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July 26, 2021

"EFFECT OF TERMINATION" PROVISIONS IN PURCHASE AGREEMENTS: CONSIDERATIONS IN AN EVOLVING M&A MARKET

To Our Clients and Friends:

One of the most common provisions in an acquisition agreement is the "effect of termination" provision. As its name implies, the provision expresses the agreement of the parties regarding what, if any, liability each party will have to the other after the agreement is terminated. It is common for the provision to state that, if the agreement is terminated, neither party will have any liability to the other except with respect to certain other provisions of the agreement, such as the confidentiality, governing law, interpretive and other boilerplate provisions, that are necessary to maintain the confidentiality of each party's information after the agreement is terminated and to maintain the governing terms of the agreement in the event of a post-termination contractual dispute or a dispute regarding the validity of the termination itself. It is also common for the effect of termination provision to include a carve-out stating that termination of the agreement will not relieve the parties from certain pre-termination breaches of the agreement.

The scope of the pre-termination breaches subject to the carve-out typically is, and should be, scrutinized in transactions in which there is significant risk of the deal being terminated, such as due to a failure to receive regulatory approval or a debt financing failure. For example, in transactions in which the buyer is a financial sponsor and is relying on the availability of debt financing to pay the purchase price, the seller typically wants to ensure that, if the buyer fails to close the acquisition when required by the agreement, it has the ability to (i) keep the agreement in place and seek specific performance of the agreement to force the buyer to close, which may be limited to circumstances in which the buyer's debt financing is available (i.e., a synthetic debt financing condition), or (ii) terminate the agreement and recover damages, often in the form of a reverse termination fee, from the buyer. The effect of termination provision should not purport to foreclose recovery of the reverse termination fee, which in some transactions serves as liquidated damages and a cap on the buyer's liability for pre-termination breaches. In other transactions, the effect of termination provision may also permit the seller to recover damages beyond or irrespective of a reverse termination fee, frequently limited to circumstances in which there was an "intentional" or "willful" pre-termination breach by the buyer of its obligations.

In an increasingly competitive M&A market, it has become more common for buyers to agree to bear regulatory approval risk and for financial buyers to agree to backstop payment of the entire purchase price with equity in lieu of the synthetic debt financing condition or reverse termination fee construct described above. In these contexts, continued and careful consideration of a buyer's liability for pre-termination breaches of a purchase agreement is critical. The scope of liability for pre-termination breaches also deserves attention in light of the now widespread use of representation and warranty insurance and transaction structures in which sellers may not expect any liability for breaches of representations and warranties, absent fraud.

The following is a summary of issues for buyers and sellers to consider when negotiating these issues in light of current and evolving M&A market dynamics.

Defining the Appropriate Pre-Termination Breach Standard

Although it is common for the effect of termination provision to include a carve-out stating that termination of the agreement will not relieve the parties from pre-termination breaches of the agreement, the relevant standard for defining the scope of those pre-termination breaches is often inconsistent in practice. Some agreements define the standard as any pre-termination breach that is "intentional and willful," "knowing and intentional," "intentional," "willful and material," or "willful." Sometimes these terms are defined, sometimes not. Sometimes the standard distinguishes breaches of covenants, on the one hand, from breaches of representations and warranties, on the other hand, and sometimes it does not. Finally, some agreements do not contain a specific standard and provide that "any" pre-termination breach is carved-out from the effect of termination provision.

This lack of uniformity, coupled with contending interpretations after a broken transaction, can lead to unpredictable or undesirable outcomes. For example, in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008), the Delaware Court of Chancery interpreted a "knowing and intentional" breach of a merger agreement as a deliberate act that in and of itself is a breach of the agreement "even if breaching was not the conscious object of the act." This could lead to an undesirable outcome for buyers, who are wary of unintentionally breaching their obligations to obtain regulatory approvals or debt financing that can be ripe for second-guessing in the context of a broken transaction. They should consider defining the standard to include only an action taken with the actual knowledge that the action would result in a breach of the agreement.

Sellers, on the other hand, should consider defining the standard to include specifically the failure of the buyer to close the transaction when required by the agreement or, if the transaction involves a reverse termination fee that does not serve as liquidated damages, the failure of the buyer to close the transaction if the debt financing is available. In transactions with a financial buyer, the importance of this issue and the relevant standard may be overlooked if there is a last minute change to a full equity backstop structure in lieu of a traditional reverse termination fee structure.

Distinguishing Breaches of Covenants from Breaches of Representations and Warranties

As stated earlier, effect of termination provisions often do not distinguish between liability for pre-termination breaches of covenants and breaches of representations and warranties. But if the parties have negotiated a "willful" breach or similar standard to define the scope of their liability for pre-termination breaches, what does it mean to "willfully" breach a representation and warranty? As the Delaware court did in *Hexion*, some may interpret the term "willful" to imply a deliberate action, which may better describe a breach of a covenant, rather than a breach of a representation or warranty. As a result, the parties should consider distinguishing breaches of covenants from breaches of representations and warranties when formulating the appropriate standard.

Aligning Expectations in Transactions with Representation and Warranty Insurance

In addition, in transactions involving representation and warranty insurance, it has become increasingly common for sellers to expect no liability for breaches of their representations and warranties in the purchase agreement, absent fraud. That expectation drives the parties to scrutinize the survival or non-survival of the representations and warranties if the transaction closes, but the parties may overlook the effect of termination provision, which would apply in a broken transaction. A seller who expects no liability for breaches of representations and warranties may insist that the effect of termination carve-out not only distinguish breaches of covenants from breaches of representations and warranties, but also provide that liability for pre-termination breaches of representations and warranties will be limited to only instances of fraud.

In summary, although the effect of termination provision may often be considered akin to boilerplate provisions in a contract, astute dealmakers should focus on the carve-outs and ensure that they best serve their client's interests under the particular circumstances of the transaction.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Mergers and Acquisitions or Private Equity practice groups, or the authors:

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