THE RETURN OF STAPLED FINANCING

Alarna Carlsson-Sweeny of Practical Law Company explores the resurgence of stapled financing and examines the related legal risks.

Stapled financing fell out of favor after 2006 amid concerns about the legal risks it involved, and remained scarce for the duration of the credit crisis. However, this position has shifted in recent months. "While credit remains somewhat restricted in the current market, the number of acquisitions is picking up and the demand for acquisition financing is rising along with it. In such a market, stapled financing seems to be re-emerging as a popular tool for targets looking to facilitate a deal," says David Wiles, a banking & finance partner at Mayer Brown LLP.

This article explains why stapled financing is once again becoming more prevalent and examines the related legal risks.

BENEFITS OF STAPLED FINANCING

In stapled financing, the bank that is advising the target in an acquisition also offers financing to the prospective purchasers (see *Box, A Typical Stapled Financing*). The commitment letter and term sheet containing the principal terms of the financing traditionally were "stapled" to the back of the material used by the target's banker to solicit bids for the target company.

There are several benefits of stapled financing. One of the most obvious is that it ensures the availability of financing for every bidder, which should theoretically create a more competitive auction process. "The comfort that comes from the confidence that financing will be available to bidders makes it easier for the seller to embark on the sale process," says Philip Richter, a partner at Fried, Frank, Harris, Shriver & Jacobson LLP.

Stapled financing also ensures that all bidders have access to financing in an amount and on terms that will result in a satisfactory price for the seller, assuming an acceptable leveraged equity capital structure. In other words, the stapled financing should provide leverage ratios allowing the bidder to bid at a satisfactory level.

Another effect of stapled financing is that it acts as a price-signaling mechanism. According to Richard Hall, a partner at Cravath, Swaine & Moore LLP, "A savvy bidder will be able to reverse engineer the financing package, in particular the ratio of debt to EBITDA (earnings before interest, taxes, depreciation and amortization), to get a good indication of the seller's price expectation. This could be considered an advantage in that it provides some price transparency to encourage bidders, however it could also be considered a disadvantage in that it may have the effect of capping prices."

THE RESURGENCE OF THE STAPLE

One of the reasons stapled financing fell out of favor after 2006 was because of the *Toys "R" Us* case and other legal concerns (see below *Potential Conflicts of Interest*). At that time, public company boards generally felt that because acquisition financing was usually available, the benefit of stapled financing did not outweigh the potential legal risks.

"However, in the current market, although leveraged acquisition financing as a whole is beginning to reemerge after the credit crisis, it is still reasonably tight. Therefore there is a stronger case for the board to conclude that there is a distinct benefit to offering stapled financing," explains Hall.

>> For an overview of acquisition finance, including a description of the various methods of acquiring a business, search Acquisition Finance: Overview on our website.

Many of the stapled financings being offered occur in the context of the sale of privately-held companies, which do not face the same level of scrutiny

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as public companies. "Boards of public companies are constantly under scrutiny, particularly when the company or a material part of it is being sold, as boards have an obligation to obtain the best deal, that is, the highest possible value for shareholders," explains Wiles. "Stapled financing is easier for privately-held companies because they are only accountable to a smaller group of private investors."

In addition, while there is a resurgence in stapled financing offerings (see *Box, Recent Deals Offering Stapled Financing*), this does not necessarily mean the stapled financings are actually being used. "Stapled financing has recently tended to be an offer rather than a firm commitment. Many buyers may take a look at the staple and then approach the banks with which they have strong relationships to see if they can get a better offer. Similarly, the bank offering the staple may ultimately decide not to commit and close the financing," says Wiles. Moreover, stapled financing is more likely to be used by a financial buyer or private equity firm rather than a strategic buyer, who would typically finance an acquisition through the capital markets or on its own balance sheet.

POTENTIAL CONFLICTS OF INTEREST

While stapled financing is undoubtedly a useful tool, it is not without controversy and risk. Most legal concerns with stapled financing revolve around the potential for conflicts of interest. If the staple is used, the target's financial advisor sits on both sides of the deal. The bank's M&A advisory department acts as the financial advisor to the seller, while the same bank's financing department acts as the lender to the bidder (or multiple bidders). The bank can therefore collect two sets of fees, one for the advisory role and one for the financing. The potential conflict arises because of the bank's incentive to recommend a transaction, and further, to favor a bidder who takes advantage of the offered financing even if it does not have the highest bid, so the bank can collect the financing fee.

TOYS "R" US

The potential risks of stapled financing were highlighted in dicta made by Vice Chancellor Strine in *In re Toys "R" Us, Inc. Shareholder Litigation (877 A.2d 975 (Del. Ch. 2005))*. In that case, the public shareholders

RECENT DEALS OFFERING STAPLED FINANCING

INTERACTIVE DATA CORP (IDC)

Goldman Sachs, financial advisors to IDC, reportedly offered a staple of five times IDC's EBITDA to prospective bidders in a recent $3 billion auction. That in turn prompted Bank of America Merrill Lynch to reportedly offer to provide debt totaling 5.5 times EBITDA to bidders.

MICHAEL FOODS

Bank of America reportedly offered financing of six times EBITDA in Thomas H. Lee Partners' $1.7 billion sale of Michael Foods to GS Capital Partners, the private equity arm of Goldman Sachs.

HILLMAN GROUP

The Ohio-based manufacturer of nuts, bolts and other fasteners was recently acquired by Oak Hill Capital Partners, a private equity firm. Barclays PLC ran the auction and reportedly offered bidders financing at about five times the company's EBITDA.

BRESNAN COMMUNICATIONS

Bresnan Communications, the cable and telecommunications provider, has retained UBS and Credit Suisse to facilitate a sale of the company. Credit Suisse is reportedly offering financing of six times Bresnan's EBITDA.

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of Toys "R" Us brought a legal action challenging the company's acquisition by a consortium of private equity sponsors led by Kohlberg Kravis Roberts & Co. Among other complaints, the shareholders alleged that the financial advisor to Toys "R" US, Credit Suisse First Boston (Credit Suisse), suffered from a conflict of interest arising out of its role in providing financing for the consortium. Credit Suisse had sought permission from the board of directors of Toys "R" Us to offer the financing after the deal had been approved.

Among other things, Vice Chancellor Strine noted that "In general…it is advisable that investment banks representing sellers not create the appearance that they desire buy-side work, especially when it may be that they are more likely to be selected by some buyers for that lucrative role than others." He further noted that this may create "the appearance of impropriety."

"The Court's comments in *Toys "R" Us* made boards of directors nervous about allowing a sell-side advisory bank to provide buy-side financing," says Wiles, "but it is important to keep those comments in context. That case was not specifically about stapled financing, strictly speaking, and in any event, the Court did not find that there was any improper influence by Credit Suisse." In the *Toys "R" Us* case, Credit Suisse was given permission to provide the buy-side financing after the merger agreement had been approved and signed by the seller and buyer (that is, after the auction process was finished) and not before, when the conflicts might be more likely to arise.

TERRA FIRMA

The potential for conflicts of interest in a stapled financing is one of the key issues raised in *Terra Firma Investments Ltd v. Citigroup Inc.*, filed in December 2009 (*Terra Firma, Case No. 603737/2009, Supreme Court of the State of New York*). In this case, Terra Firma, the British private equity group, is claiming that Citigroup fraudulently misled it into acquiring EMI, the music publisher, for £4 billion in May 2007. Citigroup served as investment advisor, lender and broker to EMI, and as lender to Terra Firma, providing it with £2.5 billion towards the acquisition.

> *Stapled financing is more likely to be used by a financial buyer or private equity firm rather than a strategic buyer, who would typically finance an acquisition through the capital markets or on its own balance sheet.*

Specifically, Terra Firma accuses Citigroup's lead banker on the deal, David Wormsley, of lying about the number of bidders interested in EMI at the time of the auction in May 2007. According to the complaint, Wormsley said that Cerberus Capital Management, another private equity group, would submit a bid on May 21 and win the auction unless Terra Firma made an offer. In reality, Cerberus and other bidders had dropped out, which could have led to a failed auction depriving Citigroup of its advisory fees and its financing fees. Terra Firma claims that if it had known there were no other bidders it would have bid far less or walked away. Terra Firma further claims that although Citigroup was advising EMI, it was also Terra Firma's advisor because it was providing it with financing. Terra Firma and Citigroup have since been vying for control of troubled EMI as Terra Firma has struggled to repay its debt.

"What is interesting about this case is that the complaint about conflict of interest caused by the financing

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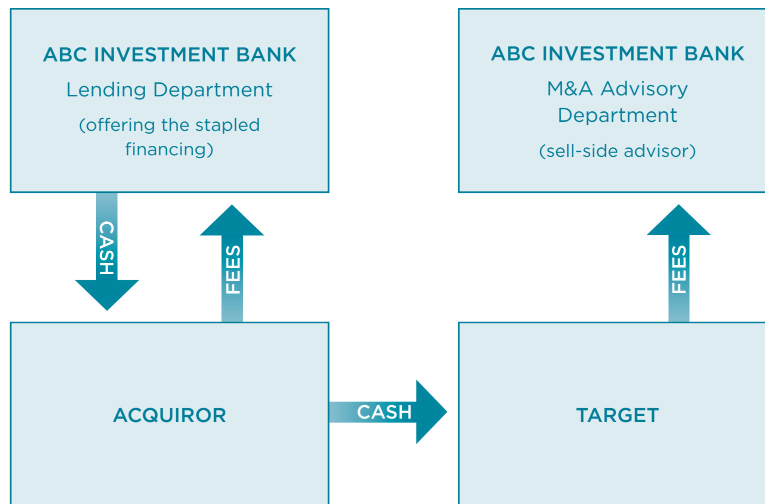

is coming from the acquiror, whereas usually the conflicts of this nature are considered from the perspective of the seller," says Hall. The case is due to go to trial on October 18, 2010.

MANAGING THE RISKS

It is important, however, not to overstate the potential legal risks. "While the potential for conflicts exists," says Richter, "these can be managed quite effectively. As long as precautions are taken, boards of directors should consider stapled financing as a legitimate option."

The first step for a target in managing potential conflicts is for the board to be advised of, and to fully consider, the potential risks associated with its advisor offering stapled financing. One risk is that the target's bank may subtly favor a bidder willing to take the bank's stapled financing package over another bidder. Another risk is that, by providing financing to the acquiror, the target's bank could become adverse to the target if, after announcement, the bank seeks to walk from its financing commitment.

The second step is to consider retaining an additional financial advisor who will not be part of the stapled financing. This second financial advisor could help manage the sale process, provide "independent" advice to the board and furnish a second fairness opinion. Indeed, "many banks have internal policies that do not allow them to be the only bank giving a fairness opinion where they are also providing financing to the acquiror" says Richter. Moreover, retaining a second banker ensures that the target's board will continue to have a financial advisor with background on the transaction in the event that the staple provider is unable to continue to represent the target.

The key point, however, is that the seller needs to make a thoughtful decision about whether the benefits of the staple, in terms of improved price or better execution or both, outweigh the downsides of the impaired independence of the seller's lead advisor.

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