brought claims against the respective buyers' financing sources for tortious interference with the acquisition agreements in jurisdictions that are relatively favorable to debtors. The actual scope of the "Xerox" provisions is beyond the scope of this article, but they involve a waiver of jury trial in any action involving the financing sources, exclusive jurisdiction of New York courts in any such actions, and certain other protections that are all intended to protect the financing sources in the event of a lawsuit by the seller. "Xerox" provisions have become commonly accepted in the marketplace since their inception, and currently, the vast majority of private equity acquisition agreements will contain such provisions, barring some highly unusual situations — for instance if the private equity sponsor for competitive reasons wants to present its bid as an all-equity bid.

In the context of “add-on” acquisitions, credit agreements do not typically contain a condition to the utilization of incremental facilities that the lenders providing such incremental facilities be satisfied with the acquisition agreement for such “add-on” acquisitions; in comparison, arrangers signing up to commitment letters for initial acquisitions by private equity sponsors will insist on the inclusion of “Xerox” protections in the acquisition agreement. However, if the relevant incremental facility is provided on a fully underwritten basis by committing incremental lenders (which is the common expectation of private equity sponsors in an “add-on” acquisition with no financing condition), there is really no substantive difference between such an “add-on” acquisition and an “initial” acquisition in terms of potential risks that lenders are exposed to vis-a-vis the seller (albeit the seller will likely have initial recourse to a more financially substantial buyer entity). Therefore, lenders and their counsel should make it clear in the commitment letters in respect of the relevant incremental facility that the lenders must be satisfied with the acquisition agreement, including the “Xerox” provisions, and that any amendments to the acquisition agreement that are materially adverse to the interests of the incremental lenders will require their consent.

U.K.-Style “Certain Funds” Conditionality

The last part of this article provides a brief overview of some aspects of the U.K.-style “certain funds” provisions and how they differ from the U.S.-style “SunGard” limited conditionality. While the intricacies of the U.K.-style “certain funds” conditionality warrants a separate more in-depth look, it is important for U.S. market participants to have a general familiarity with U.K. market practice given the use of New York-law governed financings to fund the acquisition of U.K. companies.

Unlike in the United States, in the U.K. there is a statutory requirement that an acquirer of a public company must demonstrate its ability to satisfy the purchase price. If the purchase price includes a cash component, it must be available on a “certain funds” basis in order to comply with the applicable statutory requirements. This applies to both the equity and debt financing sources for a public takeover. Under the relevant regulations, an independent financial adviser is required to give a "cash confirmation" in respect of the offer and is liable to fund the purchase price if the buyer fails to complete the acquisition for lack of funds in circumstances where the adviser has failed to perform this cash confirmation exercise properly.

While "certain funds" is a legal requirement for public-to-private transactions only, it has been a common feature of purely private transactions for many years. Under a "certain funds" approach, the conditions to funding are generally limited to the following: (1) satisfaction of all conditions precedent, (2) no change of control or sale taking place, (3) no illegality (meaning it has not become illegal for a lender to fund) and (4) no "certain funds" default continuing or resulting from funding. The provisions that are included within the ambit of the "certain funds defaults" are limited to a small subset of the representations and warranties, covenants and events of default. While the scope of these "certain funds" defaults varies from deal to deal, the key difference from the U.S. limited-condition approach is that they relate to the bidder group only and not to the target and its subsidiaries. Since compliance with respect to the target group is viewed as beyond the borrower’s control prior to the acquisition closing date, requiring such representations to be accurate with respect to the target group would not satisfy the “certain funds” statutory requirements. The effect of that and certain other characteristics of the U.K. “certain funds” regime (such as the absence of a condition that no material adverse effect with the target has occurred) is that in the U.K., especially in transactions structured as “shellco” acquisitions, it is possible for buyers to obtain a significantly greater certainty of financing being available than in the U.S.

With respect to the conditions precedent, in a public transaction they must all be satisfied or in agreed form at the time the offer for the public company is made. In practice this means, for example, that the credit agreement, intercreditor agreement and security documentation must have been entered into. For purely private transactions the degree to which the conditions precedent are satisfied or in agreed form varies, often depending on the competitive nature of the auction process, whether the transaction is a club relationship bank deal or a syndicated deal, and cost. Some sponsors will require almost all the conditions precedent to be agreed, while others will focus on the key commercial conditions precedent only (i.e., approval by the lenders of the acquisition agreement, diligence reports and tax structure paper). One relatively common feature is the use of the so-called "interim facility agreement." This is a fully negotiated short-form credit agreement that is attached to the commitment letter for the transaction and which the lenders agree to sign on short notice in conjunction with execution of the acquisition agreement. The interim facility will have a very short maturity date. Neither party intends to use it, but it gives the buyer comfort that they can close the acquisition in a worst-case scenario. In practice, the full form credit agreement is drafted and negotiated once the sponsor has exclusivity and is signed prior to closing. One of the reasons for this practice is that, unlike under New York law, there is no general requirement to negotiate in good faith under English law.

One further distinction between U.S. and U.K. practice is that while in the U.S. it may be the case that only some of the representations and warranties will be required to be made on the closing date, it remains common practice in the U.K. that generally all representations and warranties are made at closing but only the failure of certain “certain funds” representations relating to the borrower group (but not the target group) will be a funding block. The lenders will therefore preserve their rights with respect to the full suite of representations and warranties and could call an event of default post-closing, but they can't use a breach of a representation that is not a "certain funds" representation to prevent funding. In most U.K. deals the borrower is given a grace period to remedy any event of default that arises with respect to the target group within a short period post-closing. This is known as the "cleanup period." In the past few years this ability to clean up a breach resulting from an acquisition has been extended to cover bolt-on acquisitions also.

Summary

As should be apparent from this article, provisions relating to limited conditionality in acquisition financings have evolved significantly since their inception. This is, no doubt, indicative of the negotiating power of major private equity sponsors and the fiercely competitive nature of the acquisition financing underwriting business. It is safe to assume that these provisions will continue to evolve and that both arrangers and private equity sponsors will likely continue to explore whether (or not) additional flexibility will be appropriate and whether existing flexibility is appropriate in all contexts.

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