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Allocating competition law risk in merger agreements

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Most countries around the world have competition law merger control regimes. This typically means that where a transaction meets the applicable thresholds and is, therefore, subject to mandatory pre-merger notification, the parties legally cannot close before the transaction is reviewed by the regulator.

Depending on the extent of the parties' competitive overlap, the road to clearance may be a long and costly exercise that could ultimately impact the commercial viability of the deal. As such, when negotiating the merger agreement, it is critical for parties to a transaction that is subject to review to consider their tolerance for competition law risk. What follows is an overview of key contractual considerations for the allocation of competition law risk.

The primary risk is that the regulator will insist on a remedy to address competition law concerns. In Canada, as in many other jurisdictions, structural remedies, namely divestitures, are the most

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common type of remedy. From a regulator's perspective, the divestiture of a business or assets has the advantages of being permanent and not requiring compliance monitoring.

Behavioural remedies, which are binding obligations on the future conduct of the merged entity, such as supply obligations to third parties, are used as well, but are often less favoured, because they require the ongoing cooperation of the merged entity. There are also quasi-structural remedies, such as a perpetual royalty-free licence, which combine aspects of both. Regardless of the type of remedy, a competition law remedy has the potential to significantly impact the merged entity.

Negotiating the standard of efforts that a purchaser will undertake to obtain competition clearance is, therefore, crucial. The agreed upon efforts standard varies depending on the competition risk associated with the transaction, the parties' comfort level with said risk and the parties' relative bargaining strength. Merger agreements will often use general terminology, such as 'best efforts', 'reasonable best efforts' and 'commercially reasonable efforts', that may have been interpreted by case law. However, to avoid ambiguity, parties often spell out in the agreement the specific actions or inactions that are obligated.

On one end of the spectrum, a 'hell or high water' standard compels a purchaser to take any and all actions required to obtain competition clearance. This means the purchaser would be obligated to accept any remedies that the regulator deems necessary to mitigate the deal's competitive harm. Unsurprisingly, vendors prefer 'hell or high water', unless they are retaining an interest in the target or acquiring an interest in the merged entity. On the opposite end of the spectrum, the merger agreement can stipulate that the purchaser is not obligated to agree to any remedy whatsoever to obtain competition clearance.

In between those two poles, there are many creative ways to allocate risk. The purchaser may be willing to divest the target's assets, but not its own. Another approach is to obligate the acceptance of only certain types of remedies, such as behavioural remedies, but not structural remedies. The purchaser may also agree to divest anything, except certain 'crown jewel' assets. There are also financial metrics that can be used, for example a purchaser may be willing to agree to a remedy that impacts up to a certain level of revenues or earnings before interest, taxes, depreciation and amortisation (EBITDA). In a similar vein, the purchaser may agree to remedies provided they do not have a material adverse effect on the business. These types of provisions can give the vendor comfort that competition clearance is likely to be obtained, while protecting the purchaser from remedies that would negate its rationale for the merger.

In addition, merging parties may also include a reverse termination fee (also referred to as a reverse break fee) in the agreement, which stipulates that the purchaser must pay a specified amount to the seller if the deal fails to close due to, among other things, failure to obtain competition clearance. Avoiding payment of the fee can be a powerful motivator for the purchaser in getting competition clearance. Reverse termination fees can function as a proxy for more specific covenants, such as paying a $100m fee is equivalent to

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divesting assets worth $100m, although reverse termination fees are often used in conjunction with the efforts standards and specific covenants.

In Canada, and in other jurisdictions, the regulator receives a copy of the merger agreement. Accordingly, where the parties are more prescriptive regarding their obligations to obtain competition clearance, there may be concerns that those provisions could be viewed by the regulator as a signal that there are competition concerns or that they provide a road map to the regulator. In such cases, the parties may consider entering into a joint defence agreement (JDA) to set out those terms. Typically, the basis upon which parties decline to provide a JDA to the regulator in Canada is that its contents are subject to common interest privilege as part of a joint litigation strategy should the merger be challenged. However, this approach may not be available in other jurisdictions, in which case the parties must either remain comfortable with the regulator seeing the details or be vaguer in the agreement.

In Canada, it is also possible to be in a legal position to close before the regulator has completed its review. While it is customary for the closing condition in Canadian merger agreements to reflect the receipt of clearance, in seller-friendly merger agreements, the purchaser may agree to close as soon as it is legally able to do so, regardless of whether clearance has been received. Another more purchaser-friendly variation is to have the customary closing condition but allowing the purchaser to waive the requirement for clearance, thereby giving the purchaser discretion to close at risk. Similarly, the merger agreement may force closing where parties are legally able to do so even though the regulator may be threatening a challenge. These types of provisions only tend to be used where the seller will not have an interest in the continuing business and, therefore, does not bear the risk of a post-closing remedy. The more conservative approach is to include a closing condition that precludes the existence of actual or threatened litigation from a regulator.

Another consideration is each party's desired degree of control over the competition filing and review strategy. In Canada, the purchaser tends to take the lead for the competition review process; they usually 'hold the pen' for the advocacy submissions and lead discussions with the regulator. Should the purchaser, or alternatively, the vendor, wish to solidify their degree of control over the process, this can be accounted for in the merger agreement. Where the purchaser is bearing most or all the competition law risk, it is common for the agreement to include a term granting it more unilateral decision-making authority over the review process. Typically, the vendor will include terms to ensure it is involved in any submissions to, and meetings with, the regulator and is kept abreast of the status of the review.

A lengthy merger control process can also create risk, such as interloping bids or expiry of financing commitments. So, the merger agreement may also be used to provide more certainty on timing. The merging parties frequently agree on deadlines by which the competition filing must be submitted, such as 10 business days from signing. They may also agree on deadlines for responding to major information requests. For example, in Canada, the regulator can issue a 'supplementary information request' (akin to a 'second request' in the US), and the parties could agree that they will respond within 60 days if one is issued. To the extent that one party does not fully control strategy, there may also be restrictions on entering into timing agreements with a regulator or otherwise giving the regulator more time than they are entitled to under statute. On the other hand, even if a purchaser is obligated to accept a remedy, if necessary, it would still prefer to avoid one, so the agreement may only require it to capitulate in order to secure clearance by the outside date, rather than on an expedited basis.

Finally, it is important to remember that in Canada, as well as in other jurisdictions, the regulator has the power to review and challenge mergers that do not meet the applicable thresholds for mandatory pre-merger notification. While it would be quite unusual to have any competition law risk allocation provisions in the agreements for such mergers, this does not mean that there is no competition law risk. As such, it is prudent to assess the competitive overlap for all merger transactions.

Given the multitude of contractual considerations for merging parties to a transaction that is subject to mandatory pre-merger notification, merging parties should consult competition counsel early in the negotiation process to ensure their interests are protected.

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