

Selling to the club

How a seller should negotiate a club deal

With the availability of significant levels of debt and equity financing, the M&A world has seen a resurgence since its downturn in 2001. Club Deals or consortium transactions – those that involve two or more buyers joining together to acquire a target company – have played a significant role in recent M&A activity levels. These clubs or consortiums are typically composed of at least one, and often several, private equity sponsors.

The number of club deals and the values of these transactions have risen substantially over the past few years, peaking in 2006 with the now closed \$33 billion leveraged buyout of hospital-operator HCA by the consortium of Bain Capital, Kohlberg Kravis Roberts (KKR) and Merrill Lynch. This record is likely to be broken soon with the recently announced \$45 billion leveraged buyout of Texas power producer TXU by KKR and Texas Pacific Group.

Based upon the amount of capital that continues to flow into private equity and hedge funds, as evidenced by ever increasing fund sizes, and the availability of significant levels of cost-effective debt financing, there are few companies that cannot be considered potential buyout targets by clubs. The idea of a \$100 billion leveraged buyout is no longer inconceivable.

Companies that wish to sell themselves or their assets are presently dealing with the challenges of orchestrating a sale or auction with consortium bidders. The typical seller's auction of five years ago has changed with companies striving to ensure that their equity holders receive fair value in the transaction. The concern over fair value in club deals is apparently not restricted to the selling companies.

In October 2006, the Department of Justice contacted several well-known private equity firms inquiring about their practices and participation in consortiums in past sales and auctions. These inquiries likely stemmed

from the suspicion that private equity firms formed clubs in order to decrease competition amongst the bidders by colluding and rigging bids.

In addition to the Department of Justice inquiry, a class action complaint was filed in the Southern District of New York against several prominent private equity firms alleging that they formed clubs that artificially deflated a target's price by exchanging information about bid prices and agreeing upon which party would win the auction. Actions like these are causing sell side companies and their advisors to consider ways to preserve the integrity and value in the sale process.

Competitive vs anti-competitive

The formation and interactions of clubs in a sale or auction have raised questions as to their anti competitive effects. Concerns include: (i) that consortiums reduce the number of potential bidders in a process; (ii) that they monopolize financial institutions, thereby preventing other bidders from acquiring the funding necessary to submit a fully-financed bid; (iii) that clubs collude with each other and rig their offers by designating which bid will win and by setting a maximum price for the target; (iv) that consortiums agree not to bid against each other; and (v) that they abide by a collective understanding that once a firm has a formal acquisition agreement with the target, no other club will make a competing bid.

Furthermore, with the use of equity bridges, opponents of club deals are quick to point out that consortiums are no longer necessary, or certainly less necessary, to consummate most large transactions. For example, due to the confluence of the availability of an equity bridge and a significant amount of debt and equity financing, The Blackstone Group (Blackstone) was able to acquire Equity Office Properties for over \$39 billion without having to form a club in order to finance the acquisition.

In contrast, proponents of consortium deals argue that sales and auctions involving clubs have been highly competitive – that clubs, in fact, enhance competition – and that the fear of collusion is unfounded. These same proponents also dismiss the notion that clubs participate in agreements to drive down prices or willingly abandon a potential transaction if another club or private equity buyer has a formal agreement with the target.

The Freescale Semiconductor buyout is often cited as an example where a club,

composed of KKR and Silver Lake, entered the bidding after Blackstone had been announced the winner in the auction. Although their late bid did not succeed, their entrance into the auction forced Blackstone to raise its winning bid by \$1.6 billion, or almost 10 percent. Many proponents also note that club transactions enable sellers and their shareholders to ultimately receive the highest value for their assets.

By enabling bidders to pool funds and expertise in order to provide targets with value maximizing bids that would otherwise be impossible or implausible if done on an individual basis, clubs offer greater competition and higher value. Among the proponents of club transactions is Delaware Vice Chancellor Leo Strine, who wrote in the Toys “R” Us case that the formation of clubs to win auctions is “logical and is consistent with an emerging practice among financial buyers...[and allows bidders] to make bids that would be imprudent, if pursued in isolation.”

The buyer's perspective

There are several reasons why bidders seek to form clubs. Joining together allows bidders to share in the bid price, the risks related to the investment, the work and costs associated with due diligence, and the documentation involved in submitting a bid, which is particularly beneficial in the case of a bid that ultimately fails. Consortiums also have the advantage of being able to utilize all of the members' influence with financial institutions, which, in turn, enables clubs to leverage the institutions for large amounts of financing and favorable rates.

Aside from purely financial reasons, forming a consortium gives bidders the advantage of pooling the expertise of its sophisticated members, who have diverse knowledge bases, industry expertise, reputations, as well as practical experience in the M&A market. Club deals also enable some bidders to penetrate into foreign markets, which might otherwise be closed to them due to foreign ownership restrictions or limitations. By clubbing up, bidders are able to partner with local investors who meet these criteria and thus enter auctions formerly closed to them.

At the same time, private equity bidders are cautious about forming a club to acquire and own an asset. By joining together, bidders must share in the upside return of the acquisition, which reduces the absolute return on the investment. Furthermore, consortiums are effectively joint ventures that require cooperation among the members during all stages of the investment – acquisition, ownership and exit.

There is always the possibility that members' plans or philosophies for the target will differ, resulting in deadlock and the inability to effectuate a mutually agreed upon plan. In addition, although being able to access the collective expertise and knowledge of the various club members is a distinct

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advantage in a sale or auction, private equity bidders are also weary of sharing such expertise with other private equity firms that could be their competitors in a future sale or auction.

The seller's perspective

Although concerned by the formation of clubs, sellers understand that consortiums present substantial benefits to a sale process. The seller's ultimate goal is to receive the highest and best value for the asset, and since clubs have multiple sources of funding and deep experience, they are often able to provide fair value. Clubs also often enable sellers to increase the bidding pool by allowing certain bidders to enter the sale that otherwise could not, whether due to the transaction size, lack of adequate funding, need for a strategic partner or desire to share the risk.

Despite these benefits, sellers have many concerns regarding the formation of consortiums. In running a sell side auction, the seller and its advisors attempt to ensure that the process is highly competitive in order to provide the company's equity holders with a full and fair price for the company or its assets. The mere formation of a club, in and of itself, could negatively affect the ultimate price paid for the target. Specifically, if several bidders decide to join together rather than compete against each other in the auction by continually raising the price of the target, they can eliminate the competition among themselves.

Sellers are also concerned by the fact that bidders may violate a seller's non-disclosure and confidentiality restrictions when they form consortiums without the consent of the company. A seller non-disclosure agreement must be signed before a bidder is allowed access to the business and legal due diligence information of the company. A typical agreement prohibits a bidder from sharing information about the target or the proposed transaction with another party, including other bidders, without prior consent.

These restrictive provisions enable a seller to control who has access to the proprietary information of the company and who to exclude from the auction process, such as rivals who may only wish to view the seller's confidential information or bidders who are not perceived as being serious participants in the auction process. Thus, when forming clubs, it is possible for bidders to intentionally or inadvertently violate these non-disclosure requirements and invite participants into the sale process that the seller had no intention of including.

Another concern of sellers is the prevalence of so called bid jumping by club members, which occurs when the losing bidders in an auction jump onto the winning club after the bidding closes. This raises the possibility that the bid jumpers struck a deal with the winning consortium by agreeing to underbid and lose the auction in exchange for being allowed to participate in the deal after the winning club determines the price. A similar concern arises when clubs withdraw from the auction completely, and in return for dropping out, the winning consortium allows the withdrawing

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club to be part of the winning bid or the subsequent syndication of the equity.

Sellers are also concerned about the availability of adequate financing for the transaction. The formation of powerful clubs, with members whose clout and influence allows them to lock-up advisers and debt providers, limits the ability of other bidders to finance a bid and enter the auction. This has occurred in past auctions, where the seller and its advisors have had to request that banks make themselves available to other bidders.

Similarly, sellers are concerned by the potential of clubs to monopolize strategic bidders or local partners. Often times, a seller requires a local partner for strategic or legal reasons (for example, when the bidder is a foreign-based fund in relation to the target). Bidders that lock up all of these potential partners inhibit competition by preventing other bidders from delivering qualifying bids.

A final concern revolves around the relationships that develop between private equity firms that form a consortium. Firms may be unwilling to bid against an opposing club for fear of not being invited to join members of that consortium in a future deal. Related to that is the concern that firms operate according to an unwritten agreement which provides that a private equity firm or club will not enter a bid once another sponsor or consortium enters into a formal agreement with the seller.

Managing deals for the seller

Despite the concerns that may be raised by the formation of clubs in an auction context, there are certain precautions that a seller can take in order to mitigate some of the risks. To guard against consortiums stifling rather than fostering competition in an auction, a seller can limit or manage the ability of bidders to form clubs. This is usually implemented through agreements that limit bidders' ability to talk to each other, namely, cross-talk restrictions. These provisions prevent bidders from discussing any information with other potential bidders regarding the company or the transaction.

To ensure bidders' compliance, sellers can provide for the payment of monetary damages as well as equitable relief if the bidder breaches. Sellers may also remove bidders from the auction process upon a breach of these restrictions. These remedies may not always prevent bidders from breaching these agreements, but they should dissuade bidders from engaging in these actions.

A seller can also limit the ability of a bidder to form a consortium by retaining the sole right to structure clubs. In other words, bidders wishing to form clubs must first seek

approval from the seller. Through this method, a seller can also ensure that the number of bidders in an auction does not decrease too low or that the real pillars among the bidders do not join together.

However, this method is fairly aggressive, and many bidders will resist the seller dictating who their partner ultimately will be. Therefore, in practice, a toned down version of this approach is what works best for all constituents involved. This approach was recently employed by Goldman Sachs in the Albertson's auction and by General Electric in the recent sale of its plastics division.

Sellers will also want to prevent clubs from locking up financial advisers and financing providers. If a seller retains the ability to decide or manage the makeup of a club, it can ensure that each bidder group has access to separate financing sources, thereby providing that no single group has an exclusive right to these sources. Alternatively, a seller can establish that in order to participate in the sale or auction, bidders or groups cannot create exclusive arrangements with bankers or lenders, and if an exclusive arrangement already exists, then for the purposes of the transaction, other bidders will be allowed to use those bankers or lenders. Similarly, sellers can require that a consortium not lock up all strategic or local investors, enabling more bidders to join and bid in the process.

Finally, sellers can preempt concerns regarding bid jumping by drafting the bid procedures letters and agreements to bar any losing bidder from joining a winning bidder's club. This would discourage bidders from having any tacit agreements to withdraw from an auction or purposely underbid in the expectation of being allowed to later join the winner's consortium.

Ensuring a successful auction

The ultimate goal of any seller is to receive the highest and best value for its assets. Although this goal is sometimes harder to achieve when dealing with club buyers, implementing specific provisions can help protect the sale or auction from potential anti-competitive behavior and, in fact, foster competition. Ultimately, price and fairness of the terms offered, whether by a single bidder or a consortium, will dictate whether a transaction will proceed. However, by following these suggestions, a seller will be in a much better position to negotiate with clubs and ensure that the sale process will be as competitive as possible.

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