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PRIVATE EQUITY CONSIDERATIONS IN M&A DEALS

February 2008 by Steve Rhyne

SCOPE: The number and dollar volume of M&A deals, led by private equity deals, have increased dramatically since 2002. The ensuing sellers' market has caused a convergence between private equity and strategic M&A transactions as far as some deal terms, but three distinguishing features of private equity deals will always remain: their financial focus, the multiplicity of their various facets, and the unique role of the seller's management in these deals.

I. INTRODUCTION

A. *Private Equity Surge*. Between 2002 and 2006 the M&A market, led by private equity deals, saw significant growth. The dollar volume in announced U.S. deals soared 225% during the period.[1] In 2006, $1.53 trillion of U.S. M&A deals were announced, which was a 30% increase over 2005's M&A dollar volume. The number of M&A deals has also increased during this period, although not as dramatically as the dollar volume. Even with the well publicized credit crisis and market turmoil that began last July, the U.S. M&A dollar volume in 2007 exceeded that of 2006, albeit only slightly. A retrospective on 2007's contrasting dynamics and results is provided in Section VIII, *supra*.

Private equity's role in leading the dramatic increase in M&A activity during this period has been well chronicled. Domestic private equity sponsored deal volume totaled approximately $421 billion during 2006, compared to $155 billion in 2005 and $121 billion in 2004, and represented an increasing percentage of M&A activity. In 2007 private equity sponsored deal volume reached $438 billion, again notwithstanding the credit crisis which contributed to private equity dollar volume sliding dramatically in the second half of 2007.

Two factors were instrumental in the huge increase in private equity sponsor deal volume during this period. First, as an asset class, private equity had been favored and as a result enormous amounts of capital flowed into private equity funds. Buyout funds have been especially attractive, with U.S. buyout funds raising greater and greater amounts: $113 billion in 2005, $177 billion in 2006, and $228 billion in 2007 (with two funds raising more than $20 billion each).[2] Second, the competitive lending environment made it relatively cheap and easy for private equity sponsors to finance M&A transactions. The combination of these two factors dramatically increased the buying power of financial sponsors.

This enormous private equity buying power and the needs of private equity sponsors to deploy larger amounts of capital also resulted in a significant growth in the size of individual M&A targets and the rise in the use of private equity consortia for some of the largest deals, referred to as club deals. Notable recent megadeals included TXU, Bell Canada Enterprises and Alltel Wireless in 2007 and Equity Office and HCA in 2006. These deals ranged in transaction size from $27.5 billion to over $43 billion, with TXU, Bell Canada Enterprises and HCA being examples of club deals.

This growth in private equity buying power and the increased competition it generated among private equity firms also led to a sellers' market. The effect of this sellers' market was reflected in the purchase prices that were paid and in other aspects of the transactions, several of which are discussed later.

[1] The financial information in this and the following paragraph as based on information from Dealogic.
[2] *Private Equity Analyst*, Vol. XVIII, Issue No. 1 (Jan. 2008).

B. *Key Characteristics.* The differences between private equity transactions and strategic M&A transactions arise mainly from how the private equity transaction is structured and how the objectives of a private equity investor differ generally from those of a strategic buyer. A private equity investor (a "PE investor") when buying or otherwise investing in a company (the "Target") will have the following objectives:

- <u>A company with superior management</u>. As part of acquiring a company with superior management, the PE investor will align the management's interests with those of the PE investor, primarily through requiring management to purchase equity in the deal alongside the PE investor and through incentive compensation arrangements. In some limited cases, the PE investor may have a seasoned CEO or management team from outside the Target that it intends to bring on board, but appropriately incentivizing the management team is critical because the PE investor itself will not be an operator or manager of the Target once acquired.

- <u>A "leveraged" acquisition</u>. The acquisition financing will consist of equity and typically a substantial amount of new debt borrowed by the Target in connection with the closing of the acquisition. A crucial aspect of debt financing in a PE transaction is that only the Target and any newly formed acquisition entity (not the PE investor) are liable under the debt financing documents. The indebtedness not only enhances the PE investor's projected internal rate of return (IRR) from the investment, but it allows the PE investor to spread its committed capital over a greater number of investments. Plus, the tax deductions for the interest associated with the debt will shelter the Target's taxable income.

- <u>A relatively short investment period (often 5 years or less)</u>. The length of the investment affects the IRR level, plus most PE funds have finite lives of 10 years or so (at the end of which the general partner usually sponsors a successor fund).

- <u>A successful exit of its investment</u>. The importance of the exit was emphasized last year by Henry Kravis, of Kohlberg Kravis Roberts: "Any fool can buy a company. You should be congratulated when you sell." The exit's success will be determined largely by the profitability of the investment to the PE investor (usually on an after-tax basis). A PE investor requires a high rate of return on successful investments in part to cover losses on its unsuccessful investments. The investment's profitability may be due to a successful IPO, the Target's improved operating results, the Target's paying down debt from its cash flow (facilitated by tax sheltering of its income), industry consolidations, "bolt-on" acquisitions by the Target, improved market conditions, as well as a combination of these and other factors. A successful exit from a private equity investment is also one with minimal post-closing obligations (amount and duration).

The foregoing gives rise to the three aspects of private equity transactions that often distinguish them from other M&A transactions: the financial focus of the deal, the multiple interdependent transactions involved, and the role of the Target's management in the deal. Due to its complications and its particular relevance to this audience, much of the discussion herein will focus on the management's role in the transaction, as well as some of the special private equity features of the different "pieces" of the transaction.

Another characteristic of private equity transactions over the past several years has been the significant increase in litigation. This litigation may arise at either the time of investment or the time of exit (and, of course, perhaps in between). This litigation trend preceded the more publicized litigation that has arisen in the wake of the credit crisis that began this past summer. This earlier litigation trend probably reflects the increase in private equity investing and the conflicts and tensions inherent in private equity transactions, the demographics and number of participants in these transactions, and the complexity and financial focus of the transactions.

II. FINANCIAL FOCUS.

Private equity deals will always have a substantial financial focus, one that may be greater than in many strategic acquisitions. Some of this may reflect the simple fact that many PE investors are themselves financial animals (investment bankers) and not operators. This financial focus begins at the time of the PE investor's consideration of the investment and permeates the negotiation of the acquisition. The PE investor's pricing of the acquisition, the determination of the capital structure, and the rationale underlying the new compensation arrangements for management will be based on precise financial models, including the benefits from amortizing the indebtedness during the investment period and any tax benefits that can be gained from the acquisition structure. During the period when the PE investor controls the Target and its representatives serve on the Target's board, this financial focus continues—both on current operations and financial condition, as well as their effect on the exit strategy. For obvious reasons, the financial focus is especially sharp at the exit.

The financial focus is also apparent in the PE investor's diligence. Many PE investors customarily engage an experienced transaction services diligence team from one of the major accounting firms to conduct indepth financial diligence, which will be in addition to the PE investor's financial and business diligence. It is not uncommon for any discrepancies found in this financial due diligence to result in proposed purchase price adjustments, again based on the financial models. This may mean that an item discovered during financial diligence that has the consequence of reducing EBITDA by $100,000 will, in fact, result in a much larger proposed purchase price reduction if the purchase price is based on a multiple of EBITDA. On the other hand, PE investors often lack the expertise and staff to conduct the operational and administrative diligence, such as with respect to employee benefit plans, that a strategic buyer may conduct, and the diligence period for strategic buyers has historically been longer.

III. MULTI-FACETED DEAL OR SEVERAL RELATED DEALS?

As indicated above, a typical private equity transaction is a leveraged acquisition, also called a leveraged buyout (LBO). The PE investor will frequently set up a newly formed entity (NewCo), which will remain a shell company until closing. NewCo will acquire the Target using varying amounts of debt and equity. The amount of the debt, which will usually be borrowed by the Target, is typically several multiples of the amount of the equity. The lenders' recourse will be against NewCo and the Target and its assets. As discussed in more detail later, the PE investor also will negotiate new compensation and other arrangements with the Target's management.

As a result, the private equity transaction has three separate but very interdependent and integrated transactions: the equity financing (including the management arrangements), the acquisition itself, and the debt financing. Of course, in many transactions the equity financing may include several financing sources (including the Target's management), and the principal management compensation will almost always be equity-based, so the equity piece itself may consist of several related transactions. Similarly, the debt financing will often consist of first lien senior debt and a second strip (second lien senior debt or mezzanine debt), giving rise to negotiations with two separate sets of lenders, as well as negotiations between such lenders. Plus, in some deals, the PE investor and its counsel must also be prepared during these negotiations to respond to any potential litigation that may arise.

The PE investor thus needs and will use a team of attorneys with various areas of specialized expertise. While the private equity transaction can thus be viewed as separate but related transactions, they are highly interrelated and even their pace and timing should be coordinated. As a result, they should be viewed as one single, complex transaction with multiple facets requiring singular and hopefully seamless management by the PE investor and its counsel.

IV. THE EQUITY AND MANAGEMENT PIECE

A. *Basic Terms of Equity Financing*. The factors that affect the terms of the equity financing will include NewCo's entity form, the number of financial buyers and the level of investment by the management. Depending on tax considerations and what is viewed as the most likely exit, making NewCo a limited liability company is often viewed as preferable so that the double level of taxation can be avoided in the event the exit is a sale of assets.

Regardless of NewCo's entity form, another significant consideration will be whether NewCo's equity will be all common or will include preferred equity and, if so, the terms of the preferred equity. In some deals, preferred equity with fairly complicated terms may be used, in which case the amount and type of preferred dividends (PIK or cash pay) and mandatory redemption features, among other terms, will need to be determined. If preferred equity is part of NewCo's capital structure, the PE investor will acquire all or a portion of it, perhaps along with a strip of common equity. Members of the Target's management will usually be required to purchase a portion of NewCo's equity so that they will have "skin in the game". This equity may be in the same denominations as the PE investor acquires or it may be solely common equity. The equity used for the incentive compensation arrangements will be common equity, or profits interests if NewCo is a limited liability company.

Preferred stock typically has a fixed cumulative dividend payable at a specified rate. For federal income tax purposes, NewCo will not be able to deduct dividends paid or accrued on preferred stock and, if structured appropriately, the PE investor (and management) holding preferred stock should avoid paying current tax on unpaid preferred stock dividends. There are multiple tax rules (with no logical consistency) addressing the taxation of accruing preferred yield and preferred OID. Care is thus needed in drafting the preferred equity terms.

As part of the equity financing, the PE investor will require all equityholders to enter into a shareholders agreement or similar agreement to address, among other items, the following: board control, drag-along and other exit rights of the PE investor (e.g., registration rights), tag-along rights of management and minority investors, equity transfer restrictions, buy-sell arrangements ("puts" and "calls"), annual management monitoring fees to be paid to the PE investor, and information rights.

B. *Management's Uncomfortable Role*. The negotiation of the management arrangements may often be the most delicate, nuanced and complicated of all the various related transactions. This arises for a number of reasons, including two tensions inherent in such negotiations. The Target's management obviously has an existing fiduciary duty to the Target, plus members of management may also be directors of the Target with those additional duties and responsibilities. However, the members of management will also be negotiating, on their own behalf, the terms of their new arrangements with the PE investor, as well as assisting the PE investor with the new financing for the acquisition, especially the debt piece. A number of real and potential conflicts are inherent in these circumstances.

Another tension arises from the competing economic positions of the PE investor and the management regarding the terms of the management's future compensation arrangements and the governance of NewCo/Target going forward. These negotiations occur in circumstances often bearing directly on whether the PE investor and the Target itself will be able to come to terms. This is because (a) the PE investor's interest in the Target will be influenced greatly by its view of the Target's management given their future symbiotic relationship and (b) the management's view of the PE investor can be a factor in the Target's determining whether that particular PE investor should be selected as the ultimate buyer. Keep in mind that this dance between the PE investor and Target's management, which can often begin at the earliest stages, plays out through the course of the acquisition negotiations, including those times when the PE investor and the Target may be considering whether to part company. In that regard, even though the PE investor and the Target's management may have very compatible views as far as the overall strategies for the business to be acquired, once the discussions between the two turn to the management's future

arrangements, what may have begun as a very healthy and respectful relationship can go sideways. This is especially true when one keeps in mind that the PE investor is after all a ***financial*** buyer and the management may be approaching things from a more conventional perspective.

The Delaware courts have recognized in several recent decisions, which are discussed briefly in Section VIII, the conflicted role that the Target's management has in a private equity acquisition. Although these cases relate to recent going private transactions, this same conflict and the legal analysis in these opinions apply in almost every private equity transaction and this has long been understood by private equity practitioners notwithstanding the recent vintage of the Delaware cases.

Because of the conflicts faced by management in a private equity transaction, the Target's directors should focus early on the role of management in the transaction and what safeguards should be in place to counter the conflicts. In most cases, it is not advisable or practical to exclude senior management from the sale process. Nor is it automatic that a special committee of the board, with its attendant special advisors (legal and financial), be established. On the other hand, in many circumstances it is not advisable for a CEO who will be continuing in a senior position with the PE investor to be the Target's principal representative negotiating the terms of the acquisition agreement, a point that was underscored in the Delaware cases. Most importantly, as Judge Tennille has made plain, the critical question to be answered will be whether the material terms and conditions of the acquisition (including the process) were decided by the members of the board who were not conflicted. If that is the case, and if the unconflicted members of the board satisfy their other duties (e.g., exercise due care), then their actions will be entitled to the protection of the business judgment rule. Wachovia Capital Partners, LLC v. Frank Harvey Inv. Family Ltd. P'ship, 2007 WL 2570838, 2007 NCBC LEXIS 7 (N.C. Super. March 5, 2007).

C. *Timing on Management Negotiations*. When should these negotiations with management about its future compensation arrangements begin? There is no simple answer to this question. In many cases it will be too early to begin before the acquisition's deal terms are in fairly final form. In other circumstances, the future role of management, especially if the management is investing, or "rolling over," a substantial amount of the new equity, may require earlier negotiation of the new management arrangements. The Target obviously has an interest in, and should be advised of, the status of the negotiations between the PE investor and the Target's existing management; and in many cases, shareholders of the Target, especially if they are asked to approve the transaction, will need to be advised as to the material terms of the management's new arrangements.

One reason to begin at least preliminary discussions regarding the new compensation arrangements is that members of the Target's management may not have a working familiarity with the type of compensation arrangements that will be proposed. As described later in Subsection D, these arrangements and their effects can be substantially different from those with which management is accustomed. This unfamiliarity can create two issues: management may be surprised and become indignant, or even enraged, upon learning about the proposed structure or terms of the compensation and other arrangements. Even if that is not the case, management may need greater time to educate itself better about the arrangements.

An added level of complication arises if a relatively significant number of employees will be participating in the new equity compensation arrangements. Presumably, some of these employees will be less sophisticated, plus some of them may not be aware of the proposed transaction and may not be expected to be advised about it until a later stage. Plus, some in this group of expanded employees may be less financially sophisticated, which could create issues under federal and state securities laws, as well as concerns about advising them fully about more complicated matters, such as the complex terms of an operating agreement (and their receiving K-1's and being allocated profits or losses from NewCo's operations) if NewCo is to be a limited liability company or partnership. Lastly, invariably the question will arise in this context about how

much some of the more junior members of management should be advised about the specific terms of the more senior management's proposed compensation and other arrangements.

In most significant private equity transactions, the Target's management will be represented by its own separate counsel. This can add an additional level of coordination and communication, perhaps further complicated if management's separate counsel has not represented them before, which is not an unusual situation. Moreover, the separate counsel will often have very limited information about the transaction, especially if the negotiations with management begin late in the process. Management's separate counsel however can play a pivotal role in the transaction, both in educating members of management who are unfamiliar with the concepts involved in these private equity compensation arrangements and in assuring management that its interests are being well represented.

In an acquisition structured with a simultaneous signing of the definitive agreements and closing, there is more flexibility on the timing by when the management terms are to be finalized, although a simultaneous signing and closing does not obviate the need to determine at what stages, relative to the other parts of the transaction, the negotiations with management should begin and should be finalized. In the case of an acquisition to be signed in advance of the closing, an added complication arises because, if the management arrangements have not been finalized (and usually they will not have been), the final acquisition agreement will include as a closing condition that satisfactory arrangements with certain key management members must be agreed on. Since this potential veto power over the transaction can sometimes give management inappropriate leverage, it is usually advisable at a minimum for there to have been detailed discussions and some resolution of key issues about the new management arrangements before the acquisition agreement is signed.

<u>One last thought about timing</u>: In a private equity transaction, the Target's management will be involved in the sale process (including the diligence and its documentation such as schedules to the acquisition agreement), will be assisting the PE investor in its debt financing arrangements, and will be negotiating its own future compensation and other arrangements with the PE investor. And, in the middle of all this, members of management must take care of their other responsibilities (their "day jobs") and ensure that the Target continues to operate smoothly and profitably, especially since any diminution in EBITDA or operating results can result in a significant purchase price adjustment or busted deal.

D. *Different Nature of the Management Arrangements*. In almost all cases, the proposed compensation arrangements for management will vary substantially from management's then existing arrangements. Although the salary and perhaps the cash bonus of management may stay the same or may actually increase, the other compensation arrangements usually will be vastly different. Oftentimes, for example, there will be no long-term cash plans and no long-term qualified retirement plans. In addition, many of the non-compensation arrangements, such as non-competes and corporate governance, will be dramatically different. This variation arises from the financial focus of a PE investor, and its need to align the management's economic interests with its own.

An important component of the compensation—and one of the main ways the economic interests of the PE investor and management will be aligned—will be the equity incentive compensation. As opposed to annual stock option grants, with which the management may be familiar, all or almost all of the incentive equity compensation will usually be granted in total at the time of the closing of the transaction. Although in many cases, a portion of the equity compensation may vest annually or on a time basis, some and perhaps most of the equity compensation will be subject to performance based vesting.

The performance criteria will differ from the "net income" or "earnings per share" with which management might have been familiar. This performance vesting in a private equity transaction may be based on attainment of a specified IRR or level of EBITDA (which creates some interesting definitional negotiations around EBITDA) or perhaps multiple tests (such as a specified IRR ***plus*** an

amount of proceeds to the PE investor in the exit equal to a specified multiple of its investment, especially if an early exit seems likely). The foregoing compensation performance criteria is obviously based on what the PE investor will realize (or at least hopes to realize) on its exit. As one commentator has said, "equity investors are really all about paying for performance" . . . and, I might add, performance determined on an objective, formulaic basis.

Another important feature of the equity compensation is that members of management will not be entitled to realize on their equity (including vested incentive compensation) until the PE investor realizes on its investment. This lack of liquidity can obviously be a stress point for any members of management who are unfamiliar with private equity transactions. It also generates an additional issue: For members of management who have their employment terminated, when and on what basis will they receive payment for their equity (both the vested incentive compensation and any equity they purchased). The potential tension around this issue can be exacerbated by the terms of any non-compete agreements, which may be perceived by certain of the employees as locking them out of their livelihood for an inordinate time.

The amount to be paid to a management member for his or her equity upon termination will often be on differing formulaic bases which vary depending on the reason for the termination. The pricing formula for each type of termination (as well as the definition of "termination for cause") may be highly negotiated.

These payment rights and obligations if a management member is terminated will take the form of "puts" and "calls", with NewCo or the PE investor having a right to "call" the management member's equity and the management member having the right to "put" its equity, at least in certain circumstances. These "puts" and "calls" will necessitate "carve outs" in the debt financing provisions that prohibit most payments to insiders. Typically the cash amount permitted to be paid under the puts and calls will be capped under the debt agreements, in which case provision might be made for the balance of the payment to be by way of an unsecured, subordinated note from NewCo.

V. THE ACQUISITION PIECE

A. *Structure*. The considerations for determining the appropriate acquisition structure are generally the same for private equity and strategic transactions. Two tax considerations, however, that may play a greater role in private equity deals are the desirability for (a) NewCo's obtaining a "step-up" in the tax basis of the Target's assets and (b) a tax-free "rollover" into NewCo of management's pre-closing Target equity.

Depending on whether the Target is a C corporation, S corporation, partnership or limited liability company, obtaining a stepped-up tax basis may or may not be economically feasible because the Target and its owners generally will not agree to any acquisition structure that imposes a double tax on the sale. If the Target is a C corporation, the double level of tax will often make it prohibitive to obtain a step-up in tax basis. There is no double level of taxation if the Target is a partnership or limited liability company (taxed as a partnership) or if it is an S corporation and has been one since its formation or at least 10 years since its S election. As noted earlier, avoiding a double level of taxation is the reason the PE investor may form NewCo as a limited liability company.

As also noted previously, members of management (especially key members) will be required to invest or otherwise own a significant portion of the "purchased" equity in NewCo. This will be in addition to the equity represented by the new equity incentive compensation. Since the management members frequently own an equity stake in the Target (which may represent a significant portion of their net worth), ideally a portion of their existing equity can be used to acquire their equity in NewCo on a tax free basis. In fact, in many instances it may be highly problematic, if not prohibitive, if members of management incur federal and state taxes on their sale or transfer of their existing equity, especially in light of the fairly high level of investment they are expected to make in NewCo.

The simplest way to achieve a tax-free rollover of management's existing equity is by keeping the Target in place and recapitalizing Target's equity into the appropriate capital structure. In other words, the management's equity in the Target remains intact (as does Target) except to the extent members of management cash out a portion of their equity in the acquisition. One obvious disadvantage of this structure, of course, is that the entity in which the PE investor will be investing will continue to have all of the Target's pre-closing liabilities.

In general, a tax-free management rollover into NewCo can be accommodated regardless of the form of Target and regardless of whether NewCo is formed as a C corporation, partnership or limited liability company. A tax-free rollover into a NewCo formed as a C corporation may be more difficult, however, if (i) NewCo is not recently formed and the PE investor is not making an additional equity contribution to NewCo (e.g., a "bolt-on" acquisition by an existing portfolio company of the PE investor) or (ii) management is receiving NewCo debt-like preferred stock (i.e., "nonqualified preferred stock") or both cash and NewCo stock as rollover consideration. An exception to the general rule is that when the Target is an S corporation and a Section 338(h)(10) election is made in connection with the acquisition, a tax-free rollover is not possible.

B. *Acquisition Agreement*. Unlike many of the other aspects of a private equity transaction discussed above, the form and terms of the acquisition agreement will often be very similar to those in a regular M&A transaction. This is especially true since there has been some convergence in recent years between the two types of acquisition agreements, while at the same time there seems to be more standardization in the terms of M&A acquisition agreements generally. This convergence between private equity and other M&A agreements has been particularly true in going private transactions.

1. *Representations*. With regard to the representations and warranties in the acquisition agreement, in the past greater focus may have been given to the financial representations in some private equity transactions. One current, as well as historical, aspect of private equity deals is a PE investor's focus on what is perceived as "market" or "standard" for a specific provision. This long standing emphasis by PE investors on "market" terms has probably increased lately because of the highly competitive sellers' market, especially now that sellers regularly expect a full markup of the seller's proposed acquisition agreement as part of an auction. The PE investor generally will rely on its counsel for input on "market" and this quest for what is "market" has been facilitated, in part, by the proliferation of various "deal term studies". These include *ABA 2007 Private Target/Mergers & Acquisitions Deal Points Study* and the October 2007 *Purchase Agreement Study* by Houlihan Lokey.

2. *Indemnification Limits*. PE investors have also shown a greater flexibility in recent years in agreeing to meaningful limits on the seller's indemnification obligations (e.g., caps, deductibles and survival periods). There are probably several reasons for this in addition to the effect from the seller's market (including concerns about differentiation in auctions): First, in an increasing number of deals, the seller will be a PE investor and, as discussed later, will insist on limited indemnification requirements. Second, the PE investor bidding on the deal probably in the past has been the seller in some other transaction.

3. *Financing Outs.* Acquisition agreements in private equity deals frequently include as a closing condition the buyer's receipt of its financing. This typically has been either expressly stated or effectively been the case because the transaction has been structured as a simultaneous signing and closing.

When an acquisition agreement with a financing closing condition is to be signed before closing, the Target should consider taking steps to assure that the financing condition will be satisfied. These steps would include, as a minimum, inquiring about the financing and having the buyer provide the loan term sheet as well as a "comfort" letter from the lender. In many deals, it may be appropriate to have the PE investor provide signed commitment letters from the lenders in a form satisfactory to the Target and its counsel. Also, since any

debt financing will be subject to NewCo being fully capitalized, the Target should obtain signed equity commitment letters, also to be in satisfactory form. The Target might also include in the acquisition agreement a pre-closing covenant that obligates the private equity investor to use commercially reasonable efforts to consummate the financing and to seek alternate financing if the primary financing becomes unavailable.

During recent years, a number of going private deals have **not** included these financing outs, which reflected the competitive sellers' market as well as what may have been perceived as reduced exposure since debt financing seemed readily available. Indeed, during this period many lenders themselves signed financing commitments that contained very limited outs for the lenders other than the same closing conditions as those for the PE investor as buyer.

Many of these going private transactions also frequently included "reverse breakup fees" to compensate the Target if the PE investor failed to consummate the transaction in certain circumstances, including if financing was unavailable. These reverse breakup fees are the counterparts to the breakup fees that historically PE investors have sought to compensate them for their expenses and lost opportunity if a Target fails to close in certain circumstances. The reverse breakup fee is often stipulated to be the only monetary damages available to the Target for any breach by the PE investor.

4. *MAC Clauses.* In the event a Target experiences a "material adverse change" or a "material adverse effect" (a MAC or an MAE), the buyer may not be obligated to consummate the acquisition under the terms of the acquisition agreement. Historically, private equity acquisition agreements contained a no-MAC closing condition with MAC clauses somewhat more protective of the buyer than may have been customary in other M&A transactions.

The MAC in a private equity transaction typically encompassed possible adverse changes across a broad range of indicia, usually those relating to the target's assets, results of operations, condition (financial or otherwise), business and often even ***prospects***. More importantly, the definition of a MAC in a private equity deal often included ***fewer*** exceptions to its operation (i.e., items that would not be deemed to be a MAC) than was customary in other M&A deals. For example, changes in "general economic conditions" were often not included as a MAC exception or at least were regularly resisted by PE investors and their counsel. The rationale was that any adverse changes in general economic conditions could adversely affect the PE investor's ability to obtain financing, although in some cases this argument was not pursued aggressively so long as the acquisition agreement contained a financing out.

The historical use of more limited MAC exceptions in a private equity context is supportable for several reasons. As previously discussed, a private equity deal is conditioned (whether expressly or not) on the closing of significant acquisition financing and its availability can be affected by adverse changes arising either from external conditions, such as general market conditions including those experienced beginning in July 2007, or from internal conditions, such as the Target's missing its projected EBITDA (another current MAC exception). Moreover, PE investors do not have the familiarity with the general conditions and events in the Target's industry that will be possessed by the Target or a strategic buyer, including appreciation of the degree that such conditions and events might affect the Target. Accordingly, a MAC exception for adverse changes in the Target's industry, for example, seems inappropriate in many cases for a private equity deal Also, as compared to a strategic buyer, a PE investor is a short-term financial buyer and cannot benefit from what may be a long-term resolution or mitigation of the problem giving rise to the adverse change, nor will the PE investor be relying on any synergies that a strategic buyer might obtain in its other operations from the acquisition of the Target.

Notwithstanding the foregoing, there has been a convergence between private equity acquisitions and strategic acquisitions in how MAC clauses are dealt with. In addition to this convergence, there has been a significant restriction in all M&A deals in the coverage of MAC clauses. This restriction in coverage has been primarily reflected in the number of the exceptions now customarily included in the MAC clauses. All of this is due to the highly competitive sellers market, including the demand by sellers (including PE investors when they are sellers) for more certainty for closing.

Nixon Peabody completed its Sixth Annual MAC Survey in September 2007 which includes a very helpful compilation of the MAC exceptions and their frequency.[3] While Nixon Peabody's study substantiates the trend in favor of sellers, the law firm advises that its survey was completed before the credit crisis began this summer. It therefore cautions that the "overheated pro-seller market will cool off significantly as a result of less leverage being available to private buyers", and Nixon Peabody suggests that deal terms, including the MAC clauses, could become more buyer-friendly. Two high profile lawsuits involving MAC clauses, Sallie Mae and Finish Line, are discussed in Section VIII.

5. *NewCo as a Shell*. As discussed earlier, NewCo, will typically be a shell entity. As a result, either in the acquisition agreement, if it is to be signed before closing, or at some earlier stage, such as the signing of a letter of intent, the Target may demand assurances that there is an entity with assets against which it can seek recourse. In some cases, the signed equity commitment letter from the PE investor may be sufficient, while in other cases the Target may prevail in obtaining a limited guaranty from the PE investor.

VI. THE DEBT PIECE(S)

A. *Types of Debt*. As discussed before, the private equity acquisition will invariably include debt financing, and the acquisition agreement may include a "financing out". The debt financing may include both first lien senior debt as well as either second lien senior debt or mezzanine debt. If mezzanine debt is part of the financing, the subordinated lender will often receive an equity kicker in the form of a warrant for a portion of NewCo's equity. Although less common, as in other M&A deals the Target may sometimes help finance the acquisition by taking "seller paper" as part of the payment of the purchase price. Needless to say, all of these various levels of indebtedness are subject to their own series of negotiations, plus the various strips of indebtedness must be coordinated as to their terms.

Oftentimes the most challenging debt negotiations can be the ones regarding the contractual relationships between the senior and junior lenders. Although these battles will be fought primarily by the counsel for the lenders, in many instances the PE investor or its counsel will need to join the fray. This will typically be in regard to the subordination agreement between the senior lender and any subordinated lender, although sometimes these negotiations can be avoided or at least moderated if the subordinated lender's debt is to be structurally subordinated (i.e., the subordinated note is to be issued by NewCo as a holding company, with the senior loan made to a subsidiary operating company that owns the assets and is restricted in paying dividends to its parents). Even in the case of structural subordination, many senior lenders may demand a subordination agreement with the subordinated lender.

B. *Management's Role*. As discussed previously, the Target's management plays a critical pre-closing role in the negotiation and documentation of the debt documents. The Target's management will provide the PE investor indispensable input on the terms of the debt documents, especially regarding the financial covenants and other financial matters. In addition, the debt documents will contemplate fairly extensive schedules, for which the Target's management will assist in the initial preparation.

[3] www.nixonpeabody.com/linked_media/publications/MAC_survey_2007.pdf.

C. *Some Key PE Investor Provisions*. In addition to being concerned about the overall terms of the debt agreements, including the representations and the financial and other covenants, there are certain provisions to which the PE investor and its counsel will want to give special attention.

1. *Restricted Payments.* One key provision is the restriction on NewCo making dividends or redeeming equity. The PE investor will want to ensure that it can be paid its annual management fee by NewCo and, as discussed, it will also want to have the ability to buy out any departing members of management who own NewCo equity. If NewCo is a pass-through entity for tax purposes, the PE investor will often seek to have tax distributions permitted so that the equity holders receive distributions from NewCo to pay their taxes on the taxable income allocated to them by NewCo. These types of payments will usually be capped in the loan documents except perhaps to the extent that any equity buyout of a management member will be funded by an equity infusion of an equal amount. The management fee, and these other permitted payments, will frequently be prohibited in the event NewCo defaults under the loan documents.

2. *"Change of Control."* The PE investor will also need to focus on the definition of "change of control" in the loan documents. The lenders will want to ensure that the PE investor continues to control NewCo and maintains a certain level of investment in it, while the PE investor will want to retain some flexibility both to liquidate some of its investment and to bring in other investors which might affect the corporate governance or control arrangements. The "change of control" definition will often also seek to specify who will hold certain management positions in NewCo, such as CEO, and the PE investor will understandably seek some latitude so that a death or departure of the CEO does not trigger an immediate default under the debt documents.

D. *Tax Issues*. A critical tax issue in the debt financing will be structuring its terms to ensure the availability of the tax deduction for interest and original issue discount (OID) since the tax sheltering provided by the interest deductions will be critical to the deal's success. Debt issuers have substantial limitations on their ability to deduct interest and OID. In order for NewCo to be entitled to a deduction for interest (and OID) on debt, the debt instrument must be treated as debt for federal income tax purposes. A debt instrument that more closely resembles equity may be treated as equity under the subjective debt-equity test under the common law of taxation. In addition, the debt instrument must avoid at least six other statutory interest disallowance or deferral provisions: §163(e)(5) "AHYDO" rules; §279 corporate acquisition debt; §163(j) test #1 for corporate debt held, directly or indirectly, by tax-exempt organization or foreign persons; §163(j) test #2 for corporate debt guaranteed by tax-exempt organizations or foreign persons; §163(l) for certain corporate debt payable in, or by reference to fair value of, equity; and §163(e)(3) for OID on certain debt held by foreign persons.

VII. PRIVATE EQUITY SELLER

A. *Indemnification Restrictions.* Historically, PE investors when they have been sellers in M&A transactions have insisted on significant restrictions on their post-closing obligations to indemnify the buyer for any breaches of the acquisition agreement. There have been two primary justifications for this position: One, all proceeds from the sale will be promptly distributed by the private equity fund to its limited partners and therefore unavailable to pay any indemnification obligations. By making such prompt distributions, the private equity fund optimizes the IRR for its limited partners. Two, since PE investors are not involved in the daily operations of the business being acquired, there is a natural aversion on their part to accepting post-closing risks associated with the business. Accordingly, there are three primary ways in which the PE investor will seek to limit its indemnification risk:

- Limiting the representations and warranties in the acquisition agreement. This may be accomplished by excluding certain representations, limiting the breadth of other representations, and qualifying other representations based on materiality, MAE or knowledge caveats.

- Demanding a shorter indemnification period and fewer exceptions to this indemnification period.

- Agreeing to an escrow to pay any indemnification claims and making this escrow the buyer's exclusive remedy (except perhaps for a few types of claims). Depending on the amount and period of the escrow, the amount escrowed may step down at intermediate times before the specified termination date for the escrow.

The highly competitive sellers' market has resulted in more favorable indemnification terms for sellers generally and thus some convergence between the restrictions on the sellers' indemnification obligations in a private equity deal and those in a strategic M&A deal.

B. *Complications with Target/PE Investor's Management.* In the sale of a company controlled by a PE investor, the management will have the performance-based equity compensation described earlier. Unless the sale is clearly successful, there often may be questions at the time of exit about whether a performance hurdle has been met. The failure to meet the hurdle, of course, will reduce what would be paid to the management in the sale, which inures to the benefit of the PE investor and is consistent with the rationale originally underlying the incentive compensation. As with many formulaic calculations, the calculation of the performance hurdle, in light of the specific facts of the transaction, may be complex and may be further complicated by any purchase price reductions that occur, as well as issues about working capital or other purchase price adjustments.

Of course, if the buyer in the transaction is another PE investor, which has become increasingly common, the PE investor who is selling the target, as well as its management, will face the same conflicts and challenges as have been previously described with perhaps these differences:

- Management will be better educated the second time around about the process.

- If the management arrangements have correctly aligned the interests of management and the PE investor (and this alignment is reflected in the sale agreement with the new buyer, including its indemnification terms), some of the conflicts can be mitigated.

- Management may be in the position in the new deal that some (perhaps substantially all) of its portion of the "upside" that the members of management believe they have generated for the benefit of all of the Target's equity holders (including themselves) must now be deferred as part of the rollover in the new PE investor's deal.

VIII. RECENT (AND ONGOING) DEVELOPMENTS

A. *2007's First Half.* Last year was a very eventful year for private equity and in many ways. During the first half of 2007, the dynamic M&A and private equity markets accelerated and more megadeals were announced. As of June 30, 2007, over $1 trillion in U.S. M&A deals had been announced, including the leveraged buyouts of TXU and Alltel. At the end of the first six months, the Blackstone Group consummated its widely heralded IPO, amidst speculation of other private equity firms going public. Various legislative proposals to tax private equity firms also garnered attention in the financial press.

In the first six months of 2007, three noteworthy Delaware opinions were issued by the ever entertaining and quotable Vice Chancellor Leo Strine. In one case, he described a post-signing "go-shop" provision that he felt was reasonable as providing an opportunity when "the Topps board could shop like Paris Hilton." In contrast, he faulted the "go-shop" period in another case for being truncated and characterized it as requiring a "Kobayashi-like" buyer, a reference to the legendary perennial Japanese hot dog eating contest champion. All three decisions dealt with going private transactions in which the sale was to a PE investor and the company's management would be retained. See In re Netstart Technologies, Inc. Shareholders Litigation, 924 A. 2d 171 (Del. Ch. March 14, 2007); The Upper Deck Co. v. The Topps Co., 926 A. 2d 58 (Del. Ch. June 14, 2007); and In re Lear Corp. Shareholders Litigation, 926 A. 2d 94 (Del. Ch. June 15, 2007).

In his three opinions, Vice Chancellor Strine elaborated on a board of director's *Revlon* duties in a private equity transaction. His opinions reflect the scrutiny that a judge is likely to give a private equity transaction due to the concern about the management conflicts. In each opinion, he expressed skepticism about the conflicts and the roles of management based on the specific facts of the case, and he characterized the Lear CEO's role as the principal negotiator as being "far from ideal." The court permitted the sales to go forward in all three cases but only after additional shareholder disclosures were made, including disclosures about the respective CEO's conflicts. In *Netsmart*, Vice Chancellor Strine suggested also that in order to provide a more balanced description of the sale process, the company's disclosure should include his written opinion, which was highly critical of the process.

The opinions also underscore the importance of a careful process in these transactions in light of the level of scrutiny a judge (and a dissident shareholders' counsel) is likely to give to the sale process. At various steps during this process, there should be thoughtful articulation of the basis for the board's actions (as opposed to what may be viewed in hindsight as pretextual justifications), as well as appropriate documentation. Vice Chancellor Strine's decisions also include a number of holdings that private equity practitioners, as well as M&A practitioners, will need to bear in mind when advising either PE investors or a Target's board of directors.

B. *2007's Second Half*. The first half's unprecedented robust deal market was overshadowed by the turmoil in the financial markets which began in July. Buffeted by the subprime meltdown and the effects of "quant trading", the stock markets experienced a volatility not witnessed recently. In the credit markets, the shut down of CDO's (collateralized debt obligations) due to the subprime problems led to a collapse of the CLO (collateralized loan obligations) market, which has been reported to account for 70% of the institutional leveraged loan market. This created an unprecedented liquidity crisis in the credit markets, necessitating extraordinary measures by the Federal Reserve and other central banks.

The victims of this turmoil were many, including senior Wall Street executives, Blackstone's trading price (by year end it had fallen 29% from its IPO price) and a number of noteworthy announced public deals. During the second half of 2007, as compared to the first half, M&A dollar volume fell by 50% and private equity deal volume fell by 65%. These declines were led by the sharp reduction in megadeals and other large transactions. In contrast to the 32 deals of $5 billion or greater value announced worldwide during 2007's first seven months, only **one** deal greater than $5 billion was announced during the last five months.

C. *The Busted Deal Aftermath*. The unprecedented (and unexpected) nature of the market turmoil is reflected by the public deals that, after being signed and announced, then collapsed. The number seemed especially surprising because, early on, many commentators predicted that such a collapse would not occur, primarily because of the reputational concerns a private equity sponsor would have if it walked from a deal. In some of the collapsed deals, the buyer asserted the occurrence of a MAC, while in others the buyer offered to pay a reverse breakup fee and walk.

1. *Examples of Negotiated Terminations*. In the proposed buyout of Acxiom by Silver Lake Partners and ValueAct Capital, the private equity sponsors agreed to pay $65 million (half of the original $130 million reverse breakup fee) to terminate the deal after Acxiom had announced a quarterly loss. Interestingly, half of this renegotiated breakup fee was paid by two of the three lead banks for the deal (Morgan Stanley and UBS).

Kohlberg Kravis Roberts and Goldman Sachs backed out of their $8 billion purchase of Harman, a maker of audio equipment, in September. The private equity firms claimed that a MAC had occurred, apparently as a result of the company's reducing its earnings forecast. Under the merger agreement, Harman's sole and exclusive remedy against the buyers for any breach was the $225 million reverse breakup fee. Rather than litigating, the parties entered a settlement agreement in October pursuant to which KKR and Goldman purchased $400 million in convertible senior notes from Harman.

2. *Litigation Examples*. The collapsed deals have also led to major lawsuits, with a key issue in some being the interpretation of a MAC clause. Three of the more noteworthy lawsuits are described briefly below.

Sallie Mae. One prominent MAC lawsuit arose from the proposed $25 billion buyout of Sallie Mae by an investor group that was led by J.C. Flowers & Co. and included Bank of America and JPMorgan. At issue was the construction of the MAC clause, especially with regard to proposed federal legislative and budgetary measures that were under consideration before the merger agreement was signed, some of which measures were later adopted but were different in one or more respects. The following comment from Vice Chancellor Strine at a hearing in October offered some insight on the interpretative issues:

> "[T]he weakness from [J.C. Flowers & Co.'s] position is that, basically, one penny more on top of what is outlined in the agreement makes you count the whole thing as an MAE. That is not intuitively the most obvious reading of this. On the other hand, the plaintiffs' position could have been much more clearly drafted if they wished to say that, essentially, all the legislation was a baseline, and you measure incremental effect."

The basic facts in the Sallie Mae litigation were riveting: A $25 billion buyout, marquee financial institutions, a $900 million breakup fee, and Sallie Mae's December 12 announcement that it was lowering its 2008 earnings forecast by more than 13 percent, after which its stock has been trading at less than half of the $60/share buyout offer. On January 28, 2008, a settlement was announced. As part of the settlement, Sallie Mae received commitments for $31 billion of financing from a seven-bank syndicate that included Bank of America and JPMorgan. The financing replaces the $30 billion interim financing that Bank of America and JPMorgan had put in place as part of the buyout.

Finish Line. Another MAC lawsuit involves Finish Line's strategic acquisition of Genesco, which announced troubling financial results after the merger agreement had been signed. Finish Line's acquisition was premised on financing by UBS, which informed Finish Line that it was "extremely concerned about the apparent deteriorating financial position of [Genesco]." As a result, UBS indicated that Genesco may have experienced a MAC and asked Finish Line to have Genesco provide more information and give UBS "unfettered access" to Genesco's financial records so UBS could determine whether a MAC had occurred. Litigation ensued in Tennessee and New York.

The Tennessee Chancery Court issued its decision regarding the MAC clause on December 27, 2007. Genesco, Inc. v. The Finish Line, Inc., No. 07-2137-II(III) slip opinion (Tenn. Chanc. Ct. Dec. 27, 2007). In a very fact-driven opinion, based on the trial testimony of seven expert witnesses, Chancellor Lyle concluded that no MAC, as defined under the merger agreement, had occurred. The court did find that Genesco's decline in operating results—which had fallen significantly short of projections and the 2007 earnings would be one of Genesco's lowest in 10 years—constituted a material adverse change. Based on the court's view of conflicting expert testimony, however, Chancellor Lyle concluded that such adverse effect arose from general economic conditions, such as higher energy and food prices, housing and mortgage issues and increased consumer debt, and that this effect was therefore carved out of the MAC definition by the exception for "changes in general economic conditions."

The court granted Genesco's request for specific performance to require Finish Line to close the merger, subject to one caveat. That caveat is the solvency ruling to be issued in the separate New York litigation brought by UBS. The issue is whether the combined Genesco/Finish Line entity would be insolvent and therefore fail to satisfy one of the conditions in UBS's commitment letter. A favorable ruling for UBS would be ironic since the effect of the two rulings would be that circumstances which can create an insolvent corporation do not constitute a MAC (based, of course, on the definition of MAC in the merger agreement).

United Rentals. Cerberus Capital Management has refused to proceed on several announced deals. In its buyout of United Rentals, Cerberus—without asserting a MAC—offered to pay the $100 million reverse breakup fee stipulated in the merger agreement. United Rentals however sued in the Delaware courts, asserting that Cerberus breached the merger agreement and could not terminate the agreement, even with payment of a reverse breakup fee, without declaring a MAC. The issue in the litigation was whether the very detailed provision in the merger agreement purporting to make the reverse breakup fee the exclusive remedy of United Rentals was controlling or was it trumped by the specific performance provision, due in part to parol evidence. *See* United Rentals, Inc. v. Ram Holdings, Inc., 2007 WL 4496338 (Del. Ch. December 21, 2007). After Chancellor Chandler ruled against it in December, United Rentals announced that it would not appeal but would instead accept the $100 million reverse breakup fee.

Chancellor Chandler's decision, premised on the "forthright negotiator principle," is instructive. It is based on a reading of the merger agreement as well as testimony at trial from the attorneys, investment bankers and business people who negotiated the agreement. He concludes, first, that the agreement is ambiguous because of a direct conflict between the two provisions on remedies. Second, he finds that the evidence at trial on the negotiation process is "too muddled" to determine whether United Rentals' interpretation was the parties' common understanding. Third, he holds that Cerberus understood that specific performance would be precluded in the circumstances in question, and that United Rentals knew or should have known of Cerberus' understanding and did not assert its own understanding, and that Cerberus' understanding was therefore binding on United Rentals under the forthright negotiator principle.

D. *Effect on Private Middle Market Deals*. Overall private equity is widely expected to be less robust in 2008. This should be reflected primarily in what is expected to be a limited number of megadeals and other large transactions due to the state of the leveraged loan market. Indeed, 2008 began inauspiciously with the New Year Day's announcement that Blackstone could not raise the financing needed to complete its $1.8 billion purchase of PHH Corp. This was followed by an announcement on January 28, that Blackstone's proposed $6.76 billion buyout of Alliance Data Systems Corp. may be collapsing.

Anecdotal and incomplete financial media reports at this time however all indicate that, at this stage, the effect of the market turmoil on private middle market deals has largely been minimal other than for the pricing and other terms of debt financing. Two factors affecting the 2008 M&A market will be the economy and the substantial amount of private equity money remaining to be invested. Another factor may be the possible increased level of activity by strategic buyers (depending on the economy) and by foreign buyers (due to the weak dollar, foreign investments in U.S. targets almost doubled in 2007). What also remains to be seen is whether any slow down in M&A activity from the market turmoil or other factors will be a nudge, or perhaps more, on the pendulum away from a very competitive sellers' market. And if so, in what particular respects (e.g., the breadth of MAC clauses)?