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Legal Aspects of Management Buy-outs and Acquisitions

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Assets or shares?

A business may be acquired, fundamentally, in two ways, either by purchasing its assets or the corporate shell in which the assets are contained.

An asset acquisition involves the purchaser acquiring the assets that make up the business. The business is purchased as a going concern and the purchaser acquires a collection of assets such as premises, stock and plant. At the same time, the purchaser may acquire liabilities that are related to the business, such as the responsibility to satisfy contracts and, sometimes, the liability to discharge creditors.

A share acquisition involves the purchaser acquiring the shares of the company that owns the business and assets. The shares of the company are transferred. Accordingly, there is no change in the ownership of the business – the business continues to be owned by the same company and only the identity of the shareholders changes. Whatever liabilities and obligations the target company had before the acquisition will remain after the acquisition. On an asset purchase, however, the

purchaser can choose (subject to the agreement of the selling company) which assets he wishes to buy and which to leave behind.

In practice, the manner in which an acquisition proceeds is often driven by the different tax treatments of a share or asset purchase. A share sale will frequently be more attractive to the shareholders of a vendor. However, there will be situations where a choice is not available – for example, where a company has a number of different businesses within the same corporate shell, only one of which is intended to be the subject of the sale. A purchaser may insist on an asset sale to ensure that it does not unwittingly acquire any of the historic liabilities of the target. All such issues can be addressed in a properly drawn set of warranties and indemnities, but some purchasers prefer not to take the risk of purchasing litigation.

Management buy-outs (MBOs) are, essentially, the purchase of a business by its management, usually through the vehicle of a new company established for this purpose and frequently with the assistance of equity capital provided by venture capitalists. Buy-outs vary in complexity, but the key feature of all MBOs is that the managers acquire a share in the ownership of their business. An MBO can proceed by way of share or asset acquisition. A buy-out team may include members who were not previously involved in the business – such hybrid being known as a BIMBO (buy-in management buy-out). A transaction where a completely new management team purchases the business is a management buy-in (MBI).

Consideration

‘Consideration’ is the legal term given to the payment that the purchaser makes to acquire the shares or assets of the target. The suitability of different methods of payment will depend on the circumstances of the transaction. The vendor may want cash, subject to tax issues. The purchaser may wish to defer making payment of part, perhaps contingently on the performance of the target post-completion or on verification of the value of the assets being acquired. Both parties may find the use of shares as consideration issued (or procured) by the purchaser attractive.

Types of consideration

The consideration may take one or more of the following forms:

Cash

Cash is the most common form of consideration and usually the one most attractive to the vendor, for obvious reasons. From the purchaser's point of view, cash for an acquisition may be raised in a variety of ways – for example, by borrowing (possibly using the assets of the target as security, see below), by the issue of new shares, or simply from surplus cash reserves. The purchaser may wish to defer payment of part of the price, perhaps contingently on the performance of the target company or business post-completion, or by reference to the value of the net assets acquired, or merely on the passage of time.

Shares

A purchaser that acquires shares may wish to pay for them by issuing its own shares (or those of its holding company) to the vendor. Sometimes, in such a transaction, the vendors can become very significant shareholders of the purchaser, and may be given a seat on the board. A transaction involving the issue of shares may be badged as a merger, rather than a takeover. From a vendor's point of view, the degree of risk being taken in the acceptance of shares depends much on the identity of the issuer, and the liquidity in the market of the shares being accepted. Clearly, shares of a publicly listed company will be more attractive to some vendors for this reason, although shares issued to vendors of publicly quoted companies will frequently be subject to dealing restrictions for a period after completion so as to try to maintain an orderly market in those shares. A publicly quoted stock is not guaranteed liquidity.

Where a private company issues shares, the vendor should take steps to ensure that the rights attaching to those shares (eg voting, dividends) are satisfactory.

A purchaser should also be aware that shares may not be issued at a discount, ie less than the nominal value. Also, where shares are issued at a premium, a sum equal to the premium must be credited to the company's share premium account. These two rules are equally applicable where shares are issued as payment for other shares or assets. Consequently, steps should be taken by the purchaser to obtain an accurate valuation of the property proposed to be acquired in return for the issue of shares.

Loan notes

An acquiring company may issue loan notes to the vendor for the purchase price or part of it. Loan notes are no more than an acknowledgement of the indebtedness of the purchaser to the vendor. They may be secured, or perhaps guaranteed by a third party, eg a bank. The loan note 'instrument' will set out the terms on which the loan is made. Frequently, the vendor can demand repayment of all or part at six-monthly or other intervals after a certain period from completion. Loan notes have been popular in recent years to enable vendors to (attempt) to carry forward gains made on the sale of shares to future tax years, usually for the purpose of maximising taper relief. When taper relief reaches its maximum from April 2002, the incentive for the use of loan notes will diminish for many vendors who have held the sale shares for the relevant period. It should be noted that loan notes issued to maximise taper relief should be categorised, in tax terms, as 'non-qualifying corporate bonds'.

Financial assistance

The Companies Act 1985 provides that a company may not give financial assistance to purchase its own shares. Accordingly, the rule does not apply to transactions involving only the sale of assets. Breach of this rule is a serious matter, and any director who is involved in such a transaction may face up to two years imprisonment and/or a fine. Additionally, the transaction entered into by the company is void, and the company also liable to a fine. The object of the rule against financial assistance is the protection of the creditors of the target company.

The financial assistance rule is wide-ranging and covers not only situations where the company itself gives assistance, but also any of its subsidiaries. Additionally, the assistance may occur before, at the same time, or even after the acquisition. Financial assistance includes, gifts, loans, transactions at an undervalue and charges granted over the assets of the target company.

There are a number of exceptions to this rule, of which the most useful is the relaxation available to private companies. This relaxation is known as the 'whitewash procedure' and although extremely useful in practice, companies must ensure it is followed to the letter to avoid any liability. The whitewash allows a private company to give financial assistance

where either its net assets are not depleted by the giving of the assistance, or if they are depleted, if the company has sufficient distributable reserves to cover the amount of the depletion. In addition, the directors of the target (almost always the incoming directors) are to make a statutory declaration stating that they believe that the company will be able to pay its debts as they fall due for 12 months.

The agreement

Warranties and indemnities

Both share sale and asset sale agreements will almost always contain warranties. A warranty is a contractual statement or promise given by the vendor to the purchaser in respect of a particular fact relating to the target company or assets being sold. The purpose of warranties is twofold:

- They provide the purchaser with a means of obtaining information, probably of an unwelcome nature, about the target company.
- They provide the purchaser with protection against actual or contingent liabilities, losses or setbacks in the target company, typically where such matters or their scope are not apparent before completion. If a warranty transpires to be untrue, a purchaser may be able to make a claim based on the loss flowing from the breach of warranty, subject to the normal rules of mitigation of loss.

An indemnity is a contractual promise made, usually by the vendor to the purchaser, whereby the vendor agrees to hold the purchaser harmless from the consequences of the fact or circumstance giving rise to the breach of the indemnity. An indemnity is usually used where a particular risk has been identified. Comfort in relation to the tax affairs of the target are usually given on an indemnity basis. The key distinguishing feature of an indemnity, as compared to a warranty, is that the purchaser does not need to show that he has attempted to mitigate his loss. The vendor is simply obliged to pay.

Warranties in share sale agreements

A purchaser in a share sale will often seek greater warranty protection than on an asset sale. This is because the purchaser will acquire the

corporate shell, complete with all the liabilities and obligations that the company had before the acquisition.

In addition, as the liabilities acquired include the target company's tax liabilities, the purchaser will wish to ensure that it is protected against unforeseen liabilities relating to tax. Such protection is customarily given on an indemnity basis, since there is frequently little prospect of mitigating a tax liability. Such indemnities are usually contained in a separate document known as a tax deed, frequently expressed to be in favour of the purchaser (rather than the target in which the liability has arisen).

Warranties in asset sale agreements

The scope of warranties given on a business acquisition does not (usually) need to be as extensive as those given on a share sale. This is because the purchaser has to a certain extent 'cherry picked' which assets he is to acquire, and liabilities do not automatically pass with assets as they do within a separate legal entity. Warranties will generally be limited to those that relate to the assets being purchased, although a purchaser may also wish to obtain comfort as to historic trading, relationships with customers etc. The scope of the warranties, as with many other aspects of the agreement, will be governed ultimately by the relative bargaining strength of the parties.

As taxation liabilities remain with the vendor, there is no need for a tax deed or extensive warranties relating to tax.

Warranties on an MBO

During the negotiation process of an MBO, the vendor will frequently argue that the scope of the warranties given should be less than would otherwise be the case since the managers will have a significant amount of knowledge relating to the business that they have been running. Indeed, the vendor may argue, often with justification, that the purchaser knows more about the target than the vendor. However, as one of the functions of warranties is to apportion risk between the purchaser and vendor, the managers will have to carefully consider whether they are happy to receive only limited warranties, and how far their knowledge of the business extends. A parent company may be responsible for much of the administration of a group including accounting, tax and payroll functions. In addition, the backers of the

MBO team may insist on a full set of warranties, if not from the vendor then from the MBO team themselves.

Disclosure letter

Disclosure letters are commonly used in both share and asset sales. The purpose of the disclosure letter is to provide information that qualifies the warranties (but not, usually, the indemnities). A vendor's liability under the warranties will be reduced or eliminated to the extent that the disclosure letter discloses the information that renders the warranty untrue. This has the benefit (for the purchaser) of enabling him to go in with his eyes open, and (for the vendor) to reduce the risk of a claim later. Significant disclosures may lead to a renegotiation of the price or even the transaction being aborted altogether. A well-advised purchaser will not accept disclosures that are general in nature or are merely expressed to contradict a warranty. Disclosures of publicly available records (eg at Companies House) may be acceptable.

Restrictive covenants

A purchaser may wish to impose restrictions on the vendor competing with the purchaser or the target business after completion. This is particularly the case where the vendor has special skills or contacts with customers. Much depends on the circumstances, of course – competition may be less of an issue in a sale by a 70 year old than by a 40-year old. In an MBO, the vendor may wish to impose restrictions on competition by the purchaser with businesses that remain under the control of the vendor, which are likely to be allied to the business being sold. The managers of the target may be well equipped to compete with such businesses. In all cases, great care should be taken in drafting such covenants. They are regarded as anti-competitive by the courts, and are interpreted strictly against the party seeking to rely upon them. If they are too wide in scope they may not be enforceable. Where a substantial payment has been made for goodwill, enforceability may be easier.

Other relevant agreements

Aside from the principal asset/share purchase agreement, consideration may need to be given to the following:

- Service agreements, which govern the contract of employment between the company and its employees (who may also be

directors). A service agreement may be required or desirable to protect the positions of both the employer and the employee. In a leveraged transaction, the venture capitalist will be anxious to ensure that the terms (particularly the notice period required to be given by the employer to terminate) are not overly generous. Service agreements frequently contain restrictions on activity post-employment, as well as a so-called 'garden leave' clause, whereby an employer is entitled to require the employee not to attend work during his notice period (more effective than non-competition clauses as the employee will still be an employee while on garden leave and under a duty not to compete with the employer).

- A subscription and shareholders' agreement, which is frequently used where a venture capitalist is involved, to govern the relationship between the directors/managers, the company and the venture capitalist. The subscription agreement will set out the terms of the investment by the venture capitalist – that is, its agreement to subscribe for shares and the terms attaching to that agreement. If the venture capitalist is making any other kind of investment, eg a loan, the subscription agreement may deal with that too, although there may be a separate loan agreement. The rights attaching to the shares are usually set out in the articles of association (see below). The venture capitalists may require that the agreement should contain non-competition clauses from the management in favour of the investee company. These will be drafted so as to offer the investee company protection if there is a parting of the ways. Although traditionally also found in service agreements, their inclusion in a subscription agreement helps overcome enforceability problems as the consideration given by the venture capitalist (its agreement to subscribe for shares) will be taken into account. Undertakings will invariably be given by the management to the venture capitalist. These will include an obligation of management to provide full information about the business to the venture capitalist, including for example, an information pack every month (management accounts, sales reports, analysis etc), in addition to an annual business plan and any other information the venture capitalist might reasonably (or unreasonably!) require. Additional undertakings will be required as regards the management of the company: typically there will be a fairly extensive list of matters or actions that will require the venture capitalist's consent. These range from commercial issues

such as substantial acquisitions or disposals of assets outside the ordinary course of business, to legal matters such as changes to the articles of association, issue of new shares etc. Warranties are also likely to be contained in a subscription agreement; however, in this instance the management team will give them to the venture capitalist. Any management team should be cautious that they do not expose themselves to additional liability, by giving warranties to the venture capitalists that they themselves have not obtained from the vendors, although this may, particularly in an MBO, be unavoidable.

- Articles of association. In an MBO, both the new management and the venture capitalist will usually acquire shares in the new company. The articles specify the rights attaching to the different classes of shares that the company has issued covering matters such as voting, dividends and priority to assets of the company on a winding-up. In addition, the venture capitalist is likely to insist upon other rights to protect its investment or its exit from its investment, such as provisions requiring management to sell or buy the venture capitalist out if an offer to buy the company is received which is acceptable to it. Many venture capitalists use funds that have defined closing dates: they will wish to avoid management being able to frustrate their exit. The articles will also deal with the transfer of shares in the new company including:

- (i) what happens when a shareholder wishes to transfer their shares, must they first offer them to the other shareholders?
- (ii) what happens when a shareholder leaves the company, can they keep their shares or must they transfer them and should the circumstances of the departure affect the price paid for the shares (good leaver/bad leaver)?
- (iii) how is the price to be paid for the shares transferred to be agreed or determined? (particularly relevant on a compulsory transfer).

Finally, the articles will almost always contain a right for the venture capitalist to appoint a director to represent their interests on the board. This power may be exercisable from day one, or only when the venture capitalist is concerned about the performance of the company.

Other issues to consider

Employment issues

Whether an acquisition proceeds as an asset acquisition or share acquisition can have important consequences on the liability of both purchaser and vendor to the target company's employees.

Where an acquisition proceeds by way of asset acquisition, the Transfer of Undertakings (Protection of Employment) Regulations 1981 (TUPE) apply. The effect of TUPE is to transfer the contracts of employment for all employees of the target company to the purchaser. All rights and liabilities attaching to the employees (other than in relation to occupational pension schemes) transfer to the purchaser automatically, and employees will continue to be employed on the same terms and conditions, as they were before the acquisition, unaffected by it. Any dismissal of an employee for a reason connected with the acquisition will be automatically unfair, unless the purchaser can successfully run the (difficult) argument that the dismissal was for an economic, technical or organisational reason.

Where an acquisition proceeds by way of share acquisition, TUPE does not apply. This is because, legally, there is no change in the identity of the employee's employer. Again, all rights and liabilities attaching to the employee remain the same after the acquisition, but any dismissal relating to the acquisition will not be automatically unfair. Normal rules relating to unfair dismissal and redundancy will apply.

Property issues

In both share and asset acquisitions, property issues may well be relevant, and the purchaser should ensure that his solicitors fully investigate title to any properties being acquired. If time constraints do not allow for a full investigation, the solicitors may attempt to obtain a certificate of title from the vendor's solicitor and/or warranties in respect of the properties from the vendor (essential if the property in question is being offered as security).

Environmental issues have had much greater significance for a purchaser since the introduction of the Environmental Protection Act 1990. A purchaser who is aware of any environmental issues which may potentially affect the land they are to acquire should consider

undertaking a full environmental audit prior to proceeding with the deal. Warranties and indemnities should also be used in almost every matter involving property to apportion liability or risk between the parties.

As part of an asset sale, if any property is leasehold, as the identity of the leaseholder is to change, the consent of the landlord will need to be obtained in order to assign the lease to the purchaser. In the case of a share acquisition, the identity of the leaseholder remains the same (ie the company), and thus a landlord's consent may not be needed unless the terms of the lease dictate otherwise.

A purchaser who acquires property by way of asset acquisition will have the benefit of a priority period, during which they can purchase property in the knowledge that no further matters will appear on the Land Charges Register. A purchaser of shares may wish also to benefit from a priority application and will usually be able to do so either directly or indirectly (via its lender).

Pension issues

The importance of pension matters on an acquisition should never be underestimated. Indeed, the value of the target's pension funds often exceeds the consideration given by the purchaser. Pension-related considerations vary according to a number of factors. For example, is the scheme a discrete or group scheme? In the case of a discrete scheme, the target company's employees constitute the only members of the scheme, and thus the most important question is whether the scheme is adequately funded. Where a group scheme is involved, the target company's employees are part of a larger pension fund. Here, the issue to be addressed is what would be an appropriate transfer payment for the vendor's fund to make in order to provide for those target company employees transferring out of the group scheme.

Another consideration will be whether the scheme is a money purchase (defined contribution) or final salary (defined benefit) scheme. Both employee and employer usually make contributions to a money purchase scheme, although not necessarily so. The employee is not entitled to any set level of benefit on retirement. The level of benefit he receives depends upon the return on the contributions made. Accordingly, the purchaser's principal concern is to be satisfied that all contributions that the target is due to have made have been made. By contrast, a final salary scheme throws up more difficult

issues, particularly where the target employees are members of a group scheme. The level of pension an employee is entitled to receive is calculated by reference to their salary at retirement age. Consequently, with such a fund, the level of contributions made has no correlation with the level of benefits to be received by the employee. It is for the target to ensure that sufficient contributions have been made, as the liability is created at the time the employee joins the scheme. Here the help of an actuary will be invaluable in order to determine whether the fund is adequately funded. If the fund is not adequately funded, the consideration for the target should be reduced accordingly in order to reflect the amount that the purchaser will be required to contribute to the scheme. Alternatively, on a transfer out from a group scheme, the issue may be addressed by negotiating a larger transfer value, although the vendor is likely to resist this.