

The Leveraged Buy-Out with a Public Stub

By Andrew J. Nussbaum and Joshua R. Cammaker*

A strength of the private equity M&A market has always been the willingness of private equity buyers to consider improvements in transaction structures and deal technology to address a seller's particular concerns and needs. Many recent public-to-private buyouts have faced criticism and challenges from shareholder groups, hedge funds and proxy advisory firms relating to the failure to provide the target's shareholders with an opportunity to participate in the future growth of the target under private equity management. The pending acquisition of Harman International Industries by KKR and Goldman Sachs Capital Partners serves as a possible middle ground, by offering Harman shareholders the opportunity to retain a minority interest while permitting the buyers to effectively take the company private.

The Harman structure entails an all-cash transaction, but with shareholders having the ability (but not the obligation) to elect to exchange up to approximately 12.5% of the Harman shares for stock of the newly-formed acquiring parent company. The stock portion of the transaction is entirely optional, and Harman shareholders can choose to receive only cash, a combination of cash and stock or all stock, with the stock portion subject to proration if oversubscribed. Because of the leverage to be incurred post-closing, the 12.5% will represent a significantly greater percentage of the equity of the new parent company. The new shares will be SEC-registered (and the buyer has committed to file periodic SEC reports for at least two years post-closing). Shares of the new parent are not required to be listed for trading on an exchange, although trading on "pink sheets" may develop. This represents something of a middle ground on the public-to-private landscape.

The terms and amount of the rolled-over equity, or "public stub," in an LBO can be varied to suit the particular needs of the parties. However, the potential benefits to both sides of such a transaction structure are clear. The shareholders of the target company have the opportunity to continue to participate, at least in part, in the future of the target company, alongside highly respected private equity investors. Moreover, the exchange of Harman shares for parent company shares, when taken together with the private equity sponsors' contribution of cash to the parent company, is intended to qualify as a tax-free Section 351 exchange, generally allowing electing shareholders to defer at least a portion of their gain in the transaction. The election component of the transaction allows shareholders to choose their preferred consideration.

For the private equity sponsors, a Harman-style transaction provides greater flexibility in structuring the deal, and a potentially compelling proposal to the target's shareholders that may avoid some of the recent criticisms (and effective challenges) to the usual private equity deal involving a 100% cash-out of the public. Assuming shareholders elect to subscribe for the equity rollover portion, the structure also has the advantage of decreasing the amount of equity that the sponsors will need to fund. The Harman structure will not suit all sellers, nor all private equity buyers, but in today's highly competitive deal landscape, creative equity alternatives for the target's shareholders may be a useful deal tool.

* Andrew J. Nussbaum and Joshua R. Cammaker are partners with Wachtell Lipton Rosen & Katz. Mr. Nussbaum's practice involves a wide range of merger and acquisition-related matters, including cross-border transactions, spinoffs, divestitures, carve-out IPOs, private equity transactions, and joint ventures. He may be reached at AJNussbaum@wlrk.com. Mr. Cammaker concentrates his practice on mergers and acquisitions, corporate governance and securities law matters. He may be reached at JRCammaker@wlrk.com.