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Adding to the Club: Co-Investments by Fund Limited Partners

The bigger equity checks required for many private equity M&A deals in recent years has not only increased the number of club deals but also the number of co-investments, in which private equity sponsors turn to their limited partners and others to fill an equity gap.

This can be a win-win proposition. For limited partners, co-investment offers the opportunity to put additional capital to work behind a fund sponsor with a proven track record, often on better financial terms than those applicable to the primary fund. Some limited partners view potential co-investment opportunities favorably in connection with their decision to invest in a fund. For the fund sponsor, co-investment eliminates or reduces the dilution of control over governance and exit decisions that are part of club deals. This article discusses a number of threshold issues a sponsor should consider when planning to raise equity for a transaction from co-investors.

The Equity Bridge

In most circumstances, sponsors are not obligated in their fund documents to offer co-investment opportunities *pro rata* to all of their limited partners, and therefore they may limit the co-investment opportunity to a

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"We used to be an investment club. Now we're a support group."

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Letter from the Editor

The private equity scene never ceases to amaze us. This year alone has witnessed several IPOs of private equity managers, a record number of deals and record-breaking deal sizes, an increasingly challenging tax environment, hostility towards private equity from unions, increased antitrust scrutiny, as well as financing markets ranging from boom to bust. Never has being nimble and creative, as well as knowledgeable of the legal and regulatory environment, been so important for private equity professionals. This issue of the *Private Equity Report* attempts to help you to be both. First, on our cover, we look at the issues sponsors need to keep in mind when structuring co-investments from among their limited partners.

Elsewhere in this issue, we review several recent legal decisions affecting private equity firms. First, we report on the recent spate of Delaware cases interpreting the duties of boards reviewing acquisition offers from private equity sponsors. We also explain the surprisingly increased risk that private equity funds will not be able to recover indemnification costs they advance to corporate directors and how to modify existing indemnification agreements to solve this problem in light of a recent Delaware case. Finally, Gary Kubek reports on the dismissal of the recent class action antitrust suit against several leading private equity firms.

In our guest column, David Astorino, a Managing Director of RHR International, a firm of management psychologists who advise private equity sponsors on their human capital assets, outlines how sponsors should evaluate and motivate a target's senior management team in order to maximize returns.

Also, My Chi To and Jasmine Powers remind private equity investors of the process under Section 363 of the Bankruptcy Code for purchasing the assets of a distressed business.

As the market for private equity investment continues to evolve, the Debevoise private equity team and the *Private Equity Report* remain dedicated to providing you with the guidance and analysis you need in this increasingly challenging environment. As always, we welcome your inquiries and suggestions as to how we can be of most help to you and how we can make the *Private Equity Report* more useful reading. Enjoy the rest of your summer!

Franci J. Blassberg
Editor-in-Chief

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Look Out for Double Indemnity: Director Protections Take a Hit in Delaware

In a decision that has implications for all directors, but is of particular interest to private equity firms, the Delaware Court of Chancery recently decided that a director's expenses incurred in an unsuccessful effort to enforce a corporation's indemnification obligations must be paid by the director, notwithstanding the corporation's prior unconditional agreement to bear such expenses. *Levy et al. v. HLI Operating Company, Inc.*, 2007 WL 1500032 (Del.Ch., May 16, 2007). The holding increases the risk that any director of a Delaware corporation could have to bear the cost of a suit for indemnification personally.

Another aspect of the case is particularly noteworthy for private equity firms. The plaintiff directors were associated with a private equity fund that had a significant stake in the corporation. The private equity fund paid the loss that the directors might otherwise have been entitled to recover from the corporation, and it is unlikely that the fund will be able to recover from the corporation the whole amount paid. Private equity firms should reflect on this case when preparing fund and portfolio company agreements and should consider carefully the consequences of funding indemnification obligations that are shared with a portfolio company.

Background

A private equity fund (the "Fund") owned approximately 34% of HLI Operating Company, Inc. ("HLI"). Four principals of the Fund's sponsor served as HLI directors (the "Directors").

The Directors were beneficiaries of relatively standard indemnification by HLI and by the Fund. The HLI indemnification agreements provided that HLI would advance expenses of any suit brought by the Directors to enforce their rights to indemnification and that the Directors would not be obligated to reimburse HLI regardless of the outcome of the suit.

HLI restated its financials, and securities fraud litigation followed. As part of the settlement of the securities litigation, the Directors agreed to pay $4.8 million. The Directors sought indemnification from HLI. When HLI refused to indemnify, the Directors sued HLI.

For 16 months, HLI advanced to the Directors the costs of the Directors' litigation against HLI, as was required by the HLI indemnification agreements. HLI then learned, in discovery, that the Fund had paid the $4.8 million on behalf of the Directors. HLI ceased making advances and demanded that the Directors repay the amounts previously advanced.

The Decision

Vice Chancellor Lamb found that:

- The Directors do not have a valid claim against HLI for indemnification because the Fund, and not the Directors, paid the $4.8 million settlement.
- Delaware law does not permit HLI to bear the expenses of the Directors' unsuccessful suit.
- The Directors are obligated to reimburse HLI for the expenses that it had advanced.
- Although the Directors are not entitled to maintain their indemnification claim for the benefit of the Fund, the Fund can bring a contribution claim against HLI, seeking reimbursement for HLI's equitable share of the $4.8 million payment. (The Fund will have to bear the expenses of prosecuting that claim.)

The Vice Chancellor's decision may have been colored by the apparent failure of the plaintiff directors to disclose that the loss for which they were seeking indemnification had already been satisfied by the Fund, but the breadth of the holding nevertheless raises a number of concerns.

What to Do

Private equity firms should consider how to design relevant fund and portfolio company agreements to enhance the fund's chances of recovering fully from a portfolio company for payments by the fund of losses that both the fund and the portfolio company have indemnified. It may be advisable to provide in the portfolio company's indemnification provisions that the portfolio company is primarily liable for making any indemnification payments and to provide in the fund's indemnification provisions that the fund will have a right of subrogation against a portfolio company for amounts paid by the fund that relieve the portfolio company of an indemnification obligation. In addition,

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Look Out for Double Indemnity (cont. from page 3)

the fund's management agreement with the portfolio company could obligate the portfolio company to reimburse the fund for indemnification payments made by the fund to directors and officers of the portfolio company.

In any case, before a fund makes an indemnification payment for the benefit of persons also indemnified by a portfolio company or other party, careful consideration should be given as to the impact of the payment on the ability to recover from the other party. In *Levy*, for example, a loan of the $4.8 million from the Fund to the Directors, if permitted by the Fund partnership agreement, would likely have enabled the Directors to pursue the indemnification claim against HLI, at HLI's expense, with a reasonable prospect of full recovery.

Independent of the allocation of indemnification obligations between a private equity fund and its portfolio company, portfolio company indemnification agreements should be reviewed. The HLI agreements required advancement of the expenses of prosecuting the claim for indemnification without a requirement to repay under any circumstances. Prior to the *Levy* decision, we generally recommended a provision that excuses repayment except where the director's claim for indemnification is in bad faith or frivolous. If the HLI agreements had contained such a provision, the Vice Chancellor could have reached his desired result without casting doubt on the ability of corporations to pay the expenses of directors who bring colorable claims in good faith, but lose.

In light of the Vice Chancellor's broad holding, however, even the enforceability of provisions employing the "bad faith or frivolous" standard are in doubt. Accordingly, directors will want portfolio companies to consider other ways to foot the bill for prosecution of an indemnification claim, such as by depositing funds in escrow or maintaining a surety bond (in either case, from the time of entry into the indemnification agreement). Directors would be permitted to draw on the escrow or bond to pay for suits against a recalcitrant indemnitor.

Although the *Levy* decision does increase the risk that a corporate director could have to bear the cost of a suit for indemnification personally and that private equity funds will not be able to recover in full for amounts they advance to directors of portfolio companies, these risks can be mitigated through review and modification of portfolio company and fund indemnification arrangements. ■

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GUEST COLUMN

The Human Side of the Deal

Evaluating and Motivating the Senior Management Team to Maximize Returns

For deal teams in charge of evaluating the quality of portfolio company senior leadership and motivating them to deliver outsized returns, there has never been greater risk or reward in "getting it right." In a recent survey (*Human Capital in Private Equity*, 2007) completed by RHR International, a firm of management psychologists who advise private equity sponsors on their human capital assets, over two thirds of responding private equity firms viewed poor portfolio company performance as either very often or always attributable to management issues.[1] PE firms also believed that they were slow to make management changes even when they had compelling reasons to do so – over 60% of PE firms surveyed stated that they did not make management changes quickly enough, which impacted their value creation. Management due diligence in private equity transactions has become increasingly challenging in the current hyper-competitive deal market. Techniques described below for objectively evaluating portfolio company management make limited deal due diligence time more effective and help the deal team in tailoring a nuanced post-closing blueprint for motivating management and driving the value creation process.

Can the Management Team Deliver?

Research in the area of management due diligence has identified a number of factors that impede a thorough and complete management evaluation process.

- *Insufficient Face Time with Management Team.* Given the present M&A environment, there is less face time with management teams as well as less inclination on the part of sellers to permit a thorough investigation of management quality. When asked to identify difficulties in conducting a management assessment, 43% of PE firms feel that the time they spent with prospective portfolio company management is inadequate to prepare for a successful buyout.[2]
- *Pressure to Do the Deal.* With so much money chasing the same deals, PE firms have the tendency to overlook warning signs of management shortcomings.[3] Looking for the "good news" combined with time pressure to complete the deal leads to overly rosy perceptions of portfolio company management teams.
- *Over-Reliance on Incomplete Assessment Methods.* PE firms assess management talent based on references and past performance, neither of which is necessarily a predictor of future performance, especially when a change in direction and strategic focus is necessary (22% of PE firms acknowledge using inaccurate measures for judging future performance).[4]

Improving Management Due Diligence

Given the above, there are better ways to evaluate management talent, especially when more face time with the management teams is available. One such window of opportunity is the period between signing and closing where more formal due diligence in all regards occurs. Here are some suggestions for PE firms to increase

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With so much money chasing the same deals, PE firms have the tendency to overlook warning signs of management shortcomings. Looking for the "good news" combined with time pressure to complete the deal leads to overly rosy perceptions of portfolio company management teams.

1 *Bond Gunning, A.(2007). Human Capital in Private Equity. London: Mergermarket/RHR International.*

2 *Bond Gunning, A.(2007). Human Capital in Private Equity. London: Mergermarket/RHR International.*

3 *Bond Gunning, A.(2007). Human Capital in Private Equity. London: Mergermarket/RHR International.*

4 *Bond Gunning, A.(2007). Human Capital in Private Equity. London: Mergermarket/RHR International.*

the likelihood that they have the right people in the right roles to generate outsized returns.

- *Focus Due Diligence Where It Matters Most.* While PE firms are objective about financial, legal, and market due diligence, similar objectivity needs to be brought to that which creates the most value: the management team. Formal processes around management due diligence occur far more frequently in Europe (70% of the time) than in the States (less than 15%)[5] and where utilizing external consultancies to perform management assessments is common. In such situations, in-depth interviews occur with the senior team to explore their past successes and failures as leaders and how well their styles of leadership fit with where the company needs to go now. Formal management due diligence also includes thorough background checks and referencing which become another source of 'data' about the team and is combined with results from the assessment to capture a complete picture of a senior leader's potential to execute the business plan.

- *Create Necessary Face Time With Management Teams.* If opportunities for "getting to know each other" were limited prior to signing, then new owners should take a more informed and thorough approach to understanding management and organizational issues during the post-signing/pre-closing period. The process will establish an effective working relationship between management and the PE firm and increase focus on the most important strategic and operational issues to be addressed in the first 100 days of ownership.

- *Focus on the Potential for Future Performance not Just Past Results.* Those PE firms that consistently generate outsized returns through operational improvements not only evaluate management teams on their past performance and marketplace reputation, but on their ability to adapt to and execute the goals of the new business plan. Developing a template for 'what good looks like' based on a future success profile—and comparing the strengths and weaknesses of each senior executive to that—can dramatically improve the accuracy of determining if you have the right person to deliver results. For example, is the critical strategic goal to establish a solid business foundation because a portfolio company has been too loose and lacking a performance driven culture, or has it already established essential processes and efficiencies and is attempting to determine and execute key growth initiatives. Such different business case scenarios require different types of leadership skills and potentially different types of leaders.

- *Go Slow to Move Fast.* Assessing senior executives takes forethought, patience and time. However, this is the only way to build the database needed to inform management evaluations. Making the right decisions based on the right information will accelerate value creation in the long run. By some estimates, those PE firms that are most effective at management due diligence spend over 300 hours evaluating the senior team.[6]

Having critical data in hand regarding management issues before the close of the deal will ensure that the portfolio company leadership is in sync with the sponsor's strategic vision, enhancing prospects for a highly profitable outcome.

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Those PE firms that consistently generate outsized returns through operational improvements not only evaluate management teams on their past performance and marketplace reputation, but on their ability to adapt to and execute the goals of the new business plan.

5 *M. Hicks. (2004) Taking Management to the Next Level: Current Practice and Future Directions in the Assessment of Management Teams by Private Equity Firms. London.*

6 *M. Hicks. (2004) Taking Management to the Next Level: Current Practice and Future Directions in the Assessment of Management Teams by Private Equity Firms. London.*

Applying *Revlon* to Private Equity Transactions

Lessons from Recent Delaware Chancery Court Decisions

For more than two decades, every corporate director and every private equity buyer has known about a board's *Revlon* duties under Delaware law – put simply, when a company is for sale, its board must act reasonably to obtain the highest price reasonably available – and that there is no single formula for satisfying *Revlon*. In three recent decisions applying *Revlon* in the context of a sale of a company to a private equity buyer, Vice Chancellor Strine of the Delaware Chancery Court provides helpful guidance to public company boards, private equity buyers and their advisors as to how to structure and tailor the sales process in tandem with the package of deal protections built into acquisition agreements.

On the one hand, these cases, In re: *Netsmart Technologies, Inc. Shareholders Litigation,* In re: *The Topps Company Shareholder Litigation* and In re: *Lear Corporation Shareholder Litigation*, are evidence of an apparent increased scrutiny by the Delaware courts of sales processes conducted by public company boards, which could presage greater caution on the part of boards in negotiating deal protections, more attention to process matters and more focus on pre-signing market checks. Vice Chancellor Strine is particularly skeptical that management can always act in the best interests of stockholders when private equity comes knocking and the executive inevitably thinks about his or her role – and how he or she will be compensated – after a deal is done.

On the other hand, the cases also demonstrate the continued reluctance of the Delaware Chancery Court to enjoin transactions on the basis of breach of fiduciary duty claims when doing so could deny stockholders the opportunity to consider a proposed transaction, particularly in the absence of a competing transaction. Vice Chancellor Strine does not find the sales processes and deal protections adopted by the target boards in any of these three cases to be so tainted as to constitute breaches of the board's *Revlon* duties warranting a preliminary injunction, except in one unusual circumstance, though he does level significant criticism at certain aspects of these processes. What comes across loud and clear in all these cases is that boards must act reasonably, in light of the context, dynamics, facts and circumstances surrounding the particular transaction at hand. One size does not fit all. The injunctions that Vice Chancellor Strine does grant in these cases, with one exception, are to remedy incomplete or misleading disclosures to stockholders regarding the board's conduct and management's motivations during the sales process. Thus, while the conduct itself may not have merited a remedy, the failure to fully disclose the conduct did.

WHAT COMES ACROSS LOUD AND CLEAR IN ALL THESE CASES IS THAT BOARDS MUST ACT REASONABLY, IN LIGHT OF THE CONTEXT, DYNAMICS, FACTS AND CIRCUMSTANCES SURROUNDING THE PARTICULAR TRANSACTION AT HAND. ONE SIZE DOES NOT FIT ALL.

In this article, we will look at what these cases say about management's role in the process and the importance of tailoring an adequate market check and reasonable deal protections, as well as the board's disclosure obligations to stockholders. While these matters are of particular importance to the target's board, they are also significant to the savvy private equity buyer who will want to know what to expect from the target board and what actions to take – and not to take – to best protect its deal.

The Transactions

Netsmart Technologies Inc. was a "micro-cap" company, with a market capitalization of around $100 million and a thinly-traded public float. It was not generally known in the market that Netsmart was for sale. After deciding to seek interest from potential buyers, Netsmart's board determined to limit its search to private equity buyers and only then formed a special committee of non-management members of the board. After a limited auction process with several potential private equity buyers, Netsmart entered into a merger agreement with Insight Venture Partners and Bessemer Venture Partners in November 2006. Netsmart's CEO was involved significantly in the negotiation of the merger agreement. Netsmart's board relied on a standard "fiduciary out" clause and a 3% termination fee to allow for an adequate post-signing market check. The buyers rejected a proposed go-shop provision.

In contrast, Lear Corporation was a Fortune 200 company with a market capitalization in excess of $2.5 billion and

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Applying Revlon to Private Equity Transactions (cont. from page 7)

deep analyst coverage. In 2006, Carl Icahn made a large investment in Lear, and in part because of Icahn's reputation for takeovers, the market knew that Lear was "in play." Icahn approached Lear's CEO in January 2007 about a going private transaction, and after a week, Lear's CEO reported Icahn's overture to his board. A special committee of non-management directors was then formed, but Lear's CEO largely led the merger agreement negotiations. During the negotiations Icahn threatened to withdraw his bid if Lear conducted a pre-signing sale process. Lear and Icahn came to terms on a transaction in February 2007, which included a 45-day go-shop period and a two-tier termination fee (2.8% during the go-shop and 3.5% during the no-shop). Lear's stockholders ultimately rejected the proposed deal in July 2007.

Topps also involved a high profile suitor – Michael Eisner. Topps, a company struggling financially and run by one of its founders, had a market cap of less than $500 million. It was the subject of a proxy fight in 2005, which resulted in the compromise election of three "insurgent" directors to its board. Eisner approached the CEO of Topps around this time to express an interest in being "helpful" and ultimately in acquiring the company and keeping management in place. The merger agreement with Eisner included a 40-day go-shop period, a 3% go-shop termination fee and a 4.6% no-shop termination fee. At the last minute, Topps was approached by its rival (and frequent suitor) The Upper Deck Company, which expressed an interest in making a bid but did not receive any serious response from Topps. The Topps board had discussions with Upper Deck during the go-shop period which did not result in a transaction, and Upper Deck made an unsolicited proposal after the go-shop period ended, but Topps did not treat that bid as a superior proposal. Both Upper Deck and stockholders of Topps brought claims in connection with the proposed Eisner transaction.

OF GREATER CONCERN, IN BOTH INSTANCES, THE CEO WAS APPROACHED BY A PRIVATE EQUITY BUYER THAT EXPRESSED AN INTEREST IN RETAINING THE CEO AFTER CLOSING .... COULD MANAGEMENT, CONFLICTED IN THIS WAY, BE TRUSTED TO NEGOTIATE ON BEHALF OF THE COMPANY FOR THE HIGHEST PRICE REASONABLY AVAILABLE? AND, MORE GENERALLY, WOULD MANAGEMENT STEER THE COMPANY TOWARDS PRIVATE EQUITY BUYERS RATHER THAN STRATEGIC BUYERS WHO WERE UNLIKELY TO KEEP MANAGEMENT IN PLACE?

Management's Role

It is not uncommon for an interested buyer to first contact a potential target's CEO to float the possibility of a sale. Such initial contact is less formal and definitive than approaching the board directly, and this is precisely what happened in both *Lear* and *Topps*. The Court was not perturbed that the CEOs received the initial overture, although Vice Chancellor Strine was critical of Lear's CEO for waiting a full week after Icahn had made his initial contact before notifying the Lear board. Of greater concern, in both instances, the CEO was approached by a private equity buyer that expressed an interest in retaining the CEO after closing. Likewise in *Netsmart*, management was interested in staying on and having a "second bite at the apple." Could management, conflicted in this way, be trusted to negotiate on behalf of the company for the highest price reasonably available? And, more generally, would management steer the company towards private equity buyers rather than strategic buyers who were unlikely to keep management in place?

Reflecting this concern, in *Lear*, Vice Chancellor Strine said that the CEO-led negotiation process for the company was "far from ideal" and "unnecessarily raises concerns about the integrity and skill of those trying to represent Lear's public investors." Moreover, the Lear CEO had previously expressed anxiety to the board about his wealth being tied up in Lear stock and retirement benefits; a private equity transaction such as the one Icahn proposed would allow him to cash out his stock and safeguard his retirement benefits. As the Court put it, the CEO was in a "fiduciary quandary." In *Topps*, the Court was similarly concerned about the founder and long-time head of Topps favoring private equity buyers over Topps' competitor, a

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ALERT

Antitrust Class Action Against Private Equity Firms Dismissed

In the wake of the recent Supreme Court decision in *Bell Atlantic Corp. v. Twombly* clarifying the pleading standard in antitrust conspiracy cases, plaintiffs in the private antitrust class action against 13 private equity sponsors voluntarily dismissed the action by a stipulation that was entered on June 27, 2007.

The case, *Murphy, et al. v. Kohlberg Kravis Roberts & Co., et al.*, Case No. 06 CV 13210 (LLS), was filed in November 2006 in the Southern District of New York, following published reports that the Department of Justice was investigating whether joint (or "consortium") bids by private equity firms violated the antitrust laws. The case was brought on behalf of a purported class of all persons whose securities in any corporation were purchased by any of the defendants in a going private transaction beginning on July 1, 2003. The complaint, which referred to news reports about the DOJ investigation, alleged that the defendants "reportedly agreed" not to submit competing bids once a private equity firm or firms signed a definitive merger agreement with a public company, that they formed groups to submit a single bid, "thereby limiting competition," and that they "share information about their bids," thereby "depressing the price." However, although the complaint listed more than 40 going private transactions that supposedly were affected by the alleged conspiracy, it contained no allegations about specific acts by any of the defendants, as opposed to these general allegations that they formed "clubs" to bid collectively, exchanged information and agreed as to bids submitted or not submitted.

The parties agreed in February 2007 to stay the case pending the Supreme Court's anticipated decision in *Twombly*. That decision, issued May 21, 2007, reiterated the Court's prior rulings that "neither parallel conduct nor conscious parallelism, taken alone" violates Section 1, which prohibits a "contract, combination..., or conspiracy, in restraint of trade." The Court then held that to state a claim under Section 1, a complaint must allege "enough factual matter (taken as true) to suggest that an agreement was made," rather than that the defendants simply engaged in parallel conduct without any agreement. Put another way, plaintiffs must allege enough facts to "nudge[ ] their claims across the line from the conceivable to plausible."

Following the issuance of the *Twombly* decision, the plaintiffs in *Murphy* agreed to dismiss their complaint without prejudice, which means that the claims may be reasserted. Whether they will be is likely to depend on future developments, including the outcome of the DOJ's investigation. ■

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Guest Column: The Human Side of the Deal (cont. from page 6)

From Evaluating to Motivating

Once the deal is closed and the management team selected, effective motivation of the senior team is of paramount importance. Most often, PE firms seek to align their economic interests with those of management and a thorough management due diligence process can help determine the most effective way of doing this. But, while alignment of interests can be effective in cementing commitment and creating the right financial and operational focus, it is not enough to accelerate performance. Below are some suggestions for how to harness and maximize effectively the potential of management teams to deliver on the value proposition of a portfolio company acquisition:

- *Agree On The Key Priorities.* Once a deal closes, there should be a thorough understanding of what the most critical issues are facing the portfolio company. PE firm and management team agreement on these issues and what needs to be done about them is critical in motivating the senior team. Lack of alignment in this regard has the potential to foster false acceptance of what needs to be done and to slowed execution of the most important goals.
- *Determine The Motivations For Each Individual On The Senior Team.* Even if the issues and objectives are agreed, each member of the management team will ask themselves the essential question, "what's in it for me?" In addition to having an equity stake in the company, management executives also need to believe that this opportunity will benefit their own development if this is not their last executive position before retirement. PE firms will want to explore such motivations before determining how to incent each member on the team.
- *Be Explicit About What Good Looks Like.* PE firms that offer operational guidance to portfolio company management teams most often have a strong point of view of how to execute the business plan. However, they may not make such opinions explicit; rather, they will wait to see if the CEO and management team fulfill their silent expectations. Failure to establish clear expectations about how to execute strategic goals will create doubt in the management team, undermining its confidence and motivation.
- *Get Out Of The Way.* A final way to motivate the senior team is for the PE firm to empower them by being clear about objectives and metrics for determining success, but resisting the temptation to micromanage. A PE firm needs to leave the execution of the business plan to the CEO and senior team. Not clearly defining their ownership role allows PE owners to go anywhere and do anything. Such ambiguity eventually wears down a management team and creates a culture of passivity and dependence.

Once a deal closes, there should be a thorough understanding of what the most critical issues are facing the portfolio company. PE firm and management team agreement on these issues and what needs to be done about them is critical in motivating the senior team.

A Differentiating Advantage: Understanding the Most Effective Value Creation Tool

Effectively evaluating the senior management teams of PE portfolio companies gets the right people in place and identifies organizational issues critical to value creation. Management team evaluation makes due diligence prior to closing more effective by creating a deeper and more nuanced understanding of management's value creation potential. Similarly, developing a knowledge base early on as to how to best motivate and incent management enhances prospects for successful implementation of operational improvements throughout the ownership cycle. By initially demonstrating the patience and diligence required to meaningfully evaluate portfolio company management, PE firms will create a sophisticated understanding of their investments that will reveal hitherto overlooked levers of value creation and propel the portfolio company towards a successful exit. ■

David Astorino
Managing Director
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Section 363 Sales: How to Play the Game

The $64 billion question these days is not whether the sky will fall, but when. Restructuring gurus have been predicting for more than a year now that the next wave of bankruptcies is twelve to eighteen months away. This summer's tightening of the credit markets has made these predictions an increasingly safe bet.

With the anticipated rise in default rates will come a steady stream of troubled companies, some of which may be attractive targets for private equity buyers. So called "section 363 sales" – asset sales by debtor companies in reliance on Section 363 of the Bankruptcy Code – are likely to be an important feature of the restructuring driven M&A market in the next downturn. Given the large number of players in the distressed market, including "loan to own" investors, private equity buyers must be familiar with the section 363 process to take advantage of the opportunities that this will present.

More Section 363 Sales in Bankruptcy

Section 363 sales take their name from the section of the Bankruptcy Code that allows a debtor, with court approval, to sell assets – including substantially all of the debtor's assets – outside the ordinary course of its business. As a result of certain changes to the Bankruptcy Code, section 363 sales during the early stages of Chapter 11 cases will likely increase. One of these changes is the 18-month limit on the exclusive right of a debtor to file a plan of reorganization. This limit is expected to put more pressure on many companies contemplating bankruptcy to develop an exit strategy early, in many cases even before filing for Chapter 11 protection.

Asset sales may be particularly appealing for companies with large amounts of secured debt – an increasingly common feature of leveraged capital structures. If secured lenders can be paid in full from a quick sale of the business, they may be reluctant to take the risk of a potential decline in enterprise value during the Chapter 11 case or to expend resources monitoring the bankruptcy.

Although a section 363 sale has some important benefits for a prospective purchaser, Bankruptcy Code protections designed to ensure the transparency of the sale process raise significant issues of deal security and a host of tactical questions for a purchaser as to when and at what level in the section 363 sale process to engage with the seller. While many of these questions are similar to those that arise in any competitive bidding environment, it is important to understand the particularities of the section 363 sale process to fully appreciate both the risks and rewards of acquiring a company in a section 363 sale.

Key Advantages of Section 363 Sales

From the perspective of a purchaser, a section 363 sale is attractive because the bankruptcy court has the power to approve the sale free and clear of liens and most liabilities attached to the assets. Exceptions to keep in mind are environmental liabilities and successor liabilities relating to certain types of tort claims. Although due diligence should still be thorough, court approval can protect the purchaser against most trailing liabilities.

The buyer in a section 363 sale also benefits from the rights granted to a good faith purchaser of assets. Among other things, the buyer is protected against any subsequent fraudulent conveyance challenge. Large acquisitions of distressed businesses are frequently implemented through section 363 sales because buyers do not want to take the risk that, in a later bankruptcy of the seller, the transaction will be attacked as a fraudulent conveyance. If the attack is successful and the buyer is required to return the assets, the buyer may be left with an unsecured claim against the bankrupt estate that may not be worth much.

Notice and Hearing

The considerable statutory protections available to a buyer in a section 363 sale come at a price. The sale can only be approved by the bankruptcy court after notice to interested parties and a hearing.

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From the perspective of a purchaser, a section 363 sale is attractive because the bankruptcy court has the power to approve the sale free and clear of liens and most liabilities attached to the assets .... Although due diligence should still be thorough, court approval can protect the purchaser against most trailing liabilities.

Section 363 Sales (cont. from page 11)

Until the bankruptcy court approves the sale, any purchase agreement or letter of intent is not binding on the debtor, but is binding on the purchaser.

All of the debtor's creditors have a voice in the section 363 process and can object to a proposed sale. Prior to bankruptcy, the seller controls negotiations. After the bankruptcy filing, however, the sale process is usually run by the seller/debtor with the input and participation of its key creditor groups. If the debtor and the creditors cannot agree on the terms of sale, the court will decide.

Not surprisingly, creditors that will not be paid in full from the proceeds are likely to oppose the sale. A section 363 sale can generally be approved over the objection of unsecured creditors if the court finds that, among other things, the assets are sold for the highest or best price and the sale is in the best interest of the estate.

However, a section 363 sale will generally require the support of creditors with liens on the assets unless the proceeds are sufficient to pay them in full. If the debtor has first- and second-lien debt and the sale proceeds cover the first-lien debt but not the second-lien debt, there is some uncertainty in the case law as to whether second-lien creditors can block the sale. It is clear, however, that this scenario may give rise to disputes between senior and junior lien holders as to whether, when and at what price their collateral should be sold, which can delay the approval of the sale. The dramatic increase in the amount of second-lien debt over the last several years will undoubtedly give rise to some new and interesting dynamics in section 363 sales.

Although an asset sale can be implemented as part of a plan of reorganization, it can also be approved at the outset of a bankruptcy before any plan is filed. Accordingly, the buyer does not need to become involved in what are often contentious and lengthy plan negotiations. A sophisticated buyer must, however, understand the debtor's capital structure and the dynamics of the bankruptcy in order to anticipate likely objections and maximize the chances of the sale being approved.

Highest or Best Price

In addition to the notice and hearing requirement, the debtor must demonstrate that it obtained the highest or best price for the assets. To satisfy the debtor's burden of proof, the sale is usually subject to an auction conducted under the supervision of the bankruptcy court.

Section 363 sales can occur at any time during the bankruptcy. In so-called "pre-packaged" bankruptcies, section 363 sales are often subject to a double auction. Prior to bankruptcy, the seller markets the assets, selects the most attractive bid and enters into a purchase agreement or a letter of intent with the selected bidder (also called the "stalking horse"). As a condition to the sale, the seller agrees to file for bankruptcy protection shortly thereafter and to request court approval of bid procedures that will govern an auction for the assets. The terms of the purchase agreement with the stalking horse set the floor for the auction. The court approves the sale to the winner of the auction.

The stalking horse may be competing not only with strategic and financial buyers, but also with the debtor's secured creditors who may want to take control of their collateral. With the increase of complex capital structures with multiple layers of secured debt, "loan-to-own" investors holding secured debt (and second-lien debt in particular) may resist section 363 sales. Rather than subjecting the assets to a section 363 auction, these investors may prefer to capture the value of the business on favorable terms through a rights offering under a plan of reorganization.

In addition, a secured creditor may also exercise its statutory right to purchase its collateral in exchange for the satisfaction of its claim (or "credit bid") in a section 363 sale. Even if the debtor's secured debt is trading well below par, a secured creditor is entitled to bid the full face amount of the debt. Unless a third party purchaser is willing to pay the secured debt in full, it may not be able to defeat a credit bid.

Stalking Horse or Not?

A stalking horse usually has more time to perform due diligence as well as the opportunity to set a threshold price,

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With the increase of complex capital structures with multiple layers of secured debt, "loan-to-own" investors holding secured debt (and second-lien debt in particular) may resist section 363 sales. Rather than subjecting the assets to a section 363 auction, these investors may prefer to capture the value of the business on favorable terms through a rights offering under a plan of reorganization.

What's Old Is New: The Re-emergence of Stub Equity in Going Private Transactions

Background

In an ever-evolving deal environment, the pending private equity-backed bids for Harman International and Clear Channel Communications each contain what initially appears to be a genuinely novel feature: an offer to the existing shareholders to retain a portion of the target's post-closing equity. In both deals, the equity is expected to be registered with the SEC but not to be listed on any stock exchange or to otherwise trade actively. This technique, known as "stub equity," has been heralded by the financial press as "groundbreaking" and "cutting edge" based on the notion that it is unprecedented for private equity firms to allow a target's public shareholders to participate on the buy-side of a sponsored acquisition.

Stub equity in PE deals is not new, however. As just one example, sponsors used stub equity in the late 1990's to facilitate obtaining recapitalization accounting. But the size of the stub in today's deals, measured as a percentage of pro forma equity, is much larger than in prior deals. And its use is also noteworthy because it appears to derive not from accounting, tax or regulatory considerations but from sheer deal pragmatism: due to a variety of unique factors, getting to "yes" with Harman and Clear Channel is more difficult than in most deals. Sweetening the pot by giving shareholders the option to piggyback on the buying group's potential returns, without paying a carry no less, appears simply to be a price of admission in these deals.[1]

[1] *As we go to press, the dates of the shareholder meetings to vote on the Harman and Clear Channel transactions have not yet been announced.*

Where have I seen this before?

A buyer has two alternatives for accounting for most private equity-style control investments: purchase or recapitalization accounting. Prior to the FASB's 2001 changes to its purchase accounting rules (described in "Without Pooling, Are Recaps Doomed," in the Spring 2001 issue of *The Private Equity Report*) purchase accounting required a buyer to record the excess of its purchase price for a target over the fair value of the target's assets as goodwill on the target's opening balance sheet, and to thereafter amortize that goodwill over 40 years. Under recap accounting, however, a buyer is not required to restate any of a target's assets in a deal and hence has no incremental goodwill to thereafter amortize. This distinction led sponsors to want to account for an investment as a recapitalization wherever possible so as to maximize a target's earnings, and hence potentially its exit valuation.

STUB EQUITY IN PE DEALS IS NOT NEW, HOWEVER .... BUT THE SIZE OF THE STUB IN TODAY'S DEALS, MEASURED AS A PERCENTAGE OF PRO FORMA EQUITY, IS MUCH LARGER THAN IN PRIOR DEALS. AND ITS USE IS ALSO NOTEWORTHY BECAUSE IT APPEARS TO DERIVE NOT FROM ACCOUNTING, TAX OR REGULATORY CONSIDERATIONS BUT FROM SHEER DEAL PRAGMATISM.

The *sine qua non* of a recapitalization is the retention by some or all of a target's existing stockholders of at least 5% of the equity of the target following the recapitalization. In many public deals, a sponsor could ensure that a requisite portion of target's equity would be retained – and hence assure recap accounting – only by giving all stockholders the right to receive their *pro rata* portion of the merger consideration in retained shares, subject to the issuance of a minimum and maximum number of shares and a pro-ration in the event of under or over subscription.

This structure, known as a cash election merger, was effective for accounting and state law corporate purposes in all cases. But because it allowed a target's public shareholders to retain a portion of the post-closing equity, it also carried with it the risks associated with maintaining a public stub, including potential minority shareholder lawsuits, increased regulatory scrutiny and possible mark to market issues for a sponsor's internal reporting purposes. As a result, sponsors were required on a deal-by-deal basis to weigh the accounting benefits associated with achieving a recapitalization in the deal against their evaluation of the costs of a public stub in the deal.

Changes to the FASB's purchase accounting rules which provided that any goodwill created in a deal would thereafter be amortizable only to the extent of any impairment of that goodwill in subsequent periods, significantly reduced, but as noted below did not totally eliminate, the accounting benefits associated with deals structured as recaps. In the wake of this rule change, accounting-driven public stub equity

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deals largely vanished from the private equity radar screen in the United States.

It's back!

But the stub structure has made a sudden comeback in Harman and Clear Channel, as well as some other recent deals. As with the cash election mergers of the late 1990's, Harman's and Clear Channel's stockholders may elect to receive cash or stock in the post-acquisition entity as merger consideration, subject to a cap of 27% (in the case of Harman) and 30% (in the case of Clear Channel), and a *pro rata* cut-back if the stub offering is oversubscribed. But unlike the recap-driven transactions, the inclusion of a stub equity feature in these deals does not appear to have been necessitated by any particular accounting, regulatory or tax objective. Instead it appears to have been driven mostly by each buying group's pragmatic judgment in each deal that a stub equity opportunity was necessary to win board and stockholder approval.

Harman

For instance, in KKR's and GS Capital Partners' pending acquisition of Harman, the Sponsors original model appeared to contemplate a significant rollover, perhaps so as to limit the size of the equity check they would need to write to complete the deal. One way to achieve this, of course, would be through a conventional going private structure under which members of Harman's management team would provide the entire rollover. But Harman's Executive Chairman and founder, Dr. Sidney Harman, evidently made clear to KKR and GS Capital Partners at the outset of their discussions that any rollover equity must be offered to all of Harman's stockholders, on a *pro rata* basis, in much the same manner as in the cash election mergers of the late 1990's. According to press reports, a number of Harman's larger stockholders, including Fidelity Management & Research Corp., T. Rowe Price and Capital Research and Management, may have also signaled their strong interest in retaining a stake in Harman going forward, perhaps providing additional incentive for the sponsors to offer a stub structure. In any event, on April 26, 2007, the sponsors announced the merger agreement, which includes the stub feature described above.

ONE WAY TO THINK OF A PUBLIC STUB IS A CLUB DEAL, WITH THE PUBLIC ACTING AS A MEMBER OF THE CLUB. BUT IMPORTANTLY, THE PUBLIC NEITHER PAYS NOR RECEIVES CARRY IN THE DEAL.

Clear Channel

The Thomas H. Lee and Bain Capital Partners proposed buy-out of Clear Channel has been an obstacle course from the early stages, starting with the merger approval requirements under the laws of Texas, Clear Channel's state of incorporation. Unlike Delaware law, which generally requires a merger to be approved by the majority of outstanding stock entitled to vote, Texas law requires a merger to be approved by two-thirds of the outstanding stock entitled to vote. Valuation is also trickier in Clear Channel than in many deals due to the "multiple contraction" which has characterized the radio industry for several years. Plus, hedge funds hold a significant portion of Clear Channel's float and other potential buyers have been lurking under the merger agreement's "go-shop" and "no-shop" provisions throughout the pendency of the deal, which is more protracted than in most deals due to FCC approval requirements.

Against these challenging deal dynamics, the sponsors have had to be extraordinarily flexible and accommodating to keep the deal alive. Indeed they have made significant concessions along the way, including several price bumps and changes in termination fees. In the wake of significant shareholder resistance to the initial announcement of the deal, the sponsors offered to revise the deal to include a stub of up to 10% of the post-closing equity, among other changes. Clear Channel rejected a stub at that stage due to concerns about deal delay, but two price bumps later, the parties have again revised the deal to now include a stub of up to 30%. Following this change, in a positive development for the sponsors, Highfields Capital Management, a hedge fund which holds approximately 5% of Clear Channel, agreed to support the bid subject to the terms of a voting agreement.

Broader Considerations

While the Sponsors may have been motivated in Harman and Clear Channel principally by pragmatic considerations driven by the dynamics of those transactions, their respective decisions likely also reflect their evaluation of a host of other important considerations associated with a public stub in today's deal environment, including the following:

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Advantages:

- *Increased Deal Certainty.* As a general proposition, the optics of allowing the public to participate in a significant fashion in the upside of a sponsored deal, particularly given all the luster often attached to PE investments, may be quite helpful in persuading important proxy advisory firms like ISS to support a given deal and in otherwise creating favorable deal press coverage. Moreover, because most hedge funds have the financial and legal ability to tolerate the illiquidity associated with most public stubs and are otherwise generally enamored of the idea of piggybacking on private equity sponsors without paying a carry, stubs could prove to be a particularly effective, if not winning, deal tool in cases where a target's float is concentrated among hedge funds. On the other hand, despite the allure of investing alongside the leading private equity firms of the world on a carry-free basis, note that some mutual funds and other money managers may be limited under their constituent documents from holding illiquid investments, and many retail investors may not be well-suited to the illiquid nature of a stub.

- *Reduced Litigation Risk.* Because a stub affords the selling stockholders of target the opportunity to also invest on the buy side of the same deal to a meaningful extent, stubs can be an effective means to disarm, or at least weaken, the inevitable shareholder litigation in a going private transaction. These litigations in broad terms are focused on valuation, of course, and it is intuitively hard to accept that a deal price is unfair to the selling stockholders when those same stockholders are being given the opportunity to buy into the same deal at the same valuation. While not dispositive by any means, this feature may prove particularly valuable in a world of ever increasing judicial scrutiny, if not hostility, to sponsored going private deals.

BECAUSE MOST HEDGE FUNDS HAVE THE FINANCIAL AND LEGAL ABILITY TO TOLERATE THE ILLIQUIDITY ASSOCIATED WITH MOST PUBLIC STUBS AND ARE OTHERWISE GENERALLY ENAMORED OF THE IDEA OF PIGGYBACKING ON PRIVATE EQUITY SPONSORS WITHOUT PAYING A CARRY, STUBS COULD PROVE TO BE A PARTICULARLY EFFECTIVE, IF NOT WINNING, DEAL TOOL IN CASES WHERE A TARGET'S FLOAT IS CONCENTRATED AMONG HEDGE FUNDS.

- *Smaller Equity Investment.* To the extent a portion of the equity in a deal is effectively "purchased" by existing shareholders via a retained stake in the surviving company, a sponsor will need to invest that much less into the deal, freeing up cash for other deals and perhaps obviating the need to team with another sponsor. Indeed one way to think of a public stub is a club deal, with the public acting as a member of the club. But importantly, the public neither pays nor receives carry in the deal.

- *Limited Governance Rights.* While the 20-30% stubs of today's deals is much larger than what was offered in the recap-driven deals of the late 1990's, the Harman and Clear Channel stubs are structured, and other stubs could also be structured, so as to significantly limit the governance rights enjoyed by the stub holders. Because the equity stub is not listed, the governance requirements of the exchanges are not applicable.

- *Recap Accounting May Improve Earnings.* As discussed in our September 2001 issue in "Without Pooling are Recaps Doomed?", recap structures have some continuing accounting benefits, particularly in deals where there would be a significant write-up of a target's fixed assets or identified intangibles (such as specific patents), because purchase accounting rules still require that the fair value of such assets be written up on the opening balance sheet. The assets at their written-up value then must be amortized and depreciated in subsequent periods with a resulting hit to earnings, a result which can be avoided if the transaction qualifies as a recap for accounting purposes.

Disadvantages:

- *SEC Registration Requirements.* Because a deal structured as a stub involves an offering of the securities, the stub needs to be registered under the Securities Act in much the same manner as the equity of the buyer must

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be registered in a stock-for-stock merger transaction. This will require the sponsors to file a Form S-4 with the SEC, extending the timetable for completion of the deal. It also creates the possibility of incremental liability under the securities laws for material misstatements and omissions in the Form S-4.

- *Ongoing SEC Requirements.* Once a Form S-4 is declared effective, the target will also be required for at least a period of time thereafter to comply with the Securities and Exchange Act, including the periodic disclosure obligations thereunder and certain requirements under Sarbanes-Oxley. To the extent a sponsor in a stub deal is otherwise issuing public debt to finance a portion of the debt, the target will have to comply with the '34 Act and certain aspects of Sarbanes-Oxley anyway, but some aspects of Sarbanes-Oxley apply more rigorously to equity issuers than debt issuers, including the proxy rules. Deregistration may eventually be possible if there are fewer than 500 shareholders of record.
- *Fiduciary Duty Claims.* Even if the stub equity holders have no formal governance rights, and the target would be a public debt filer anyway, the inclusion of a stub would still subject the target's directors – and perhaps its controlling stockholders – to fiduciary duty claims by minority stockholders, which at a minimum may prove a potential distraction.
- *Economic Considerations.* By sharing the equity with the public stockholders, a sponsor's investment will obviously be that much less leveraged, thereby reducing its risk, but also its potential return. In addition, sponsors may disfavor stubs as an economic and precedential matter since, as noted above, the current stubs allow members of the public, including hedge funds and institutional investors, to participate *pro rata* in the upside of a deal without having to pay a promote.

BY SHARING THE EQUITY WITH THE PUBLIC STOCKHOLDERS, A SPONSOR'S INVESTMENT WILL OBVIOUSLY BE THAT MUCH LESS LEVERAGED, THEREBY REDUCING ITS RISK, BUT ALSO ITS POTENTIAL RETURN. IN ADDITION, SPONSORS MAY DISFAVOR STUBS AS AN ECONOMIC AND PRECEDENTIAL MATTER SINCE, AS NOTED ABOVE, THE CURRENT STUBS ALLOW MEMBERS OF THE PUBLIC, INCLUDING HEDGE FUNDS AND INSTITUTIONAL INVESTORS, TO PARTICIPATE PRO RATA IN THE UPSIDE OF A DEAL WITHOUT HAVING TO PAY A PROMOTE.

- *Mark to Market.* Although stub equity has not to date been required to be listed on an exchange, one can imagine a target negotiating for this in a future deal, with the corresponding governance issues that it would implicate. In any event, even in the absence of a listing, shares nevertheless may be traded on some basis – perhaps on the "pink sheets" – and it is possible that a sponsor, required to mark its investment to market, would experience increased volatility in its reporting of investment values to its limited partners, which could have implications for distribution of carry. This will likely ultimately depend on the exact nature of the trading market that actually develops for a stub and the precise terms of a sponsor's organizational documents.

Conclusion

Because of the unique nature of the Harman and Clear Channel transactions, it is possible that the return of stub equity will prove to be only a blip on the PE deal radar screen. But it seems likely that sponsors in isolated cases will continue to find a stub structure attractive, given the host of significant advantages potentially associated with the use of a stub in the right transaction.

Of course the potential disruption to the deal market associated with the instability in the debt markets as we go to press complicates this prediction. On the one hand, sponsors may find stubs increasingly attractive as a means to fill out the capital structure on certain deals. On the other hand, even hedge fund investors may suddenly be a bit skittish about buying into (rather than realizing full liquidity in) certain deals. ■

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Co-Investments by Fund Limited Partners (cont. from page 1)

subset of their limited partners, focusing in many cases on those with the largest dollar commitments to the funds or those who have indicated an interest in co-investment opportunities. However, even if the group of potential co-investors is small, it may be impractical in light of confidentiality or timing concerns to approach these parties prior to signing the purchase agreement. The target company will nevertheless want the sponsor fund to provide equity commitment letters that cover all of the needed equity financing prior to signing the purchase agreement. If the sponsor fund is unable or disinclined to cover the entire commitment itself, it may need to seek an equity bridge.

An equity bridge may be offered by the financial institution providing debt financing for the deal as an accommodation to the sponsor fund; though lenders may not be willing to provide an equity bridge in all circumstances. Equity bridges were readily available in the first half of 2007, but they may well be more scarce since the debt markets have tightened. To put an equity bridge in place, the sponsor fund enters into a separate commitment letter for the equity financing detailing the fees payable for the commitment itself, utilization fees if the bridge equity is funded and additional fees that would increase if the lenders' equity has not been purchased from the lender within a specified amount of time following the closing. The equity bridge provider may seek the right to collect a *pro rata* portion of any break up fee that might be paid by the target if the deal is terminated but, conversely, may resist signing a guarantee or otherwise committing to pay any "reverse break up fee" that may become payable in the event of a breach by the buyer. The sponsor would remain liable for this amount and may not be released from this obligation by the target if limited partners do ultimately commit to purchase. (Of course, the limited partner co-investors may backstop a portion of the reverse breakup fee.)

The equity bridge commitment letter will also describe sell-down efforts by the parties. The sponsor will usually have a right to control the sell-down process, but this control right may be subject to certain limitations if the sell-down is not completed within a specified time frame.

The obvious alternative to obtaining a formal equity bridge from a financial institution is for a fund to "bridge" the gap between what it needs to commit to get the deal done and its long-term equity investment objective by delivering an equity commitment large enough to cover all of the equity required for the transaction with the intention of finding co-investors prior to or immediately after closing. Before doing so, however, it is important that the fund's partnership agreement be reviewed to confirm that equity bridges are permitted and any funds drawn can be recycled, as well as to confirm that the bridge would not cause the fund to run afoul of any diversification limitations or other fiduciary considerations.

The Form of the Investment

Co-investments by limited partners are often structured by offering the limited partners the right to purchase equity in a limited partnership or limited liability company (which we will refer to as "Co-Investment Co") that will invest side-by-side with the primary fund. Use of a Co-Investment Co has the benefits of (1) minimizing the number of parties that the investee company (and its equityholders) will have to interface with and which may be afforded minority statutory or common law rights, (2) facilitating regulatory and tax structuring to address concerns of individual fund investors, (3) accommodating any investment policy or regulatory restrictions co-investors may have on holding certain types of securities directly and (4) providing the fund sponsor with control over voting and exits. The choice between a limited partnership or a limited liability company for Co-Investment Co will, in part, depend on where the investment is being made (*e.g.*, a limited liability company is not a good choice if the target portfolio company is Canadian or organized under the laws of certain European or other jurisdictions since such entities may not be recognized there). Limited partnerships are most commonly used.

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The Economics of Co-Investing

The major economic issues relate to whether the fund manager charges a management fee or carried interest and, if so, the amount of each. If charged, practices vary, from full management fee and carried interest (often reserved for hot deals by fund managers with a stellar track record and leverage) to arrangements in which a one-off fee is charged, rather than an annual fee, at a rate lower than that charged to the primary fund. If appropriate, the carried interest may be lower than is the case for the primary fund. Sometimes, carried interest arrangements on co-investments are already "built-in" to the primary fund documents (*e.g.* carried interest is only paid on co-investment amounts that are in excess of the co-investor's commitment to the primary fund).

Transaction fees, monitoring fees and other fees received by the fund manager are generally not shared with the co-investors, irrespective of whether a fee offset applies to the primary fund. However, the language of the primary fund agreement needs to be reviewed on this issue. Most fund managers do charge investors for the actual out-of-pocket expenses of administering a Co-Investment Co. Such expenses are often subject to a cap, but the range varies significantly depending on the circumstances.

One of the appeals to fund sponsors of co-investment arrangements is that they generally do not need to share governance or control with the limited partners in the same manner as they would in a consortium deal.

Co-Investors' Rights

As noted above, one of the appeals to fund sponsors of co-investment arrangements is that they generally do not need to share governance or control with the limited partners in the same manner as they would in a consortium deal. The limited partnership agreement or operating agreement of the Co-Investment Co will likely provide that it will divest of its ownership in the holding company on substantially the same terms and at the same time as the primary fund. If the Co-Investment Co is given preemptive rights, the limited partners may receive a *pro rata* right to make additional capital contributions to fund. In general, the limited partners are restricted from transferring interests in Co-Investment Co without the fund sponsor's consent. The opportunities for the limited partners to transfer their interests are quite limited, but special accomodations are typically made for affiliate transfers and to address situations where continued ownership by the limited partner would be illegal for the limited partner as a result of a change in legislation or regulation or would result in the assets of Co-Investment Co being deemed "plan assets" for purposes of ERISA.

Typically, the limited partners who elect to co-invest will sign a short subscription agreement in which they make basic authorization representations and acknowledge their ability to bear risks associated with the investment. The Co-Investment Co. similarly makes basic representations regarding its formation and authorization. No representations are made by Co-Investment Co regarding the target company's business.

Disclosure to Limited Partners

If the co-investment is being offered to a large number of limited partners in the fund, it is likely that an information memorandum will be prepared. Sometimes, the information memorandum is a stand-alone document. In other cases, investors are provided with the "bankbook" or any disclosure materials prepared for mezzanine lenders, together with a "wrapper" geared to the co-investors and these documents together make up the information memorandum. Distribution of the information memorandum often follows distribution of an initial letter to the limited partners asking if they have an interest in participating. Only those who indicate interest receive the information memorandum.

The information memorandum, and the structuring of the co-investment, should be developed in close consultation with legal counsel since they both raise a number of legal and regulatory issues (including disclosure concerns under applicable securities laws, blue sky considerations, broker-dealer, Investment Company Act, Investment Advisers Act, ERISA and general fiduciary issues). The confidentiality agreement in place with the target company or sellers will need to be reviewed carefully to determine whether offering the investment opportunity to potential co-investors and disclosure of non-public information to them is permitted, even once the acquisition agreement is signed. If the confidentiality agreement does not permit discussions with or disclosure to potential co-investors during the negotiation process, this flexibility should be built into the terms of the

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definitive acquisition agreement. Similarly, if the confidentiality agreement in the principal fund agreement will not adequately cover information provided regarding the co-investment opportunity, including applicable requirements under the target confidentiality agreement, the limited partners will need to sign an additional confidentiality agreement.

Distribution of the information memorandum and diligence information may be followed by a conference call or in-person information session along the lines of a road show although the target company's management may or may not participate in these sessions. The entire process of distributing information and soliciting commitments from limited partners may take eight to twelve weeks.

Co-Investments in Club Deals

Co-investing becomes a more complex venture for both sponsors and limited partners if it occurs in the context of (rather than in lieu of) a club deal. As a first step, the sponsors should mutually develop a set of principles outlining the basic rules which will govern co-investments in the transaction. As a threshold issue, the sponsors should determine the amount of equity commitments that each member of the consortium will be allowed to allocate to co-investors. In addition to determining the amount of permitted co-investment equity, the sponsors may also address the manner in which the co-investors are invited to participate in the transaction and the level of information that will be provided to the co-investors.

To efficiently address the myriad of issues that arise in the context of co-investments in consortium deals, sponsors can create a committee, comprised of representatives of each private equity fund, whose sole purpose is to facilitate and govern the co-investment portion of the transaction and develop the rights and obligations of the co-investment vehicles, including the governance and exit rights of such entities.

Although some sponsors prefer to leave each sponsor in the consortium to determine its own co-invest process, others prefer to coordinate since many limited investors may be potential co-investors with more than one consortium member. There is generally a strong interest in creating a process to equitably allocate the equity of such investors with multiple positions across its sponsoring funds. Since private equity funds are often reluctant, if not completely precluded, from releasing the names of its limited partners to a competing fund, a neutral party should collect the names of the limited partners in each participating fund and identify all investors that are limited partners of multiple funds participating in the club. The investing committee should then be responsible for marketing to such investors as well as determining the allocation of such investors' equity to the sponsoring funds.

Finally, sponsors participating in a club deal will want to ensure that securities held by its co-investment vehicle are counted for purposes of ownership thresholds that may be relevant in the governing documents. For example, if a sponsor is required to hold at least 20% of the equity in the company to retain its board seat, equity held by the sponsor's co-investment vehicle should be aggregated with the sponsor's equity for purposes of calculating the amount of equity held by the sponsor.

* * *

Although the management of a co-investment process does add some administrative burdens and is not without its complexities, co-investment is an increasingly viable source of funding for private equity deals when the equity check required for a deal is more than the fund is able to write on its own. ■

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strategic player with its own management team, because of his desire to keep his family in charge of Topps.

Finally, in *Netsmart*, the Court was highly critical of the board's failure to seek out strategic buyers in any meaningful manner and its decision to ride "the private equity wave." The Court found a basis to perceive that management had favored the private equity route, because they "desired to continue as executives and they desired more equity." The Court was also bothered by the failure of the Netsmart board to form a special committee until after the decision to focus only on private equity buyers was adopted, suggesting that a potentially conflicted management could have influenced that decision for the wrong reasons. Vice Chancellor Strine also criticized the "virtually unlimited access" to special committee deliberations given to Netsmart's CEO and chided the special committee for permitting management to drive the due diligence process, which could allow management to give off different "body language" to preferred buyers.

Ultimately Vice Chancellor Strine did not find that management's role in negotiating the transactions on behalf of the company fatally tainted the process in any of the cases. But his concern was clear. As a result, private equity buyers may expect more target boards to establish non-management board committees from the outset and to empower that committee to run the sales process and oversee the diligence process. Private equity buyers may also find these committees asking potential buyers not to engage in discussions with management about terms for their post-closing employment until after definitive acquisition agreements are executed or even later (*e.g.*, after a go-shop period has expired). The delicate balance for the private equity buyer of locking up management early, versus ensuring the purity of the sale process, may become somewhat more difficult to strike, and should in any case be discussed early on in any process.

PRIVATE EQUITY BUYERS MAY EXPECT MORE TARGET BOARDS TO ESTABLISH NON-MANAGEMENT BOARD COMMITTEES FROM THE OUTSET AND TO EMPOWER THAT COMMITTEE TO RUN THE SALES PROCESS AND OVERSEE THE DILIGENCE PROCESS … [AND ALSO] ASKING POTENTIAL BUYERS NOT TO ENGAGE IN DISCUSSIONS WITH MANAGEMENT ABOUT TERMS FOR THEIR POST-CLOSING EMPLOYMENT UNTIL AFTER DEFINITIVE ACQUISITION AGREEMENTS ARE EXECUTED OR EVEN LATER.

Market Checks and Deal Protection

In *Netsmart*, *Lear* and *Topps*, the Court reiterates the established principle that no one blueprint or checklist exists for boards to follow when *Revlon* applies. What kind of sales process would maximize a company's ability to attract suitors depends on the particular facts and circumstances applicable to the target, including the strategic landscape of its industry; its market capitalization, trading volume and volatility; the extent to which the market is aware it is on the block and the results of any recent discussions with potential suitors, among other factors. In these cases, the Court scrutinizes the directors' conduct closely, and levels a number of criticisms against the boards. But the cases also demonstrate that if directors take into account the particular facts and circumstances of the target, its history and industry, and act reasonably in designing and executing a tailored sales process, the Court is apt to remain deferential to their judgment.

For example, the Court found the deal protection terms and the contemplated post-signing market check in the Topps transaction to be reasonable. Although the Court said that the 4.3% termination fee was "a bit high in percentage terms," it was explainable because it included Eisner's expenses and because of the relatively small size of the deal. Topps decision to enter into the merger agreement with Eisner in the face of a rival bid from Upper Deck was a closer call for the Court, but in accepting this the Court found that Topps rightfully was suspicious of Upper Deck's sincerity and noted that the Upper Deck bid excluded a "floundering" business line of Topps. In addition, the merger agreement provided for a 40-day go-shop period during which "the Topps board could shop like Paris Hilton." Vice Chancellor Strine also placed significance on the fact that

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even after the go-shop period Topps could entertain an unsolicited superior proposal from a bidder given access during the go-shop period and continue negotiations.

In *Lear*, the Court also found that the deal protections terms were reasonable. In making its finding, the Court once again placed great weight on the particular facts and circumstances of the company and the transaction: Lear was a large company with substantial analyst coverage, the public knew Lear was in play, and Icahn had made a credible threat that he would withdraw his bid if any pre-signing market check were performed. Notably, Vice Chancellor Strine gave little weight to the lower termination fee during the go-shop period. The go-shop provision required a "Kobayashi-like" buyer – a reference to the recently dethroned hot dog eating contest winner – to get an entire deal done during the 45-day period since, unlike some go-shop provisions, the merger agreement did not allow the board to continue negotiations after the period ended (without triggering the "fiduciary out" provision and the higher breakup fee).

Notably, although it is significant that in both *Topps* and *Lear* the Court found the use of a go-shop to be reasonable, Vice Chancellor Strine makes clear that go-shops are not a panacea that can be used in every context in lieu of a pre-signing market check, and that the specifics of any go-shop provision can make a difference.

In *Netsmart*, the Court did find a reasonable probability of success for the plaintiff's claims that the board members' failure to seek out strategic buyers in any meaningful way was unreasonable and breached their *Revlon* duties. In doing so, Vice Chancellor Strine criticized the board for trying to rely on only limited contacts with potential strategic buyers over a long period of time. He was looking for a recent market check, clearly documented, that showed a "material effort at salesmanship." Vice Chancellor Strine also chided Netsmart's board for its "rote assumption" that the terms of the merger agreement would allow for an adequate, post-signing market check. The terms of the Netsmart merger agreement included a "fiduciary out" provision allowing the board to consider unsolicited superior proposals, and the Netsmart board had determined that this provision, in light of a termination fee of approximately 3%, would allow a sufficient post-signing market check. The Court disagreed. While the Netsmart merger agreement provisions might work for large-cap companies, Netsmart was a far smaller "micro-cap" company, was thinly traded and had limited analyst coverage.

ALTHOUGH IT IS SIGNIFICANT THAT IN BOTH *TOPPS* AND *LEAR* THE COURT FOUND THE USE OF A GO-SHOP TO BE REASONABLE, VICE CHANCELLOR STRINE MAKES CLEAR THAT GO-SHOPS ARE NOT A PANACEA THAT CAN BE USED IN EVERY CONTEXT IN LIEU OF A PRE-SIGNING MARKET CHECK, AND THAT THE SPECIFICS OF ANY GO-SHOP PROVISION CAN MAKE A DIFFERENCE.

Despite Vice Chancellor Strine's frequent criticisms of the processes followed by these target boards, the only *Revlon*- based claim that resulted in the Court granting a preliminary injunction was Topps' failure to release Upper Deck from its standstill agreement. The Court believed the Topps board was using the standstill improperly as a way of fending off an undesired acquirer. Again, Vice Chancellor Strine's skepticism about management's motivations seemed to play a part in this decision. Even in *Netsmart*, the Court declined to issue an injunction in spite of its determination that the plaintiffs had a reasonable probability of success on the merits. The Court was concerned that the buyer would walk, depriving the stockholders of the ability to decide for themselves once armed with more complete and accurate information.

These cases have been closely followed by practitioners, and private equity buyers may as a result see some additional push back on deal protection terms. Targets may also be more likely to pursue a pre-signing auction or insist on robust go-shop provisions

Disclosure

Although generally reluctant to enjoin transactions on the basis of *Revlon* claims, Vice Chancellor Strine did not hesitate to enjoin the transactions pending the correction of misleading or incomplete proxy disclosure. The disclosure deficiencies he was most troubled by related to what troubled him most in his analysis of the *Revlon* claims – the motivations of those who negotiated the transactions and weaknesses in the sales processes.

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In *Netsmart*, the Court ordered the company to include complete and accurate information about the board's decision to rule out strategic buyers or to at least provide to shareholders the Court's opinion. The Court did not believe that an injunction was warranted to remedy this process failure but strongly desired to ensure that the stockholders had an understanding of the deficient sales process conducted by Netsmart before voting on the proposed deal.

A TAINTED PROCESS IS IN NOBODY'S INTEREST AND RUNS THE RISK OF DELAYING AND POTENTIALLY LOSING A DEAL. THE SOPHISTICATED PRIVATE EQUITY BUYER WILL KEEP ITS EYE ON THE PROCESS AND CAREFULLY WEIGH HOW AND WHEN TO APPROACH MANAGEMENT AND HOW HARD TO PUSH FOR DEAL PROTECTIONS TAKING INTO ACCOUNT THE FACTS AND CIRCUMSTANCES AT HAND.

Vice Chancellor Strine also wanted to ensure that the stockholders of both Lear and Topps knew more information about the conflicting interests of their management teams that may have affected their efforts in negotiating the deals. In *Lear*, the Court required the company to disclose that its CEO had recently approached the company about cashing in his retirement benefits to mitigate the risk of having the bulk of his wealth tied up in a single investment. The Court noted that "a reasonable stockholder would want to know an important economic motivation of the negotiator singularly employed by a board to obtain the best price for the stockholders" when those motivations could rationally lead the negotiator to favor a deal at a less than optimal price. In *Topps*, the Court found that the Topps proxy statement created a misleading impression that Topps' management had been given no assurances about their future by the private equity buyer and required the company to disclose the assurances Eisner had given the Topps CEO.

In *Topps*, Vice Chancellor Strine also wanted the company to correct misleading disclosure about the proposed terms, and risks associated with, the rival Upper Deck bid. For instance, the company identified Upper Deck's failure to sufficiently assume antitrust risk related to the deal but failed to disclose that Upper Deck's last proposal had included a "hell or high water" provision and that Upper Deck had provided Topps with the opinion of a reputable antitrust expert that there was no material antitrust risk.

Finally, another important theme of *Netsmart* was the importance of documenting activities of the board and management in conducting a sales process, including the reasons underlying significant board decisions. Some of the Vice Chancellor's most blistering criticisms surrounded the failure of Netsmart to keep accurate minutes of meetings and the "doubtful accuracy" of records that were kept.

Target boards are likely to be increasingly cognizant of the concerns about disclosure raised by the Court, and private equity buyers should keep in mind when doing deals that disclosure documents may contain significant detail about the sales process – particularly about discussions with management and the pros and cons of rival bids.

* * *

The sales process – including determining who leads it, and how a market check is conducted – is the target board's job. But a tainted process is in nobody's interest and runs the risk of delaying and potentially losing a deal. The sophisticated private equity buyer will keep its eye on the process and carefully weigh how and when to approach management and how hard to push for deal protections taking into account the facts and circumstances at hand. ■

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Section 363 Sales (cont. from page 12)

contract terms and transaction structure. As a result, the stalking horse may become more comfortable with more limited representations and warranties and a purchase agreement that does not include a purchase price adjustment or escrow. This may give the stalking horse an advantage over other bidders who, having conducted less due diligence, may not be able to match these terms.

In addition, the stalking horse can also negotiate moderate deal protections, including a break-up fee, expense reimbursement and bid procedures. The break-up fee is intended to compensate the stalking horse for its lost opportunity costs should it lose the auction. Although bankruptcy courts are divided as to the appropriate standard of review for break-up fees, the generally-accepted range is between 1% and 3% of the aggregate purchase price. Negotiations usually focus on the conditions under which the break-up fee is payable. The stalking horse bidder usually also negotiates the right to be reimbursed for certain actual, out-of-pocket expenses up to a cap based on the expected intensity of due diligence and the complexity of the transaction. Because the initial overbid must be sufficient to cover the break-up fee and expense reimbursement, creditors and other parties in interest may object to the break-up fee and expense reimbursement if, taken together, they would make it prohibitively expensive for other parties to participate in the auction.

In addition, these monetary protections, the stalking horse should carefully negotiate bid procedures with the seller. Bid procedures typically describe which parties are qualified to participate in the auction, what constitutes a qualifying bid, and what are the minimum initial and subsequent overbids. Bid procedures also set out the sale timeline, which allows the stalking horse to influence the bid deadline (which is effectively when bidders must have completed their due diligence), the date of the auction (typically a few days after the bid deadline) and the date of the sale hearing (usually shortly after the auction). Short deadlines make it more difficult and expensive for a potential bidder to complete the necessary due diligence and submit a bid. In addition, any delay in the sale may have an adverse impact on the assets being purchased. As with the break-up fee and expense reimbursement, the bid procedures have a direct impact on the likelihood of competing bids. Depending on the level of support of key creditor groups for the stalking horse bid, the bid procedures will be scrutinized to ensure that they do not chill the auction process.

The perspectives of the debtor and the stalking horse on deal protections are not hard to predict. The stalking horse wants as large a break-up fee and as restrictive bid procedures as can be extracted from the debtor and successfully cleared with major creditors and the bankruptcy court. The debtor, in contrast, wants the smallest fee and the least restrictive bid protections acceptable to the stalking horse to make it easier for competing bidders to participate in the auction.

The perspective of creditor groups is more complex and may depend on their position in the capital structure and the price offered by the stalking horse. Senior creditors expected to be paid in full from the consideration offered by the stalking horse are likely to be focused primarily on the speed and certainty of the sale process. Given these goals, their perspective on deal protections may be similar to that of the stalking horse. More junior creditors that will not be paid in full if the stalking horse prevails will almost certainly be focused on price and stimulating the competitive bidding that is most likely to maximize price. For them, a large break-up fee and restrictive bid protections are highly undesirable because of their chilling impact on bidding. As a result, junior creditors – often in the form of the official committee of unsecured creditors – are frequently the most vociferous opponents of a substantial break-up fee and restrictive bid protections.

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A stalking horse usually has more time to perform due diligence as well as the opportunity to set a threshold price, contract terms and transaction structure. As a result, the stalking horse may become more comfortable with more limited representations and warranties and a purchase agreement that does not include a purchase price adjustment or escrow. This may give the stalking horse an advantage over other bidders who, having conducted less due diligence, may not be able to match these terms.

Section 363 Sales (cont. from page 23)

Who prevails in this negotiation and where within the permissible range the deal protections fall will likely depend on several factors, including the complexity of the transaction, the adequacy of the purchase price and the availability of alternatives other than the stalking horse bid.

Even if the stalking horse succeeds in negotiating favorable deal protections, there is no guarantee that it will win the auction. Any qualifying bidder that submits a bid in compliance with the court-approved procedures may participate in the auction, and the bidder that is prepared to pay the most likely will win. In addition, the break-up fee and expense reimbursement may not adequately cover the stalking horse's up-front work and costs associated with performing due diligence and negotiating contract terms. Finally, the possible reputational damage associated with a failed bid may also deter certain prospective buyers from acting as the stalking horse.

Conclusion

A purchaser in a section 363 sale benefits from significant protection against undisclosed liabilities and other claims against the assets. However, it must be prepared to assume the risks associated with the inherent unpredictability of the bankruptcy process and to compete with the growing number of investors in the distressed market. Given that the purchaser will be negotiating not only with the debtor, but also with the debtor's key creditor groups, understanding the particular intercreditor dynamics of a distressed seller is critical. In addition, to secure the stalking horse position, a prospective buyer must be able to move quickly as companies may increasingly attempt to negotiate section 363 sales prior to bankruptcy. ■

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