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Managing Deal Risks in a Challenging Regulatory Environment: Strategies and Deal Terms

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Key Points

– With increasingly aggressive antitrust and foreign direct investment reviews, companies pursuing strategic transactions must assess and anticipate regulatory issues before they sign a deal.

– That analysis will frame many aspects of their negotiations and form the basis of a well-informed regulatory strategy.

– Careful thought needs to be given to deal terms that mitigate and allocate the risks of delay or a failure to gain approval while creating incentives for both parties to complete the transaction.

The already complex business calculus that goes into a merger has become even more complicated in the past several years because of stepped-up government scrutiny. Major transactions have been blocked or abandoned in the face of opposition by regulators in the U.S., U.K. and European Union on competition and national interest or national security grounds.

Regulators may insist on remedies based on novel theories of harm, and the value of a deal may be eroded by delays or significant regulatory demands. In this environment, outcomes have become less predictable, and there is an increased risk that a deal raising competition issues may not be completed by the contractual deadline, or may fail altogether.

To navigate their deals in the face of these challenges, companies need to have a thorough understanding of regulators' priorities, a clear strategy for obtaining approval — with terms in their transaction agreement to address and allocate the regulatory risks — and spell out the parties' respective obligations.

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Here, we will discuss the various legal and strategic choices companies will face, along with some practical considerations based on our experience.

Preparation

Pre-Signing Analysis: Evaluate the Risk of a Blocked or Abandoned Transaction

Before entering into a transaction, companies must assess the regulatory risks. That analysis will inform the negotiation of the terms of the transaction agreement and ground their strategy for gaining clearances.

Potential regulatory hurdles include:

- **Antitrust/competition.** These reviews have become less predictable and lengthier as regulators in the U.S., U.K. and EU have adopted new approaches to competitive analysis, expanded their notions of competitive harm and challenged mergers that would have been routinely approved in the past, and generally taken a more skeptical view of mergers. In addition, some regulators outside the U.S. have broadened the grounds on which they will assert jurisdiction.
- **Industry-specific.** Some companies — *e.g.*, public utilities, financial institutions, and transportation, telecommunications and broadcast companies — may be subject to industry-specific regulators in different jurisdictions that may have mandates to consider factors beyond competition, such as safety or the public good.
- **Cross-border.** Foreign buyers of U.S. companies have to consider the Committee on Foreign Investment in the United States (CFIUS), which reviews deals for national security concerns. Other countries also have various regimes to screen foreign direct investments (FDIs).

Competition reviews are often the most lengthy and difficult, so it is crucial to conduct a probing analysis that goes well beyond traditional competition measures such as horizontal overlaps and combined market shares, which might have sufficed in the past. Today, the analysis should extend to possible future product development, as well as current and future relationships between the companies' products.

Early-stage analysis may involve collecting relevant materials and data and interviewing key business people. For more complicated deals, antitrust diligence may also include hiring an economist to help analyze the available evidence and engaging the other party's counsel, who should be doing the same work on its side.

Regulators in the U.S., U.K. and EU increasingly request that companies produce significant volumes of internal documents to thoroughly assess the rationale, valuation and other aspects of a transaction. The analysis should therefore also consider the parties' documents as early as possible in the process, in addition to assessing the expected reactions of customers, suppliers, employees, industry groups and competitors, because those increasingly factor into regulators' decisions.

Whatever the nature of the review — competition, FDI, national security, or state or federal industry-specific commissions — the parties need to understand the relevant authorities' current enforcement priorities and any novel doctrines that key officials espouse. In cross-border deals, they will also need to evaluate the impact on national "industrial policy." That will include any connection to highly sensitive or favored industries and other policy goals that regulators may pursue as part of their review.

Today, those could include climate change, data privacy, artificial intelligence (AI), employment and even wealth distribution. (See "Antitrust Enforcers Are Increasingly Focused on Labor Markets, and Not Just in the Merger Context" and "The Meteoric Rise of Generative AI Has Regulators Gearing Up To Preserve Competition.")

From the outset, the parties will need a strategy to address anticipated concerns head-on. What will be the pitch to regulators? Should the parties make preemptive divestitures to moot problems and speed a review? At what point should they be prepared to litigate?

Information Sharing and Its Limits

Before signing an agreement, the parties will need to work together to understand regulatory risks and agree on a strategy to obtain approvals, and then will need to work collaboratively to obtain those approvals.

That is complicated by rules requiring that competitors aiming to merge remain fully independent and continue to act as competitors until their transaction is consummated. "Gun-jumping" rules prohibit (a) the passing of competitively sensitive information between parties to a pending merger without appropriate protections in place and (b) actions by the buyer to control the target business before the regulatory process concludes. The Department of Justice (DOJ), Federal Trade Commission (FTC) and the European Commission have each pursued violators and won fines.

Parties therefore will need to establish procedures that ensure compliance with the law while allowing the exchange of sufficient information to anticipate regulatory issues. They may want to employ comprehensive nondisclosure agreements and perhaps additional restrictions for particularly sensitive information — for example, detailed employee census data where the parties compete for employees.

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Tactical Trends We Have Observed

In recent transactions, we have seen:

- Greater sensitivity by the parties to the increase of time it takes to obtain regulatory approvals.
- A heightened interest in "fix-it-first" preemptive remedies to address possible competition concerns.
- Contractual provisions expressly addressing whether the parties are required to litigate to obtain regulatory approvals.
- An increasing need to prepare for litigation in parallel with traditional negotiations over remedies.
- An increased focus on whether to grant regulators' requests for extensions of their deadlines, given that, if the matter is going to be litigated, the parties will want to start as soon as possible.
- An increased use of termination fees to provide the parties with a negotiated exit strategy.
- Well-considered references to foreign regulatory agencies where their approval is not mandatory but they could exercise discretion to "call in" a transaction they perceive to raise competition risks.

Agreement Terms To Mitigate and Allocate Risk

There is a well-established toolbox of M&A terms that companies can draw on to manage regulatory risks and specify who bears them, but these are likely to be heavily negotiated because the acquirer's perspective and priorities will differ from the target's.

- **The seller's** key goal is getting paid as soon as possible without the risk of a deal not closing and without undue delay in regulatory approvals.
- **The buyer** aims to preserve the value of what it is purchasing, which means minimizing any remedies necessary for regulatory approval, including divestitures.

Timing Provisions

A potentially lengthy period between signing and closing may affect the value of the deal from the seller's standpoint, based, if nothing else, on the time value of money. Virtually all agreements where a delayed closing is possible contain an outside ("drop-dead") date at which point one or both parties can opt to terminate the agreement. As extended reviews and challenges have become more common, outside dates have moved further out from signing and often include provisions for extensions.

Other provisions can offer protection to the target in the event of delay:

- "Ticking fees," by which the cash consideration is increased daily if the closing does not occur by a specified date. (These are relatively uncommon.)
- If legally permissible, loans from the acquirer to the target that are forgiven if the primary transaction does not close.
- Expanded reimbursement for the target's costs to negotiate and consummate a divestiture.
- Additional employee retention funds for the target if the deal does not close within certain time periods, typically shouldered by the target but sometimes reimbursed by the acquirer.

Providing in the merger agreement for possible delays can help avoid a situation where a party seeks to renegotiate terms if the deal drags out longer than expected.

Efforts Covenants

Efforts covenants, which require both acquirer and target to work together to obtain regulatory approvals, including by agreeing to divestitures and other remedies, are the most common terms adopted to cover the regulatory process.

- **Sellers** are likely to want something as close as possible to a "hell or high water" covenant — one that requires the parties to accept all divestitures or other remedies that regulators demand.
- **Buyers** will want something more like a reasonable best efforts standard, potentially limited by qualitative materiality or a quantitative cap (*e.g.*, a dollar amount or specific assets or business lines) that limit the concessions that the parties are required to accept.

The key is to negotiate a level of commitment that matches the most likely outcomes. This provision will be framed based on the initial analysis of possible scenarios. It is important to keep in mind, too, that even a "hell or high water" commitment does not guarantee consummation of a deal in the face of resolute regulatory opposition.

Reverse Termination Fees

Where there is a significant risk that the transaction will not be approved, even with remedies, the target may negotiate for a reverse termination fee payable by the acquirer in the event regulatory approvals are not obtained and the transaction fails to close. These fees provide an additional incentive to the acquirer to obtain approvals.

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Reverse termination fees are typically 4% to 6% of the transaction value (occasionally much more), but from the seller's standpoint, they may be a poor substitute for completion of the intended transaction.

Preemptive ('Fix It First') Divestitures

To head off problems with regulators, the parties can decide to exclude assets that create issues for the transaction. For instance, where something less than a whole company is being purchased, the seller might agree to retain the problematic asset. In transactions involving a whole company, the parties may agree to a "fix it first" strategy, divesting a business or asset to a third party at or near the time they sign the main agreement. These can resolve regulators' concerns early and shorten the time it takes to obtain approvals.

One advantage of proposing remedies is that, if the government later challenges the deal, it will have the burden of proving that the remedies are insufficient to address projected anticompetitive effects. A disadvantage is that regulators may view such agreed-upon divestitures as just a starting point for negotiations.

Interim Operating Covenants

Given lengthy regulatory review and approval time periods, the target's interim operating covenants have taken on even more importance.

- **Sellers** will want flexibility in these covenants if a lengthy review is anticipated. Restrictions that may be tolerable for nine or 12 months may be untenable longer term, and sellers should not be forced to choose between complying with the covenants and harming their business. And failure to comply may jeopardize payment of a reverse termination fee that would otherwise become due.
- **Buyers** will want the interim operating covenants to be as tight as possible so they can be confident that the business will continue to operate as expected during the interim period. But they will need to weigh which covenants are truly critical to protect the value of the target business.

Transaction Agreement Covenants: Deals in the Meantime

Parties may also need to provide for the ability to pursue other nonconflicting M&A transactions while waiting for regulatory signoff for their main transaction. For example, in a merger of equals where both companies have historically grown through M&A, they may each want to continue ordinary-course M&A activities.

Their agreement may set limits defined in financial terms. However, their ability to inform each other of their intentions may be limited by restrictions on the sharing of competitive information discussed above.

One way to manage the sharing issue is to require each party to inform a designated outside counsel for the counterparty of the name of any potential M&A target. Counsel will then obtain a list of all active potential M&A activity from his or her client. If counsel determines there is no overlap, counsel will be more comfortable allowing the parties to share full information about a potential transaction and obtain any necessary consents to bid under the interim operating covenants.

If, however, there is overlap and both parties are contemplating bids, it will be critical to prevent information sharing that would impact the bidding of either party.

Where M&A activity is a possible scenario, companies may establish a mechanism for obtaining approval of a bid without disclosing the target and bidding information to individuals at the target who could also be preparing a bid. For example, notice could be given to an officer of the counterparty (or its sponsor) who is not involved in the day-to-day M&A business informing them that a bid is in the works that conforms to the capital investment assumptions in the parties' agreed-upon business plans and meets required financial metrics.

Express Covenants To Litigate

With antitrust authorities increasingly ready to challenge transactions even where the parties have offered significant remedies, many agreements now spell out when the parties are obligated to litigate if regulators challenge the deal in court. These clauses may also provide for tolling of the time to close during the litigation. An obligation to litigate without a sufficient outside date to allow for that process, or a tolling of the outside date, could be of little practical value.

Without these clear provisions, disputes can arise about the meaning of the more general efforts covenants as they relate to litigation. An obligation to litigate can also serve as a useful signal to regulators that the parties are serious about defending their deal.

Control of the Divestiture Process and Maximizing Proceeds

It is important to specify who will control the process of seeking approvals. Often, it will be the party that bears the regulatory risk with respect to the applicable approval (for example, a buyer that will pay a termination fee if approval is not obtained).

The parties will also need to consider how to maximize proceeds from any disposals. If a company is forced to divest assets, it may find itself in a weak bargaining position. Perceived bargaining power generally declines as the review process advances and potential bidders become aware of each other's identities and credibility. That is one reason companies make "fix it first" preemptive

divestitures. By arranging a sale before a remedy package has been formalized with regulators, an auction can be run with more secrecy and perceived competition.

Of course, the regulators' requirements cannot always be anticipated, and different jurisdictions may require different concessions, so there is a significant risk that the agreed-upon divestitures the parties market to buyers will not line up with those that merger authorities require. That can sometimes be addressed with "accordion" options, which give the divestiture seller the right to add other assets into the package at an agreed price.

In Sum

With the current challenging merger approval process and amplified risks, companies should:

- Conduct a penetrating assessment of the regulatory risks at the outset.
- Formulate a well-informed strategy for obtaining approval.
- Negotiate terms to provide for the possibility of a delayed or blocked deal, and to mitigate and allocate those risks.
- Monitor progress with the deal's outside date in mind.
- Be prepared for litigation.

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