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Questions to Ask Before You Join a Club

Laura N. Beny
University of Michigan Law School, lbeny@umich.edu

Paul S. Bird
Debevoise & Plimpton

Franci J. Blassberg
Debevoise & Plimpton

Michael P. Harrell
Debevoise & Plimpton

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Debevoise & Plimpton

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Questions to Ask Before You Join a Club

Despite the recent flurry of large transactions in which a consortium of private equity firms have teamed up to make joint bids and acquisitions, "club deals" themselves are not breaking news. In fact, they have been a staple of small- and middle-sized private equity M&A transactions for years. Recently, however, there has been a growing trend toward large club deals with enterprise values over $1 billion.[1] Due to their size, complexity and, often, international dimension, these transactions have generated considerable attention in the business press and have prompted much discussion among private equity professionals and the limited partners whose money they manage.

The increased number of very large club transactions arises from a number of factors, including the tremendous growth in the availability of private equity capital and the popularity of auctions in the sales process. Even more importantly, perhaps, because of difficulties in the debt markets, the percentage of equity needed to complete transactions has increased to such a degree that in the largest transactions even large private equity firms cannot complete a transaction without running afoul of the diversification limitations in their limited partnership (fund) agreements. (Most buyout funds limit the amount that can be invested in any portfolio company to 20% or 25% of the fund's committed capital.) Therefore, a club deal may be the only way to raise the required equity to finance a very large transaction.

Club deals offer private equity firms:

The Chance to be a Winner, Especially in Very Large Transactions. By participating in a club deal, a private equity firm may increase its chances of acquiring an interest in a "prized property" that it would otherwise not have sufficient equity to obtain. In addition, sharing judgments about valuation and limiting the other number of competitors are added benefits of being part of a club bid.

Diversification and Risk-sharing. Club transactions are also a way of spreading investment risk by permitting firms to use their available equity to participate in a larger number of transactions and to spread the risk of a single transaction among similarly situated private equity firms.

Greater Leverage with Financing Sources. Teaming up with another private equity firm may well make it easier for club members to get the best financing terms available. Financing sources would generally find club deals attractive, especially since they will be able to serve more than one client in a single transaction.

Running on the "Inside Track" and Breaking New Ground. Club deals might also permit a private equity firm to benefit from the industry (*e.g.*, telecom) expertise or prior relationships (*e.g.*, with management or the seller) of its co-bidders.

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1 Notable recent examples include: the acquisition by Texas Pacific Group, Inc. (the lead investor), Bain Capital, Inc. and Goldman Sachs Partners, LP of Burger King Corporation from its British parent, Diageo plc for $1.5 billion in December 2002; the acquisition by The Carlyle Group, LP (50% equity) and Welsh, Carson, Anderson & Stowe (50% equity) of QwestDex, a subsidiary of Qwest Communications International, Inc. for $7.05 billion in August 2002; and the acquisition by funds managed by Providence Equity Partners Inc. (49% equity and lead investor), Soros Private Equity Partners, LP and Goldman Sachs of Eircom plc for $2.5 billion in June 2001.

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Ability to Penetrate Foreign Markets. Joining a local firm in a transaction based in a foreign market might provide a good introduction to that market for a private equity firm that has not previously (or regularly) invested in that market. Collaborating with a local private equity firm could reduce the risk of investing in a new geographic area.

Before participating in a joint bid or joining a "club," private equity investors should understand the complications involved – both at the bidding stage and if the bid is ultimately successful.

Preliminary Deal Matters. Before joining a bidding process, each party should consider the following issues:

- ***Exclusivity.*** What holds the bidding group together? Will they be exclusively tied to each other? Until the auction is over, or only until a certain date, or until they disagree on fundamental terms or strategy? Can they switch partners mid-stream? Who decides to admit a new member?
- ***Bidding strategy.*** How should the bidding be handled? Should the indication of interest range include a stretch price, dependent on due diligence findings? Do the club members agree on the highest price that they are willing to pay?

Before participating in a joint bid or joining a "club," private equity investors should understand the complications involved – both at the bidding stage and if the bid is ultimately successful.

- ***Role of management.*** What opportunities and incentives are the bidders willing to offer to management to work with them in the selection process?
- ***Negotiating control.*** Who will control the bidding process? Should there be a "lead" investor? Should it necessarily be the firm that will contribute the most equity or that initiated the transaction, or perhaps another club member with a strong relationship with management? Private equity firms tend to operate by consensus. Should one individual at each firm be responsible for making decisions for that firm so that the process works smoothly?

Relationships with advisors, including the investment banker (if any), the accountants, outside counsel, etc. How will advisors be selected? Often each member of the group selects one of its traditional advisors, such as accountants or counsel, although sometimes "neutral advisors" are chosen so that each member of the group has the same degree of relationship with the advisors. In choosing outside counsel, we have found that the club is best served by selecting counsel not only with private equity M&A experience, but also with an understanding of the special requirements of the private equity funds (*e.g.*, tax, ERISA, partnership agreement investment restrictions) and their investors, which will be providing the equity in the transaction.

Financing structure. While determining the amount of equity that each club member commits to should be fairly easy, other aspects of the financing structure can be more problematic. For example, some club members may be prepared to "bridge" some of the purchase price from their funds, while others may not be permitted to do so or may prefer other alternatives. Determining the overall financing structure, including the debt sources, is something the club members should carefully review. Are the co-bidders in agreement on the degree of financing certainty that is acceptable for their bid? Are club members willing to pay for commitments from financing sources, or can they rely on historical relationships to obtain the requested commitment letters?

Allocation of expenses. If the transaction is not successful, how will the club members allocate the "dead deal" costs?

Allocation of any break-up fees. If the transaction is not successful, how will the club members share in any break-up fees?

Participants in a joint bid also need to have tackled a number of other issues before submitting their bid in order to feel confident that they will have a good working relationship with the co-investors if the bid is successful.

Governance Rights. Among the most important issues to be addressed are governance rights. The allocation of governance rights among the club members will be a function of, among other factors, their relative equity stakes in the company, their relative bargaining positions, their expertise in the business or some combination thereof. Matters to be covered in allocating governance rights among club members include:

- ***Board representation and committee membership,*** including chair positions, replacement procedures and adjustments to board representation when investors' equity stakes change. Jointly selected independent directors should be considered to round out the Board. If the company is going to issue public debt, care should be taken to have directors that will meet Sarbanes-Oxley requirements. Investors that are

private equity funds may be required to obtain rights to board seats to satisfy the venture capital operating company (VCOC) exemption from the plan asset regulations under ERISA.

- ***Supermajority voting rights and veto rights.*** The club members should first decide the matters, if any, that will require a supermajority vote of the Board. Items for consideration might include new equity issuances, payment of dividends or other distributions, sales or purchases of significant assets, extraordinary corporate transactions such as mergers or joint ventures, CEO hiring and firing, transactions with affiliates (including deal and management fees), and exits from the investment. Veto rights may also be appropriate in some transaction but, particularly in a club with three or more members, might tend to create logjams. In 50/50 club deals, the club members should devise mechanisms for dealing with deadlock, perhaps by having independent directors on the Board.
- ***Anti-dilution protection: preemptive rights, warrants and convertible stock.*** In order to provide dilution protection, private equity firms typically consider preemptive rights, convertible securities and/or veto rights over new security issuances by the company. In some instances, participants will not know if they will be able to provide additional capital to maintain their *pro rata* interests when new equity infusions are required because they are close to completing the investment of a fund's capital or are in jeopardy of running up against diversification limits. In those circumstances, the private equity firm might want to put the investment in a new fund (subject to limited partner approval) or permit its prior fund's limited partners to participate directly. Because participants in a club transaction may have different abilities to provide additional capital and/or may require limited partner approval for follow-on investments, these constraints should be analyzed when the transaction is structured initially.
- ***Information and observation rights.*** A minority investor that is unable to secure board membership should insist upon having information rights – the right to inspect the company's books and records and the right to receive financial reports and other periodic disclosures, for example – and/or observation rights for purposes of satisfying VCOC requirements.
- ***Allocation of deal and management fees among the club members.*** This issue is close to the hearts of private equity investors and should be resolved early in the process. Many private equity firms charge investing banking, origination, directors and monitoring fees to their portfolio companies. If the transaction is successful, which firms may charge which fees? When? How much? Because different investors will hold different percentages of the equity post-closing (and thus effectively bear different percentages of fees charged), and because some private equity firms share larger percentages of fee income than others (and thus may be less anxious to charge transaction fees, for example) this can be a contentious issue.

Portfolio Company Management, Exit Strategy, etc. Once a transaction is completed, participants in a club deal may face challenges because of the nature of joint ownership. To enhance the likelihood of a smooth working relationship, club members should discuss operating philosophies at the outset of the deal. That means, for example, sharing a common understanding of the company's business and growth plans and the appropriate strategy for achieving such goals. Among the items to be considered are:

- ***The company's strategic plan.***
- ***The management team.*** The club members should focus on the management team: Is it strong? Does it need supplementing, especially if the transaction is a divestituture?
- ***The optimal management incentive mechanisms.*** The club members should agree on the various incentivization approaches (stock purchase, options, warrants, bonuses, etc.) that most closely align managers' incentives with the club members' financial objectives.
- ***The courses of action to follow if the company starts performing poorly.*** For example, is there someone at one of the participants' firms who could run the business on an interim basis if a management change is required?
- ***Exit strategy.*** The club members should determine whether they have roughly similar time horizons and target rates of return on the investment.

Limited Partner Reaction. In deciding whether to participate in a club deal, a private equity firm should consider the potential reactions of the limited partners in its funds. Limited partners that are investors in funds that jointly acquire a business may take issue with the way the transaction impacts them, regardless of the merits of the transaction.

- ***Anti-diversifying effect.*** For limited partners, club deals may have an anti-diversifying effect by increasing their risk exposure when multiple private equity firms in which they are investors invest in a single portfolio company. Limited partners may find themselves "over-invested" in a transaction in which several of their private equity managers have jointly participated.

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- ***Control investing.*** Some limited partners expect (by agreement or otherwise) the private equity firms in which they invest to participate primarily in control investments. If a private equity firm engages in more than an occasional club deal in which it is a minority player or 50/50 investor, it might fail to satisfy the expectations of its limited partners who anticipate that it will engage mostly in control transactions.
- ***Cross-ownership problems.*** Limited partners that are invested in a single transaction through multiple private equity firms may be subject to unanticipated tax treatment in certain exit transactions unless sponsors carefully monitor the situation. In addition, such cross-ownership issues may limit exit alternatives.
- ***Management fees.*** Limited partners may feel that private equity firms that participate primarily in club deals should receive a lower management fee because such limited partners may view participation in club deals as devaluing what the "deal finders" bring to the table.

Put and Call Rights. If a strategic investor is participating with private equity firm(s) in a club deal, the parties should consider whether to include put and call rights in the shareholders' agreement. Such rights could be structured to enable the private equity firm(s) to require the strategic partner to buy out the private equity firm(s) at an agreed upon multiple or to permit the strategic investor to acquire a larger stake (through exercise of a call right) at an agreed-upon IRR. Such arrangements are much less typical in club deals solely among private equity firms.

Large club deals appear to be a permanent part of the private equity landscape. Private equity firms that anticipate participating in such transactions should do some careful planning in order to structure those investments in a way that avoids surprises and conflict between both club members and their limited partners. ■

— Paul S. Bird
psbird@debevoise.com

— Franci J. Blassberg
fjblassberg@debevoise.com

— Michael P. Harrell
mpharrell@debevoise.com

— Laura N. Beny
lnbeny@debevoise.com