

CHAPTER 2

Sample LBO Deal Documentation

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§ 2.01 Sample LBO Deal Documentation¹

For ease of understanding the sample deal documents in this text, here-with a summary of a leveraged buyout transaction that involves the acquisition of a Delaware public company (“Target”) by an investor group led by two well-known large private equity investors (the “Sponsors”) pursuant to an Agreement and Plan of Merger, dated as of April 1, 2005 (the “Merger Agreement”).

The parties to the Merger are:

Target, Inc.

A public company.

¹ Contributing Editors, Lorraine Massaro and Ricardo Hollingsworth, Kirkpatrick & Lockhart Nicholson Graham LLP.

Acquisition, Inc. (“Parent”).

A Delaware corporation owned in equal parts by the two Sponsor groups through certain newly formed private equity funds affiliated with the Sponsors. Parent was formed solely for the purpose of entering into the Merger Agreement and consummating the transactions contemplated by the Merger Agreement. It has not conducted any other activities.

Acquisition Merger Sub, Inc. (“Merger Sub”).

Merger Sub is a Delaware corporation and a wholly-owned subsidiary of Parent. Merger Sub was formed solely for the purpose of entering into the Merger Agreement and consummating the transactions contemplated by the merger agreement. It has not conducted any other activities.

The Merger is structured as a reverse subsidiary merger (the “Merger”) and once the Merger Agreement is approved by Target’s stockholders and the other closing conditions under the Merger Agreement are satisfied or waived, at closing, Merger Sub will merge with and into Target and Target will be the surviving corporation and a wholly-owned subsidiary of Parent. As the surviving corporation in the Merger, Target assumes by operation of law all of the rights and obligations of Merger Sub under the new Notes discussed below and the related indentures. Target’s Class A and Class B common stock, (other than shares held in treasury or owned by Merger Sub, Parent or any direct or indirect subsidiary of Merger Sub and other than shares held by stockholders who properly demand appraisal rights) will be converted into the right to receive \$100 in cash, without interest. Target will then delist from the NYSE and become a private company.

Target and the Sponsors estimate that the total amount of funds necessary to complete the Merger and the related transactions is approximately \$5.75 billion, which includes approximately \$5 billion to be paid out to Target’s stockholders and holders of other equity-based interests with the remainder to be applied to pay related fees and expenses in connection with the Merger, the financing arrangements and the related transactions (including redeeming the Old Notes). These payments are funded by a combination of equity contributions by affiliates of the investors in Parent and debt financing as well as available cash of Target (approximately \$1 billion).

The Sponsors cause up to \$1.5 billion to be contributed as equity to Merger Sub immediately prior to the Merger. The actual amount of equity contributions made as part of the Merger funding will consist of indirect contributions of approximately \$1.2 billion provided by investment funds associated with or designated by a Sponsor (collectively, the “Sponsor Funds”), including certain other funds investing directly through a Sponsor Fund; approximately \$275 million provided by certain investors who have agreed to co-invest with the Sponsor Funds or through a vehicle jointly controlled by the Sponsors (the “Co-Investors”); and approximately \$25 million provided by certain of members of Target’s senior management.

The Sponsors further finance the Merger with cash on hand at Target, a new \$2 billion senior secured term loan facility, a new senior secured asset-based revolving credit facility providing financing of up to \$500 million, of which \$150 million was drawn at the closing, and the private placement of

\$500 million aggregate principal amount of 9%/10% senior notes due 2015 (the “Senior Notes”) and \$500 million aggregate principal amount of 12% senior subordinated notes due 2015 (the “Senior Subordinated Notes”). In addition, in connection with the closing of the Merger and related transactions, Target redeems all of its 6% senior notes due 2010 (the “Old Notes”) and terminates its existing \$500 million unsecured revolving credit facility.

After giving effect to contemplated draws by Target under the new debt commitments, and taking into account the \$125 million aggregate principal amount of Target’s Old Debentures that will remain outstanding after completion of the Merger, total existing and new debt outstanding at the closing of the Merger transactions will be approximately \$3 billion, which amount may be increased (i) to the extent additional borrowings are available under the debt financing commitments if specified financial ratios are satisfied and (ii) in respect of certain drawings under the Asset-Based Revolving Facility on the closing date for working capital purposes.

In April 2005 Target and Holding, LLC (an affiliate of the Sponsors) each file a Notification and Report Form with the Antitrust Division and the Federal Trade Commission and request an early termination of the waiting period. The Federal Trade Commission grants early termination of the waiting period initiated by these filings. Except for the required filings under the Hart-Scott-Rodino Act and the filing of a certificate of merger in Delaware at or before the effective date of the merger, there are no material federal, state or foreign regulatory requirements or approvals required for the execution of the Merger Agreement or completion of the Merger.

The closing of the Merger occurs simultaneously with the closing of the new credit facilities, the issuance of the new Notes, the call for redemption of the Old Notes and the provision for Guarantees and security for various debt instruments.

[1]—Events Leading Up to The LBO

In December 2004, Target’s board of directors discussed the benefits and risks associated with both a sale of Target and a recapitalization. The board authorized management to engage Bank I Securities LLC, as financial advisor (“BIS”) and to begin contacting potential purchasers of the company in accordance with a staged process. In addition, because BIS will both act as Target’s financial advisor and provide financing in connection with the Merger and in light of the related potential conflicts of interest, the board decided to retain another financial advisor (“Investment Bank”) to evaluate the fairness of any potential transaction and to assist Target in considering its strategic alternatives.

During early January 2005, BIS and management made an initial approach to the one potential purchaser identified that was not a financial buyer. This strategic purchaser declined to make an offer. Following this initial solicitation, beginning in late January 2005, a number of private equity firms who had demonstrated the ability to complete large-scale transactions, the ability to preserve confidentiality and an interest in Target’s industry were approached.

Following execution of confidentiality agreements, each of which prohibited the potential purchaser from discussing, at this stage, the proposed transaction with any co-investor or financing source without the prior consent of Target, confidential presentations were made by the management of Target to each potential purchaser during the course of February 2005. During the course of the confidential presentations, BIS communicated to each potential purchaser its willingness to provide financing and the parameters of such financing, which in each case was the same for all potential purchasers. This financing reflected the preliminary views of the credit rating agencies as to leverage that could be placed on Target.

Each of the potential purchasers of Target to whom management presentations were made were then invited to submit preliminary indications of interest with respect to a possible acquisition of all of Target's outstanding stock at the same price per share. In late February 2005, Target received preliminary indications of interest from all such potential purchasers, which in each case provided for an *all cash* purchase of all of Target's outstanding capital stock.

At various board meetings, Target's board of directors discussed, among other things, the key offer provisions included in the indications of interest, including, among other matters, price and the ability of each potential purchaser to finance the proposed transaction. Target's board of directors discussed various strategic alternatives, and BIS and members of Target's management respond to questions from the directors. After further discussions, Target's board determined, in light of the price ranges set forth in the preliminary indications of interest, to continue the process along the lines of the following steps outlined by BIS.

In the beginning of February 2005, Target permitted each of the financial sponsors to begin speaking with a single co-investor and asked BIS to work with the financial sponsors in forming "teams." The formation of teams was considered necessary due to the substantial equity financing required to complete an acquisition of Target and is done in a manner designed to maximize the likelihood of fostering competitive bidding. As a result, four teams of potential purchasers were formed, each initially consisting of two financial sponsors.

At this time, Target also authorized each potential purchaser to hold discussions with and engage potential debt financing sources. Also, throughout February 2005, Target made due diligence materials available to all of the potential purchasers and their advisors and held in-depth management presentations with each bidding team.

On February 15, 2005, Target circulated to the four bidding teams an initial draft of the Merger Agreement and later in the month, the bidding teams each submitted their initial comments on the draft Merger Agreement. The bidding teams continued to engage in an extensive due diligence review of Target. Later in February 2005, Target's attorneys and BIS contacted the bidding teams and their advisors to clarify the material terms reflected in the bidder's proposals and to identify aspects of their proposals which raised issues for Target. The key terms addressed included the potential purchasers' financing-related covenants and conditions, the parties' conditions to closing

the transaction and the provisions relating to the termination of the merger agreement. Each of the bidding teams was requested to improve the non-financial terms and conditions of its proposal.

On March 1, 2005, Target sent to the bidders a letter outlining the procedures for submitting a final bid on March 21, 2005. On March 10, 2005, revised drafts of the Merger Agreement were circulated to the bidders. Pursuant to the bidding instructions, each bidder was asked to submit any final comments they might have to the draft Merger Agreement, along with their debt and equity commitment letters, by March 15, 2005, several days in advance of the final bid date.

On or about March 14, 2005, comments to the Merger Agreement were received from all bidding teams, along with their respective debt and equity commitment letters. All of the comments submitted reflected the same basic structure, which remained the same throughout the bidding process and provided for Target to be the surviving company in a merger in which all of Target's outstanding stock is acquired at the same price per share.

During the week of March 14, 2005, in advance of receipt of revised financial terms of the bid proposals, counsel for Target engaged in negotiations with outside legal counsel to each of the bidding teams to identify aspects of their proposals which raised issues for Target and to attempt to narrow the legal issues presented in the revised Merger Agreement drafts containing the comments of each bidder. The focus was on achieving Target's desire to execute a merger agreement that was not contingent on the purchasers' ability to obtain financing for the transaction and otherwise limiting conditionality. In addition, each of the bidding teams requested, as part of their response to the draft Merger Agreement, that certain members of management who owned shares of Target's common stock enter into a stockholder agreement concurrently with the Merger Agreement, pursuant to which each of these persons would vote such shares in favor of adoption of the Merger Agreement and against any competing transaction.

On or about March 17, 2005, each bidding teams submitted a proposed stockholder agreement to such stockholders.

At a meeting of Target's board of directors on March 17, 2005, it was reported that, in the context of management meetings with each of the potential purchasers relating to the diligence process, certain members of management were willing to remain with Target following any acquisition and are receptive to converting some portion of their current equity interests in Target into equity in the surviving corporation. Management did not yet have discussions regarding the terms and conditions of any employment arrangements or equity investment by them in the entity to be formed by the potential purchasers to effect the proposed acquisition other than to the extent that members of management indicated their willingness to extend their employment term and such purchasers explained the general way in which they typically structure the equity investment by management and the options to be granted to management. The board discussed the matter and subsequently conveyed to management their desire that no further discussions between management and any bidders occur prior to board authorization of a definitive agreement.

On March 21, 2005, Target received written bid proposals from each of the bidding teams and a meeting of the board of directors is convened to discuss the bid proposals received. Representatives of Target's lawyers, Investment Bank and BIS participated in this meeting. A detailed summary of the material legal terms of the proposals received was presented, including the equity and debt financing commitment letters submitted by the bidding teams as well as the relative strength of the commitment letters delivered by the bidders. Target's board discussed, among other things, the price per share proposed by each bidder, the conditions to closing proposed by each of the bidders, the execution risks relating to each bid proposal and the other material changes made by each bidder to the draft Merger Agreement. The board then determined to continue negotiations with one bidding team (the Sponsors) and directs management and the advisors to seek to reduce the conditionality associated with the Sponsors proposed debt commitments and Merger Agreement terms.

On March 23, 2005, Target's board convened to consider whether to approve the transaction being proposed by the bidding group. Its lawyers reviewed for the board in detail the terms of the Merger Agreement and other legal aspects of the Sponsors' proposal, including a detailed discussion of their debt financing commitments and again discussed with the board of directors the legal duties of directors in connection with an extraordinary transaction such as the proposed Merger. BIS and Investment Bank then reviewed and analyzed, among other matters, the financial aspects of the proposal and, on a comparative basis, the strategic alternative of a recapitalization as well as considerations associated with engaging in a leveraged buyout transaction.

After further discussions, Target's board of directors requested that Investment Bank render an opinion as to whether the proposed merger with the Sponsors was fair from a financial point of view to the Class A and Class B stockholders. The Investment Bank delivered to the board an oral opinion, which was subsequently confirmed by delivery of a written opinion dated April 1, 2005, that, as of such date and based upon and subject to the factors and assumptions set forth in the written opinion, the consideration to be received by the holders of Target's common stock in the proposed Merger, was fair, from a financial point of view, to such holders.

The Merger Agreement was executed by Target, Parent and Merger Sub and the stockholder agreement was executed by Parent, Merger Sub and the stockholders party thereto, in each case, as of April 1, 2005. On April 2, 2005, prior to the opening of trading on the NYSE, Target and the Sponsors issued a joint press release announcing the transaction.

(Pursuant to the stockholder agreement, the stockholders agreed that, during the period from and including April 1, 2005 through and including the earliest to occur of (a) the closing of the Merger and (b) the termination of the Merger Agreement in accordance with its terms (the "voting period"), they would vote or execute consents with respect to the shares beneficially owned by them on the applicable record date, at any meeting or in connection with any proposed action by written consent of Target's stockholders, among other things, *in favor* of the Merger Agreement and *against* any alternative transaction offer made prior to the termination of the Merger Agree-

ment (other than one made by Parent), any extraordinary dividend, any change in the capital structure of Target and any other action that would reasonably be expected to, in any material respect, prevent, impede, interfere with, delay, postpone, frustrate the purposes of or attempt to discourage the transactions contemplated by the Merger Agreement.)

[2]—Financing

[a]—Equity Financing

Affiliates of the Sponsors caused \$1.5 billion of cash to be contributed to Merger Sub, which would constitute the equity portion of the Merger financing. Each of the Sponsors (through their affiliated funds) delivered an equity commitment letter for \$500,000,000 to Parent. In turn, Parent delivered an equity commitment letter to Merger Sub for \$1.5 billion, the aggregate amount of the equity commitments. Each of the Sponsors could assign its commitment to purchase up to 49% of the equity interests in Parent to other investors, so long as each such investor agreed to be bound by the obligations of the applicable Sponsor.

Each of the equity commitment letters provided that the equity funds would be contributed on or prior to the closing of the Merger to fund a portion of the total Merger consideration, pursuant to and in accordance with the Merger Agreement, and to satisfy any liabilities or obligations of Parent or Merger Sub arising out of or in connection with any breach by Parent or Merger Sub of their respective obligations under the Merger Agreement. Each of the equity commitments was generally subject to the satisfaction of the conditions to Parent and Merger Sub's obligations to effect the closing under the Merger Agreement. Each of the equity commitment letters would terminate upon termination of the Merger Agreement, unless the Merger Agreement was terminated by Target due to a breach by either Parent or Merger Sub of any of its respective representations, warranties, covenants or agreements under the Merger Agreement such that the conditions to closing would not be satisfied, or the Merger Agreement was otherwise terminated pursuant to a breach by Parent or Merger Sub of their respective obligations under the Merger Agreement and Target was not in breach of its obligations under the Merger Agreement.

[b]—Debt Financing

In connection with the execution and delivery of the Merger Agreement, Merger Sub obtained commitments to provide up to \$4 billion in debt financing (not all of which was expected to be drawn at closing) consisting of (1) a senior secured asset-based revolving facility with a maximum availability of \$500 million (the "Asset-Based Revolving Facility") and (2) term and bridge loan facilities and senior secured notes with an aggregate principal amount of up to \$3 billion to finance, in part, the payment of the Merger consideration, the redemption of the Old Notes and the payment of all outstanding amounts under the Existing Credit Facility and to pay fees and expenses in connection therewith and, in the case of the Asset-Based Revolving Facility, for general corporate purposes after the closing date of the Merger.

The facilities and notes contemplated by the debt financing commitments were conditioned on the Merger being consummated prior to the merger agreement termination date, as well as other customary conditions including: receipt of an amount equal to at least 25% of the pro forma total consolidated capitalization of Parent (on the closing date of the Merger) in equity or junior capital from equity investors, including affiliates of the Sponsors; completion of a borrowing base audit and delivery of appraisals in respect of the Asset-Based Revolving Facility; the reasonable satisfaction of the agent for the Asset-Based Revolving Facility with the cash management systems, blocked account agreements and lockbox agreements of Target in connection with such facility; certain maximum financial ratios; and Parent having available to it under the Asset-Based Revolving Facility at least \$300 million (less amounts drawn to fund the working capital needs at the closing of the Merger) of unused borrowing capacity at closing.

Parent agreed to use its reasonable best efforts to arrange the debt financing on the terms and conditions described in the commitments and the Merger Agreement. In the event that any portion of the debt financing became unavailable on the terms and conditions contemplated in the commitment papers, Parent would use its reasonable best efforts to arrange to obtain alternative financing from alternative sources in an amount sufficient to consummate the merger and other transactions contemplated by the merger agreement on terms not materially less beneficial to Merger Sub (as determined in the reasonable judgment of Parent) as promptly as practicable following the occurrence of such event, but no later than the last day of the marketing period. This debt financing would not be subject to any due diligence or “market out.”

[c]—Asset-Based Revolving Facility

The commitment to provide the Asset-Based Revolving Facility was issued by Bank II. Borrowings under the Asset-Based Revolving Facility were limited by a borrowing base, which was calculated periodically based on specified percentages of the value of eligible inventory, subject to adjustments for reserves and other matters. The Asset-Based Revolving Facility was guaranteed by Parent and Target’s U.S. subsidiaries (subject to certain exceptions) and was secured by a perfected first priority lien on substantially all personal property of Parent, Target and Target’s U.S. subsidiaries consisting of inventory, cash, deposit accounts and proceeds of the foregoing and a second priority lien on capital stock, real estate, accounts receivable (other than credit cards receivables) and other assets. The borrower would be able to borrow under the Asset-Based Revolving Facility on the closing date (i) up to \$150.0 million for purposes of financing the Merger and related transactions (including payment of the aggregate Merger consideration, the repayment or refinancing of some of Target’s currently outstanding debt and all related fees and expenses), but only to the extent that the aggregate principal amount of the term loan facilities and senior secured notes was reduced on a dollar-for-dollar basis by the amount of such borrowing, (ii) to fund certain upfront fees and/or original issue discount in respect of the debt financing, (iii) to fund an amount equal to the excess, if any, of the working

capital of the borrower as of the closing date over the working capital of the borrower as of December 31, 2004 (in each case, with working capital to exclude current assets and current liabilities relating to any credit card receivables) and (iv) in respect of certain letters of credit.

[d]—Term Loan Facility and the Senior Secured Notes

The commitment to provide the term loan facility was issued by Bank I. The commitment to purchase the senior secured notes was issued by Bank I Securities LLC and Bank II Securities Inc. Borrowings under the term loan facility were made on the closing date, and the senior secured notes were issued on the closing date. The term loan facility and the senior secured notes were guaranteed by Parent and the U.S. subsidiaries (subject to certain exceptions) of Target and were secured by a second priority lien on substantially all personal property of Parent, Target and the U.S. subsidiaries of Target consisting of inventory, cash, deposit accounts and proceeds of the foregoing, and a perfected first priority lien on capital stock, real estate, accounts receivable (other than credit cards receivables) and other assets.

[e]—Bridge Facilities

The commitment to provide the bridge facilities was issued by Bank I Securities LLC. Borrowings under the bridge facilities could be used by Parent in a single draw on the closing date in the event that Parent did not complete other contemplated permanent financings at or prior to such time. The bridge facilities would be guaranteed (on a senior subordinated basis, in the case of the senior subordinated bridge facility) by Holdings and the U.S. subsidiaries of Target.

[f]—Existing Senior Notes and Debentures

Prior to the Merger, Target had outstanding \$250 million of unsecured senior notes and debentures to the public. This debt was comprised of \$125 million of Old Notes and \$125 million of Old Debentures. Parent's financing arrangements contemplated that, in connection with the Merger transactions, the surviving corporation redeemed all of Target's Old Notes or otherwise fully satisfied and discharged such indebtedness. The entire principal amount of the Old Debentures remained outstanding after completion of the Merger and was equally and ratably secured by certain assets constituting the collateral securing obligations under the new Senior Secured Notes described above to the extent required pursuant to the terms of the indenture governing the Old Debentures.