

Sealing The Deal: Akin Offers Choice In Zombie Fund Buyout

By **Liz Hoffman**

Law360, New York (October 24, 2012, 6:18 PM ET) -- Willis Stein & Partners LLC was in a tight spot. Its third buyout fund, a 2000 vintage, was underwater, worth more on paper than it could reasonably sell its three remaining portfolio companies for. It had already gotten two one-year extensions from investors, but by early 2012, patience was waning.

The firm wanted a comprehensive fix, one that would hand its portfolio off to a new majority owner and cash out antsy investors, while keeping Willis Stein as general partner. It needed a deep-pocketed backer with experience in the secondaries market, and a deal structure that would bend over backwards to be transparent and accommodating to investors, many of whom were at the end of their rope.

Akin Gump Strauss Hauer & Feld LLP stepped in with a midsummer save.

Representing a buyout group led by London-based Vision Capital LLP, the law firm put together a deal that offered cash to investors who wanted out and interests in a new fund to those who wanted to stay. Structured as a merger — a rarity among fund vehicles — the deal required a 600-page disclosure document, amendments to a decade-old partnership agreement, a full limited partner vote, a spin-off of certain Willis Stein assets not included in the sale, and a delicate swap of limited partner interests.

And the transaction, which closed Aug. 29, could offer a blueprint for other funds that find themselves long in the tooth. The key takeaway, attorneys said, is to offer investors a choice. A flexible deal structure with full disclosure can quiet grumbling and lessen the risk of litigation down the road, they said.

“We really wanted to give the LPs the opportunity to make a new investment decision, whether that was accepting cash or rolling over into a new fund structure,” said Ackneil Muldrow III, the lead Akin attorney on the deal. “We wanted to make sure we were giving every option we reasonably could.”

Willis Stein's third buyout fund had closed in 2000 on \$1.8 billion with a five-year investment period and 10 years to pay out. But 12 years later, it was still stuck with three investments: Education Corp. of America Inc., an operator of for-profit colleges; Strategic Materials Inc., a Houston-based recycling company; and Velocitel LLC, which provides IT services to the communications and solar power industries.

Its second one-year extension was set to run out in July. In January, the fund's advisory board called for a review of its options, and the firm hired Moelis & Co. to look for interested buyers.

An early front-runner was Vision Capital, a direct secondaries investor with \$2.1 billion in assets under management that specializes in whole portfolio acquisitions. The firm and its co-investors, Landmark Partners and Pinebridge Secondary Partners, became the preferred bidder in late April with an offer to buy out a majority of the fund's investor base using a new fund that would house their LP interests.

But structuring the deal proved thorny. Private equity funds aren't set up to merge and rarely do. The vehicle is a wrapper for the assets inside, and most partnership agreements don't envision a change of control at the fund level. Any merger would also change participation rights, governance and other issues among investors, which required tweaks to the governing documents.

And because the deal blended elements of a portfolio company sale, which would come with all the usual representations and warranties, and a secondary LP interest sale, which wouldn't, Vision and Willis Stein pushed back and forth on due diligence and indemnification.

The lawyers — Akin Gump for Vision and Kirkland & Ellis LLP for Willis Stein — looked around for precedent and came up empty.

“There was nothing we could pull off the shelf,” Muldrow said. “These documents were going to have to come from scratch. That meant we had a lot of freedom, but it also meant we were out on our own.”

The attorneys first considered a tender offer, which would offer a faster close. But Vision had big plans for the fund's portfolio companies and needed a sizable majority stake to get to work. The firm worried that a tender offer could leave it hanging — out hundreds of millions of dollars but without the control position it sought.

“We're not a passive investor,” said Andrew Lobb, Vision Capital's general counsel. “We're looking for opportunities to provide active management, and we needed a deal structure that got us there.”

So the parties settled in late May on a shareholder vote. All 130-some investors in the fund would have to vote twice: first, on whether to approve the merger and second, on whether they wanted to cash out or roll over their stakes into the new fund.

The new plan gave Vision the certainty of control. But it also opened the deal to a higher level of scrutiny under Delaware law, requiring Vision's legal team to prepare a detailed proxy statement and tackle concerns like fiduciary duty, transparency and fairness.

Under Delaware law, any offer had to meet the “entire fairness” standard. And because Willis Stein owed a fiduciary duty to its investors, any hint that the firm was getting a better deal than its limited partners could open the transaction up to a legal fight, which would almost certainly be made messier by the merger, the lawyers said.

Vision retained Morris Nichols Arshat & Tunnell LLP as Delaware counsel and the lawyers quickly set about bulletproofing the deal.

“You can say [Willis Stein] took a haircut and it was a great deal for the LPs, and maybe it was,” Morris Nichols' Louis Hering said. “But it was still an interested transaction between related parties, and that's going to be looked at very carefully by the courts.”

They knocked off challenges one at a time. Protection for Vision against breaches of representations and warranties? They used a pile of unrelated Willis Stein assets being held in escrow as an indemnification fund. Possible conflicts of interest in the indemnification dispute resolution? They drafted new documents that gave legacy LPs a voice. No merger provision in the partnership agreement? Two sets of new amendments, passed by a majority of investors. And that pesky ticking clock? One final, temporary extension to buy time toward closing.

The lawyers mailed a 600-page disclosure document to investors in late June, detailing what their interests in the new fund would look like and how much they could expect to receive if they cashed out. In the end, a majority voted to take the money, but a “significant number” stayed in, Lobb said. Vision and its partners swallowed the remaining LP interests and ended up with a “sizable” majority in the new fund, Lobb said, declining to disclose the final tally.

“From the advisory board, we had a sense of where some of the big LPs were, but we knew that LPs generally would have diverse aims,” Lobb said. “So we had to build in a structure with some flexibility.”

The deal could provide a rough roadmap for other funds that find themselves in Willis Stein's shoes. Of the roughly 10,000 funds raised over the past 15 years, at least 200 are in such a position, according to consultants TorreyCove Capital Partners LLC. These funds have outlived their 10-year time frame and are stuck holding portfolio companies with slim exit prospects.

“Investor patience is starting to run out and a transaction like this one, I think it's a creative solution to a bad situation,” TorreyCove CEO David Fann said. “You're providing a choice, and that's as close to a win-win as you're going to see.”

Lobb, for one, likes the precedent set by the Willis Stein deal. Vision Capital is a savvy shopper in the market for portfolios of assets and sees the industry's post-bubble landscape as providing a host of opportunities.

“There will be more of these as funds come to the end of their natural life, invariably with more assets than they've had historically,” Lobb said. “Investors are increasingly vocal in the kinds of options they want to see. And that's where we see the opportunity for us.”

The Vision investor group was represented by Ackneil Muldrow III, Kelly Labritz and Steven Pesner of Akin Gump. Morris Nichols Arsht & Tunnell LLP served as Delaware counsel, led by Louis Hering and James Honaker.

The Kirkland team representing Willis Stein included Richard J. Campbell, John A. Weissenbach, Michael D. Belsley, Carol Anne Huff, Jeffrey M. Loeb and Ellen K. McIntosh. Richards Layton & Finger PA served as Delaware counsel.

--Editing by Jeremy Barker.