2010 Acquisition Financing: Trends From 2009

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This article discusses acquisition financing trends that emerged in 2009 and draws some tentative conclusions about what 2010 may bring.

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A LOOK BACK AT A TUMULTUOUS YEAR

The loan markets began 2009 in the shadow of the credit crunch that began in the summer of 2007 and escalated to a credit meltdown in the fall of 2008. The average secondary bid for institutional loan tranches was in the 60s, the market for new collateralized loan obligations (CLOs) had shut down, many arrangers of debt financing had either exited the market, merged with a competitor or obtained government assistance and market participants worried about refinancing cliffs and spiking loan default rates.

As dire as things seemed then, by the end of 2009 there were signs that the acquisition financing market may have begun to see a dramatic recovery. Warner Chilcott's $3.2 billion leveraged acquisition financing, which closed oversubscribed in October, confirmed that in the right sector, for the right credit and with the right economics, multibillion-dollar acquisition financings could get done (see *Practice Note, Market Trends Emerging?: The Warner Chilcott Acquisition Financing (www.practicallaw.com/0-500-8114)*). The uptick in leveraged buyout (LBO) activity that followed (including TPG/CPP/IMS Health and Blackstone/Busch Entertainment), coupled with some financings to fund dividend recapitalizations (including Booz Allen), even caused some commentators and regulators to speculate that a new debt bubble was on the horizon, noting, among other things, that leverage levels in some transactions had approached those last seen in 2007.

This Article looks at the trends that emerged in this dramatic year and attempts to draw some tentative conclusions about what 2010 may bring.

CONCERN FOR DEAL CERTAINTY

In 2009, financial sponsors and strategic buyers alike were forced to adapt to tight credit conditions, including by eliminating debt financing entirely, or by changing the terms of acquisition agreements. At the same time sellers were increasingly focused on ensuring the deal would go through in the aftermath of the 2005-2007 "LBO boom", which saw many high profile transactions fail or become the subject of renegotiation or litigation. For example, despite predictions to the contrary, financing outs have not become common in financial sponsor deals that required debt financing. This seller focus on deal certainty meant that pressure remained on buyers to ensure that their loan commitments had the fewest possible conditions precedent to funding. Meanwhile, mindful of the failed or delayed syndications of 2007, arrangers were focused on ensuring that they had enhanced flexibility to deal with material adverse changes in the market or in the financial condition of their borrowers.

A review of some key conditions precedent typically found in loan commitments illustrates how arrangers and borrowers are balancing these competing objectives.

Market MACs and Flex Provisions

The market MAC condition (which allows the arrangers to refuse to fund a loan commitment if there has been a material adverse change in the financing markets) did not, as some had predicted, become common in loan commitment letters in 2009, suggesting buyers and sellers continued to be unwilling to accept the deal uncertainty that this condition entails. Instead, arrangers appeared to be relying on enhanced flex provisions to mitigate market risk. Flex provisions allow arrangers to unilaterally modify (within specified limits) the terms of a proposed financing if a successful syndication cannot be achieved with the initial terms. Although flex language has been a common component of financing commitments for a number of years, the agreed scope of available flex language has changed dramatically from that which prevailed during the LBO boom.

LBO boom financing commitments typically contained very circumscribed flex language, limited to an ability to change interest rates on the loans (pricing) within a narrow band and a limited ability to reallocate debt among tranches or facilities. Several 2009 loan commitments, by contrast, granted the arrangers broad authority to modify the terms of the committed debt, including through more liberal rights to reallocate the debt among tranches or to allocate a portion of the committed amount to newly created tranches or facilities, such as mezzanine or second lien debt.

In addition, arrangers continued to be reluctant to commit to particular covenant levels and related definitions or agree to use sponsors' forms of documents as precedent for the loan documents. Arrangers also sought to clarify that flex rights were available to them even if the exercise of those rights would not result in a successful syndication. This change was in direct response to experiences during the financial crisis, in which arrangers found themselves in disputes with borrowers about whether they had the right to flex the terms of a transaction in circumstances where no amount of flex would allow the arrangers to reduce their exposure to the level defined as a "successful syndication".

But perhaps the most dramatic change has been in the scope and nature of pricing flex provisions. Instead of the 25 to 75 basis-point limit typical during the LBO boom, some 2009 financings included pricing flex at levels substantially higher than expected market-clearing prices, and with additional adjustments for changes in market indices (such as Markit LCDX or benchmark high-yield indices). Moreover, because the higher flex caps were often expressed as a weighted average which applied to all debt tranches and facilities, the arrangers were able to allocate the pricing increases to the portions of the financing that they concluded most needed it.

(For more on flex provisions, see *Practice Note, Fee Letters Overview: Lending: Flex Language (www.practicallaw.com/5-381-0293)*.)

Solvency

As a direct consequence of the experience of lenders in Hexion/Huntsman and other recent cases (see *In Dispute: Hexion Specialty Chemicals, Inc./Huntsman Corporation (www.practicallaw.com/5-384-1893)* and *In Dispute: Genesco, Inc./The Finish Line, Inc. (www.practicallaw.com/0-385-3647)*), arrangers appear to be more focused on the requirements that have typically been specified in loan commitments relating to the solvency of the borrower following the acquisition. During the LBO boom, the mere delivery of a customary certificate from the borrower's chief financial officer was generally sufficient to satisfy the solvency condition.

In 2009, arrangers often required that the solvency certificate be in form and substance satisfactory to them and that the truth of the borrower's solvency representation be a condition to closing. This gives arrangers greater flexibility to refuse to lend if the resulting company appears to be insolvent, even if no material adverse effect (MAE), as defined, has occurred (for example, because the material adverse change condition has a carve-out for industry-wide conditions that do not disproportionately affect the borrower).

"SunGard" Limit on Additional Closing Conditions

SunGard language arose in the early stages of the LBO boom as a mechanism for increasing deal certainty (see *Standard Clause, Commitment Letter: "SunGard" Clause (www.practicallaw.com/9-381-9833)*). It provided that there could be no conditions precedent to closing in the definitive loan documents except as expressly specified in an annex to the commitment letter (conditions annex). It limited the representations required to be true at closing to material representations specified in the acquisition agreement and a narrow set of additional "specified representations". It also limited the actions required to be taken by the borrower pre-closing to perfect security interests in collateral. These limits were designed to assure buyers and sellers that if the conditions to closing under the acquisition agreement were met, the lenders would not have an additional reason not to fund the loan beyond the narrow set of conditions in the conditions annex.

To the surprise of some, SunGard provisions appeared in several 2009 transactions, albeit in modified form, with an expanded set of specified representations and more targeted provisions for collateral (see *Practice Note, Market Trends Emerging?: The Warner Chilcott Acquisition Financing (www.practicallaw.com/0-500-8114)*). This experience suggests that in the right circumstances, a SunGard provision that is tailored to the particular facts of the transaction may provide an acceptable level of protection to the arrangers without compromising deal certainty to the buyer and seller.

Ratings or Performance-Based Conditions

In several recent strategic acquisition financings (including Pfizer/Wyeth and InBev/Anheuser Busch), lenders have insisted on a pro forma investment grade rating as a

condition to closing. Minimum EBITDA and maximum leverage ratio test conditions were also more common in 2009 transactions, both in acquisition agreements (such as MSC Software/Symphony Technology) and in commitment letters (such as Warner Chilcott/P&G). The inclusion of these conditions in loan commitment letters continues to be a source of considerable negotiation, as they introduce additional uncertainty into a transaction. However, it appears that sellers, buyers and arrangers are willing to negotiate performance-based conditions on a case-by-case basis, such as leverage conditions that can be satisfied through the injection of additional equity or minimum EBITDA conditions set at levels that buyers and sellers are confident can be met. (For samples of recent commitment letters, including Warner Chilcott/P&G, see *Practice Note, What's Market: Commitment Letters (www.practicallaw.com/5-500-4967)*).

Merger Agreement-related Conditions

Early drafts of loan commitment letters typically contain a condition that the acquisition agreement be satisfactory to the arrangers. In recent transactions, arrangers have added language specifying that the acquisition agreement will not be deemed satisfactory (and therefore a condition to funding will not be met) unless, among other things, it contains the provisions discussed under Lenders Seek Limits Too (for example, that the lenders benefit from any limitation on liability granted to the buyer). Later drafts of loan commitment letters will typically replace this condition with a condition that the acquisition agreement not be modified from the version delivered to the lenders before signing the commitment letter. During the LBO boom, the prohibition on modifications to the acquisition agreement was usually limited to "material adverse" modifications or amendments.

In 2009, arrangers pointed to their experiences during the financial crisis, in which adverse changes in the target company's business were addressed through amendments to the acquisition agreement that, it was argued, did not meet the definition of a material adverse modification. For example, if the acquisition agreement was modified to reduce the purchase price of the target company due to perceived softness in the seller's business, the buyer could argue that the amendment was not a materially adverse modification because it lowered the cost of the acquisition. 2009 experience suggests that arrangers are increasingly insistent that there be no material changes (whether or not adverse) to the acquisition agreement, or that certain changes, such as changes to price or structure, be deemed to be materially adverse.

A WORD ABOUT BRIDGE LOAN FACILITIES

The terms and nature of bridge loan facilities included in leveraged acquisition financings are closely related to issues of deal certainty, conditionality and flex rights. Bridge facilities (short-term loan facilities that bridge to a capital market securities issuance or other takeout that refinances the bridge loan) were originally designed with pricing and terms that were intended to be unattractive, reflecting both sides' expectation that the bridge facility would not be drawn. During the LBO boom, as pricing and terms became more favorable to borrowers, bridge facilities were increasingly viewed by borrowers and financial sponsors as a relatively inexpensive financing option, without rigorous covenants, that could be used to close a transaction and form a temporary, or even long-term, part of the capital structure until the capital markets provided an attractive opportunity to refinance.

At the same time significant limitations were imposed on the arrangers' right to issue a securities demand (a right to require that the borrower issue securities into the debt capital markets to refinance the bridge loan). Among other things, a securities demand often could only be made after the bridge loan was funded (frequently only after a grace period, called a post-closing holiday) and the securities issued were required to be sold to unaffiliated third parties on terms that were consistent with sponsor precedent in previous deals (see *Practice Note, Fee Letters Overview: Lending: Securities Demand (www.practicallaw.com/5-381-0293)*).

Experience in 2009 suggests a return to the pre-LBO boom approach to bridge facilities. In addition to higher pricing and tighter covenants, there is some evidence that arrangers are seeking greater flexibility to make securities demands, including by removing many of the limitations that applied during the LBO boom, and permitting arrangers to require that the securities be issued into escrow before closing. While it would be premature to make any predictions about the future of bridge loan facilities, it seems clear that arrangers and borrowers are continuing to assess the risk and cost of including these facilities as part of a proposed capital structure in light of evolving market conditions.

BUYERS ARE LESS ABLE TO HIDE BEHIND LENDERS

The increased focus on deal certainty has also reduced buyers' ability to use lenders' purported reluctance or refusal to fund as a way to attempt to renegotiate or walk away from the transaction. In recent deals, sellers typically have the

right to seek specific performance of buyers' obligations to obtain financing. These obligations have generally become tighter and often include specific obligations to take enforcement action, including seeking specific performance, against lenders. Not surprisingly, some sellers have sought to gain third party beneficiary rights under loan commitment letters so that they can directly sue lenders that refuse to fund. While it is not uncommon for sellers to obtain these rights in equity commitment letters (such as in Parallel/Apollo), these requests gained no traction with lenders in 2009. As leveraged deals continue to be structured with limited recourse to parent sponsors, sellers may continue their efforts to obtain direct enforcement rights of the debt commitments. Lenders will most likely continue to resist.

For more on acquisitions that involved disputes over specific performance, see:

- *In Dispute: Genesco, Inc./The Finish Line, Inc. (www.practicallaw.com/0-385-3647)*
- *In Dispute: Clear Channel Communications, Inc./Bain Capital Partners, LLC & Thomas H. Lee Partners, L.P. (www.practicallaw.com/5-383-4840)*
- *In Dispute: United Rentals, Inc./Cerberus Capital Management, L.P.*

LENDERS SEEK LIMITS TOO

At the same time, lenders are scrutinizing more closely the provisions of the acquisition agreement, including provisions that require the borrower to cause the debt financing to close. In some instances, lenders have succeeded in softening this language by providing that the decision to enforce the commitment will be at the buyer's sole discretion, or eliminating language that expressly requires that the buyer bring an action against the lenders. However, in general, lenders have had only limited success in having this language modified.

Lenders have also sought, with increasing determination, to limit their liability to buyers and sellers in the event that a reverse termination fee is paid. The Xerox/ACS acquisition agreement, for example, provides that the payment of the reverse termination fee is the sole and exclusive remedy against the lenders as well as the buyer. The seller also agreed that any actions brought by it against the lenders would be heard exclusively in New York and that the lenders were third party beneficiaries of that agreement. This is likely a response to the experiences of Clear Channel and Hexion/Huntsman, where sellers brought tortious interference claims against lenders in forums that were viewed as more friendly to those sellers (see *In Dispute: Clear Channel Communications, Inc./Bain Capital Partners, LLC & Thomas H. Lee Partners, L.P. (www.practicallaw.com/5-383-4840)* and *In Dispute: Hexion Specialty Chemicals, Inc./Huntsman Corporation (www.practicallaw.com/5-384-1893)*).

FROTHY MARKET FEATURES RETREAT (OR DO THEY?)...

In addition to changes relating to conditionality and deal certainty, other top-of-the-market features were largely absent in 2009, despite some signs toward the end of the year of a possible reappearance. Covenant-lite loans, PIK toggles, general purpose accordians and equity cures continued to be largely out of fashion.

However, arrangers' attitudes toward these features may be more nuanced than they at first appear. Some covenant-lite tranches were entered into in late 2009 as add-ons to or refinancings of existing covenant-lite loans. Anecdotal evidence suggests that limited equity cures may be available, though arrangers have as yet not been willing to commit to them if the syndicate lenders object. And modified versions of the PIK toggle have reappeared in some high-yield bond transactions, suggesting that their reemergence in the loan market context is not out of the question.

...AS OTHER CREDIT CRUNCH TECHNOLOGY IS INTRODUCED

As a direct result of arrangers' experiences during the financial crisis, certain technology has emerged or been recycled from the pre-LBO boom days and become part of many arrangers' standard forms. Defaulting lender provisions, which, among other things, strip insolvent, bankrupt or otherwise defaulting lenders of certain rights, have become a fixture in most loan documents (see *Practice Notes, What's Market: Defaulting Lenders (www.practicallaw.com/4-500-3888)* and *Defaulting Lenders (www.practicallaw.com/4-500-2148)*). Various provisions designed to protect lenders against market dislocations of the sort seen in 2008 have also become more common, including provisions ensuring base rate pricing will not be less than 100 basis points over LIBOR pricing and a floor on LIBOR itself below which the LIBOR rate cannot fall (see *Practice Notes, What's Market: Eurodollar Rate/LIBOR Interest Rate Provisions (www.practicallaw.com/8-*

385-8146) and *What's Market: Market Disruption Clauses (www.practicallaw.com/6-386-0428)*). Finally, several recent transactions, including Warner Chilcott/P&G, have included pre-wired loan buyback mechanics designed to allow borrowers to repurchase loans without lender consent, while offering lenders protections designed to ensure procedural fairness and minimize interference with the normal lender-borrower relationship (see PLC*What's Market, Warner Chilcott Corporation Credit Agreement Summary and Practice Notes, Understanding Loan Buybacks (www.practicallaw.com/7-385-0650)* and *Further Developments in Loan Buybacks (www.practicallaw.com/2-386-1302)*).

A LOOK AHEAD

The fundamental tensions in acquisition financings have not changed. Buyers and sellers desire deal certainty and unconditional loan commitments and arrangers desire flexibility to ensure a successful syndication. What emerged in 2009 was a continuing evolution in the ways that market participants balanced these competing objectives in light of new market realities and reduced access to credit. As noted above, the SunGard limitations have survived but are more carefully negotiated for the individual transaction. Market MACs have not returned, but concerns about changes in market conditions have been addressed through expanded flex provisions.

In addition, some of the post-financial crisis technology is likely here to stay. Base rate pricing will not be permitted to be less than LIBOR pricing, solvency conditions will continue to be more carefully scrutinized and arrangers will continue to look for ways to reduce and quantify their exposure.

As credit conditions continue to improve, one question will be to what extent buy-side loan market participants' appetite for yield and arrangers' appetite for fees will outweigh some of the current focus on structural issues. Evidence from late 2009 suggests that some top-of-the-market features that were viewed as "off the table" in 2008 (such as covenant-lite and equity cures) may, under the right circumstances, be fair game for negotiation between borrowers and sponsors and arrangers in 2010. In addition, finding the right balance concerning 2009 developments such as enhanced market flex provisions and pre-closing securities demands will likely occupy a significant amount of participants' time and energy. It promises to be an interesting year for arrangers and sponsors alike.