

Private Equity: The management guide

Setting the scene

You are a key member of a management team for a business which is up for sale. It may be one which is part of a larger group, a public company seeking to go private, or even a business owned by institutional investors looking to exit. Whatever the reason, you are part of a team that has succeeded in attracting the interest of a private equity investor to fund a management buy-out of the business. Alternatively, you could be a manager whom the private equity investor is looking to integrate into the team. In either situation you would be right to think that the greatest challenge you face as part of the management team is to deliver (and convince the private equity investor that the team can deliver) on its business plan by taking the business forward and generating target returns for the team and the private equity investor. There is no doubt though, that the legal and transaction process for a management buy-out presents you with some challenges too, challenges which this guide seeks to explore.

Rocket science and the world of private equity

For many managers, embarking on a management buy-out involves being faced with a whole new vocabulary and a range of issues not faced before and emanating from an array of different advisors and consultants. The good news is that none of this involves rocket science!

The jargon can nonetheless be bewildering. You may not have been told that 'private equity investor', 'venture capitalist' and 'institutional investor' are pretty much interchangeable terms. Likewise, you may not have had explained to you the distinction between an MBO (a management buy-out where the existing management team buys out the business it manages), an MBI (a management buy-in, where the institutional investor brings in a new management team from outside), a BIMBO (part management buy-in, part management buy-out) or an IBO (an institutional buy-out, where the institutional investor sets up a company to acquire a business and gives management a small stake either at the time of or after completion of the deal). You also may not have been told that the term 'leveraged buy-out' is short-hand for any of these types of transactions.

It is the leverage element, i.e. debt, which is fundamental to generating the desired level of returns for the institutional investors and management team alike. The acquisition debt finance adds another layer of jargon and complexity as you are introduced to the joys of senior and junior debt. Senior debt is usually advanced by commercial banks and so called because they normally take first-ranking security over the assets of the business. Junior debt, often referred to as mezzanine debt, is so called because it ranks behind the senior debt but ahead of equity (and probably all other unsecured creditors). Do not necessarily be impressed by a larger shareholding percentage offered by one private equity investor over another where the larger percentage ranks behind, for example, very expensive debt. Being at the bottom of the pile when the cash is divided up on an exit means that you may simply be entitled to a larger percentage of fresh air!

Understanding your institutional investor

The jargon may be unfamiliar at first but understanding what drives an institutional investor on a leveraged deal is simple. Essentially it is getting the right mix of equity and debt to leverage the equity returns. This will be determined by confidence in the strength of the business plan and the amount of debt it is believed the business can support through its free cash flow.

The institutional investor, once sufficiently impressed by the management team and business to show an interest in investing, will look to its lawyers to prepare documentation to protect the investment. To the uninitiated, these protections may seem over the top, suffocating even. It is tempting to think that the institutional investor is looking to control the business and impose a straight jacket on management. This is almost never the case. Institutional investors approach investments with heavy duty documentation to ensure that a basic level of protection for their investment is maintained, while the management team is left to run the business. You would probably be happy about this approach if it was your pension money that was being invested!

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Having an understanding of what protection an institutional investor will expect and a realistic expectation of what safeguards the managers should be able to negotiate for themselves, is an important part of straightening the often winding road to completion. You should look to your legal advisor to lead you through this particular maze.

Getting your house in order

Having a credible and robust business plan is essential. Key to moving from the initial interest shown, to closing the deal with an institutional investor, is already having your house in order. The private equity investor, the debt providers, their lawyers and accountants and possibly other specialist advisors, can be expected to do due diligence on the management team, the business, the market and the business plan. This means that thorough preparation needs to be undertaken by the team.

The management team

As location is to property, so management is to management buy-outs. The quality of the team is crucial and the private equity investor will, to a great extent, see the buy-out as an investment in the management team, so you will need to choose your team carefully from the start. You will need to ensure that, in addition to all-round strength, the individual members of the team have the different capabilities and attributes required of the team in the key business areas and that each justifies their inclusion on merit.

The typical positions that need addressing, depending on the specific business needs, include:

- > Managing Director / Chief Executive Officer - a clear leader with strategic vision, ambition and drive is important in uniting the team and driving the business forward.
- > Finance Director - demonstrates intimate knowledge of all accounting information, competent in forecasting and budgeting and understands how changes in the business environment impact on results and budgets.
- > Sale / Business Development Director - a key driver of revenues and potential new business who is results-driven and capable of motivating others.
- > Operations / Production Director - has a clear and practical understanding of the business processes, technology (if relevant) and techniques, as well as being able to control production costs and capital expenditure.

Protecting the business

As with any business where buyers or investors are being courted, you can avoid a lot of headaches, and possibly the transaction going off the rails completely at a later stage, by working to ensure that the contractual and other legal arrangements in all business areas are on a sound footing before institutional investors are approached. Whilst this is good advice for any business at any time, it particularly pays to concentrate on this during the period prior to due diligence and negotiations. Areas to focus on might include:

- > Commercial contracts - formally documenting the terms upon which commercial relationships which are key to the business are conducted, such as those with suppliers, customers, agents and distributors, will give investors clarity and confidence in what they are investing in and underpin the business plan. Having complete and signed copies of those terms is important!
- > Intellectual property, know-how, trade secrets and brands - putting in place measures to take stock of and protect these, very often important, assets from onward disclosure or infringement can be essential.
- > Litigation - actual and potential commercial disputes should be monitored, assessed and managed to minimise their impact on the value of the business.
- > Long-term financial commitments and revenues - you should review and appraise the contractual basis of long-term commitments and revenue flow, e.g. property and equipment leases and customer contracts, so as to appreciate the degree of flexibility available to change strategies or manage costs and the reliability of revenue streams.
- > Stand-alone issues - if the business is part of a larger group, you need to assess the extent to which, for example, head office is relied upon for business services and infrastructure which will have to be budgeted for and sourced independently following the buy-out and plan accordingly. Relevant areas may be payroll, tax planning, audit, IT systems, software and hardware.

Focusing on these issues at an early stage should make the transaction process an easier one. However, at the same time, you also need to be sure not to lose sight of your fiduciary duties as company directors or the task of running the business. You risk breaching your fiduciary duties if you do not run the business in the interests of its current shareholders.

Therefore, spending company time and expense on your proposal as well as passing confidential information to third parties should not be done without the shareholders' prior approval. It is crucial that the company's performance is in-line with expectations during the buy-out process. An unforeseen dip in turnover or profits at this stage can lead to less favourable investment / lending terms or, possibly, to investors walking away from the deal.

Understanding the risks in the business

An institutional investor's confidence in a management team will stem in large part from its assessment of the strengths and weaknesses of the business and the robustness of its business plan. When seeking funding you must, therefore, be able to demonstrate:

- > that your business has depth and breadth in its revenue streams, suppliers, customer base and its management;
- > an understanding of your market, industry and the trends they face over the next few years;
- > an understanding of the competition, their strengths, weaknesses and how their market position will develop;
- > how your business will respond to these challenges.

The best demonstrator that risk will be under control is your team's personal experience and your business track record.

Due diligence

Once you have found potential investors and before you get down to negotiating the investment documentation, they will want to undertake due diligence to gather more information about you, your team, the company and its products. The due diligence process requires those 'in the know' to divulge everything they know about the investee company to the potential investor, enabling it to make a fully informed assessment of the value and potential of the company. It can be a tedious and time-consuming exercise, but this can be alleviated if you are prepared for it.

Legal due diligence will form only a part of this exercise. The financial due diligence will be key and there will also typically be commercial, environmental and insurance due diligence exercises undertaken at the same time. Sellers may commission their own due diligence (known as vendor due diligence) in advance to expediate the process.

The investment documentation

A large number of different legal documents are a common feature of leveraged buy-outs.

Those most likely to be involved (aside from the acquisition agreement itself) include the following:

Confidentiality agreement

Before terms are discussed and information is exchanged, a confidentiality or non-disclosure agreement should be put in place to keep a lid on the detailed negotiations and to safeguard the secrecy of information supplied throughout the buy-out process.

Term sheet

Once the key terms of the investment have been agreed in principle, a term sheet (sometimes referred to as a heads of terms, memorandum of understanding or letter of intent) may be prepared and agreed. Although the term sheet is not in itself legally binding, a carefully crafted term sheet will assist in drafting the investment documentation, as it will be a record of the intent of the institutional investors and the managers. It should not only record the commercial terms, such as valuation, but also the rights attaching to the managers' and the institutions' shares to ensure there are no big surprises in the investment documents.

Investment agreement

The institutions will have specific rights which have to be negotiated, such as the appointment of a non-executive director, veto rights and other rights protecting their investment. These are set out in a shareholders' agreement entered into between the institutions and the managers. It is more commonly called an investment or subscription agreement.

Articles of association

In addition to containing the usual internal rules covering governance and shareholder rights in the buy-out vehicle, the articles will also be the means by which many of the investment rights and protections will be formalised, e.g. the right to receive a particular level of dividend and share transfer rights, requirements and restrictions.

Debt instruments

By definition, these will feature on any leveraged transaction and could range from conventional acquisition and working capital facilities to less

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conventional forms of debt which can take a variety of forms, such as loan notes, payment in kind notes and deep discounted bonds. The terms of these instruments will vary depending on the specific economics of the buy-out and could be secured or even have conversion rights, for example. The impact of the interest rates attaching to the debt instruments issued to the institutions should be carefully modelled and understood. This will set the hurdle which needs to be achieved before there will be any return on your equity.

Directors' service contracts

You and any other managers making up the team will continue to work in the business. It is usually the case that your terms and conditions of employment are reviewed and, if necessary, renegotiated as a part of the overall investment negotiations. Typical issues include notice period, non-competition arrangements and bonus structures.

Personal tax position regarding managers' shares

This requires a brochure in itself! However, signature of the correct tax election and due consideration of the issues should avoid most problems.

The following sections highlight the key areas of protection for institutional investors and managers alike in the two documents which are perhaps most central to the equity investment: the investment agreement and the articles of association for the buy-out vehicle.

Key provisions in the investment agreement

Subscription

This deals with the number of shares and other instruments the parties will receive and the subscription price to be paid. You should understand as early on in the process as possible what you will need to pay and how that will be funded.

Warranties

You and your team will be asked to give warranties about the reasonableness of your forecasts, projections and the business plan, and to confirm certain factual information contained in the various due diligence reports commissioned by the institutional investor. You may also be asked to give warranties about the business and its affairs more generally and information given to the institutions. If you fail to disclose anything which makes a warranty untrue, you will be in

breach of warranty and may be liable to pay the institution's damages. However, you should expect to be able to cap your liability under the warranties by negotiating a financial limit on your liability and ensuring the warranties expire after a certain period of time. Don't be put off by this process. Proper preparation and disclosure mitigate against the risks of any claim arising.

Matters requiring prior institutional approval

Institutions will usually specify certain shareholder and operational matters which need their approval before the company can undertake certain actions, such as varying the rights attaching to their shares, issuing new shares, entering into unbudgeted expenditure or appointing directors. These can be unofficially known as the 'mustn't blow your nose' restrictions if too onerous! They therefore need to be closely reviewed and debated to ensure they work in practice in the context of your business.

Right to appoint a director

The institutions will invariably insist on a contractual right to appoint at least one of their representatives to the board of directors or at least to attend board meetings as an observer. That director (or his alternate) will usually have to be in attendance at all board meetings for them to be valid. Look out for the fees to be charged.

Financial information

The investor will usually require that certain financial information is provided within an agreed period. Typically this would include rights to:

- > receive the monthly management accounts;
- > receive quarterly reports on the company;
- > examine the books and accounts of the company.

Management undertakings

As a management team, you will be asked to take primary responsibility for ensuring that the company undertakes certain actions such as maintaining insurance, complying with laws and taking steps to protect its intellectual property and key contractual rights.

Restrictive covenants

The reason for having restrictive covenants in the investment agreement is broadly similar to the reason for having restrictive covenants in a contract of employment. They are intended to prevent you and your fellow managers engaging in activities which may damage the business of the company. The covenants are necessary in

the investment agreement as well as contracts of employment, as this gives the institutions a direct cause of action against a manager for any breaches.

Although restrictive covenants in an investment agreement will look similar in content to those in a contract of employment, the covenants in the investment agreement can be harsher in scope. However, to be enforceable restrictive covenants must be reasonable. What is considered 'reasonable' in a contract of employment is determined by reference to the person bound by the covenant being an employee, who has a basic right to earn a living, and who therefore should not be restricted from working without legitimate justification. In an investment agreement 'reasonableness' is determined by reference to investors being induced to invest in a company in part by the restrictive covenants. It is therefore usual to see more onerous restrictive covenants in the investment agreement than those in contracts of employment. Make no mistake, if properly drafted these will be enforceable and therefore, need to be closely reviewed.

Key provisions in the articles of association

Pre-emption rights

An institutional investor will often insist that if the company wishes to issue shares, or a shareholder wishes to sell his or its shares, then those shares are offered first to the institutions. There will be exceptions to this, such as share issues to satisfy allocations from a pre-approved pool of unissued manager shares and transfers to a family member, or trust, or to new members of the management team. However, an investor will not look kindly on a manager who wishes to sell out. There may, therefore, be a prohibition on any such sale until the institutions exit.

Good leaver / bad leaver

In most cases when a shareholding manager departs, the remaining shareholders will not want him to continue to be involved in the company by being able to vote at shareholders' meetings or to benefit from future growth. They will usually require him to offer to transfer his shares to other shareholders, or a third party for value. What value should be paid to the departing manager for his shareholding? From the institutional investors' and continuing managers' point of view, why should the departing manager get market value if he has left the company voluntarily?

The concept of good leaver / bad leaver is therefore often introduced to determine what price should be paid for those shares. The usual position is that a good leaver will receive market value for his shares and a bad leaver will receive the lesser of market value or nominal value, although many variations can be negotiated.

The following are examples of circumstances in which a departing employee shareholder may be described as being a 'bad leaver':

- > breaching his contract of employment;
- > leaving the company voluntarily;
- > being asked to leave, perhaps before the expiry of an initial period.

However, care is needed. Close scrutiny of first drafts of a bad leaver definition can reveal a really quite good leaver!

A 'good leaver' can be defined simply as somebody who is not a 'bad leaver'. This typically includes those who have ceased to be employees of the company because they are permanently incapacitated or have been constructively or unfairly dismissed.

Because of the effect of leverage and the circumstances which give rise to departure, market value and £1 for the entire shareholding may be the same, so these debates on good leaver / bad leaver valuations can sometimes turn out to be sterile. Agreeing a vesting schedule so that an increasing number of shares can be retained in the event of departure, may make more sense.

The good / bad leaver issue, probably more than any other, is key for management in protecting their downside. Negotiating the provisions when the transaction is in full swing can damage the goodwill between institutional investors and managers, not to mention creating legal budget pressures, so this is really one to sort out upfront or, if possible, before you are committed to a particular investor.

Drag-along

'Drag-along' is a mechanism which ensures that if a specified percentage of shareholders (generally institutional) agree to sell their shares, they can compel the others to sell. If an offer is made, it will almost certainly be on the basis that the purchaser acquires 100% of the company. Ambitious managers should aim to agree a threshold at which the 'drag' right can be used by the institutions which involves at least a proportion of the shareholding managers being needed by the institutions to back the sale. Alternatively, the drag rights could be suspended until, say, three or five years have expired, to give the managers the opportunity to follow through on the business plan.

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Tag-along

The 'tag-along' provision ensures that if a material level of shareholders receive an acceptable offer from a third party for some or all of their shares (maybe subject to a minimum), they are obliged to procure that the third party also makes an offer to the other shareholders on the same terms for the same proportion of their shares. Tag-along differs from drag-along in that there is no obligation for the non-selling shareholders to accept the offer. In practice, the institutions will expect to have a veto on transfers of shares by the managers so the provisions are very often only of benefit when the institutions are looking to sell and the managers want to join in the exit.

Swamping rights

These give the institutional investor additional voting rights in certain default situations such as a material failure to perform against budget. They are intended to allow the institutions to effect an emergency issue of shares or remove/appoint directors if they do not already have control.

In summary

From start to finish, the buy-out process can be a challenging one. To the uninitiated, the jargon can seem alien and the range of issues overwhelming, but being prepared and understanding what drives your institutional investor can make all the difference. Taylor Wessing's private equity team works with institutions, individuals and management teams on every aspect of the private equity process and is well equipped to advise on and act as your guide throughout.

Our Private Equity practice

Taylor Wessing's international Private Equity practice is considered a prominent and growing force in the market for leveraged cross-border transactions. The team comprises eight dedicated partners in London, together with a further 60 dedicated private equity partners, associates and specialist lawyers across the different jurisdictions in which we operate.

As a truly integrated international team, we are now one of only a limited number of firms with the necessary expertise to operate in the premier midmarket. We have a core focus on working and building relationships with the private equity houses, management teams and key intermediaries operating in this area.

For more information, please contact one of our dedicate Private Equity partners shown opposite.

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