GUEST ANALYSIS: PROTECTING SELLER INTERESTS IN A LEVERAGED BUYOUT

By James A. Deeken and Jean Lu, Akin Gump Strauss Hauer & Feld LLP

October 7, 2010

While the state of the economy has made it more difficult for buyers to obtain the optimal amount of financing desired to consummate leveraged buyouts, buyers have attempted to bridge the financing gap by having sellers provide seller financing either in the form of seller notes or deferred earn-out payments.

Even once the principal terms have been agreed on for seller financing or earn-out payments, the real job of protecting a seller's interest is only commencing at that point. Without effective follow through based on the advice of competent counsel, the seller could lose the benefit of economic bargain over the non-cash consideration if the components are not structured properly in the face of senior debt that the buyer may have and effective legal protections for the seller are absent.

Seller Financing

A common means used to bridge the financing gap is to essentially ask the seller of a business to provide seller financing by taking a portion of the purchase price consideration in the form of a note issued by the target. While such financing is issued by a company that the seller knows very well, seller financing presents the following threshold issues that should be considered by a seller:

• *Subordination Agreement Issues*: In a leveraged buy-out, the buyer will typically finance part of the cash portion of the acquisition price by taking out a bank loan against assets of the target. Thus, the issuer of the seller financing will often be the issuer of bank financing. Bank lenders will typically require that the seller execute a subordination agreement subordinating the seller financing in right of payment to that of the bank's.

Although a subordination principle is reasonable in the event that there is a default in the borrower's obligations to make a payment to the bank lender, the key issue that a seller will need to examine is whether, and to what extent, the bank lender can block payment under the seller financing in the event that there is a non-payment related default under the bank loan. Without being aware of these issues, a seller could find itself without a significant portion of the consideration that it thought it bargained for in the event that the target breaches a technical financial or other covenant post-closing.

• *Structural Issues in Seller Financing*: In addition to the issue of subordination, a senior bank lender may require that any seller financing be issued by a holding company or acquisition vehicle, while the bank debt is issued by an operating company.

This structure essentially renders the seller financing structurally subordinated to the debt of the senior bank lender, as the debt owed to the senior bank lender is backed by assets of the operating company, whereas the debt of the holding company would be solely backed by the equity interests that the holding company holds in the operating company. The result being that the bank debt is backed by hard assets, while the seller financing is backed by equity issued by an entity that is already encumbered by debt and thus of limited value in the event of a foreclosure.

To address this risk, a seller will sometimes be able to negotiate with the bank lender to allow the operating company to issue a guaranty of the seller financing debt. However, if such guaranty is allowed, the bank lender will typically require a tightened subordination agreement. In any negotiation of a subordination agreement that arises when debt is issued by an upper tier entity, the seller may want to ask for a provision that would allow the upper tier entity to sell equity and use the proceeds to redeem and payoff the seller financing.

• *Security Interest Issues*: Regardless of who the issuer of the seller financing is, a seller will at times request that the seller financing obligations be secured by assets of the issuer and in the event that there is a guarantor, assets of the guarantor as well. Even though any such security interests would likely need to be subordinated to the security interests of a senior lender, the presence of security interest would provide that the seller financing debt would rank above most trade debt of the issuer in the event of an insolvency of the issuer. This is often, however, a negotiated issue as the issuer will want to preserve the flexibility to grant liens for working capital lines and the senior bank lender will sometimes require that no other liens be placed on the assets of the issuer of the senior bank debt.

• *Issuer Capital Raising Ability*: A prudent seller may wish to examine the capital structure of the issuer to assess the likelihood that the issuer will have sufficient capital to make payment on the seller financing in light of the debt burden posed by a senior layer of bank debt. The senior facility may require that cash generated from operations be used to pay down senior debt or otherwise held in the company unless certain financial covenant ratios are met. A provision such as this in the senior facility potentially reduces the cash that the issuer would have available to make payment on the seller financing.

One mechanism that a seller may wish to consider is ensuring that the senior debt documents allow the issuer to sell additional equity and use the proceeds of such equity to make a required payment on the seller financing. At times, when the seller financing is issued at a holding company level, a bank lender will indifferent to allowing this if the sole purpose of the equity fund raising is to make payment on the seller financing, as it brings capital into the company, as opposed to cash from operations, that would otherwise not be there.

• *Covenants*: Covenants in seller financing are not always common, but a seller will need to analyze its ability to exercise some degree of control of the business post-closing to allow it to optimize efforts to make sure the issuer is operated in a manner that will generate sufficient cash to make the required payments. However, since the issuer is aligned in interests to maximize profit covenants generally only focus on covenants against further subordination of the seller financing.

• *Single Asset*: In a case where the buyer is purchasing distinct assets, the seller may negotiate to have certain distinct assets placed in a special purpose entity that will issue debt to the seller and attempt to persuade the senior lender to lend solely on the basis of other assets of the business, leaving the special purpose entity debt to the seller unencumbered. In practice, however it is often fairly difficult to get senior lenders to agree that certain carved-out assets should back seller financing especially when such assets constitute a critical portion of the larger business that is being sold.

Earn-outs

When a seller agrees to take a portion of its consideration in the form of a deferred component of the purchase price that is tied to the performance of the business post-closing, the presence of an earn-out component raises all of the same issues presented above with respect to seller financing, as an earn-out is merely a form of seller financing that it is tied to a performance metric for the business post-closing.

Lawyers who represent sellers receiving a portion of the purchase price in the form of an earn-out often focus on post-closing covenants to ensure that the business is run post-closing in a certain manner and that the sellers, if retained as management, have the ability to run the post-closing business in a manner designed to maximize the chances that the relevant earn-out metric will be met. However, in many cases, lawyers in this position often overlook that, even if the performance metrics and covenants are met, the buyer’s ability to actually make the earn-out payment may conflict with and be prohibited by the terms of the buyer’s senior debt, unless the issues are above are fully considered with respect to the contingent earn-out payment.

Recent Case Study

A recent example of a seller's efforts to protect its interests when presented with contingent payments can be seen in the merger agreement providing for the acquisition by TNS, Inc. of Cequint, Inc. In addition to the consideration to be paid at the effective time of the merger, contingent cash payments are to be made to Cequint stockholders based on the Cequint achieving certain targets over a certain three-year post-closing period.

TNS's obligations in respect of the earn-out (and any stockholder's claim for damages against TNS for any breaches relating to the earn-out obligations) are subordinate and junior to the full payment of obligations under an existing credit agreement of TNS. Pursuant to the terms of the merger agreement, if either an event of default under the senior credit agreement occurs or such an event of default would result after giving effect to the payment of any earn-out obligations, then the payment of any such earn-out would be suspended until such event of default is waived or otherwise cured.

The stockholder representative of the Cequint stockholders agreed in the merger agreement not to seek or enforce any right or remedy during such suspension period, provided that any suspended earn-out payments would accrue interest at eight percent interest until paid. In exchange, TNS agreed to use good faith efforts to obtain a waiver of any event of default under such credit agreement and deliver any default notice under such agreement to the stockholder representative.

The Cequint merger agreement also provides that upon a bankruptcy of similar event involving bankruptcy or a similar event, all senior indebtedness of the TNS would be paid first before any earn-out obligations would be paid. Senior Indebtedness shall first be fully paid in cash before any Subordinated Obligations may be paid. The stockholder representative agreed, among other things, not to initiate, prosecute or join any proceeding challenging the enforceability of the senior indebtedness or any liens and security interests securing it.

About the Authors

James A. Deeken *is a partner in the Investment Funds and Private Equity practice of Akin Gump Strauss Hauer & Feld LLP. Read his full biography.*

Jean Lu *is an associate in the Investment Funds and Private Equity practice of Akin Gump Strauss Hauer & Feld LLP. Read her full biography.*

Related Resources from Westlaw BUSINESS

Westlaw Business Currents Coverage
[Earnout Structures: Terms, They are a Changin'](#)
[Private Equity: Buyouts Lift, but Terms Shift](#)
[M&A: Earnouts Earn Their Keep](#)
[M&A Post-Closing Provisions: Neither Plain Nor Paltry](#)