

## An Introduction to Management Buyouts and their Legal Aspects

### 1. What Is A Management Buy-Out And How Do They Arise?

1.1 A management buy-out ("MBO") is the term given to the acquisition of a substantial or controlling interest in a business from its owners by its managers, *i.e.* those involved in its day to day running.

1.2 MBOs may be simple - as simple as the owners of the business selling to the managers personally. However, particularly where the sums of money involved are large and/or the managers have insufficient funds to finance the deal, MBOs can be amongst the most complex of transactions. They may well involve three, four or even five distinct parties or groups, who are normally:

- The seller (which may also retain an equity stake).
- The buy-out vehicle, which is usually a company formed specifically for the purpose ("Newco").
- A venture capital organisation or merchant bank providing equity funding for the MBO team.
- A bank or other funder providing working capital, term loan, revolving credit or mezzanine finance.
- The individual members of the MBO team.

Where financiers other than a bank are involved they will require at least a significant minority shareholding but, in large-scale MBOs, they will often take a majority holding.

If there are four or five parties involved there may well be considerable differences of interest between them, which often makes the negotiation of an MBO much more complicated than a straightforward acquisition. In many cases even the interests of the individual members of the MBO team diverge. For example, one manager may be putting in considerably more money than his colleagues and may require better protection; another may wish to sell his interest in Newco in the future or to dispose of it to members of his family. Other members may disagree with this and wish to place restrictions on the sale or transfer of shares. If there are senior and junior managers they may have differing rights and obligations.

1.3 MBOs most commonly arise in the following situations, (although they may arise in others):

- The restructuring or rationalisation of a company or a group of companies may result in the sale of divisions which are not part of its main business, or which are regarded as unprofitable, or to raise cash for the "core" business. This has happened frequently in recent years, as many large UK and multi-national companies have concentrated on their "core activities" and sold those which, although possibly useful and profitable, have been peripheral, or which have required too great a level of financial and management commitment.

In the case of private companies such a disposal can have the advantage of being relatively quick, non-public, not disruptive and may lead to a continuing trading relationship between the parent company and the company sold.

- Whilst shareholders of private companies may sell out to larger companies, they may well decide (for example, on retirement) to sell to their existing managers in some cases out of loyalty to those who have helped them build up the business over the years.
- Viable parts of a business which has gone into receivership or liquidation may be sold off by the Receiver or the Liquidator to existing management, often for the sake of speed and at a discounted price.

1.4 A variation on the MBO is the management buy-in ("MBI"), where a small team of managers, who have not been employed by the Company but who have an in-depth knowledge of the industry, acquire the Company almost totally financed by outside investors. Structurally, MBIs are very similar to MBOs, but can be complicated by the fact that the team will not have the same detailed knowledge of the business, and as a result substantial and detailed warranties will be required from the vendors.

## 2. Practical Points

### 2.1 Complexity

Members of the MBO team may not have been involved before in a transaction of the complexity of a team MBO. It is, therefore, important that their accountants and legal advisers make clear to them at the outset what is involved in the transaction in terms of the matters to be dealt with, the time scale and the personal risk to the members of the MBO team from the point of view of the future management of the business and their personal position, particularly if they are giving security over their own assets.

The MBO team should also review their personal financial and tax affairs to maximise and protect their interests in the event that the MBO should lead to a considerable increase in private wealth.

They will need advice on, e.g., the tax efficiency of their shareholdings and borrowings, capital gains tax and inheritance tax, a carefully drafted will and adequate insurance cover for the protection of dependants.

In addition, an MBO may be further complicated by the need for tax planning to reduce the burden of taxation on the transaction in order to minimise the cost to the MBO team and maximise the sale proceeds to the vendors. These important matters can be overlooked by the MBO team partly because they are closely connected with the business, have an intimate knowledge of it and are usually more interested in "getting the deal done".

### 2.2 Co-ordination

It is important that MBOs are properly co-ordinated. Normally either the lawyers or accountants to the MBO team will co-ordinate the deal, as only they are involved in all aspects of the transaction. From a legal point of view, MBOs can be very complex. The component parts of a typical MBO, *i.e.* the acquisition of shares or assets, the raising of debt and/or equity finance, the creation of management and control mechanisms in the target company, and the incentivisation of managers and employees, can be complicated enough, but they become much more so when they have to be fused together, usually under great pressure of time. Detailed timetables help all parties, as does a list of the documents which will be necessary.

### 2.3 Prejudice to management

Inevitably, the buying of a business will place stress on the members of the MBO team. It is important that their professional advisers realise that the MBO team will still be running the business - and it is important that they be allowed to do so without the buy-out dominating everything, since it is their management of the business which will give the company the best start once it is purchased.

2.4 Day to day management may be disrupted by visits of the interested parties to the premises of the target business during the negotiations, since this helps them understand the nature and problems of the business and enables them to better assess the capabilities of the MBO team and their employees.

## 2.5 Costs

This issue must be dealt with at an early stage. The costs of the accountants' report and the legal costs of an MBO can be substantial. Management may not be able to afford them and investors will not be prepared to speculate at this stage. Ideally the MBO team should negotiate for the costs to be paid by the vendor until the transaction is completed, when the costs of the MBO team and its financiers will be paid out of the funds raised by Newco. Failing that, the professional advisers may agree variable fees including success related fees.

## 3. Is The Buy-Out Proposal Viable?

### 3.1 Is it possible to make the business more profitable?

In many cases where an MBO is under consideration, the company will be relatively unprofitable or be suffering from poor cashflow. The MBO team will need to be able to justify its belief that the existing business can be made more profitable, particularly if it wishes to obtain external financing. Most managers will not consider an MBO unless they are sure that they can improve the business, but financiers or institutions require hard facts and figures to show that the business will be commercially viable, even if it is not so prior to acquisition. The MBO team will need a thoroughly researched and professionally prepared Business Plan as a selling document to prospective financiers. This will normally include the issues of strategy, marketing, production, finance and profit and cash flow forecasts.

The reasons most frequently cited by MBO teams for believing that a business can be made more profitable, particularly when it is part of a large group, are that:

- they will have far more direct control over their own costs and they will be spared the sometimes disproportionate costs of the administration of a large group - this can often be a significant saving;
- their marketing policies are better than those currently used, or will be more specifically geared to the product, or they have seen a gap in the market into which they can expand;
- their financial controls will be more stringent and their financial management will be better.

The MBO team will be closely questioned by their potential backers on all aspects of the Business Plan.

### 3.2 Further operation

It is most important, before an MBO, that the team make a very thorough examination and a realistic assessment of their own strengths and weaknesses and the strengths and weaknesses of the business and the market in which that business is going to operate. It will need to demonstrate to its financiers and bankers that it has the ability and commitment to run and develop the business. The team will also need to be very sure that they can retain essential staff within the business once it has been bought out. This is particularly so if the company is breaking away from a larger group, and is particularly relevant in the case of employees necessary to provide financial management, marketing advice and support, and also to develop new products for the company. Very often such staff may themselves wish to become part of the MBO team, or at least to be given a greater share in the running of the business than before.

### 3.3 Accountants' report

Whilst members of the MBO team may have, and be able to produce, detailed reports on the financial position of their business, they will need to appoint accountants to investigate and to produce a report on it. Many institutional investors require an accountants' report before they will consider funding a company. If cash is to be raised from the public, an accountants' report supported by current valuations will certainly be required.

## 4. Buy-Out Structure

### 4.1 Buy-out vehicle

*Company:* Often the vehicle for an MBO will be a limited company specifically formed or acquired for the purpose. The company will usually be private unless it is proposed that shares in the company be issued to the public, in which case a public company must be used. The MBO team normally become shareholders in the vehicle and additional finance is then raised from institutional or venture capital backers to make the acquisition. In many cases, even if it is intended that the company will at a future date be listed on the Stock Exchange, the acquisition will be completed by way of a private company, and the business retained and conducted as a private company, until the shareholders and the investors consider that the time is right for a stock market flotation.

*Partnership:* In some circumstances it is advantageous for the team to trade as a partnership in the early years, rather than as a limited company. This is normally so if the business is likely to generate losses, or excess capital allowances in its early years. Trading as a partnership permits the MBO team to take advantage of tax rules which permit individuals commencing trade in partnership, and incurring losses in any of the first four tax years, to carry those losses back and set them against their taxable income for the three years

preceding the year in which the loss is incurred. The principal disadvantages of this alternative are that:

- financiers are less likely to invest in a partnership; and
- it involves joint and several unlimited liability (although this may be reduced by adopting a limited partnership).

### 4.2 Purchase of assets or shares

The buy-out vehicle will buy the shares of the "target" company. In many cases the selling company will "hive down" the assets which it proposes to sell into a separate company (often itself newly formed for the purpose) which will then be sold to the buy-out vehicle. The MBO team may particularly wish the buy-out to be by a purchase of shares, if the buy-out business has unrelieved trading losses which are substantial. This is because, on an asset purchase, the benefit of trading losses cannot generally be transferred to the purchaser and carried forward against future profits of the same trade. However, under Section 768 of the Income and Corporation and Capital Gains Tax Act 1988, carry forward relief is lost if the trade carried on by a company is significantly altered within three years before or after the change of ownership. This is to prevent trading companies being purchased solely for their tax losses. However, intending purchasers should bear in mind that, if a business is making losses, the changes required to restore it to profitability may well prejudice the availability of tax relief for past trading losses.

The team may sometimes prefer to buy assets rather than shares in the company in order to avoid taking over any undisclosed tax or other liabilities within the company.

## 5. Legal Aspects

MBOs involve numerous, often complex, legal aspects and legal problems. The team's legal advisers will have to identify, evaluate and advise upon them. They may include the following:

5.1 In some cases (usually the larger transactions) MBOs can put some or all of the MBO team in breach or potential breach of their contractual and fiduciary duties to the company (e.g. conflict of interest, insider advantages and confidentiality). Each team member should, as a first stage, analyse his legal position, to pre-empt allegations by his company or its shareholders of breach of duty, unfair prejudice and breach of contract. These issues will require separate professional advice.

- The conflict of interest issue can be particularly important in larger MBOs. The members of the MBO team who are also directors must be able to convince shareholders that the price offered is better than fair, and that the team is not trying to seize an opportunity which should be made available to all shareholders. As part of this process, independent financial advice should be obtained preferably by directors who are not part of the MBO team. This should be made known to the shareholders, thus resolving the conflict of interest between the members of the team as buyers and their position as directors. In this connection, proper procedures must be observed at all times. The provisions of relevant statutes and the Articles of Association must be strictly followed, and supporting documentation, e.g. Board minutes or notes of meetings between buyer and seller, must be properly kept and accurate.
- The duty of confidentiality could be broken inadvertently. The MBO team can in strict confidence disclose confidential information about the

company to their professional advisers, but as soon as they commence discussions with potential financiers or other third parties and divulge such information, they are likely to be in breach of this duty unless the prior consent of the company is obtained and documented. In the case of a hostile MBO, members of the MBO team are very likely to be in breach of their duty of confidentiality to the company during the course of formulating their plans and to risk injunctions, dismissal or a claim for damages for breach of confidence.

- Team members who have to spend time during the working day in discussions about the MBO may be in breach of the "whole time and attention" clause in their service agreements.
- Team members must be aware that, if the buy-out fails, the strains generated by the negotiations may well prejudice the future employment relationship between the MBO team and the company, and could even lead to termination of employment for breach of duty and a claim for damages.

5.2 There are a number of statutory constraints and obligations upon which the MBO team must take advice, e.g. as to complying with the appropriate provisions of the Companies Act 1985 relating to disclosure of contracts in which directors are interested, and the acquisition directly or indirectly by a director of the target company of assets from that company, or shares in the company from its parent.

5.3 The preparation of the offer letter normally requires legal advice. This is because this letter (or "shut-out agreement" as it is sometimes called), although not intended to be a binding contract for the purchase, should be binding in three areas for the protection of the MBO team:

- the consent of the vendor to disclosure of confidential information,

- an undertaking by the vendor not to offer the company to any other purchaser for a given period, and
- the agreement of the vendor either to bear or to share the costs of the MBO team until the transaction is completed.

The offer letter should also set out the broad understanding of what has been agreed in regard to the principal terms of the offer, so as to avoid later misunderstandings or disputes.

- 5.4 If the financing of the MBO requires Newco to offer shares to raise funds, it will often involve the issue of a carefully drafted prospectus, unless the offer can be constructed so as to fall within the appropriate exemptions.

The relevant provisions of the Financial Services Act 1986 must be considered so far as they relate to offers of securities and investment advertisements, etc.

- 5.5 The solicitors acting for the MBO team and its financiers will need to ensure that the transaction will not, after completion, fall foul of the provisions of the Insolvency Act 1986 relating to preferences and transactions at an undervalue, in order to avoid the risk of a subsequent administrator or liquidator seeking to set aside the transaction. The financiers' lawyers will also wish to be satisfied that any floating charge given to financiers by Newco will not be subsequently challenged.

- 5.6 If the MBO involves the purchase of a subsidiary or a division of a quoted company, the MBO team's solicitors will have to be familiar with, and to advise on, the City Code on Takeovers and the Stock Exchange Rules, including the "Yellow Book".

- 5.7 If part of the finance is debt finance from various lenders, the legal advisers must negotiate the question of priority of the realisation of assets in a winding-up. This

will be contained in a Subordination Agreement.

- 5.8 The very important rules against a company giving "financial assistance" for the purchase of its own shares. These are explained in further detail later in this information sheet.

- 5.9 The warranties which the MBO team will be required to give to its financiers, and which the MBO team will also require from the sellers (together with tax indemnities) will need to be carefully negotiated by the legal advisers. The situation between the sellers, the MBO team and its financiers can become complex. Further details of this are given later in this information sheet.

- 5.10 The transfer of pension entitlements can involve difficult legal issues which are often not easily understood by the parties.

- 5.11 The vendor will usually be required to give non-competition covenants. The negotiation and drafting of such restrictions requires great care, as the courts have the power to strike down any agreement reached between the parties if considered to be against the public interest. They can also be rendered unenforceable if they do not comply with the rules and regulations made by, or pursuant to, the Restrictive Trade Practices Act 1976.

The financiers may also require key members of the MBO team to give restrictive covenants in the Subscription Agreement, as well as in their Service Agreements.

- 5.12 Of all the documents generated in an MBO, the Articles of Association of Newco are frequently the most complex. Not only will they contain extended versions of the provisions normally found in private company Articles, but also the basis upon which the future wealth of the MBO team will be calculated, including variation of class rights, new issues of shares, the ratchet mechanism referred to later in this

information sheet, provision for the reward of successful managers, and penalisation of failures.

## 6. Documentation

The principal documents which an MBO will generate are:

- 6.1 Agreement for the sale and purchase of the buy-out business (*i.e.* shares or assets);
- 6.2 Subscription Agreement for direct investment in Newco by a financial institution (*e.g.* venture capitalist);
- 6.3 Property sale and lease-back documentation, if applicable;
- 6.4 Shareholders' Agreement between the members of the MBO team and, where applicable, the investors (and possibly the vendor retaining an equity stake)
- 6.5 Security documentation, charging either or both:
  - the MBO team's shares in Newco and possibly other personal assets; and
  - the assets of the buy-out business as security for the investment of the financial institution pursuant to the Subscription Agreement at 6.2 above;
- 6.6 Articles of Association of Newco containing the rights attaching to various classes of shares;
- 6.7 Service Agreements. Members of the MBO team will normally be expected to enter into Service Agreements with Newco - the theory is that this ensures their continued involvement in the business;
- 6.8 Employee Incentives, such as Share Option Agreements or Employee Share Ownership Plans (ESOPs), may be included.

The parties' legal advisers will be heavily involved in advising upon and drafting all of the above

documentation, most of which is likely to be complex.

## 7. Financing

### 7.1 The MBO team's share

Unless the business to be acquired is small, MBO teams normally provide only a small proportion of the acquisition cost and working capital resources of the business themselves. Nevertheless, most managers buying out a business also require a substantial share in the business. Institutional investors tend to accept this as reasonable, because it is the involvement of the MBO team, their interest and their work in improving operational efficiency and performance, which will boost the business and expand it in the future. Often the MBO team seeks a high ratio of loan capital to equity capital. Some potential backers are prepared to lend to highly-gearred businesses, but they will require to be satisfied that its cashflow will be high (and positive), and that the business will be able to meet all interest charges and repayments.

### 7.2 Methods of finance

There are various methods of financing available to MBO teams. Some of the most common are:

- direct financing from a merchant bank or specialist venture capital company;
- funding from the vendor, for example, by agreeing to take deferred consideration, or deferring existing loans or in larger MBOs, funding part of the price by retaining an equity stake in the business by acquiring shares in Newco;
- the private placing of shares or loan stock;
- a public issue of shares under, *e.g.* an Enterprise Investment Scheme;

- if the business to be bought out includes property, it is sometimes possible to sell that property to a financial institution and lease it back, thus retaining the use of the property but releasing capital, although the tax problems which arise if this is done will need careful consideration;

Direct financing from institutions or venture capitalists is normally achieved by their taking a percentage of the shares in Newco. These may be ordinary shares, preferred ordinary, preference and redeemable preference shares, and also secured and unsecured loan stock. They are also often convertible. Whatever the form of the participation, it is important that all rights attaching to the various classes of shares are set out in Articles of Association of the buy-out vehicle. This is something upon which the MBO team's lawyers will advise carefully - as will the lawyers to the investors.

### **7.3 Conversion rights**

Investors will often take convertible shares or convertible loan stock which may be converted into ordinary shares. The Articles of Association of the vehicle may well contain a "ratchet mechanism" under which the rights to convert are related to the trading profits of Newco in its initial years.

A ratchet mechanism works by setting targets for successive years, and increasing the level of conversion rights in each year if the profit target for that year is missed. When the conversion rights are exercised, the preference share or loan stock holders will effectively have increased their stake in Newco - something they may be very keen to do if the company is very profitable.

The MBO team should resist a graduated ratchet mechanism such as that referred to above. It is preferable for the MBO team to relate investors' conversion rights to aggregate profit over a period of years or

to their overall return on investment. This is because, although it is not uncommon for individual yearly targets to be missed over a period of, say, five years, the aggregate profits for the whole period may well exceed the aggregate of the individual profit targets for that period. Growth in new businesses or newly acquired businesses may often be uneven or fluctuating, and the ratchet mechanism takes this into account.

Members of the MBO team should look closely at the conversion rights which will attach to the shares or stock to be held by the investors, as those will determine the eventual percentage share which the MBO team will retain in Newco. It is important that the MBO team's legal and financial advisers examine these rights most carefully - as indeed should the advisers to the investors.

### **7.4 Restrictions**

Most investors view MBOs as "high risk" and, therefore, frequently seek to impose considerable restrictions on the MBO team's freedom to deal with its business as it sees fit. Such restrictions often relate to the issuing of further capital, the raising of additional finance, entering into substantial borrowings or other financial commitments, any change in the nature of the business of the company or the purchase or disposal of valuable assets. MBO teams need to carefully examine these and to assess their impact on the team's ability to run the business. In cases where the managers are, as a group, in the minority, they may seek some form of basic minority shareholder protection in relation to the investors.

### **7.5 Financial assistance by a company for the purchase of its own shares**

Occasionally the buy-out transaction may involve the giving of financial assistance, either by Newco or by the target company for the acquisition of its own shares. This is particularly so if the transaction involves

a sale and lease back, or the giving of security over the assets of the business. Section 151 of the Companies Act 1985 prohibits companies from giving financial assistance for the purpose of acquiring their own shares, save in certain limited circumstances. If the company giving the financial assistance is a private company, then the rules are slightly more relaxed. The consequences of unlawful financial assistance can be very serious (e.g. any security which is given in breach of the section may well be void). Contravention of s.151 is also a criminal offence and officers of any company which breaches the section face potential prosecution (although this is rare). Therefore, the MBO team must consider these provisions extremely carefully, as must the investors.

## 8. Warranties And Tax Indemnities

### 8.1 Seller's warranties and indemnities

In agreements for acquisitions of companies and businesses it is normal for the buyer to take extensive warranties and tax indemnities from the seller. In MBO situations the seller will usually try to resist giving warranties, on the basis that it is selling to people who actually run the business and who have the day to day knowledge of its affairs which it lacks.

Since, however, the MBO team are accepting a three-fold risk of (a) acquiring the company, (b) giving warranties in relation to it, and (c) incurring significant personal indebtedness towards the purchase price, it is reasonable for them to require the seller to accept responsibility to reflect the price it is receiving, even if certain warranties are qualified on an "awareness" basis. Therefore, minimum warranties should be obtained from the seller; these will need the careful attention of the MBO team and their advisors, to give protection against current or future obligations created by the seller of which the MBO team could not have been aware. This is particularly important in the case of sales of companies forming part of a group

where certain matters, e.g. tax, pensions, insurance, capital commitments and borrowings, may be dealt with by central departments which are divorced from the day to day running of the business. The seller should have little reason to object to giving tax indemnities because tax is normally dealt with by the seller or at group level and certain tax sections can create liability on the target through no fault of its own.

### 8.2 MBO team warranties

Investing institutions will normally require the MBO team to give warranties (including some tax warranties). As far as possible, these should reflect those given to the MBO team by the seller, so as to limit the potential exposure of the MBO team to claims. To the extent that these can be obtained from the seller, they can, unless the seller objects, be assigned to the financiers, who will then be able to make any claim directly against the seller and the MBO team will avoid the expense of involvement in such claims.

In a "leveraged" buy-out, the pressure to give a full set of warranties and indemnities will come from the financiers. The MBO team may be well advised to let the lawyers acting for the financiers take the lead in warranty/indemnity negotiations. The seller will be less able to resist giving sensible warranties and tax indemnities if it is aware that they are crucial to the provision of the finance for the buy-out. In practice, however, it is likely that the MBO team will have to give more of the warranties required by the investors; great care will be required in the drafting of these.

## 9. Tax

MBOs raise several tax points which may include those following:

## 9.1 Income tax relief

*On loan interest:* Members of the MBO team normally borrow to finance their own investment in the buy-out vehicle - whether by topping-up their own mortgages or by some other means. Income tax relief is usually available for interest paid by an individual on a loan used to purchase ordinary shares in a close company (*i.e.* a company registered in the UK and controlled by five or fewer participants or any number of participants who are directors), provided that the individual has an interest of more than 5% in the issued share capital of the company or, if his interest is 5% or less, he works for the greater part of his time in the actual management and conduct of the company. If the company is not "close", the members of the MBO team will not be entitled to tax relief.

*On losses on shares:* If the buy-out venture fails, as many do, income tax relief may be available on the loss incurred on the shares in Newco provided, broadly, that:

- the shares are subscribed for and not purchased;
- the company is an unquoted trading company (including those whose shares are traded on the Alternative Investment Market); and
- there is an arm's length sale of the shares, or a distribution on dissolution or winding-up.

## 9.2 Corporation tax relief

Relief for interest payments on loans to Newco for the purposes of its business should be available against its taxable profits, but no relief is available in respect of dividend payments on share capital. If loan interest is dependent on the results of the business, it may be treated for tax purposes as a dividend and not as interest.

On an asset purchase, the interests of the vendor and Newco will differ in relation to the apportionment of the purchase price, which must be negotiated between the professional advisers. Newco will be particularly concerned in relation to, *e.g.*, maximising of capital allowances, and the tax effects of purchasing stock or debtors at a discount and later realising them at full value.

## 9.3 Stamp duty and capital duty

Stamp duty at the rate of up to 3.5% is normally payable on transfers of certain assets, and at the rate of 0.5% on transfers of shares.

## 9.4 Value added tax

*On shares:* VAT is not charged on the sale of shares or securities.

*On assets:* Provided that the transfer of assets of a business or part of a business is done on a going concern basis, VAT is not normally charged. However, if the assets are sold otherwise than as a going concern or part of a going concern and involve supplies of, for example, intellectual property, or plant and machinery, the sale would give rise to VAT. There are very complex regulations relating to land and buildings which will require careful consideration in every case.

This information sheet has been prepared by the Commercial Group at Thomson Snell & Passmore to highlight some key issues relating to management buyouts. It is intended to be for general guidance only and is not a substitute for specific advice. It is based upon our understanding of the position as at June 2000 and may be affected by subsequent changes in the law.

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