

# SmartCapital

European Edition—Current Legal Issues for Investors in European Businesses



Bryant Edwards

## Are Hybrid Bonds the Next Big Thing in Leveraged Finance?

By Bryant Edwards & Rudolf Haas

Hybrid securities, developed by banks and financial institutions to bolster their regulatory capital, have in the last two years become increasingly popular with seasoned European corporate issuers. In 2005, European companies issued more than €6 billion of hybrid bonds and bankers predict that the issuance by European companies of hybrid bonds could skyrocket in the next few years.



Rudolf Haas

Hybrid bonds offer many of the benefits of issuing equity at less than the cost of actual equity with no dilutive effect on outstanding share capital. IFRS allows European companies to treat hybrid bonds meeting certain characteristics as equity on their balance sheets, strengthening their leverage ratios. The rating agencies give hybrid bonds whole or partial equity credit, boosting the issuers' credit ratings. Yet most European companies are still able to treat hybrid bonds as debt for tax purposes, allowing them to deduct interest payments.

To date, most hybrid bonds have been issued by investment-grade European companies, such as the US\$1 billion

offering by Porsche in January 2006 and the €1.3 billion offering by Bayer AG in July 2005.

Because the interest payments on hybrid bonds can be deferred, in some cases indefinitely, and because the remedies available to hybrid bondholders in a distressed situation are extremely limited, hybrid bonds have been considered most appropriate for investment-grade corporate issuers with limited risk of default.

However, non-investment grade European issuers have successfully tapped the hybrid market in recent months. Casino Guichard, a French retailing group, issued €600 million of BB+-rated hybrid bonds in January

*Continued to Page 2*

## Inside This Issue

Are Hybrid Bonds the Next Big Thing  
in Leveraged Finance? . . . . . 1

Debt Push Down into Germany: An  
Introduction from a Tax Point of View . . . . 4

Country Updates . . . . . 6

Control and Consolidation . . . . . 7

Recent European Deals . . . . . 8

US Highlights:  
*What it Takes to Make a  
Consortium Work* . . . . . 9

*US Deal Highlights* . . . . . 11

Latham News . . . . . 12

2005, an issue pegged two notches below Casino's senior rating. TUI, a large German tourism and shipping company, issued €300 million of B+-rated hybrid bonds in December 2005. Both offerings were highly oversubscribed.

#### Using Hybrid Bonds in Leveraged Acquisitions

TUI used the proceeds of its issuance of hybrid bonds to help finance its €1.7 billion acquisition of CP Ships, a Canadian shipping company. Most recently, Lottomatica announced that it is planning to finance its €4 billion acquisition of Gtech, among other things, with a €750 million hybrid bond. The Lottomatica hybrid bonds will be the first use of hybrid bonds in a structured European leveraged acquisition.

they receive whole or partial equity treatment by the rating agencies, hybrid bonds may serve as a partial substitute for the equity that sponsors would otherwise be required to put in such an acquisition. Unlike holding company PIK bonds, which in general restrict any payment of dividends to the sponsors, hybrid bonds have no negative covenants or restrictions on the payment of dividends, allowing the sponsors to receive dividends and other restricted payments permitted by the other debt instruments. Moreover, because of the "soft" payment features of hybrid bonds, the lack of covenants and the inability of holders to declare a default other than in a liquidation, hybrid bonds would be "patient" capital, providing more time for the shareholders to complete a workout that preserves value for all

**Unlike holding company PIK bonds, which in general restrict any payment of dividends to the sponsors, hybrid bonds have no negative covenants or restrictions on the payment of dividends, allowing the sponsors to receive dividends and other restricted payments permitted by the other debt instruments.**

#### Will Hybrid Bonds Develop into a Serious Financing Option for Non-Investment Grade European Issuers Making Leveraged Acquisitions?

In recent years, the financing structures for European leveraged acquisitions have become more and more complex, with additional layers of debt utilised to appeal to additional new and different investor groups (such as hedge funds) and to drive leverage higher and higher. Where in the past European leveraged buyouts frequently consisted of two layers—senior bank debt and European mezzanine debt—acquisition debt today often uses three and sometimes four layers, often including first and second lien senior secured debt, unsecured high yield senior subordinated debt and sometimes structurally subordinated holding company pay-in-kind (PIK) bonds or loans. If used in acquisition finance, hybrid bonds would constitute the most junior level of acquisition debt and would likely replace the holding company PIK debt in European leveraged acquisitions.

For sponsors and other leveraged buyers, hybrid bonds have significant advantages over holding company PIK debt as acquisition financing. Because

investors, particularly the equity. In contrast, holding company PIK bonds have covenants, cross-payment defaults and cross-acceleration rights which would give holders of such PIK instruments more leverage to "get to the table" in a restructuring and more ability to put pressure on the equity.

#### Will Institutional Investors Buy Non-Investment Grade Hybrids?

Yield-hungry investors have been lured by the high interest rates paid on hybrid bonds issued by non-investment grade issuers. For instance, the TUI hybrid bonds paid an initial fixed rate of 8.625 percent—350 basis points over the 5.125 percent interest rate offered on the TUI senior notes that were sold in a simultaneous offering. But 350 basis points is low compared to the 450 to 600 basis point premium (over the next layer of debt) that sponsors had to pay hedge funds and other institutional investors for buying holding company PIK notes in recent leveraged European acquisitions.

That pricing disparity raises the question whether investors in European hybrid bonds are being adequately compensated for the additional risk associated with holding a security with extremely

limited remedies. Many institutional investors have stayed clear of this market and have urged caution, worried about the limited rights that hybrid bonds provide investors.

Institutional investors have focused on the following features of hybrid bonds:

**No Maturity Date.** Most hybrid bonds are perpetual bonds with no maturity date. Most convert to floating rate pricing with an interest rate step-up of up to 100 basis points after eight or 10 years, which together with a right at such time to redeem the hybrid bonds with the proceeds of an equity or pari passu offering, provides the issuer with an incentive to refinance the hybrid bonds at such time.

**Deferral of Interest Payments.** Most hybrid bonds provide that interest payments may be deferred by the issuer for up to 10 years, or even indefinitely in some cases, so long as it does not pay dividends to, or does not redeem or repurchase, any security that is pari passu or junior to the hybrid bonds, including its share capital. Unlike typical preferred share capital, hybrid bondholders get no board representation or any other remedy upon such a deferral. Importantly, interest does not accrue on such deferred payments, so there is an economic benefit to the issuer in deferring such payments.

**No Covenants and Limited Events of Default.** Hybrid bonds have no covenants, so holders have no remedies for corporate actions that would constitute events of default under traditional corporate debt instruments. In addition, hybrid bonds have no payment defaults, no cross-defaults or cross-acceleration defaults. The only event in which hybrid bondholders can declare the bonds due and payable is a liquidation or dissolution of the issuer.

**Deep Subordination.** The principal of hybrid bonds is typically fully subordinated to all other debt of the issuer, including debt to trade vendors. Moreover, in most instances, deferred interest on hybrid bonds does not represent a debt claim in an insolvency. Instead, deferred interest would be treated as an equity interest and hybrid bondholders would only recover deferred interest to the extent that shareholders receive value in an insolvency.

This limited package of rights and remedies will certainly raise red flags for institutional investors contemplating an investment in hybrid bonds, particularly those used as a junior level of debt capital for leveraged acquisitions.

**Since hybrid bondholders can only declare the bonds due and payable upon a liquidation or dissolution, which is unlikely ever to occur in such a restructuring, they have few cards to play in a negotiated restructuring.**

Since most European restructurings are accomplished through out-of-court settlements or through schemes of arrangements, it is important that lenders and investors have the rights and remedies that will get them “to the table” in workout negotiations. In some aspects, however, hybrid bondholders will have less ability to get to the negotiating than even preferred or ordinary shareholders. In an out-of-court restructuring in which debt is being exchanged for equity, for instance, it is likely that the issuer will have to get approval from the shareholders for a share capital increase, giving the shareholders leverage in negotiating a recovery. Since hybrid bondholders can only declare the bonds due and payable upon a liquidation or dissolution, which is unlikely ever to occur in such a restructuring, they have few cards to play in a negotiated restructuring.

### Conclusion

While we believe that hybrid bonds offer significant benefits for European corporate issuers and for sponsors in leveraged acquisitions, we predict that institutional investors for non-investment grade paper will continue to be troubled by the lack of rights and remedies inherent in hybrid bonds and that they will not be significant buyers unless hybrid bonds are priced to take such limitations appropriately into account. ■



Stefan Süß

## Debt Push Down into Germany: An Introduction from a Tax Point of View

By Stefan Süß

The structuring of private equity deals in Germany has tended to follow trends. The tax exempt step-up models of the late nineties and the multi-layer partnership models of the early 2000s are gone — but the debt push-down element has remained and is growing in importance due to the increasing use of debt financing in private equity transactions. This article provides an overview of the current tax environment for debt push-downs into Germany.

### The Basic Idea

In private equity transactions, the initial purchase price paid for the acquired business is frequently debt financed. Regardless of whether the debt capital is provided by the private equity funds sponsoring the transaction or by banks as third party lenders, the tax structuring will always be focused on offsetting operational income from the targeted business against interest expenses incurred in relation to the acquisition. In a pure German domestic environment, the structural answer is simple: the acquiring German HoldCo enters into a fiscal consolidation with the German TargetCo. German fiscal consolidation rules allow for an unlimited offsetting of the interest expenses at German HoldCo level against operational income at the level of German TargetCo.

German tax laws do not allow for fiscal consolidations with non-German entities. Therefore, as many private equity transactions are targeting pan-European or global businesses with local operating companies in many jurisdictions, an effective debt push-down requires more complex structuring.

### Country Holding Concepts

One common structure is the country holding concept (see Diagram 1), in which the sponsoring private equity funds establish several local holding companies, which are funded with equity by a European HoldCo (e.g. located in Luxembourg) and debt from both the sponsoring private equity funds and the banks providing the acquisition facility. The local holding companies purchase the respective local operating companies in their country. As soon as fiscal consolidations have been established in the respective jurisdictions, an offset of operating income against interest expense on a per country basis is possible.

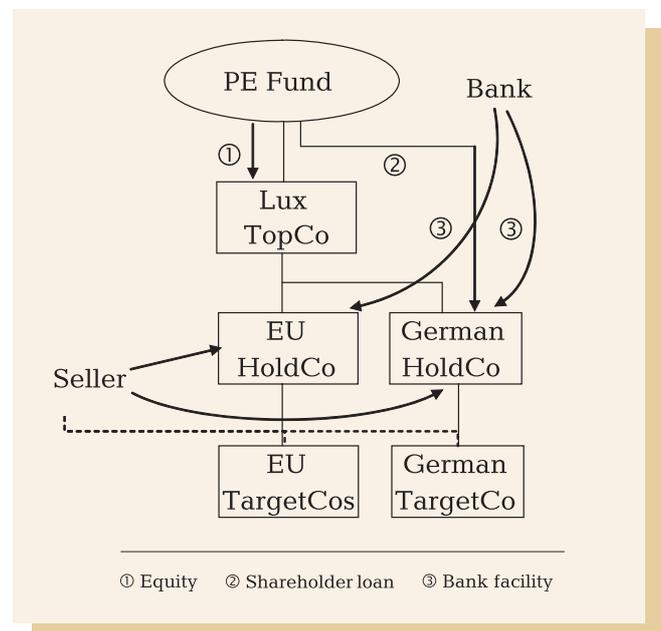


Diagram 1: Country Holding Concepts

Unfortunately, this rather simple solution to the debt push-down issue is not always possible. Sellers are frequently only prepared to sell the pan-European or global holding entity and not the individual local operating companies. In addition, the purchase price allocated to each local business (which is an essential part of the concept) may not, in practice, correlate to the available cash flow. The result may be an inefficient tax structure. Furthermore, local corporate and tax laws may impact the structure. The German thin cap rules, for example, are a key issue in each structure using the country holding company concept.

## Merger Concepts

Where the country holding company structure is not feasible other structures need to be considered. A “state of the art” alternative is the so-called merger concept (see Diagram 2).

In this structure some German operating companies are merged, post closing, into another German entity. The merger is performed at fair market values for accounting purposes, but at book values for tax purposes. The entity receiving the assets of the merged entities distributes the merger gain to its parent company. This distribution is not by way of a cash payment, but by way of assuming the parent company’s debt (or debt of another entity in the participation chain above). The merger concept may be ultimately viewed as a debt pull-down than a debt push-down. The assumption of debt by the operating company opens the door for an offset of interest expense against income.

The merger concept is surprisingly robust. Two court decisions made on similar structures support the analysis, that the accounting and tax treatment may follow different option rights. As with every tax structure, the merger concept also has its issues: withholding tax treatment, thin cap analysis and auditors views need to be harmonised. However, the idea behind it provides an effective way to start a debt push-down into Germany.

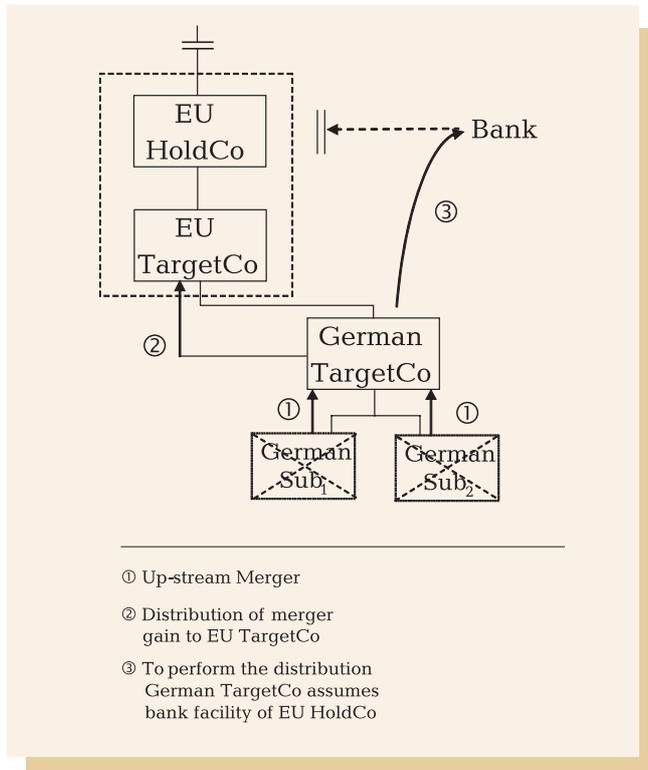


Diagram 2: Merger Concepts

## Fiscal Consolidation Concepts

Sometimes the effective structures are the simple ones. The newest fiscal consolidation concepts (see Diagram 3) are simple — but efficient.

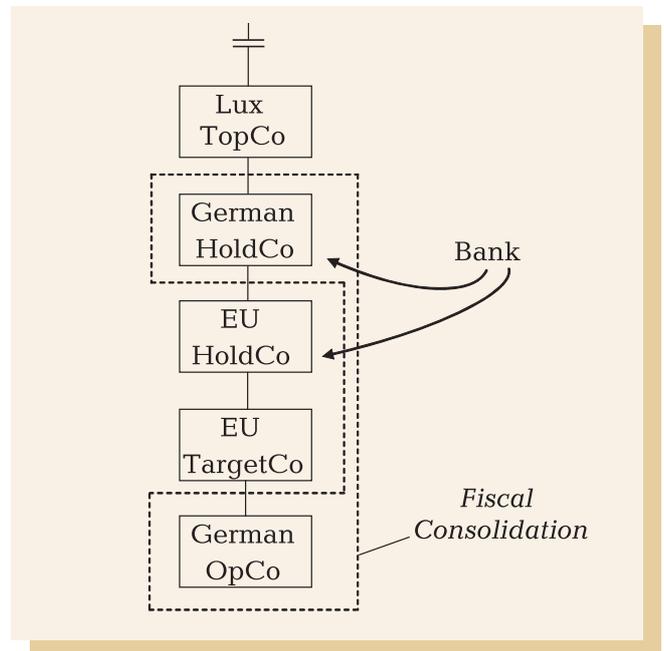


Diagram 3: Fiscal Consolidation Concepts

To accomplish this structure, the sponsoring private equity funds establish an upper or lower-tier German holding entity, which, after closing, will indirectly hold more than 50 percent of the targeted German business (detailed rules to determine the percentage are provided by the law). After having entered into a profit transfer agreement with the German target entities, the German holding entity may offset interest expense against the target companies’ profits. Detailed corporate law and tax law analysis on the level of each jurisdiction interposed between the German holding company and the German target entities is required. This concept has already been tested in respect of some jurisdictions — and can provide an alternative to more complicated structures. ■

## France

### Regulations Governing Foreign Investments in “Strategic” Business Sectors in France

On 30 December 2005, a decree was published defining the scope of Article L. 153-1 of the French Financial and Monetary Code under which certain foreign investments in France are subject to a prior authorisation from the Ministry of Economy. In practice, this decree is likely to result in stricter controls on foreign investments in France. Prior authorisation will now be required where: (1) the investment relates to a company in France that is involved (either wholly or partially) in a “strategic” business sector and (2) the investment results in the transfer of the controlling rights in such a company (or in a business line thereof) to a foreign investor. The decree applies these criteria differently depending on whether potential investors are EU or non-EU investors, the regime being less restrictive for EU investors. The decree defines the “strategic” business areas as five main sectors: gambling, private security, pharmaceutical and biotech, technology and information systems and national defense, including businesses involved with certain “dual-use” items and technologies. The Ministry of Economy must render its decision within two months of receipt of the corresponding application file and the authorisation may be with or without conditions.

### A Bill Introducing the EU Directive on Takeover Bids in France

A bill was passed on 23 March 2006 to incorporate the EU Directive on takeover bids into French law. In order to increase the attractiveness of the Paris financial market, it requires that any defensive action must be pre-approved by the shareholders of the target company. It also gives French companies the option to incorporate provisions into their by-laws that neutralise, during the offer period, certain restrictions on voting rights or on securities transfers. However, in order for French companies to use suitable defensive actions against hostile bids, the bill allows the target company not to apply the provisions referred to above where the bidder is not bound by similar provisions.

The bill further provides that a majority of shareholders of the target company may authorise the free allocation to existing shareholders during the offer period of warrants that give the right to subscribe shares at preferential conditions. Finally, the bill requires that, in mandatory bids, the offer price be at least equal to the highest price paid by the bidder for the same securities in the preceding 12 month period and confirms the current threshold of 95 percent required for a squeeze out.

## United Kingdom

### The Company Law Reform Bill

The Company Law Reform Bill is expected to be passed in the summer of 2006 with most provisions becoming effective in April 2007. The Bill represents a substantive overhaul of many aspects of current company law. We will be covering the impact of this legislation in more detail once it is in more final form, however, some of the provisions are already clearly relevant to private equity and venture capital investors including the abolition of the rules prohibiting financial assistance by private companies, the abolition of authorised share capital, a relaxation of the rules regarding reductions of capital and the codification of directors’ duties.

### Increases in Merger Fees

From 6 April 2006 fees levied under the UK merger regime will triple and the scope of transactions potentially liable to pay fees increase.

Fees are potentially payable on any merger that qualifies for a reference to the Competition Commission irrespective of whether any reference is made. Fees are payable when a statutory merger notice is filed; or in the case of non-statutory merger filings or where no filing is made, when a OFT publishes a decision making a reference or clearing a merger.

Mergers where neither the buyer or target is resident in the UK have been exempt. This will change. Thus mergers where the sales of the parties trigger UK jurisdiction will qualify for the fee.

Merger fees will increase as follows:

Where the UK turnover in the last financial year of the target is:

- £20 million or less, the fee will increase from £5,000 to £15,000;
- between £20 million and £70 million, the fee will increase from £10,000 to £30,000; or
- more than £70 million, the fee will increase from £15,000 to £45,000.

A further increase with effect from 6 April 2009 which will see the fees in each of the bands double to £30,000, £60,000 and £90,000 respectively has also been announced.

When these increases are taken with the sizeable increases introduced in Italy for filing fees and increases in other European Member States, as well, too there is clearly the potential for sizeable additional costs for buyers. ■



Will Seivewright

## Control and Consolidation

By Will Seivewright

When acquiring a stake in an entity with the intention of consolidating its revenues with your own, the deal that can be struck with the remaining shareholders should be carefully considered. Whether you are reporting under US GAAP, UK GAAP or IFRS, giving veto rights to minority shareholders, especially in relation to the day to day running of the company, may prevent consolidation.

Specific accounting advice will always be necessary to ensure consolidation is possible, especially as this is an area where all accounting regimes are currently undergoing change. The International Accounting Standard Board in the UK (IASB) has almost completed its project to produce a single IFRS on consolidation to replace IAS 27 and is also looking to converge this with US GAAP. UK GAAP and IFRS are now largely the same in this area. Whether US GAAP will now move towards this position is still unclear. The IASB and the Financial Accounting Standard Board in the US (FASB) have agreed to collaborate on several significant issues, including consolidation. The likelihood, and the SEC's preference, is that they will move towards the IFRS model but there is an acceptance that neither consolidation model is perfect.

To determine consolidation, IFRS focuses on the concept of power to control an entity. US GAAP is traditionally based upon voting control although recent guidance has broadened this scope to include a 'risks and rewards' model such that where a parent does not control the voting but nonetheless absorbs the majority of the expected losses or returns, then consolidation can occur.

IAS 27's definition of a subsidiary is "an entity, including an unincorporated entity such as a partnership, that is controlled by another entity (known as the parent)." Control is defined as the power to govern the financial and operating policies of an entity so to obtain benefits from its activities. When assessing control under IFRS, the existence and effect of potential and current voting rights (including on those that will arise on conversion) should be considered. This differs from the UK GAAP position which would not include options until they are exercised. US GAAP simply applies a presumption

of control by the investor with a majority of the voting rights.

The IASB is due to report in the fourth quarter of 2006 with their replacement for IAS 27, however, it has published its views on consolidation ahead of this report. The FASB has not yet given any input into this process although it is monitoring the project closely. The IASB based its views on the following key principles:

- a parent and its subsidiary should report as though they are a single economic entity;
- whether or not an entity is a subsidiary should be based upon the notion of control which means: (i) access to economic benefits and (ii) associated exposure to risks;
- only one entity can control another entity, *i.e.* control cannot be shared;
- consolidation cannot be avoided because a parent's operations or measurement models differ to that of the subsidiary; and
- a single IFRS should apply to all entities, specifically including special purpose vehicles.

The IASB's preliminary view is that control of an entity is the ability to direct the strategic financing and operating policies of an entity so as to access benefits flowing from the entity and increase, maintain or protect the amount of those benefits, *i.e.* three separate criteria. This is in contrast with the position under US GAAP which states that consolidation is appropriate when one entity has a controlling financial interest in another, the usual condition for which is ownership of a majority voting interest.

The IASB considers that veto rights, even if limited to the ability to block actions, may negate control if those rights relate to operating and financing policies. To negate control, those veto rights must also relate to decisions in the ordinary course of business,

**To determine consolidation, IFRS focuses on the concept of power to control an entity. US GAAP is traditionally based upon voting control . . .**

rather than being limited to fundamental changes in the organisation (such as disposals of business units or acquisitions of significant assets). This would be consistent with US GAAP which states that consolidation may not be possible for a majority shareholder where a minority has a 'substantive participating right'. This would include a veto over ordinary course decisions such as selecting, terminating or setting the compensation of management or operating and capital decisions such as budgets. Rights that would not negate consolidation ('protective rights') would include such things as amendments to the articles of incorporation, related party transactions, liquidation or significant acquisitions and disposals.

The IASB has gone further to point out tentatively that, in some circumstances, veto rights may be sufficient to enable minority shareholders to exercise control, for example, if the balance of holdings is dispersed and the other shareholders have not

organised their interests in such a way that they exercise more votes than the minority holder. This is sometimes referred to as 'de facto control'.

The fact that control of an entity might be temporary does not of itself change the assets that are controlled by that entity. During the time that control is held, the controlled assets are part of the economic entity and should be recognised as such. This is the same under all regimes. Consider, for example, if under US GAAP a minority was given veto rights only during an earn-out period which constituted substantive participating rights: the holder of the majority interest could be prevented from consolidating during the earn-out period, but not thereafter.

In practice, the decision to consolidate is based on numerous factors which can lead to the same result under US GAAP, UK GAAP and IFRS. It is clear, however, that this is an evolving area on which specific advice should be taken in order to ensure consolidation is achieved. ■

## Recent European Deals

**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 recent European deals.**

### Materis Group

Representation of Wendel Investissement in the LBO acquisition of Materis Group, one of the global leading building materials supplier.

**€2,000,000,000**

### Alain Afflelou

Representation of Bridgepoint Capital in its acquisition of Alain Afflelou, the French listed opticians chain, from Alain Afflelou and Apax Partners.

**€500,000,000**

### Group Souriau

Representation of investment fund, Sagard, on its acquisition of Group Souriau, Europe's leading connector manufacturer, from Axa Private Equity in an MBO transaction.

**€220,000,000**

### Rhodium GmbH

Representation of NORD Holding Unternehmensbeteiligungsgesellschaft, Hannover in the management buy-out, with Bayerische Beteiligungsgesellschaft and the management, of Rhodium GmbH, a leading worldwide wire mesh manufacturer.

**Not Public**

### Apollo-Redos Retail Fund

Representation of Apollo Real Estate Advisors and Redos Real Estate GmbH in establishing the ApolloRedos Retail Fund and in the structured loan financing of the fund by ABN AMRO.

**€300,000,000**

### Histoire d'Or

Representation of PPM Capital in its acquisition of Histoire d'Or, the French chain of jewel stores, from Apax partners in an MBO transaction.

**€230,000,000**

### Stankiewicz GmbH

Representation of the management of Stankiewicz GmbH in the sale of Stankiewicz to Dutch investor Gilde Buy-Out Fund by Continental AG.

**Not Public**

### Gardiner Groupe Europe

Representation of Electra Partners Europe in the sale of Gardiner Groupe Europe, a European security products distribution company, to Honeywell.

**Not Public**

### IMO Car Wash Group

Representation of The Carlyle Group in its acquisition of IMO Car Wash Group, the world's largest car wash company, from JPMorgan Partners.

**Not Public**

### Vivanco Gruppe AG

Representation of Deutsche Bank AG London in the acquisition of debts and proposed investment in Vivanco Gruppe AG.

**Not Public**



Eric J. Schwartzman

## 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 deals 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 participate competitively 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 US\$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 often to prohibit explicitly the formation of

consortiums without the seller's prior consent. Such a provision typically resides in the confidentiality agreement 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, 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 US\$7 billion. At the time, the Dex Media deal was the largest buyout since Kohlberg Kravis Roberts acquired RJR Nabisco in 1989.

According to a recent article by David Marcus writing for TheDeal.com of about 60 club deals involving US targets valued at US\$1 billion or more since 2001, 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 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 US\$4.8 billion in April 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

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

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 the point where it is able to walk away practically. 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-publicised 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

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

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 recognising, appreciating and working to make the most of differences. The institution of marriage 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 publicised, 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*.

# Highlights *US Deals*

**Classic Media, Inc.**

Representation of Spectrum Equity Investors in their acquisition of a controlling stake in Classic Media Inc.

2005

**Not Public**

**DENA Power Generation Assets**

Representation of LS Power Equity Partners in their acquisition of DENA Power Generation Assets from Duke Energy

Pending

**\$1,500,000,000**

**Serena Software, Inc.**

Representation of Silver Lake Partners in their acquisition of Serena Software, Inc.

Pending

**\$1,200,000,000**

**The Tire Rack, Inc.**

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

2005

**Not Public**

**VNU**

Representation of a consortium consisting of affiliated funds of AlInvest Partners N.V., The Blackstone Group L.P., The Carlyle Group, Hellman & Friedman LLC, Kohlberg Kravis Roberts & Co. L.P. and Thomas H. Lee Partners, in the public offer purchase of VNU. The deal must be approved by VNU shareholders.

Pending

**\$8,900,000,000**

**York Insurance Services Group**

Representation of Odyssey Investment Partners LLC in their acquisition of York Insurance Services Group

Pending

**Not Public**

## Latham News

### New Partner Hires

Latham & Watkins is pleased to announce that three new partners will join the London office:

- Graeme Sloan, a renowned practitioner in the UK private equity market, will join the firm's Corporate Department in London. He joins from Maclay Murray & Spens in Edinburgh and London where he has practiced for 15 years. Sloan joins Latham's strong private equity practice in Europe, with a team of 20 in London, 24 in Paris and 16 in Germany.
- Daniel Friel and Sean Finn, both tax partners, will join from Lovells expanding Latham's European Tax Department to 18 lawyers. Mr. Friel is a well regarded UK practitioner with a track record advising private equity and corporate clients on complex transactions spanning multiple jurisdictions. Prior to becoming a lawyer, Mr. Friel was a Chartered Accountant at Coopers &

Lybrand. He received his LLB from Reading University.

Mr. Finn is considered a rising star within the tax profession advising high profile corporate clients across a number of sectors and industries. Prior to joining Lovells in 1997, he was an associate in the tax department of Arthur Andersen. He received his law degree from Liverpool University and is a member of the Chartered Institute of Taxation.

### Deal Update: Latham & Watkins Advises Bayer AG in €16.3 billion "White Knight" Bid for Schering

Latham & Watkins is representing the German pharmaceuticals and chemicals company Bayer AG in its friendly tender offer for Schering AG. Bayer announced an €86.00 per share bid for Schering, valuing it at €16.3 billion. This friendly "white knight" bid has brought an end to the Merck/Schering hostile takeover battle. Schering is dual listed in Germany and the US. ■

#### Office locations:

**Brussels**  
**Chicago**  
**Frankfurt**  
**Hamburg**  
**Hong Kong**  
**London**  
**Los Angeles**  
**Milan**  
**Moscow**  
**Munich**  
**New Jersey**  
**New York**  
**Northern Virginia**  
**Orange County**  
**Paris**  
**San Diego**  
**San Francisco**  
**Shanghai**  
**Silicon Valley**  
**Singapore**  
**Tokyo**  
**Washington, D.C.**

[www.lw.com](http://www.lw.com)

Latham & Watkins operates as a limited liability partnership worldwide with an affiliate in the United Kingdom and Italy, where the practice is conducted through an affiliated multinational partnership. © Copyright 2006 Latham & Watkins. All Rights Reserved.

*SmartCapital — European Edition* is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the attorneys listed below or the attorney whom you normally consult. A complete list of our publications can be found on our Web site at [www.lw.com](http://www.lw.com).

If you wish to update your contact details or customise the information you receive from Latham & Watkins, please visit [www.lw.com/resource/globalcontacts](http://www.lw.com/resource/globalcontacts) to subscribe to our global client mailings program.

If you have any questions about this issue of *SmartCapital — European Edition*, please contact Charles Fuller in our London office at +44 20 7710 1000, or any of the attorneys listed below.

#### Brussels

Andreas Weitbrecht  
+32 (0)2 788 60 00

#### Chicago

Mark D. Gerstein  
Thomas E. Keim, Jr.  
Richard S. Meller  
+1-312-876-7700

#### Frankfurt

Claus Gerber  
Hans-Jürgen Lütt  
+49 69 60 62 60 00

#### Hamburg

Christian Edye  
Götz T. Wiese  
+49 40 41 40 30

#### Hong Kong

John A. Otoshi  
David T. Zhang  
+852-2522-7886

#### London

Bryant Edwards  
+44 20 7710 1000

#### Los Angeles

Jeffrey L. Kateman  
Scott P. Klein  
Paul D. Tosetti  
Alex W. Voxman  
+1-213-485-1234

#### Milan

Michael S. Immordino  
+39 02-3046-2000  
(also based in London)  
+44 20 7710 1000

#### Moscow

Anya Goldin  
+7-501-785-1234

#### Munich

Jörg Kirchner  
+49 89 20 80 3 8000

#### New Jersey

David J. McLean  
+1-973-639-1234

#### New York

R. Ronald Hopkinson  
Raymond Y. Lin  
Howard A. Sobel  
David S. Allinson  
+1-212-906-1200

#### Northern Virginia

Scott C. Herlihy  
+1-703-456-1000

#### Orange County

Charles K. Ruck  
+1-714-540-1235

#### Paris

Nicolas Bombrun  
Thomas Forschbach  
+33 (0)1 40 62 20 00

#### San Diego

Scott N. Wolfe  
+1-619-236-1234

#### San Francisco

Scott R. Haber  
+1-415-391-0600

#### Shanghai

Rowland Cheng  
+86 21 6101-6000

#### Silicon Valley

Peter Kerman  
Anthony J. Richmond  
+1-650-328-4600

#### Singapore

Mark A. Nelson  
+65-6536-1161

#### Tokyo

Satoshi Karashima  
Michael J. Yoshii  
+81-3-6212-7800

#### Washington, D.C.

Daniel T. Lennon  
William P. O'Neill  
+1-202-637-2200