# Governance 'term sheet' for a buyout

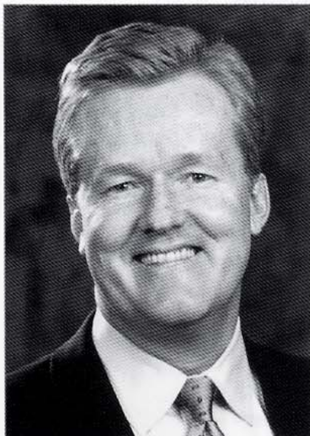
*If you're going to buy your own company, here are key governance issues that you need to get agreement on with your equity partner right at the outset — while you still have some leverage.* **BY RICK RICKERTSEN**

MANAGEMENT BUYOUTS (MBOs) are acquisitions of an operating company or a corporate unit in which the current or future senior management of the business participates as a significant equity partner in the acquisition. They used to be called leveraged buyouts, but this term fell out of favor with the last dance of the Predator's Ball. It is no longer used in the industry, or in polite company, although the concept of leverage is alive and well, under other aliases.

Contrary to popular belief, the buyout industry wasn't started by KKR in the 1980s. The management buyout industry was started early this century when financiers such as J. P. Morgan, Charlie Allen, and John D. Rockefeller used money borrowed against the assets of a target company to acquire a series of companies and build a large business. In those days, the deals were called "bootstrap" deals, but it was essentially the same structure as used today (though in those days they probably paid only three times cash flow!). The buyout business became institutionalized by a number of today's largest and best-known masters such as KKR and Clayton, Dubilier & Rice in the mid-1970s. The private equity industry expanded rapidly through the 1980s. The massive leveraged buyout deal growth of the 1980s, driven partly by Michael Milken's junk bond business at Drexel Burnham Lambert, culminated with the race to acquire R.J. Reynolds for $25 billion in the biggest buyout ever at the time. In 1989, when Drexel collapsed and the debt markets dried up, the industry hit a big bump in the road, and growth slowed dramatically until 1992.

At the time, no one ever expected to see another "era of greed" like we saw in the late 1980s. But, to paraphrase Mark Twain, the rumors of the death of the industry were greatly exaggerated. Surprisingly, the stable economic growth of the 1990s led to a resurgence in the buyout industry that makes the deal velocity of the 1980s look like child's play. For example, in 1996 the buyout industry as a whole raised around $18 billion to invest in deals. This was more than was ever raised in any one year in the 1980s. Industry watchers thought this level would never be matched again. Amazingly, from 1996 to today, the dramatic growth has continued. Industry estimates are now that there is more than $200 billion of uninvested equity standing by to pursue your buyout.

As a management buyout investor for more than 15 years, I have consistently been amazed by how little senior executives understand their huge opportunity to create equity value for themselves by purchasing their own company or operating unit. A top manager with a shot at being a CEO might be making $300,000 per year. But as a buyout leader he could create $30 million of equity value away from the parent, running his own company.



**Rick Rickertsen** is the chief operating officer of Thayer Capital Partners, Washington, D.C., and the founding partner of Thayer's two corporate buyout funds totaling over $1.2 billion. In his 15-year career in the management buyout world, he has led more than 50 buyouts, including Ritz-Carlton Hotel Co. and SAGA Software. In his capacity as chairman and director of several publicly traded technology companies, he has worked with managers to set strategy and maximize equity returns. Rickertsen's Web site is www.buyoutbook.com. This article is adapted from his new book, *Buyout*, © 2001 by Rick Rickertsen, published by AMACOM Books, New York, a division of the American Management Association (www.amacombooks.org).



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## How decisions will be made

What does it take to succeed in a buyout? Professional skills in the target industry are a requirement, although some of the most important parts of the deal do not show up on your resume. They are not the specific actions you take or documents you sign, but the intangible qualities and tangible skills you and your partners bring to the table. They have to do with trust and relationships.

Your relationship with the buyout firm is defined by a set of agreements — among them, governance.

Governance is the structure that defines how decisions will be made after closing. It is important *before you sign the deal* to have detailed discussions with your partner about governance issues. You need to deal with these tough issues right at the outset or you will have to deal with them later under circumstances where you no longer have any leverage. The term sheet should describe the governance structure for the new company and address some of the key issues you may face going forward. The equity partner usually wants a few members on the board to be actively involved in the firm's progress. The agreement should specify how many people are on the board, who will serve as chair, and the respective responsibilities of the board and the CEO.

## Also on the term sheet

The term sheet should also discuss whether you can be fired and on what basis, and the nature of decisions that are handled by management versus those that are handled by the board. Among the key governance issues are these:

**Termination.** If you are the CEO, on what basis can you be fired? The equity firm usually controls the majority of the company and can make these decisions. Though it is unlikely, it is possible the buyout firm can turn around and fire you the day after closing. Because they control the board and most decision making, you need to define the bases upon which they would have those kinds of conversations. Usually they only consider firing you if you are meaningfully off plan, but you need to negotiate all severance arrangements up-front to make sure you are fully protected.

**Severance.** Negotiate your severance deal to make sure if they fire you, you have one full year of salary for the CEO or CFO. If they fire you early on, without cause, a small portion of your equity should vest upon that termination.

**Board.** You need to have clear conversations about how the management team is going to interact with the board, and which investment professionals at the firm will be your daily contact. Who will be on the board? How often is the board going to meet? Typically, in the first six months, the board meets monthly and moves to quarterly meetings after the critical post-closing period.

**Scope of Control.** You need to specify what issues the board will control and which ones management will control. For example, you might negotiate specific clipping levels on expenditures. The CEO may be able to approve expenditures under $250,000. Anything above that goes to the board. These levels depend very much on the size of the company and the nature of its business. Can the CEO unilaterally hire and fire key executives and enter into supplier or customer agreements? Who is responsible for approving acquisitions, divestitures, and sales of stock and issuances of debt? (Hint: Almost always, it's the board.) Make sure all governance issues are clear to avoid setting up flash points for later conflicts.

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**Points of Contact.** Discuss with investors how their points of contact are going to work. Can they call your direct reports without your knowing? Typically, the investor would call the CEO and CFO directly, who would route calls through to directors. Most investors feel they can call anyone in the company anytime they want to. This is an issue that needs to be clarified.

**Board Composition.** Who is going to represent you on the board? For example, a seven-person board may have two members from management and five from the investor team. The CEO and CFO often sit on the board. The investor may bring in three people from within the firm and two outsiders with specific industry experience. You also need to determine whether these investors and directors are going to have compensation. Will they receive options or draw board fees? Any compensation going to the board is coming out of the company, which means it is taken from your hide. Typically, representatives from the investment firm do not receive compensation. The outside directors get some stock in the company, which is dilutive to managers. Directors may receive $50,000 in stock that vests over three years if they serve on the board. Members who leave the board forego a portion of the stock due to these vesting provisions. ■

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