# Private Equity Strategies for Exiting a Leveraged Buyout

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This Note explains the main exit strategies for private equity sponsors making control investments in portfolio companies through leveraged buyouts, including initial public offerings, Rule 144 resales, secondary registered offerings, sales to a third party, leveraged and non-leveraged dividend recapitalizations, redemptions rights and tag-along rights, and discusses the main advantages and disadvantages of each strategy.

When a private equity fund makes a control investment in a portfolio company through a leveraged buyout (LBO), the majority of the purchase price for the portfolio company's equity is usually financed through debt. The remaining portion of the purchase price comes from the fund's own capital, given by the investors, and represents the fund's at-risk investment in the portfolio company. Private equity funds typically enter these transactions with the view toward increasing the portfolio company's value and realizing a positive return when the fund exits its investment. Exits usually occur somewhere between three to seven years after the initial investment.

This Note focuses on the most common exit strategies, including the advantages and disadvantages of each, and how a private equity sponsor can plan for a fund's exit from the time of the investment.

The most common exit routes include:

- Initial public offerings (IPOs) (see *Initial Public Offering*).
- Selling shares after the IPO through either:
  - Rule 144 sales under the Securities Act of 1933, as amended (Securities Act) (see *Sales after the IPO under Rule 144*); or
  - registered secondary offerings (see *Secondary Registered Offerings*).
- Sales to a third party, typically through the exercise of drag-along rights (see *Sale to a Third Party*).
- Dividend recapitalizations (see *Dividends and Recapitalizations*).
- Redemptions (see *Redemption Rights*).
- Tag-along rights (see *Tag-along Rights*).

For more information on LBOs generally, see *Practice Note, Buyouts: Overview (http://us.practicallaw.com/4-381-1368)*.

## PREPARING FOR EXIT

Private equity funds typically have fixed life spans of about ten years. At the end of its life span, the fund is closed and the remaining principal plus any profits made during the fund's life are paid out to its investors and the fund sponsor. To maximize the return to itself and its investors, a sponsor plans for two five-year investment periods during the fund's ten-year life. In each five-year investment period, the fund invests in a portfolio company's equity (such as in an LBO) and then at the end of the period, exits its investment and recovers its capital (and a return on its

investment, if any). Often that recovery coincides with the period in which a sponsor is trying to raise capital for new funds. Therefore, the sponsor has every incentive to control the timing and nature of its exit and to begin planning for the exit as early as the initial investment stage. Early exit planning can help the fund protect its investment and maximize its return. Sponsors must also remain vigilant throughout the life of an investment to ensure that they can make a successful exit.

## INVESTMENT STAGE EXIT PLANNING

The sponsor should plan for the fund's exit during the initial investment stage as the sponsor negotiates its buyout of the portfolio company. That way, the fund can ensure to exit its investment at the time and in the manner the sponsor deems best.

### Control and Liquidity

The sponsor must ensure that it has sufficient control and liquidity from the beginning of the investment. This may involve amending the portfolio company's existing charter documents, stockholders agreements and registration rights agreements. More typically, however, this may involve entering into new agreements to ensure the fund's investment is protected. Common rights that sponsors negotiate at this stage include:

- **Board control or veto rights.** Sponsors making a control investment typically do not manage the portfolio company's daily operations. However, having designees on the board or veto rights over extraordinary actions help protect the sponsor's investment.
- **Registration rights.** Sponsors should ensure they have the power to trigger or participate in registered public offerings of the portfolio company's equity through board control or registration rights (see *Practice Note, What are Registration Rights Agreements? (http://us.practicallaw.com/3-386-4395)*).
- **Redemption rights.** In some cases, sponsors may negotiate the right to cash out their investment under certain circumstances by requiring the portfolio company to acquire its equity (see *Redemption Rights*).
- **Drag-along rights.** Drag-along rights provide sponsors with greater liquidity by allowing them to force minority investors to participate in the sale of the portfolio company (or the parent holding company, as applicable) (see *Planning at Investment Stage*).
- **Tag-along rights.** In the case of club deals or co-investments with other private equity sponsors, tag-along rights provide the ability to participate pro rata in sales by other co-investors (see *Tag-along Rights*).

For more information these provisions, see *Practice Notes, Stockholder Protections (http://us.practicallaw.com/6-382-7132)* and *Key Corporate Governance and Exit Considerations for the Sponsor-backed IPO Candidate (http://us.practicallaw.com/1-503-0874)*.

### Management Incentives

When a sponsor executes a buyout, it does not intend to control the portfolio company's daily operations and needs a qualified management team to operate the business. That management team will also need to oversee the sponsor's exit and effectively market the portfolio company to potential buyers or investors. Therefore, it is important for management to support the transaction.

During the initial investment, sponsors typically enact equity incentive plans to provide incentives and compensate a portfolio company's new or existing management, or both. Any equity awarded is usually subject to a prohibition on the transfer for either a period of time following the buyout or until an IPO by the company. In addition, there are other transfer restrictions (such as rights of first offer or rights of first refusal and forfeiture and call rights if the executive leaves the portfolio company). Typically, these plans are designed in a way that closely aligns the value of management's awards to the success and value of the portfolio company and the return that the sponsor receives on its investment (for instance, through subjecting equity awards to time or performance vesting, or both).

In addition, if structured properly, these plans create incentives for management to stay with the portfolio company after the sponsor liquidates its investment in the company. Having the existing management remain with the portfolio company after the fund's exit can be critical to maximizing the amount the fund realizes when it exits. In an IPO or sale to another financial buyer, the ability to retain current management to run the portfolio company will be factored into the price that buyers or investors are willing to pay for the company.

For example, the sponsor can set up an equity incentive program with awards that have either a:

- **Single trigger.** The awards only vest if the employee stays with the portfolio company for a set period of time after the transaction.
- **Double trigger.** The awards only vest following both the change of control and the termination of the employee within a period of time after the transaction.

However, in the case of a sale to a strategic buyer, which typically has its own management team, rewarding the management team for remaining with the business until the closing may be the optimal solution. In this case, the awards would vest on the change of control.

For more information on management incentive plans and transfer restrictions in private equity transactions, see *Practice Notes, Management Equity Incentives in Buyouts (http://us.practicallaw.com/2-500-2291)* and *Management Equity Incentives: Rights and Restrictions (http://us.practicallaw.com/2-500-6213)*. For a discussion of practical limitations on a sponsor's ability to structure management equity incentives for senior management in a going private transaction due to the potential heightened disclosure requirements under Rule 13e-3 of the Securities Exchange Act of 1934, as amended (Exchange Act), see *Practice Note, Going Private Transactions: Overview: Disclosure Obligations in a Going Private Transaction (http://us.practicallaw.com/8-502-2842)*.

## POST-INVESTMENT EXIT PLANNING

After the LBO is complete, but before making the decision to exit, there are several steps the sponsor can take to ensure a smooth and more profitable exit. These steps include:

- Addressing known issues.
- Enacting value-building strategies.
- Maintaining proper governance and administrative practices.

### Addressing Known Issues

The sponsor should prepare the portfolio company to make it more attractive to potential buyers or a better candidate for an IPO. Often the best place to start is by correcting any issues that the sponsor uncovered during its due diligence process.

### Enacting Value-building Strategies

Despite any issues that it uncovered, the sponsor completed the LBO because the sponsor believed that it could increase the portfolio company's value through better management, streamlining operations or acquiring other companies to create synergies and economies of scale. Enacting these strategies efficiently and successfully will be key factors in determining when a sponsor can exit a portfolio company investment successfully.

### Maintaining Proper Governance and Administrative Practices

The professionalization of administrative and operational functions will not only help the portfolio company run more efficiently but it will also make the portfolio company a more attractive target when the sponsor exits the investment. The sponsor should review and ensure there are proper practices of:

- Record keeping and document management.
- Internal and external controls.
- Human resources and payroll.
- Finance and accounting functions.

The fund should also ensure the portfolio company (and any parent holding company) is following appropriate corporate governance practices, particularly if it anticipates an IPO.

For more on maintaining proper governance and administrative practices ahead of an IPO, see *Practice Note, Preparing a Company for an Initial Public Offering: Corporate Structure (http://us.practicallaw.com/2-380-8512)*.

# INITIAL PUBLIC OFFERING

As discussed (see *Control and Liquidity*), when completing an LBO, the sponsor should ensure that it has the board control and contractual registration rights to trigger and participate in an IPO, and to veto an IPO proposed by the portfolio company. Negotiating these rights at the time of the initial investment gives the sponsor the right to control if and when the portfolio company goes public. In addition, the sponsor should ensure it has the contractual registration rights to trigger and participate in registered secondary offerings after the IPO so it can, if it chooses, use these offerings to complete its exit after the IPO (see *Secondary Registered Offerings*).

When a fund exits its investment through an IPO, it does so through an offering of shares to the public of either:

- The portfolio company.
- The parent holding company that wholly owns the portfolio company and through which the fund made its investment and owns equity.

For a discussion of the typical structure of an LBO, see *Practice Note, Buyouts: Overview: Buyout Vehicle (http://us.practicallaw.com/4-381-1368)*.

## ADVANTAGES OF AN IPO EXIT

Sponsors consider exiting through an IPO owing to the advantages of this form of exit.

### Higher Exit Valuation

Sponsors often prefer an IPO because IPOs typically result in higher valuations for portfolio companies than other possible exits. In addition, although IPOs typically do not result in a full exit for the fund, the fund benefits from any post-IPO increases in a portfolio company's value. An IPO also gives the sponsor a readily ascertainable valuation so it can better time a future exit, compared to relying solely on theoretical private valuation techniques.

### Increased Liquidity

Unlike other partial exits (for example, partial dividend recapitalizations (see *Dividends and Recapitalizations*) or partial secondary purchases (see *Sale to a Third Party*), an IPO provides a sponsor increased future liquidity. Once public, a portfolio company's equity has an established public float and the company must produce public disclosure on a regular basis, giving the sponsor a market for its securities (see *Ongoing Disclosure and Reporting Obligations*). As a result, the sponsor may find it easier to achieve a full exit from its investment in a relatively short time and for an easily demonstrated price.

### Management Support

A supportive management team is crucial for a successful IPO and makes it easier for a sponsor to achieve an exit. Unlike a sale to a third party (particularly to a strategic buyer), the management team is more likely to support an exit through an IPO. On the advice of underwriters, members of the management team often do not participate in the IPO by selling equity themselves. There is a view that significant management participation may affect negatively the equity's price. Nonetheless, management often feels a sense of increased wealth due to future liquidity for its shares and additional equity compensation on an IPO. In addition, the management team often views as a positive the heightened prestige and publicity

for the portfolio company. For an overview of the importance of the role of management in the IPO process, see *Timeline and Responsibility Chart: Initial Public Offerings (http://us.practicallaw.com/9-380-8542)*.

## DISADVANTAGES OF AN IPO EXIT

Sponsors considering exiting through an IPO must also consider the disadvantages of this method of exit.

### Lack of Complete Exit

A fund typically does not fully liquidate its investment through the portfolio company's IPO for several reasons, including:

- The fund's investment, with the shares the company sells in the IPO, is typically too large to be sold into the market at one time at a desirable price.
- The underwriters' concern that an exit of the fund in the IPO tells investors that the company has limited upside, which is the wrong message to send.
- The underwriters' concern about negative investor response to the IPO if a substantial portion of the proceeds of the offering go to the fund instead of the portfolio company. Public investors often want to see the offering proceeds used to pay down the company's debt given the high leverage of sponsor-backed portfolio companies.

Instead, the IPO is the first step to a full exit for the fund. Following the company's IPO, the fund can sell its remaining investment:

- In unregistered sales that comply with Rule 144 under the Securities Act (see *Sales after the IPO under Rule 144*).
- In one or more registered secondary offerings (see *Secondary Registered Offerings*).

For more information on the IPO process generally, see *Practice Notes, Preparing a Company for an Initial Public Offering (http://us.practicallaw.com/2-380-8512)* and *Registration Process: Overview (http://us.practicallaw.com/7-380-8736)*.

### Timing

The IPO process can be a lengthy process and taking four to six months is common (see *Timeline and Responsibility Chart: Initial Public Offerings (http://us.practicallaw.com/9-380-8542)*). In addition, IPO underwriters typically require in the underwriting agreement or lock-up agreement that funds not sell any shares in the portfolio company for up to 180 days following the IPO (known as the lock-up period).

The fund's continued ownership of a significant portion of the company's equity following the IPO puts downward pressure on the company's stock price. This is because the market understands that the fund wants to exit and is likely to sell those shares into the market (known as market overhang). To limit this downward pressure on the company's stock price, the underwriters may insist the fund sell a limited amount of shares over particular periods of time. Therefore, a full exit in connection with an IPO is a lengthy process because post-IPO follow-on offerings can take up to an additional two to four months for each offering.

For more on lock-up agreements in connection with an IPO, see *Standard document, Lock-up Agreement (http://us.practicallaw.com/0-386-6174)* and *Practice Note, What's Market: Lock-up Agreements (http://us.practicallaw.com/5-501-8196)*.

### Cost and Distraction of Management's Attention

An IPO can be costly and can distract management from their main job of running the portfolio company's business. The IPO process demands significant amounts of senior management's and other key employees' time and attention, including:

- Deciding the size and timing of the IPO.
- Participating in the road show to market the offering to potential investors.
- Overseeing the Securities and Exchange Commission (SEC) registration process.

Significant costs of an IPO include underwriters' compensation, the fees of accounting and legal professionals, financial printing costs and filing and listing fees.

For an overview of the importance of the role of management in the IPO process, see *Timeline and Responsibility Chart: Initial Public Offerings (http://us.practicallaw.com/9-380-8542)*.

### Ongoing Disclosure and Reporting Obligations

Both during and after the IPO process, the company will be subject to extensive rules and regulations under the Exchange Act, including:

- The SEC's periodic reporting and proxy requirements.
- The requirements of Regulation FD.
- The certification and other requirements of the Sarbanes-Oxley Act of 2002.

Preparing the required reports and other documents, and the design, setup and maintenance of the internal controls, procedures and systems necessary to do so, will be costly and require a significant amount of the portfolio company personnel's time.

In addition, company insiders and major stockholders, including the fund while it continues to meet certain ownership thresholds, will become subject to the reporting requirements of Sections 13 and 16(a) of the Exchange Act. This will require the fund to file reports with the SEC concerning its ownership of the company's securities. These filings are normally prepared with the assistance of counsel.

For an overview of the reporting requirements of public companies and their major stockholders, see *Practice Note, Periodic Reporting and Disclosure Obligations: Overview (http://us.practicallaw.com/7-381-0961)*.

### Insider Short-Swing Profit Recovery and Insider Trading Concerns

As stockholders of a public company, the fund and its sponsor have potential liability for actions that they may have taken in the ordinary course as stockholders in a private company.

The fund will be subject to Section 16(b) of the Exchange Act if the fund owns 10% or more of the company's public stock after the IPO (or in some cases if it owns 10% or less but has the right to board representation). Under Section 16(b), the fund can be required to disgorge to the issuer all profits realized from purchases and sales of any equity securities of the issuer within a six-month or less period of a purchase or a sale (known as short-swing profits). For detailed information on Section 16(b), see *Practice Note, Section 16(b) Short-swing Profit Liability: The Perils of Turning a Quick Profit (http://us.practicallaw.com/8-503-3911)*.

In addition, if the sponsor continues to have access to material nonpublic information (known as inside information) about the portfolio company after the IPO (for example, through board representation), the sponsor can be subject to liability under Rules 10b-5 and 10b5-1 for insider trading if it trades in the portfolio company's securities while it is aware of that information (see *Practice Note, Periodic Reporting and Disclosure Obligations: Overview: Insider Trading Issues (http://us.practicallaw.com/7-381-0961)*).

### Loss of Control

Even if a sponsor retains a significant interest in the company after the IPO, the sponsor may lose control of the company's board of directors or the stockholder voting process.

After the IPO, to satisfy SEC requirements relating to audit committees, the company will need to have at least three independent directors (and new independence rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), which the SEC expects to adopt by August, 2011, may impose similar requirements on compensation committees) (see *Practice Note, Summary of the Dodd-Frank Act: Corporate Governance (http://us.practicallaw.com/9-502-8358)*). If the company is going to be listed on an exchange, the company will also need to comply with the director independence requirements of that exchange, unless the company can qualify as a "controlled company." Compliance with these requirements will make it more difficult for the sponsor to control the company and continue implementing its strategy for improving the company's value. For more on these requirements, see *Practice Note, Corporate Governance Standards: Board of Directors (http://us.practicallaw.com/0-381-5330)*.

In addition, stockholders agreements typically, but not always, terminate or are terminated on the IPO. This means that any control protections like veto rights also terminate.

Sponsors can attempt to counteract this loss of control by:

- Maintaining the contractual right to nominate a majority of the company's board seats (through voting agreements among significant pre-IPO stockholders).
- Keeping certain control protections which require the sponsor's consent (for example, veto rights on material corporate transactions such as issuing new classes of stock, incurring significant debt and undergoing a change of control). Although, in IPOs of sponsor-backed companies, it is common practice to give up these rights and only in some cases can sponsors negotiate narrow veto rights.

For more information on governance planning after the IPO, see *Practice Note, Key Corporate Governance and Exit Considerations for the Sponsor-backed IPO Candidate (http://us.practicallaw.com/1-503-0874)*.

### Execution Risk

External and internal market factors may prevent the company from getting the IPO pricing or level of investor interest that it predicted. In that case, the IPO typically fails and the time and money involved is lost. An IPO's failure can create the perception that:

- The company was overvalued.
- There is a material problem with the company.

If the sponsor needs to pursue another exit strategy after a failed IPO, the sponsor will have to seek an alternative in a market that is aware of the failure.

## SELLING SHARES AFTER THE IPO

A sponsor typically cannot liquidate fully the fund's investment in a portfolio company in the company's IPO. To complete a full exit after the IPO, a fund can sell shares in unregistered sales that comply with Rule 144 of the Securities Act or in one or more registered secondary offerings.

### SALES AFTER THE IPO UNDER RULE 144

When a fund purchases shares of a private company in an LBO, those shares are restricted securities under the Securities Act. Restricted securities can only be resold in transactions registered with the SEC or in transactions exempt from registration. Resales of restricted securities made under Rule 144 of the Securities Act are considered exempt from registration. Sponsors often use Rule 144 to resell shares in portfolio companies that have gone public.

The requirements of Rule 144 differ depending on whether:

- The seller is, or in the last three months has been, an "affiliate" of the company.
- The company has been a reporting company under the Exchange Act for at least 90 days, and is current in its reporting obligations.

Affiliate is broadly defined in the Securities Act to include any person that has the power to control or direct management and policies of the company. Generally, any stockholder that owns 10% or more of the company's stock is considered an affiliate. A stockholder that owns less than 10% of a company's stock can also be considered an affiliate, particularly if that stockholder has contractual rights to representation on the company's board.

The portfolio company (or the parent holding company, as applicable) will become a reporting company under the Exchange Act as soon as it goes public, so assuming it remains current on its reporting requirements, the company will satisfy this requirement 90 days after the IPO.

Under Rule 144, a fund that is not an affiliate of the portfolio company and has not been an affiliate for the last three months can sell shares in the portfolio company at the expiration of the IPO lock-up period or 90 days after the IPO, whichever comes first, assuming it has held those shares for at least six months and the company stays current in its Exchange Act reporting. Even if the company is not current in its Exchange Act reporting, a non-affiliate can resell restricted shares under Rule 144 as long as it has held them for one year or more.

A fund that is an affiliate of the company must comply with the same timing restrictions as a non-affiliate and also with the following requirements:

- **Volume restrictions.** During any three-month period, the fund may not sell shares representing more than the greater of:
  - 1% of the company's outstanding shares of the same class; or
  - the average weekly reported trading volume of the class of shares for the previous four calendar weeks, if the class of shares is listed on a US securities exchange.
- **Manner of sale.** The sales must be broker transactions, transactions with a market maker or riskless principal transactions, each as defined in Rule 144.
- **Notice of sale.** If the amount of sales exceeds 5,000 shares or $50,000 in any three-month period, the seller must file a notice of the proposed sale on Form 144 with the SEC. The sales will also probably trigger reporting obligations under Section 13 or Section 16(a) (see *Practice Note, Periodic Reporting and Disclosure Obligations: Overview (http://us.practicallaw.com/7-381-0961)*).

In addition, the fund must not solicit or arrange for the solicitation of orders to buy the shares in connection with the sales or pay anyone for the offer or sale of the shares, other than the broker-dealer that executes the order to sell the shares.

For more information on Rule 144 resales, see *Practice Note, Resales Under Rule 144 (http://us.practicallaw.com/4-382-8769)*.

Unlike a registered sale, an unregistered sale is quicker, less expensive and does not require a broad marketing campaign to ensure the offering is fully subscribed. An unregistered sale may also be more likely to succeed than a secondary registered offering during market downturns for registered offerings.

However, the timing, volume and manner of sale restrictions that Rule 144 places on resales by a fund considered an affiliate of a portfolio company can make unregistered resales a slow exit strategy.

In addition to the timing and volume requirements imposed by the SEC, a fund typically agrees to a contractual lock-up period of up to 180 days with the IPO's underwriters (see *Timing*). During the lock-up period, the fund is prohibited from selling any shares in the portfolio company. This can make an unregistered public resale an inflexible and unattractive method for making a full exit from an investment in a portfolio company, and may make unregistered sales more suitable for small, partial exits intended to capitalize on favorable, temporary market conditions.

## SECONDARY REGISTERED OFFERINGS

A second way that a sponsor can exit its investment after an IPO is through one or more secondary registered offerings. A secondary registered offering is a public resale of the company's shares held by its stockholders instead of a primary offering of shares by the company itself.

For a sponsor to sell its shares in a secondary offering, the portfolio company (or the parent holding company, as applicable) must first file a registration statement registering the sale with the SEC. The registration process in a secondary offering is less time consuming and expensive than in an IPO. But a company still incurs the costs associated with preparing the registration statement. Therefore, a company may be reluctant to register the fund's shares unless obligated to do so under a registration rights agreement (see *Practice Note, What are Registration Rights Agreements? (http://us.practicallaw.com/3-386-4395)*).

It is important that the sponsor negotiate registration rights at the time it makes its initial investment in the company because the sponsor may no longer control the company after the IPO (see *Investment Stage Exit Planning*). Registration rights require a company to register securities held by the stockholder exercising the rights. Typically, a registration rights agreement provides that the holder of registration rights has a certain number of demand registrations and unlimited piggyback registrations. Importantly, demand registration rights permit a sponsor (under certain limitations) to force the company to register its shares with the SEC. For a form of registration rights agreement, see *Standard Document, Registration Rights Agreement (Section 4(2) Private Placement Form) (http://us.practicallaw.com/8-500-6936)*.

Secondary registered offerings are a preferred method for sponsor exits because of the comparative flexibility and speed. The timing, volume and manner of sale restrictions that apply to sales by affiliates under Rule 144 do not apply in a secondary offering (see *Sales after the IPO under Rule 144*). Therefore, a registered offering, if demand for the company's equity is sufficient, may provide a sponsor with an immediate, complete exit.

On the other hand, secondary registered offerings are subject to some of the same shortcomings as IPOs (see *Disadvantages of an IPO Exit*). These offerings are likely to provide sponsors with only a partial exit to their investment unless there is a high demand for the company's stock. In addition, depending on the size of the public float, the fund's investment could still be too large to be sold in the market at one time at a desirable price. Furthermore, the registration process itself, though usually less extensive than the initial registration, can still take up a large amount of management's time, attention and other company resources, especially if the company does not qualify to use the shorter Form

 

S-3 registration statement. In addition, the sponsor's ability to sell through a secondary offering is subject to its ability to compel the company to file a registration statement covering the fund's stock.

For more information on secondary registered offerings, see *Practice Note, Follow-on and Secondary Registered Offerings: Overview (http://us.practicallaw.com/5-381-0957)*.

# SALE TO A THIRD PARTY

The most common exit alternative for a sponsor of an LBO is a sale of the portfolio company to a third party. Sales can be made to either a:

- Strategic buyer (such as a competitor, customer or supplier of the portfolio company).
- Financial buyer (such as another private equity fund or other financial purchaser) in a secondary purchase.

## SPECIAL CONSIDERATIONS FOR PRIVATE EQUITY SELLERS

The sale of a portfolio company follows a similar process to any private sale transaction. However, what will drive certain aspects of the sale is the sponsor's goal to exit its investment and return capital to its investors.

### Planning at Investment Stage

The sponsor must begin planning for the sale at the time of its initial investment. To realize the greatest return on its investment, a sponsor must be able to deliver the entire business to the buyer, including all of the portfolio company's outstanding shares. To ensure it has this ability, the sponsor should negotiate drag-along rights in its stockholders agreement at the time of its initial investment. Drag-along rights allow the fund to force any minority stockholders (including management) to join in the sale of the company under the same price, terms and conditions as the fund is receiving. For more on drag-along rights in stockholders agreements, see *Practice Note, Stockholder Protections: Drag-along and Tag-along Rights (http://us.practicallaw.com/6-382-7132)* and *Standard Clause, Stockholders Agreement: Drag-along Rights (http://us.practicallaw.com/6-383-5245)*.

The sponsor should also consider the type of buyer to whom the portfolio company may be sold. If the portfolio company is sold to a financial buyer, the sponsor will want to have a management retention plan in place to allow the sponsor to deliver the retained company's management to the buyer. This will increase the value of the company to the buyer, and increase the purchase price and the amount the fund realizes on its investment (see *Management Incentives*).

### Auction Process or Single Bidder

In selling the portfolio company, the sponsor can choose to negotiate with a single buyer or shop the portfolio company in an auction process and receive offers from multiple bidders. In an auction, though the seller is typically in control of the sale process by setting the timetable for negotiating and completing the sale, and drafting the transaction documents, the process can take longer than a single buyer negotiation. However, an auction with multiple bidders can result in a higher sale price for the portfolio company than in a single buyer process or other exit method. The process forces bidders to bid against each other and offer terms more favorable to the seller than they would in a single buyer process. For more on auctions, see *Auction Timeline (http://us.practicallaw.com/9-381-0700)* and *Practice Notes, Auctions: From the Seller's Perspective (http://us.practicallaw.com/6-383-1087)* and *Auctions: From the Bidder's Perspective (http://us.practicallaw.com/5-503-3724)*.

### Clean Break

In the sale, the sponsor will want to obtain a clean break from the portfolio company and distribute the proceeds to investors. Therefore, in purchase agreement negotiations, sponsors typically are concerned with:

- **Survival.** It is important to ensure the representations, warranties and covenants survive for a finite period of time. This includes representations and warranties relating to fundamental matters, like due authority, capitalization and taxes, which buyers sometimes want to survive in perpetuity. For more on negotiating survival periods from the seller's perspective, see *Standard Document, Stock Purchase Agreement (Auction Form) (http://us.practicallaw.com/3-502-5305)*.
- **Cap on indemnification.** Sponsors will also want to be able to distribute as much of the proceeds from the sale to their limited partners as possible. They cannot do so if the purchase price continues to be at risk because of potential indemnity claims by the buyer. The sponsor should structure the agreement to limit its exposure for breaches of representations and warranties to a percentage of the purchase price and for all other matters to no more than the amount of the purchase price. For more on negotiating indemnification provisions from the seller's perspective, see *Standard Document, Stock Purchase Agreement (Auction Form) (http://us.practicallaw.com/3-502-5305)*.
- **Limited escrow.** The sponsor should attempt to limit the buyer's recourse if there is a breach to an amount placed in escrow at the closing of the sale. The sponsor should try to have any escrow period be as short as possible because the sponsor cannot distribute the amount in escrow until it has been released. For more on escrow agreements, see *Standard Document, Escrow Agreement (http://us.practicallaw.com/1-386-3603)*.
- **Consideration.** Sponsors should also negotiate for the consideration to be cash or other liquid assets. Earn-outs and other deferred consideration as well as illiquid forms of consideration should be avoided if possible. For more on earn-outs, see *Practice Notes, Earn-outs (http://us.practicallaw.com/0-500-1650)*.

### Dual Track Process

The financial uncertainty during the last few years has sometimes made it difficult for sponsors to exit successfully their portfolio companies. As a result, it has become increasingly common for

sponsors to prepare simultaneously for both an IPO and a sale process (known as a dual track). With a dual track, there is a greater likelihood that some transaction will occur and the sponsor increases its chances of an exit. The sponsor ultimately chooses to pursue to closing the exit that seems most likely to succeed and to generate the greatest return. For more on dual track exits, see *Practice Note, Managing a Dual-track Exit Strategy (http://us.practicallaw.com/2-503-9911)*.

### ADVANTAGES OF A SALE PROCESS

There are several reasons why a sponsor may find a sale to be more advantageous than an IPO. It offers:

- **A complete exit.** Unlike an IPO, sales typically allow a fund to make an immediate and complete exit. At the closing of the sale, the fund usually transfers its entire interest in the portfolio company to the buyer and ends its investment in the company.
- **More control.** In a sale of the portfolio company, the fund has more control over the sale process than in an IPO, where many of the terms are controlled by securities laws, exchange rules or the underwriter.
- **Speed.** The seller and potential buyers often simultaneously complete due diligence and negotiate the terms of the acquisition document. Once the diligence and negotiations are complete, the seller and the buyer execute the definitive agreement. Once the definitive agreement is signed, the deal can be closed as soon as any applicable regulatory approvals are obtained and, if applicable, the buyer obtains financing. In a sale process with a single bidder, the process can take as little as two to three months.

### DISADVANTAGES OF A SALE PROCESS

Sales also pose potential downsides for sponsors, such as:

- **Resistance from management.** The portfolio company's existing management may be resistant to a sale involving a strategic buyer because buyers often replace the portfolio company's managers with their own team. As a result, in a strategic sale, the sponsor cannot always count on management to assist the transaction from the start.
- **Risk from competitors.** The sales process can expose a portfolio company to risks from competitors that enter bids only to determine the portfolio company's value or gain access to the portfolio company's confidential information. Sponsors must verify the genuineness of a competitor's interest in purchasing a portfolio company before granting the competitor this access. Sponsors should also consider limiting access to sensitive contracts and information until the later stages of the process when it is easier to determine a competitor's motive. Also, if competitors are involved in a sale process, the terms of the confidentiality agreement and having strong company protections becomes even more important. For more on confidentiality agreements in this context, see *Practice Note, Confidentiality and Nondisclosure Agreements (http://us.practicallaw.com/7-501-7068)* and *Standard Document, Confidentiality Agreement: General (Unilateral, Pro-discloser) (http://us.practicallaw.com/9-501-6497)*.
- **Regulatory delays.** Sales to strategic buyers may be delayed by antitrust review. For an overview of the main US antitrust statutory provisions and regulatory structure, see *Practice Note, US Antitrust Laws: Overview (http://us.practicallaw.com/9-204-0472)*.
- **Risk from financial buyers.** Financial buyers may not be able to pay as much as strategic buyers because financial buyers cannot factor synergies into their cost. Financial sponsors also finance their deals with debt, which adds risk that the deal may not close if they are not able to obtain financing (see *Practice Note, Buyouts: Overview: Financing a Buyout (http://us.practicallaw.com/4-381-1368)*). Many financial buyers counter this risk by providing a reverse break-up fee in the purchase agreement, particularly in a going private transaction. However, that may not be a sufficient remedy for a seller that wants more certainty to close the deal. For a discussion of these issues, see *Practice Note, Reverse Break-up Fees and Specific Performance (http://us.practicallaw.com/8-386-5095)*).

## PARTIAL EXITS

### DIVIDENDS AND RECAPITALIZATIONS

Sponsors may achieve a partial exit from their investment in a portfolio company through a special dividend issued by either the portfolio company to its parent holding company or by the parent holding company itself (for an overview of the typical structure of an LBO and the use of buyout vehicles, see *Practice Note, Buyouts: Overview: Buyout Vehicle (http://us.practicallaw.com/4-381-1368)*). The type of dividend is defined by the source the company (or the parent holding company) uses to finance it:

- A non-leveraged dividend recapitalization is financed by the company by using cash that it already has on hand.
- A leveraged dividend recapitalization is financed by the company by incurring additional debt.

#### Non-leveraged Dividend Recapitalization

Typically, a non-leveraged dividend recapitalization is smaller than a leveraged dividend recapitalization because a non-leveraged dividend recapitalization relies on cash already on the portfolio company's balance sheet. Therefore, non-leveraged dividend recapitalizations rarely result in a full exit from the investment for the fund.

However, if a non-leveraged dividend reduces the amount of the fund's at-risk capital invested in the portfolio company, a non-leveraged dividend does reduce the level of the fund's downside risk. Non-leveraged dividends, unlike a leveraged dividend recapitalization, do not substantially increase the portfolio company's risk profile or increase the size of its debt service payments, and do not usually lead to bad press for the sponsor.

### Leveraged Dividend Recapitalization

Leveraged dividend recapitalizations are often funded by having the parent holding company of the portfolio company take out debt secured by its shares in the portfolio company. Lenders typically prefer this structure over issuing debt to the portfolio company itself, especially if the portfolio company has already incurred a significant amount of debt in the LBO.

A leveraged dividend recapitalization has certain advantages as an exit strategy:

- **Larger size and possible full exit**. A leveraged dividend often can be larger than a non-leveraged dividend and often can provide the fund a full return of the dollar value of its invested capital. If so, the fund and its investors will have no further downside risk in the portfolio company investment.
- **Ability to maintain control**. Unlike in an IPO (see *Loss of Control*), a leveraged dividend recapitalization does not require the fund to give up any control to realize its partial exit.

However, sponsors considering a leveraged dividend recapitalization must consider the disadvantages of this exit strategy:

- **Typically not a full exit**. Leveraged dividends usually do not provide the fund with a full exit of its investment and make the fund's remaining investment in the portfolio company riskier. This is because the portfolio company and its business and assets will be the sole source of servicing the debt (even if the debt is placed at the parent holding company level), and, as a result, the portfolio company will have higher leverage and an increased debt load.
- **Bad press for the sponsor**. Leveraged dividend recapitalizations can also result in bad press for the sponsor, and make the sponsor appear to be raiding the portfolio company for its own benefit.
- **Market limitations**. In a tight credit market, parent holding companies and portfolio companies may be unable to secure financing (or financing with desirable pricing) for a dividend recapitalization forcing sponsors to pursue a different transaction to gain liquidity.
- **State corporate law limitations**. As a matter of corporate law, a company can only make dividends out of available cash. For example, under Section 170 of the Delaware General Corporation Law, a company may only pay dividends out of available surplus.
- **State and federal fraudulent conveyance limitations**. In addition, federal and state bankruptcy laws provides that if a company is already insolvent or is rendered insolvent by paying a dividend, then the dividend may be voided as a fraudulent conveyance. In that case, the fund would have to repay all or a portion of the dividend it received. For a discussion of fraudulent conveyance issues for sponsors, see *Practice Note, Fraudulent Conveyances: Issues and Strategies for Lenders and Private Equity Sponsors (http://us.practicallaw.com/8-382-2478)*.

## REDEMPTION RIGHTS

Sponsors may also achieve at least partial liquidity (and possibly complete liquidity) by forcing the portfolio company to redeem their stock for cash. At the time of the LBO, sponsors can negotiate for redemption rights that allow the fund, at its discretion, to return their shares to the portfolio company in return for an immediate payout of cash or some other consideration. Redemption rights are typically built into either the charter provisions or stockholders agreements.

Charter provisions can provide for the company to issue the fund redeemable preferred stock with a liquidation preference. This gives the fund the right to redeem its stock as well as to be the first stockholder paid back if the portfolio company enters liquidation. For an overview of the rights of preferred stock, including redemption rights and priority liquidation rights, see *Practice Note, Preferred Stock: Overview (http://us.practicallaw.com/2-504-1419)*.

A stockholders agreement can give the fund put rights allowing the fund to sell its shares to the portfolio company at an agreed price. For a further discussion of redemptions and put rights, see *Practice Notes, Stockholder Protections: Protections Relating to Stock Ownership (http://us.practicallaw.com/6-382-7132)* and *Stockholders Agreement Commentary: Overview of Transfer Provisions (http://us.practicallaw.com/7-381-0517)*.

Redemption rights give sponsors the ability to get an immediate return of at least a portion of the fund's at-risk capital. In addition, redemption rights typically are priced at a premium providing a return for the sponsor even in a transaction where the fair market value of the equity at the time of redemption is about the same price the fund paid for its initial investment.

However, exercising redemption rights is still an exit of last resort for a sponsor that is typically only used in unsuccessful investments because:

- Unless all of the stockholders are redeemed pro rata (and, as a result, the fund's relative equity ownership in the portfolio company does not change), the sponsor loses some of its upside potential in the investment because the fund gives up its stock (and reduces its ownership percentage) in a redemption.
- The price at which a sponsor can redeem its stock typically provides the fund with far lower returns than what were originally expected by the sponsor and promised to the fund's investors.
- A sponsor's ability to exercise redemption rights is limited by how much cash the portfolio company has on hand, how much additional debt it can borrow and its ability to pay for the redeemed shares. As a practical matter, if a portfolio company has insufficient cash or borrowing capacity to pay the redemption, the sponsor will be unable to exercise its rights.

## TAG-ALONG RIGHTS

In multi-sponsor or club deals where several sponsors own equity in the same portfolio company, tag-along rights can help a sponsor protect its investment and maximize its return. The sponsor should provide for tag-along rights in a stockholders agreement at the initial investment stage. Tag-along rights give their holder the right to force another stockholder that is selling its shares to include the other holder's shares in the sale, on a pro rata basis. A tag-along holder has the right to sell its shares for the same price and on the same terms as the selling stockholder.

The advantage to tag-along rights is that it ensures a fund can participate in a sale by another equity holder for a price and on terms the sponsor deems to be advantageous. However, tag-along rights rarely provide a fund with a complete exit from its investment in a portfolio company. Because tag-along rights only allow their holder to participate in a sale on a pro-rata basis, the extent to which a fund will be able to gain liquidity through tag-along rights will be limited by both:

- How many shares the purchaser wishes to acquire.
- The fund's proportional ownership in comparison with the other selling stockholders.

In addition, the benefit of tag-along rights to a sponsor owning a controlling equity interest in a portfolio company is limited because, in those situations, tag-along rights mostly serve as a disincentive to the company's other stockholders. Other stockholders may be reluctant to spend the time and resources searching for a third-party buyer and negotiating a sale of their stock if the sponsor, by exercising its tag-along rights, can reap the majority of the benefits of the selling stockholders efforts (due to its ability to sell more shares on a pro rata basis in the transaction).

For an example of a tag-along provision, see *Standard Clause, Stockholders Agreement: Tag-along Rights (http://us.practicallaw.com/8-383-5254)*.



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