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Private Equity and the Board of Directors

The wave of private equity deals has refocused attention on the role of the board of directors. There has now been sufficient experience and adaptation to identify some of the key issues for directors who — as in other takeover contexts — act as gatekeepers on the fundamental question of whether, and under what circumstances, a proposal for the sale of the company should be put before the stockholders.

The board's role in the private equity context is essentially no different than in all takeover circumstances. The board oversees the consideration and, if desired, implementation of a transaction in a manner that is appropriate in the context of the company's particular circumstances. There is never a legal imperative to pursue, or to shun, a private equity transaction. How to appropriately pursue a private equity transaction is a matter of art, not science. There are no per se rules. There is no single blueprint, either for all companies or for any company in all circumstances. Retaining flexibility and the ability to adapt quickly is essential. The informed exercise of judgment by the directors is inescapable.

Consideration of a private equity transaction does inject the possibility of senior management conflict of interest, given the prospect of management retention and participation in the equity of the new company. The omnipresent possibility of that type of conflict is undeniable, and should be recognized by the board at all points, including in managing any sale process. That specter, however, does not invariably warrant exclusion of senior management from some or all parts of the process. The key is for the board to be cognizant of the conflict possibility and vigilant in managing it, while seeking to assure that the process is reasonably calculated to achieve the most valuable transaction for stockholders — including as to the selection of potential bidders, conduct of due diligence and dealing with the ultimate bidders. There is no automatic need to create a special committee of directors, or to layer on separate newly-retained advisors (legal or financial) simply because a private equity deal looms as a possibility. The range of appropriate structures through which the directors may act remains a subject of judgment, and should be considered with the advice of the company's outside counsel. It may be sufficient for senior managers, including management directors, to recuse themselves from parts of the board's deliberations and voting, without the need for any greater complexity of structure. All that is essential is for independent (non-management) directors to make the critical decisions if management may be conflicted.

By the same token, there is no warrant for any specially-enhanced judicial scrutiny of private equity deals or sales processes. The informed exercise of directorial judgment will be respected by the courts. As in all sensitive situations, it is important that the board's thinking and conduct be well documented (most importantly, by meeting minutes that are drafted and approved in a timely manner) so that there is a clear record of the steps taken by the board, and the board's reasoning and knowledge basis.

The particular issues that typically arise can be addressed thematically, against the backdrop that the process should be at all points board-centric with the overall goal being a process reasonably designed to achieve the most advantageous transaction if one is desired (including, of course, both price and certainty); and with the understanding that there can be no advance prescription for all situations.

Initiation. The board of directors is entitled to determine if, when, and under what circumstances a company should engage in a sales process. No company needs to be, or should be, run as if it were constantly up for sale. At the same time, it is not inherently unlawful or improper for a CEO or other members of senior management to explore the possibility of accessing the private equity market in order to determine if an attractive transaction might be devised that would be worthy of board consideration; indeed, it is to be expected, and advisable, for senior management (who are charged with maximizing stockholder value) to keep abreast of that marketplace and the prospects it might offer for the company. The key point is that the board should remain the gatekeeper, and management ought not take steps that would preclude the board's ability to fulfill that role. Of course, management should not present a board (or special committee) with a "deal" that commits the company to a course of action the board cannot reverse, or put the board under undue time pressure by management's having gotten ahead of the directors.

Given the possibility of confusion that discussions with possible private equity sponsors can create, boards of directors should provide clear guidance to senior management on the subject. What is most important is for the board to consider what policy it believes is best, and communicate it clearly to management.

Advisors. If a transaction is to be considered, there is a range of appropriate decisions to be made concerning the retention of advisors, legal and financial, to assist the board. The company's pre-existing advisors should not be automatically disqualified. Those advisors may be extremely knowledgeable and best-equipped for the role. In some cases, their relationship with senior management may nonetheless counsel toward retention by the board of different, or additional, advisors. The choice is one for the board to make, and should not be co-opted by management's prior selection of the company's advisors to represent the executives. The possibility of post-hoc criticism is possible in any course — either that the board received "tainted" advice, or that the board allowed itself to be "decapitated" by usurpation of its advisors to serve management — and should not deter the board from doing what makes sense. It is almost never necessary or appropriate for the board to insist that all advisors with prior relationships with the company be disqualified entirely for any role in the transaction.

Typically, the most compelling reason in favor of utilizing a special committee is logistical rather than legal. Sale processes involving private equity are often lengthy and complex, and a special committee of three or more directors may function more efficiently than the full board (or the full board with the CEO recused). The formation of a special committee for this reason does *not* imply that the normal legal rules or judicial scrutiny for special committee conduct, developed in the context of a squeeze-out proposal by a control shareholder, should apply, simply because something called a "special committee" has been created. To avoid confusion arising out of the case law, especially given the possibility of litigation outside of the Delaware Court of Chancery, such committees should be called "transaction" or "independent director" committees, or some such term.

Even if a special committee structure is being utilized, the terms of the financial advisor's retention should be subject to approval by the full board, since the company may incur significant expense whether or not a deal eventuates. Despite the criticism directed towards contingent banker fees in one recent Delaware opinion (contrasted with the acceptance of such fee structures in other opinions), most prominent financial advisors are unwilling to accept engagements for flat fees — except extremely large ones — and boards are sensibly reluctant to agree to such large flat fees where the likelihood of an eventual transaction is unknowable. Whether the banker's fee has a significant contingent component is a matter of judgment for the board. Obviously, a board may be reluctant to obligate itself to a large fee if the likelihood of a transaction is not high. A board should be able to take into account the possible effect of a contingency fee in directing, monitoring and evaluating the banker's work, advice and opinions.

<u>Clubbing</u>. It is a fact of life that a substantial percentage of large private equity deals are done by clubs of sponsors. Most clubbing is driven by a desire to share risk, and ought not reduce the prospect of competition substantially given the number and size of sponsors. If a private equity market canvass is being pursued, thought should nonetheless be given to requiring the company's prior consent to club arrangements. Of course, whether the company will have sufficient leverage to impose a no-club condition, or whether such a condition is even economically desirable, depends on a host of company-specific circumstances. The issue should be considered, and the board should receive advice on what set of limitations is most advantageous and achievable.

<u>Market checks and deal protections</u>. In pursuing a transaction, boards have considerable latitude in methodology, ranging from a full-blown public auction to the negotiation of a transaction with a single bidder subject to various forms of post-agreement market check. The choice of methodology should be made by the board with the advice of its financial and legal advisors. Although invariably subject to stockholder-plaintiff challenge, the choice selected should be respected by the courts if it can be demonstrated that the directors carefully considered the options and determined that the path chosen was likely to yield the most advantageous transaction for the company and its stockholders in the circumstances faced. An important element of that analysis will be the decision whether to pursue a single prospective bidder, or only private equity sponsors or only strategic buyers, or a mix of the two.

The Delaware court's recent *Netsmart* opinion points up the need for a board's decision whether or not to limit a market canvass to private equity to be based on demonstrably sensible considerations, and does not mean that it is always required to include strategic buyers in the process if there is good reason not to do so (*e.g.*, bona fide concerns about employee retention, maintenance of confidentiality, absence of financially-able strategic buyers). Given the court's concerns that such issues could be pretexts, and the potential for management conflict, the board should be prepared to demonstrate the reason for whatever limitations and methodologies it chooses. The board should seek and receive expert advice on whether a post-agreement market check is likely to be effective, given the company's particular characteristics (size, analyst coverage, or attractiveness) and, critically, the eventual "deal protection" features it is able to negotiate for in the contract.

That closely-related subject of deal protections is one that the board should itself consider carefully. The urge to view such features as having been commoditized should be strongly resisted. As the Delaware Chancellor noted in the *Caremark* decision, it is a mistake to view deal protections as some "customary set of devices" or that there is some "naturally occurring rate of deal protection." Familiarity with these tools ought not mask their significance and the importance of even slight variations, or the need to consider them in context — both of the particular company, and in relation to each other. The *Caremark* opinion provided a helpful list of the factors a reviewing court focuses upon in assessing the "real world risks and prospects confronting [directors] when they agreed to the deal protections":

> the overall size of the termination fee, as well as its percentage value; the benefit to shareholders, including a premium (if any) that directors seek to protect; the absolute size of the transaction, as well as the relative size of the partners to the merger; the degree to which a counterparty found such protections to be crucial to the deal, bearing in mind differences in bargaining power; and the preclusive or coercive power of *all* deal protections included in a transaction, taken as a whole.

Recently, private equity deals have included both sell-side "fiduciary out" break-up fees as well as "reverse" break-up fees payable by the buy-side, *i.e.*, the amount the private equity firm must pay the seller if it fails to deliver the promised deal because of an inability to obtain financing or a required regulatory approval. This practice has impacted the level of break-up fees on both sides (the trend is toward equal amounts), as has the increasingly common use of a "go-shop" period containing a "stepped" break-up fee (a fee that is lower during the go-shop period than afterwards). While some skepticism has been expressed about the effectiveness of go-shops given a perception that private equity buyers may be reluctant to compete against signed-up deals, there is no empirical evidence supporting the view that go-shops are ineffective, and there is at least anecdotal evidence (Maytag, Catalina Marketing, EGL) that private equity firms *are* willing to top publicly announced deals.

<u>Due diligence</u>. In dealing with multiple prospective bidders, especially if some are financial and some strategic, it is important for the board to seek to minimize the risks of management spin. Even beyond informational parity, as the Delaware court noted in the *Netsmart* opinion, "'she's fine' can mean different things depending on how it is said." It is, therefore, advisable for the board's financial or legal advisor to participate in critical due diligence sessions with prospective buyers, along with management.

<u>Stapled financing</u>. Providing a financing option can facilitate a robust competitive bidding environment. The conflict possibility inherent in a financial advisor's providing stapled financing — dually, in the risk of favoring a transaction over none, and a financial buyer over a strategic — is a subject the board should consider carefully when asked to permit that role. It is likely that stapled financing (as well as the seller's banker providing other forms of financing to one or more bidders) will come under increasing scrutiny from the courts; in the *Toys 'R' Us* decision, the Delaware court pointedly noted that "it tends to raise eyebrows" if the investment banker provides financing, and declared it "advisable that investment banks representing sellers not create the appearance that they desire buy-side work, especially when it might be that they are more likely to be selected by some buyers for that lucrative role than by

others." That admonition is heightened when the fees on the buy-side dwarf those on the sell-side.

If stapled financing is offered, it is not always necessary to retain a second advisor to render an opinion on fairness; it is by no means clear that a board is better advised by a new advisor required to get up to speed quickly and in an environment in which a deal has already been reached. That is particularly the case if the prospective second advisor is less experienced or knowledgeable as to the particular industry or transaction marketplace. If a second banker is used, care should be taken to ensure that it has the time, resources and expertise to do a quality job. Moreover, the reality is that there may be no such thing as an entirely unconflicted major financial advisor. It may therefore simply be necessary to focus more on managing the possible conflict than a goal of eliminating conflict.

Innovative transactions. It is not necessary that private equity transactions be all cash. Transactions involving part cash and part debt and transactions involving the shareholders' having a stub-equity option are legal and feasible. They are subject to the same procedural and fairness considerations as all-cash deals.

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