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

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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-

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

(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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