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Learning From A Failed Merger: The Sinclair-Tribune Pitfalls

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This past summer smoldered with regulatory success in major media mergers. In June, AT&T Inc. won its battle against the U.S. Department of Justice regarding its proposed acquisition of Time Warner Inc., allowing the $85 billion deal to close within days of the court's decision. Just two weeks later, The Walt Disney Company received approval from the DOJ Antitrust Division for its proposed acquisition of 21st Century Fox Inc., valued at over $52 billion. This paved the way for shareholder approval of the acquisition in late July, with the expectation that the transaction will be completed by early 2019.

In light of these regulatory successes, the failure of, and ensuing fallout from, Sinclair Broadcast Group Inc.'s attempted acquisition of Tribune Media Company came as a shock to many. Given the seemingly friendly regulatory environment, Sinclair appeared poised to breeze through regulatory scrutiny. Yet, in a surprising turn of events, the Federal Communications Commission announced on July 16, 2018, that it had "serious concerns" about the deal, which triggered the merger being referred to a hearing before an administrative law judge and ultimately termination of the deal by Tribune. As a result, instead of finalizing shareholder approval of the proposed acquisition and closing the deal, Sinclair now faces an explosive billion-dollar lawsuit regarding its purportedly belligerent conduct with regulators.

As the fallout from Sinclair-Tribune merger demonstrates, the ramifications of a failed M&A deal reverberate well beyond the acquisition itself. Indeed, Sinclair's stock price is down 21 percent year to date and the notoriety resulting from the failed deal has led to public and legal scrutiny of Sinclair's general business and merger practices. Given the importance of avoiding such complications and successfully consummating a proposed M&A transaction, it is imperative that parties identify and then mitigate any potential issues deriving from the terms of a merger agreement or discussions with regulatory bodies.

In a nutshell, well-advised bidders and targets will (1) carefully vet the propose deal for antitrust deal killers before signing an acquisition agreement; (2) remember to treat antitrust regulators with the respect and deference they have earned and deserve; (3) give the regulators no reason to think that they have been misled or haven't received the full story; and (4) use specific contractual provisions as to minimize reliance on inherently vague “reasonable best efforts” provisions and the like.

A Brief Overview of the Sinclair-Tribune Merger

Rumors of a potential Sinclair-Tribune merger initially surfaced in March 2017, and were confirmed on May 8, 2017 when the parties entered into a deal for Sinclair to acquire Tribune for $3.9 billion. Pursuant to the merger agreement, Sinclair would acquire Tribune as a fully owned subsidiary, bolstering Sinclair’s position as the largest television broadcaster in the United States. Given the size of the transaction—Sinclair stations would have been broadcast in 72 percent of homes in the United States and Sinclair would have possessed a duopoly in several regions—antitrust regulatory scrutiny was all but inevitable.

As is generally the case, the closing of the merger was contingent on clearance under the Hart-Scott-Rodino Antitrust Improvements Act by the Antitrust Division, as well as consent by the FCC. Accordingly, both parties committed in the merger agreement to take certain actions in order to facilitate regulatory approval and consummation of the deal.[1] Specifically, the agreement contemplated that Sinclair would agree to make certain broadcast station divestitures if “necessary or advisable to avoid, prevent, eliminate or remove the actual, anticipated or threatened (x) commencement of any Proceeding in any forum or (y) issuance of any Order that would delay, restrain, prevent, enjoin or otherwise prohibit consummation of the [merger].”[2]

As anticipated, the merger was immediately met with regulatory scrutiny and the parties participated in discussions with the DOJ and FCC for close to a year.[3] The discussions primarily centered on the divestiture of certain broadcast stations by Sinclair and disagreements between the parties soon became apparent.[4] Sinclair was allegedly unwilling to divest certain stations, even after the DOJ made clear it would cease its investigation and approve the merger were Sinclair to divest these stations.[5] Further, Sinclair purportedly failed to disclose that it would retain de facto control of several of stations that it proposed to divest, given the pre-existing business relationships between Sinclair and the parties to whom the stations would be sold.[6]

In an unexpected turn of events, FCC chairman Ajit Pai issued a public statement on July 16, 2018, that he had “serious concerns” about the deal and would designate issues relating to the merger for a hearing before an ALJ.[7] An FCC order for hearing—a process by which an ALJ will examine whether a proposed transaction may violate the Communications Act—will typically delay a pending transaction, but is by no means a death knell for a merger. But the order was the last straw for Tribune, which announced on Aug. 9, 2018, that it was terminating the merger agreement in light of the parties’ failure to complete the deal.[8]

Simultaneously with this announcement, Tribune filed a seething lawsuit accusing Sinclair of failing to adhere to its contractual obligation to use “reasonable best efforts” to consummate the merger by facilitating regulatory approval and avoid the entry of orders which may delay and preclude the merger’s closure.[9] Tribune laid forth in its complaint a slew of allegations related to its breach of contract claim. According to the complaint, Sinclair failed to make the DOJ’s requested divestures, as contemplated in the merger agreement, and instead undertook “belligerent and unnecessarily protracted negotiations” where it “fought, threatened, insulted, and misled regulators.”[10] In this regard, the complaint details multiple instances of Sinclair representatives directing inflammatory rhetoric at DOJ officials. These comments allegedly included Sinclair counsel accusing Assistant Attorney General Makan Delrahim of “completely misunderstand[ing]” the broadcast industry, as well as Sinclair counsel challenging Delrahim to “sue me” when negotiations surrounding divestment reached an impasse.[11]

Sinclair has responded in turn, filing a counterclaim that alleges that it was Tribune who breached the merger agreement by itself failing to use “reasonable best efforts” to consummate the transaction.[12] According to the counterclaim, while Sinclair remained committed to consummating the transaction after the FCC hearing on the merger was ordered, Tribune prioritized preparation for litigation with Sinclair at the expense of its obligations to obtain regulatory approval.[13] Sinclair alleges that this failure to use reasonable best efforts precluded the parties from being able to consummate the deal and breached the provisions of their merger agreement.[14]

Insights Derived From the Sinclair-Tribune Failure and Ways to Avoid Potential Pitfalls

It remains to be seen which side will prevail, but irrespective of who ultimately succeeds in litigation, both parties have suffered irreparable damage. Years of negotiations have now been wasted, enormous fees have surely been incurred, and most importantly, a deal that would have apparently been highly beneficial to the parties and shareholders has fallen to the wayside. What remains is a critical question to onlookers involved in the M&A world: how to avoid having a deal suffer a similar fate. The following details several affirmative steps a party can take to minimize their risk of stumbling into M&A pitfalls that can detrimentally impact the likelihood of consummating a deal.

The Importance of Due Diligence

At the center of the Sinclair-Tribune debate are objections by the public to Sinclair's proposed divestitures to Steven Fader and Cunningham Broadcasting Corporation. During the public comment period to Sinclair's proposed divestitures, it came to light that Sinclair's pre-existing business relationships with certain proposed purchasers raised the question of whether Sinclair would retain de facto control of these companies. The FCC had already questioned the legitimacy of these divestitures, given the close personal ties between Sinclair's executive chairman David Smith and the proposed purchasers: Steven Fader was a close business associate of Smith, and the estate of Smith's late mother had long owned Cunningham Broadcast.[15] But it was only after public commentary—where additional details came to light regarding the relationship between Fader and Smith as well as Sinclair's guarantee of millions of dollars of Cunningham's debt—that the FCC a public statement expressing its concerns, which ultimately catalyzed the termination of the merger.[16]

This fallout illustrates of the need to fully explore the potential antitrust concerns in the United States, and around the world, before entering into any proposed merger. The most effective way to identify any potential issues is a fulsome and comprehensive due diligence review well before entering any executed agreement. This often involves document collection and review by both companies, client interviews and, if time and money permit, analysis by third-party economists. While costly at the outset of any proposed deal, this can save both companies needless litigation and unwarranted public scrutiny for years to come.

Nevertheless, some uncertainties are unavoidable despite robust due diligence. First, once an investigation is opened, one of the first steps the DOJ will take is to contact customers and industry stakeholders to determine if there are any concerns about the deal. A company is simply unable to fully gauge customer or industry reaction, and cannot predict which entities the DOJ will approach in the first instance. While it is advisable to speak to customers in advance of any merger in order to understand what those the customers' attitudes may be, customer reaction to the deal and information provided to the regulators during the public comment period will remain an inevitable uncertainty that should be considered when entering into any agreement.

In addition, it is impossible to know the complete scope of the other party's documents. While it is common practice to exchange documents during the due diligence period, a company can never ensure that it receives all relevant documents from the other side. The scope of facts and information that may be disclosed during the course of a regulatory investigation can therefore never be fully appreciated. For example, the fact that Sinclair was the guarantor of millions of dollars of debt in Cunningham Broadcasting Corporation was allegedly not identified in Sinclair's initial disclosures, but instead become known through the public comments process regarding Sinclair's proposed divestitures.[17] In any event, a comprehensive document review and client interviews will help to mitigate these risks.

The Importance of Respect and Cooperation With Government Entities

In its complaint, Tribune alleges that, in response to the DOJ's demanded divestitures, Sinclair proposed a "highly contingent trust structure that kicked the divestitures down the road and caused further delay."[18] Tribune further alleges that "Sinclair's stubborn insistence on proposing its highly contingent trust proposal predictably had the opposite effect, slowing the FCC review process and requiring multiple rounds of repetitive applications, antagonizing the FCC staff, and subjecting the Merger to the higher risk accompanying protracted scrutiny at the Commission."[19] According to Tribune, Sinclair continually pushed the envelope with government regulators in blatant disregard of its contractual obligations to use reasonable best efforts to seek swift regulatory approval. Perhaps of even great concern is the FCC itself expressed concern over Sinclair's representations made during the negotiations—noting a "potential element of misrepresentation or lack of candor" with respect to the proposed divestitures."[20]

While it remains unclear exactly what unfolded during negotiations between Sinclair and the DOJ, it seems that the negotiations were far from amicable—with the negotiations allegedly culminating in Sinclair counsel's expression that the DOJ should "sue me" and threats to take the DOJ to court.[21] Discovery in the pending civil litigation will surely shed light on the line to be drawn between negotiating with authorities to effectuate the best possible deal for the companies and effectively ensuring that the deal will not go through.

However, even without knowing the nuances of the negotiations, it is clear that a certain level of respect and cooperation in dealing with government regulators, including the DOJ and the Federal Trade Commission, is key asset to ensuring that any company sees a smooth and easy approval. In this regard, it is important not to blow any potential issues out of proportion and risk the parties' relationship with the government regulators and the success of a pending deal.

Draft Clear Covenants to Avoid Any Unnecessary Uncertainty

The merger agreement that Sinclair and Tribune entered into was replete with qualifications of "reasonable best efforts." Indeed, this phrase appears no less than 37 times in the 103-page document. The Sinclair-Tribune dispute boils down to what "reasonable best efforts" were needed to secure regulatory approval. Tribune argues that Sinclair's belligerent behavior toward regulators amounted to a failure to use reasonable best efforts and therefore a breach of contract, while Sinclair argues that it did not commit to be the guarantor of approval but rather was attempting to negotiate the best possible deal with the government.[22]

While each transaction poses its own set of facts and considerations, there are many various contractual protections that may be deployed to clarify and define an acquirer's obligations and, hopefully, avoid protracted litigation. A few example will be discussed here.

Perhaps most common are requirements that specific divestitures be made to get HSR approval. The clearest—and most desirable provision from a target's perspective—is a "Hell or High Water." An HOHW requires the acquirer to divest any or all of its—or the to be acquired—businesses in order to obtain antitrust approval.

Of course, acquirers typically are not keen on being obligated to give up everything they may be acquiring. Often the parties will meet somewhere in the middle by setting forth specific business lines or revenue amounts that must be divested. Reaching an informed agreement requires significant up front antitrust analysis. Both parties' counsel need to analyze all possible competitive overlaps across all product/service lines to determine which, if any, may raise concerns if the two parties are to merge or otherwise combine. While there were divestiture provisions in the Sinclair and Tribune agreement, they apparently were not clear or specific enough to avoid the current dispute.

Such divestiture "caps" are typically paired with a reverse break fee. While these fees vary significantly, they typically range from about 2.5 percent to 7.5 percent of the purchase price. This leaves the acquirer with a choice. If the antitrust authorities seek more than they agreed to divest, the acquirer can pay the break fee and walk away.

There are also "ticking fees." These are periodic payment(s) to be made by acquirer to target if approval is not obtained by a certain date(s). There are also "reverse walk away" rights which give the target (as opposed to the acquirer) the choice (at certain date(s)) of taking additional incremental ticking fees—or even a full break fee—if approval is not obtained by certain date(s). On the flip side, these provisions provide certainty and protection for the acquirer in that the amount of payment will be set by the contract—and not by the trier of fact after a likely costly (in terms of time, money and uncertainty) litigation.

Again, one size does not fit all. The proper contractual protections will vary based on specific facts. However, the Tribune/Sinclair litigation is a strong argument that both sides need to get into the proverbial weeds—as opposed to relying on a relatively vague efforts standard.

Conclusion

As the failed Sinclair-Tribune merger demonstrates, safely navigating a major merger from initial agreement to consummation is no small task. Both parties to the deal were highly sophisticated, yet fell prey to some of the common pitfalls that can arise during merger agreement negotiations and ensuing regulatory review. Businesses are well-advised to hire effective legal counsel versed in addressing and solving these issues, to mitigate the risk of a deal suffering a similar fate to that of Sinclair and Tribune.

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[1] See, e.g., Tribune and Sinclair Merger Agreement (the "Merger Agreement") §7.1(a) (providing that Sinclair and Tribune would use "reasonable best efforts to take, or cause to be taken, all actions and to do, or cause to be done, all things necessary, proper or advisable under applicable Law to consummate and make effective the Merger and the other transactions contemplated by this Agreement as promptly as reasonably practicable."); id. §7.1(i) (providing that Sinclair would use its "reasonable best efforts" to "take action to avoid or eliminate each and every impediment that may be asserted by any Governmental Authority with respect to the transactions contemplated by this Agreement so as to enable the Closing to occur as soon as reasonably practicable.").

[2] Id. §7.1(i).

[3] Compl. ¶ 61.

[4] Id. ¶ 13.

[5] Id. ¶ 69.

[6] Id. ¶¶ 117-23.

[7] Compl. ¶ 111.

[8] Id. ¶ 127.

[9] Compl. ¶ 138.

[10] Id. ¶¶ 7-8.

[11] Id. ¶¶ 82, 88.

[12] Counterclaim ¶¶ 115-117.

[13] Id. ¶¶ 95-111.

[14] Id. ¶¶ 115-117.

[15] Compl. ¶ 105.

[16] Id. ¶ 110.

[17] Compl. ¶¶ 19, 110.

[18] Compl. ¶¶ 97-98.

[19] Id. ¶ 102.

[20] Id., Ex. C. ¶ 2.

[21] Compl. ¶ 82.
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[22] Compl. ¶ 138; Counterclaim ¶¶ 13-27.

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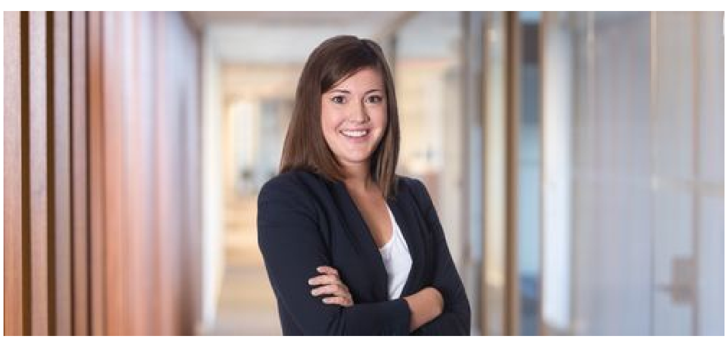

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