**Private equity funds**

**The key parties and documents**

This section will focus on the key parties and documents in an institutional buy-out funded by a private equity fund where the management team is being retained

**Parties in the Buyout**

* **Private equity fund ‘Fund’**
* **Lawyers for the private equity fund/borrower:** Prepare and negotiate the acquisition documents on behalf of Bidco. Negotiate the loan facilities agreement, any intercreditor agreement, equity documentation.
* **Seller**
* **Seller’s solicitors:** They conduct negotiations for the sale of the target
* **Management team:** Core directors of the target or external team put together by the Fund.
* **Lawyers for management team:** Advise on structure of management’s equity investment and negotiate key documents.
* **Accountants:** the Fund will appoint accountants to carry out full accounting due diligence on the target and to analyse and report on the Management’s business plan and financial projections.
* **The lenders:**The lenders are often a bank, a second lender or a credit fund or small club of lenders.
* **Lawyers for the lenders:** They prepare security documentation, fee letters; ancillary finance documentation and review the due diligence to assess their risk.

**Main concerns of the key players:Private equity fund**

**Information**

The Fund, through its professional advisers, will conduct extensive due diligence on the target. This due diligence exercise will be carried out to ensure that Bidco is paying the proper price for the target and that risk is apportioned appropriately. The due diligence exercise will be particularly important for the Fund and the bank, since they will not have the depth of understanding and knowledge about the target that management has. Consequently, the due diligence reports will sometimes be addressed not only to Bidco but to the Fund and also to the bank.

The projections contained within any business plan prepared by Management, and which are the basis on which the Fund is prepared to invest in Topco will also be reviewed by the lawyers and accountants acting for the Fund. Any areas of weakness will be the subject of further scrutiny by the lawyers and accountants acting for all parties and will usually result in further contractual protection being built into the Acquisition Agreement in the form of warranties and/or indemnities, perhaps a reduction in price or an alteration to the way in which the consideration will be paid and a consideration of the impact of such information on the projections.

**ESG considerations**

The Fund will consider several key factors when screening potential investments including environmental, social and governance (**'ESG**') issues. ESG is relevant because often the Fund and/or the limited partner will have to comply with strict ethical investment criteria as part of their own  ESG policies and therefore this needs to be addressed at the outset of the transaction.

A target's poor ESG record may affect the long-term value of the Fund's investment. For example, if a target continually breaches its own ESG commitments it may be at risk of fines or sanctions leading to a loss of business and reputational damage. Furthermore, the target may find it more difficult to raise finance (financial institutions will have their own ESG requirements) or to attract a buyer on an exit.

To guard against any risk to their investment or any potential liability relating to ESG concerns, the Fund will ensure their due diligence exercise encompasses ESG factors. In some instances, the Fund may instruct experts to produce an ESG report of the target's social and environmental reputation and risks.

**Control**

Where the Fund has a majority stake in Topco it will not be necessary for the Fund to have extensive provisions restricting the activities of Topco, although since the management will run Topco on a day to day basis and will be in the majority on the board of Topco, a clear line of communication and reporting obligations on the part of Topco and the management will be built into the Investment Agreement. This will take the form of **positive and negative** covenants to ensure that the Fund’s position is protected and that the Fund is fully informed of the progress of its investment. Rarely, the Fund will just take a minority stake in Topco. Where this is the case, there will be extensive provisions in the documentation, restricting the activities of Topco by ensuring that permission is obtained from the Fund before any major decisions are taken.

As part of the **monitoring of Topco** and the Management, the Fund is very likely to insist that it has a provision inserted into the Investment Agreement giving it the right to appoint a director to the board of Topco or an ‘observer’ who may attend and speak (but not vote) at board meetings.

**Risk (on buyout)**

Although the Fund will have an extensive knowledge of the target (via Management), the Fund will still require a full set of warranties and the usual indemnity cover from the seller on the basis that the seller is receiving the proper purchase price and if something in the target is not what the Fund thought it was at the time of completion, it should have a right to sue the seller in the usual way. Alternatively, **warranty and indemnity insurance** may be considered a possible way for the Fund to seek some financial protection.  (It is worthy of note that when the Fund comes to Exit, the Fund will not give warranties, other than in relation to its title in the shares and its capacity to sell the shares, and a buyer may only receive warranties from the management sellers. As a result warranty and indemnity insurance common to protect the buyer)

Whether or not the Fund receives a full set of warranties from the seller(s), it will always require warranties from the management regarding amongst other things the **accuracy** of the information used to prepare the business plan and the projections set out in it. These are designed to encourage the management to give full information to the Fund (through disclosure) as opposed to providing the Fund with financial redress from the management in the event that the target is overpriced.

**Share transfer provisions**

It is normal to see **pre-emption rights** on transfer attaching to all classes of share in Topco. Certain types of transfer may be permitted to go ahead without pre-emption rights applying. In the case of the Fund’s shares, such exceptions are likely to be transfers in favour of members of the Fund’s own group, other funds on an agreed syndication and to entities that will stand in the shoes of the Fund.

With regards to the Management’s shares such permitted transfers usually include transfers to members of their immediate family, family trusts and ‘leaver’ provisions.

**Drag along provisions**

While the Companies act provides a statutory ‘**squeeze-out’** provision which allows a buyer the right to buy out minority shareholders in certain circumstances. The statutory squeeze-out is complicated, time consuming and costly and is generally only used in public M&A (you may cover this in Equity Finance, Listed Companies or Equity Finance and public M&A knowledge stream).

The Fund will not want to rely on these statutory provisions therefore it will want to ensure that **drag along** provisions are included in the transactional documents. This means that if the Fund wishes to accept an offer for its shares, it can compel the remaining shareholders  to sell their shares to the purchaser. This ensures that 100% of the shares can be transferred to a potential purchaser at the time of an exit.

The management team may also benefit from drag along provisions because if most of the managers want to sell their shares, they can force any dissenting minority managers to sell their shares too.

**Tag along rights**

The management team will want some protection in the event that the Fund decides to sell its shares.  The managers will, therefore, seek to **negotiate tag along** provisions which means the Fund cannot complete the sale of its shares without first ensuring that the proposed purchaser makes the managers an offer to acquire their shares. Tag along rights enable the managers to exit at the same time as the Fund.

The managers will want the offer to be on the same terms as the purchaser's offer to the Fund, but this will have to be carefully negotiated. Purchasers will often want to acquire 100% of the shares and therefore the Fund will view tag along rights as unnecessary.

Drag along and tag along provisions are included in the articles of association of Topco.

**Good leaver/bad leaver**

As shares are used by the Fund to provide an incentive to the management of Topco, the Fund commonly requires that **good leaver/bad leaver** provisions are drafted into the articles of association of Topco or alternatively, in the Investment/Subscription Agreement.

These provisions determine the treatment of shares held by the managers should they decide to leave (for whatever reason). The categorisation of a member of management as either a good leaver or a bad leaver will often determine the price at which they are required to sell some or all of their shares in Topco on departure. A bad leaver might be restricted to selling shares for the lower of their market value and their issue price (or, less common, their nominal value), with a good leaver generally able to offer their shares at market value. The reason for the departure determines whether the relevant manager is classed as a good leaver or a bad leaver and can be the discussion of significant negotiation.

**Main concerns of the key players**

**Management**

**Share structure/ratchets**

The management will also subscribe for equity in Topco. Where this happens, the Management may be investing most or all of their personal wealth in the buyout and will therefore want to ensure that they receive a reasonable share of the value of Topco when an Exit occurs and of any return (by way of dividends) in the interim. In addition to this financial investment, the Management will also be devoting their time and energies over the forthcoming few years to make a success of the venture.

For tax reasons (see below), the shares subscribed for by the Management will be ordinary shares. The Fund will also subscribe for ordinary shares. In a typical buy-out the investment made by the Fund will be much greater than the investment by the Management, so if all the money invested by the Fund were used to subscribe for ordinary shares, the Management would be left with an insignificant proportion of the equity. This is not generally what either the management or the Fund wishes to achieve.

**So how do the parties decide how much of the value of Topco should go to the Management and how much should go to the Fund?**

The Fund will work out how much it wants to be able to earn from the investment and this will be expressed as a target ‘internal rate of return’ (‘IRR’). The Fund will want to ensure that the Management are sufficiently incentivised to work hard to make a success of the venture so that the Fund receives the required IRR on its investment. This incentivisation of the Management in a buyout can be achieved by devising a mechanism known as a **ratchet** whereby the Management’s proportion of the equity on an Exit will be adjusted according to the actual success of the bought-out business and the value at the Exit.

The parties will agree the proportion of the equity to which the Management should be entitled if the Fund’s required IRR is achieved at the time of the Exit. If the venture proves less successful and the Fund’s IRR is lower, then the Management’s share of the equity will be reduced accordingly.

Once the parties have agreed the proportion of the equity to which the Management should be entitled if the Fund achieves its required IRR, the share structure will be organised so that the Management subscribe for that proportion of the ordinary share capital. The Fund will then subscribe for the remaining ordinary shares.

The rest of the money to be invested in Topco by the Fund will either be in the form of **convertible preference shares or convertible loan notes** which may be converted into ordinary shares in accordance with the provisions of the ratchet, depending on Management’s overall entitlement once the performance of the target has been reviewed.

The **class rights** associated with the shares in Topco and the terms of the ratchet will therefore be the subject of much negotiation. Note that ratchets can operate in a variety of different ways and that this is just one example.

Ratchet provisions will normally be found in the Articles of Topco or alternatively, in the Investment/Subscription Agreement.

**Example:**

A Plc has agreed to sell its subsidiary  to the subsidiary's management  for £12 million. The management will be investing £217,000 and the Private Equity Fund (‘PEF’) will be investing £4 million. The remaining funds will be provided by a term loan from a bank. It has been agreed that if PEF obtains its specified target internal rate of return (‘IRR’) on their investment, the management should be entitled to 31% of the equity in Topco on an Exit but that if the IRR is below a specified minimum, the management should only be entitled to 10% of the equity.

Management will subscribe £217,000 for 217,000 ordinary shares in Topco. PEF will subscribe £483,000 for 483,000 ordinary shares in Topco.

**Management shares 217,000 (31%)**

**PEF shares 483,000 (69%)**

**Total ordinary share capital 700,000**

The remaining £3,517,000 invested by PEF will be in redeemable convertible loan notes. If PEF’s target IRR is achieved, the share capital will remain as it is. If the IRR is less than the target, then a proportion of PEF’s loan notes will convert into ordinary shares in accordance with a ratchet. If the IRR is below the specified minimum, the share capital post-conversion will be:

**Management shares 217,000\* (10%)**

**PEF shares 1,953,000\* (90%)**

**Total ordinary share capital 2,170,000**

\*Note that the number of ordinary shares owned by the Management does not change. The percentage changes as a result of the Fund’s shareholding increasing.

**Service contracts**

Management will also be keen to ensure that the terms of their new service contracts are favourable so that their employment is reasonably secure.

**Exposure in relation to warranties**

Where the transaction is a Management Buy Out **(‘MBO’**), the Management will also be required to give warranties to the Fund in the Investment Agreement regarding the accuracy of the business plan and the information upon which it was based. The Management are therefore not only investing their personal wealth but are also accepting a **potentially large liability** contingent upon the accuracy of a business plan that was designed to generate interest in the MBO. **Therefore, Management should ensure that all information used to put the business plan together is not only accurate but objectively verifiable and is not affected by any of the disclosures made by the seller of the target throughout the period leading up to completion.**

Limitations will also be agreed in relation to their exposure. Such limitations are generally related to their salary.

**Main concerns of the key players**

**Lenders**

The lenders' main concern will be that the loan interest is paid and that the assets used as security are of sufficient value against which to lend the agreed sum. There are a number of different debt structures that are used for example, the 'Unitranche' debt structure or a traditional senior mezzanine structure.

**Example: Unitranche debt structure**

The normal order of priority as between investors in Topco and lenders to Bidco on a return of capital will be:

* **Super Senior Debt** in the form of a revolving credit facility from the Bank to Bidco;
* **Senior Debt** lent to Bidco by a credit fund or a small club of lenders;
* **Loan notes/preference shares** held by the Fund in Topco;
* **Equity** (i.e., ordinary shares) in Topco (in accordance with the class rights).

**Example: Traditional senior mezzanine structure**

The normal order of priority as between investors in Topco and lenders to Bidco on a return of capital will be:

* **Senior Debt** in the form of a term loan from the lender to Bidco;
* **Mezzanine Debt** lent to Bidco by the lender (if any; it is usually used only on larger transactions). Mezzanine debt is debt that ranks in priority behind senior debt but ahead of trade creditors or equity;
* Loan notes/preference shares held by the Fund in Topco;
* Equity (i.e., ordinary shares) in Topco (in accordance with the class rights).

Alternatively, the debt structure may be a simple 'all senior' structure without ranking among lenders of different facilities.

**Principal documentation – key issues**

The fundamental issues for negotiation on a buyout will be:

* how the equity investment in Topco will be **structured** as between the Fund and the management (**note that the term ‘equity investment’ is used to refer to the ordinary shares only, not to any loan notes or preference shares which may be issued**);
* the rights associated with the **different classes of shares** in Topco;
* how Topco will be **managed** after completion;
* the **terms of employmen**t of the members of management;
* the **terms of the acquisition** of target by Bidco from the seller;
* the extent of the **contractual protection/information** given by the management to the Fund; and
* the terms upon which the lenders will provide any debt finance.

**Principal documentation**

You are likely to encounter the following documentation that seeks to deal with all the issues raised on the previous slide:

* Investment/ subscription agreement
* Articles of association of Topco
* Service agreements
* Finance documentation
* Management warranty deed
* Equity Commitment Letters
* Principal documentation
* Acquisition documentation

We will now consider each documentation in turn.

**Acquisition documentation**

The documentation you have encountered on a standard share or business purchase will be equally applicable on the acquisition of the target on a buyout (which can be by way of a share or a business purchase), with appropriate adaptations.

This would include:

* the **Acquisition Agreement** (being a share or asset sale agreement);
* a **disclosure letter** from the seller to the buyer (Bidco) disclosing against the warranties in the Acquisition Agreement;
* **completion documents**; and
* any **ancillary documents**.

**Principal documentation**

**Investment/Subscription agreement (1)**

The Investment Agreement is similar to a Shareholders’ Agreement. The parties to this document will commonly be the Fund, the Management and Topco. Key provisions include:

* veto rights for the Fund i.e., what the Management can and cannot do without the consent of the Fund. Typical matters that require the consent of the Fund may include:
  + the issue of shares;
  + any change to the articles of association of Topco or its subsidiaries;
  + any change in the nature of the business; and
  + entry into, or termination of, material contracts.
* how the ratchet provisions (if any) will work.

**Investment/Subscription agreement (2)**

* **warranties** given by the Management to the Fund. These are needed notwithstanding that the Fund will have carried out an extremely thorough due diligence exercise on the target. This is because much of the information that the due diligence exercise is based on will have been provided by the management themselves (on an MBO). These warranties therefore provide the Fund with an action in contract, rather than having to rely on an action for negligent misstatement or misrepresentation (although note that breach of warranty claims against management are extremely rare). Typical warranties that you would expect to see in the Investment Agreement relate to:
  + the reasonableness of the business plan prepared by the Management;
  + the accuracy of the financial information used to construct the business plan; and
  + the accuracy of the information given to the lawyers and accountants preparing due diligence reports.

These warranties are often alternatively included in a **Management Warranty Deed.​**

**These warranties will be disclosed against by the management in a disclosure letter (in addition to the disclosure letter which accompanies the Acquisition Agreement).**

**Articles of association of Topco**

In addition to the standard articles that you would expect to see, the articles of Topco will include matters such as:

* dividend entitlements;
* rights of shareholders on a return of capital;
* pre-emption rights on the transfer of shares;
* good leaver/bad leaver provisions (see above);
* drag along/tag along provisions (see above); and
* any ratchet provisions (see above).

Note that some of these provisions may alternatively, be found in the Investment/Subscription agreement.

**Service agreements**

Whilst the Management will often be currently employed by the target, the Management will also become employees of Topco and will enter into new service contracts. The major issues to be considered will be:

* restrictive covenants;
* notice provisions, including PILON clause (briefly: a contractual right to pay an employee a lump sum rather than require them to serve out their statutory or contractual notice period);
* gardening leave; and
* remuneration (possibly including discretionary/contractual performance related bonus schemes).

**Finance documentation**

Lenders are likely to provide both a revolving credit facility and a term loan both of which will be secured on the assets of Bidco, the target and any subsidiaries. The following documents are likely to be put into place:

* Loan facilities agreement(s);
* Intercreditor agreement;
* Security Documentation;
* Fee letters; and
* Other ancillary finance documents.

One final document worthy of note are **Equity Commitment Letters**. These letters govern the agreement of the Fund to invest money into Topco and can also include a promise from the Fund to invest money to support any successful claims made against Bidco and/or the target by the sellers.

**PEF: Key parties and documents**

* The key parties in a private equity backed buy-out will be the private equity fund, the bank, the management team, the seller and their professional advisors.
* In addition to negotiating the acquisition documents commonly found in a bilateral sale, the parties will have to negotiate the Investment Agreement, the Articles of association of Topco, Service Agreements for the Management team, equity commitment letters, loan note agreements and the banking documentation.