

# Leveraged private equity



The management  
guide

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# Leveraged private equity - The management guide

You are a key member of a management team for a business which is up for sale - one which is part of a larger group, perhaps, or possibly a public company seeking to go private, or even a business owned by institutional investors looking to exit. The team has succeeded in attracting the interest of a private equity firm to fund a management buy-out of the business. Or you could be a manager whom the private equity firm is looking to integrate into the team. Quite possibly in each case in the face of significant and well funded competing interests. In this situation you would be right to think that the greatest challenge you face as a team is to deliver (and convince the private equity investor that you can deliver) on your 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 and an MBI (a management buy-in, where the institutional investor brings in a new management team from outside) or a BIMBO (part management buy-in, part management buy-out) or a MEBO (a management and employee buy-out, where employees are also offered equity participation). You may not have been told, for example, that the term "leveraged buy-out" is short-hand for any of these types of transactions.

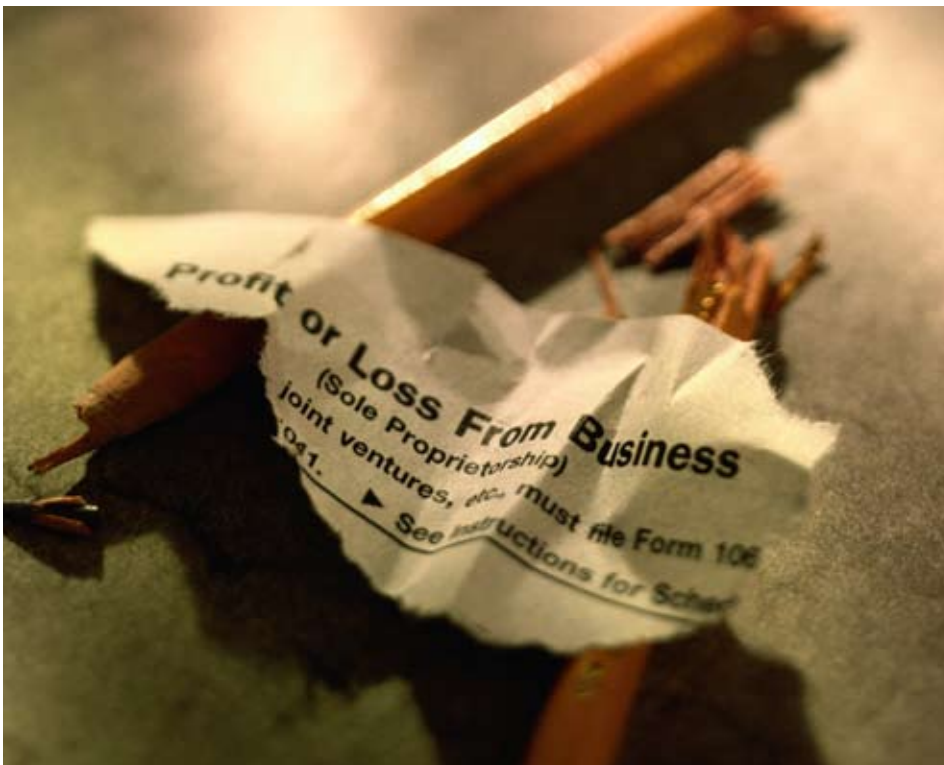
It is the leverage element, i.e. debt, which is fundamental to generating the desired level of returns for the institutional investors and management team alike. The acquisition debt finance adds another layer of jargon and complexity as you are introduced to the joys of senior debt, usually advanced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

The institutional investor, once sufficiently impressed by the management team and business to show an interest in investing, will look to his 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 a basic level of protection for their investment is maintained, while the management team is left to run the business. If it was your pension money that was being invested you would probably be happy about this approach!

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 smoothing the often winding path 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 your 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 by 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 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's processes, technology 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 heartache 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 pays to concentrate on this in particular during the period prior to due diligence and negotiations.

- **Commercial contracts** - formally documenting the terms upon which commercial relationships which are key to the business are conducted, such as suppliers, customers, agents and

distributors, will give investors clarity and confidence in what they are investing in and underpin the business plan.

- **Intellectual property, know-how and trade secrets** - 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 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, e.g. payroll, tax planning, audit, IT systems, software and hardware.

Focusing on these areas 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 his assessment of its depth of understanding of the strengths and weaknesses of the business and the robustness of its business plan. When seeking funding, therefore, you must be able to demonstrate:

- that your business has depth and breadth - in its revenue streams, its suppliers, its 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's track record.

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 them 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.

## Investment documentation

A large number of different legal documents are a common feature of

leveraged buy-outs. Those most likely to be involved include the following:

### ■ Term sheet

Once the 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' shares and the private equity investors' 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 corporate vehicle for the buy-out, this document 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 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 conventional forms of debt which can take a variety of forms, such as loan notes, payment in kind notes, deep discounted bonds. The terms of these instruments will vary depending on the specific economics of the buy-out and could be secured or have conversion rights, for example. At some point you will be introduced to the financial assistance "whitewash process"

in connection with targetco giving security over its assets to the senior lenders, involving a formal statement by management as to solvency going forward. If this sounds problematic a two year prison sentence for incorrectly swearing the relevant statutory declaration takes things up a further notch or two. However, so long as proper care is taken, this results in neither blindness nor a prison sentence for that matter! New legislation may make this particular bit of legal ritual dancing a thing of the past.

### ■ Directors' service contracts

You and any other shareholding-managers making up the team will continue to work in the business. It is usually the case that the terms and conditions of shareholding-managers 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 sections which follow 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 acquisition company.

# Key provisions in the investment agreement

## Subscription

This deals with the number of shares the institutions receive, the type of shares (usually investors will subscribe for shares which have preferential rights over the managers' ordinary shares) and the subscription price paid.

## Warranties

You and your team will be asked to give warranties about most areas of the business and any information (including the business plan) 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. You should, however, 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.

## Matters requiring prior institutional approval

Institutions will usually specify certain shareholder and operational matters which need their approval before the company can go ahead and take the action, 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 restrictive!

## Right to appoint a director

The institutions will usually insist on a contractual right to appoint one of their representatives to the board of directors or to attend as an observer. That director or his alternate will usually have to be in attendance at all board meetings. 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.

## 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, that is 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. Restrictive covenants must be reasonable. However, 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.

## Syndication

An institutional investor may fund the institutional equity for the buy-out itself with the intention of selling-on part of its stake as lead investor to other institutional investors within a few months after the buy-out completing, as a means of spreading investment risk. If this is planned, the investment agreement will generally make specific provision to pass on the benefit of investor protections. The managers, naturally, will want to have a clear understanding of the extent to which the lead institution can syndicate its interests to unknown third parties.



# 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 good leaver/bad leaver shareholder wishes to sell their shares, then those shares are offered first to the institutions. There will be exceptions to this, such as issues to satisfy the exercise of share options and transfers to a family member or trust or to new management. 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 and will 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 founder 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 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
- misconduct or repudiation of his contract of employment giving the company the right to terminate.

Care is needed however. 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" and 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 be somewhat sterile.

Agreeing a vesting schedule so that an increasing number of shares can be retained, in the event of departure, may make more sense. This issue, probably more than any other, is key for management in protecting the 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" 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.

## Tag-along

You and your management team are the people who will be conducting the day-to-day management of the company and are therefore more likely to come across third parties who are interested in purchasing shares in the company. If the offer to purchase shares from a third party purchaser is an attractive offer, the institutions may also wish to participate. Similarly, if the institutions receive an attractive offer you may wish to participate. The "tag-along" provision ensures that if a shareholder receives an acceptable offer from a third party for some or all of his shares (maybe subject to a minimum), he is 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 very often are only of benefit when the institutions are looking to sell and the managers want to join in the exit.



# Legal checklist for investing managers on leveraged buy-outs

## A. Pre-transaction

- 1 Planning for members of management buy-out/buy-in team:
  - (a) Good faith obligations in respect of existing employment terms.
  - (b) Tax relief on borrowings for share purchase (NB 5% interest).
  - (c) Section 431 elections.
  - (d) EIS/EMI.
  - (e) Putting shares in trusts.
  - (f) Wills/Inheritance Tax.
  - (g) Ensure no cheap share problems.
  - (h) Alert managers to whitewash requirements.
- 2 Business plan - N.B. future warranty issue
- 3 Vehicle for acquisition  
Limited liability company - set up newco. Explore best timing from a tax perspective.
- 4 Offer letter to vendor/heads of agreement (see section B for main acquisition agreement):
  - (a) Subject to contract.
  - (b) Exclusivity.
  - (c) Costs indemnity/inducement fee.
  - (d) Standstill on non-ordinary course activity.
  - (e) If strength of bargaining position allows, specify outline warranties, indemnities and restrictive covenants.
  - (f) Data room arrangements.
- 5 Term sheet/heads of agreement from institutions to management (see section C for contents):
  - (a) Subject to contract.
  - (b) Clarify institutions' key legal/control requirements.
  - (c) Exclusivity.
  - (d) Costs responsibility. Management to have costs covered. N.B. potential personal tax liability for benefit. N.B. VAT recovery issues.
  - (e) Conditions precedent e.g. keyman insurance.

## B. Acquisition

- 1 Acquisition agreement:
  - (a) Agreement for sale (of shares or business as going concern or certain assets and obligations).
  - (b) Price (initial, net asset/working capital adjustments/completion accounts, deferred consideration/earn-out/retention, scope to optimise tax position through allocation of price across different assets (business transfers/repayment of debt) - N.B. vendor tax planning may require loan stock which will require tax clearances. Share rollover will require the same.
  - (c) Completion accounts? - Basis for assessing net assets and/or other determinant of final price?
  - (d) Pre-conditions to completion e.g. regulatory/stock exchange.
  - (e) Allocation of business risk during period of any gap between signing and completion and right to withdraw from acquisition in certain circumstances.
  - (f) Warranties and indemnities generally (including tax).
  - (g) Inter-relationship of warranties and indemnities with subscription agreement warranties for management.
  - (h) Specific provision relating to pensions.
  - (i) Competition restrictions on vendors - how long?
  - (j) On-going trading/supply/property lease/transitional service agreements with vendor.
  - (k) Publicity restrictions - All announcements in agreed form.
- 2 Disclosure letter  
Specific and accurate - general reference to unannexed documents not accepted. To arrive in good time for signing/completion.
- 3 Specific tax clearances  
Revenue clearances under section 138 TCGA 1992.

## 4 Due diligence:

- (a) Accountants' report and accounting information and possible market/sector/regulatory due diligence.
- (b) Tax.
- (c) Contracts.
- (d) Property (including valuation/surveys and searches).
- (e) Existing contractual commitments and whether terminable on change of control (share sale) or assignable (asset sale).
- (f) Intellectual Property: protection, infringement by/of third party Trademark/Patent searches.
- (g) Pensions.
- (h) Litigation.
- (i) Employment terms.
- (j) Insurance.
- (k) Information systems.

## C. Financing

### 1 Subscription agreement:

- (a) Investment structure (senior debt, mezzanine and equity) - any ratchet?
- (b) Institutional equity, ordinary shares (separate class of ordinary share?) and cumulative/convertible/redeemable/participating/preference/loan stock (N.B. can balance sheet allow loan stock instead?) (See also Articles).
- (c) Warranties and indemnity on tax - from whom? Inter-relationship with vendor's warranties. N.B. *Levison v Farin* principle of absolute disclosure.
- (d) Restrictions on ongoing activities - on whom?
- (e) Information flow - e.g. obligation to provide institutional investors with monthly management accounts promptly, annual budgets etc. Institutions normally reserve the right to obtain information themselves in the event of default.
- (f) Restrictive covenants - on whom? These typically curtail management from setting up in competition for 12 to 24 months post termination of employment. They are likely to be more enforceable than covenants in a service agreement.
- (g) Institutional right to appoint director(s). Fees for so doing.
- (h) Fees and professional costs.
- (i) Priority on liquidity, i.e. institutional right to preferential return up to a particular level.
- (j) Management shares to lose voting rights if under-performance/breach of investment agreement/articles.

### 2 Articles:

- (a) Employees to sell shares on leaving? To whom sold? At what value? Impact of good leaver/bad leaver on value. Vesting provisions, i.e. whereby right to shares becomes inalienable?
- (b) Institutional veto on transfer of shares. If consent given then transfers subject to offer round provisions. Institutional shares normally reasonably transferable within fund management groups and in any event on syndication, within co-investment schemes etc.
- (c) Drag rights whereby management can be compelled to sell if the institutions so require.
- (d) Tag rights whereby all shareholders can tag pro rata if another shareholder sells.
- (e) Preference shares voting rights in the event of default in payment of principal or coupon and other specified circumstances?
- (f) Dividend rights.
- (g) Rights on return of capital.
- (h) Quorum/decisions to require institutional shareholder vote/approval.

### 3 Managers' declarations

These basically constitute a warranty about any prior bankruptcies, public criticism, material litigation etc.

### 4 Debt:

- (a) Secured/unsecured? Pre-pay without penalty?
- (b) Inter-creditor agreements.
- (c) Share warrants on mezzanine finance.

### 5 Financial assistance:

- (a) Authority in articles to "whitewash" (N.B. Prohibition in 1948 Table A).
- (b) Net assets/distributable reserves.
- (c) Solvency declaration to cover 12 months.
- (d) Accountants' S. 156 report/comfort letter forthcoming N.B. management representation letter to auditors?
- (e) Special resolution.

### 6 Employment contracts?

- (a) Between the Company and whom? Restrictive covenants if employees not a party to the Subscription Agreement.
- (b) Notice period.
- (c) Can breaches of investment agreement/articles give rise to summary termination?

### 7 Further issues:

- (a) Share Option Scheme. Consider other incentives.
- (b) Repetition of warranties/indemnity on any further tranches.

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