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In Real Estate Listings Deal With Zillow, Trulia Bears Most of the Risk

By STEVEN DAVIDOFF SOLOMON

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The success of Zillow's $3.5 billion acquisition of Trulia may depend not on an "and" but an "or" that the parties put in their acquisition agreement to deal with antitrust issues. Not only that, but the deal leaves Trulia the loser if the merger fails on antitrust grounds.

Zillow, an Internet real estate site, is seeking to acquire one of its biggest competitors, Trulia, in a combination aimed at consolidating the online market for real estate listings and saving the combined company tens of millions of dollars in costs.

Antitrust was probably the subject of discussion among the parties. Indeed, Trulia states in its annual report that Zillow is a "principal competitor" along with Homes.com and Realtor.com. Because of this, Zillow and Trulia needed to decide what they would do if their deal was challenged by the federal government on antitrust grounds.

The bargain the two competitors struck is completely in Zillow's favor. It permits the company to walk away from the transaction if regulators take any step to limit the combined company on antitrust grounds. Not only that, the parties agreed to severely limit what Trulia can do in the operation of its business until the deal closes or is terminated.

It's an unusual deal for Zillow, and this is where that "or" comes in.

The acquisition agreement puts relatively normal requirements on Zillow to obtain antitrust approvals, requiring the company to take “reasonable best efforts” to obtain clearance.

So far so good, but here is where things get a bit technical because the lawyers crafted a big exception from this requirement for Zillow.

The acquisition agreement, like any other for a public company, has conditions for completion of the deal. These conditions must be satisfied or Zillow is not obligated to acquire Trulia. Conditions like these usually involve shareholder approvals and any other consents required for the deal to go through, including antitrust clearances.

The antitrust provision in the Zillow-Trulia agreement states that Zillow is not required to complete the deal if the government seeks to require it to sell assets, limits its ability to “conduct” the business or requires Zillow to hold the shares of Trulia separately and not control the company.

This provision is intended to deal with government attempts to limit Zillow’s ownership of Trulia. That would happen if, for example, the government decided that Zillow should license technology or change its fee structures to preserve competition after the acquisition. But this is quite broad – and would cover basically any restriction the government might seek on Zillow’s rights as an owner of Trulia.

A second part to the provision states that if there is an action by the government that would have a “material adverse effect” on Trulia or Zillow, Zillow is not required to complete the deal. This language is common and basically means that if the government attempts to do anything that is significantly damaging to Trulia and Zillow, then Zillow can walk away.

The term “material adverse effect” is a term of art that means something of long-term effect that is significantly adverse to Trulia or Zillow. This is a high standard under Delaware law, the law governing the acquisition agreement. And no Delaware court has ever found a material adverse effect to exist.

Here is where that "or" comes in. Normally, the condition about government restrictions would be satisfied if the government placed restrictions on Zillow "and" the restrictions also had a material adverse effect.

Since the material adverse effect condition is a high one, it would mean that the government would have to take significant steps that were harmful to Zillow to give it grounds to walk away. But that is not what the agreement says. Rather, it says that if the government places restrictions of any kind on Zillow "or" a material adverse effect occurs, Zillow does not have to acquire Trulia.

What is the effect of this? Zillow and Trulia stated in their news release about the deal that "the majority of advertising dollars in the real estate sector have yet to migrate online or to mobile." Moreover, they said, the companies are in the broader market of "media," not just the home valuation market, and the two brands "have limited consumer overlap."

The net effect, then, is to build Zillow's argument that there are no antitrust issues here. And the broad exception allows Zillow to reinforce this point with regulators.

This may all be true, but Trulia has taken most of the risk here. If the authorities disagree and impose any type of restriction on the deal, however minor, Zillow can walk away and pay a $150 million termination fee. Whether the fee would compensate Tulia for the time and expense of being left to wait for up to 18 months is uncertain.

And there is perhaps a bigger problem. If this condition is not satisfied because of actions by government regulators, Zillow has to wait until the termination date for the acquisition agreement, Jan. 28, 2016, to walk away from the deal.

That is 18 months, an eternity in the technology sector. During that time, the acquisition agreement would stay in effect and Trulia would be limited in what it could do without Zillow's approval. Trulia could not make acquisitions, capital expenditures or borrow money. Trulia could not enter into an employment agreement involving compensation higher than $275,000, except to fill a void – and the successor's compensation would be limited to no more than 10 percent above what the departing person made. Trulia also could not begin any intellectual property actions.

Zillow has none of these restrictions, putting Trulia at a significant competitive disadvantage while it wait to see whether the deal will clear regulatory scrutiny.

This is all speculation about the future, of course, and Zillow seems keen on a deal, meaning that it might not walk away even if the antitrust authorities do act. But then again, that is what acquisition agreements are for – to deal with events that may have low probability and high impact.

In this case, that "or" puts all the risk on Trulia's plate.

Correction: July 31, 2014
An earlier version of this article misstated the terms of Zillow's agreement with Trulia on a termination fee. Zillow would have to pay a $150 million fee. It would not avoid a termination fee.

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