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In Defense of Stapled Finance

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Despite concerns regarding conflicts of interest, stapled finance remains an important tool for companies trying to obtain the highest possible price for a business being sold.

The phrase "stapled finance" is generally used to refer to prepackaged financing terms offered by the seller's financial advisor to financial buyers. Typically, the Confidential Information Memorandum sent to prospective purchasers regarding the business being sold informs potential purchasers of the availability of stapled finance and how to obtain information regarding its terms. In some cases, sellers have declined to make the terms of the stapled finance available to strategic buyers – who typically do not want or need the same type of financing – to prevent them from reverse engineering estimates of the maximum amounts financial buyers will be capable of paying using the stapled finance and thus impairing the competitiveness of the auction.

Generally, all bidders are offered the same terms, at least initially, but the ultimate financing terms agreed may be tailored to the needs and attributes of a particular purchaser based on a variety of characteristics including differences in business plans and capital structures and the ability of certain financial buyers to justify better terms based on past performance.

Recent events have focused increased attention on potential conflicts relating to stapled finance. For example, Vice Chancellor Leo Strine's Toys "R" Us opinion, included the following dicta:

> "The [decision of the financial advisor to request the Board's consent to provide financing to the winning bidder] was unfortunate, in that it tends to raise eyebrows by creating the appearance of impropriety, playing into already heightened suspicions about the ethics of investment banking firms. Far better, from the standpoint of instilling confidence, if First Boston had never asked for permission, and had taken the position that its credibility as a sell-side advisor was too important in this case, and in general, for it to simultaneously play on the buy-side in a deal when it was the seller's financial advisor. In that respect, it might have been better, in view of First Boston's refusal to refrain, for the board of the Company to have declined the request, even though the request came on May 12, 2005, almost two months after the board had signed the merger agreement."[1] (*For more on the Toys R' Us case and Vice Chancellor Strine's decision, see the September issue of* *The M&A Lawyer*, *"Revlon Duties 'R' Us"; vol. 9, no.4*)

That view, coupled with the NASD's proposed rules regarding fairness opinions[2] and various articles in the press[3] have focused attention on two major sources of potential conflicts in connection with stapled finance:

Conflicting Roles – Even as an independent contractor (as opposed to a fiduciary), the seller's financial advisor generally has a duty to act in good faith, presumably in a manner it believes is not opposed to the interests of its client, the seller. But as a source of financing for a prospective purchaser, the financial advisor will insist on the ability to exercise rights in its own interest, which may at times be in direct conflict with the interests of the seller (e.g., the contracted right common in financing commitments to declare that a material adverse change in the business being sold has occurred and withhold financing from the buyer);

Conflicting Fees – Although most courts have recognized that sell-side advisory fees based on a percentage of the aggregate transaction consideration align the interests of the seller's financial advisor with the interests of the seller,[4] concern has been expressed that the payment of significant fees contingent upon the closing of a transaction creates an incentive to support transactions at inappropriately low price levels.[5] That concern is exacerbated if the financial advisor stands to earn substantial additional fees from financings that are equally contingent upon consummation of the transaction.

Others have expressed concern that the sell-side financial advisor will tilt the playing field in favor of a bidder more likely to use it to finance the transaction. According to a finance professor at New York University's Stern School of Business "If the same investment bank is having relationships with both parties, there are alarm bells that go off.... Does the investment bank consciously or even subconsciously tilt the auction so that the bidder that emerges victorious is the one that will take the financing?"[6] Upon closer inspection, it's hard to construct a plausible scenario in which a sell-side financial advisor could tilt the playing field in favor of a bidder that it believes is likely to use its financing. The winning bidder is selected by a board of directors that will almost always choose the highest, fully financed bid, absent differences in closing risk.

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Despite these conflicts, the benefits of stapled finance can often be compelling. The availability of prepackaged financing may:

- *induce more bidders*, as it confirms that a transaction is financable without the investment of any time, money or other resources by prospective purchasers and, if the sell-side advisor is one of the seller's traditional lenders or sources of financing, signals that a financial institution that is familiar with the business being sold is comfortable with the business's ability to service the debt to be incurred under the stapled finance package;
- *create a more competitive bidding process*, by ensuring that at least one source of potential financing is available to all interested bidders, even as financial sponsors increasingly require potential sources of financing to go "exclusive";[7]
- *result in speedier agreement and consummation of a transaction* because the provider of stapled finance will have completed its due diligence and will have obtained the necessary internal approvals to provide financing commitments;
- *create a financing floor* that limits the ability of the winning bidder to renegotiate the purchase price based on a claimed deterioration in the terms of the financing available from third party sources of financing; and
- *provide greater certainty of consummation* as a result of the demonstrated capacity of a small group of investment banks, which may include the seller's financial advisor, to successfully market the significant amounts of high yield securities and/or loans necessary to finance large leveraged acquisitions.

Some sellers also believe that it can be advantageous to have their financial advisor involved in the buyer's financing because the sell-side advisor will be less likely to pull its financing commitment as a result of a deterioration in the business being sold or other problems than third party sources of financing with no historical relationships with the seller or other interests in the transaction.

It's also worth noting that stapled finance is routinely used by financial sponsors, the most sophisticated market participants, when they choose to sell businesses that may be attractive to other financial sponsors. According to the co-head of European leveraged finance at Deutche Bank, "Staple financing was offered by banks this year in about 90 percent of the auctions in Europe where buyout firms sold businesses to other buyout firms."[8]

For their part, investment banks are well aware of the concerns regarding their potential conflicts of interest and have implemented a variety of policies and procedures designed to address them, including:

- the use of separate teams of bankers to provide financial advisory services to the seller and to work on financing arrangements for different bidders;
- the implementation of informational barriers designed to prevent the unauthorized disclosure of information from the financial advisory team to financing teams, and vice versa;
- generally requiring that all bidders be informed that stapled finance is being made available and that the terms of the stapled finance be provided upon request to all bidders, or at least all financial buyers;
- permitting potential purchasers to freely choose their preferred sources of financing;
- refusing to offer stapled financing when representing a special committee evaluating a management buyout;[9] and
- effectively requiring sellers desiring a fairness opinion to obtain a fairness opinion from an unconflicted financial advisor.[10]

The ability to provide stapled finance is not always a blessing. Some providers of stapled finance are unwilling to materially vary the terms of the financing offered to different financial buyers prior to the completion of the auction, in part for fear of damaging commercial relationships with those it offers less favorable terms. Third party sources of financing are not so constrained and can often offer more advantageous financing terms to selected bidders who are free to accept those terms rather than the stapled finance. This in part explains the relative success of third party financing sources in lead managing the financings of winning bidders even if the stapled finance was relied upon by most purchasers for purposes of submitting initial bids. In a German study, KPMG reported that "[a]lmost two-thirds of the PE houses questioned indicated that they used the providers of such stapled finance packages first and held discussion with them. It is interesting, however, that only around a fifth of the PE houses indicated that they actually funded the acquisition with the aid of such finance packages."[11]

Ultimately, many companies get comfortable with their financial advisors providing stapled finance because the members of the investment banking team providing financial advice to the seller are often trusted advisors who have proven their worth and integrity over time and the companies do not believe that they will risk their reputation and a long-standing and mutually beneficial commercial relationship on one fee opportunity. Nevertheless, the decision by a seller to allow its financial advisors to provide stapled finance should not be undertaken lightly. To weather potentially skeptical judicial scrutiny, companies should establish a detailed record demonstrating that the board's decision was fully informed and followed careful consideration and deliberation of the issues, including an evaluation of specific risks and benefits and, if appropriate, was conditioned upon the implementation of certain procedures and restrictions, such as those described above.

In such circumstances, a properly functioning and rational board of directors may reasonably conclude that the benefits of allowing its financial advisor to provide stapled finance (or offering to provide or otherwise assist the winning bidder in obtaining financing after the completion of the auction) outweigh the risks posed by the potential conflicts and such a decision should be legally protected.

Notes

1. *In re Toys "R" Us, Inc. Shareholder Litigation*, 877 A.2d 975, 1006 (Del. Ch. 2005). But, Vice Chancellor Strine also acknowledged the potential for countervailing benefits. *Id.* n. 46 ("By stating this, I do not want to be perceived as making a bright-line statement. One can imagine a process

when a board decides to sell an entire division or the whole company, and when the board obtains a commitment from its financial advisor to provide a certain amount of financing to any bidder, in order to induce more bidders to take the risk of an acquisition. These and other scenarios might exist when roles on both sides for the investment banker would be wholly consistent with the best interests of the primary client company.")

2. NASD, Form 19b-4 Proposed Rule Change to Establish New NASD Rule 2290 Regarding Fairness Opinions (June 22, 2005, as amended on November 30, 2005), available at:http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_014558.pdf and http://www.nasd.com/web/groups/rules_regs/documents/rule_filing/nasdw_015636.pdf.
3. *See e.g.*, David Marcus, *Stapling under strain*, Corporate Control Alert, November 2005, Julia Werdigier and Christine Harper, *'Stapled' Loans Create Potential Conflicts for Merger Advisers*, Bloomberg.com, October 24, 2005, available at: http://quote.bloomberg.com/apps/news?pid=10000006&sid=aNS.Y5u9qCb8&refer=home and Rimin Dutt and Paul Ziobro, *J.P. Morgan to Wear Many Hats in Auction*, The Wall Street Journal, December 8, 2005, § 3, at 4.
4. *See e.g., Toys "R" Us, Id.* at 1005. ("This feature of the contract was designed to provide an incentive for First Boston to seek higher value, and has been recognized as proper by our courts."); and *In re The MONY Group Inc. Shareholder Litigation*, 852 A.2d 9, 22 (Del. Ch. 2004) ("This financially sophisticated Board engaged CSFB for advice in maximizing stockholder value. It obtained a fairness opinion from CSFB, itself incentivized to obtain the best available price due to a fee that was set at 1% of transaction value;...").
5. *See In re Tele-Communications, Inc. Shareholders Litigation*, No. 16470, slip op. at 30 (Del. Chanc. Dec. 21, 2005) ("A contingently paid and possibly interested financial advisor might be more convenient and cheaper absent a deal, but its potentially misguided recommendations could result in even higher costs to the special committee's shareholder constituency in the event a deal was consummated."), available at: http://courts.delaware.gov/opinions/(iperq255fyp4cv2yj0j50av4)/download.aspx?ID=69980. *See also* letter from Charles M. Elson, Arthur H. Rosenbloom and Drew G.L. Chapman to NASD, dated December 21, 2004, providing comments in response to the NASD's Request for Comment on Whether to Propose New Rule That Would Address Conflicts of Interest When Members Provide Fairness Opinions in Corporate Control Transactions (the "NASD Request for Comments") ("[a]s we stated in an article cited by the NASD in [the NASD Request for Comments], a number of factors tend to undermine the usefulness of fairness opinions. These include the conflicts of interest of many opinion givers due to the success fees they stand to receive upon the successful consummation of the transaction.... In response to these flaws, we have proposed...requiring fairness opinions...to be issued by independent investment banks that do not receive a fee that is contingent upon the closing of the transaction in question..."), available at: http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013213.pdf, letter from American Federation of Labor and Congress of Industrial Organizations to NASD, dated January 10, 2005, providing comments in response to the NASD's Request for Comments ("we encourage the NASD to strengthen its proposal by including an outright ban on the most egregious conflicts, notably arrangements in which part of an investment bank's fee for rendering its opinion is contingent upon the transaction closing"), available at:http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013218.pdf and letter from Ohio Public Employees Retirement System, dated November 30, 2004, providing comments in response to the NASD's Request for Comments ("Ideally, fairness opinions should consist of an independent legal appraisal by outside experts, who are not connected to the transaction, to ensure that the valuation is fair to shareholders. However, fairness opinions are frequently prepared by the same investment bank that is driving the transaction and also stands to financially benefit when the transaction is completed by receiving millions of dollars in fees."), available at: http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_013215.pdf.
6. Julia Werdigier and Christine Harper, *'Stapled' Loans Create Potential Conflicts for Merger Advisers*, Bloomberg.com, October 24, 2005, available at: ttp://quote.bloomberg.com/apps/news?pid=10000006&sid=aNS.Y5u9qCb8&refer=home.
7. The effect of exclusivity, particularly in auctions of very large companies, is to lock up the handful of financial institutions capable of financing multibillion dollar transactions so that they are committed to financing only one bidder. As Andrew Ross Sorkin recently noted in the New York Times "[t]hese banking arrangements can effectively lock out competitive suitors. A case in point is the latest $16 billion auction for the supermarket company Albertson's. In that deal, a group of buyout firms led by Kohlberg Kravis Roberts has corralled three of the biggest investment banks, Citigroup, Credit Suisse First Boston and Deutsche Bank, to exclusively lend them money to support their offer. Another team led, by Thomas H. Lee Partners, has done the same with Morgan Stanley, Bank of America and UBS. Several other bidders, including Cerberus, may be forced to drop out if they can't find financing." Andrew Ross Sorkin, *One Word Nobody Dares Speak,* N.Y. Times, October 16, 2005, § 3, at 6.
8. Julia Werdigier and Christine Harper, *'Stapled' Loans Create Potential Conflicts for Merger Advisers*, Bloomberg.com, October 24, 2005, available at: http://quote.bloomberg.com/apps/news?pid=10000006&sid=aNS.Y5u9qCb8&refer=home#
9. In the case of Toys "R" Us, the seller's financial advisor did not offer stapled finance but was merely granted permission to participate in the buyer's financing after the completion of the auction and the seller's selection of a winning bidder, thus significantly limiting the opportunities for conflict. Some financial advisors have adopted even more restrictive policies that generally prevent them from offering stapled finance in connection with the sale of a public company, effectively restricting stapled finance to divestitures and sales of private companies.
10. This is accomplished by either refusing to provide a fairness opinion if authorized to offer financing or by conditioning the rendering of a fairness opinion on the seller's receipt of a fairness opinion from a second financial advisor. In many cases the first advisor will agree to absorb the additional cost of hiring the second advisor to provide an independent fairness opinion.
11. Martina Ecker et al., KPMG Leveraged Finance Study 2004: *Insight into the German leveraged finance market and relationships between equity and debt providers,* (Frankfurt am Main, February 2005), available at: http://www.kpmg.de/library/pdf/050216_KPMG_Leveraged_Finance_Study_2004_en.pdf.

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