In Practice

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Deal contingent derivatives: managing risk in M&A transactions

In this In Practice article the authors consider the key terms of deal contingent derivatives.

WHAT ARE DEAL CONTINGENT DERIVATIVES?

Deal contingent derivatives (DCs) are transactions that can be used to hedge risks associated with an acquisition or disposal where there is a split exchange and completion, or a material period between an offer and the deal closing. They can be used in private sale processes, IPOs or exits through SPACs. DCs are often used to manage FX risk but can also be used for interest-rate or inflation-rate risk. The most common form of DC is a deal contingent forward (DCF). The main benefit of DCs (and the key difference between DCs and "vanilla" derivatives) is that if the *contingent event* (usually completion of the underlying transaction) does not occur, the DC falls away at no cost to the non-bank party.

CONDITIONALITY

A bank writing a DC will focus on the likelihood of completion occurring. If the underlying deal is not consummated, the bank will not only lose the premium that would have been payable to it by the non-bank party, but it will also have to settle any back-to-back trade entered into to hedge the bank's own risk (potentially incurring a significant loss). Due diligence is therefore an integral part of any DC process, with the conditionality to completion (such as anti-trust, regulatory or tax authority approvals or shareholder votes) being the subject of considerable scrutiny. Users of DCs (and their legal counsel) should be prepared to answer detailed questions about the commercial rationale for the transaction, the funding arrangements and, in particular, the conditions to completion. A bank's view on the likelihood of completion will influence the pricing it offers and the legal terms of the DC long form confirmation (LFC).

NOTABLE NEGOTIATED TERMS OF DC LFCs

- **Definition of "Completion"**: The orthodox approach is to use the definition of "Completion" (or similar) from the underlying deal transaction documents. However, the chosen definition should be carefully considered because completion will be the contingent event for the DC and must be sufficiently certain to avoid future disagreement between the DC parties. For example, banks will be wary of deals where completion is in the gift of the parties, rather than reliant upon a third party.
- **Amendments to transaction documents:** Amendments to the underlying transaction documents during the gap period should be considered carefully, especially if they impact the conditions to completion. Such changes could alter the risk that the bank has underwritten and break the nexus with the LFC. Ideally, amendments should be discussed with the DC bank in advance, and it is not uncommon to see notification of amendment requirements added to LFCs.
- **Phoenix clause:** The phoenix or "lookback" clause is viewed as a protection which mitigates the bank's risk exposure under any back-to-back trade entered into in connection with a DC. If the underlying deal fails to complete but a transaction (or series of transactions) which is equivalent to the underlying deal completes within a specified period, the phoenix clause requires a true-up between the bank and the non-bank party. The purpose of this is to put the parties in the position they would have been had the original deal completed and the DC executed. The length of the phoenix period is often heavily negotiated based on attributes of the underlying transaction.
- **Settlement**: Although settlement provisions are largely mechanical, it is essential that settlement of the DC is aligned with the funding arrangements of the underlying deal. Where funding mechanics are complex, parties must ensure that the settlement window provides sufficient time for the DC monies to be transferred whilst minimising double transfer risk. The timing of delivery of settlement notices also requires careful attention because many banks will include cut-off times for settlement notices relating to certain currency pairings which, if missed, will delay the transfer of funds (potentially impacting the underlying deal).
- **Bespoke ATEs?**: From an LFC perspective, the market has seen a change in approach to transaction conditionality in recent years and additional termination events (ATEs) tied to specific conditions to completion – the purpose of which are to allow the bank to terminate, with the non-bank party then likely to incur liabilities – are much less likely to be found in contemporary LFCs.

REGULATION

DCs are in-scope for EMIR/UK EMIR purposes and the usual aspects of regulatory compliance must be considered. There were discussions regarding whether a DCF should be subject to mandatory variation-margin collateralisation. The market has settled on the view that DCFs are physically settled FX forwards which, for many DC users, will mean that they are outside the scope of mandatory variation-margin collateralisation.

FINAL THOUGHTS

Steady growth in the number of banks interested in the DC space is a good indicator that DCs have their own valuable niche in the derivatives market: for banks that have appetite for this risk, successful DCs offer higher returns than vanilla derivatives; for non-banks, DCs can be an effective tool to manage gap period risks. Interested parties must, however, have the specialist knowledge required to understand the risks in the underlying deal, and to negotiate the bespoke provisions of the LFC that do not feature in vanilla derivatives. ■