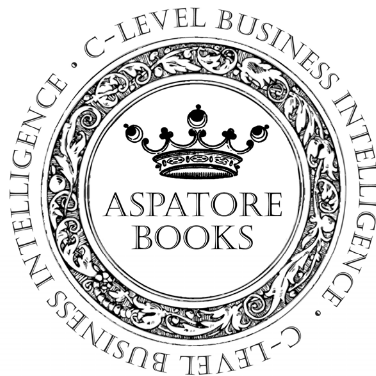
INSIDE THE MINDS

Private Equity and Venture Capital Deal Strategies

Leading Lawyers on Brokering, Negotiating, and Structuring Deals



BOOK & ARTICLE IDEA SUBMISSIONS

If you are a C-Level executive, senior lawyer, or venture capitalist interested in submitting a book or article idea to the Aspatore editorial board for review, please email AspatoreAuthors@thomson.com. Aspatore is especially looking for highly specific ideas that would have a direct financial impact on behalf of a reader. Completed publications can range from 2 to 2,000 pages. Include your book/article idea, biography, and any additional pertinent information.

WRITING & EDITORIAL ASSISTANCE

In select instances Aspatore will assist in helping our authors generate the content for their publication via phone interviews. Aspatore editors create interview questions that help generate the main content for the book or article. The content from the phone interviews is then transcribed and edited for review and enhancement by the author. If this method could be of assistance in helping you find the time to write an article or book, please email AspatoreEditorial@thomson.com for more information, along with your biography and your publication idea.

©2007 Thomson/Aspatore.
All rights reserved. Printed in the United States of America.

No part of this publication may be reproduced or distributed in any form or by any means, or stored in a database or retrieval system, except as permitted under Sections 107 or 108 of the U.S. Copyright Act, without prior written permission of the publisher. This book is printed on acid free paper.

Material in this book is for educational purposes only. This book is sold with the understanding that neither any of the authors or the publisher is engaged in rendering legal, accounting, investment, or any other professional service. Neither the publisher nor the authors assume any liability for any errors or omissions or for how this book or its contents are used or interpreted or for any consequences resulting directly or indirectly from the use of this book. For legal advice or any other, please consult your personal lawyer or the appropriate professional.

The views expressed by the individuals in this book (or the individuals on the cover) do not necessarily reflect the views shared by the companies they are employed by (or the companies mentioned in this book). The employment status and affiliations of authors with the companies referenced are subject to change.

Aspatore books may be purchased for educational, business, or sales promotional use. For information, please email AspatoreStore@thomson.com.

ISBN 978-1-59622-842-9 Library of Congress Control Number: 2007940265

For corrections, updates, comments or any other inquiries please email AspatoreEditorial@thomson.com.

First Printing, 2007
10 9 8 7 6 5 4 3 2 1

If you are interested in purchasing the book this chapter was originally included in, please visit www.Aspatore.com.

Being Cooperative Without Rolling Over

David S. Schaefer

Managing Partner, New York Office

Loeb & Loeb LLP

About Investors

Private equity (PE) and venture capital (VC) describe two different types of investors. From a business or investing point of view, they are worlds apart, but from the point of view of a deal attorney, the differences are more nuanced. It will be helpful to first understand the differences between the two types of investors before I discuss the role of the deal attorney.

PE firms generally acquire entire companies or businesses. Although the ostensible goal is to acquire and own 100 percent of the target, usually a portion of the equity is reserved for management as part of an equity incentive plan, like stock options or restricted stock. Sometimes the target's management or new management brought in by the PE firm co-invests in the target company with the PE firm. Occasionally, a PE firm will not acquire the entire company or business from the seller. In those situations, however, the PE firm will acquire at least a substantial majority, so the PE firm will have virtually complete control over the target company, and the seller will have some upside and some risk, by virtue of its minority interest (known as having "skin in the game").

On the other hand, VC firms most frequently make non-controlling investments in companies of less than 50 percent. However, venture capitalists will often control many major decisions regarding the business through special voting or approval rights contained in the company's organization documents, such as certificates of incorporation, bylaws for a corporation, or operating agreements for a limited liability company. In addition, most companies obtaining VC financing go through several or more rounds of financing. Therefore, venture capitalists who participate in the early rounds expect to have their percentage ownership reduced by virtue of the later rounds. So long as the investments in later rounds are based on greater valuations, the venture capitalist's investment is increasing in value. Most VC investments contain anti-dilution protection. Anti-dilution protection protects the value of the venture capitalist's investment, in whole or in part, against dilution in value if subsequent rounds of financing are made at valuations lower than the valuation at which the venture capitalist made its investment.

PE Investment Targets

PE and VC are also different with respect to the types of businesses in which they usually seek to invest, and in the stage of the business's development. As discussed below, these differences do have some bearing on the necessary skill sets for the deal attorney, but they do not change the deal attorney's primary function in the deal process. PE and VC investments are also typically very different with respect to deal size and terms.

PE firms will typically seek to invest in companies with substantial tangible assets, such as real estate, machinery, equipment, and finished goods inventory. The businesses these firms invest in have historically included low-tech manufacturers, distributors of goods, or service businesses, although increasingly companies with substantial intangible assets that can be valued and sold in the marketplace separate from the business are also being acquired, such as media companies. Most deals are for medium or large companies. However, the range is being stretched at both ends of the spectrum. For example, niche PE firms are increasingly looking at smaller businesses to acquire in the specific industry in which the PE firms chose to specialize, while large PE firms, which are now capable of raising billions of dollars, are (usually with one or more other large firms) acquiring companies with price tags in the $10 billion range.

PE firms also seek companies with substantial amounts of positive cash flow. Cash flow is significant, because PE firms almost always use substantial amounts of debt to finance their acquisitions, and therefore cash is needed to service the debt. Most PE deals have two levels of debt, usually referred to as "senior debt" and "mezzanine debt." Some deals will have three, four, or more levels of debt and occasionally two or more levels of equity. PE transactions are often called "leveraged buyouts" or "management buyouts."

Before a PE firm closes a deal, a post-closing business plan is developed by the PE firm, usually in conjunction with management. The plan is not the same for all companies (although some PE firms will only look to do deals that fit their playbook). A business plan can call for some financial engineering, creating new operating efficiencies, or getting into new markets

or products (sometimes by acquiring other companies). The plan will contain a timeline for accomplishing the plan, at which point the company will be sold or taken public. The financial press (and, more recently, the mainstream media) often suggests that PE firms quickly and easily find targets, buy them, and flip them for fantastic returns. It happens, but in truth, it is rare. The more common reality is that finding good deals takes a long time and involves looking at many deals that never get past the first or second cut. In addition, many deals may look good initially, but after long, thorough, and tedious work they fall apart, are taken off the market, or are won over by a competitor.

VC Investment Targets

VC firms will typically look to invest in early-stage companies with very high growth potential, and are usually less concerned with whether the target companies have tangible assets or positive cash flow, although revenue is usually important. VC firms rarely use debt to finance their investments, and generally, a target company must not have any indebtedness for borrowed money. VC firms are often associated with investments in software, hardware, Internet, new media, biotechnology, pharmaceuticals, medical devices, and other businesses with proprietary intellectual property or know-how. Relative to PE, VC is a higher-risk, higher-reward type of investing. Failures (investments that return less than the investment or that go bankrupt) are more common and perhaps more expected in VC investing than in PE investments.

The Role of the Management Team

Most early-stage companies have a management team (usually the founders plus experienced professional executives) that may be incomplete or require change. For example, not all founders make good executives. The management team will typically have a plan for which it is seeking VC funding. Most venture capitalists will say they invest at least as much in the management team as they do in the business and the business plan.

Most companies seeking VC financing are initially financed by the founders and their friends and family. For many companies, the initial or seed capital round of financing may also be provided by angel investors (that is, high net

worth investors who make investments in start-ups). Some angel investors are passive, while others will take some role in helping the start-up get to the point where it can attract VC investment. Typically, venture capitalists receive preferred stock when they invest in a company. The first issuance of preferred stock is designated Series A preferred stock. Thereafter, each subsequent round of financing will be for a new series of preferred stock, designated in sequence (i.e., Series B preferred stock, Series C preferred stock, and so on). The jargon in the industry is to refer to each round of financing by reference to the preferred stock designation (i.e., Series A round financing, Series B round financing, and so on). When the time is ripe, the company will either go public or be sold—perhaps to a PE firm.

The PE Lawyer's Part in the Investment Process

Despite all of these differences, the roles, skill sets, and knowledge base of a PE and VC lawyer are very similar. I have had, and continue to have, the pleasure of representing both PE and VC investors. For ease of reference, I am going to use "PE" to refer to both private equity and venture capital, although I will occasionally distinguish between the two.

The role a PE lawyer serves depends on the client and the circumstances. PE is a very competitive business, usually populated with very experienced professionals. Most PE firms will use the same law firms repeatedly. Therefore, a PE attorney and a PE firm usually work together on a regular basis.

The PE investment process is like a team sport, with each team member playing a specific role. For each deal, a new team is put together, its members drawn primarily from the PE firm and the PE firm's accounting and law firms. Depending on the resources of these firms, other team members will be brought in to serve specific roles, such as consultants to deal with certain regulatory, political, or industry issues; appraisers to deal with the valuation of the target or certain of its assets or local or special legal counsel if legal issues in foreign jurisdictions or specialized legal issues arise. In some cases, prospective managers are also on the deal team. A prospective manager will be involved when the PE firm knows existing management will need to be replaced or supplemented. Occasionally, a prospective chief executive officer or an entire senior management group will team up with a PE firm with a view of acquiring one or more companies.

The Structure of a PE Deal

The primary legal functions of a PE attorney are to provide advice on how to structure the deal, to conduct legal due diligence, and to prepare and negotiate legal documents. However, the PE attorney can also expect to be deeply involved in one or more of the following tasks: formulating the game plan by identifying the discrete tasks necessary to successfully complete the deal, identifying the team members responsible for each task, and establishing the timeline for when each task should be commenced and completed. The PE attorney usually gets involved once a potential deal gets through the initial screening process by the PE firm. This process consists of screening the candidates to determine which are worth making a preliminary valuation, and if the preliminary valuation is positive, to develop a range of valuations. Thereafter, most PE deals follow a similar pattern, as set forth below:

- **Preliminary due diligence:** This consists of reviewing the confidential information memorandum or business plan for the target, financial statements and projections, and fundamental due diligence documents such as organizational documents, agreements among stockholders, and documents that affect the target's capital structure.

- **Letter of intent:** If the preliminary due diligence leads to a deal, the next step is preparing and negotiating the letter of intent (sometimes referred to as a term sheet, memorandum of terms, or memorandum of understanding). The letter of intent sets forth the fundamental business terms of the deal and the conditions to closing, and it governs the conduct of the target and the seller during the time from signing the letter of intent to signing the definitive documents, or abandoning the deal.

- **Due diligence:** Following the execution of the letter of intent, a more intense level of due diligence commences. At this point, the deal team will complete the accounting, tax, legal operational due diligence, and for some targets, regulatory and political due diligence.

- **Regulatory clearances:** The regulatory approval process frequently begins prior to the execution of definitive documents, but in some cases, it does not begin until the definitive documents are executed and delivered. Regulatory clearances are not usually required in VC deals.

- **Financing:** The process of obtaining financing begins immediately following the execution of the letter of intent and sometimes beforehand, especially in a hot market when there is a lot of competition for deals and the lending market is robust. Financing is rarely a part of a VC deal.

- **Post-closing business plan:** Most PE firms have a definitive plan of the steps to be taken immediately following the closing. A fair amount of work usually goes into this process before closing, with the assistance of existing or new management. To the extent that management incentive compensation has not been structured and negotiated as part of the letter of intent, it becomes a central element of the work going into this plan. Management incentive compensation has many legal elements to it and requires the involvement of the deal attorney. The post-closing business plan is not usually a distinct element of a VC deal, as it is usually prepared by management in advance of seeking VC financing. That is not to say the VC firm and the target company will not work together both pre- and post-closing to modify and implement the target business plan, but they are qualitatively different, and the VC deal attorney is rarely involved.

- **Definitive documentation:** Preparing, negotiating, and executing the definitive documentation is what most people think of as the central role of the PE attorney. The documentation for a PE deal is very different from the documentation for a VC deal.

- **Closing:** This is the event where it all comes together—the funds change hands, and transactions are consummated. Many agreements contemplated at the signing of the letter of intent and the definitive documentation stages are executed at this point, such as financing documents, new employment agreements, and agreements among stockholders.

Key Elements of the Deal

Both the preliminary and final due diligence are key to the deal. The PE attorney participates in all the elements of due diligence (not just legal due diligence) and advises on the results and risks attendant thereto. To the extent that issues arise that were not contemplated in or were outside the scope of the initial screening, when the deal team was being put together, or in the preliminary due diligence, the PE attorney should be alert to suggest other experts to join the deal team. The main due diligence and the other legal matters, such as preparing and obtaining regulatory approvals and other consents, do not start until the deal is negotiated. Most deals are struck at the letter of intent stage.

At the letter of intent stage, the first issue is whether there should be a letter of intent. Sometimes there is an outline of material deal points and the parties go straight to negotiating the definitive documentation (subject to a confidentiality agreement). This is not uncommon in a deal where the target company is a public company. There are of course pros and cons, and the deal attorney will help sort them out with the PE firm. For example, some think letters of intent are a waste of time, money, and hurt the momentum of getting a deal done, while some think it is the best opportunity to make sure there is a real meeting of the minds on all material business issues and will result in less haggling and re-trading of deal points later. It is rare for there not to be a letter of intent for a VC deal. Except for the business terms and different nature of the type of deals, the letters of intent for PE deals are not very different from the letters of intent for VC deals.

Basic Business Terms of PE and VC Deals

The basic business terms of a PE deal (as opposed to a VC deal) are the deal structure (e.g., a purchase of stock, a purchase of assets), price, the nature of the consideration (e.g., cash, stock, a combination), when the price will be paid (e.g., are there contingent payments?), and indemnification issues (only in private company deals). Other provisions are whether there will be an exclusivity period (known as a "no shop") or a period when the target can seek a better deal (known as a "go shop"), the time to complete the deal, access to the target and its management, customers, suppliers, and advisers, payment of fees and expenses, and

closing conditions. The issue of closing conditions is usually a significant negotiation, especially for a public company.

The basic business terms for a VC deal are the pre-money valuation and how it is calculated, how much is being invested and over what period of time, the nature of the anti-dilution protection, the degree of control or veto rights the VC will have, and the number of seats on the board that will be controlled by the venture capitalist. Other issues usually revolve around restrictions on transfer, the right to sell shares with the insiders when insiders sell their shares (so-called "tag-along rights"), the right to cause the company to be sold, go public, or to buy back the venture capitalist's investment, and the right to participate in future rounds of financing.

The Role of the Attorney

After the letter of intent is signed, or if there is no letter of intent but a deal is struck, the due diligence and other functions typically kick into high gear. At this point, the roles that members of my firm and I will serve in any given deal depend on the depth and breadth of experience of the client's team members, how long we have worked with the client, the client's style in how involved the deal attorney should be, and how the deal process is being orchestrated.

To third parties, a lawyer in a PE deal should be the client's alter ego, and to the client the lawyer should be their conscience. No matter how many roles I am asked to serve, my primary role is to know the client's parameters or objectives, and to work to keep everyone focused on those parameters and objectives. A client's parameters and objectives can usually be reduced to two issues, namely what the client is willing to pay and how much risk the client is willing to take. This means the lawyer must know what the deal-killers are and protect the client from being personally liable.

Pricing Issues

On its face, the issue of price would seem to be self-explanatory and relatively outside the scope of the deal lawyer. In PE deals, however, this is definitely not the case. The price for the acquisition of a target company, or the pre-money-valuation of a company in which a VC firm is going to make

an investment, are all based at least in part on an evaluation of a variety of contingencies. Some of these arise in the ordinary course of the deal, and some do not.

All companies, for example, are subject to risk contingencies. Many of these contingencies are shared by all companies or all companies within a particular industry or geographic area. These contingencies are those that arise in the ordinary course of business, are usually well known to the prospective buyers, and are often expressly addressed in the negotiations over price or pre-money valuation. The deal team is not dependent on due diligence, legal structure, or documentation to address these issues, because the PE firm usually has the expertise to evaluate these contingencies. The caveat to this norm is when a PE firm is investing in an industry for the first time. In those instances, the PE firm will usually know to retain an industry consultant and, if appropriate, to retain additional legal counsel that is expert in that industry. If the PE firm does not recognize this, the PE attorney should at least know enough to raise the issue.

Regardless of whether a target is seeking to be acquired by a PE firm or obtain financing from a VC firm, there is a universal list of issues that derives from the differences between what a seller wants versus what a buyer wants. The seller wants certainty that the deal will close, certainty regarding the purchase price, and comfort that the board of directors have fulfilled their fiduciary duties. The buyer wants certainty that the business it acquires will be the business as represented, that they have recourse for misrepresentations and surprises, and that the deal will not be lost to a third party.

To some degree, whether the target is a public company or a private company will have bearing on these issues. In public company deals, much more of the process is tailored to reflect the expectations of stockholders and the other constituencies that have a role, such as the Securities and Exchange Commission. Also, in public company deals, a busted deal can have significant adverse consequences on the target company's stock price and the perception of the target and its management. Finally, in public company deals there is no post-closing indemnification. In private company deals, there is less standardization and more flexibility to creatively deal with issues because the public is not looking over the shoulder of the players. Of

sometimes greater importance is the marketplace and the competition. The marketplace refers to the strength of the stock market, the debt markets (public, quasi-public, and private), and liquidity (generally, the funds available to PE firms and, to a lesser extent, strategic investors) to invest in deals. When the markets are strong and there are more buyers competing for deals and more financiers competing to provide the debt, valuations for targets tend to rise, less equity is required because more debt is available to finance the purchase price and at lower prices (i.e., interest rates and fees), and more risk is tolerated by all.

Where the PE attorney really plays a role is in having a thorough understanding of the legal and business risks that are not generic to all companies or all companies in the target company's industry, and to devise and recommend protection in the event that they turn out to be greater than the price or valuation reflects. The first step is due diligence. The PE lawyer's role is to make sure the due diligence, both legal and non-legal, is sufficient in scope and depth, and that the results are understood and brought to the attention of the client. This is frequently the most time-consuming and biggest portion of the legal and accounting fees a client will pay.

Fulfilling the Buyer's and PE Firm's Objectives

The buyer's objective is typically to gather as much information as possible, to analyze it, and, if it contains negative information that was not previously revealed by the seller, to use it to negotiate a lower price. PE firms, in contrast to strategic buyers (i.e., operating business in the same or similar line of business as the target), tend to ask for more information because they do not have the industry knowledge a strategic buyer would have. This can be disruptive to a prospective target company.

Increasingly, target companies, or their investment bankers, will orchestrate an auction of the target company, in part to obtain the highest price and in part as a way of managing the due diligence process and evening out the information available to prospective buyers. Frequently, the target company will prepare a selling memorandum that will describe the target company's business and its historical financial results, and will purport to identify the

investment opportunities, the investment considerations (i.e., the upside), and the risk factors (i.e., the downside) or contingencies unique to the target company. The target company will also put together what is known as a "due diligence room." This is often a figurative term, but in essence, the target company prepares a list of information and copies of material documents that are customarily requested by prospective buyers in similar transactions. In a very competitive auction for a target company, known as a seller's market, a prospective buyer may not be able to obtain from the target company any more information than what is typically contained in a selling memorandum and the material documents that are typically made available in a due diligence room. In these situations, having industry knowledge and specific knowledge about the target company can be essential to not overpaying.

For example, a target company that manufactures and distributes widgets discloses in its selling memorandum that it uses certain hazardous materials in the manufacturing process, that the Environmental Protection Agency has commenced an investigation, that the company has changed its processes, and that the company has established a $25 million reserve for possible liability. The due diligence room contains all the material correspondence and documents. Our due diligence then uncovers that the company's reserve is approximately 50 percent less than the likely clean-up costs, and that the Environmental Protection Agency is likely to be more aggressive with the target company because of other prior occurrences, which will result in higher legal costs and a possible distraction of management. In addition, because the company only recently changed its processes, the additional costs associated with the new processes are not reflected in any historical financial statements.

The client will now have to factor these results into the negotiations over price, or perhaps deal with it in other ways. For example, if the target is a private company, a portion of the purchaser price can be held back pending resolution of certain contingencies, or the seller could indemnify the buyer or use a portion of the purchase price to acquire insurance to cover the costs. If the target company is a public company, the options are usually more limited to price and insurance, but occasionally other solutions are possible, such as finding a third buyer to assume the risk.

Environmental issues are but one example of matters that come up in due diligence. Others include obsolete inventory, obsolete technology, poor conditions of machinery, equipment, or other physical plant components, tax issues, aggressive accounting practices, or poor internal controls.

Deal-Killers: Significant Liability

Occasionally, our due diligence will reveal deal-killers—risks that cannot be addressed through price adjustments, hold-back, indemnity, or insurance, or legal structures that limit liability and just kill the deal. Most deal-killers are apparent to a PE firm before the deal term is put together.

Deal-killers are not necessarily bad things. Some PE firms will not invest in certain kinds of industries. In addition, some PE firms will not invest in companies whose asking price or valuation is higher than some indicative range, such as a multiple of EBITDA (earnings before interest, taxes, depreciation, and amortization) on the theory that if the company is so unrealistic about price, it will be equally unrealistic about everything else. Second, deal-killers are not universal. A deal-killer for one PE firm may be an opportunity for another. Distressed companies or companies in distressed industries are an example of this—there are PE firms that focus on just these kinds of opportunities.

Other types of matters that can kill a deal are criminal activity—even conduct that is no longer happening—on the part of the company or management; activity that, while not criminal, would create a reputation risk for the PE firm; tax, environmental, or similar contingent liabilities, the reserves for which would make the deal uneconomic; aggressive tax or financial reporting; and relationships or transactions with affiliates that leave the company too vulnerable to those affiliates post-closing.

Liability can also arise in the deal process itself. The first liability for which a PE firm seeks protection is the liability that can arise by being deemed to be legally obligated to complete the investment before the PE firm is actually ready to commit. This can happen both before and after the definitive agreement for the deal is executed and delivered. The scenario in which this type of liability frequently occurs is when a letter of intent is used to negotiate the basic deal terms before proceeding to a definitive contract.

Documents of this type that do not clearly disclaim they are not binding agreements have been interpreted by the courts to be binding agreements. Occasionally, even when a letter of intent states it is non-binding, courts have found them to be binding because the parties' conduct or other actions taken have been held to contradict the language of such documents. For example, the letter of intent in *Texaco Inc. v. Pennzoil Co.*, 729 S.W.2d 768 (Tex. App. 1987, writ ref'd n.r.e.), *cert. dismissed*, 485 U.S. 994 (1988), was styled a "memorandum of agreement" and exhibited many features typical of a non-binding letter of intent. The *Texaco* court held that while any of these features might, independently, indicate that the parties did not intend to be bound to any agreement, "There was sufficient evidence for the jury to conclude that the parties had reached an agreement on all essential terms of the transaction with only the mechanics and details left to be supplied by the parties' attorneys." A PE attorney needs to be vigilant about such documentation and counsel his or her client and the other members of the team about types of conduct that can undermine the express terms of such documentation.

Liability in the Definitive Agreement

Liability to consummate a deal when the PE firm otherwise believes it is not obligated to close can occur after the definitive agreement is executed and delivered. Most acquisition agreements associated with PE deals are structured so the closing occurs sometime after the agreement is executed and delivered. The delayed closing is often necessary to allow for governmental or non-governmental consents to be obtained, for financing to be put in place, or for other matters to be addressed that could not be accomplished until the parties were bound to the deal. In these circumstances, there are conditions to closing that must be satisfied or waived before the parties are obligated to close. Generally, the PE attorney wants broad conditions so the PE firm will have maximum flexibility. The seller's counsel wants the narrowest of conditions so the PE firm cannot get out of the deal except for the very specific issues addressed in the conditions precedent. Usually, the target company has the most to lose if a buyer walks away from a deal after the definitive agreement is signed.

One of the provisions over which attorneys spend a good portion of time negotiating is the MAC clause. MAC is the acronym for "material adverse change."

Under a MAC clause, the buyer has the right to walk if there is a material adverse change in the target company. Usually matters of generally applicability are excluded from that clause, such as general economic, political, regulatory, and industry matters. This clause has also been subject to much litigation.

Another provision over which attorneys spend a good deal of negotiating time is the scope, if any, of any conditions precedent that is related to post-signing due diligence. The PE attorney needs to make sure these provisions are tied to those items that were revealed during the due diligence process and are material to the deal. Success in negotiating good conditions precedent is tied to doing good due diligence, analyzing what is important and what is not, and developing solutions that can be translated into clear conditions precedent so a trier of fact, such as a judge or jury, would have no difficulty ascertaining whether they had been satisfied. Chapters in treatises and lengthy law review articles have been written about these topics, and the specifics are certainly beyond the scope of this chapter. The relevant point for the PE firm is that if these provisions are not carefully crafted, the PE firm could find itself obligated to consummate a transaction under conditions in which it thought it had the right to walk away from the deal.

Additional Liability Issues

Another situation in which PE firms can find themselves faced with liability is when they seek to outbid a third party for a target company, after the target company and the third party have already signed an agreement. These are difficult situations to address, involving complex questions of law and issues of fact, and they often depend on the legal jurisdictions involved. In the most well-known situation, involving Texaco's acquisition of Getty Oil after Getty Oil and Pennzoil entered into a letter of intent, the court made a $10.53 billion award against Texaco in favor of Pennzoil ($7.53 billion in compensatory damages and $3 billion in punitive damages).

Another situation in the deal process where the PE firm may have liability is in connection with stockholder litigation over the sale process. The issues that arise are whether management, including the board of directors, should be selling the company; and if so, whether they are in fact negotiating for the best possible price in light of the fact that they may have conflicts of interest. Most of the time, a target company will set up an independent

committee of the board to mitigate these issues. While acquirers usually do not incur actual damages in connection with these issues, a prospective acquirer can be subject to litigation and incur the attendant costs of legal fees, wasted time, and the expenses of a broken deal if it decides, and has the right to so decide, to abandon the deal.

Post-Deal Liability

The last area of potential legal liability for PE firms typically occurs after the deal is consummated and the representatives of the PE firm are involved in the target company's business—usually as directors on the board, although they are sometimes actively involved as officers, even though they do not have titles. The issue involves drawing the line between the PE firm and the target company, as well as drawing the line between the responsibilities the representative owes to the PE firm, the responsibilities the representative owes to the target company and its other owners, and, depending on the target company's financial condition, its creditors.

In the situation where the PE firm wholly owns the target company, these issues are largely academic. In situations where the PE firm is one of several owners, which is very typical in a VC investment, or where the target company goes public but the PE firm retains an ownership stake and representation on the board of directors, these are very serious issues. For the individuals involved, these situations may result in a breach of their fiduciary duty to the target company. All directors and executive officers, including those individuals serving in those capacities, whether or not they have the title, owe the fiduciary duties of loyalty, fair dealing, and good faith. These duties could be breached if confidential information or corporate opportunities belonging to the target company are used for the benefit of third parties, such as the PE firm itself or other target companies in which the PE firm has made investments. Likewise, the PE firms could have potential liability for the conduct of their representatives, because such conduct could be imputed to the PE firm.

Similarly, the conduct of the target companies could be imputed to the PE firm in those situations where the target company acted unlawfully. One theory is that since the PE firm controls the target company, it is responsible for the conduct of the target company. The general principal of corporate law is that the stockholders of a company are not liable for the

actions of the company. However, in situations where the stockholders control the company, and the stockholders, either directly or through the company, perpetrate some fraudulent conduct and a third party is harmed, it may be possible to pierce the corporate veil.

Recently, a variety of plaintiffs have been trying to expand the scope of liability by using other theories of liability under other laws, such as aiding and abetting liability. For many PE firms, the topics of liability after the deal closes are new territory. As PE becomes more a mainstay of the merger and acquisition world, as larger public companies become privately owned by PE firms, and as PE firms end up controlling a larger share of the economy, it is likely that these theories of liability will be pressed further.

Differences in PE and VC Investing

One of the significant differences between PE and VC investing is that PE firms are often acquiring public companies. It is rare that a VC firm will invest in a public company, although it is becoming more popular. On the PE side, there are significant differences between acquisitions of private and public companies. Almost by definition, private company deals are done in private. Coupled with the fact that private company deals are generally smaller, it is therefore easier to manage the due diligence process. Although much work can be done on a public company acquisition before a public announcement has to be made, the risk of leaks is great. A leak may trigger the need to make a public announcement, which in turn could require the process to accelerate.

In a private company deal, the buyer can always have recourse to the seller for undisclosed liabilities and breaches of the agreements. In a public company acquisition, there is no one left to sue after the deal closes. In a private company deal, the sellers, in addition to the target, can be bound to the deal, the deal structure considerations and terms can be varied to meet the objectives of both the buyer and the seller, and the deal can usually close quickly, subject to regulatory approvals. Conversely, in a public company acquisition, fiduciary considerations may prevent the buyer from locking up the deal. Public shareholder expectations permit little variation on deal structure considerations, terms, and conditions, and the deal must usually be approved by stockholders. Many public company acquisitions are

lost during the time a stockholder vote is being solicited or a tender offer is being conducted. Finally, in a private company acquisition, if the deal does not close because a condition is not satisfied, or there is an intervening event or discovery, it is not likely to be catastrophic or nearly as catastrophic in a public company acquisition.

Successful Strategies of the PE Attorney

For a PE attorney, like all other members of the PE team, discipline and thoroughness are crucial, followed by the ability to work quickly and continuously for extended periods. All deals, especially public company deals, have a certain momentum, usually a fast one. If a deal does not move quickly through its stages, the parties often get deal fatigue, and that is when deals can unravel.

The PE attorney also needs to be a master of many legal disciplines. Certainly, a knowledge of corporate law as it relates to acquisitions of companies is necessary, but a PE lawyer needs to have mastered corporate governance, as well as matters relating to capital structure and finance, including corporate finance, securities offerings, senior and mezzanine financing, and contract law. A PE attorney also needs to have a good working knowledge of corporate and partnership tax (as many companies are organized as limited liability companies, which are taxed like partnerships), employment law, real estate, environmental law, and intellectual property law. A PE attorney also has to be well versed in accounting. PE is about business, and businesspeople need to know how to read and understand financial statements and the clues they provide.

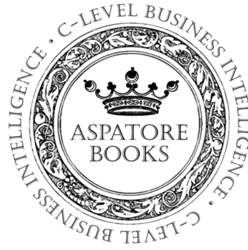
Final Thoughts

Representing PE firms is a high-pressure practice. Although the stress can be great, and buying companies always involves an element of adversarialness, it must be remembered that the process is essentially a marriage. Every PE firm that is looking to buy a company needs to develop a rapport with the sellers because, although money is the driver, the interpersonal relationships between the PE team members and the seller's team members are frequently what keeps deals from falling apart when the deal hits a bump in the road and develop a relationship with management.

Since counsel is the PE firm's alter ego, our conduct reflects directly on the PE firm. This can be critical in a competitive environment. Sellers will be looking to determine whom they can work with when bringing the deal to a close. Management will be looking to determine whom they can effectively work with after the closing. Although there may be times when a little good cop/bad cop type of persuasion is appropriate, or where pushing back is necessary, in most cases more gets done and gets done faster—and with greater candor and efficiency—if a cooperative attitude is taken.

Being cooperative, however, does not mean rolling over. Every PE attorney needs to be able to be tough in negotiations, thorough on requests for information, and relentless in pursuing important points, and do so without offending the seller, management, and their legal and non-legal advisers. It is rare that yelling, screaming, or bullying accomplishes anything, and those tactics should only be used as a last resort.

David S. Schaefer's practice is primarily transactional and is concentrated in the areas of mergers and acquisitions, corporate finance, private equity fund formation and investments, workouts and restructurings, and complex commercial transactions. His clients range from multinational corporations to closely held companies. Many are active in the industries of financial services, including private equity funds, media, information technology, and telecommunications. Mr. Schaefer has also acted as counsel to companies and boards of directors on corporate governance matters.

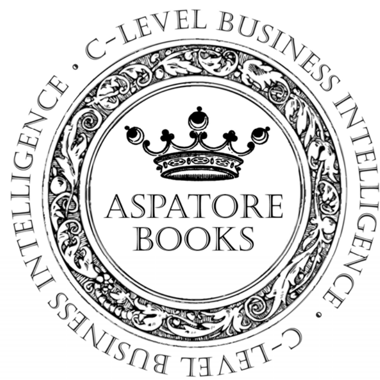


www.Aspatore.com

Aspatore Books is the largest and most exclusive publisher of C-Level executives (CEO, CFO, CTO, CMO, Partner) from the world's most respected companies and law firms. Aspatore annually publishes a select group of C-Level executives from the Global 1,000, top 250 law firms (Partners & Chairs), and other leading companies of all sizes. C-Level Business Intelligence™, as conceptualized and developed by Aspatore Books, provides professionals of all levels with proven business intelligence from industry insiders – direct and unfiltered insight from those who know it best – as opposed to third-party accounts offered by unknown authors and analysts. Aspatore Books is committed to publishing an innovative line of business and legal books, those which lay forth principles and offer insights that when employed, can have a direct financial impact on the reader's business objectives, whatever they may be. In essence, Aspatore publishes critical tools – need-to-read as opposed to nice-to-read books – for all business professionals.

Inside the Minds

The critically acclaimed *Inside the Minds* series provides readers of all levels with proven business intelligence from C-Level executives (CEO, CFO, CTO, CMO, Partner) from the world's most respected companies. Each chapter is comparable to a white paper or essay and is a future-oriented look at where an industry/profession/topic is heading and the most important issues for future success. Each author has been carefully chosen through an exhaustive selection process by the *Inside the Minds* editorial board to write a chapter for this book. *Inside the Minds* was conceived in order to give readers actual insights into the leading minds of business executives worldwide. Because so few books or other publications are actually written by executives in industry, *Inside the Minds* presents an unprecedented look at various industries and professions never before available.


C-LEVEL BUSINESS INTELLIGENCE • C-LEVEL BUSINESS INTELLIGENCE •
ASPATORE
BOOKS