

UK PRIVATE EQUITY

Financial assistance in buyout transactions

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Private equity transactions now represent a significant percentage of UK M&A activity. In 2003 there were 670 buyouts in the UK, worth £16.2bn, and the financial firepower of private equity houses makes it likely that these new conglomerates will continue to play an increasingly important role in today's markets.

Buyouts are complex transactions, however, and the decisions in two recent UK Court of Appeal cases have exasperated advisers and forced parties involved in UK private equity deals to reconsider the financial assistance implications of certain aspects of these deals.

This article examines how buyouts involving the acquisition of shares can be affected by the UK prohibition on financial assistance, and comments on the prospect of changes in the rules relating to financial assistance in the light of the UK government's ongoing review of company law.

Financial assistance in buyout transactions

In a typical buyout of a target business, a private equity house and the incumbent or incoming management will subscribe for equity shares and other non-risk capital, such as fixed

interest preference shares or loan stock, in a new company (newco) set up specifically for the purpose of making the acquisition. Usually newco will also secure financing from a bank or other financial institutions to help fund the acquisition of the target's shares.

Each of three principal elements of a typical buyout – subscription, acquisition and debt – can give rise to its own financial assistance headaches. Principally these relate to the various cost undertakings and indemnities ordinarily given by the various parties, and the guarantees and security that will be required by the lenders from the target (newco, by its very nature, will normally have no assets of its own to offer).

To attempt to understand – and solve – the problems associated with these aspects of a buyout one needs to understand what financial assistance is and what may be prohibited.

General prohibition

In the UK, where a person is acquiring shares in a company (which includes a subscription for new shares), it is generally not lawful for that company (or any of its subsidiaries) to give financial assistance for the purpose of

that acquisition.

The statutory definition of financial assistance is very wide and includes providing an indemnity, allowing net assets to be reduced to a "material extent" or giving a gift, loan or guarantee. This general prohibition against the giving of financial assistance, contained in section 151 of the Companies Act 1985, applies whether the assistance is given before, at the same time as or after the acquisition. Thankfully there are exceptions to these rules, but the consequences for failing to comply with the legislation are serious: there are criminal penalties – the offending company can be fined, and its directors (who are in default) are liable to imprisonment and/or a fine – as well as civil consequences, notably that the transaction could be void and unenforceable.

Whitewash

The exception to the general financial assistance prohibition which is most commonly relied on in a buyout is the "whitewash" procedure. This is only available to private companies and, not surprisingly, certain conditions must be fulfilled before the financial assistance can be allowed. These include the rele- ►►

vant company having net assets at the time it gives the assistance which are not reduced by the giving of the assistance or are only reduced to the extent of its distributable profits. The company's directors must also confirm that they believe that the company will be able to pay its debts immediately after the financial assistance is given and that it will continue to be able to pay its debts as they fall due during the next twelve months. There are other practical and timing issues which need to be considered but they are not generally insurmountable.

Costs

Whether or not the payment of costs relating to a buyout constitutes financial assistance depends very much on who pays them and what they relate to.

Institutional investors and management will incur fees relating to their subscription for shares in the newco which will acquire the target company. In particular, legal fees in connection with the preparation and negotiation of newco's constitutional documents, including the investment agreement which will generally record the subscriptions of both parties and govern the relationship between the managers and the private equity investor, and set out the ground rules for the future operation of newco and the acquired business.

While the payment by newco of the costs which relate to the acquisition of (or subscription for) newco's shares may avoid the financial assistance prohibition, the payment of, or the agreement to pay or reimburse costs in relation to the acquisition of the target's shares by the target or any of its subsidiaries will usually be financial assistance, and will need to be whitewashed by the target to be lawful. Views differ, but essentially, although the payment of such fees is no longer considered to be outside the scope of the prohibition on financial assistance, provided newco's agreement to pay fees does not constitute an indemnity or materially reduce its net assets, the assistance should be lawful. These agreements need to be structured very carefully, however, and advice as to what constitutes available net assets will need to be taken. As a general rule of thumb, provided the fees payable represent less than one percent of the value of the aggregate equity investments (excluding bank debt and investor loan stock) and the agreement to pay is conditional on clos-

ing, the arrangements should not fall foul of the financial assistance prohibition. Alternatively, it may be possible to structure the payment of fees as a commission (which should not be caught by the general prohibition) or to have target pay some or all of the fees relating to the investment, although in such a case the arrangement would need to be whitewashed.

The payment by newco of the costs which relate to the acquisition of the target will not be financial assistance in relation to the acquisition of (or subscription for) newco's shares, but payment of, or the agreement to pay or reimburse such costs by target or any of its subsidiaries will usually be financial assistance in relation to the acquisition of target's shares, and will need to be whitewashed by target to be lawful.

Equally, costs in relation to advice on acquisition finance can generally lawfully be met by newco, but not target or its subsidiaries. The most common financial assistance problem with finance arrangements is the requirement for security over the assets of the target and/or its subsidiaries which will usually be financial assistance to the extent that the debt is used to fund the acquisition (as opposed to working capital). As explained below, such security is usually whitewashed by the target and the charging subsidiaries.

Break fees

The agreement to pay a break (or abort) fee, also sometimes known as an inducement fee, obliging one party to bear the professional and other advisory costs incurred in the negotiation and the due diligence stages of a deal if it does not complete, not only needs to be within the express or implied powers of the company giving the undertaking, as well as in its best interests, but can also fall foul of financial assistance legislation in the UK if given by the target. This is notwithstanding the fact that an acquisition of shares does not take place. It is the agreement to pay the break fee which is generally considered to be unlawful financial assistance. However, provided that a break fee is worded properly so that it does not amount to a gift or an indemnity and does not give rise to a material reduction in the net assets of the target (an inducement fee capped at 1 percent of the value of the offer is generally considered not to constitute a material reduction), it should not be unlawful.

To avoid constituting an indemnity, the directors of the target should agree with the bidder, at the outset of a transaction, a fixed, pre-determined fee which is independent of the expectations as to the bidder's actual costs and which is not subsequently adjusted by reference to the costs actually incurred.

Security

As mentioned above, in a buyout the lending banks will look to the target's assets for security to support newco's borrowings since newco will have no assets of its own. The financial assistance prohibition prevents a target company from giving security over its own assets and those of its subsidiaries to a bank in respect of borrowings incurred in order to purchase its shares, and as a result these debentures and any guarantees of newco's borrowings will need to be whitewashed.

The future

In 2002 the Government began a formal consultation on a draft Bill to replace the 1985 Companies Act. The main aim of the Government's review is to simplify the company law regime, particularly for private companies, and to make it more accessible and easy to use. One of the major recommendations of this review, which dates back to 1998, has been to remove the prohibition on private companies giving financial assistance for the acquisition of their own shares. For public companies, the suggestion has been to revise some of the existing exemptions from the prohibition on financial assistance, and to introduce new exemptions, although the prohibition will remain for public companies in view of the requirements of Article 23 of the Second Company Law Directive.

This project has been slowed considerably by the scale of the task of reforming and rewriting such a complicated piece of legislation. Recently, the Government has also prioritised a separate Bill dealing with post-Enron reforms to accounting practice in the UK. However, given the buoyant buyout market, and the differences of opinion and variances in practice amongst even the leading UK law firms, the sooner the current financial assistance rules are simplified, the better. ■

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