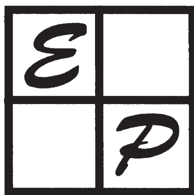

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Private Equity Clubs: Seller Beware? Latest Developments and Practice Tips

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2006 was another record year for private equity activity, and, if the first two months are any indication, the buyout boom will likely continue in 2007. The North American buyout market continues to be marked by private equity consortia completing record-setting buyouts. On almost any given day you can open a newspaper and read about the latest going-private transaction being pursued by a consortium of private equity funds. The deal making headlines lately is the six firm bid, led by TPG, KKR and Goldman Sachs, to acquire Texas utility TXU Corp. for $44 billion, in what would be the largest leveraged buyout in history.

With private equity in the spotlight, target boards and their advisors can expect to face heightened scrutiny any time they sell to a private equity consortium. This was made abundantly clear by the Delaware Chancery Court's recent decision in the *Netsmart* case in which the Court held that a board breached its *Revlon* duties in a going-private sale process by marketing the company only to private equity firms and not to strategic buyers. The *Netsmart* decision highlights the importance of running a thorough sale process that takes into consideration the relevant M&A market dynamics and is reasonably calculated to maximize the return to investors.

The rising popularity of club deals, transactions in which two or more private equity funds join forces to acquire a company, has created a new set of challenges for sellers and their advisors. In some instances, a seller may be forced to allow bidders to form a consortium or face receiving no bid at all. In other cases, a seller may be able to tease out the highest value by coupling multiple bidders together to compete against other consortia. Either way, sellers need to be prepared. By implementing bidding procedures and confidentiality restrictions to control the process, a seller can set up a dynamic that promotes competition while preserving the flexibility to permit risk sharing and capital aggregation among private equity funds that can lead to the highest price.

Private Equity on the Hot Seat

The continued success of private equity transactions and the size and frequency of consortium-led deals has invited regulatory scrutiny of the private equity industry and the process for control of public companies. The defining moment of 2006 was the October announcement of the Justice Department's antitrust investigation of private equity "club" deals. As many predicted, the DOJ's investigation was quickly followed by class action shareholder litigation asserted against 13 private equity firms. The Kinder Morgan going-private transaction, sponsored by Carlyle and Riverstone, provided insight into a new challenge to consortium deals when the Federal Trade Commission required the sponsors to cede control of their interests in portfolio companies with overlapping businesses. The *Netsmart* case is just the latest development in which a private equity sponsored transaction has faced very public scrutiny.

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How Sellers Are Now Reacting

With all sights firmly trained on the impact of club deals, both public and private targets and their advisors need to carefully consider the implications of a private equity consortium participating in their sale process. To exclude them would be foolhardy, but improperly managing the process can be just as damaging. Setting aside the dynamics of dealing with a multi-headed purchaser, the two primary risks that concern targets when bidding consortia are introduced to the process is that they will limit competition by colluding to set prices or by conspiring to keep bidders out of the auction in the first place.

In the face of the heightened scrutiny being placed on private equity, it's not surprising that target boards and their advisors are giving increased attention to anti-clubbing provisions. When General Electric put its plastics business up for auction in January, it was widely reported that Goldman Sachs was prohibiting bidders from joining together to acquire the business without Goldman's prior approval.

GE isn't the first seller to impose bidding conditions to try to enhance competition in the sale process. In 2005, for the sale of Nieman Marcus Group Inc., Goldman Sachs initially restricted private equity bidders to contacting only one additional buyout firm to form a club. Again in 2006, with the $17.4 billion sale of supermarket chain Albertsons, and the record setting $33 billion buyout of hospital operator HCA, it was reported that the sellers attempted to prohibit bidders from talking to each other and forming bidding consortia to ensure that interested buyers would not be deterred by the presence of one strong team.

By limiting the number of participants in a club, sellers also hope to foster the creation of multiple bidding consortia to compete with one another. Several observers have noted that the competitive auction for Freescale Semiconductor between KKR and Bain Capital on the one hand and the consortium of Blackstone, Carlyle, Permira and TPG on the other, led the Blackstone team to pay $1.6 billion more than it had originally agreed. This begs the question, are club deals really such a bad thing after all?

The Delaware Chancery Court had occasion to express its view on the role of club deals when shareholders challenged the sale process for Toys "R" Us. In dismissing the plaintiffs' motion, Vice Chancellor Strine observed that the decision by CS First Boston, the company's investment bank, to approve a joint bid by KKR, Bain and Vornado was a rational means of eliciting a good offer "and to avoid getting no bid at all." He further noted that "by banding together, these buyers are able to make bids that would be imprudent, if pursued in isolation." This gave the company a strong competing bid to the Cerberus consortium, and ultimately the highest bid for the company.

Practice Tips for Sellers

So what's a seller to do? Target boards need to be constantly mindful of satisfying their *Revlon* duties to maximize price. Although the courts have recognized that there is "no single blue-print" for fulfilling the duty to maximize value (*Barkan v. Amsted Indus.,* 567 A.2d 1279, 1286 (Del. 1989)), the *Netsmart* ruling is an important reminder that the Delaware courts will scrutinize the sale process. In the current environment when private equity buyers are regularly outbidding strategic buyers and competition often comes from another private equity shop, having an appropriate methodology for dealing with consortium bidding is a key element of a sound sales process.

Even with today's mega funds, the equity demanded by a large transaction can be beyond an individual fund's capacity or comfort level. By banding together to meet the demands of a higher price, consortium members are able to reduce the size of the investment relative to the size of the fund (portfolio diversification), and raise the large amounts of equity necessary to consummate the multi-billion transactions which now seem commonplace. However, there's a natural tension between permitting private equity bidders to join together to spread risk and maximize their offer and reducing the number of competitors in the process. A properly constructed "anti-clubbing" provision can be an effective tool for managing that risk while permitting groups to participate in auctions which might otherwise be beyond their means.

To maximize value, a seller and its advisors want to run a fully-competitive auction in which they control the process in a manner that ensures the greatest number of qualified bidders (or groups of bidders) and prevents groups from colluding on price or inhibiting individual bidding. There are both legal and commercial solutions that can help achieve that objective.

a. Legal Solutions

One of the primary tools a target has at the inception of a sale process is the confidentiality agreement. Most standard confidentiality agreements prohibit the recipient of confidential information from disclosing to any other person other than its agents, representatives and financing sources (1) the confidential information, (2) the fact that it has been provided, and (3) the fact that discussion or negotiations are taking place with the information provider regarding a transaction or any of the terms thereof. These basic limitations often do not adequately prevent disclosure to other bidders who can be brought in as consortium partners under the broad umbrella of "representatives" or "financing sources".

By specifically addressing club bidding, a seller can promote transparency and combinations that maximize price while preventing anti-competitive behavior. The three key elements that should be incorporated into the standard confidentiality provisions are:

1. Prohibitions on discussions intended to dissuade any other party from bidding—For example, requiring recipients of confidential information to represent and covenant that they do not have (and will not enter into) (a) any agreement or understanding with any other party that such party will refrain from bidding on the company, or (b) any agreement that any other person will have a right to participate in such bidder's deal if successful and the other party has not bid.

2. Prohibitions on activity intended to restrict access to financing—For example, requiring bidders to represent and covenant that they do not have (and will not enter into) any agreement or arrangement with any potential debt financing sources which may reasonably be expected to limit such financing source from acting as a financing source for any other potential acquirer.

3. Requirements to disclose all arrangements with other proposed club members—For example, requiring bidders to specifically disclose all unaffiliated financing sources (debt and equity) with whom they propose to share confidential information and making the seller's explicit consent a precondition of disclosure to or participation by any additional parties. This provision does need to be approached with caution however, as many bidders will be reluctant to tip their hand on their financing sources for fear that they will be co-opted. Ultimately, the seller's interest is in ensuring that it knows whether and when groups are bidding together so that it can properly assess any joint bid in context.

b. Commercial Solutions

1. Limit the size of bidding groups, or independently arrange the groups—One approach is to limit the size of consortia. Coles Group, the Australian retail chain currently being targeted by a number of private equity firms, has reportedly issued instructions limiting bidding consortia to no more than four firms. In other transactions, including GE plastics, the rules of engagement are intended to keep the four largest players from working together, but not from working with others.

2. Get your staple finance provider to provide bridge equity as well—Staple financing, in which a seller lines up financing commitments (often from the same institution running the auction) which are made available to all prospective bidders, has become fairly common place in the auction context. The next logical step is for the staple finance provider to also make a bridge equity facility available. Bridge equity may come at a cost to the ultimate price, but it does help permit more bidders to participate by neutering the argument that a single fund can't foot the entire equity check. Bridge equity can also be an attractive alternative to buyout funds that allow them to limit their direct exposure while retaining the ability to syndicate the investment to their limited partners, many of whom are growing increasingly wary of paying fees to multiple sponsors for access/exposure to the same deal.

Club deals are a practical reality in today's market and can often lead to the best price. When faced with the alternative of allowing a consortium to form or getting no bid at all, courts have recognized the rationale for approving club bidding. Well thought-out bidding procedures and confidentiality provisions aimed at preventing collusive practices and controlling consortium building can help a target board fulfill its fiduciary obligations and balance the risks and rewards of allowing bidders to band together.