

## private equity developments

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### The Sallie Mae MAE Dispute: A Useful Reminder for Buyers & Sellers

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The current dispute between SLM Corporation (“Sallie Mae”) and a consortium of buyers led by J.C. Flowers II, L.P. (“JCF”) concerns the invocation by the buyers of a “material adverse effect” (“MAE”) clause in the parties’ merger agreement. The dispute not only provides a useful opportunity to revisit *IBP, Inc. v. Tyson Foods, Inc.*,<sup>1</sup> the leading Delaware case on MAE clauses, but also serves as a reminder of the importance of clear and unambiguous language in critical deal provisions.

#### Background

On April 15, 2007, Sallie Mae, the nation’s largest college student loan company,<sup>2</sup> entered into a merger agreement with the JCF consortium. The agreement provided for the acquisition of Sallie Mae for \$60 per share in cash (or a total value of \$26 billion) and the payment by the JCF consortium of a \$900 million termination fee if it failed to comply with its obligations to consummate the transaction. At the time of negotiations, both parties knew that Congress was considering legislation that could have a material impact on the student loan industry. Consequently, Sallie Mae and JCF negotiated specific language, through a carveout in the definition of “Material Adverse Effect,” which sought to allocate this risk. The relevant part of the MAE definition is as follows:

## inside

2 | Go-Shop Provisions

3 | In The News

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“Material Adverse Effect” means ***a material adverse effect*** on the financial condition, business, or results of operations of the Company and its Subsidiaries, taken as a whole, ***except to the extent any such effect results from:***... (b) ***changes in Applicable Law (provided that, for purposes of this definition, “changes in Applicable Law” shall not include any changes in Applicable Law relating specifically to the education finance industry that are in the aggregate more adverse to the Company and its Subsidiaries, taken as a whole, than the legislative and budget proposals described under the heading “Recent Developments” in the Company 10-K, in each case in the form proposed publicly as of the date of the Company 10-K) or interpretations thereof by any Governmental Authority;*** (c) ***changes in*** global, national or regional political conditions (including the outbreak of war or acts of terrorism) or in ***general economic, business, regulatory, political or market conditions or in national or global financial markets; provided that such changes do not disproportionately affect the Company*** relative to similarly sized financial services companies and provided that this exception shall not include changes excluded from clause (b) of this definition pursuant to the proviso contained therein...

On Sept. 27, 2007, Congress enacted the College Cost Reduction and Access Act of 2007 (the “Act”). The Act reduced the direct subsidies Federal Family Education Loan Program (“FFELP”) loans, reduced the federal guarantee of FFELP loans, and increased FFELP lender origination fees. On Oct. 2, 2007, the consortium informed Sallie Mae that, as a result of the enactment of the Act and the impact of recent turmoil in the credit markets, Sallie Mae had suffered an MAE, and the conditions of the buyers to consummate the merger were not satisfied.

In response, Sallie Mae filed suit in the Delaware Chancery Court seeking a ruling that the consortium had rescinded the merger agreement and that no MAE has occurred under the merger agreement. Sallie Mae claims that it is entitled to the \$900 million termination fee.

#### Summary of the Parties’ Main Arguments: Differential Impact vs. Materiality Threshold<sup>3</sup>

According to Sallie Mae, an MAE can only be declared on the basis of the Act if the difference between the adverse impact caused by the Act and that of proposed legislation disclosed in Sallie Mae’s annual report constitutes a “material adverse effect” on its business. According to Sallie Mae, the proposed legislation is likely to result in an incremental decrease in its projected net income of only between 1.8 and 2.1% over the next five years.

*continued on page 2*

## The Sallie Mae MAE Dispute

continued from page 1

According to the consortium, if a “change in Applicable Law” is, in the aggregate, more adverse to Sallie Mae than the proposals described in Sallie Mae’s annual report, then the entire impact of the legislation must be assessed for purposes of the MAE clause. The buyers claim that the full impact of the Act constitutes an MAE under the merger agreement. In addition, they argue that even if Sallie Mae’s interpretation of the MAE clause is accepted and a differential test applied, the result would be the same because, among other things, the Act calls for \$22.3 billion in subsidy cuts, whereas the proposed legislation contemplated between \$10 billion to \$15.5 billion in subsidy cuts.

### **IBP v. Tyson**

The leading case interpreting an MAE clause under Delaware law is *IBP v. Tyson*. Tyson executed a merger agreement with IBP on Jan. 1, 2001. During the next financial quarter, IBP suffered poor financial performance and disclosed that accounting fraud had occurred at one of its subsidiaries, resulting in the write-off of the value of that subsidiary, a modest contributor to the revenues and earnings of IBP (approximately 1%). At the end of March 2001, Tyson terminated the merger agreement and brought a claim, arguing that the deterioration of IBP’s sales performance over two quarters triggered the MAE clause and gave Tyson the right to terminate the agreement.

Vice Chancellor Leo E. Strine, Jr. held that no MAE had occurred and ordered specific performance of the Tyson merger agreement. In his decision, Vice Chancellor Strine construed the MAE clause to exclude short-term deteriorations in performance that had not been shown to affect the long-term performance of the seller, despite the absence of any explicit language on duration of the adverse impact in the MAE definition.

In light of the *IBP* decision, practitioners have stressed the importance for buyers and sellers to use clear and unambiguous language in critical deal provisions to avoid costly and

potentially adverse legal battles. Buyers are encouraged to seek express “outs” to a purchase agreement (e.g., an express closing condition or termination right), rather than take their chances that a court will interpret exclusions to an MAE clause in a favorable manner. Sellers are encouraged to draft exclusions to an MAE clause with precision.

### **Vice Chancellor Strine’s Initial Reaction to the Sallie Mae MAE Clause**

The *Sallie Mae* case is a good example of how even sophisticated parties represented by expert M&A counsel can find themselves in a legal quagmire as a result of ambiguous drafting. Vice Chancellor Strine, who is presiding over the case, made the following comment on the parties’ MAE provision in a scheduling conference:

I have to say, the [buyers], the weakness from their position is this idea that, basically, one penny on top of what is outlined in the agreement more makes you count the whole thing as an MAE. That is not intuitively the most obvious reading of this. On the other hand, [Sallie Mae’s] position could have been much more clearly drafted if they wished to say that, essentially, all the legislation was a baseline, and you measure the incremental effect. I’m not sure that this is the greatest example of clear scrivener from either side.<sup>4</sup>

This dispute serves a useful reminder for both buyers and sellers that language in a transaction agreement concerning critical risk allocation must be clear on its face to reduce the risk of costly and potentially adverse legal battles. ■

<sup>1</sup> *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001).

<sup>2</sup> Sallie Mae primarily provides federally guaranteed student loans originated under the Federal Family Education Loan Program and offers resources to assist students, parents and guidance professionals with the financial aid process.

<sup>3</sup> This summary focuses only on the MAE claim related to the Act and not on the claim that adverse credit market conditions resulted in a MAE.

<sup>4</sup> Delaware Court of Chancery Transcript from the Scheduling Conference, Oct. 22, 2007.

## Go-Shop Provisions

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While there are many ways for a public company to engage in a sales process, a privately negotiated sale offers advantages to both the buyer and the target company. A privately negotiated sale enables the buyer to avoid the competition-based issues associated with an auction, such as having to share access to the target’s management, dealing with a management whose attention is fragmented, and receiving the same diligence information as all other bidders. The target, for its part, may have concerns about the impact that a public auction would have on its business operations and stock price, as well as the possible consequences of announcing its intention to sell itself, especially if the result is a busted auction. To avoid these risks, a target may choose to enter into a purchase agreement without making a prior public announcement of its intention to sell or engaging in an auction, and utilize a “go-shop” provision as a post-signing market check.

A go-shop provision is a clause that permits a target company to actively solicit offers from other potential buyers for a limited time following the signing of a purchase agreement. Upon the expiration of the go-shop period, the target company would then be subject to a customary “no-shop” restriction on solicitation with a “fiduciary out” clause, which restricts the target’s ability to receive offers from and negotiate with other bidders except for unsolicited, non-negotiated superior offers.

While go-shop transactions are not the norm in public company acquisitions, they are becoming more common.

According to FactSet TrueCourse MergerMetrics, in the first four months of 2007 there were 21 deals involving U.S. target companies that contained a go-shop provision, as compared with 16 deals containing such a provision in all of 2006.<sup>1</sup> In many of these deals, the transaction involved a private equity buyer.

Go-shop provisions can vary as to their terms and, as such, can be structured to provide differing levels of deal protection and advantage to a buyer. Common terms that are negotiated include the length of the go-shop solicitation period, whether there is a “hard stop” or “soft stop” at the end of such period, the discount of the break up/termination fee during the go-shop period, the buyer’s right to be updated as to alternative bids, and the buyer’s right to match or top competing bids. And when negotiating these terms, it is important to remember that go-shop provisions primarily serve to allow the target’s board of directors to fulfill its fiduciary duties; because the buyer assumes the target’s liabilities once the deal is consummated, the risk of a shareholder lawsuit ultimately falls on the buyer.

While go-shop solicitation periods have ranged from as short as 10 days to as long as the deal’s completion, in 2007 the majority of deals had go-shop periods of between 30 and 50 days from the signing of the purchase agreement. Obviously, the shorter the length of the go-shop period the more difficult it is for another bidder to complete its diligence process and submit a topping offer. Also, adding a “hard stop” to the go-shop provision (i.e., requiring that

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## Go-Shop Provisions

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a competing offer must be accepted, and an agreement entered into, and not just negotiated or submitted, during the go-shop period) gives the buyer additional protection. A “soft stop,” which permits parties that began negotiating with the target or made an offer to it before the end of the go-shop period to continue to negotiate with the target after expiration of the go-shop period, increases the chances of a topping bid.

Most go-shop provisions have a two-tiered structure for termination fees, with a lower fee for deals that break up during the go-shop period and a higher fee for deals that are terminated after the expiration of the go-shop period. While there is no standard fee, the amount charged during the go-shop period is usually one-third to two-thirds of the fee charged after the go-shop period expires. A buyer should attempt to secure a provision that allows for a reduced termination fee only if a bid is accepted and a deal is signed during the go-shop period, but with no reduction in the termination fee for bids that are tendered during the go-shop period but are not accepted until after the go-shop period expires.

As with no-shop deals, it is important for a buyer to secure a provision requiring the target to inform the buyer of any alternative proposals it receives, to provide the buyer with copies of any written proposals and to share with the buyer all information that the target provides to competing

bidders. Inclusion of such a provision ensures that the buyer will be alerted to any potential threats to the signed deal in a timely manner, giving the buyer the time and information necessary to prepare to match or top another bid.

In addition, a provision obligating the target to renegotiate with the initial buyer for a specified amount of time before accepting a bid submitted by an interloper affords the initial buyer ample opportunity to evaluate whether or not it wants to match a competing bid. This term has the added benefit of serving as a deterrent to potential interlopers, who must consider the possibility that any bid they make could be matched, resulting in wasted effort and unrecoverable expense.

While a go-shop provision increases the possibility of a buyer losing out to a topping bid during the go-shop period, it is important to note that competing offers are made in only about 10% of the deals containing go-shop provisions. In addition, successfully negotiating the terms of such a provision can yield substantial deal protection while also providing a buyer with the assurance of at least some compensation for its time and effort in the event of a topping bid. ■

<sup>1</sup> See *An Examination of Go Shop Provision Success Rates*, MERGERMETRICS.COM, May 1, 2007, available at [https://www.mergermetrics.com/marequest?an=dt.getPage&st=1&pg=/pub/rs\\_20070501.html&rnd=96704](https://www.mergermetrics.com/marequest?an=dt.getPage&st=1&pg=/pub/rs_20070501.html&rnd=96704).

## in the news

### **Cerberus Capital Management, L.P./Chrysler Holding LLC**

SRZ recently represented Cerberus Capital Management, L.P. in the acquisition, from DaimlerChrysler AG, of a majority interest in the Chrysler automotive business and its sibling financial services company, in a transaction that involved a \$7.2 billion equity investment by Cerberus and its affiliates. Cerberus is the first private investment firm to buy a controlling stake in a U.S. automaker. Under the terms of the deal, a Cerberus affiliate obtained an 80.1% equity interest in a new company, Chrysler Holding LLC, and DaimlerChrysler retained the remaining 19.9%. Chrysler Holding LLC owns 100% of two separate entities: Chrysler LLC, which produces and sells Chrysler, Dodge and Jeep vehicles; and DaimlerChrysler North America Financial Services LLC, which provides financial services for these vehicles in the NAFTA region.

### **Veritas Capital/Aeroflex Incorporated**

SRZ represented a consortium of buyers led by The Veritas Capital Fund III, L.P. in their acquisition of Aeroflex Incorporated, a global provider of high-technology solutions to the aerospace, defense and broadband communications markets which designs, develops, manufactures and markets a broad range of testing, measurement and microelectronics products. The Veritas-led consortium, which includes Golden Gate Private Equity Inc. and Goldman Sachs & Co., paid approximately \$1.2 billion for Aeroflex which traded on Nasdaq prior to the buyout. The transaction closed in the midst of tumultuous debt markets with financing provided by Goldman Sachs Credit Partners.

The transaction is a rare example of a successful topping bid made pursuant to a “go shop” provision, a relatively new provision in merger agreements designed to provide a market check. In March 2007, private equity funds General Atlantic and Francisco Partners entered into a merger agreement to acquire Aeroflex for \$13.50 in cash per share. The agreement contained a go-shop provision that allowed Aeroflex to solicit competing bids for 45 days and to negotiate with any bidder who submitted a proposal during such period that the Aeroflex board of directors

determined was or would lead to a superior proposal. Veritas and its co-investors submitted a proposal during the 45-day period and ultimately agreed to pay \$14.50 in cash per share resulting in Aeroflex’s termination of the original merger agreement.

### **NewPage Corporation/Stora Enso’s North American Paper Business**

SRZ is representing NewPage Corporation, a portfolio company of Cerberus Capital Management, L.P., and one of the leading U.S. producers of coated papers in North America, in its acquisition of the North American paper business of Stora Enso Oyj, an integrated paper, packaging and forest products company based in Helsinki, Finland.

In the transaction, NewPage will acquire all of the outstanding stock of Stora Enso North America, Inc. (SENA) in exchange for \$1.5 billion in cash, a \$200 million note and 19.9% of the outstanding shares of the new indirect holding company that will own the combined NewPage/SENA businesses. The transaction, which is valued at \$2.52 billion (including the assumption of certain liabilities), is expected to close during the first quarter of 2008, subject to receipt of customary regulatory approvals.

The deal marks the first major acquisition for the Miami-based, Ohio-based NewPage, which was formed by Cerberus for the purchase of MeadWestvaco Corporation’s papers business in 2005. With more than 4,300 employees, NewPage operates integrated pulp and paper manufacturing mills located in Escanaba, Mich. Luke, Md. Rumford, Maine, and Wickliffe, Ky., and a converting and distribution center in Chillicothe, Ohio. The mills have a combined annual capacity of approximately 2.2 million tons of coated paper.

Announced on Sept. 21, the deal was also noteworthy for being one of the first transactions for which a significant debt financing commitment was obtained after the recent credit market turmoil. ■

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