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Recent Trends in the US Investment Grade M&A Loan Market

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Introduction

Debt issuances in all segments of the credit markets have stalled since the start of the global credit crisis and syndicated lending, both leveraged and investment grade, has been no exception. Although the investment grade bond market has remained open to a certain extent in both the US and in Europe, bank lending remains constrained for even the most highly-rated investment grade companies. However, the increasing ability of investment grade companies to access the bond markets in recent months (according to Dealogic, first quarter investment grade volume for 2009 was twice that of first quarter 2008) has encouraged certain lenders to reopen the loan market to a limited extent. While lenders are still not originating new leveraged loans to back private-equity buy-outs, lenders have been willing to provide substantial new loan commitments to back select strategic M&A transactions.

Those companies able to secure new loan commitments in the current market have been highly-rated investment grade non-financial companies in what are generally considered defensive sectors. In December of 2008, Altria obtained $6 billion in bridge loan financing for its $10.4 billion acquisition of UST and Verizon obtained $17 billion in bridge loan financing for its $28.1 billion acquisition of Alltel Corp. The first quarter of 2009 saw the trend towards large investment grade M&A bridge loans continue with Pfizer's $22.5 billion bridge loan financing backing its $68 billion acquisition of Wyeth and Merck's $7 billion bridge financing package for its $41 billion acquisition of Schering-Plough.

These bridge financings involve substantial capital commitments even by pre-credit crisis standards, and represent the first significant re-entry by lenders in the M&A loan markets since the onset of the credit crisis. These financings, however, have been limited to one-year credit facilities designed for quick bond take-outs and the companies involved are those whose bonds attract substantial investor interest. So while the wide syndications of these financings indicate a revival of the syndicated loan market is possible, in the current market, lenders are only extending credit to top-tier bond issuers and remain reluctant to commit longer term capital in the loan market.

New Terms

While lenders are beginning to selectively extend credit, they are doing so on new terms. As the terms of recent bridge financings indicate, even highly-rated borrowers are facing historically high margins and stricter terms, including pricing structures, covenants and conditionality typically associated with leveraged

private-equity transactions rather than strategic mergers by investment grade companies. Despite the credit quality of the borrowers involved, recent bridge financings have involved higher underwriting and market fees, and margins on drawn loans have increased by as much as ten-fold over the last two years (e.g., from Libor plus 25 bps to Libor plus 250-300 bps for single A-rated companies according to the Loan Pricing Corporation). Besides higher margins, pricing and fee structures have been introduced in order to incentivize borrowers to complete take-outs of the bridge facilities as quickly as possible. Pricing grids based on credit ratings are now typical and may include periodic margin step-ups over the term of the loans. In addition, duration fees have been included which are payable at specified intervals based on an increasing percentage of the amount of bridge loans outstanding on the applicable calculation date. Extension fees for those facilities providing extension options are built in as well. Not surprisingly, Altria, Verizon and Pfizer have each closed large bond issuances within the first or second month of obtaining their respective bridge facilities.

Stricter lending standards in the current market are also exerting an influence on M&A transaction structures themselves.

For investment grade borrowers who are generally used to minimal, if any, covenants under their credit facilities, using bridge financing in the current market also means having to accept covenant restrictions and complying with financial ratios. The restrictive covenants in recent bridge financings are far more expansive than the covenants typically found in the existing working capital and commercial paper backstop facilities of the borrowers involved. The covenant restrictions in the bridge facilities are similar to those traditionally found in leveraged financings, including limits on dividends, investments, liens and negative pledges and additional subsidiary debt. Financial maintenance covenants are also beginning to look more like their leveraged counterparts. For example, the bridge facilities for Altria, Verizon and Pfizer each contain leverage ratio maintenance tests based on EBITDA rather than debt to capitalization or net worth tests more common to investment grade credit facilities.

In another deviation from historical investment grade practice, subsidiary guarantees have been required in some cases to protect bridge lenders against structural subordination. For example, where a target has a substantial amount of bonds that will remain outstanding, a guaranty will serve to put the bridge lenders on equal footing with the target's existing bondholders.

M&A Structures and Conditionality

Stricter lending standards in the current market are also exerting an influence on M&A transaction structures themselves. Like the leveraged terms finding their way into investment grade facilities, certain concepts typically associated with private-equity transactions are finding their way into strategic M&A transactions – in particular, financing outs and reverse termination fees.

In 2008, reverse termination fee structures started surfacing in strategic M&A transactions, including Wrigley's $23 billion acquisition of Mars and Foundry's initial $3 billion acquisition of Brocade. Reverse termination fees in private-equity buy-outs had evolved before the credit crisis to the point where the reverse termination fee, combined with a bar on specific performance, became the exclusive remedy of a seller for a breach by an acquirer under the merger agreement. This included the acquiror's failure to close despite satisfaction of all closing conditions under the merger agreement. Although there was not typically a specific financing out in those deals, this structure in effect allowed the acquirer to pay the reverse termination fee if financing became unavailable. Both Pfizer and Merck feature reverse termination fees, but unlike many private-equity deals with reverse termination fees, they are still required to close the transaction if financing is available. In this sense, the reverse termination fees have not been adopted in strategic M&A transactions to provide the acquirer with a pure "option" to complete the acquisition but only to provide limited recourse for certain specified failures to meet conditions, including financing failures.

The lenders providing Pfizer's bridge financing are not required to fund their commitments if Pfizer's credit ratings drop below certain levels or if there has been a Pfizer material adverse change (each as defined in the acquisition agreement). If the lenders do not fund their commitments because of the failure of either of these two conditions, Pfizer is not required to close the acquisition under the merger agreement, but instead required to pay a reverse termination fee which is in excess of 7% of the deal value and Wyeth is precluded from seeking specific performance under the merger agreement in these circumstances. A lower reverse termination fee is payable in the event of the failure of certain other conditions suggesting

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Change of Control – Is It or Isn't It?

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Change of control provisions are found in many debt agreements, including high yield and, increasingly over the past few years, investment grade debt securities, and in credit agreements. These provisions are generally intended to ensure that creditors are protected against changes in ownership that could affect the way their borrower/issuer is managed. This protection typically functions as a change of control "put" right in debt securities (under which the issuer is required to make an offer to purchase the debt securities at par or a premium to par) or as an event of default in credit agreements. In either case, the change of control provision gives the creditor assurance that it will have the opportunity to reevaluate its original investment upon the occurrence of a significant change of ownership.

Stated this way, the concept appears logical and straightforward. However, in fact, these provisions are hardly uniform. A review of a random sampling of debt agreements will reveal a complex thicket of definitional refinements and express and implied exceptions that can make interpreting and applying the change of control provision to a particular set of facts (such as a proposed acquisition or other M&A transaction) difficult for even the most seasoned and sophisticated investor. This uncertainty, which one could argue is undesirable even in the best of times (at least from a market efficiency perspective), has taken on increased importance in recent periods when constraints on availability of capital have made keeping debt in place (and avoiding the need to refinance) critical. Fundamentally, the question of whether a proposed transaction will or will not trigger a change of control under a transaction participant's debt instruments can make or break the deal.

This article will (i) briefly review the basic terms of a typical change of control provision, along with several permutations, and (ii) analyze some recurring interpretive issues in the hope of providing a small bit of clarity in this muddled area.

Typical Change of Control Triggers

The definition of "change of control". The most common triggers, which are usually found in the definition of "change of control," are (some alternative wording, which as will be discussed later can have important consequences, is provided in [square brackets]):

- The acquisition by any "person" or "group" [other than a "permitted holder"] directly or indirectly, of "beneficial ownership" of more than [50%] of the total voting power of the voting stock of the company.

  The threshold can vary, and some common variations are 35%, 40% and 50%. Also, note the use of the active word *acquisition*. Some provisions use a slightly different formulation along the lines of "any person or group *is or becomes* the beneficial owner of more than [ ]% . . . ." The difference between active (acquires) and passive (is or becomes) can be significant. More on this later.

- The company merges with or into any person other than in a transaction in which the shares of the company's voting stock are converted into a majority of the voting stock of the surviving person.

  This trigger overlaps substantially with the prior one and, as a general matter, is most likely to be relevant only where the issuer/borrower is a public company. In such a case, the clause would be triggered if the issuer merges with another company – even in the absence of a new controlling shareholder of the combined entity – unless the pre-transaction shareholders of the public issuer/borrower continue to hold a majority of the voting stock of the survivor on a post-transaction, pro forma basis.

- A change in the majority of the board of directors of the company over a fixed period of time (usually two years) other than changes that are approved by the existing board.

  As a practical matter, this provision (often referred to as a "continuing directors" provision) is only triggered by the acquisition of control of the board of directors via a hostile proxy contest. As such, it is almost never triggered.[1]

- The sale, lease or transfer of all or substantially all of the assets of the company to any "person" [other than a "Permitted Holder"] in one or a series of related transactions.

  In some agreements (typically older ones), this trigger is sometimes worded as the sale of the assets of the company "substantially as an entirety." While professionals spend much time (and experience much anxiety) attempting to determine the difference between the two standards, there is virtually nothing in the way of legally reliable guidance on this question.

- The adoption of a plan relating to the liquidation or dissolution of the company.

Some variation of the foregoing triggers are present in most debt agreements containing change of control provisions, although this list is not exclusive. Additional triggers include the failure of a holding company to maintain 100% ownership of an operating company, the loss of control by existing controlling shareholders (often expressed as the existing controlling shareholder falling below a specified threshold (*e.g.*, 35%) sometimes with the additional requirement that the existing controlling shareholder also ceases to be the single largest shareholder), and a "cross-change of control" that would be triggered if a change of control put or event of default is triggered in another debt instrument.

Single v. double trigger. Agreements in which the put right or event of default is triggered by the "mere" occurrence of a change of control (as defined) are sometimes referred to as "single triggers." This is to be distinguished from a "double trigger" provision, which requires the occurrence of the change of control and a ratings downgrade. Typically, the downgrade must take place within a specified period of time following the public announcement of the change of control transaction. Some (generally older) formulations also require that there be a stated nexus between the downgrade and the change of control transaction. Double trigger provisions are typically limited to investment grade debt, where the impact of the change of control on rating (and, presumably, trading prices) is more meaningful to investors.

Some additional key concepts. So far, it could be argued, the concepts discussed above are relatively straightforward (for example, it should be easy enough to figure out if someone has or has not crossed a 50% ownership threshold). The devil is in the details, however, and many of the difficult interpretive issues arise from some deceptively simple words and legal concepts that are embedded within the definition of "change of control." These words will often determine whether shares owned or acquired by a given person should or should not be counted towards a change of control.

Two concepts which can function to *include* shares in the determination of whether a new ownership position has crossed a change of control trigger threshold are "group" and "beneficial ownership." Recall, as noted above, that a change of control is usually triggered by the acquisition by any person or "group" of "beneficial ownership" of more than an established percentage of shares. Both of these terms have technical meanings under the US securities laws, and indeed most debt instruments directly incorporate the applicable securities law definitions.

The concept of a "group" comes from Section 13(d) of the Securities and Exchange Act of 1934 or, the Exchange Act. A group typically is deemed to have been formed when two or more persons agree to act together for the purpose of acquiring, holding, voting or disposing of securities of an issuer. An agreement creating a group can be formal or informal and is a question of fact.

The concept of "beneficial ownership" comes from Rule 13d-3 of the Exchange Act. Generally, a person is deemed to be the beneficial owner of any security as to which the person has or shares voting or investment power. Beneficial ownership may be direct or indirect (*e.g.*, a person is deemed to be the beneficial owner of shares held through one or more intermediate entities) and may exist by virtue of a contract, arrangement, understanding, relationship or otherwise.

The concepts converge in that all securities that are "beneficially owned" by all of the members of a "group" are imputed to be beneficially owned by *each* member of the group. To sum up, then, the application of the "group" and "beneficial ownership" concepts will often mean that the holdings of several individual holders are lumped together for purposes of determining if a change of control threshold has been crossed.

On the other hand, two concepts which can function to *exclude* shares from a change of control trigger are "permitted holder" and "affiliate." Recall again, as noted above, that a change of control may *not* be triggered if the person who acquires (or holds) more than the requisite percentage of shares is a "permitted holder." The following is a typical definition: "'Permitted Holders' means the 'Sponsor' and its 'Affiliates.'" The "Sponsor" is often defined as the founder or a private equity fund or group of funds that either already owns a substantial stake in the company or is acquiring that stake in the transactions being financed by the debt in which this provision appears.

The term "Affiliate," similar to group and beneficial ownership, is typically taken straight from the securities laws (in this case, Regulation D under the Securities Act of 1933 as amended), and is defined as, which respect to any specified person, any other person controlling or controlled by or under common control with such specified person.

It will be seen, then, that the combination of these two concepts – the first, a specifically excluded entity (the sponsor), and the second, a relatively

undefined but somewhat related number of holders (the sponsor's affiliates) – can create a situation in which a fairly large ownership stake can be acquired (or transferred) without triggering a change of control. The interplay between all of these concepts can be particularly baffling when they seem to work at cross-purposes. For example, it may be the case that a sponsor is deemed to be part of a "group" for purposes of determining whether the ownership threshold has been crossed (for example, because the sponsor is acting in concert with other persons who are acquiring securities of the issuer), yet is also included in the definition of who is a "permitted holder." In this situation, one set of definitions works to *include* the sponsor's shares in the calculation, while the others *exclude* them. Addressing this potential inconsistency has given rise to somewhat twisted exceptions to exceptions – the most common of which is the addition of language to the definition of "permitted holder" to the effect that a "group" of which the permitted holder is a member will be deemed to be a permitted holder if the sponsor and its affiliates collectively own more than 50% of the securities held by such group.

Some Recurring Problematic Situations

While the interpretive questions that arise under change of control provisions in debt instruments are as numerous and varied as the unlimited creativity of market participants, we have found that there are a handful of issues which seem to recur with some frequency. These issues can be categorized according to potential transaction structures as follows:

Transfers of ownership by one "private" owner to another. One commonly encountered situation involves a private equity sponsor seeking to sell a portion of its equity stake in the issuer/borrower to another private equity sponsor or other investor. Let's assume that the original owner, who currently owns 100% of the issuer's equity, wishes to sell a 25% stake to the new owner. Let's also assume that the original owner is included in the definition of "permitted holder." Common sense might suggest that this transaction should NOT be a change of control; after all, the original "permitted holder" still owns more than a majority of the company. However, if the original sponsor and the new minority owner constitute a "group" (which could well be the case if the two sponsors enter into a shareholders agreement relating to the voting or disposition of their securities), there is now a new group which, it could be argued, has just acquired 100% of the voting stock of the company. This would be a pretty anomalous (wrong) result.

On the other hand, picture the same situation but this time the original owner wishes to transfer a 75% stake to its new co-investor. This time, common sense would suggest that this transaction SHOULD be a change of control. However, if the definition of "permitted holder" includes any "group of which the permitted holder is a member" – with no caveats as to the percentage of the group's shares that must continue to be owned by the original sponsor – this may not trigger a change of control. This would be an equally anomalous (and wrong) result.

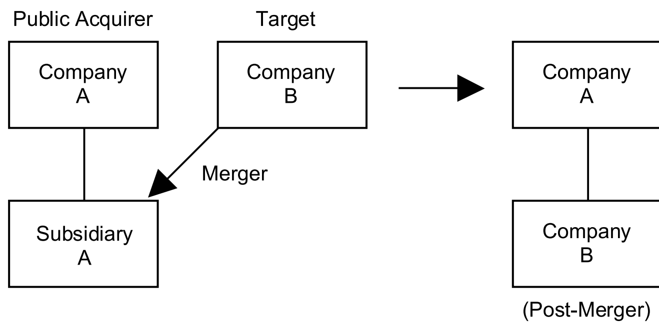
Of course, "right" and "wrong" have little place in this discussion, since it is well established that the rights of borrowers/issuers and creditors/noteholders are defined by the governing legal documents (as opposed to moral judgments). Still, one would like to think that, at least to some extent, common sense expectations ought to correspond to legal results. The bottom line advice for this recurring situation would seem to be that unless the definition of "permitted holder" clearly articulates that the original sponsor's shares should not be included in holdings of a newly formed group of which the original sponsor has become a member, then the formation of such a group would most likely be found to constitute a change of control (assuming, of course, that the group's holdings exceeded the applicable threshold).[2]

Transfers of ownership to a "public" owner. Another frequently encountered situation involves the acquisition of a company that has debt with change of control provisions by a public company. In this case, strangely, the answer to the question of whether a change of control provision is triggered may depend on the structure of the transaction, even though, legal structure aside, the end result of the transaction from a financial point of view will be exactly the same. For example, if the public company acquires all of the shares of the target via a direct stock purchase from the target's shareholders (easily done if the target is privately owned by a small number of shareholders). This would almost invariably trigger the change of control because a new "person" has acquired 100% of the voting stock of the company.

Similarly, if the acquisition is effected via a reverse triangular merger in which the target/issuer becomes a wholly owned subsidiary of a public company (see Figure 1 on page 6), which is a fairly common acquisition structure where the target's shares are widely held, this typically would trigger a change of control, again because a new "person" (this time, the public company acquirer) would have acquired 100% of the voting stock of the issuer.

On the other hand, if the acquisition is structured as a direct merger of the public company with the issuer (see Figure 2 below), this might not trigger a change of control if, after giving effect to the transaction, no single shareholder or "group" of shareholders of the surviving corporation to the merger owns more than the applicable threshold of the surviving company's voting stock.[3]

Figure 1



Interestingly, the foregoing analysis can yield a different answer as a result of the application of the "permitted holder" and "affiliate" concepts. For example, in the reverse triangular merger example (Figure 1 above), the end result might not trigger a change of control if the target has an existing controlling shareholder and the definition of change of control excludes that controlling stockholder (as a "permitted holder") and its "affiliates." In such a case, if on a pro forma basis the public company/ acquirer (or, in Figure 2, the surviving corporation) is an "affiliate" of the original permitted holder, which might be the case if the sponsor ends up holding a significant equity stake (see Figure 3 below), the transaction would not be a change of control. Query what happens, however, in this situation when six months later the original permitted holder sells all or a part of its interest in the public company. At some point, the public company will cease to be an affiliate of the original permitted holder, at which point a person (the public company, who at that point would not be a permitted holder), would own 100% of the stock of the issuer. Does this mean that a change of control would be deemed to occur at that point, notwithstanding the fact that the "real" transaction took place months before? The answer to this question could hinge on a documentation issue referred to earlier,

Figure 2

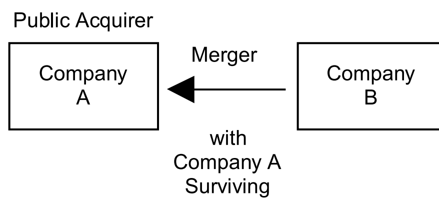
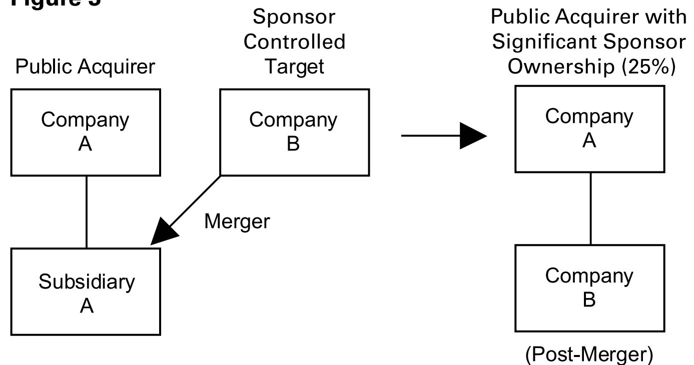


Figure 3



namely, whether the debt agreement provides that a change of control is triggered only by the "acquisition" of a specified percentage of voting stock, or by the fact that a person "is or becomes" the owner of that percentage. If the provision requires an actual "acquisition," then one could well take the position that this is not a change of control, because at that point in the transaction, no one is acquiring anything (to the contrary, the former permitted holder/sponsor is disposing of shares, not acquiring them). On the other hand, if the provision is triggered by "mere" ownership, the better position would seem to be that a change of control is triggered, because clearly a person who is not a permitted holder (the public company which is no longer an affiliate of original permitted holder), does in fact own 100% of the issuer.

A recent "real life" example of how deal structure can be driven by the desire to avoid triggering a change of control is the announced acquisition of Schering-Plough by Merck. Schering is a party to a key distribution agreement that contains a change of control provision with both ownership and merger triggers. If the transaction was structured as Merck acquiring Schering (either via stock acquisition or triangular merger), both provisions would have been triggered. Instead, the transaction was structured as a "reverse merger" in which a subsidiary of Schering was merged with Merck and Merck ending up as a subsidiary of Schering, with Schering continuing as the ultimate publicly traded parent – and as a result, no new person acquired control of Schering.

Schering's incumbent directors elected Merck nominees to the Schering board, which meant that the new directors qualified as "continuing directors" of Schering. Finally, to perhaps add insult to injury, Schering will change its name to Merck.

Creation of holding companies. A final frequently encountered fact pattern requiring change of control analysis involves the creation of a holding company to hold the shares of the issuer/borrower.[4] When this happens, the "ultimate" beneficial ownership of the voting stock of the issuer/borrower is unchanged. However, the newly created holding company is a new person, and this new person has become the beneficial owner of 100% of the voting stock of the company, so absent an exception this transaction would trip the trigger. The common exception would be for a permitted holder in a situation where the company is controlled by a large shareholder which is a "permitted holder" and the definition of "permitted holder" includes "affiliates" of the large shareholder, because the newly created holding company will be controlled by (and, therefore, will be an affiliate of) the existing large shareholder.

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It should be clear (or clearer) by now that, particularly in the current economic environment, the existence of change of control provisions in debt instruments can pose substantial challenges to deal participants trying to structure transactions so as to avoid having to refinance existing debt. The examples described above demonstrate how a lack of clarity can place extraordinary pressure on deal participants to push the interpretive envelop. While more uniform drafting and interpretation would help guide market participants,[5] it is perhaps too much to expect that this will happen in any meaningful way. In any event, until this happens, market participants will continue to grapple with these imperfect provisions while applying them to increasingly complicated transactions.

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1 An exception to this historical general rule (almost) occurred recently in a transaction involving AIG. According to published reports, due to the public outcry surrounding certain bonuses paid at AIG, the French government attempted to replace an executive at Banque AIG. As it turns out, this action would have violated a continuing directors and executive management provision in some of Banque AIG's derivative contracts and could have caused up to $234 billion notional value of such contracts to become immediately due and payable. The French government dropped the idea.

2 Perhaps a better way to express this would be to say that, while this interpretive issue is hardly free from doubt and will depend, as always, on the exact words, as a general matter it would be difficult for counsel to affirmatively opine that the formation of such a group did NOT trigger a change of control, which is effectively the same thing, since the inability of counsel to opine on the matter will likely make it impossible for the transaction to proceed.

3 This structure could still be a change of control if the target's debt documents contain the "merger provision" (the second bullet point in the discussion of typical triggers above). Also, obviously, this discussion ignores other provisions of debt agreements that might have an impact on transaction structure, such as a covenant restricting mergers and consolidations.

4 This situation can arise in several contexts. For example, sometimes the owners of a company will want to interpose a holding company in between themselves and the company in order to be able to maximize leverage (by making it possible to place additional "holdco debt" in the capital structure. Another example is where there may be advantages to creating a holding company in order to take the company public.

5 One such drafting guide was published by the Credit Roundtable in a "White Paper" released December 7, 2007. The paper provided model covenant provisions for investment grade debt instruments.

Participating in the TALF – Considerations for Sponsors of ABS

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The severe economic turmoil in the US has caused the federal government to undertake unprecedented efforts to stabilize and reinvigorate the financial markets.

Of particular interest to participants in the securitization industry is the Federal Reserve Bank of New York's ("NY Fed") Term Asset Backed Securities Loan Facility (the "TALF").[1] Under the TALF, purchasers of eligible asset backed securities ("ABS") may finance their purchase by borrowing up to three year non-recourse loans from the NY Fed, which loans are secured by the eligible ABS. The NY Fed established the TALF in an effort to resuscitate the new issuance market for ABS. The US government recognizes that the securitization markets "have historically been a critical component of lending in our financial system" and that ABS in particular are "an important means by which financial institutions fund loans to businesses and households."[2] The U.S. Department of the Treasury estimates that prior to 2008 securitization represented 40% of all lending in the US.[3]

For most of the past eighteen months the securitization markets have seen minimal new issuances come to market. As credit has tightened in the US during this time, many traditional investors in ABS have moved to the sidelines and are waiting to see how the securitization markets redefine themselves. The US government sees the TALF as a program that over time will stimulate and increase demand for ABS, which in turn will allow sponsors of ABS to bring more deals to market, and therefore, should trigger an increase in credit available to businesses and consumers.

ABS collateral eligible for the first funding of the TALF in March 2009 included prime retail auto retail leases and loans, subprime retail auto loans, RV/motorcycles, auto floorplans, prime and subprime credit cards, private and government guaranteed student loans, and SBA small business loans. This list of eligible ABS collateral was expanded by the NY Fed in connection with the April 2009 funding of the TALF to also include commercial and government auto fleets, rental car fleets, equipment loans and leases, non-auto floorplans and residential mortgage servicing advances. In connection with the June 2009 funding of the TALF, the NY Fed recently added commercial mortgage backed securities and securities backed by insurance premium finance loans to the eligible collateral list. The NY Fed has left open the possibility of expanding the list of eligible ABS collateral to include additional asset classes. In addition to limiting the types of collateral that may secure eligible ABS, the TALF also places limitations on the date of origination of such collateral.[4]

A decision currently confronting sponsors is whether it makes commercial sense to proceed with structuring and issuing a TALF-eligible transaction.

So what is a sponsor of ABS to make of the TALF? A decision currently confronting sponsors is whether it makes commercial sense to proceed with structuring and issuing a TALF-eligible transaction. This decision requires an evaluation of a number of considerations, including the following:

What are the implications of structuring a transaction to an AAA rating without the benefit of third party credit enhancement as required by the TALF? In order for securities to be eligible for a TALF funding, they must be rated AAA by at least two nationally recognized statistical ratings organizations without the benefit of any third party credit enhancement (such as monoline insurance). Achieving "natural" AAA ratings for many ABS asset classes requires significant levels of overcollateralization as credit enhancement, which comes at the cost of reduced proceeds to the issuer/sponsor. While the reduced proceeds could be mitigated through the issuance of subordinated notes (thereby monetizing a portion of the incremental enhancement), the potential considerable costs associated with the returns that will be demanded by investors in mezzanine and subordinated ABS must be weighed against the cost of the loss of proceeds. In addition, in the current market it is not yet clear how broad an investor base is willing and able to invest in mezzanine and subordinated ABS for any price. This issue is particularly acute for sponsors of ABS in asset classes that have historically relied on monoline insurance.

Are there adverse pricing implications associated with issuing TALF-eligible securities? Investors are subject to haircuts on TALF loans borrowed from the NY Fed, ranging from 5% to as much as 16% depending upon

the ABS asset class purchased with the proceeds of such TALF loans. The TALF also requires subscribing investors to pay to the NY Fed an administrative fee of 5 basis points of the total loan amount borrowed from the NY Fed. These are costs that must be factored into the pricing of any TALF-eligible securities.

In addition, NY Fed President and Chief Executive Officer William C. Dudley recently noted that the TALF is off to a relatively slow start, partially due to "the reluctance of some investors to participate because of worries about the potential implications for them of the TARP funding that is involved in the TALF program".[5] One must presume that such reluctance will factor into pricing considerations for those investors who are looking to purchase TALF-eligible securities, notwithstanding the fact that the NY Fed has stated that TARP's executive compensation restrictions will not apply to investors solely as a result of their participation in the TALF.

What other sources of financing are available? Sponsors should also consider what sources of alternative financing are available to them, such as the issuance of ABS that is not TALF-eligible, as well as banking and other credit lines, if any, as well as the immediacy of their financing needs.

Approximately $12 billion in TALF-eligible ABS came to market in connection with the first two fundings of TALF loans, dominated mainly by auto loan-backed transactions. Reports indicate that as much as $10 billion in TALF-eligible ABS deals have priced in connection with the May funding of the TALF, including deals backed by student loans, credit cards, small business loans, equipment loans, auto loans, and auto leases.[6] In addition, over the same period approximately $9 billion in non-TALF-eligible ABS deals have come to market, representing asset classes ranging from student loans to equipment loans. While this may not represent the surge that the NY Fed hoped for, it does represent a small increase in activity relative to the remainder of the first quarter of 2009. However, issuance in the first quarter of 2009 was down 76% as compared with the first quarter 2008 and down 94% from the first quarter of 2007.[7]

This leaves us with the question of why have more TALF-eligible transactions not come to market. Certain sponsors believe that TALF-eligible deals are just uneconomical for them, either because they can achieve more efficient financing by structuring a non-TALF-eligible deal or because they have access to more efficient funding through non-ABS markets. In addition, some sponsors believe that future market conditions are likely to improve and therefore they are waiting to see how the ABS markets evolve and how the terms of TALF-eligible and non-TALF-eligible deals diverge. Whatever their circumstances, most market participants would like to see the TALF prove successful in its efforts to jumpstart the ABS markets.

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1 For a detailed summary of the TALF and the U.S. Department of the Treasury's Public-Private Investment Program, see Issues #3 and #5 of Weil Gotshal's *Hedge Funds Returns* newsletter available at www.weil.com.

2 Joint Press Release of the U.S. Department of Treasury and the NY Fed, March 3, 2009.

3 Quarterly Report to Congress, April 21, 2009, Office of the Special Inspector General for the Troubled Asset Relief Program, page 93.

4 For a summary of the limitations on the date of origination of collateral underlying TALF-eligible ABS, see footnote 2 of Issue #3 of Weil Gotshal's *Hedge Funds Returns* newsletter available at www.weil.com.

5 Remarks of William C. Dudley, President and Chief Executive Officer of the NY Fed, at the Vanderbilt University Conference on Financial Markets and Financial Policy Honoring Dewey Daane, Nashville, Tennessee, April 18, 2009.

6 Issuance to Surge with TALF's Next Round, *Asset Backed Alert*, April 17, 2009.

7 Fed Assistance Shifts Issuance Paradigm, *Asset Backed Alert*, April 3, 2009.

8 Another factor that may deter sponsors from utilizing the TALF is the three or five year limits on the term of TALF loans. Currently all TALF loans have three year maturities, but beginning with the June 2009 funding, five year TALF loans will be available to finance purchases of commercial mortgage backed securities, ABS backed by student loans and ABS backed by loans guaranteed by the Small Business Administration.

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that a limited amount of financing risk has been transferred to Wyeth in exchange for the higher reverse termination fee from Pfizer.

Though the Merck merger agreement does not include a specific financing out, a similar result is achieved. Merck can postpone closing if the committed or alternative financing becomes unavailable. Each party may terminate the merger agreement on the outside termination date under the merger agreement if the closing does not occur because of the unavailability of financing (the outside termination date may be extended from December 2009 to March 2010 if financing is the only remaining condition). If the closing has been delayed because of the unavailability of financing and either party terminates the merger agreement on the termination date, Merck owes Schering-Plough a reverse termination fee of approximately 6% of the transaction value. As in Pfizer, the reverse termination fee is the exclusive remedy of Schering-Plough against Merck for any claims related to the transaction and specific performance is not available in the event that financing is not available.

The credit ratings condition in the Pfizer merger also signals that lenders are approaching financing outs related to business performance in new ways. Typically, lenders providing acquisition financing require the absence of a material adverse change as a condition to their commitments and agree to mirror the material adverse change financing condition to the corresponding provision in the applicable merger agreement. However, the ability of acquirors to successfully invoke material adverse change provisions under merger agreements has been limited and Delaware courts have repeatedly ruled against acquirors attempting to invoke these provisions. The Pfizer credit ratings condition, and corresponding financing out in the Pfizer merger agreement, suggests that lenders are finding comfort in conditions tied to objective criteria rather than relying solely on traditional material adverse change conditions.

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