

MERGERS & ACQUISITIONS

Anti-Sandbagging And Other Anti-Ambush Clauses In Merger Agreements

ABSTRACTED FROM: *Debunking The Myth Of The Sandbagging Buyer: When Sellers Ask Buyers To Agree To Anti-Sandbagging Clauses, Who Is Sandbagging Whom?*
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M&A Lawyer, Vol. 11, No. 1, Pgs. 3-7

Courts get it mostly wrong. Buyers suing over misrepresentations in a merger agreement sometimes knew about the inaccuracy long before signing the agreement or closing the deal. Trying to protect business sellers from this sort of ambush, called *sandbagging*, courts in many states insist on proof that the buyer relied detrimentally on the false statement, as if the claim were for the tort of deceit rather than for breach of the contract. Attorneys Glenn West and Kim Shah view this labored interpretation as misguided. Courts in several states do not require reliance. They hold that the representations and warranties often reflect known factors as a means to allocate risk in the transaction; therefore, all they require is proof of a breach. Courts in New York and elsewhere recognize the defense of waiver: if the buyer closes the deal while knowing the seller has breached an express representation or warranty, the buyer loses its right to sue over that breach.

Seesaw game. Given the uncertainty of the case law, sellers try to incorporate anti-sandbagging clauses into their merger agreements, which will prevent a claim that relies on facts known to the buyer before closing. The typical anti-sandbagging clause states that the seller has no liability for breaching a

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representation or warranty insofar as the buyer knew of the breach either before signing the agreement or before closing, or if the seller gave the buyer documents disclosing the correct information. The authors object to the clause because it allows the seller to ambush the buyer by disclosing defects either so late in the process or so inconspicuously that the buyer cannot spot or digest the data.

No way to save the day. Buyers seek to incorporate anti-anti-sandbagging (or “knowledge savings”) clauses, which will allow a claim against the seller when the buyer demands indemnification for a shortfall in business value resulting from the nonexistent-though-promised state of affairs. The typical knowledge savings clause recites the parties’ intent that the stated representations and warranties form the basis for the bargain and that no actual or constructive knowledge on the buyer’s part affects enforcement of the seller’s indemnities. Without a knowledge savings clause, the authors conclude, the buyer’s bargain might not be enforceable in many states, even if the agreement did not have any anti-sandbagging clause.

Tips and tricks. The authors caution buyers: Do not assume that, even with a knowledge savings clause, courts in all states will enforce the seller’s indemnities, so consider very carefully the choice-of-law clause. Buyers should also demand other protections in the agreement, including special indemnities for specifically identified risks, and should try to limit the scope of knowledge in an anti-sandbagging clause to “actual knowledge” by a narrowly defined group of senior managers. (The group definition should clearly exclude lawyers and accountants.) For sellers, the authors advise avoiding hazy expressions that base liability on “fraud,” since this language may encourage the court to import tort doctrines and possibly impose liability in the absence of intentional deception.

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INVESTMENT BANKING

Investment Bankers Size Up 2007 Prospects

ABSTRACTED FROM: *Is The Banking Boom Sustainable?*

BY: Alex Chambers

Euromoney, February 2007, Pgs. 84-87

Some economic adversity is likely. In 2006, investment banks increased their revenues by almost 20% over 2005, collecting an eye-popping \$76.7 billion. After such an exceptional year, bankers foresee more difficult circumstances in 2007. While no one expects a terrible year where everything goes wrong in the markets, Alex Chambers finds that most bankers anticipate economic challenges, which will require some innovative thinking to maintain bank revenues. A correction in equities markets seems probable. Credit portfolios may deteriorate and become more difficult to manage. Yields curves could sink. With increased global activity, bankers also need to be on the lookout for unexpected challenges in emerging markets. Global bankers expect general economic growth in Europe and Asia but a soft landing for America’s economy, whose dominance will be challenged when London gains ground at the expense of the New York markets.

Product mix may change. Private equity will continue to grow and, in so doing, will continue to buoy equity valuations, the author reveals. Blackstone set a record in 2006 when it secured

commitments of \$15.6 billion for a private equity fund. Hedge funds may have already topped out, however, and it is not clear what new forms they might take. Bank revenues from hedge funds have not grown nearly as rapidly as volume, and the hedge funds themselves may be looking for new niches. Some hedge funds seem to be transforming into longer-term investors. Meanwhile, banks are acquiring investment firms, which will put them into competition with their clients. This is a tension whose limits have yet to be tested. Although underwriting remains strong, banks are branching out into other financial activities to expand revenue. Some banks have acquired or set up debt originators.

Bulge-bracket and boutique firms have best prospects. As globalization escalates, more and more companies seek investment bankers who can operate around the world. The bulge-bracket investment banks have benefited accordingly. As the global banks have grown in both geographic reach and the number of financial activities, a niche has opened for more specialized and local or regional boutiques. These two poles of the investment banking spectrum are likely to enjoy the greatest success, while larger banks that fit neither category will probably have more problems. If they aspire to a global presence, for example, they may be stuck taking on less profitable business simply to grow volume and establish a presence in areas where the existing global banks already dominate. Competing is hard when the bank has to take on the business drags simply to be a player. Any vicissitudes in the global economy will force many to rethink their goals, the author warns.

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GLOBAL MARKETS

Rocky Yet Promising Road Ahead For China's Banks

ABSTRACTED FROM: *After The Gold Rush*

BY: Thomas Clouse

Global Finance, February 2007, Pgs. 38-40

Rocky road to success. As many investment bankers have learned over the last few years, China's economic forces have a far-reaching (and growing) impact on the world's markets. Today, the banks central to economic growth in that region face new challenges and opportunities, which will shape their destinies for years to come, reports Thomas Clouse. Chinese banks operate on a huge scale in terms of their loans, branches, deposits, and even their increasing attractiveness to global investors. Reform measures have refined their risk control and corporate governance mechanisms, while their profits remain strong. At the same time, challenges loom. Government limits on deposit and loan rates, which have kept the former low and the latter significantly higher, could be lifted in the next few years. The country's buoyant equity market threatens to lure deposit and loan customers, including Chinese companies that may decide to raise capital by issuing stock instead of borrowing from banks.

Change in the wind. To remain competitive, Chinese banks will need to develop and maximize other sources of income (e.g., credit cards and fee-based services) and to make loans to small and medium-sized businesses, which are generally more profitable than state-run enterprises. Establishing relationships with these smaller businesses will require a greater knowledge of sophisticated risk assessment and pricing techniques than many of China's banks currently have. The bankers will need to become better versed in bank M&A, which should become more commonplace as large domestic and

international banks compete for the smaller financial institutions. For now, monitoring and controlling growth is a major concern, the author notes. Investors and currency speculators are flooding bank vaults with new money, raising the government's fears of an overheated economy. The rapid growth of bank loans in 2006 prompted policymakers to raise interest rates, introduce other tightening measures, and limit loans to certain industries. While lending growth has cooled to a more measured pace, concerns remain that speculators could drive the country's hot stock market to dangerously unsustainable levels. As leaders evaluate ways to continue tightening without choking off growth, many expect the Chinese stock market to remain strong.

The trade imbalance time bomb. The country's trade relationships are becoming more complex, as demand for its goods and services remains strong and world economies rely more heavily on its economic growth. China's exchange rate is linked to a basket of currencies, rather than market rates, and follows the value of the US dollar. Critics charge that this provides an unfair advantage by keeping the cost of Chinese exports artificially low. Protectionist measures appear more likely under a US Congress controlled by Democrats, yet they could pose a threat to China's economic expansion. However, such measures may help in the long run by reducing China's dependence on foreign trade and prompting lawmakers to search for ways to boost domestic consumption. Allowing the yuan to appreciate more rapidly would decrease the price of imports and encourage spending, the author points out, but the Chinese financial system may not be prepared for such a shock. Instead, the central government is working to increase domestic consumption through other measures. It may require state-owned companies to pay dividends, thereby putting money in the hands of Chinese investors and increasing government revenue for social services.

Abstracted from *Global Finance*, published by Global Finance Media, 411 Fifth Avenue, New York, NY 10016. To subscribe, call (212) 447-7900; or visit www.gfmag.com. **Editor's Note:** For more on dealmaking and the capital markets in China, see "Going Public, Chinese Style" by Bruce Einhorn and Frederik Balfour, *BusinessWeek*, March 5, 2007, Pg. 40; and "Firms Jockeying For Chinese IPO Action" by Sheri Qualters, *National Law Journal*, April 2, 2007, Pgs. 1, 22.

PRIVATE EQUITY & VENTURE CAPITAL

Corporate Expectations For Venture Capital's Noncash Support Exceed The Results

ABSTRACTED FROM: *Venture Capital Funds: Do They Meet The Expectations Of Portfolio Firms?*

BY: Prof. Terje Berg-Utby, Prof. Roger Sørheim, and Prof. L. Øystein Widding

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Venture Capital: *International Journal of Entrepreneurial Finance*, Vol. 9, No. 1, Pgs. 23-41

Get the Rolodex after the cash. When new companies and venture capitalists are courting each other, the availability of nonfinancial support plays a major role in establishing the venture capital relationship. Business professors Terje Berg-Utby, Roger Sørheim, and L. Øystein Widding examined how nonfinancial support impacts the relationship between portfolio companies and the venture capitalists. In addition to much-needed capital, venture capital funds offer knowledge and expertise. Venture capitalists can help frame successful business plans, advise on budgeting and accounting matters, and suggest

managerial practices as well. Those who specialize in particular industries understand the resources required by the startups they fund and can offer strategic advice on both products and markets. Venture capitalists maintain extensive networks of industry professionals who can lend needed guidance. The components of nonfinancial support vary, based on the portfolio company's life stage, the external market conditions, and the company's relative success in reaching its goals.

Companies expect strategic and knowledge resources. By surveying the CEOs of 240 current or newly exited portfolio companies in Norway, the authors determined what the executives expected from their investment partners. In addition to ongoing financial support, portfolio companies expect VC funds to provide some or all of the following nonfinancial support: accounting resources, strategic advice, networking resources, business alliances, marketing expertise, customer insights, sales advice, and, to a lesser extent, advice on product development and production. Although outliers have very high or low expectations, the typical company expects moderate or greater knowledge and strategic contributions from their venture capital investors. The research shows that only companies facing great market uncertainty or experiencing real challenges to their survival felt the venture capitalists had equaled or exceeded expectations for assistance.

Expectations unmet in every category. However modest the expectations of portfolio companies, the venture capitalists managed to underperform their expectations for every type of support measured. Such consistent failure to meet portfolio company expectations suggests to the authors that venture capitalists present overly optimistic pictures of available resources during the courtship period. Rather than relying on quite general descriptions of venture capitalist strengths and assets, companies seeking venture capital support might want to explore the specifics of the different types of help to be provided. Venture capital companies vary in their levels of assistance, but none treat all their companies the same. Some tend to send in the fire brigade when a company is in poor shape. Others concentrate their resources in the more successful ventures that will produce the biggest return on investment. Dealmakers would benefit from exploring the investment attitudes and practices of each venture capital fund before selecting a VC partner.

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How To Avoid Major Private Equity Pitfalls

ABSTRACTED FROM: *The Seducers*

BY: Alison Stein Wellner

Inc. Magazine, March 2007, Pgs. 110-115

Avoiding pitfalls. Private equity is not just for high-profile companies such as Outback Steakhouse, Four Seasons Hotels, Neiman Marcus, Hertz, and Dunkin' Donuts (all of which have recently taken on significant private equity financing). Angel investors, venture capitalists, buyout firms, and other private equity investors are also seeing smaller companies as lucrative investment opportunities. The stakes are high for the entrepreneurs, whose success or failure can hinge on attracting the right private equity investor and handling the negotiations skillfully. Being unprepared for the process can lead to common blunders, but Alison Stein Wellner offers advice from those who have been through it. If an entrepreneur can identify and avoid eight major pitfalls of private equity, success is likely to follow.

Move slowly, and keep (or yield) control. The prospect of a multimillion-dollar avalanche of cash often leaves entrepreneurs with fantasies about how they will spend the venture capital. While daydreaming, they are overlooking the potential downside of the deal. Take time to reflect on any offer, the author suggests, and to seek advice from trusted advisors and fellow entrepreneurs. Not all investors

have a company's best interests in mind, and some prey on a cashflow crisis or lack of confidence. Figure out (and remember) the goal. Entrepreneurs need to weigh the tradeoff between giving up control and gaining access to the capital, connections, and resources of the private equity investors. Private equity investors almost always acquire a degree of control, although some demand more than others. They often want to bring in their own managers. One business owner received an offer that would have required him to give over a large equity stake. Before saying yes, he realized that he was not willing to take the risks that might follow losing control and having an outsider running his business. Yet another business owner was willing to cede a large ownership stake so he could have more time to devote to managing the enterprise.

Get the books in order. Before seeking private equity, get the company prepared for due diligence. One entrepreneur discovered that providing a prospective private equity investor with the necessary information to conduct due diligence was consuming huge amounts of time. He ended up neglecting day-to-day management duties. As the business suffered, the potential investor lowered the price. After almost seven months of due diligence, the business owner called the deal off. Spend time finding the right advisors, suggests the author. Ask for references, and interview them carefully. Stay on top of things, and do not let the attorneys drive the process.

Do not hide weaknesses. Entrepreneurs should highlight the company's selling points but must be forthright about weaknesses and how they are being addressed. If evidence of a strong competitor, lawsuit, or other problem comes up during due diligence, the author warns, the private equity candidate will lose credibility with the potential investor if it was not disclosed earlier in the process. Investigate a would-be investor by speaking with the CEOs of other portfolio companies, as well as with those who have moved on. Listen to intuitive clues, and do not discount the importance of chemistry. Even when a deal looks great on paper, it will not thrive if the people involved are not comfortable with one another.

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Best Exit Is Still An IPO ... Except When It Is A Private Sale

ABSTRACTED FROM: *An IPO Resurgence?*

BY: Rob Garver

CFO, February 2007, Pgs. 33-34

IPOs on the rise in 2007. The IPO market is gathering steam. Deals in the fourth quarter of 2006 accounted for nearly one-third of that year's total of 228. While the number of deals fell a hair short of the 240 IPOs in 2005, the amount of capital raised—\$46.1 billion—was 25% higher. The 2006 deals also included 13 valued at over \$500 million. Despite these optimistic numbers, the market is far below its \$70 billion all-time high, reached in 1999 at the height of the IPO bubble. Bankers are much more cautious these days about approaching the capital markets with young companies, since startups lacking products and profits are not welcomed by investors. Additional rounds of financing for later-stage companies are coming instead from private equity firms, many of which are awash in cash, although owners and investors alike remain committed to the goal of taking their startups public. Ample cash, \$100 million or so, is readily available to good late-stage companies in the private sector. For example, Rob Garver cites Internet provider Clearwire, which is scheduled to go public in 2007. It postponed its IPO by raising \$1 billion in venture money during August 2006.

Sarbanes-Oxley not a roadblock. US bankers complain that Sarbanes-Oxley regulations and strict listing requirements have led some late-stage startups to go public on the European markets. Others disagree, asserting that many newly public companies had dealt with Sarbanes-Oxley previously (when they were part of a public company). Some pre-IPO executives view Sarbanes-Oxley-type restrictions as

a template for best practices when operating a business. For example, NightHawk Radiology Holdings, a medical technology company used to working with patient privacy and other security requirements, was not stifled by the prospect of Sarbanes-Oxley compliance. It raised \$83 million in its February 2007 IPO. The owners chose public equity over additional venture money primarily to maintain liquidity by avoiding additional debt. On the other hand, Bain Capital, The Blackstone Group, and Thomas H. Lee Partners, owners of the venerable publishing firm Houghton Mifflin Co., took the opposite route when they sold Houghton to a private third party, Ireland's Riverdeep Holdings. Houghton had been planning an IPO for 2007, but getting the best price will always represent the trump card.

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INITIAL PUBLIC OFFERINGS

Institutional Investors Reap Greatest Returns From IPOs

ABSTRACTED FROM: *Do Institutions Receive Favorable Allocations In IPOs With Better Long-Run Returns?*

BY: Prof. Beatrice Boehmer, Prof. Ekkehart Boehmer, and Prof. Raymond Fishe
Mays Business School, Texas A&M University (BB, EB);
Robins School of Business, University of Richmond (RF)

Journal of Financial & Quantitative Analysis, Vol. 41, No. 4, Pgs. 809-828

Take the money and run. Institutional investors take the money left on the table by most IPO issuers. Typically, institutional investors flip their IPO shares on the first or second trading day, raking in the profits from IPO underpricing. During the first two days of trading, institutional investors flip an average of 42% of their IPO allocation, accounting for 15% of the total trading volume for the new issuance. Business professors Beatrice Boehmer, Ekkehart Boehmer, and Raymond Fishe compared that with the behavior of retail investors who have bought an initial IPO allocation. The latter flip only 19% of their allocation, which accounts for just 3% of the total volume. Most flipping is done in the first or second day after the IPO. In the remainder of the first month of trading, both institutional and retail investors sell only 10% more of their shares. Flipping increases when underpricing is greater, but retail investors are more influenced by the greater underpricing. While both groups make hefty profits during these early transactions, returns on IPOs tank after the first year and then tend to underperform. The headiest early trades are often followed by worse-than-average long-term performance, although not all IPOs perform badly over time.

Follow the leader. In making allocations, underwriters might be exercising discretion based on the shares' long- as well as short-term potential. Institutional investors receive higher allocations in the best-performing new issues, the authors' research indicates. They also seem to know which issues should be flipped and which held for longer periods. Some investors succeed in maximizing their long-term IPO returns as well as enjoying a first-day pop. The IPOs that perform best over both the short haul and the long term are those with the highest proportion of institutional allocations. Underwriters may well advise their best institutional clients based on each client's investment goals. Perhaps clients that want to take advantage of the first-day pop and flip much of their allocation immediately are guided to the more underpriced IPOs, while those looking for long-term investment receive allocations of IPOs

that are less underpriced but more likely to perform well over time. Whatever the reason, institutional investors know when to flip and when to hold. Higher institutional flipping at the beginning indicates poorer long-term performance. Conversely, when institutional investors hold their stock, the shares tend to perform well.

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