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WSJ M&A 101: A Guide to Merger Agreements

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Ronald Barusch spent more than 30 years as an M&A practitioner at Skadden, Arps, Slate, Meagher & Flom LLP before retiring this year. He is no longer affiliated with the firm and the views expressed here are his own.

My posts frequently contain discussions about the wonky world of merger agreements. I realize that some readers may never have actually read a merger agreement like the ones I have blogged about in Hertz/Dollar Thrifty or Blackstone/Dynegy.

You can be forgiven for that. Merger agreements can run from 80 to 100 pages — longer than Dickens' A Christmas Carol.

Today's post contains some guidance on being your own M&A lawyer, things you should understand if you want to invest in "deal stocks" or simply want to better understand how the arcane world of deals really works.

It all starts with that merger agreement. In this post I discuss the provisions of the agreement that occupy 80% of the space and are irrelevant 95% of the time: Those sections which address when a party has a right not to close.

In the overwhelming majority of deals and in the absence of a global financial crisis, the parties are enthusiastic about closing and these provisions are not relevant. But lawyers are paid to think about things that can go wrong.

To understand how lawyers can take what seems like a simple concept of a purchase of a company and turn it into a monstrous document, you need to understand a bit about how the sausage is made. Merger agreements are not drafted by a lawyer sitting down and dictating to a secretary. They are always based on a precedent transaction or melding several precedent transactions—and the opposing lawyer expands it with even more precedents which favor his side.

If you want to understand the dynamic involved, pull out your mortgage or your will, which you probably have not read carefully either. Their wordiness has three

things in common with merger agreements: First, the basic language and structure are based on what similar documents looked like over a century ago. Second, every time a problem arises (for wills, think a secret illegitimate child and, for mortgages, think the fauxclosure scandal) lawyers want to address these contingencies with additional provisions. Third, over time there are more laws and regulations, adding still more provisions in response.

There are other elements that apply to mergers but probably not to your documents. First, when two parties negotiate a provision, the wording almost always gets longer, not shorter. Compromise tends to increase complexity. Second, when you are dealing with billions of dollars, no contingency or risk is too small to merit a section. And finally, word processing has replaced typewriters and carbon paper allowing unlimited rewrites and expansions, which lawyers love. As a result, drafting acquisition agreements is truly a growth industry, even if it is not true that lawyers are paid by the word.

Turning to the substance, there are four "Articles" in every merger agreement that define the rights of a party to avoid closing:

Conditions. The conditions article tends to be quite short– just two or three pages— and relatively straightforward. For example, regulatory requirements need to be satisfied. The representations and warranties (or "reps" as they are shorthanded and which I discuss below) need to be true in all material respects both at signing and closing. And most importantly, there cannot have been a "material adverse change" in the business.

The "MAC" clauses are heavily negotiated. Buyers are concerned by recent court cases making it relatively difficult to invoke these clauses. Sellers try to carve out certain events from the MAC clauses—for example the circumstances under which general industry or economic developments would not give the buyer a right to walk.

Unlike most of the wording of the provisions discussed in this post, this provision always involves input from the most senior lawyers, bankers and client executives. Finally, there can be conditions specific to a deal: for example, a private equity buyer planning to use significant borrowed funds may insist on a financing condition. Obviously a buyer resists this and I will discuss some of the implications of such a condition in my subsequent post.

Representations and Warranties. When you buy a private company, it can be a bit like buying a toaster. You get a series of reps which, if they turn out wrong (like a toaster not working), you can use to get your money back. In public deals, though, it is not realistic to offer the buyer a refund for breaches of the reps. Yet the parties still give reps. Their only function is to trigger the condition discussed above and blow up the deal.

Nevertheless, enormous amounts of time can go into negotiating the reps. For example, extended discussions can be had around whether a particular rep should be qualified by

materiality—so that if it is just a little not true, it is not a breach. And similarly lengthy discussions can occur over whether a representation is given to a company's "knowledge." Ironically, these qualifications make little or no difference. Remember that the reps only have to be true "in all material respects" to require the other party to close regardless of individual qualifications. And "knowledge" is one of my favorites of the meaningless discussions: since the reps function as conditions and the reps need to true at closing, a buyer can give the seller knowledge by whispering in his ear at closing. So why do lawyers fight over these words in the reps? No one likes to give a flat statement and be wrong—even if it has no contractual consequences—so lawyers spend a lot of time helping their clients hedge the language.

Covenants. A merger agreement generally contains extensive covenants restricting how the business of the target is operated between signing and closing. To some extent this is the mirror image of the reps and warranties—reps and warranties discuss what has happened and covenants discuss what will happen. A breach of a covenant could produce a lawsuit, but once again the primary remedy for a material breach is usually a right to walk away.

Termination. The agreement can be terminated for a number of reasons: breach by the other party, failure to obtain required shareholder or regulatory approval, and if the conditions cannot be satisfied by a specified "drop dead" date. This article contains the right to terminate the deal if a better offer comes along—the so-called "fiduciary out"—which I will discuss in my subsequent post.

In most cases, would a buyer walk away from a major merger if the seller refuses to give a separate representation that there are no zoning issues at any of seller's numerous properties or that all insurance is in place when there is no reason to believe these are critical subjects? Generally no. (After all, buyers always get reps on the accuracy of the public filings and the presentation of financial statements.)
Some buyers have more leverage than others and get more of what they want. In many cases, though, the resolution of numerous minor disputes, laid out in thousands of words, is largely an arbitrary process. If anything, each side wants to feel it received a "fair" number of points against its negotiating partner. This, of course, encourages each side's lawyers to raise lots of points.

My next post on merger agreements will address a very different set of issues: deal protections, fiduciary outs and "social issues" (which means how management is to be treated after the merger). These are almost always contentious, require resolution at the highest levels and are make or break issues. Together with pricing, they create the drama in a merger negotiation.