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What it Takes to Make a Consortium Work

By Eric J. Schwartzman

Club deals have many facets, and partners in a consortium must share similar values and appreciate each other's differences to make the union successful.

Over the last few years, the proprietary private equity deal seems to have become a relic of the past and auctions controlled by sellers and their investment bankers are the deal du jour. This, combined with the multibillion-dollar assets that are now regularly for sale, has given birth to club deals consummated by various types of private equity consortiums.

Why Clubs Form: Pros and Cons

For the private equity firms (or sponsors) bidding in an auction, as well as for the seller, sponsors forming private equity consortiums can be attractive for many reasons.

From the sponsor perspective, club deals allow private equity firms to competitively participate in auctions by being able to increase aggregate bid price and share the burden and risk of writing a large equity check. Although several funds approaching or even exceeding $10 billion have been raised in 2005 by The Carlyle Group, Apollo Management, The Blackstone Group, Goldman Sachs Capital Partners, Warburg Pincus and CVC Capital Partners, the multibillion dollar price tags attached to the assets being offered to and sought by private equity investors make it unlikely that any one sponsor would be permitted (most fund documents provide for diversification of holdings by restricting sponsors from investing too large a percentage of a fund in any one transaction) or willing to fund the entire equity portion of the purchase price.

Aside from the pure size of the equity financing required to consummate any given multibillion-dollar acquisition, club deals can also bolster debt financing because selling high-yield bonds and syndicating bank loans is often facilitated when several large, well-known sponsors attach their names to a deal. Additionally, forming a consortium allows sponsors to combine, enhance and supplement expertise, bringing the best resources to bear for the benefit of the investment and portfolio company and to enhance potential return.

From a seller's perspective, consortiums arguably provide a livelier auction, where participants who might not have otherwise been involved can team up and offer a higher price. On the other hand, some sellers worry that the formation of consortiums dampens competition in auctions because sponsors who would otherwise be bidding against each other team up to bid jointly and drive down the sale prices. This worry has caused sellers and their investment bankers to often explicitly prohibit the formation of consortiums without the seller's prior consent. Such a provision typically resides in the confidentiality agreement

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that sponsors must first sign to gain access to information memorandums, management presentations and due diligence materials. It provides a mechanism for sellers and investment bankers to remain in control of the auction process and encourages the formation of consortiums comprised of sponsors, at least partially, who might not have otherwise been involved in the auction. Additionally, in a shotgun marriage consortium (discussed below) there might be tension between the desire or need of the initial sponsor to share information regarding the target with the joining sponsors, on the one hand, and the confidentiality obligations owed by the initial sponsor to the seller, on the other hand,

The timing and circumstances in which a consortium forms affect the dynamics among the consortium's members and the issues they will face.

because the typical confidentiality agreement does not permit information to be shared with joining sponsors without prior consent of the seller. Nonetheless, policing these activities and enforcing confidentiality agreement provisions are difficult tasks, and sellers are unlikely to turn away an attractive offer from a consortium simply because it might have been formed without formal permission or in breach of the non-disclosure provisions in a confidentiality agreement.

Recent Club Deals

For the reasons discussed above, club deals tend to form in large, multibillion-dollar transactions. An early example of a high profile club deal was the 2002 acquisition of Dex Media from Qwest Communications by The Carlyle Group and Welsh Carson Anderson & Stowe for more than $7 billion. At the time, the Dex Media deal was the largest buyout since Kohlberg Kravis Roberts acquired RJR Nabisco in 1989.

Of about 60 club deals involving US targets valued at $1 billion or more since 2001 (according to a recent article by David Marcus writing for TheDeal.com), many targets were standalone companies, many were large divisions of even larger conglomerates and a good number were household names. Notwithstanding any of those characteristics, however, all of them fit the main criterion that makes deals ripe for potential buyers to form consortiums: they were all multibillion dollar deals where no one private equity firm could have funded the entire equity piece or would have been willing to take the risk of doing so even if it could have funded the equity. Additionally, most of these clubs had only four or fewer members. Although there seems to be safety in numbers and a desire to share risk and operating expertise, consortiums also must face the task of allocating and sharing control over the investment. When facing those issues, a manageable sized consortium is more likely to yield success.

How Clubs Form: Timing and Types

Timing is always critical, and members of private equity consortiums come together in different circumstances. The formation of a private equity consortium is often akin to courting and marriage. There is the traditional marriage, where sponsors join together from the beginning to conduct diligence, submit the bid and negotiate the acquisition of the target. There is also the shotgun marriage, where the initial sponsor has made significant progress in the auction process and the joining sponsors enter before submitting the actual bid or after the bid is submitted but, in either case, before executing definitive documentation. Then there is the late-life marriage, where the signing sponsor seeks to syndicate a portion of its equity commitment post-signing. Lastly, there is the arranged marriage, where the seller selects which sponsors will join together to acquire the target. The timing and circumstances in which a consortium forms affect the dynamics among the consortium's members and the issues they will face.

Internal Issues: Governance and Equity Commitments

After the marriage has been set — or at least once the members are engaged and bidding in the auction — there are several internal issues that the members of the consortium must face as largely dictated by the type of marriage that formed the consortium. Such issues include shareholder arrangements governing control of the board of the target and exit strategies, as well as the type and nature of any equity commitment letter that will be delivered at the seller's request. These issues can have long-lasting implications that sponsors must often work out quickly and adeptly.

Although not always the case, many traditional marriages involve sponsors taking an equal percentage of the deal and therefore having equal rights and obligations. This dynamic often leads to straight-forward and even-handed arrangements for how the consortium will approach the bidding process (including the equity commitment letter) and then negotiate the ultimate shareholders' agreement covering post-closing governance of the target — which many consortiums wait to do until after they have won the auction, signed the deal and are approaching the closing. The key here is how the personalities of the players at each sponsor member mesh and whether the firms have a similar approach and outlook. If this is the case and the sponsors view each other — economically and otherwise — as partners who can each add to the mix in the effort to share a smaller piece of a larger pie, the negotiations, governance and ultimate exit will go smoothly. The importance of having a similar approach and outlook might partially explain why most

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SEC Proposes Amendments to the Best Price Rule

By John E. Sorkin and John Giouroukakis

On December 16, 2005, the Securities and Exchange Commission proposed long-awaited amendments to Rule 14d-10(a)(2) under the Securities Exchange Act of 1934, the so-called "best price rule." The best price rule prohibits an acquirer from making a tender offer unless the "consideration paid to any security holder pursuant to the tender offer is the highest consideration paid to any other security holder during such tender offer."

Some courts have interpreted this rule broadly by refusing to grant summary judgment on shareholder claims that severance and other employment arrangements, as well as ancillary agreements with principal stockholders, represent hidden payment of additional consideration in tender offers. This has substantially decreased the attractiveness of tender offers as a means of effecting acquisitions and business combinations.

The SEC's proposed amendments are intended to clarify that the best price rule applies only with respect to the consideration paid for securities tendered in a tender offer and generally not to employment and severance arrangements. If the proposed amendments are adopted, they should increase the use of tender offers in acquisitions and business combinations.[1]

History of the Best Price Rule

From the best price rule's inception in 1986 until 1995, case law and available SEC interpretations consistently applied the rule temporally so that it applied only during the tender offer process as measured from the statutorily defined commencement of the tender offer through its expiration. Since the Ninth Circuit's 1995 decision in *Epstein v. MCA, Inc.*,[2] however, a series of court decisions have created a significant level of uncertainty relating to the application and scope of the best price rule. *Epstein* involved a negotiated tender offer by Matsushita for MCA. Prior to the formal commencement of the tender offer, Matsushita entered into an agreement with Lew Wasserman, MCA's Chairman and CEO, under which Matsushita would acquire Wasserman's MCA shares in exchange for preferred stock of a newly formed Matsushita subsidiary with a value intended to equal the cash price in the tender offer. The closing under Wasserman's agreement was conditioned upon consummation of the tender offer. The Ninth Circuit declined to read an explicit temporal limit into the rule, opting instead for an interpretation that the rule applied to all transactions that are an "integral" part of the tender offer.

Following Epstein, some courts have followed this "integral part" test, while others have not. As a result,

If the proposed amendments are adopted, they should increase the use of tender offers in acquisitions and business combinations.

acquirers have increasingly avoided tender offers in favor of using conventional, one-step statutory mergers to consummate friendly transactions. This has resulted in particular from plaintiffs' attorneys claiming that severance and compensation arrangements for target executives, as well as ancillary agreements with principal stockholders of the target, are intended as payment for their shares, thereby justifying alleged damages literally in the billions or trillions of dollars. The plaintiffs' reasoning is that once the severance or other payments are properly characterized as part of the tender offer consideration, a recomputation of the "highest consideration paid" is required under the best price rule and the recomputed highest consideration is then owed to all other target shareholders.

The combination of the potential expense of litigating a best price rule claim, the significant risk inherent in a jury trial and the inevitable cost of settlement has come close to eliminating tender offers as a structure for friendly business combinations. This has occurred in spite of the fact that tender offers can be completed more quickly and efficiently than statutory mergers (twenty trading days versus three to four months for a statutory merger).

[1] For a more extensive discussion of the history of the best price rule and the proposed amendments, please see Latham & Watkins, M&A Deal Commentary—SEC Proposes Amendments to Best Price Rule, available at http://www.lw.com/resource/Publications/_pdf/pub1468_1.pdf.

[2] 50 F.3d 644 (9th Cir. 1995), *rev'd on other grounds sub nom Mazsushita Electric Industrial Co. v. Epstein*, 516 U.S. 367 (1996).

The Proposed Amendments to the Best Price Rule

Clarification of the Best Price Rule

The SEC proposes to modify the best price rule to read as follows:

> "[t]he consideration paid to any security holder for securities tendered in the tender offer is the highest consideration paid to any other security holder for securities tendered in the tender offer."

The substitution of the clause "for securities tendered in the tender offer" expressly clarifies that the intent of the rule is to apply only to consideration that is actually paid for securities tendered in the tender offer and not to other payments made to individuals who happen to be shareholders of the target company.

Specific Exemption for Compensatory Arrangements

To minimize the most common deterrent to tender offers arising under the best price rule — claims attacking various compensation payments and arrangements as hidden tender offer consideration — the SEC has proposed a specific exemption for employment and compensatory arrangements. The proposed exemption provides that the best price rule would not apply to any employment compensation, severance or other employee benefit arrangement made or to be made in connection with a third party tender offer where the amount payable:

- relates solely to services performed, to be performed or to be refrained from performing, and
- is not based on the number of securities that the employee or director owns or tenders.

The language of this exemption is ambiguous and could be construed to deny applicability of the exemption and related non-exclusive safe harbor to stock-based incentive programs. We anticipate that this ambiguity will be eliminated through the comment process, so that stock-based incentive plans would be treated like all other compensation and benefit plans under the amended rule.

Safe Harbor for Compensatory Arrangements Approved by Compensation Committees

To provide greater certainty, the SEC also has proposed a non-exclusive safe harbor (to which the exemption described above would be deemed to apply) for employment compensation, severance or other arrangements that are approved as meeting the requirements described above by a compensation committee (or a committee performing similar functions) of the acquirer or the target (whichever is the party to the arrangement) comprised solely of independent directors.

Potential Impact on Business Combinations and Private Equity Transactions

While the SEC did not go as far as some M&A practitioners had hoped, the proposed amendments to the best price rule should eliminate the risk of lawsuits

Private Equity Deal Highlights

Our comprehensive experience in all aspects of private equity investment enables us to service the full array of legal needs of fund sponsors and investors alike, from fund formation to investment acquisition, structuring, financing and disposition. The following is a selection of US deals.

AMC Entertainment Inc.
Apollo Management LP
JPMorgan Partners

Acquisition by AMC Entertainment Inc. of Loews Cineplex Entertainment Corporation

2006

Not Public

Dex Media, Inc.
The Carlyle Group
Welsh, Carson, Anderson & Stowe

Acquisition of Dex Media, Inc. by R.H. Donnelley Corporation

2006

$9,800,000,000

JPMorgan Partners

Acquisition by JPMorgan Partners of PQ Corporation

2005

$775,000,000

Kohlberg Kravis Roberts & Co.

Acquisition by Kohlberg Kravis Roberts & Co. (KKR) Bain Capital and Vornado Realty Trust of Toys "R" Us

2005

$6,600,000,000

Kohlberg Kravis Roberts & Co./Silver Lake Partners

Acquisition by Kohlberg Kravis Roberts & Co. (KKR) and Silver Lake Partners of Agilent Technologies, Inc.'s Semiconductor Products Group (SPG)

Pending

$2,660,000,000

Leonard Green & Partners, L.P.

Representation of Leonard Green & Partners. L.P. in its investment in The Tire Rack, Inc.

2005

Not Public

alleging violations of the rule in most situations, particularly those arising from employment compensation and other employee benefit arrangements. As a result, the use of tender offers in friendly acquisitions and business combinations should increase significantly if the proposed amendments are adopted with some clarifications.

Cash Tender Offers

Due to the fact that a cash tender offer coupled with a back-end (almost always a short-form) merger can be consummated more quickly and inexpensively than a conventional one-step cash merger, we expect that adoption of the proposed amendments would result in cash tender offers supplanting conventional mergers as the preferred method to structure friendly strategic business combinations for cash. The proposed amendments would eliminate any uncertainties with respect to employee compensation and related employee benefit arrangements that currently deter most acquirers from considering the use of tender offers.

Private Equity Acquisitions

The ability of private equity buyers to utilize cash tenders offers to acquire public companies will depend on the use of financing structures that comply with the margin rules while enabling the buyer to obtain financing for the acquisition of shares in the tender offer regardless of whether a sufficient number of shares have been tendered to permit a short-form merger under state corporate law. Since private equity acquisition financing is typically secured by the target's assets, tender offers are not often used by private equity buyers because security interests in the target's assets cannot be given until the closing of the second step merger. A number of margin rule compliant structures, however, have been used for leveraged tender offers in the past. If the proposed amendments to the best price rule are adopted we expect that private equity buyers will begin to consider the use of tender offer structures in public company acquisitions, especially in auctions where strategic buyers are competing in the bidding.

Exchange Offers

In 1999, the SEC adopted a broad package of amendments to the rules governing, among other things, tender and exchange offers, mergers and other business combinations. Under these amendments, the SEC sought to harmonize the time frames for cash tender offers and equity exchange offers by permitting an acquirer to commence an exchange offer utilizing securities as part or all of the consideration immediately upon the filing of the registration statement, which is the analog to the filing requirement for commencement of cash tender offers. If the proposed amendments are adopted, acquirers would no longer be deterred from using an exchange offer structure as a quicker and more efficient alternative to statutory mergers for friendly stock-for-stock business combinations. ■

LS Power Equity Partners

Acquisition by LS Power of Duke Energy's DENA Power Generation Assets.

Pending

$1,500,000,000

Metro-Goldwyn-Mayer Inc.

Acquisition of Metro-Goldwyn-Mayer Inc. by a consortium led by Sony Corporation of America & its equity partners, Providence Equity Partners, Inc., Texas Pacific Group and DLJ Merchant Banking

2005

$5,000,000,000

Odyssey Investment Partners LLC

Acquisition by Odyssey Investment Partners LLC of York Insurance Services Group

Pending

Not Public

Silver Lake Partners

Acquisition by Silver Lake Partners of Serena Software, Inc.

Pending

$1,200,000,000

Spectrum Equity Investors

Acquisition by Spectrum Equity Investors of a controlling stake in Classic Media Inc.

2005

Not Public

The Carlyle Group

Acquisition by The Carlyle Group of Verizon Hawaii from Verizon Communications, Inc.

2005

$1,650,000,000

The Carlyle Group

Acquisition by The Carlyle Group of all of the outstanding common stock of SS&C Technologies, Inc.

2005

$982,000,000

The Yucaipa Companies LLC

Representation of The Yucaipa Companies LLC as plan sponsor in connection with the acquisition of Aloha Airlines through a plan of reorganization

2006

Not Public

Deal Talk with Charles Nathan

By David S. Allinson

Deal Talk interview featuring Charles Nathan, Global Co-Chair of Latham & Watkins' Mergers and Acquisitions Group and corporate partner resident in the New York office.

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Question: Chuck, as a frequent commentator on general M&A trends and a veteran M&A dealmaker, what current developments do you believe will have the most significant impact on private equity M&A in the long term?

Answer: I think there are a number of powerful forces in the market that have the potential to change drastically the frequency and structure for taking public companies private. They include the increasingly expensive and distracting regulatory and corporate governance climate facing public companies. Another major factor is the increasing size and appetite of private equity funds, coupled with a heavily worked private company market, which are making large public companies more attractive and more attainable as going private targets. Another driver will be the coming amendment of the SEC's Best Price rule which will liberate the tender offer as a viable acquisition structure and has the potential to put private equity buyers of public companies on an equal or superior footing compared to strategic acquirers.

Question: What do you see as the connection between regulation or corporate governance and an increase in "take private" deals?

Answer: The economic cost differential between being publicly held or privately held is escalating rapidly, at least in the US and I suspect in Europe as well. This is not just a matter of compliance with an increasingly regulated environment, although the growth of government intervention and regulation has escalated tremendously in the post Enron/WorldCom era of Sarbanes-Oxley. The barriers to sound economic performance by public US companies also include the increasing intrusion of corporate governance initiatives by activist institution reformers. When you combine these external forces you produce an environment in which the management and board focus is of necessity one of adherence to relatively rigid and unforgiving externally imposed rules of behavior, rather than one in which management's first and primary focus is on operational and strategic initiatives.

Question: Are regulation and corporate governance the only new factors affecting a company's desire or decision to go private?

Answer: No, this is only part of a more complicated set of issues that are combing to make public ownership less attractive than private ownership. Another is the continued pressure being placed on public companies to show performance on a quarterly basis. The addition of activist hedge funds to an investor community dominated to a large extent by the desire for near-term, quarterly results has further complicated the managerial role, and sometimes perversely impedes rather than fosters long-term, sustainable economic growth. And, the hedge funds don't necessarily play as politely as more traditional investors in their search for improved near-term results. Many of the most vocal hedge funds use very aggressive tactics, including public vilification and proxy contests, to force corporate events that in their view will create immediate value for their share holdings. My point is not whether this is good or bad investment strategy, or even whether it is good or bad for our economy. My point is that the prevalence of short-term, result driven investors stimulates management and boards to contemplate the different

"I believe the coming amendment of the SEC's Best Price Rule will liberate the tender offer as a viable acquisition structure and has the potential to put private equity buyers of public companies on an equal or superior footing compared to strategic acquirers."

world of private equity ownership where time frames tend to be longer and more strategically driven.

Question: What are some of the other drivers behind this "going private" trend?

Answer: I think other critical events include the growth in private equity fund size and an appetite for larger and larger deals. Like the escalating cost of remaining public, the increase in fund and target size has a number of underlying causes. After 20 years of active LBO investing, the US market has been extensively, if not exhaustively, tilled and at the moment, there are fewer buying opportunities than buyers. The competition for targets has not only increased valuations of target companies and diminished the private equity community's return goals, but has also led funds to seek larger and larger targets in an effort to expand the number of available targets and to diminish competition by diminishing the number of potential bidders. Last year saw, for example, some notable mega-sized take private deals for public companies, including Sun-Guard, Toys "R" Us and Albertsons in which there was markedly less visible competition than the norm for smaller deals.

Question: Earlier in our discussions you mentioned the Best Price Rule, which regulates prices paid in tender offers. What impact may an amended rule have on take private transactions?

Answer: In a nut shell, the current version of the rule, as interpreted by the courts, has made it very risky to use a tender offer structure to acquire a public company in a negotiated deal. Without getting into the details, changes in employee compensation plans or severance agreements or even merely accelerating payments already provided for in a plan or agreement, could under court interpretations constitute breaches of the rule leading to damage claims of million, billions or sometimes trillions of dollars. As ludicrous as the claims may be, very few acquirers were willing to take on the risk of an adverse finding, let alone the costs of litigation and settlement. This was particularly true of private equity buyers. As a result, for the past 10 years or so, the tender offer virtually disappeared as a takeover structure and was replaced by the one-step merger.

Question: Even if the tender offer will be resuscitated as a viable acquisition structure as a result of the proposed amendments to the Best Price Rule, explain how this could affect competition between private equity buyers and strategic buyers.

Answer: Another long story, I'm afraid. First, notwithstanding the risks inherent in using a tender offer, rather than a one-step merger structure, some strategic buyers have shown a willingness to take these risks, in part because they may have more economic leeway in their acquisition model for the costs of litigation and settlement than a private equity buyer in a highly levered transaction would.

More important, I believe, is the advantage the tender offer has over a conventional one-step merger in terms of deal protection and avoidance of topping bids. Because a tender offer can be closed 30-40 days after execution of the acquisition agreement, it is much less susceptible to topping bids than a one-step merger which under the best of circumstances will require 75-90 days to close. Moreover, unlike a strategic acquirer, a private equity buyer will rarely be held up by antitrust review and often will get early antitrust approval. This gives the private equity buyer using a tender offer structure a huge advantage in practical terms over a competing strategic buyer who will not enjoy the same freedom from HSR review and therefore cannot predict with the same degree of certainty that the tender offer 30-40 closing timetable will be met.

Yet another competitive advantage for the private equity buyer is that once signed, its tender offer deal structure will be far less

vulnerable to topping bids because of the shortness of time available for the strategic bidder to tee up a superior bid, to accomplish due diligence and to overcome the timing advantages of the private equity tender offer, particularly given the strategic bidder's likely need for substantive antitrust review. We have seen an increasing number of topping bids in the market in the past year, including Qwest's bid for MCA, Cnooc's bid for Unocal, Whirlpool's bid for Maytag and Boston Scientific's bid for Guidant. None of the topping bids could have succeeded in the context of a tender offer because of their internal time requirements. They were possible and credible only in the context of a conventional merger structure where the regulatory review and shareholder voting process was measured in many months, not just days.

Question: Traditionally, private equity buyers have favored one-step merger transactions as opposed to two-step transactions — tender offer followed by a back-end merger — because of increased financing cost and margin regulation issues associated with the tender offer process. Do you think private equity buyers will use the tender offer process notwithstanding the financing issues?

Answer: I think they will for a number of reasons. First, if the terms of the auction call for a tender offer structure, or if one bidder is willing to use a tender offer structure, it seems clear to me that the other serious bidders will have little choice but to use a tender offer if it is feasible. Second, as I pointed out earlier, private equity buyers can create a competitive advantage against strategic buyers by proposing tender offer structures, uninhibited by the need to wait for substantive regulatory approvals. If I were running a private equity firm, I would push that competitive advantage as hard as I could, even if it added complexity or cost to my financing so long as I was able to factor those costs into a successful bid.

Question: Your answer begs the second aspect of our question. It's fine in theory to assume the financing issues can be overcome. Can they be in practice?

Answer: I believe they can be in one of several ways. The first and easiest solution would be for the private equity buyer to obtain an unsecured bridge commitment from its financing sources. The reality of the tender offer structure is almost universally that the bidder receives tenders from well over the 90 percent (or occasional 95 percent) short form merger threshold with the result that the tender and the short form merger can be closed and funded at a single closing. Under this scenario, the permanent financing can be put into place at the final closing, and the bridge never needs to be drawn. The lawyers among us will of course point to the risk, as small as it is, that the short form merger threshold won't be achieved and the merger will require a shareholder vote. Even in this remote case, however, because the tender will be conditioned on a minimum majority tender, the outcome of the vote will never be in doubt and the only risk to the bridge lender will be the exact duration of the unsecured bridge loan. This risk can be taken into account in the pricing of the bridge facility.

Another financing structure that should be available in many cases would be the one our investment banking clients used to finance the Cox Communications going private tender offer at the end of 2004. Rather than have the acquiring Cox entity bridge its tender offer for its majority owned subsidiary, the transaction utilized two coordinated and simultaneous tender offers — one by the parent for the number of subsidiary shares it believed it could comfortably finance on the parent's balance sheet and the second as a self-tender by the subsidiary being taken private for the number of its own shares that were to be financed directly on the subsidiary's balance sheet.

There almost certainly are other financing structures that will comply with the Federal margin rules and will be appropriate for take private tender offers by private equity funds. Lawyers' and investment bankers' ingenuity will be more than equal for the task. As long as the private equity buyers see the strategic advantage of using the tender offer format, the market will respond to make it possible. ■

club deals are made up of private equity sponsors and few (probably 10 percent or so) involve strategic buyers (although one noteworthy club deal — because the primary strategic investor led a group of high-profile private equity investors — was where Sony Corporation of America led a consortium made up of Comcast Corporation, Providence Equity Partners, Texas Pacific Group and DLJ Merchant Banking Partners to acquire Metro- Goldwyn-Mayer for $4.8 billion in April of 2005). In the shotgun marriage, where an initial sponsor has made significant progress and is then joined by other sponsors (which, for example, was the case in the SunGuard transaction where Silver Lake was actively negotiating with SunGuard before being joined by the members that ultimately made up the consortium), the smoothness of establishing the parameters of the consortium can vary. Almost regardless of whether the economic stakes are equal, the initial sponsor might often be viewed as the lead investor who will most influence — if not dictate — strategy, governance and exit. In these situations, the initial sponsor has an advantage by being first into the fray. Sometimes, however, being first can be a potential weakness if the initial sponsor is so entrenched in the deal and beyond

Many traditional marriages involve sponsors taking an equal percentage of the deal and therefore having equal rights and obligations.

the point where it will practically walk away. In these situations, the other sponsor members who may be willing to walk from the deal but yet know their equity participation is essential to the initial sponsor could have an advantage vis-à-vis the initial sponsor and be able to level the playing field, at least for essential governance and exit decisions.

Although most discussions about member relations focus on the post-closing period and the shareholders' agreement, sometimes members also enter into agreements that cover the period between signing and closing. These agreements are intended to be short-lived, but can be essential because they address control over which member or members can decide to walk away from a signed deal if problems were to emerge at the target or with the debt financing. In other words, the interim agreements govern the control of the closing conditions that are set out in the acquisition document with the target. This topic may also be covered in the equity commitment letter, especially in the shotgun and late-life marriages, where the initial sponsor has already signed a purchase agreement and other sponsors are joining after the fact. In those instances, the interim agreement might well involve a sponsor-to-sponsor equity commitment where, although the initial sponsor is liable to the seller, it can seek recourse against the joining sponsors for failure to fund.

So far, club deals have enjoyed a rising tide of fund raising, economic and exit strategy success. Therefore, relationships among consortium members have not yet been truly tested, which will probably happen when there is a highly-publicized problem with a jointly owned and managed portfolio company or a downturn in the markets that have been fuelling private equity investments. If and when a deal that closes blows up, the staying power of sponsors' ability to continue to work together will be tested and, at that time, similarity of outlook and personalities — more than what the shareholders' agreement might or might not say — will probably be of paramount importance.

Considerations for Seller's Executive Team: In-house Counsel and CFO Issues

Sponsors are known for doing extensive financial, business and legal due diligence before consummating transactions and for being involved in monitoring and/or managing investments post-closing. With consortiums, that means there are a lot of cooks in the kitchen and a seller's executive team must be prepared to answer multiple questions from multiple sources. During the sale process, the task of supplying sponsors and their advisers with abundant and detailed information largely falls on the in-house counsel and CFO, with the help of the investment bank that is running the auction. Although this adds layers of complexity for the executives, it also creates opportunities for individuals who are exposed to many sponsors in multiple bidding consortiums. If they perform well and are perceived to possess skill and integrity, these executives can stay on in their positions post-closing or be presented with even more lucrative roles in other portfolio companies or future deals involving the sponsors.

Keep Them Coming to the Altar

There are numerous ways to get hitched, and consortiums, like married couples, come in all different shapes and sizes. The key to any successful marriage is commonality of values and perspectives while at the same time recognizing, appreciating and working to make the most of differences. The institution of marriages has lasted for centuries. Likewise, club deals, if they can survive the first real economic downturn or major financial failure at a portfolio company that is highly publicized, are likely to be here to stay. ■

This is an abridged version of an article that was originally published in *IFLR's The 2006 Guide to Private Equity and Venture Capital.*

Industry Focus

David S. Langer
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Is "All Appropriate Inquiry" Appropriate?: EPA's New Standards for Environmental Diligence

By David S. Langer

On November 1, 2005, the U.S. Environmental Protection Agency ("EPA") released its long-awaited final rule defining the standards for All Appropriate Inquiry ("AAI") under the Comprehensive Environmental Response Compensation and Liability Act of 1980 ("CERCLA"). 70 Fed. Reg. 66070 (November 1, 2005). This rule is the first time that EPA has defined standards for environmental site assessments and will necessarily impact the discussion, if not the practice, of environmental diligence.

Although the rule is not officially effective until November 1, 2006, private equity funds and other companies should consider whether to use AAI for their environmental diligence in pending transactions. In most deals, radical changes will not be required to meet AAI. In some situations, however, AAI-conforming assessments may be necessary and could increase the time, complexity and cost of environmental diligence. Careful assessment of the objectives for environmental diligence in the context of each transaction will be needed to ensure that environmental assessments are designed to provide useful information without needless cost or delay.

It is critical to understand that the AAI rule was developed by EPA primarily for the limited purpose of establishing one element of the statutory defenses to CERCLA liability that are available to current owners of a contaminated site. Purchasers of real estate assets who wish to assert one of these defenses will, among other requirements and continuing obligations, need to ensure that their pre-acquisition diligence fully complies with AAI. In the deal structures frequently used in private equity transactions (*e.g.*, stock acquisitions or mergers), however, the statutory CERCLA defenses are typically not available and, absent a contractual indemnity, the liability for existing contamination remains with the purchaser or surviving entity. While careful environmental diligence is still recommended in such cases, an AAI-compliant site assessment will not provide additional protection against statutory liability.

Regardless of its connection with CERCLA defenses, AAI will likely become the default standard for "Phase I" site assessments. Concurrent with the promulgation of

Strict adherence to AAI [or ASTM E1527] will not guarantee satisfactory diligence [for many transactions].

EPA's AAI rule, the prior standard for site assessments (the ASTM's Standard E1527-00) has been revised to incorporate the AAI requirements. Significantly, EPA has affirmatively acknowledged that the

revised ASTM standard (E1527-05) is consistent with AAI requirements. Thus, even before the effective date of EPA's AAI rule, a request for an ASTM-compliant site assessment will be a request for an AAI-compliant report.

As with the prior versions of ASTM E1527, strict adherence to AAI or ASTM E1527-05 will not guarantee satisfactory diligence for many transactions. The scope of both AAI and the new ASTM are limited to site contamination issues. Unless specifically added, an AAI assessment will not address regulatory compliance, off-site disposal liability, liabilities associated with prior properties, subsidiaries or operations, and a host of other site-specific environmental concerns, such as asbestos, mold, lead paint and wetlands. Whether or not to include these issues in the scope of the assessment should be addressed early in the diligence process and before engaging the consultant.

Equally important are aspects of the AAI assessment that a purchaser may want to omit in a particular transaction. For example, the AAI rule now requires that, in addition to interviews with current owners or occupants, the site assessment include interviews with past owners, operators or occupants to the extent necessary to obtain relevant information. Since the prior owner's or occupant's knowledge may not be apparent without the interview, the AAI rule could be interpreted to require the lengthy, difficult and costly process of identifying, locating and speaking with the prior owners or occupants. Depending upon the specific context, these additional interviews could cause problems, either by delaying completion of environmental diligence or, if the deal is confidential, by risking inadvertent disclosure of the purchaser's interest in the property.

Another concern is the AAI requirement that the consultant identify and comment in the site assessment report on the significance of any "data gaps" that affect their ability to identify environmental conditions. Where CERCLA defenses are being sought, this evaluation will be necessary but may also serve to highlight the limitations of the report and provide arguments that the defense should be denied because insufficient efforts were made to eliminate the data gaps. In other contexts, the data gap analysis may encourage speculation about potential concerns that might be eliminated by further investigation. Particularly if reports are shared with lenders or subsequent buyers, a data gap analysis that is overly speculative about potential issues and unknowns could negatively affect the parties' assessment of environmental risk and, accordingly, their economic evaluation of the deal. Purchasers who are not otherwise eligible for CERCLA's statutory defenses may prefer to exclude the data gap evaluation from their report.

Obviously, the impact of the AAI will depend upon how the standards are actually implemented in the transactional market. Some of the anticipated costs and difficulties associated with AAI compliance may never materialize. AAI, however, may not be appropriate or necessary for all deals. Parties will need to carefully define their diligence objectives for each transaction and develop a scope and format for the environmental assessment that reflects the needs of the individual deal. ■

Latham & Watkins has a leading Environment, Land Use and Resources practice. For more information on this article and related issues, please contact **David Langer** in our New York office at +1-212-906-1200 or any of the following individuals:

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Industry specialists in a number of fields will be providing articles in upcoming issues of *SmartCapital — US Edition*. For a list of other areas of Latham industry expertise, please refer to Page 16.

The Road to Exit — The Dual-Track Process

By Nick Cline

Nick Cline
Partner
Corporate Department

Auctions have become a common sight in the private equity and M&A landscape in recent years. M&A practice has changed to cater for the incidence of auctions and high level focussed financial and legal due diligence by prospective purchasers backed up (at least with respect to financial information) by vendor diligence packs have become more commonplace.

The incidence of initial public offerings (IPOs) along the road to exit has decreased in recent years. For a company with the right profile, however, an IPO still represents a real alternative to a private sale either on the full list, the Alternative Investment Market and/or an appropriate overseas exchange.

Whether you are a private equity sponsor or a group contemplating the sale of a subsidiary or division, it goes without saying that maximizing value is key. In addition, obtaining a clean exit on favorable terms will be a priority and, for the private equity sponsor, an absolute requirement. A well organized auction process directed at a limited number of appropriate potential purchasers can add value. So too can combining such a process with an IPO process (often referred to together as a 'dual-track' process) — and this is what increasing numbers of private equity sponsors and trade sellers have been doing.

An example of a dual-track process used to good effect was the recent sale of the Coral Eurobet Group. Charterhouse funds acquired Coral Eurobet in 2002 and, after three years of growth, the company commenced a process for an IPO on the full list of the London Stock Exchange. Concurrently with the IPO process, interest in a private acquisition of the group was received from several parties and so a limited sale process was set up while the IPO process continued. Ultimately, the group was sold to Gala Group Finance Limited (backed by Cinven, Candover and Permira) for £2.18bn. Latham acted for Charterhouse on the acquisition of the group in 2002 and also on the IPO and sale process which was completed in October of last year.

Another recent high profile exit structured via a dual-track process was the €7bn sale of Viterra AG to Terra Firma by E.ON AG. Latham acted for Viterra AG.

Potential upside for a seller in using a dual-track process include:

- increasing the chances that the exit will take place on the basis that it may be possible to complete on a private sale at a time when the timing is not ideal for an IPO;
- prospective purchasers in the sale process will be incentivized to bid higher than each other, but also to provide an attractive alternative to an IPO value. The seller will also be able to pursue an IPO exit, the process of which will be already up and running, if there is insufficient appetite from prospective purchasers at the target valuation;
- prospective purchasers will be encouraged to close their bid on a timeline dictated by the seller prior to any hard deadlines in the IPO process and on 'clean exit' terms that provide the seller with an attractive alternative to an IPO;
- the IPO data room can be used, with minimum additional work (depending upon the nature of the target business), as a sale process data room; and

Coral Eurobet

Representation of Charterhouse Capital Partners in the sale of Coral Eurobet to Gala Group Finance Ltd.

£2,180,000,000

Viterra AG

Representation of Viterra AG in a dual track procedure in which its 100% shareholder E.ON AG disposed of all its shares. A trade sale and IPO were prepared in parallel. In the end, Viterra AG was sold at a purchase price of €7 billion (including assumed debt) to Terra Firma.

€7,000,000,000

- it should be easier for the seller to demonstrate to its investors/ shareholders that the sale price was maximized both in choice of process and purchaser.

A well organized auction process directed at a limited number of appropriate potential purchasers can add value. So too can combining such a process with an IPO process (often referred to together as a 'dual-track' process) — and this is what increasing numbers of private equity sponsors and trade sellers have been doing.

Potential challenges for a seller using a dual-track process include:

- confidentiality of information disclosed in the sale process is absolutely crucial if the IPO process is not to be compromised. Similarly, prospective purchasers should be cognizant that if the IPO is completed they will likely be restricted from dealing in the company's securities by virtue of being in possession of inside information. Particular attention should be paid to putting in place and enforcing comprehensive confidentiality agreements with prospective purchasers. For these reasons, a limited auction/sale process to a select few prospective purchasers is well suited to a dual-track process;
- transaction costs will be higher for the seller running two processes;
- it will be necessary for management to buy-in to the dual-track process and to focus on both processes concurrently to avoid either process losing momentum. Availability of management will necessarily have to be well managed and co-ordinated; and
- although not strictly a 'challenge', not all companies will be well suited to an IPO, so a regular private sale/ auction process may be preferable in some cases.

The secret sauce to a successful exit, especially when is it is structured as a dual-track process, is to have a well managed process with clear staged objectives that management, bidders and advisors can buy-in to. With this in hand, there are clear benefits to a dual track-process, and it is likely that this is a form of exit process that will be seen more often, especially as secondary or tertiary buy-outs continue to be a real alternative to an IPO of large and high profile corporates. ■

Recent Deals

Amadeus S.A

Representation of BC Partners and Cinven in connection with the financing of the acquisition with Iberia, Air France and Lufthansa, of Amadeus S.A., a public Spanish company

2005

€4,000,000,000

iesy

Representation of BC Partners, with respect to the merger of TeleColumbus, their portfolio company, with iesy, a television cable operator and portfolio company of Apollo

2005

Not Public

InMedia

Representation of Carlyle Europe Venture Partners LP in the sale of Inmedia for £68.5 million to Macquarie Bank Limited

2005

£68,500,000

MediMedia

Representation of MediMedia in the acquisition by Reed Elsevier of MediMedia's European and US Netter professional and medical publishing businesses (MediMedia MAP)

2005

€270,000,000

Médi-Partenaires Group

Representation of Sagard in its acquisition, with others, of the Médi-Partenaires Group in its investment with other financial investors in connection with the acquisition of the Médi-Partenaires Group

2005

€320,000,000

ProSiebenSat.1 Media AG

Representation of Saban Capital Group, one of the partners of German Media Partners, in the sale of the majority of German Media Partners' shares of ProSiebenSat.1 Media AG to Axel Springer AG

2005

€2,470,000,000

Urbium PLC

Representation of the management team of Urbium PLC in the public to private by way of recommended cash offer by Lightflower Acquisition, a company backed by Electra European funds, for Urbium

2005

£113,000,000

World Minerals, Inc.

Representation of Imerys in the acquisition by Imerys of World Minerals, Inc., a US based producer of industrial materials, from Alleghany Corporation

2005

€208,000,000

New Office Opening

Latham & Watkins Opens New Office in Munich

Latham & Watkins is pleased to announce it has opened an office in Munich, adding capabilities in the economically dynamic and prosperous Bavarian region to the firm's full service practices in Frankfurt and Hamburg. Three new partners form the core team in Munich: **Dr. Jörg Kirchner**, **Claudia Heins** and **Stefan Suess**.

The firm's new Munich office will initially focus on private equity and mergers and acquisitions, tax and employment law advice and, supported by our strong practices in Frankfurt and Hamburg, will help us expand our participation in the robust German private equity market and will expand our M&A footprint in Germany, Europe and globally.

The New Team

Three new German partners joined Latham & Watkins on December 7, 2005: Dr. Jörg Kirchner, widely acknowledged as one of the leading private equity lawyers in Germany; Claudia Heins, an employment law specialist whose practice includes company restructurings and transactional employment law advice; and Stefan Suess, whose practice involves tax optimization of financial products and fund formation, as well as the tax aspects of private equity transactions. The three partners join from the Munich office of Ashurst and will form the core team in Munich.

- **Dr. Jörg Kirchner** holds a Dr. Jur from the University of Munich and an LLM from George Washington University; he is admitted to the German and New York bars.
- **Claudia Heins** received her legal education at the University of Hamburg and the University of Montpellier in France and was admitted to the German bar in 1991. She holds the qualification as a specialist in employment law.
- **Stefan Suess** received his legal education at the University of Regensburg and holds qualifications as a tax advisor and specialist tax law counsel. He was admitted to the German bar in 1997.

Jörg Kirchner, who has been appointed the managing partner of Latham's new Munich office, is a strong match for our strategic growth plans in Germany, while Claudia and Stefan are among the leaders in their respective fields. Building a strong M&A practice — both in regard to transactions within our domestic markets and on a cross-border basis — remains a principal strategic focus for Latham in Europe and globally. Private equity has proven a major growth driver toward realising that objective, and the addition of this team perfectly complements our successful private equity practice in Frankfurt and Hamburg.

. . . Latham's proven track record in the area of private equity and its strong entrepreneurial culture will support the growth of the new practice.

This development continues the successful growth we have achieved in both Hamburg and Frankfurt and more broadly in Europe. Our continued commitment to client service and to be among the best in each market in Europe and Latham's proven track record in the area of private equity and its strong entrepreneurial culture will support the growth of the new practice.

Munich as a Center for Private Equity

Munich, Germany's third largest city behind Berlin and Hamburg, has established itself as the private equity hub of Germany — the third largest market globally behind the US and UK — with more than 50 private equity and venture capital funds based there. It is home, moreover, to some of the largest German companies and is a center for German television and movie production, IT and telecommunications, and biotechnology, pharmaceutical and medical device companies. Latham's deep private equity and investment banking client base and its broad global presence, position it ideally to serve the increasingly complex needs of the private equity market. ■

Market/Event Updates

Market Update

There are a number of recent changes relevant to premerger notification under the Hart-Scott-Rodino Antitrust Improvements Act of 1976. Some of these changes may affect your transactions. In particular, notification thresholds have been adjusted as a result of an indexing rule that came into effect in 2000. Businesses active in the U.S. now have to file a premerger notification form and wait for the termination or expiration of a waiting period, if the acquirer will hold assets or voting securities valued at more than $226.8 million. Smaller transactions have to be notified only if the acquirer will hold assets or voting securities in excess of $56.7 million, and one of the parties has more than $113.4 million in annual sales or assets and the other party $11.3 million. The exemptions to the notification requirement remain unchanged, as do the filing fees of $45,000 for transactions valued at less than $113.4 million, $125,000 for transactions valued at $567 million or less, and $280,000 for transactions whose value exceeds $567 million. In addition to the most recent year's data, the premerger notification form now calls for 2002 sales data (as opposed to the previously applicable 1997 sales data).

If you have questions about these changes, any other technical changes or HSR filing requirements generally, please call Manfred Gabriel in our New York office at +1-212-906-1833.

Event Update

Latham & Watkins hosted a multi-city General Counsel Forum breakfast in February on “Critical Issues for the 2006 Proxy Season: Majority Voting and Executive Compensation Proposals, New SEC Rules and Best Practices.” As the 2006 proxy season is rapidly developing into one of the most critical and difficult in years, the forum addressed, and proposed best practice responses to, the host of challenges that activist institutional investors, ISS and the SEC have each contributed to create, including:

- a proliferation of binding majority voting by-law proposals to replace the historic standard of plurality voting across Corporate America that cannot be excluded from company proxy statements;
- the failure of modified plurality and director resignation policies (such as Pfizer and General Electric) to pre-empt majority vote proposals;
- a raft of shareholder proposals for mandatory changes in executive compensation policies and practices and increased disclosure of executive compensation “costs”;
- strong ISS support for majority voting proposals, extensive restrictions on executive compensation and extensive executive compensation disclosure requirements, coupled with explicit threats of withhold vote recommendations for specified non-compliance with ISS positions on executive compensation; and
- proposed extensive new SEC disclosure rules for executive compensation that are sure to influence executive compensation practices and disclosures for the 2006 proxy season, including a new and challenging template for mandatory compensation committee reports to shareholders and important interpretations regarding reporting of perquisites such as aircraft usage.

For more information on this and future Latham & Watkins seminars, please contact Wendy Moore at +1-212-906-1200.

Industry Focus

Latham is one of the few full-service law firms capable of delivering seamless representation at a global level with 1,800 attorneys in 22 offices around the world. Our attorneys work collaboratively across legal disciplines and geographic boundaries and specialize in a multitude of industries. For more information on our industry expertise, please contact Meloudy Sadat at +1-212-906-1200.

Antitrust / Competition

Communications / Telecom

Employee Benefits

Energy Regulatory

Entertainment / Media

Health Care and Life Sciences

Leveraged Finance

Outsourcing / IP

Project Finance

Real Estate

Tax

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