Leveraged Buyouts and the Board

Putting the right policies in place can help directors and management skirt a minefield of potential conflicts in the LBO process.

by Carl Ferenbach

You are president and chief operating officer of your company, which is publicly owned. You earn an attractive salary, a good cash bonus, and you own a few thousand shares of stock and options to buy more at recent market prices. If everything works out for you, you might own a million dollars of your company's common stock some day — bought at market prices.

Suddenly, three events occur: your chairman announces his impending retirement; Victor Posner announces he has acquired 8 percent of your company's common stock; and a leveraged buyout firm or investment bank approaches you and offers you the opportunity to be CEO of a new company organized to acquire your current company. For relatively little money, you and your top 20 managers will own 15 percent of the new company, and, if you do your job well, five years from now your investment may be worth 10 times what it is today. And you can accomplish this with little change in current income.

The lure of being a multimillionaire with a fair modicum of control over a business has led more and more managers to consider a leveraged buyout. LBOs are nearly always transactions in which the key management of the company being sold will own a significant interest in the new corporation, which is organized to effect the LBO. If after several years the management has been successful in reducing the new corporation's debt burden while growing earnings before interest and taxes, the leverage will have worked and substantial wealth will have been ensured for the new investors, including management itself.

Because this potential wealth is perceived as far exceeding the wealth management can create in a corporation's standard form of ownership, and because management has a responsibility to the corporation's existing shareholders, management's interests in the decision to undertake an LBO are often in conflict — e.g., obtaining the best possible price for the current shareholders will increase the risk inherent in

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the leverage taken on by the new company and reduce the new owners' returns.

Two questions of corporate policy, then, are at issue:

— Should the corporation be sold to an investor group that includes management?

— What must the board of directors do to ensure it has received a fair price and fulfilled its responsibility to exercise its business judgment in considering the sale of the corporation?

This article examines alternatives for handling such conflicts of interest arising from LBOs — first, of a public investor-owned corporation, and, second, of a division/subsidiary of a larger corporation. Guidelines for coping with the problems are suggested.

Unique board concerns

The board of a publicly owned corporation that is considering an LBO must weigh factors that would not normally concern it if the corporation were being sold to a well-financed corporate purchaser. These include:

Management-initiated LBO proposals are a trap for both corporate and division management.

Time: The time required to arrange financing for an LBO and to negotiate the interests of the various parties to the transaction is inevitably longer — perhaps as much as 90 to 120 days longer — than in a conventional transaction.

Uncertainty and Exposure: The time required creates uncertainty for the corporation's constituents, i.e., its employees, customers, suppliers, and shareholders, and exposes it to other bids. (This in spite of the fact that the tender offer has now been used to acquire control of a target in an LBO.)

Price: The price an LBO group can pay has clear limitations: (1) What is competitive in the acquisition marketplace; (2) What is financeable; (3) What an independent investment banker thinks is fair; (4) The investment group's own requirements for a rate of return. The group's rate-of-return requirements and the lender's evaluation of the borrower's credit generally restrict buyout groups from making preemptive offers or engaging in bidding wars. The board of directors should know that in most cases the buyout group offer is open to the risk that it will be topped once it is made public. Over the past two years this has happened in at least 15 cases of which I am aware.

Management Conflicts: As noted earlier, management is a buyer of the new company and should view the buyout as a significant wealth-creating opportunity. Its opportunities to influence the transaction — primarily its price — are numerous. Earnings-related decisions can be taken through management's control of operations. Discretionary charges can be taken to hold earnings down. Management may have concerns about third-party acquirers who have expressed interest in the company in the past or who are currently owners. (For example, at least seven buyouts have been precipitated by Victor Posner's announced intent to acquire a significant interest in a business.) The potential for acting in self-interest is considerable.

Solicitation of Offers: The board, when it has decided to consider a buyout proposal, must decide whether to solicit other offers. Management and the group organizing the deal will resist. There are valid arguments on both sides of this question.

Financing: The purchaser typically makes its offer contingent upon obtaining financing. The board needs to be able to evaluate whether this financing can be obtained at the price being offered. One favorite ploy of buyers is to offer more than can be financed and then to change the deal at the last minute to reflect what really can be done.

Shareholder suits

Many other factors specific to buyouts are worthy of note:

☐ Fees are unusually large. Merrill Lynch, for instance, received a $20 million breakup fee for its City Investing activities.

☐ Disclosure. The activities of the board and the interests of management in the new company will be fully disclosed.

☐ Legal action. Public-company buyouts have increasingly drawn shareholder suits alleging self-dealing, conflicts of interest, and inadequate price.

The best solution to the possible problems these unusual factors cause is to anticipate and address each of them before they occur.

The board should first establish an independent committee. The committee's members should have no interest whatsoever in the new company. The committee should assume control of all aspects of the transaction. Its first steps should be to retain counsel and a reputable investment bank experienced in evaluating LBO proposals. Management should be advised of its conflicts and of the limited role it will have in the

Getting to the Right Price: The CEO's View of LBOs and the Board

What constitutes the role of the board of directors in leveraged buyouts? It can probably be summed up very succinctly by saying that the board's role is to ensure that shareholder values are protected and best served by the magnitude of the price paid for the outstanding shares of the company in question. However, the situation is considerably more complicated than this.

In the first place, since incumbent management collectively usually end up as part owners of the newly formed business, it is impossible for them to be entirely objective. For this reason, it is important to establish at the outset an evaluation committee comprised of outside directors to thoroughly explore all facets of the offer and proposal under consideration.

Obviously, it is helpful if the directors have been on the board of the company in question long enough for them to be familiar with the strengths and weaknesses of the management and of the strategic position of the company itself. It is important for them to have private discussions, in which inside directors and other company managers are not present, with the attorneys and investment bankers. The latter, in particular, are crucial with respect to providing input on both a fair and attractive return to shareholders, with such considerations as the price in relation to the underlying strength of the assets of the company, and both book value and market value. The premium to be paid the shareholders, the subject of dividends, the timing of any dividends due and payable under the normal course of events, the possible withholding of dividends depending on the particular circumstances involved — from the time that a price is fixed to the closing date — are also essential matters to be considered.

Another complicating factor that frequently arises is the likelihood of one or more additional offers which may come to the company from other parties after rumors or publicity on the buyout become widespread. Generally, it is reasonable for the evaluation committee — after negotiations have commenced with the firm initiating and negotiating the buyout — not to solicit offers from others, but to insist that the board consider any serious offers that might be made in the interim.

It is essential for the board to agree upon the selection of a second investment banker for a second opinion. To my knowledge, this is generally a fairly routine process. The investment banker selected normally receives a handsome fee and the brotherhood among investment bankers may lead them to quick support in the anticipation of reciprocity at some time in the future. This requires thorough evaluation of the second opinion to assure that a sufficiently comprehensive study has been made of the company being purchased to support a valid opinion.

The board does not have an obligation only to the shareholders. The future of company managers, with whom many of the board has frequently had a long association, is highly dependent upon their being able to generate cash. A strong and steady positive cash flow is necessary to reduce the enormous leverage resulting from a complete switch from a low debt-to-equity ratio before the buyout to a very high debt-to-equity relationship after the buyout, e.g., from 40 cents debt/$1 equity to $5 debt/$1 equity.

Management must change to an entirely new business philosophy — managing for cash flow.

In considerations by the board of the likelihood of success of the company once they go through a buyout, one of the most important features is management and its adaptability. Management must change to an entirely new business philosophy. Most of them have had growth in earnings as their principal objective; and now, of course, the generation of cash becomes paramount. They must manage for cash flow. This means a new management style — a new way for many of the key managers who will become part owners of the restructured company. Their ability to change is vital to the success of the leveraged buyout, whether it remains a private company or goes public a few years down the road.

Edward S. Smith

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board's decision to sell the company. The committee should have a full review from management of current operations, of prospects for the balance of the current fiscal year, and of any projections that will be used to obtain financing for the buyout. The committee should negotiate all fees and should empower its advisers to confirm in detail all financing proposals. To reduce the uncertainty caused by the time required to obtain financing, specific time limits should be placed upon the buyout group and disclosed to all.

Comfort on price

Price is, of course, the ultimate issue. The best means to obtain comfort on price is to solicit offers from other qualified bidders. Management and the buyout group would each have legitimate grounds for withdrawing their offer if this occured: Management because it jeopardizes their jobs if they bid and lose; the buyout group because their offer will be shopped once the deal has been negotiated and announced. Further, a complete negotiation will include a form of lockup or option or breakup fee and possibly a contract, and it is important that management not benefit from these.

One favorite ploy of buyers is to offer more than can be financed and then to change the deal at the last minute.

Many boards have felt comfortable that the time that elapses between announcement of the LBO offer and its consummation (60 to 120 days) is sufficient for other parties to make their interests known; and, as noted earlier, when other parties felt they could pay more, they have. The recent use of the cash tender offer to effect an LBO may change this, but in my mind the shorter time should not be material to the board's decision to not solicit other offers.

A fairness opinion from the financial adviser should also be sought and relied upon by the board. It is important to have the investment bank confirm the availability of financing and its terms both to gain assurance that the price offered will be paid and that the transaction will close without renegotiation.

A somewhat different set of problems for the board can arise with the sale of a division or subsidiary. The first comes when the division/subsidiary management initiates the buyout. The second comes when the board authorizes corporate management to divest a division/subsidiary and the division/subsidiary management wants to make its own offer.

Proposals initiated by management have become increasingly common as the LBO market has expanded and drawn more attention in the business press. Particularly when no investor group is sponsoring the offer, management-initiated proposals are a trap for both corporate and division management.

For division management, a set of choices has been forced on corporate management:

— Accept or negotiate;
— Solicit other offers;
— Reject out of hand;
— Terminate division management.

Division management, of course, hopes to precipitate a negotiation. But it may have trapped itself. By raising the prospect of sale of the division, it also raises questions about its own ongoing commitment and dedication if the division is not sold to it. It would also be fair for corporate management to question whether it has been told everything about operations and prospects that it should have been told.

Looking for an exit

Corporate management is also trapped. It has a competent — maybe even excellent — management group looking for an exit with ownership of its division. First, corporate management doesn't want to lose good people. Second, it may not want to lose a good business or, at least, it wants to get the best possible price for the division.

There are ways to avoid these traps. The board can establish guidelines for the initiation of divestitures by management, permitting them under clearly defined circumstances and otherwise prohibiting them; or the board can simply prohibit division management from taking such initiatives. For its part, division management can seek out a sponsor — an investor group — and then remove itself entirely from the process. Out of harm's way, their idea can receive an objective hearing.

Irrespective of how the board and corporate management elect to deal with these initiatives, I believe they will be forthcoming in increasing numbers and that some form of policy is the corporation's only defense against losing outstanding people unnecessarily.

In the second case, a board-authorized divestiture, it is essential that a clearly defined process be established that is fair to everyone. If the division is an LBO candidate, the management will surely wish to make an offer. If the division is marketed broadly, several professional investor groups will want to make offers in which management would participate. As a result, management finds itself playing a very difficult role. Usually it does not have the financial ability to make its own bid without the help of a professional group. While making its own bid, it must professionally describe its business to all prospective purchasers, fully disclosing prospects and problems. How does it maintain objectivity and serve its corporate owners' interest while serving its own interest?

No compromise of management

In this case, it's up to senior management and the board to require a very rigid process that does not compromise division management. Ideally, an outside professional, or investment bank, is appointed as agent for the sale of the business. Management is excluded from making an offer but is asked if it wishes to participate in a buyout. If it does, the agent then so advises all buyout groups that express an interest in the division and establishes ground rules for management's participation. Comfortable that some objective standards have been established in its interest, the division management can become an objective party in the sale of their division.

The foregoing can be summarized in four guidelines which, I believe, can represent the core of a corporate LBO policy for the board and corporate management:

1. There should be clear statements of corporate policy regarding management's role in developing or considering an LBO. Leveraged buyouts should be permitted, even sought, but management should know that it will have to stand aside when proposals are made.
2. Every effort should be made to preserve the independence and objectivity of the body considering the buyout (usually the board) and the management participating in it.
3. Whenever possible, professionals should be used to manage the process.
4. Every step should be taken to prevent valuable people from trapping themselves, thereby unnecessarily costing the corporation their services.

If these guidelines are followed, fair pricing and open process will follow. The transactions will be successful and, hopefully, undisputed by shareholders of the selling corporation. As one who believes strongly that management LBOs are beneficial to our economy and the people who work in it, I join all those interested to see that these transactions are carried forward in a fashion that places them above reproach. ■

Some form of LBO policy is the corporation's only defense against losing outstanding people unnecessarily.

Reader Response

More on LBOs and the Board

Followed Recommendations

I read with great interest your recent article, "Leveraged Buyouts and the Board," written by Carl Ferenbach [Fall 1984]. I believe Mr. Ferenbach understands the pros and cons of leveraged buyouts and is incisive and articulate in his appraisals. He succeeds in registering the point that no two leveraged buyouts are exactly the same, as are no two individuals. They are also taking place in a constantly changing economic and financial atmosphere. I personally found it rewarding that the Norton Simon board of directors and myself followed almost identically his recommendations.

David J. Mahoney
New York, N.Y.

Need a Third Party

When confronted with a leveraged buyout which includes internal management in the acquiring group, I believe that the board of directors of any company should disassociate itself from decisionmaking as to the pricing and to the selection of the acquiring group.

Board members have close relationships with senior management. In most cases, individuals are asked to join a board by the management of the company. To ask a board to treat a situation in which their associates and in many cases their patrons are involved is unfair to the directors. It puts them in a situation where their judgment might be influenced by association.

Can a director be completely impartial in his judgment towards management, towards his own ongoing relationship with the company, and towards its shareholders? I question the ability of most individuals to be impartial. If the director approves of the plan submitted by internal management, he may be accused of favoring his associates. If he disapproves, he runs the risk of injuring his ongoing relationship with the company. When a leveraged buyout of a division occurs there is less likelihood of the director being compromised, but it still exists.

In my opinion, whenever management of a company is involved in a leveraged buyout a third party of repute should be utilized as the determinant rather than the board. The third party would be better able to evaluate the fairness of any offer to the shareholders, and provide judgment not colored by relationships.

Victor K. Kiam III
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Full Disclosure

Your article mentions that the board's activities and management's interests "will be fully disclosed," but the significance of this is understated. Companies often are confronted with issues about the degree to which their proxy materials should disclose the role of the board and management in the LBO. These are sensitive to the LBO participants, but should be resolved by erring on the side of over-inclusive disclosure. This approach can eliminate liability under the securities laws for improper or incomplete disclosure, and usually limits dissenting shareholders to the right of appraisal. Also, as a practical matter, shareholders considering an LBO are usually more concerned about the amount of the above-market premium to be paid on their investment than they are about the role of the board and management in the deal. So it is unlikely that complete disclosure of the financial interest of the board or management would prevent the LBO from receiving shareholder approval.

Alexander D. Bono
Blank, Rome, Comisky & McCauley
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Deserve Rewards

I enjoyed reading the article on LBOs in your recent issue. From time to time we have considered a management and investor buyout via an LBO.

One discouraging factor, or irritant, is the problem of strike lawyers who warm up their word processor and file a lawsuit — on a knee jerk reaction — no matter what the price. Every LBO that I have seen gives the shareholders an excellent premium over the then-market price of the stock and, in most cases, points above the all-time high.

The management and/or the institutional investors are left running a company with an enormous debt load and that isn't my idea of operating in a relaxed atmosphere. And in most cases, the management investors are betting a substantial part of their net worth on the future success of the company. If they win, I think they deserve substantial rewards.

Daniel E. Hogan
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