

Seller as partner: the cooperative LBO

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The market facing private equity firms and other LBO acquirers continues to be both active and expensive. Acquirers strive to gain a competitive advantage at the front end of the dealmaking process by avoiding auctions and generating proprietary deal flow, thereby increasing their prospects of achieving desired returns. Although buyers can still utilise industry expertise and relationships to identify potential acquisition targets and facilitate deals outside of an auction environment, another strategy for finding and winning the deal can turn on the structuring of the deal.

Specifically, one approach that we have seen successfully executed by private equity firms operating in the middle market is what we have termed the 'cooperative LBO'. In these transactions, our clients have either avoided auctions or differentiated themselves in the auction process by structuring deals as control transactions where the sellers retain significant post-closing financial and operational interests. Like a traditional LBO, the buyer finances the transaction through some level of equity investment, with the balance of the purchase price coming from third-party lenders in the form of both senior debt secured by the assets of the target and unsecured or second lien mezzanine financing. What distinguishes these deals from the normal LBO model is that the seller will retain a significant minority ownership position. In addition, the sellers will generally stay on with the company after the closing as chief executive officer or in another senior management position.

Circumstances conducive to the cooperative LBO

Clearly, circumstances need to be right to facilitate the cooperative LBO and not all transactions are conducive to this structure. As an initial matter, the deal hinges on the

presence of an entrepreneurial seller who has an interest in playing an active post-closing role and who the LBO buyer views as having the ability to take the company to the next level. The seller's continued role as chief executive or otherwise as a key manager of the company has the potential to lead to conflicts between the buyer and its new partner – and former seller – if the parties differ significantly with respect to strategic planning or management philosophy. In order for this operational power sharing to work most effectively, the buyer must have confidence in the management ability of the seller and a willingness to cede some of the operational control that an LBO buyer usually demands. The corollary point is that the seller must believe in the buyer's ability to facilitate the growth of the business, increase profitability and maximise return on final exit. In this structure, the seller is retaining an interest in what has previously been its own enterprise, but is also making an investment in the LBO buyer's abilities. This is where the buyer can most clearly distinguish itself from other potential acquirers and win the deal based on both its objective track record and other more subjective factors. As compared to the typical auction process where results turn on purely financial terms such as price or indemnification baskets and caps, winning the deal in these cases may be tied to more personal factors.

Benefits to the seller – immediate liquidity and risk mitigation with additional upside potential

As mentioned above, cooperative LBO transactions typically involve an entrepreneurial seller, who has played the central role in building the company and has a firm belief in its future success. Given the current state of the M&A market and valuation multiples available to sellers, many

entrepreneurs believe that they need to sell now to take advantage of these conditions. At the same time, they may not be ready to completely walk away from their companies, preferring to maintain some equity stake going forward. A cooperative LBO gives the seller an opportunity to cash in immediately on past achievement while retaining additional upside potential, providing three separate sources of liquidity. First, the seller achieves an immediate liquidity event in the initial sale transaction, allowing them to mitigate the risk of missing their chance to exit on the current market upswing. Second, as a continued owner, the seller participates in distributions of earnings during the period of their joint ownership with the LBO buyer. Finally, the seller participates in the ultimate exit and, if the LBO model succeeds, gets the same high-return benefits as the buyer relative to the amount of their at-risk equity investment.

Benefits to the buyer – increased leverage without additional equity plus solid management

From the standpoint of the LBO buyer, the continued financial investment and operational involvement of the seller offers several advantages. On the financial side, the seller's continued equity position reduces the required equity contribution of the buyer without reducing the buyer's ability to borrow the necessary funds to finance the acquisition. Operationally, the buyer is able to retain the key manager who built the company that the buyer found to be an attractive target. Moreover, because the seller/operator is already significantly invested in the company, the equity incentive typically reserved for the CEO is unnecessary, which makes more equity available for other key employees or to be retained by the buyer. ►►

Post-closing capital structure and governance issues

The capital and governance structure of the target company takes a different shape in these deals than in instances where the LBO buyer has 100 percent (or nearly 100 percent) post-closing ownership, with these points negotiated in the LLC Agreement or other charter documents of the go-forward

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company. The seller typically holds a *pari passu* equity security with the buyer in the post-closing capital structure of the target company, which enables the seller to share in any hurdle or PIK benefiting the LBO buyer and take an equivalent (pro rata) place in distribution waterfalls. Depending on the particular deal circumstances, sellers may obtain varying levels of minority shareholder/member rights as relates to their equity interests and governance matters. At the most basic level, minority owners can expect to have the right to participate in additional equity issuances, as well as tag-along rights to accompany the drag-along rights that any LBO buyer will demand. The seller can also expect to have board representation, with control retained by the buyer. In some cases, sellers are able to negotiate more significant protections, such as limitations on the issuance of additional equity to protect the seller against future dilution where they choose not to participate in an offering. Some sellers are also able to obtain consent rights with respect to additional indebtedness incurred by the company, particularly in cases where a portion of the purchase price takes the form of a promissory note from the company to the seller. In these two instances, the buyer will likely retain the ability to force an equity issuance or additional indebtedness if working capital or other needs require it. More generally, in most instances, the LBO buyer will have the ability to direct decision-making on key matters. However, the seller will likely have more robust rights than would be typical for management or other minority equity holders. And, in addition to any contractual rights, the relationship dynamics present in these deals encourage the parties to act cooperatively. Even if the buyer can force an action, there are significant incentives against doing so when the company's CEO holds the greatest operating expertise, as well as a material portion of the equity in the company.

Acquisition agreement points

Relationship dynamics also affect the negotiation of the acquisition agreement and related documents. In most of these deals,

buyers prefer to start the negotiation with a 'middle of the road' acquisition agreement, offering up certain points in the first draft that would usually be held back at the outset of the negotiation process. For example, they may include indemnification baskets and caps, as well as knowledge or materiality qualifiers with respect to representations and warranties, to an extent that would not be normal for a buyer's first draft. Given the post-closing relationship between buyer and seller, the buyer is unlikely to make an indemnity claim unless the matter is of such significance to warrant ending the cooperative relationship. The real and immediate benefits of building trust on the front end through a reasonable acquisition agreement outweigh the potential benefits of winning some of the finer points on agreement provisions. From a process standpoint, keeping the business principals above the fray and away from legal wrangling over the acquisition agreement can be particularly critical in these transactions. Given the importance of post-closing trust and cooperation, it is wise to shield the seller/operator from the normal 'what if' discussions regarding the buyer's rights and remedies if the target's products are defective or its financial statements are fraudulent.

Conclusion

As capital continues to flow to private equity funds and other LBO acquirers at unprecedented levels, the pressure to win the deals necessary to achieve promised returns is only increasing. Under the right circumstances, LBO buyers may be able to differentiate themselves from the market by giving sellers an option other than a complete sale. By offering a seller the opportunity to be a post-closing partner through the cooperative LBO structure, a buyer may increase its own chance of winning the deals necessary to satisfy the demands of its more traditional partners – its investors. ■

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