

Secondary buyouts

Moving on

Illustration: Phosphor Art



Phil Sanderson of Travers Smith Braithwaite considers the legal and commercial implications of secondary buyouts.

A buyout can be described as the acquisition of a business by a management team, backed by private equity finance, usually provided by a *private equity fund* (see *Glossary*) established to invest specifically in unquoted securities. A secondary buyout is a buyout of a buyout and is becoming a feature of UK corporate transactions: in 2003 an exit for a buyout was as likely to be a sale to another private equity backed vehicle as to

a trade buyer (see box “MBO exits: 2000–2003”).

This article:

- Explains why secondary buyouts have become so common.
- Considers some of the basic mechanics of a buyout and examines two particular themes inherent in secondary

buyout negotiations, namely, the “warranty gap” and “alignment”.

- Provides practical legal and tax advice on completing secondary buyouts successfully.

WHY SECONDARY BUYOUTS?

The usual exit for a buyout is one of a sale to a trade buyer; a flotation; a secondary buyout; or insolvency or wind-

MBO exits: 2000-2003

Exit Type	2000			2001			2002			2003		
	Buy-out	Buy-in	Total	Buy-out	Buy-in	Total	Buy-out	Buy-in	Total	Buy-out	Buy-in	Total
Trade sale	91	46	137	65	30	95	42	37	79	32	18	50
Flotation	10	6	16	4	3	7	5	6	11	4	1	5
Secondary buy-out	17	11	28	23	12	35	46	19	65	31	17	48
Receivership	57	46	103	72	41	113	81	40	121	54	28	82
Total	175	109	284	164	86	250	174	102	276	121	64	185

Source: CMBOR/Barclays Private Equity/Deloitte & Touche
 * Year 2003 figures are for the first nine months only

ing-up. The decision to exit in a particular way and at a particular time will generally be driven by the potential cash returns on offer to both private equity investors and management.

The current wave of secondary buyouts can be explained in terms of demand and supply:

Buy-side. Private equity is predominantly funded by institutional investors (such as pension funds, banks and insurance companies) committing money to funds set up by private equity managers (*for further information, see feature article "Private equity funds: US and UK features", www.practicallaw.com/A29763*). The popularity of private equity as an asset class has increased over the last decade. Confidence in its potential returns has also increased as confidence in public markets (particularly since 2000) has diminished. Private equity merger and acquisition (M&A) activity in the UK currently outstrips public market funded M&A activity. There is now an "overhang" of private equity money to be spent, of which a large proportion should, under the contractual arrangements constituting the funds, be invested over the next two to three years (*see box "Private equity timeline"*).

Sell-side. All buyouts are focused on exits, which usually take place three to five years post-investment. In addition to management fees, private equity fund managers are rewarded in the form of "carried interest" for returning profits to investors. This is usually a 20% share of

profits once investors have got their money back and a "cost of money" related hurdle has been achieved (by completing successful exits). In addition, managers will be conscious of the business need to raise their next fund. Typically, the new fund raising process can start once a fund is 70% invested, but since new (or existing) investors will be unlikely to invest in the next fund unless or until the existing fund is showing good returns, they too will focus carefully on the exit history of the existing fund.

Because of the cyclical nature of private equity, fund managers will, rightly, be focused on completing exits even, as now, in a market where trade sales are harder to find and flotations a realistic possibility only for the chosen few. The secondary buyout is therefore a viable alternative and it is difficult to imagine that the number of secondary buyouts will not be maintained for the foreseeable future.

BASIC STRUCTURE

A secondary buyout is structured along the lines of a primary buyout (*see boxes "Typical buyout structure" and "Typical secondary buyout structure"*). In the case of a secondary buyout, the principal parties will be:

- The management of the primary buyout vehicle (target), some or all of whom will be exchanging their shareholdings in target for shareholdings in Newco, the secondary buyout vehicle, and continuing to work in the business post-deal.

- The new private equity investor for Newco.
- Target's private equity investor, which will be selling some or, more commonly, all of its shareholding in target and receiving repayment of the debt it provided to target.
- Newco (as purchaser).
- The senior debt provider (usually a bank or group of banks).

Lawyers for the parties will be required to advise on:

- The incorporation of Newco (or group of Newcos) to buy target.
- The sale or purchase of the shares of target (documents including sale and purchase agreement, disclosure letter and tax deed).
- The equity agreements between the new private equity investor and management of target post-acquisition (documents including Newco's articles of association, investment (or shareholders') agreement, management disclosure letter and any documents required to record any private equity investor debt).
- The senior (and mezzanine) debt, most buyouts being "leveraged" by senior debt with a view to improving the return on the private equity investment (documents including the facility agreement(s), security documents and intercreditor agreement).

General considerations

The following issues are likely to arise in the context of a secondary buyout:

Conflict of interest. In a primary buyout, a conflict of interest will exist for target's management team between their duties to the target, their desire to achieve a successful buyout, and their future plans for Newco. In the case of a secondary buyout, these conflicts are compounded by their need to manage their relationship on the sale with both the selling and the buying private equity investors and by the fact that they are themselves sellers. Particular conflicts can arise if, for example, a bidding private equity investor offers less upfront cash (to both the selling private equity investor and management) but a better equity deal going forward than, for example, a trade buyer who offers more cash, but no equity. If possible, potential conflicts should be understood and best practice adopted at an early stage.

Taxation. On most secondary buyouts management shareholders will be cashed-out in part and will "roll" or "reinvest" in part, the "rolled" portion generally being a mixture of shares and loan notes in Newco. From a tax perspective the management's objectives will be clear: to pay 10% capital gains tax on the consideration they receive in cash, to defer any tax on the "rolled" portion until the Newco exit and to incur an ultimate tax rate of 10% on that "rolled" portion. However, these objectives may be difficult to achieve in the context of secondary buyouts (see box "Management tax objectives").

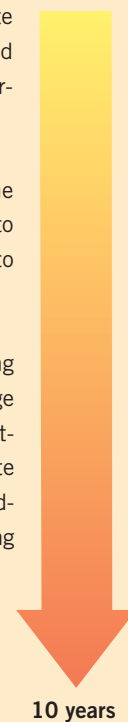
As in any buyout there will also be a significant amount of planning surrounding the tax position of the Newco group. The objectives are likely to include obtaining an effective tax shelter for the financing costs (this may involve pushing debt down to local operations); minimising the stamp duty and other tax costs of acquisition; and ensuring the acquisition structure is tax efficient for the future exit strategy. Tax (and indeed banking) considerations often lead to a multiple Newco structure.

Private equity timeline

Fund raising. This can take between nine months and two years. Private equity investors can only start charging a management fee once the fund has reached first closing (commonly at least six months after first marketing).

Investment period. The fund documents will prescribe the time that the private equity house has to invest fund commitments, usually three to five years. During this period, the management fee usually amounts to 2% of fund size.

Divestment period. Fund documents prohibit further investments during this period and management fees reduce to either a reduced percentage of fund size or 2% of the funds actually managed (that is, funds committed but not realised). A fund is usually wound up after ten years. Private equity fund managers are usually only permitted to start the next fund-raising process once they have invested more than 70% of the existing fund's commitments. Key to the continuing profitability (or possibly survival) of the private equity manager will be the ability to replace the management fee as soon as possible after it starts to reduce during the divestment period.



Selling shareholders. Advisers will need to understand who owns, or has options or warrants over, shares in target. Particular issues that may arise include the following:

- Do all shareholders want to sell? If not, to what extent will a buyer be able to rely on *drag along rights* in target's articles of association? The same question should be asked in relation to persons entitled to shares (through options or warrants).
- Do all shareholders agree how the sale consideration will be split, particularly if target's articles contain a *ratchet*?

(See also "Alignment" below and box "Practical advice for buyers".)

KEY ISSUES

Two issues require more detailed consideration. The selling private equity investor is likely to be entitled to a substantial portion of the purchase price and will almost always refuse to give any warranties or indemnities in respect of target (see "Warranty gap" below). Target's management will generally wish to receive as much cash on the sale of their

target shares as the buying private equity investor permits while maintaining a significant share in the potential upside (that is, profits) of the secondary deal, in search of a life-changing sum of money on a later sale or flotation of Newco. The management will also be sensitive to any suggestion that its right to upside (both that made on the primary buyout and any future upside on the exit of the secondary buyout) be linked to their ongoing participation in Newco's management. This leads to a debate over alignment (see "Alignment" below).

Warranty gap

A basic assumption on the acquisition of a company has always been that a buyer is entitled to expect protection against pre-acquisition, unknown liabilities or other matters which lead to a diminution in value of target as at the acquisition date. The negotiation of this protection, in the form of warranties and indemnities, is "bread and butter" to M&A lawyers. A private equity backed buyer is no different in seeking protection. Indeed, private equity managers owe fiduciary duties to their fund investors and on most buyouts full warranties and indemnities will be sought, supplemented by due diligence reports (financial, com-

mercial and legal). On a primary buyout the monetary cap on such protection will often equal the consideration paid.

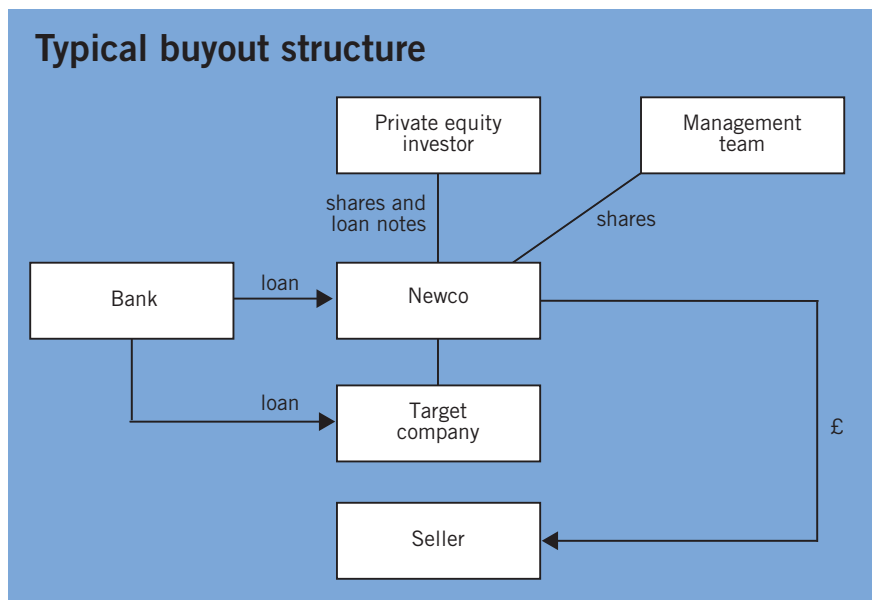
This will not be possible on a secondary buyout, where the selling private equity investor will almost certainly refuse to provide any warranty or indemnity protection. The difference between the amount of warranty and indemnity cover available and that required by the buyer (anything up to price paid) is commonly known as the warranty gap.

Particular issues and/or solutions for the buyer to consider are as follows:

Potential warrantors. Target's management will normally agree to provide customary warranties and indemnities. On successful sales this could provide sufficient protection to a buyer. For example, if the managers are themselves together receiving cash or cash-equivalent consideration of £10 million, it is possible that a buying private equity investor will consider this acceptable protection. In doing so the investor will need to consider whether a warranty claim is likely to exceed this £10 million cap and whether the managers would risk such money (and potential upside) without committing themselves to an exhaustive due diligence process.

A principal purpose of warranties is to elicit disclosure so that a buyer can properly understand any issues that may exist and price the deal accordingly. This purpose should be possible regardless of the warranty gap. However, buyers may require more comfort. The management consideration (and consequential cap on warranty and indemnity claims) may be too low (whether in actual terms or by reference to the perceived risks associated with target, particularly tax risks) or the private equity investor may feel exposed if its sole recourse is against those individuals it has backed to make the secondary buyout a success.

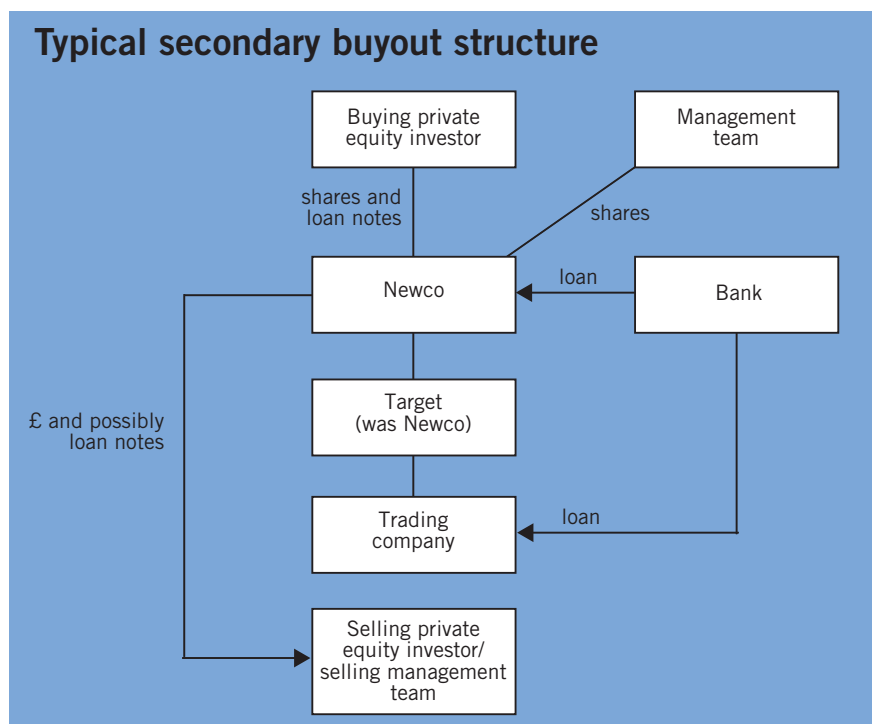
In addition, not all of target's managers will necessarily be providing warranties. Advisers will need to check this early in the process. No manager can be forced to give warranties (even in circumstances



where the articles of association or investment agreement require him or her to sell their shares (see "General considerations" above)). Some do refuse, particularly those who will not participate in the business going forward or non-executives who often claim lack of knowledge and/or alignment to the private equity investor as justifications for not giving warranties. Conversely, if managers who will not be involved in the business going forward (for example, a retiring founder or chief executive officer) are to receive substantial cash consideration and do give warranties, this may ease the private equity investor's concerns about having to sue its own management team.

It is generally a mistake for the buyer to compromise on the scope of the warranties sought. To identify and evaluate key business risks will be vital, particularly where the monetary cap on warranty and indemnity cover is low. A buyer should not confuse this with a concession that general warranty protection is not required. A buyer may be wrong when identifying risks. Full warranties elicit full disclosure, even if the buyer agrees that the warranties that may appear less significant are qualified by seller awareness.

Completion accounts. Most selling private equity investors will accept that



Management tax objectives		
Objective	Achievable?	Deal implications
Pay tax at 10% on the target shares they sell for cash	Yes, but only if: <ul style="list-style-type: none"> Existing shares are held in capital (rather than income) regime. Note this will not always be the case and that existing <i>ratchets</i> (see <i>Glossary</i>), in particular, may be susceptible to income tax treatment. If income treatment applies the whole or part of the proceeds will be subject to PAYE and National Insurance contributions (NICs). Maximum taper relief is available. Tax clearance is obtained under section 707 of the Income and Corporation Taxes Act 1988 (this will not always be the case). If tax clearance is denied there is a risk that a portion of the cash proceeds (related to the level of distributable reserves in target) will be taxed as a distribution subject to a 25% effective tax rate. 	<ul style="list-style-type: none"> Disincentivised management if a tax rate above 10% applies. Potential NIC costs for target if income treatment applies. Need to obtain advance Inland Revenue tax clearance has a timing implication. The Inland Revenue has 30 days to consider a clearance request.
"Rollover" into loan notes so as to defer any tax until ultimate exit on this element of the consideration	Yes, provided that: <ul style="list-style-type: none"> Tax clearance is obtained under section 138 of the Taxation of Chargeable Gains Act 1992 (TCGA). This clearance is normally forthcoming. The loan notes are non-qualifying corporate bonds. (They should not be discounted bonds). 	<ul style="list-style-type: none"> Timing implication of tax clearance application.
Pay tax at 10% on redemption of loan notes in Newco	Yes (provided that taper relief conditions are satisfied), but note: <ul style="list-style-type: none"> Depending on history of shareholding in target a 10% rate may only be achievable with further planning. This treatment is dependant on successful section 707 clearance. If clearance is denied there is a risk that a portion of the redemption proceeds will be taxed as if they were a distribution subject to a 25% effective tax rate. 	<ul style="list-style-type: none"> Timing implication of tax clearance application.
"Rollover" into shares in Newco so as to defer any capital gains tax until disposal of Newco shares	Yes, provided target shares are in capital regime, clearance is obtained under section 138 of TCGA and technical conditions are satisfied.	<ul style="list-style-type: none"> Timing implication of tax clearance application. Use of exchange agreements and put and call options if multiple Newco structure.
10% tax rate on disposal of shares in Newco	Yes, provided: <ul style="list-style-type: none"> New shares are in capital regime (see box "2003 Budget changes"). Taper relief conditions are satisfied. 	<ul style="list-style-type: none"> Ensure Newco group qualifies for taper relief.
Avoiding income tax/NIC charges when acquiring the shares in Newco as consideration for their shares in target.	Yes, but only if the unrestricted market value of the shares in Newco (see box "2003 Budget changes") is not more than the restricted market value of the shares in target.	<ul style="list-style-type: none"> Accountants' valuation may be required to ensure no income tax charge is triggered.

completion account adjustments should be borne proportionately by selling shareholders, including themselves. A completion accounts process will give comfort to a buying private equity investor in a number of ways (*for further information, see feature article "Understanding company accounts: An overview", www.practicallaw.com/A32119*). Depending on how the process is crafted it has the potential to:

- Help the buyer understand the balance sheet it is buying and provide for recourse if actual assets and liabilities

are proved to be different. The most common form of completion accounts adjustment is tied to a "target" net assets figure. To agree what the target should be, the buyer and its financial advisers will need to understand the historic figures and the impact of current trading.

- Help the buyer understand and take account of the target's working capital and cash position. It is likely that a private equity backed company will have been groomed for a sale. Part of this could be a tight management of work-

ing capital (for example, reduction of debtor days, increase of creditor days). It is also customary to value companies on a "cash free" basis. The combination of the above makes it imperative for the buyer (and the bank leveraging the buyout) to feel comfortable with working capital and the level of cash required to fund the business.

- Allow adjustments for pre-completion issues that only come to light or become understood post-completion (but before the completion accounts are agreed).

2003 Budget changes

- Newco managers will wish to avoid an income tax charge when acquiring their shares in Newco and to pay capital gains tax on disposal of these shares. Assuming maximum reliefs are available the capital gains tax rate is 10%. By contrast the income tax rate is 40% (see box "Management tax objectives").
- The manager will avoid an income tax bill upfront if he pays an amount equal to the market value of his shares. In establishing market value for these purposes ignore any leaver provisions or dividend, voting or other restrictions. This is referred to as unrestricted market value (UMV).
- The manager will be treated as paying UMV if he falls within a safe harbour negotiated between the Inland Revenue and the British Venture Capital Association (BVCA) (www.practicallaw.com/A32946). This is referred to as the Memorandum of Understanding (MOU).
- If the MOU conditions are not satisfied a valuation will normally be carried out to establish UMV.
- If the manager pays less than UMV he can elect to pay a (normally small) amount of income tax on subscription (the amount being calculated on the undervalue) or a normally larger amount of income tax in the future (the amount being calculated as a proportion of the sale proceeds).
- If income tax is payable the employer will also suffer a national insurance bill at 12.8%.
- Managers will generally wish to make an election to pay any income tax due on subscription so as to minimise their exposure to a larger amount of income tax on exit. Private equity investors will generally insist on such an election in order to protect Newco group against substantial national insurance liabilities which could otherwise arise on ultimate exit.
- Elections will now generally be made as a precautionary measure even if the managers believe they fall within the MOU or have paid UMV.

A completion accounts mechanism sympathetic to a buyer's concerns can protect against key financial and business risks. It wins that protection from the selling private equity investor (as well as management) and can reduce the risk of the buyer having to sue its own management team for breach of warranty. It may permit a right of recourse against a seller on whom no reliance will be placed in the future. However, it may not be possible to agree a satisfactory completion accounts process (often the actual protection is minimal because the room for debate has been restricted by use of agreed guidelines and fixed provisions and valuations) and, in any event, liabilities

may only surface once completion accounts have been signed off.

Specific indemnity. If a specific risk or potential liability is identified through due diligence a buyer is likely to seek an immediate reduction in the purchase price or an indemnity providing pound-for-pound compensation if the liability crystallises (or becomes the subject of litigation). Selling private equity investors who refuse to give general warranties and indemnities may be persuaded to give specific (usually capped) indemnities, particularly if the alternative is a price reduction. Buyers on a secondary buyout should focus on whether any

such issues exist, conscious that a price reduction or indemnity from all sellers is preferable to general warranty or indemnity cover from the management team only.

Advisers should distinguish between general business risks and those specific issues that should be negotiated between the buying and selling private equity investors. For example, if tax due diligence reveals a particularly aggressive approach to target group tax planning with specific risks attached, the buyer's advisers should consider whether to seek a specific indemnity rather than rely on any protection in the general tax deed. Experience suggests that private equity investors will resist providing any form of indemnity, however specific, but indemnities have been given in practice where the risk is real and quantifiable or are negotiated in conjunction with a request for an escrow (see below).

Escrow/retention. This is where all (or some) selling shareholders, including the selling private equity investors, agree to put a proportion of their proceeds into an escrow account for an agreed period of time. Practice differs but these accounts can be prescribed to operate as a "sinking fund" for all warranty and indemnity claims, even though, in the case of the selling private equity investor, this may mean that their proceeds are clawed back or reduced on settlement or determination of another's (that is, management seller's) liability.

This may appear tantamount to actually giving the warranties and indemnities and, economically, is little different, but private equity houses are rightly keen to avoid establishing a general precedent for giving warranties that would damage returns and generally hinder the efficient operation of the fund which they manage. In particular, it would be difficult to administer or wind up a fund and generally calculate fund profit shares if sale proceeds were subject to a possible warranty claim clawback. In any event, an escrow is only likely to be debated on very successful exits and for limited periods of time (generally less than two years).

Practical advice for buyers

Advising the buying private equity investor

- Understand why your client wants to do the deal, which managers are key going forward and why.
- Check the deliverability of the deal: can all target's shareholders (that is, shareholders in the company created by the existing management buyout) be forced to sell (check **drag along rights** (see *Glossary*) in the target articles of association)? Ask if there are any dissenting shareholders.
- Ascertain early on whether the deal requires any form of tax clearance. Provide as much information as possible to management's advisers to ensure all tax issues are dealt with in advance of the completion week.
- If target has issued options or warrants, check the impact of the proposed buyout and, in particular, check for mistimings in option exercise mechanics.
- Agree who is to undertake the due diligence of the managers' tax position and understand the impact of this aspect on documents and timing.
- Identify the warrantors, quantify the warranty gap and discuss with client (see "*Warranty gap*" in the main text). If warranty and indemnity insurance or escrow (or both) are likely to be required, agree a negotiation strategy, conscious that the selling private equity investor could be asked to pay or share the insurance premium cost. Talk to the insurance broker.
- Understand the agreement between the selling and buying private equity investors regarding access to management: the buying private equity investors will wish to see management as buyers rather than sellers. A selling private equity investor will be sympathetic to this, although eager to agree with management the extent of their co-operation in the sale and the manner in which the target is managed pre-completion. Recognise the conflict inherent in the management position and ease and clarify the process wherever possible. A non-executive chairman is often given the role of mediator on conflicts.
- Ensure that the management team is receiving proper advice both as selling shareholders and in relation to the equity arrangements going forward.
- Be as co-operative as possible with the management team and its advisers: this includes resolving tax structuring issues and carrying out target due diligence.

Advising management

- Know your client. Are you able to advise all managers/optionholders? Are you also advising the selling private equity investor? Consider if there are any conflicts.
- Understand each manager's motivation for the secondary buyout.
- Ensure that the management team is well advised on the financial deal being proposed by the buying private equity investor.
- Understand your client's inherent conflict as both buyer and seller. Recognise when it is important for the management to act as buyer alongside the buying private equity investor, but ensure that this is not done at the cost of the relationship with the selling private equity investor.
- Ensure that the sale of 100% of the share capital is deliverable.
- Understand and prepare the ground on the warranty gap issue.
- Encourage key equity terms to be agreed upfront.
- Agree who pays management's professional fees (including share valuation fees, if relevant to tax planning following the changes made in the 2003 budget (see box "*2003 budget changes*").
- Co-ordinate and understand the tax advice. This is critical.
- If any of the selling managers are to cease to be employed by target, consider whether conflicting issues arise. In particular, caution is required over the giving of several warranties as Newco will be more willing to sue the target management that leave than ongoing management.

Advisers to target's management will be keen to balance their client's desire to realise cash from the escrow against the possibility of a later claim which will not be part-funded by the selling private equity investor.

Warranty and indemnity (W&I) insurance. Although many advisers are circumspect about the use of W&I insur-

ance, it has on many occasions provided a satisfactory solution to the warranty gap (for further information, see feature article "*Warranty and indemnity insurance: Keeping a lid on risk*", www.practicallaw.com/A18715).

In fact, it is arguably tailor-made for the secondary buyout. At its most effective insurance can:

- Provide comfort to the buying private equity investor where the monetary cap on warranty and indemnity claims is too low, bridging the warranty gap.
- Reduce the exposure of the ongoing management team and help persuade target's management to give customary warranties and indemnities.

Glossary

Drag along rights. These are rights for shareholders who hold a specified percentage of shares and who accept an offer to buy their shares to force the holders of the remaining shares to accept the offer.

Good leaver/bad leaver. A good leaver is a manager who leaves in “good” circumstances (for example, death, retirement, unfair or wrongful dismissal) as opposed to “bad” circumstances (for example, resignation or dismissal with cause). There is always debate about what circumstances constitute a good or bad leaver. Death or disability usually constitute good leaver grounds while an employee who is summarily dismissed will almost always be regarded as a bad leaver. More contentious is if the company gives the employee contractual notice: whether this constitutes good or bad leaver grounds will depend on the particular transaction.

Private equity fund. A private equity fund is an actively managed collective investment vehicle that invests almost exclusively in securities which are not publicly listed or traded or which will cease to be publicly traded after acquisition by way of a “public to private” transaction (for further information, see feature articles “From public to private: Changing direction”, www.practicallaw.com/A29762 and “From public to private: Management buyouts of listed companies”, www.practicallaw.com/A8477).

Ratchet. A ratchet is a common feature of private equity transactions, designed as an incentive for owner managers as its effect will commonly be to increase the amount of equity held by managers. The terms of the ratchet are normally contained in the company’s articles of association. The performance measure for a ratchet is usually the realisation proceeds or the market capitalisation of the company on a sale or listing.

A ratchet is often introduced into pricing negotiations between management and private equity providers to bridge the gap between management’s optimistic performance forecasts and private equity providers’ more conservative projections. It is ordinarily structured so that the private equity provider’s shares convert into valueless shares, causing the percentage of equity held by management to increase. The particular method chosen to achieve the ratchet should be considered carefully from a tax perspective, particularly in light of the 2003 Budget changes (see box “2003 Budget changes”).

Advisers on W&I insurance will need to focus on:

- The amount of cover provided.
- The amount of any claim not covered by insurance (often referred to as a “deductible” or “self-insured” piece).
- The cost of cover.
- Any material exclusions impacting on claims under the insurance.

For example, a purchase price for target of £100 million is divided up into either: (A) £99 million to the selling private equity investor and £1 million to target’s

management; or (B) £80 million to the selling investor and £20 million to management. Buyers should determine the actual size of the warranty gap: in (A) this is anywhere between zero and £99 million; and in (B), between zero and £80 million, assuming in each scenario that target’s managers are prepared to provide cover up to the value of their consideration. This will equate to the amount of cover requested.

It is possible that insurers will require more seller exposure and/or a self-insured piece before the insurance claim can be triggered. The warranty cap of £1 million in (A) is likely to be considered too low on a £100 million sale. This may

be solved by the selling private equity investor contributing to an escrow (see above) or by the insurer only agreeing to insure over a higher level, say £2 million, so that the buyer has cover from the sellers for the first £1 million of any claim, is self-insured for the next £1 million and insured only above that level.

Conversely, it is possible that in (B) an insurer will offer insurance cover in respect of claims exceeding, say, £10 million. The buyer may then be prepared to accept a warranty cap in the sale and purchase agreement at this lower amount, allowing the selling management to take half their consideration free of the risk of warranty claim clawback.

Buyers should not accept that they will seek insurance to “bridge” the warranty gap without first having spoken to an insurance broker to ascertain what cover may be possible (and its cost). In particular, insurance policy exclusions need to be considered in detail; for example, insurance is not intended to cover known matters raised in the due diligence or disclosure process. Most other exclusions can be negotiated by advisers experienced in such policies, particularly if they can convince the insurers that effective due diligence has been carried out (minimising the actual risk of warranty claims being made).

Alignment

Alignment requires the economic interests of the managers being backed to be aligned to those of the private equity investor. On a primary buyout, alignment is achieved by virtue of the issue of ordinary shares (often referred to as “sweet equity”) to management. The equity provides the carrot of a capital gain on the eventual sale of Newco, which will itself deliver the sale of the private equity investor’s shares. A private equity investor is usually best advised to consider departing from the alignment principle only in exceptional circumstances.

Application of principle. From a legal perspective, the alignment principle requires the equity held by managers to be the overriding incentive to the managers

up until sale or flotation of Newco. To achieve this, Newco's articles of association will usually provide that:

- Management are prohibited from transferring (or even charging) their shares until the eventual sale or flotation.
- A manager will "lose" his or her shares at a set price if he or she leaves the business (for whatever reason). The debate usually revolves around the price at which leavers are required to sell their shares. Generally a *good leaver* will be required to sell at fair market value, a *bad leaver* at the lower of cost and market value. To allow a leaver market value at any time before the private equity investor's exit could be seen as inconsistent with the alignment principle but this needs to be balanced against the risk of the leaver becoming a dissenting shareholder or benefiting from the continued efforts of the remaining managers.

Loss of alignment. On a secondary buyout, alignment is more difficult to achieve. If the secondary buyout follows a successful primary buyout (which is likely to give rise to a management windfall in share sale proceeds) target's managers will be in a good position to push for a significant amount of cash-out. Buying private equity investors will be concerned that the managers' ongoing motivation will be impaired as they will be less economically dependent on, and may therefore be less motivated by the eventual exit of, the secondary buyout. In such circumstances, the buying private equity investor may seek to defer the consideration payable to key ongoing management, for example, by minimising cash consideration and maximising deferral into a loan note only repayable on the later exit. On the other hand, target's managers are likely to want to receive a portion of cash on the sale of their shares on the completion of the secondary buyout (and in an auction process may be in a position to favour a private equity bidder who is able to offer this). In practice, a balance must be struck.

Alignment case study

The shareholders of A Ltd, a successful primary buyout, have decided to exit, partly driven by the selling private equity manager coming under pressure from its fund investors to realise cash and partly by the desire of the two "founding" directors to realise cash and incentivise their successors while retaining a stake in the perceived future growth potential of the business (see "Alignment" in the main text).

A Ltd's success means that its founders are in a good position to negotiate a significant amount of "cash-out" (or cash consideration). This cash may be sufficient to retire in comfort but not in the manner to which they feel they could become accustomed. The founders write a business plan that will deliver an upper quartile return for new private equity investors, another substantial return to them and a substantial return to the remainder of their management team.

Negotiations begin with a new private equity investor who has agreed to back a Newco, B Ltd, to buy A Ltd. The founders of A Ltd and the new private equity investor agree that:

- The founders should be allowed to realise a substantial amount of cash upfront. This is only agreed once the investor is comfortable (through meetings and character referencing) that the founders would not consider the agreed amount of cash to be "life changing", just a stepping stone. In other words, the investors are keen that the founders should remain incentivised in respect of the business's ongoing performance.
- The founders should "roll" the remainder of their share consideration, part into Newco loans repayable prior to the private equity investor debt and part into Newco loans repayable at the same time as the private equity investor debt.
- The founders' incentive (in ordinary shares in B Ltd) is made sufficiently enticing to ensure each remains motivated. The usual leaver provisions are applied to the ordinary shareholdings of the founders in B Ltd.
- Tight leaver provisions are included in respect of the middle managers' shareholdings in B Ltd and succession planning is debated and implemented from the outset.

To retain or reset alignment, careful consideration needs to be given to structuring the consideration payable to selling managers and negotiating legal terms, in particular, the leaver provisions (see above). For example, if a deal is struck to provide for the entire management consideration to be rolled into equity, management will be keen to protect this value, which they may feel they have already worked hard to realise. They will resist any suggestion that this equity could be taken from them should they leave the business.

Each deal is different (see box "Alignment case study"), but the most common approach is to offer the selling manage-

ment consideration for their target shares in the form of:

- A small amount of cash.
- Loan notes in Newco (often, in part at least, subject to repayment at the same time as the private equity investor loans are repaid) (see also "Institutional strip" below).

At the same time, management are incentivised by the opportunity to invest in equity in Newco, which is usually subject to customary leaver provisions.

Most problems arise if it is agreed that the selling managers should be issued

“vested” equity in Newco, that is, ordinary shares which are not subject to leaver provisions and which the founders can retain even if they leave the company. This is more likely to be debated on a secondary buyout where management argue they have already made a significant contribution to the lasting growth of the business. Where vesting is agreed, a non-contributing former manager can benefit from the hard work of continuing managers. Where a manager leaves in acrimonious circumstances, allowing a potential litigant to retain a shareholding may result in shareholder actions by the leaver against Newco and a successful exit may be jeopardised.

Institutional strip. Managers in a secondary buyout often roll their target shareholdings into an “institutional strip”. An institutional strip is a participation in the debt/equity investment of the private equity investor on equivalent economic terms. For example, if the private equity investor is proposing to invest £50 million, to comprise £5 million in preferred ordinary shares and £45 million in secured loan notes, then managers with £5 million to “roll” into Newco may be required or given the opportunity to invest £500,000 in preferred ordinary shares and £4.5 million in secured loan notes, in each case, economically at least, alongside the private equity investor. To some extent this impacts on alignment in the same way as allowing cash-out.

If drafted to give economic rights only (and not customary institutional investor rights, for example, to detailed business and performance information and to consent to certain corporate ac-

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tions) an institutional strip should be workable and not impair equity alignment going forward. Indeed, it can create another form of alignment in that managers whose interest in Newco includes an institutional strip will be motivated to achieve at least “money back” return on such strip (and therefore the private equity investors’ investment) even in circumstances where

the ordinary equity has ceased to have value.

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