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SPEED READING: TOP 10 ISSUES WITH CONSORTIUM BIDS

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Consortium bids are deals in which two or more unaffiliated entities either provide equity financing or divide the business being acquired. These transactions can range in size from the giant private equity club deals of 2006 and 2007 in which the target remained intact to much smaller deals in which a target is broken up and sold to multiple strategic buyers.

Consortium bids raise many complex legal, economic and strategic issues beyond those typically dealt with in M&A transactions. Consortium bidders and their advisors need to focus carefully on their role in the bidding process to avoid delays and mistakes that can cost them the deal. Sellers and their advisors need to focus carefully on the substantive and execution risks associated with having multiple buyers involved in a transaction. Many of these risks can be mitigated through advance planning. This article highlights 10 issues that frequently arise in connection with consortium bids.

This article is part of the "Speed Reading" series, in which the authors highlight practical tips and recurring issues in M&A transactions and corporate governance. They are: M&A Transactions and Antitrust Risk, 2012 Emerging Issues 6642; Special Committees in Going Private Transactions, 2012 Emerging Issues 6205; Foreign Corrupt Practices Act in M&A Transactions, 2012 Emerging Issues 6206; Designating Directors: Issues and Implications, 2011 Emerging Issues 5788; Charter and Bylaw Issues, 2010 Emerging Issues 5372; Top 10 Due Diligence Issues in M&A deals, 2010 Emerging Issues 5124; Issues in a Public Company Merger Agreement, 2010 Emerging Issues 4883.

1. Strategic Considerations for Sellers

Sellers need to consider whether permitting bidders to team together and form a consortium will ultimately result in a higher or lower price. On the one hand, allowing bidders who otherwise would not be likely to bid on a stand-alone basis to form a group should result in a more competitive bidding process and a higher price. On the other hand, consortium bids can also reduce the number of potential bidders by grouping bidders together, which in turn can make an auction less competitive. In fact, there have been governmental investigations and lawsuits over whether certain club deals were an illegal attempt to collude and drive down the prices of acquisitions.

Most sellers opt to prohibit "teaming" (also known as "cross-talk") as part of their standard form of confidentiality agreement, such that potential bidders must obtain the seller's permission before they can form a consortium. This gives the seller some time to evaluate the identities of the prospective consortium members to determine if they would otherwise have the financing capacity and/or investment mandate to do the deal on their own. Since most of the information likely to be relevant to this analysis is non-public, there is no substitute for good advice from a well-informed financial advisor familiar with the various bidders that may participate in the target's strategic process. Relevant factors may include the following: the extent to which the bidder historically has taken majority (as opposed to minority) stakes in investments; the bidder's existing exposure to the seller's industry; and the extent of the bidder's undrawn capital commitments or fund-raising efforts (in the case of a private equity bidder) or its balance sheet (in the case of a strategic bidder).

In deciding whether to permit "teaming" in leveraged transactions (depending on the state of the market), the seller needs to be armed with information about the percentage of equity banks will require the buyer to contribute in the deal (versus the amount of debt financing, including equity bridges, available). This information will allow the seller to assess which bidders have the funding to write the equity check on a stand-alone basis, versus which bidders are likely to need to team up with others. A good financial advisor may even proactively make recommendations about how the seller can promote teaming among unrelated bidders to address potential regulatory issues, financing gaps, operational needs and tax-structuring plans. Even if the seller is inclined to permit "teaming" in such a deal, however, the seller may want to impose restrictions on the bidders' ability to tie up debt-financing providers with formal or informal "exclusivity" commitments. The fear is that the consortium will monopolize commercial banking institutions and prevent other bidders from accessing debt financing.

Sellers also need to consider whether they will allow "losing" or "withdrawing" bidders to join a consortium with the winning bidder. Conveying a willingness to permit this up front may discourage bidders from putting their best foot forward in an auction process. A separate but related question is: Having allowed bidders to form a consortium, will the seller allow any of those bidders to then syndicate its equity commitment to third parties? Some private equity buyers like the ability to syndicate equity commitments to favored wealthy individual investors, management teams and limited partners. In principle, sellers should be indifferent to letting buyers grant syndication rights provided all of the original members of the consortium remain "on the hook" for their full equity checks. In practice, however, sellers usually need more control, and possibly even veto rights, over equity syndications. Among other things, sellers need to feel comfortable that the syndication does not increase the legal or regulatory complexity of the deal (such as by bringing in buyers who have additional regulatory issues, or by bringing in the management team in a manner that triggers Rule 13e-3 disclosure requirements). Even absent such legal and regulatory issues, syndication can magnify the complexity of transactions by introducing more parties into the governance equation and the closing date funds flow.

2. Strategic Considerations for Buyers

Fundamentally, bidders need to determine whether joining forces with other bidders in a consortium will enhance their bids (such as by providing needed financing or mitigating potential regulatory concerns), whether sharing both the upside and the downside of the investment is economically attractive to them and whether they feel they can work with the other bidders in the consortium.

Certainly joint bids can reduce the amount of equity that any one bidder has to contribute to a deal. Joint bids can also have a positive impact on the debt financing side in that strategic bidders in a consortium that plans to divide up the target post-acquisition may get separate, smaller loans from different banks (meaning that no single bank has to take on too great of an exposure). However, these factors have some down-side if the banks do not want to share the deal with other banks or the bidders do not want to share the upside of the investment with other bidders.

Joint bids can allow different bidders to pool their respective expertise and capabilities. For example, a bidder with substantial financial resources that does not have the requisite industry expertise to evaluate a potential investment may benefit from joining forces with a smaller co-bidder that already operates in the relevant industry. Likewise, a bidder with experience making unsolicited bids might be an attractive partner if the target is unwilling to consider a transaction initially, and in some circumstances having an offshore co-bidder might help to address tax planning issues in the transaction.

One consideration private equity bidders should bear in mind when deciding whether to join a consortium is the extent of overlaps between their own limited partner composition and the identity of the other consortium members' limited partners. If there are significant overlaps, the transaction could result in an unacceptable concentration of risk for limited partners who were otherwise seeking to diversify through their investments in different funds. In addition, those limited partners may feel they are bearing too high transaction costs by entering an investment indirectly through multiple bidders, all of whom will have expenses and will potentially assess management fees.

3. Governance Issues

Consortia holding a portfolio company over the long term (rather than splitting it up immediately after the initial acquisition) have a lot in common with joint ventures. Initially, they are easier to form than joint ventures in the sense that the bidders are usually just contributing cash and deal expertise, not assets, such that the only valuation work that needs to occur relates to the target's businesses. However, like joint ventures, consortia need governance rules to address how they will function going forward. Among other things, they need to set a dividend policy in advance and decide which consortium members will designate directors to the portfolio company's board and to what extent individual bidders will have the ability to veto decisions made at the portfolio company level. Most bidders insist on having the ability to veto any requirement for additional capital contributions in the future, and this is usually not controversial. The answer is less clear as relates to operational questions, such as capital expenditures policies, borrowing policies and executive compensation. From time to time, bidders may even have disparate interests. For example, non-U.S. bidders may have different tax sensitivities than U.S. bidders that lead them to take conflicting positions regarding the desirability of tax distributions (as opposed to reinvesting capital in the business).

Beyond veto rights, one especially complex governance issue consortium members need to address up front is how they will handle conflicts of interest and corporate opportunities in the future. Conflicts of interest can arise, for example, if one consortium member believes the consortium vehicle has suffered a harm as a result of actions by one of the other consortium members. In such cases, where the claim essentially is a derivative claim, it would not be fair for the allegedly misbehaving consortium member to be able to veto the commencement of proceedings against it. As for corporate opportunities, most private equity consortium members willingly agree that all members of the consortium are free to take any opportunities they wish provided the consortium vehicle itself did not bring those opportunities to their attention. The landscape is a little more complicated when the consortium consists of strategic parties who may compete with each other or the target company in the same industry. In such cases, not only may it be necessary for the consortium to design more nuanced corporate opportunity rules, but the consortium may also need more refined procedural rules around recusal from certain board and management discussions and protections of competitive information.

4. Admission and Exit Issues

As with a joint venture, the question of when and how a consortium can admit new members or allow existing members to exit is highly customized from deal to deal. Prior to signing a definitive transaction agreement, bidders usually retain the right to walk away at will. A casual exit in the pre-signing phase can damage a bidder's reputation but, absent unusual circumstances, usually would not result in any legal liability for the bidder. In contrast, once a definitive agreement is executed, bidders may find themselves bound to each other for the long term. If the seller has an interest in the identity of the consortium members (as would be the case if the seller had outstanding rights under a post-closing purchase price adjustment), the seller will likely prohibit any bidder from assigning its obligations to a third party without the seller's consent. Meanwhile, co-bidders usually resist finding themselves partners with unfamiliar third parties and accordingly also would like veto rights over any transfers of another bidder's interests. However, such veto rights give the remaining bidders tremendous hold-up value. As a way to find a middle ground, bidders often explore traditional joint venture-like structures such as rights of first offer, rights of first refusal, tag-along rights and drag-along rights. Private equity consortia arrangements usually also address to what extent bidders can initiate an IPO process for the target once the acquisition is complete. In certain leveraged transactions, of course, the consortium needs to be conscious that the target's credit agreements may have restrictions or triggers linked to the identity of the equity investors.

Since few bidders would be willing to commit up front to contribute additional capital to a portfolio company post-acquisition, the consortium members also need to agree what happens if the company should need additional funding. These discussions usually lead to provisions addressing potential dilutive issuances, preemptive rights, the ability to bring in new consortium members, the ability to issue convertible debt and related topics. Again, the "technologies" widely used for addressing these issues in consortia are similar to those used in traditional joint ventures.

5. Coordination of Pre-Signing Process for Sellers and Buyers

Coordinating a consortium bid process can raise numerous difficulties for both buyers and sellers. Some consortia are relatively sophisticated and efficient, such as in cases where they have made joint bids together in prior deals or have designated a single lead bidder with authority to make decisions on behalf of the entire consortium. This tends to be the case more often in private equity deals where the consortium may be led by a fund manager and include not just the fund, but also separate investments by otherwise passive limited partners of the fund. Other consortia, however, can be more unruly and difficult to manage. This especially tends to be the case in consortia comprised of strategic buyers with disparate operational interests in the target and with different visions of how to maximize synergies in the transaction.

There is no single roadmap for coordinating a consortium bid. Most importantly, consortium members must discuss their expectations for the bidding process at the outset. Consortium bidders frequently enter into a consortium/joint bidding agreement addressing key process considerations like the sharing of expenses and who has authority to make “go/no go” decisions. Since the foundation of any consortium bid is some degree of mutual trust and respect, however, most consortium agreements do not go into extensive detail about the parties’ bidding strategy or tolerance for risk in the underlying transaction. For example, in a case where a consortium is bidding for a public company and where a topping bid or match rights can come into play, all members of the consortium need to communicate their willingness (if any) to engage in future price bumps, but it would be highly unusual for them to agree in writing to a range of price increases lest the details become public through required disclosures, litigation discovery or leaks.

In addition to discussing and potentially documenting key terms of the intra-consortium member arrangements, a seller will usually insist on separately documenting each consortium member’s equity commitments such that the seller is in privity directly with each bidder. As a documentation matter, many large private equity consortia agree to use the same form of equity commitment letter for each bidder to ensure consistency of terms and equal treatment of all bidders. In contrast, in some smaller consortia, a seller could receive draft equity commitment letters based on different forms and containing radically different risk-allocation terms for each bidder, such as terms related to when the equity is at risk should the deal not close.

A seller also usually will insist that each member of a consortium sign a separate confidentiality agreement with the seller (or, at least, a joinder to an existing confidentiality agreement). Again, the purpose of having these stand-alone arrangements is so that the seller can enforce its rights directly against individual consortium members. Even with such confidentiality agreements in place, however, there remains a high risk of leaks in consortium deals because of the number of parties involved. This issue is exacerbated in leveraged deals where the consortium also has to involve multiple commercial banks to provide financing. If the seller is a public company, or is otherwise especially worried about leaks, the seller should have a frank discussion with the consortium about keeping its deal execution team narrow and focused so as to avoid a mushroom cloud of individuals crossing the wall and receiving confidential information about the transaction. The seller may also want to include some customized language in its confidentiality agreements to restrict disclosures to those who "need to know" the information and to prohibit the expansion of who constitutes a "representative" of a consortium bidder beyond individuals or advisory firms identified on a pre-approved list.

In deals where the seller has a particular concern about maintaining legal privilege (such as if the seller is sharing its analysis of litigation or compliance risks), the seller should also give some thought as to how best to preserve privilege. In addition to entering into joint defense agreements as needed, the seller may want to restrict access to privileged information to a very narrow, specific subset of the consortium's team. For example, the seller may ask the consortium to designate a single outside antitrust advisor to receive information about market shares and competitive overlaps analyses, with a restriction on the outside counsel sharing that information with individual consortium members without the seller's approval.

A key feature of coordinating a consortium bid in the pre-signing phase is allocating responsibility for due diligence. Sellers usually respond very negatively if they start to get multiple duplicative or conflicting diligence requests from different members of the same consortium or if "casts of thousands" show up for management presentations. Management teams may find this process "unmanageable" and get recalcitrant. Likewise, bidders get frustrated with their co-bidders when information shared with a single co-bidder is not promptly disseminated to the rest of the bidding group. Accordingly, consortia need to spend a little time up front coordinating the due diligence process, including designating which legal, accounting and other outside advisors will take the lead for different components of the process. Usually, even where a single member of a consortium takes the lead in performing a portion of the due diligence, a consortium or joint-bidding agreement will disclaim any liability on the part of individual bidders for other bidders' having relied on their work. In other words, bidders usually take a *caveat emptor* approach. This is another reason why the most successful consortia tend to be those where the bidders have worked together before and have a good understanding of each other's areas of relative expertise.

6. Role of Advisors; Expenses

The retention of advisors is an important subset of coordinating the process of a consortium bid. Consortium members need to determine to what extent they will share legal counsel, financial advisors and other specialists – not just for the diligence process described above but also for the delivery of advice taking into account their individual and unique requirements. Just as a seller is unlikely to be willing to tolerate receiving diligence requests from multiple members of a consortium, a seller is also unlikely to be willing to have to negotiate a purchase agreement with multiple bidders who are part of the same team. In practice, what usually seems to work best is for the consortium to retain and share the cost of "consortium counsel" and "consortium financial advisors" who interface with the seller, but for each bidder separately to retain and bear the costs of such other counsel and advisors as it requires for individualized advice. Individualized advice tends to be needed if a consortium member faces regulatory issues distinct from other members of the consortium, such as bank regulatory restrictions on exercising control over portfolio companies, unique antitrust overlaps or public disclosure requirements not shared by other consortium members. A bidder also might want to keep its individual counsel involved in a deal if there is a possibility that the consortium bid may not go forward, but the bidder might join a different consortium or proceed with a solo bid in the future.

Engagements letters for consortium advisors need to address whether the advisor is being retained by an acquisition vehicle (and, if so, the advisor should take a keen interest in how its fees will be funded) or by individual bidders. In either case, the engagement letter for an advisor expected to provide a due diligence report should address who from the bidding group will be entitled to receive and rely upon the diligence report. In addition, the consortium legal counsel's engagement letter should address what happens if conflicts, such as litigation, arise between members of the consortium in connection with the deal. Usually in such cases the consortium counsel is not entitled to represent any bidder in the conflict/litigation.

Even with a single set of "consortium advisors", consortium bids can require a slightly longer turn-around time to collect comments on drafts of the definitive deal documents (and sometimes negotiate them amongst the consortium members before involving the seller). Bidders and sellers alike should bear this in mind when imposing deadlines, designing exclusivity periods and planning deal announcement timelines.

Most bidders, whether or not part of a consortium, are usually loathe to put money into a bid that may or may not succeed. In the consortium context, however, the bidders need to address their responsibility for expenses up front with an expense reimbursement arrangement. For example, a joint bidding/consortium agreement could indicate that each bidder will bear transaction expenses in proportion to his or her equity commitment level, and that expenses in excess of specified amounts need to be approved by all or some of the other bidders. The same expense-sharing rules may continue to apply in the interim period between the signing and closing of a transaction, but a seller may insist that the bidder's equity commitments extend to reimbursement of expenses during that period even if the transaction is not closing.

While this article mainly discusses consortia in the bidding context, consortia can also be sellers as they exit a portfolio company. In such cases, the expenses issue is also very interesting, because the parties need to address whether the exiting consortium members' responsibilities for indemnities, termination fees or other expenses are joint and/or several and similar matters.

7. Disclosure Issues

If the target of a consortium bid is a public company, or if one of the bidders is a public company, consortium bids can raise interesting disclosure issues. For example, co-bidders are likely to be treated as a group for Section 13(d) of the Exchange Act purposes. Accordingly, if any of the bidders owns 5% or more of the target's shares, the bidders will then be subject to the Schedule 13D filing requirements, including the provisions requiring beneficial owners to disclose their intent and certain changes in their ownership positions. This disclosure regime can present a strategic challenge if the consortium wants to initiate an unsolicited bid. Likewise, if a consortium in a leveraged buy-out contemplates substantial equity roll overs by target management, the consortium may find itself subject to the Rule 13e-3 "going private transaction" disclosure regime.

Even setting aside the 13D and 13e-3 disclosure regimes, consortium bidders involved in public company acquisitions need to be aware that the target will likely have to disclose some background information about the transaction in a proxy statement. This disclosure could include a brief discussion of the target's rationale for allowing the bidders to form a consortium and, in the worst cases, can result in airing some dirty laundry about the target's view of the viability of various consortium member's ability to bid independently. More importantly, the target will discuss its interactions with members of the consortium, which highlights the importance of the consortium designating a lead bidder to manage communications with the target and ensure all consortium members stay "on message".

8. Additional Complexity of Regulatory Filings

Even setting aside the club deal big rigging litigation noted above in this article, consortium bids can be positives or negatives for deals from a regulatory perspective. Recent changes to the U.S. HSR filing requirements now require private equity funds to provide more information about their associated entities (*i.e.*, portfolio companies). At a minimum, it is possible that a consortium with multiple bidders will have more complex regulatory filings. In more dire circumstances, the addition of certain bidders to a consortium, if they compete with the target, can worsen the substantive antitrust analysis for a deal. In a more positive light, the pre-wired divestiture of certain assets to specified members of a consortium can actually provide a "fix-it-first" remedy that will make the deal more likely to get regulatory approvals. As with any joint venture, the regulators will be keen to ensure the consortium is not used as a vehicle for competitors to exchange competitively sensitive information for purposes of coordinating pricing, for example, and that the consortium governance arrangements do not give rise to prohibited interlocking directorships or similar positions.

The regulatory issues are not confined to antitrust issues. For example, in regulated industries, such as banking, members of a consortium may need the ability to take non-voting equity interests instead of voting equity interests in order to comply with regulatory requirements. These "work-arounds" can add complexity to the portfolio company's resulting capital structure, and the use of board observers (in lieu of directors) or passivity commitments can also impact the consortium member's relative governance rights. Bidders need to think through these issues at the outset of a deal to ensure they are aligned in how they will handle them.

9. Carve-Out Deal Issues

In transactions where the target is not going to continue as a single, unified entity with a group of consortium investors, but rather will be split up among different members of the consortium, the parties face all of the issues present in a spin-off or a carve-out in addition to all of the consortium-related issues described above in this article. The complexity may well be worth the trouble in situations in which the carve-out is part of a "fix-it-first" strategy for addressing antitrust risk, or results in the seller getting a higher aggregate price because "two halves are worth more than the whole" to the bidders. However, as always, these transactions require a lot of advance planning and foresight into potential issues.

The issues raised by these transactions can include the following: allocating responsibility for the tax costs associated with carving-up and extracting assets from the target; the potential need for entirely separate debt financing packages for each bidder; addressing whether the larger transaction with the seller will be conditioned on the successful completion of the carve-out; addressing what happens if one consortium member's part of the business suffers a "material adverse effect" but the rest of the parts of the business, and the target as a whole, are not deemed to have suffered a "material adverse effect"; determining how to divide up management and employees and their associated benefit plans and the potential added retention risks arising from splitting up management teams; determining, as an operational matter, how to split up shared assets and facilities and entering into shared services or supply agreements as needed; and addressing what happens should one member of the consortium fail to show up at the closing with its share of the purchase price but all of the other members of the consortium are ready and able to close.

10. <u>Coordination of Claims Against Sellers</u>

Once a consortium signs an acquisition agreement, the consortium may need to decide from time to time whether to pursue claims against the seller under the agreement. These claims could arise, for example, in a situation where the consortium believes the target has experienced a material adverse effect that caused the failure of a closing condition to be satisfied. The consortium needs to establish rules for deciding when and how to exercise its rights under a definitive acquisition agreement. Two key factors influencing this decision are how many members there are in the consortium and whether the consortium includes only financial buyers or strategic buyers.

In small consortia of two or three bidders, all key decisions tend to be consensus-based/unanimous. In contrast, in consortia comprised of five or six bidders (such as was sometimes the case in the big club deals at the height of the 2006–2007 LBO boom), the bidders sometimes agree to act by supermajority approval on all but a very short list of specified matters, like changes in the purchase price or decisions to terminate the purchase agreement.

If all of the bidders are financial buyers, their interests on questions of whether to pursue claims against the seller or third parties tend to be roughly aligned. This is not always the case with consortia comprised of strategic bidders. For example, in deciding whether to terminate an agreement due to the seller's breach of a covenant, a strategic bidder's views may vary depending on to what extent the breach impacts the businesses it plans to extract from the target. In such cases, bidders often agree on an implementation principle whereby whichever bidder is disproportionately affected by a particular issue gets to lead the decision of whether to pursue a claim against the seller for that issue. This is especially effective for post-closing indemnity claims with measurable damages, but not as effective with respect to "go/no-go" decisions about whether to close the transaction.

Conclusion

Consortium deals are by their very nature time consuming and resource intensive. They should not, however, be avoided in all cases, because consortium deals permit buyer to do deals they otherwise would not be able to do and can often create meaningful additional value for sellers. As is the case in so many M&A transactions, some of the issues associated with consortium deals can be mitigated through advance planning, careful process management and creative problem-solving.

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