Allocating the antitrust risk in merger agreements

By *Charles T. (Chris) Compton* and *Scott A. Sher.*

Many industries – particularly in high technology – are in a period of rapid and accelerating consolidation. In many markets, hundreds of competitors have become dozens, or dozens reduced to a handful. According to one recent market report, more than 25% of the leading software companies have disappeared in the last year as a result of increased merger and acquisition activity.

With consolidation has come increased antitrust scrutiny, by both US agencies and the European Commission. That heightened antitrust attention has made it all the more important for merging parties to consider antitrust at each stage of the deal process. Antitrust risk management starts not with announcement of the deal, but at the earliest phase of the merger process – during the drafting of the merger agreement.

Mitigating and shifting antitrust risk

Where a merger presents a potential antitrust concern – for example, when two competitors in a relatively concentrated industry plan on combining – it is wise to engage antitrust counsel at the outset. Counsel should assess the likelihood of agency review, whether a formal "Second Request" or "Phase Two" investigation is likely, and whether to expect an antitrust challenge. Armed with that assessment, the company will be positioned to effectively mitigate antitrust risk – not only by controlling its document trail and public statements, but also by allocating the antitrust risks as the merger agreement is negotiated.

Sellers typically face the greater risks: they often find themselves haemorrhaging customers or employees during an extended antitrust investigation. Sellers therefore need quick resolution of the antitrust issues. Run-away buyers – acquirers with no restrictions on their ability to communicate, negotiate or reach deals with the various international competition agencies – are free to ignore the effects of their decisions on the continuing viability of the target company. The buyer may even benefit by further weakening the target company as a competitor. Several clauses in the merger agreement are key in minimising and allocating the antitrust risk:

Cooperation Clause

For the target or seller, it is important to mandate that the parties and their counsel consult and cooperate with one another in the antitrust analysis and during agency review – in presentations to or meetings with the reviewing agency, in white papers, stipulations with the agency on timing and submission of materials, and in any negotiation of a proposed consent decree or remedial measures. Key decisions during the antitrust investigation should be subject to the review and approval of both the purchaser and seller. Cooperation clauses may go so far as to prohibit the initiation of *ex parte* communications with the antitrust agencies; they should at least require prompt notice and disclosure of such communications.

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Best Efforts

Best efforts clauses establish the effort required by both parties to ensure successful clearance of the various shareholder and regulatory hurdles – including antitrust. The clause might require, for example, that the buyer use "all commercially reasonable efforts to resolve any objections [by the FTC, DOJ or European Commission]." Such wording probably does not mandate that the acquiring party divest assets in order to secure antitrust approval. The standard of efforts may be calibrated higher by requiring "reasonable best efforts" or even "best efforts," which imply increased levels of sacrifice by the acquirer, and the target, in surmounting antitrust objections. However, without a provision in the merger agreement expressly requiring divestiture, even a best efforts standard may not mandate that the buying party shed material assets or license significant intellectual property in order to resolve antitrust objections.

Divestiture limitations

As a result, the target may wish to articulate clearly that the buyer must "make any and all divestitures that are a prerequisite to the FTC, DOJ or EC's clearance of the transaction." The buyer, by contrast, may wish to specify that "reasonable best efforts" does not require it to sell, license or otherwise dispose of or hold separate "any material portion of the business or assets" involved. Materiality itself may be calibrated as relative only to the company or assets being acquired, or more broadly to the entire business of the combined companies. Alternatively, rather than agreeing to divest specific assets or divisions, the acquiring party may place a ceiling on its divestiture obligation by reference to a specific sales level. Such a clause would permit the buyer to retain crown jewel assets or divisions with sales exceeding this sales threshold (without naming the crown jewels).

More detailed and express divestiture provisions, of course, signal to the agencies that the parties have antitrust concerns about their deal, and are willing to accept certain remedies if pushed. Careful judgment is required here.

Break-up fees

Break-up fees may be negotiated to compensate either party for failures by the other under its respective representations and warranties. The buyer, for example, may be entitled to a break-up fee should the target's board or shareholders later reject the merger, or accept a competing offer. Buyers also offer break-up fees as the price for dropping out of the deal in the event of material adverse changes. Monolithic Systems Technology, for example, recently settled its suit against Synopsys for payment of the $10 million break-up fee, when Synopsys cancelled the merger agreement shortly before closing.

The target company may also seek payment of a break-up fee in the event that the transaction is blocked for antitrust reasons, or delayed by antitrust review beyond a negotiated "drop-dead" date (typically six to nine months after signing). In this situation, break-up fees are intended to compensate the target for the sales and development opportunities sacrificed during the aborted merger process. The magnitude of a break-up fee should reflect the anticipated damage if the deal falls apart or is challenged. Breakup fees in technology mergers can vary from 1 to15% of the total deal value, but most often cluster in the 2% to 3% range.

Termination clauses.

Virtually every merger agreement has a clause outlining the various reasons one or both parties may terminate, such as for bankruptcy, failure to satisfy conditions to the closing, or expiration of a drop dead date for any reason – including delays due to antitrust difficulties. Where antitrust problems are anticipated, the target (or the buyer) may also seek an event-based right to terminate – for example, when the competition agency: launches a formal investigation; announces that it will challenge the transaction; obtains an initial court order barring the deal; or obtains a final, non-appealable court order prohibiting the transaction (which can be years down the line).

Where a transaction presents substantial antitrust risk, both parties must assess the costs and benefits of a protracted battle with the antitrust agencies. The timing of a right to terminate is crucial, especially from the target's perspective: does the target want to hold the buyer's feet to the antitrust fire, risking its own engagement in a long and protracted legal battle that may end badly? Or is it best to have an escape hatch early in the process, perhaps without full visibility into the most likely outcome of the antitrust investigation? The buyer, for its part, must consider whether the right to terminate due to antitrust delays should be within the sole discretion of the target, which may have the incentive to get out at the first sign of trouble and collect a substantial break-up fee.

Payment of regulatory/antitrust fees and expenses

Oftentimes, parties do not consider the extraordinary costs of an extended, formal antitrust investigation, which may multiply with simultaneous review by the competition agencies in the US, Europe and others of the 70-odd nations with merger control regimes today. A Second Request investigation in the US alone can cost each party several million dollars in legal fees, economic consulting fees and document production expenses. Litigating a later government challenge to the merger can double those expenses. It may therefore be prudent for smaller target companies to negotiate for the buyer to pay all costs of any formal antitrust investigation or litigation.

Conclusion

Perhaps the most common mistake, particularly in smaller or rushed transactions that may carry antitrust exposure, is not involving competition counsel early in the process and addressing these alternative clauses in an informed manner. Counsel can ascertain the likelihood and extent of antitrust review, and where protections should be built into merger agreements to offset the effects of potentially lengthy delays in the process. Counsel can also advise at the outset on how best to anticipate and protect against agency challenge and formulate remedies to resolve expected competition objections. cf

Biographies

Charles (Chris) T. Compton heads Wilson Sonsini Goodrich and Rosati's antitrust practice, focusing on merger regulatory and intellectual property issues.

Since joining the firm in 1980, Chris has overseen the antitrust regulatory work in nearly 700 mergers, acquisitions and joint ventures--many of which involved formal investigations by the Federal Trade Commission, Department of Justice, the European Commission and other international competition agencies. The firm's record of success, including Hewlett Packard's $18.7 billion acquisition of Compaq Computer in 2002, has been unparalleled.

Scott Sher is a senior associate at Wilson Sonsini Goodrich & Rosati's, where he focuses on antitrust and trade regulation issues, and has significant experience working with high-tech clients. In particular, Scott has advised clients on issues pertaining to mergers and acquisitions, joint ventures, the Robinson-Patman Act, pricing and distribution issues, trade association and patent pooling matters, and the Sherman Act. In addition, he assists clients with antitrust issues that arise throughout the merger and acquisition process.