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The Evolution Of Specified Reps In Acquisition Finance

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In an acquisition in which third-party debt financing is a component of the capital structure, it is critical to both the buyer and the seller that the debt financing not be an impediment to closing the transaction. As it has become uncommon for acquisition agreements to contain an express "financing out," the buyer party may have more leeway to walk away from the proposed deal if its financing does not come together for closing.

While many deals may not contain an express financing out, most sellers recognize that if they are going to proceed with a buyer that is reliant on debt financing, then it is also in the seller's interest to facilitate the closing of the debt financing in order to make the acquisition closing more viable. Therefore, both parties to the acquisition transaction are incentivized to ensure that the buyer's debt financing can close in order to facilitate the closing of the acquisition.

As a result, buyers have long pressured their financing sources to minimize the scope of the conditions precedent required to be satisfied on the debt financing for closing, as well as to hem in the "documentation risk" (i.e. the risk that the debt financing sources and the buyer will fail to reach an agreement on the terms of the definitive debt documentation in time for closing). Private equity sponsors, in particular, are able to move the market on these items given their propensity to work with multiple debt providers on repeat transactions, thereby enabling them to set precedent that influences the documentation of debt providers not only in the sponsor-side market but also in the strategic (corporate) buyer market.

A primary area of contention regarding commitment letters for debt financing for an acquisition is the scope of the representations and warranties that will constitute conditions precedent to the closing. Sellers and buyers both want to minimize the conditionality in an acquisition financing commitment letter and, indeed, the seller in a competitive auction process will often be able to review and comment on multiple bid packages and commitment letters to ascertain which commitment letter will most likely ensure that the deal will close.

Lenders, particularly in a competitive process, may well be forced to accept less favorable conditions

because the seller of the relevant business or asset will not proceed with the lender's buyer unless the lender agrees to more limited conditions. However, in today's market, including in the traditional middle-market space, it is customary for lenders to serve up commitment letters with "SunGard," or "certain funds," language. This language will typically address three primary areas of concern for both the seller and the buyer in an acquisition financing: (1) which representations and warranties in the purchase agreement will be a component of the debt closing conditions; (2) which specific representations and warranties of the buyer will be a component of the debt closing conditions (the "specified representations"); and (3) if the debt deal is a secured deal, what steps must be taken regarding the collateral as a condition to closing. This article focuses on the concept of the specified representations.

As debt sources have become more various and numerous in the last few years, the specifics of the SunGard language have varied considerably. Indeed, with the interagency leveraged loan guidelines currently in force, it is likely that this trend will continue. One of the basic considerations is whether the specified representations (i.e., the more circumscribed set of representations and warranties that will serve as a condition to closing) must be "made" or must be "accurate" as a condition precedent to closing.

A lender would clearly prefer that the representations and warranties, including the specified representations, must be accurate as a condition to closing. If a representation proved to be inaccurate when made, whether a specified representation or not, the lender could call a default. The buyer/borrower would prefer that the representations and warranties, including the specified representations, must merely be "made" on the date of the closing and if a representation is inaccurately made, the borrower could theoretically remedy it post-closing before any representations and warranties are made again.

A more recent trend, and one that may be the most sensible approach for both sides, is to adopt a "the making and accuracy of which" formulation, which would help to clarify that only the specified representations must be made as a condition to closing and that they must be accurate for closing to occur. For a seller, perhaps the most important consideration is the list of the specified representations, as opposed to the specifics of the post-closing effects on the buyer of a "making" versus "accuracy" (or "making and accuracy") formulation.

The list of specified representations is subject to considerable variation across lending sources and is heavily negotiated. The initial set of specified representations that appeared in the Silver Lake Partners-led acquisition of SunGard Data Systems Inc. was narrow. However, as the concept has become more commonplace across the market, including outside of "large-cap" deals, lenders have sought to include additional representations and warranties as specified representations. This reflects that, unlike the large-cap market, in which large banking institutions are the most common players and in which the largest private equity sponsors also command a great deal of leverage to settle the market on these points, in the middle market, a panoply of alternate lenders are now critical to the deployment of capital in leveraged buyout deals, and the credit quality and size of sponsors are less uniform. As a result, it is more difficult to "make the market" in middle-market deals on these closing conditionality issues.

In the middle market, it is common to see the specified representations include the nearly universal package of corporate existence, power and authority to enter into the definitive loan documents; due authorization, execution, delivery and enforceability of the definitive loan documents; Federal Reserve margin regulations; the Investment Company Act of 1940; execution and delivery of loan documents not being in violation of laws or organizational documents; and the effectiveness, validity

and perfection of the loan document liens, subject to various closing date limitations. However, while the large-cap market may not always contain many incremental representations as specified representations, the middle market is far more likely to also include, among others, representations on:

- the Office of Foreign Assets Control, the Patriot Act and other anti-terrorism or anti-money laundering laws,
- the absence of conflict with various material agreements of the buyer and/or the target,
- the need to obtain governmental or other third-party consents for closing, and
- the absence of litigation, orders or judgments that might affect either or both of the closing of the debt financing or the acquisition.

The extent to which a buyer may be forced to agree to a longer list of specified representations will usually reflect its own financial strength, the status of the negotiation with the seller and whether the seller is actively pursuing other buyers and bidders with more competitive terms, as well as the specifics of the due diligence of the deal and the lender's comfort with the diligence that the buyer has conducted because the lender is often largely relying on the diligence work completed by the buyer.

As the number of middle-market acquisition deals with specified representations increases, and as the large-cap market continues to be homogenized with the middle market (while lenders in the middle market try to compete for lucrative private equity sponsor repeat business and thus move to harmonize their terms with the terms on offer in the large-cap market), counsel may well be able to negotiate a more coherent and uniform set of specified representations for their clients on both sides of the deal. This outcome would significantly benefit middle-market leveraged buyouts as greater certainty of closing and less negotiation of these critical deal terms should reduce friction cost in completing successful commitment letters and definitive loan documentation, thereby resulting in more acquisitions closing with debt financing in place.

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