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BUYOUTS

Structuring European cross-border buyouts

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In recent years European private equity has established itself as an asset class in its own right, and as a result, buyouts now represent a significant portion of European M&A deals.

Introduction

A decade ago, private equity firms were fringe players on the European M&A stage. Now these "new conglomerates" employ one in six people in Britain (2.7 million people representing 18 percent of the private sector workforce) and in 2003 were responsible for over _60 billion of deals across Europe (around 20 percent of total announced European M&A volume). As the market has matured in the UK – traditionally the preferred playground for buyout firms – the action has been shifting to the Continent where potential deals are plentiful but where cultural and legal hurdles are higher.

The growth and popularity of private equity has led to an unprecedented demand for legal advisers with experience and understanding of the buyout process. Whichever jurisdictions are involved, buyouts can be complex transactions, involving a large number of legal documents, and which give rise to commercial and tax considerations which may not need to be addressed in a typical trade sale.

In its simplest form, a management buyout is the acquisition of a target business by a private equity investor (or often in very high value deals these days, a consortium of investors) in such a way that the incumbent or incoming management receive a potentially significant share of the equity.

There are a variety of names or acronyms given to buyouts (MBO, MBI, LBO etc.) but most of the issues which an investor's or manager's legal advisers will need to consider will apply in each case.

In a typical buyout, a new company (newco) will be formed and this company receives the proceeds of the equity investments by management and the private equity investor. Most private equity investments are structured so that the larger part of the investment by the private equity provider in monetary terms is in some form of non-risk capital, such as fixed-interest preference shares or loan stock, with the balance in risk-bearing equity shares. Newco will usually also secure bank finance from senior, and sometimes mezzanine, lending institutions in order to help fund the acquisition of the target, and to provide working capital for itself and its subsidiaries. Efficient structuring of the transaction at the outset is essential from both management and the investor's perspective, and tax advice in particular will need to be taken early on in the process. Both managers and private equity investors will wish to minimise the amount of tax payable on the capital gain they expect to make on their investment on exit, and also the tax payable by the new group on its trading profits during the life of the investment.

If the transaction is multi-jurisdictional, different subsidiaries of newco may be incorporat-

ed in the various jurisdictions and used to acquire target group companies in the relevant countries. The structure ultimately adopted for any buyout, however, will be influenced by:-

- legal barriers and, specifically, the requirements of the jurisdiction in which the target company is incorporated; and
- accounting and tax considerations, notably the ability to consolidate group profits and losses to offset tax, and the desire to ensure tax-efficient repatriation of profits from foreign subsidiaries. In cross-border leveraged deals, there may also be tax advantages to be gained by placing acquisition debt (and therefore tax-deductible interest) in subsidiaries of newco. Before doing so, however, it will be essential to ensure that each member of the group has sufficient cash flow to repay its share of the debt and, subject to local rules regarding the giving of financial assistance, that it can give adequate security for the debt.

A buyout typically comprises three key components; equity, acquisition and debt.

Each of these components has its own set of legal documents which all need to interrelate so as to avoid circularity and to ensure that, for example, no commitment to acquire the target is made without the conditions to the debt financing having been satisfied. Where there is a gap between contract signing and completion, the business risks and legal complications can increase and care needs to be taken to ensure that the conditions precedent in the debt financing, equity and acquisition documents are compatible.

Equity

Although the equity finance documentation can be extremely sophisticated, the key assumptions which underlie it are generally the same, namely that:-

- it should provide the ground rules for the good governance of newco. Private equity investors place heavy reliance on the management team and the equity documents will reflect the high standards of governance expected of them, counter-balanced by performance incentives;
- the investor is likely to want to exit within three to five years (either by way of trade sale, secondary buyout or initial public offering);
- it must facilitate an exit when the investor deems it appropriate, in good or bad times;
- the investor will usually retain the right to take control or appoint new managers if a successful exit is at risk; and
- the investor will generally be looking for an internal rate of return in excess of 25-30 percent and/or a multiple of at least 2-2.5 times money invested.

The main equity finance documents are the:-

- *Investment agreement* (also sometimes known as the subscription and shareholders' agreement). This agreement governs the relationship between the managers and the private equity investor and sets out the ground rules for the future operation of newco and the acquired business. The investment agreement will record the subscriptions for equity shares by the investors and managers, and the issue of preference shares or loan stock to the investor. It will also contain warranties from the managers (and sometimes newco as well) to the investor. Other key provisions generally include an enshrined right for the investor to appoint one or more directors to the board of newco and the target (known as investor directors), its right to receive regular information on newco's performance and finances, restrictive covenants from management in favour of newco and the investor to protect the goodwill of the business should a manager leave ; and positive and negative covenants given by the management (who after all will be managing the business on a day-to-day basis) which ensure that certain key business and constitutional decisions can only be taken with the prior consent of the investor.
- *Articles of association* (or by-laws). These will set out the share rights (dividends, votes, return of capital etc.) and impose restrictions on the transfer of newco's shares (the guiding principle from the investor's point of view being that shares are issued to management to incentivise them and should not, except in limited circumstances, be sold without the investor's consent). In drafting and negotiating the articles, it is vital for advisers to understand the economics of the equity deal reached between the private equity provider and the management team. For example, the articles may contain a "ratchet" whereby management's share of the equity increases on exit if the business has performed well. Other key provisions will include obligations on management to surrender their shares in newco if they leave (so-called "leaver" provisions) and the investor's come-along (or drag-along) rights which will oblige management to sell their shares if the investor wishes to exit, sometimes accompanied by a tag-along whereby the management can put their shares up for sale if control of newco is set to change.
- *Service agreements*. The management team will usually be given new service agreements (employment contracts) with newco which tie in with the equity arrangements. In a cross-border buyout involving managers participating in different jurisdictions, some managers may wish their employment arrangements to be governed by the laws of their particular country, which can cause difficulties if the effect is that managers are employed on different terms.

Acquisition

The mechanics of the acquisition of a target business in a buyout are likely to be similar in many respects to a trade acquisition. The key document is the share purchase agreement, ▸▸

which in a multi-jurisdictional deal will often be in English and governed by English law if the deal is being led by a UK private equity investor, and is sometimes known as an "umbrella" or "framework" agreement.

However, some issues relating to the acquisition process are unique to buyouts. Before the investor is prepared to embark upon an expensive due diligence exercise and prepare binding contractual documentation, it will usually require that heads of terms are signed up, containing binding confidentiality, exclusivity and break fee provisions. Break fees protect the investor against abortive costs if the deal fails to complete, but raise difficult legal issues which require careful handling. Also, investors should be aware that in some civil law jurisdictions, the parties may have an implied duty to negotiate in good faith, which is not the case in the UK where pre-contract negotiations are carried out "subject to contract".

Management, if they have not initiated the buyout, will need to be involved at a very early stage, as it is likely that they, rather than the vendor, will be generating much of the due diligence information, and the investor will want to ensure that it obtains the full benefit of their existing knowledge of the business.

Where managers initiate a buyout, they must be extremely careful to ensure that they do not breach any duties of confidentiality that they owe to their employers (for example, by disclosing financial information or trade secrets to potential funders), and that they do not place themselves in breach of their service contracts (for example, by spending too much time trying to pursue the buyout and neglecting their day-to-day duties as employees). They should seek legal advice as early as possible in the process and, wherever possible, obtain permission from their employer and non-participating board members to pursue their objectives.

The level of warranty cover will generally be a contentious issue in a buyout. The vendor may be unwilling to warrant matters which are within the knowledge or control of the management who are more closely involved with the target business. So, it is common in buyouts for a vendor to seek to restrict the scope of the warranties to specific areas of the business, for example, head office functions, or otherwise limit its exposure under the warranties by reference to management's knowledge, actual or imputed. From an investor's point of view, however, knowledge limitations introduce an element of uncertainty into warranty protection; that is, newco may be unable to recover under the warranties if the management knew or ought reasonably to have known about a particular liability. For this reason, knowledge limitations are generally resisted as forcefully as possible. Whether or not such resistance succeeds, the investor will expect the managers themselves to be directly on the hook to the investor and newco for warranties on the target business in the investment agreement and to disclose fully against those warranties based on their knowledge of the business.

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As target businesses in buyouts often operate in niche markets, where the business is being acquired from a larger group, restrictive covenants (such as not to compete or solicit customers or key employees etc.) are often requested by investors to be given in favour of newco by the vendor on behalf of itself and the other members of its group.

Debt

The principal components of the debt, or acquisition finance arrangements are:-

- the facility agreement or agreements between the lender and newco (and possibly subsidiaries if there are any) relating to the loan facilities made available to newco to fund the acquisition and its ongoing working capital requirements. There may be different layers of debt provided by one or more different lenders;
- an inter-creditor agreement between newco, its lender(s), both senior and mezzanine if any, and any holder of loan stock (namely the investor), which regulates the priority between the different layers of debt finance; and
- the security arrangements. The ability of the target and newco to provide security is key to a successful funding of the project. In a typical buyout, however, the giving of security by the target may constitute financial assistance for the purchase of its own shares. In many jurisdictions, financial assistance is prohibited or only allowed in certain circumstances, and the initial structuring of the deal will need to take these limitations into account. ■

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