OSLER

What public-style private deals mean for buyers and sellers

SEPTEMBER 17, 2018 4 MIN READ

Related Expertise

- Private Client
- Private Equity

Author: Shahir Guindi, Ad. E.

Public-style private deals are private company M&A transactions that are run and closed with risk allocation constructs that are similar to public company acquisitions.

They took anchor in the United States but are also now being seen in Canada, especially in large and high-profile private equity transactions.

With so much capital chasing a limited number of available targets, in some cases, sellers have been able to insist on placing more risk on the buyer – risks that, until recently, buyers would not have taken.

This trend will likely continue, so it's important for PE firms and other buyers to understand the implications and for sellers to understand the opportunity.

Public-style private deals and risk

In the past, in private M&A deals, whether the buyer was a PE fund or not, buyers have traditionally been armed with robust risk protection mechanisms.

These included fulsome representations and warranties, extensive disclosures, indemnity packages, escrow or holdback arrangements and sometimes more than that!

These mechanisms not only mitigated the chances of a post-closing claim, they also gave the buyer a solid basis upon which it could pursue legal action against the seller in the event of a breach of representation, warranty or covenant.

This private company M&A norm is in stark contrast to the acquisition of a public company, in which the buyer essentially takes on all of the risk and there is no recourse to the target's selling shareholders after the deal closes. Public company shareholders-vendors provide no indemnity, post-closing covenants, escrow, holdbacks or other assurances.

Shifting risk to the buyer

In public-style private deals — like public deals — the buyer does not have the benefit of an escrow or holdback. In addition, and perhaps more startling, the buyer has only very limited indemnity protection.

More specifically, other than protection in the event of a breach of fundamental representations or key covenants or fraudulent actions, the buyer will have no claim, under an indemnity or otherwise, against the seller(s).

Even a breach of very important (but not "fundamental") representations and warranties – such as on the financial statements, litigation, tax, material contracts, no material adverse change, ordinary course of business, environmental or intellectual property matters, etc. – will be precluded.

As a result, the risk of a problem largely shifts over to the buyer. We treat the private company seller almost in the same way that a shareholder of a public company is treated when it is selling its public company shares.

Mitigating risk in public-style private deals

To mitigate risk in such transactions, buyers have been forced to take an even deeper and more expensive dive into financial, technical, market, human resources, tax, legal and other due diligence items.

In addition, buyers are having to source and pay for their own representation and warranty (R&W) insurance, which essentially shifts responsibility for breach of many (but not all) seller representations to a third party.

In such a competitive deal environment, R&W insurance can also help the buyer gain an advantage when bidding on an asset (i.e., so there is less onus on the seller to offer an indemnity or escrow), and generally serves as one of the only realistic substitutes for the traditional robust buyer-friendly indemnity provisions.

However, buyers should be mindful that R&W insurance is not a perfect alternative for a seller indemnity package, and they should take into account the implications of that approach to risk mitigation.

R&W insurance will not cover all heads of liability, can be expensive, won't cover items that have been disclosed in the transaction process, requires time and thorough due diligence to put in place, and in some cases is not obtainable.

Other implications

There are other implications of public-style private deals that need to be considered: everything from definitions (such as the MAC clauses) to the financing provisions.

For a buyer, these need to be carefully considered and factored into the bidding process as well as the costing and negotiation of the deal.

A seller, on the other hand, ought to consider whether the asset it is offering is "worthy" of this type of structuring.

This construct will work for the largest and most hotly chased assets. Smaller deals, and deals that cannot generate fervent interest in the marketplace, will not garner this type of deal construct – the buyers would not allow it.

The buyers are open to this construct in only certain types of competitive bidding circumstances. Most often, we will see this in PE sponsor-to-PE sponsor sales. It is less likely that a strategic buyer will accede to this deal dynamic or that an owner-operator of a smaller business will get its benefit.

Concluding thoughts

Given the state of the current market — flush with capital but limited deal opportunities — public-style private deals will likely become increasingly common, especially in PE deals.

Sellers will try to leverage the competitive market conditions to achieve the most favourable deal terms, which in some cases will exclude indemnity packages and other traditional deal protection features.

Buyers need to understand and carefully evaluate the risks and benefits when entering into public-style private deals. Sellers ought to consider imposing them.

Note: This article originally appeared in The PE Hub Network.