Preparing a Portfolio Company for Sale

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This practice note addresses a private equity fund sponsor's process in preparing a portfolio company for sale. This process is time-consuming and involves significant preparation and coordination from multiple internal and external resources and advisors. This practice note offers guidance on the timing and scheduling of steps in preparation for sale, and advice to practitioners regarding coordination of the sale process.

The Importance of Preparation

The countdown to an eventual exit begins the moment a private equity fund acquires a new portfolio company, if not even earlier. To maximize the return on the sponsor's investment, it is also critical that the sponsor find itself in a position to sign a definitive sale agreement at the time when the competitive tension among potential acquirers is at a peak, without delays arising from unanswered due diligence questions, unfinished negotiations with management or other administrative loose ends. As a result, private equity firms and their advisors should begin their planning and preparation well in advance of the commencement of an actual sale process, given the speed at which windows of opportunity can open and close in today's market.

To allow the maximum flexibility for a well-timed exit, the planning and preparation for a sale process should be as much of a part of owning and managing the portfolio company as seeking operational improvements and revenue and cash flow growth. The fact that the company will eventually need to be marketed, investigated by bidders, and then sold should inform every material decision taken from the time of the acquisition forward, including financing decisions (flexibility to roll to a new sponsor/obligation to provide parent/sponsor guarantees, etc.), structuring decisions (have a clear view of what will be sold and the consequences to both the sponsor (as seller) and the acquirer as a result of the chosen structure), and even commercial decisions (Is that bolt-on acquisition, growth capital investment, or joint venture really worth the costs and restrictive covenants it may impose on the business?). Sponsors should attempt to avoid decisions that, while potentially beneficial in the short term, may materially complicate a future sale process and distract a potential buyer's focus from the company's core businesses.

Both the internal and external teams who will ultimately be responsible for managing key aspects of a sale process should be identified early and they should be introduced to each other. The members of management who will be responsible for elements of the sale process should understand that such a process will occur, and they should be mentally prepared for that process and, as part of their ongoing responsibilities, be tasked with taking the steps necessary inside the business to ensure that the process goes smoothly. The external teams that are expected to be involved in the sale process (including financial advisors, lawyers, accounting and tax advisors, with others as needed) should be identified and stay relatively familiar with the company's business and operations; ideally, they will maintain open lines of communication with their counterparts within the company's management so that the sale process becomes an extension of existing working relationships rather than a disruptive new integration of unknown outside advisors into the company's business.

Action Items

Below are action items that should be part of the day-to-day preparation for a sale process, all of which are good practices in any event. All these items will be requested by bidders or their advisors in the due diligence process. Importantly, having these items prepared at the outset will ease the burden on management and the internal legal function during a sale process (and any burden on management can quickly become a delay in the desired timeline to selecting a winning bid and signing a definitive purchase agreement). The private equity firm, with assistance from management, should:

- Prepare annual budgets and projections
- Maintain contract databases, including summaries of material contracts and charts highlighting which contracts contain change of control provisions, confidentiality provisions, renewal/termination rights, most favored nation provisions, and other provisions that companies should be monitoring compliance within the ordinary course
- If applicable to the business, prepare form contracts that include the company's position on key terms (e.g., indemnification obligations)
- Maintain an updated capitalization table with management incentive equity and vesting information
- Maintain readily accessible records regarding employment and separation documents and know who will be owed a payment (and how much) in connection to a transaction
- Maintain a litigation log along with key dates and copies of all applicable documents
- Track outside legal spend and responsibilities of each external law firm
- Maintain copies of key transaction documents of any follow-on investments (including a copy of the data room and diligence memorandum prepared in connection with such acquisition) or divestitures, and consider preparing summaries of the key transaction terms highlighting any ongoing obligations or contingent liabilities
- Maintain title documents for owned real properties, and lease documents for leased spaces
- Maintain reasonably current environmental assessments of material properties/sites
- Consider maintaining a relatively current data room or other structured repository of company-specific documents (this can be also useful for financings, re-financings, etc.) –and–
- Make sure to obtain an electronic copy of the data room used in the initial acquisition process

As we have already highlighted, the preparation for a sale process should begin well before there are immediate plans to sell the company or launch a sale process. However, once it has been determined that the appropriate time to exit has come and the sale process will begin in earnest, take the following steps, each of which is discussed in detail in the sections below:

- Select a financial advisor
- Identify potential acquirers
- Prepare the teaser or confidential information memorandum
- Draft and negotiate a non-disclosure agreement
- Construct a data room
- Consider and purchase representations and warranties insurance
- Notify management of the prospective transaction

Select a Financial Advisor

When considering strategic alternatives (mainly a sale), the first step is typically to select the financial advisor. It is important to consider the following factors:

- **Preexisting relationship between an advisor and the company and/or the sponsor.** Does the advisor know the business? Can the sponsor trust their advice?
- **How the financial advisor is organized and how the matter will be staffed.** Will it be staffed with sector experts or with M&A experts or will the financial advisor use an integrated team?
- **The advisor's fee structure.** It is important that the advisor has incentives to maximize value for the sponsor, rather than to simply ensure that a transaction happens.
- **Potential conflicts of interest.** Conflicts should be vetted early in the process and the sellers should understand the advisor's relationship with potential acquirers, particularly if the advisor's banking side is a potential financing source. At a minimum, the advisor should be able to provide an accurate assessment of how the capital markets will view the potential sale and what the potential buyers' financing packages may look like.
- **Exclusivity vs. multiple financial advisors.** If multiple financial advisors will be used, be very clear on the delineation of roles, as squabbling financial advisors will not streamline a process.
- **Engagement letter.** Although it is not necessary to finalize the engagement letter immediately upon selecting the financial advisor, it does help to address it early in the process. This may focus the financial advisors (and eases any concern around the security of their expected fee), and it relieves the sponsor from the distraction of an unpleasant last-minute surprise negotiation around the fee.

Understanding the Potential Universe of (and Concerns Related to the Identity of the) Acquirers

The financial advisor should be able to provide insight into the universe of the potential acquirers and, from a preparation perspective, it is important to understand whether potential buyers are likely to be strategic bidders, sponsors, or a combination of both. Due to antitrust and other concerns, sponsors should be cautious regarding sharing certain detailed product information with strategic bidders or with sponsors that own portfolio companies in competitive industries. There may be a need for a clean team process and different data rooms for different bidders, and, therefore, the relevant members of the deal (including management and M&A/antitrust counsel) should begin reviewing, flagging, and redacting key documents as may be necessary well in advance of the bidders' intensive due diligence review to ensure that addressing these competitive concerns will not delay the process.

The nature of the buyer will also impact management's views of the transaction. With a financial buyer, key members of management may be asked to roll over a significant amount of their pre-transaction equity but will likely remain part of the management team post-closing and may even be awarded additional incentive equity under the new owner. With a strategic buyer, however, management may be able to fully cash out their equity stakes in the company but will also be more likely to be made redundant as the company is integrated into its new owner's structure. The seller should be aware that these facts may affect management's view of different potential buyers.

The legal team should also work with the financial advisors to examine the list of potential buyers from a regulatory perspective (e.g., which bidders may create antitrust or Committee on Foreign Investment in the United States (CFIUS) concerns).

Preparing the Teaser / Confidential Information Memorandum

The financial advisors are largely responsible for the preparation of the teaser / confidential information memorandum (the CIM), but these documents require significant data to be provided by management, including commercial/market assessments and detailed and thoughtful projections. If this information is not readily available, the preparation of the CIM will take significantly more time. It is important that lawyers review a relatively early draft

of the CIM to ensure that it does not contain statements that are problematic from the perspective of antitrust or securities regulation.

Non-disclosure Agreement Process

The process of negotiating and executing a non-disclosure agreement (NDA) with each prospective bidder can be rather time-consuming if there are several bidders showing interest (or even a small number of bidders that wish to heavily negotiate their NDAs). As a threshold matter, the sellers must decide whether the bankers or lawyers (internal or external) will run the negotiation process.

In most cases, there is limited benefit to having an overly aggressive NDA and, if it is too aggressive, many bidders (especially acquisitive strategic bidders and large institutional buyout shops) may simply substitute their own form of buy-side NDA in lieu of editing the draft they initially receive. If there are more than a handful of NDAs being negotiated, the primary consideration should be getting through the process relatively quickly and painlessly while bringing as many bidders into the fold as possible. It is generally helpful to have the lawyers prepare an aggressive buy-side markup of the form NDA and discuss it with the sponsor deal team and key members of management to anticipate potential issues and have clear views on what points are acceptable and what points aren't acceptable.

An easily overlooked point regarding the NDAs is that proper recordkeeping is essential. As soon a definitive agreement is signed with the winning bidder, the company's legal team should mail out letters that instruct the losing bidders to return or destroy all of the confidential information in their possession that they received access to as part of the due diligence process. Without a proper record of each bidder that executed an NDA and received access to the data room, this process is difficult to carry out efficiently and the portfolio company's sensitive information may be at risk.

See Confidentiality/Non-Disclosure Agreements in Private M&A Deals for additional detail on the NDA process.

Data Room

Virtually all sale processes involve a virtual data room of due diligence materials. As mentioned above, consider maintaining a periodically updated current data room, using the initial acquisition's data room as a base. In addition to the typical buckets of information provided in a data room, below are other various items to consider when preparing the data room that can further streamline the diligence process:

- Prior to opening the data room, aim to have the draft auction purchase agreement, draft disclosure schedules, and other key ancillary agreements in a shareable form.
- Before the sale process starts, determine whether new environmental Phase I assessments are needed and, if so, have a consultant engaged to prepare them so they are ready when the data room opens.
- Consider whether there are any issues with the company's title to any of its owned real properties that need to be cleaned up.
- Consider obtaining commercial/market diligence reports ahead of time.
- Consider engaging an accounting firm to prepare a sell-side quality of earnings report.
- Consider whether multiple data rooms (or restricted access clean team folders within the same data room) need to be maintained for different acquirers (i.e., considering any competitive or regulatory sensitivities).

From an organizational perspective, it is important that the responsibilities for maintaining and populating the data room are known in advance (this effort is usually led by the bankers in consultation with the outside M&A/antitrust lawyers, working with documents that are produced by members of the in-house financial and/or legal functions). Every document proposed to be posted in the data room should be reviewed from a legal and commercial standpoint before being made available to bidders, as no one should be surprised by what documents are in the data room. Any issues that arise from such review should be proactively addressed, if possible.

There is also utility in conducting a relatively complete self-diligence review to identify potential roadblocks, so a plan came to be implemented to address each of these self-identified issues. Sellers should also consider providing bidders with an executive summary of the materials in the data room as well (e.g., an entity by entity overview). The goal should be to make review of the data room as quick and easy as possible.

See Due Diligence Review Tools in M&A Deals for additional information on the role of data rooms in M&A transactions.

R&W Insurance

In today's market it is common for sellers to insist that the buyer obtain a representations and warranties insurance policy (R&W Insurance) and to rely on that insurance policy as a primary source of recovery for breaches of representations and warranties, rather than offering up a robust traditional indemnification/escrow package. The benefit of R&W Insurance from the selling sponsor's perspective is that it minimizes the amount of sale proceeds that must be escrowed with a bank or reserved by the sponsor for future indemnity claims—sponsors can distribute more of the proceeds immediately to their limited partners. However, for this approach to yield good results, the rep and warranty package covering the target company in the purchase agreement must be insurable without significant exclusions. Although it would be rare that a deal would not be insurable, obtaining representation and warranty insurance policy quotes will be helpful to understand what terms insurers will offer and if there are material exclusions. If there would be material exclusions, then the sellers can consider whether to get ahead of the issue and provide for a limited special indemnity in respect of such excluded items. Since the negotiation of an R&W Insurance policy can be relatively time-consuming, it is also helpful to upload such quotations to the data room so bidders can prepare their markups on the auction draft based on the quotations.

See Representations and Warranties Insurance for the Private Equity Industry for further information on the role of R&W Insurance.

Management

Key members of the management team should be aware that the sale process is going to be a significant distraction from running the business and should have a plan for managing their time and their duties accordingly. Some high-level members of management will be key for negotiating the transaction, and others will be needed to assist in producing documents for the data room in response to bidder due diligence requests. At the highest level, management should understand that, in connection with a sale to a financial sponsor, they will likely be requested to roll over a significant amount of equity, although they will likely receive additional equity or bonus opportunities from the new sponsor as well. If management needs to be additionally incentivized to get the deal done quickly and conscientiously, arrangements to otherwise compensate management (i.e., transaction bonuses) can be considered, with the understanding that these payments will be borne by the selling sponsor. Management should be encouraged to hire separate counsel to negotiate new arrangements with a financial buyer—the seller's law firm should not be negotiating on behalf of management.

Resolution of management-related issues must also be considered as part of the overall timetable to get a transaction signed (and there shouldn't be any remaining issues to solve between signing and closing—otherwise, management will possess hold-up value). While sellers generally do not want management engaging with multiple bidders, the successful bidder will need time to work out any issues related to the new arrangements for members of the management team that will be continuing after the sale. The last thing a seller wants is for a management-related issue to hold up a transaction, and properly aligning management's incentives with the sponsors are key to avoiding these holdups.

Conclusion

It is important to always be prepared for an impending sale process, and, therefore, advanced preparation beginning from the outset is vital to a streamlined sale process. An efficient sale process that ensures that a definitive agreement can be signed at the most opportune time will avoid any deal fatigue among the parties and, most importantly, maximize the value of the sponsor's investment.

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Annotated Clauses

- Indemnification Clauses (Representations and Warranties Insurance)
