

MBO: the lawyer's perspective

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The legal adviser's role is integral to the successful completion of an MBO. Smoothly guiding management through the complex and pressurised process is a diplomatic as well as legal exercise. Nick Johnstone spoke to a number of experienced legal advisers for a rundown on the issues confronted in an MBO.

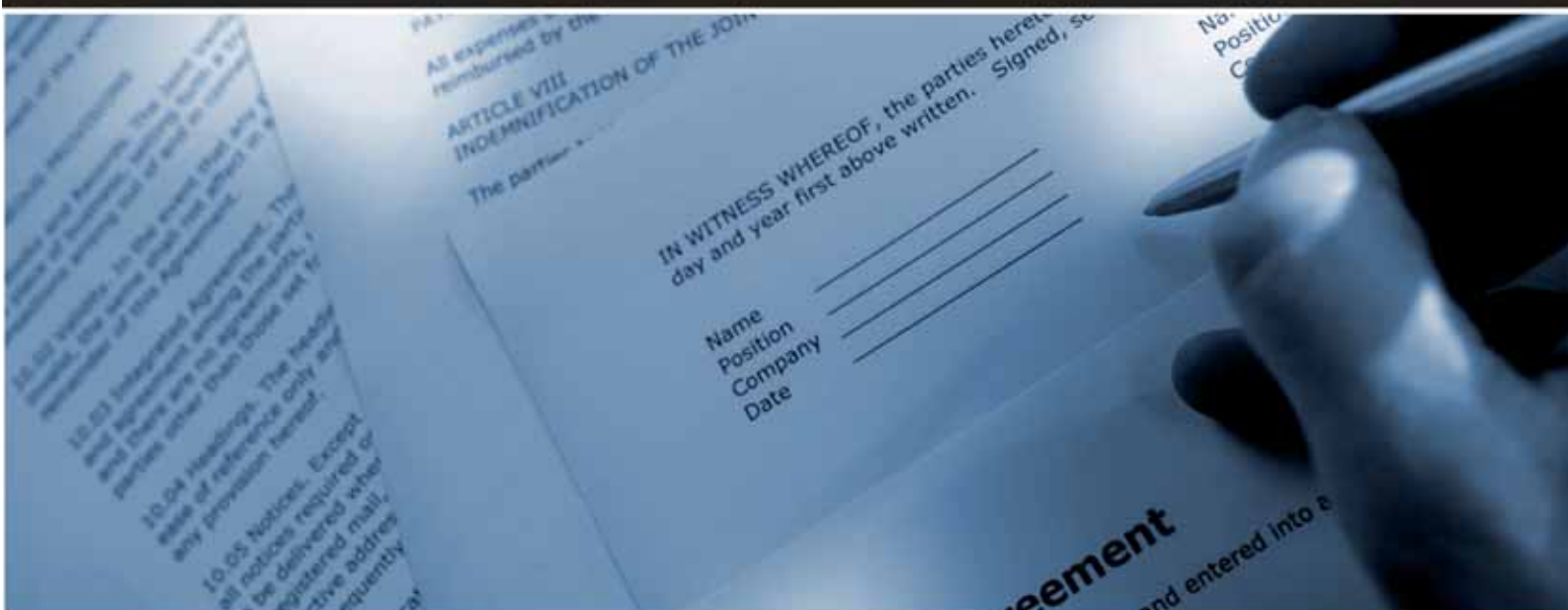
For management teams taking on a mid market business, an MBO is usually a first time experience and a daunting one. Beyond understanding a legal process that can last anything from three months to over a year, lawyers must be able to advise on deal structure, negotiate warranties and hold the hands of a management team more accustomed to dealing with the every-day running of a business than the legal labyrinth.

Knowledge is everything

One of the most challenging aspects for a legal team is obtaining warranties from the vendor. The MBO team's advisers will almost invariably struggle to secure a full set of warranties from an owner-manager, as the vendor is sure to claim that the management team knows just as much about the target, including all its potential liabilities.

John Thelwall of Park Woodfine Heald Mellows explained that the MBO team's negotiating position hinges on their involvement in the company prior to the deal. "If the team is at director level in a larger business, then it's reasonable that they should have an intimate knowledge of the company," he said. "On the other hand, if they are at manager level and buying out an existing owner, I can expect to be looking for much more in the way of warranties."

It is no secret that any MBO team can expect warranties given by a seller to be significantly fewer than those offered in a simple trade sale. An even greater challenge for the lawyers, however, is the added component of equity funding. The increased use of venture capital in MBOs has added significantly to the lawyer's remit



as a hand-holding negotiator in recent years.

As David Bright at Horsey Lightly pointed out, the demands of a private equity sponsor tend to exacerbate an already delicate warranty negotiation process. "The management's often extensive knowledge of the business can be problematic when the MBO has venture capital backing, because investors are likely to seek more warranties than tend to be required by management or offered by the seller," he said. "This is often an area of significant negotiation."

A buyer's market

The credit squeeze has created a buyer's market in which warranties have become easier to secure from a vendor. A year ago, vendors would typically have been obstinate about giving them away. Even the number of warranties offered by the MBO team was limited, as VCs were aggressive on price and could expect to take little comfort from a transaction.

Now, explained Matthew Martin at Manches, it is an easier task for advisers to negotiate warranties from the vendor. "This is because equity sponsors are looking for more security in the businesses they're investing in. If the vendor is particularly intent on selling the company and is putting it up for auction, we are more likely to secure a full set of warranties because the seller is looking for the highest figure available." Last December, David Tighe led a Manches team advising the vendor on one such deal – he advised his client that cooperation by offering a full set of warranties was the way to get the best price under the current market conditions.

David James at Moorhead James explained that the process had become more of a risk issue than a knowledge issue in the current climate. "It's now easier to make the argument that the funder is getting nervous when the vendor isn't prepared to give warranties," he said. "The credit crunch has made some transactions go on longer than hoped, because people are taking time to make

themselves more comfortable in terms of negotiating their position against the vendor than they might have done one or two years ago."

By returning to a more traditional, even-handed position, the market now places management teams and their advisers in an even tighter position during the transaction process. On one hand, legal advisers typically recommend that the MBO team adopt a 'business as usual' approach to the company throughout, fulfilling their official duty to the seller as well as delivering warranties to any third party buyer on the seller's behalf.

Yet managers are consistently aware that they are soon to be under the aegis of the very same buyer. The adviser must therefore navigate the management through this potentially suffocating process, ensuring they exercise the necessary diplomacy whilst bargaining for them if unreasonable demands are made.

Relationship counsel

This uncomfortable half-way house was described by Kevin McCarthy of Mishcon de Reya as a management squeeze. "It's a difficult position to be in, because the MBO team is with the seller today but with the buyer tomorrow, and they look nervously in both directions," he said. "It's crucial to prevent the management's nervousness from becoming a reason for the transaction to fall over. Private equity buyers are generally very experienced operators but, nonetheless, transactions can falter if management become overly anxious and start to dig their heels in."

Whilst the MBO team's financial involvement might be fairly minimal, their influence on the deal's outcome is crucial. "The role of the adviser to management is therefore a facilitating one to some extent," said Kevin McCarthy. "It's oil on the wheels of the transaction, and you have to carefully look after their position while, at the same time, getting the deal done."

The degree of power to be wielded by a private equity sponsor post-deal can create further legal

challenges during the deal process. Whilst a management team might know the business and feel like the company is under their command, the weight of funding invested by a sponsor gives them ultimate jurisdiction, and accordingly, the funder's approach will usually be a 'take it or leave it' offer. Private equity offers set out the ongoing information required by the sponsor post-deal, such as audit accounts and budgets, as well as tying the team into various restrictions as to where their power stops.

Alistair Latham at Stamp Jackson and Procter pointed to this as a potential source of considerable contention. "The contention arises because any equity shareholders involved want to be in control of absolutely everything, while the MBO team actually see themselves as the company, and therefore want full control for themselves," he said.

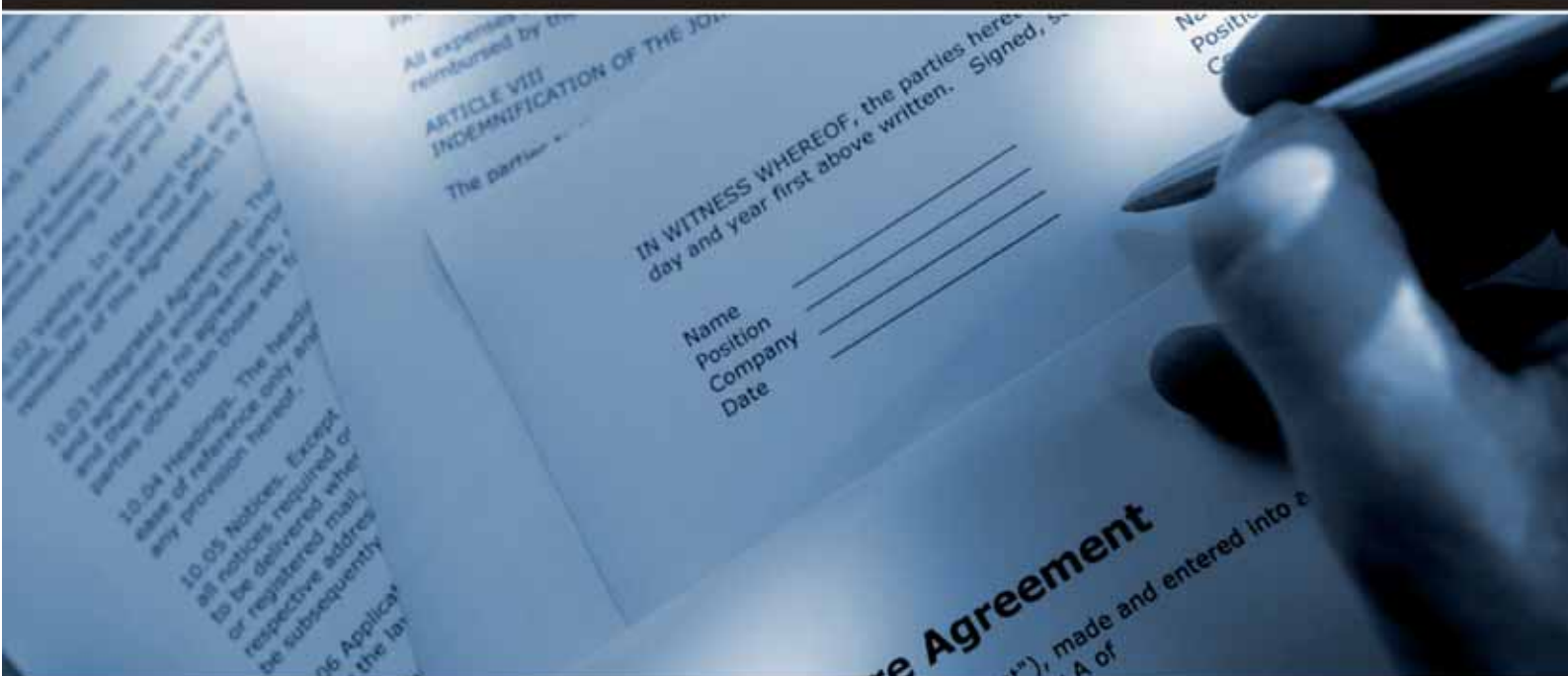
"In short, the biggest issue for the MBO team is the concept in equity financed deals that they are in fact not the buyer. Newco and the equity financiers are. The MBO team are there to run the business but have to get consent from the equity sponsors before they make any significant moves."

Investing in management

More than simply investing capital, equity sponsors facilitate ongoing growth by investing an MBO team with responsibility for Newco. Among the adviser's concerns are guaranteeing the team's expertise to the sponsor and to each other, as well as balancing interests within the team itself.

"One MBO team member usually emerges as leader from the outset, but it's rare that the dynamics of the team remain the same throughout the buy-out and post-deal," said Matthew Martin. "In one deal I advised on, the FD appeared to be a weak link at first, while one salesperson seemed to rise above the rest as a strong leader. By the end of the deal, these roles had changed completely, and the FD had outshone the other guy. Equity sponsors tend to be aware that these changes happen, and already have contingency plans in place."

Whilst the existing relationships within the



management can be integral to the fabric of the company, there is no guarantee of common interests in the MBO process, and this is capable of fracturing the most ostensibly robust bonds.

According to Gerard Cranley at Howard Kennedy Solicitors, existing ties can be an advantage, particularly when there is no competing bidder. "However, situations involving auction processes and competing bids can place strains on the best of relationships," he said. "Generally, as long as best practice procedures are followed and the parties have respect for each other, these problems can be managed."

John Thelwall said this involves sitting down with the buyers at a very early stage to find out whether they have a common set of aims. "This raises the question of whether it is appropriate to be advising them as individuals as well as a team, or whether some of them have different interests and therefore ought to be seeking independent advice.

"If the MBO team members are at director level with specific areas of responsibility, the next question is whether those directors should warrant their expertise to the other directors. A production director might, for example, know that a bad batch has gone out, and would therefore anticipate repercussions after the deal. Legal warranties guarantee such roles are adequately fulfilled."

Securing the bonds

Among the many criteria for equity sponsorship is inevitably the guaranteed unity of a cohesive MBO team. Duncan Reid at Ward Hadaway explained that if MBO team members are long acquainted, the adviser's job is considerably easier, as they all understand their own clearly defined roles.

"It's important that the private equity house feels that the management appears as a united

front," he said. "One way of doing this is trying to spend as much time as possible with them as a team, building up that relationship so that we're not dealing with their individual interests."

Advisers also widely recommend that management teams are fronted by a spokesperson to deal with the legal intricacies of the MBO on behalf of their colleagues. This leaves the remainder of the MBO team to continue with the day-to-day running of the business, only needing to appear at hinge points during the deal process. Communication efficiency and costs are also streamlined, and this comes with the added bonus of appearing to private equity as a management team cohesive enough to depend on one another.

David James at Moorhead James said: "Quite often, the MBO team implicitly trust each other. One or two of them will be delegated with all the legal negotiations and the others are more than happy just to let them get on with it," he said. "Some have never been through the process before, while members such as the financial director are perhaps more likely to have previous experience of an MBO. When the completion meeting goes on all night, for instance, it's helpful that they can reassure other members of the team that it's all terribly normal."

Legal due diligence

An integral part of the legal process in an MBO is the legal due diligence questionnaire which an adviser will submit to the vendor. Due diligence results can make or break a deal, and advisers will generally approach the equity sponsors and the MBO team first to establish what information is required.

Alistair Latham explained that by ascertaining the nature of due diligence questioning, advisers can avoid unnecessary hassle for the vendor. "That would only sour a deal at the outset and put the MBO team on the back foot," he said. "The advan-

tage of doing it this way is that it saves time and the MBO team can explain the financial reasoning behind the questions. Without answers, there is no finance, and without finance, no deal."

According to Gerard Cranley, this focused due diligence process is particularly relevant at the lower end of the market where legal costs relative to the size of the transaction are an issue. "Clients are increasingly aware that one way of controlling costs is to carry out a carefully focused due diligence exercise and agree some form of report afterwards rather than the traditional one hundred page 'brick', which is all too often distributed too late to be useful in the negotiation process. In most cases, this means early identification of 'icebergs' which might sink a transaction rather than leaving those issues to be unearthed by the client from a full-form report."

The easily digestible due diligence report is not simply a convenient way of communicating legal complexities; it is a crucial factor in the completing of the transaction process. This commercial approach is increasingly adopted by savvy advisers hoping to find the pressure points early on.

Duncan Reid said: "We don't just tend to regurgitate the documentation, we tend to deal with commercial factors on four different levels: those that affect whether the deal is completed; issues that affect price; factors that are important but can be resolved during the transaction; and issues that might need resolving post-deal.

"So, they're categorised into those levels of importance and presented to the private equity sponsor in that way."

It is hardly surprising that the more complex the deal's structure, the more rigorously the legal due diligence process must be handled. The need for clear communication lines increases with the number of parties involved. Elucidating this point, David Bright at Horsey Lightly drew on the example of a recent deal involving three companies

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with similar businesses being hived up into a Newco, owned by the management team as an acquisition vehicle.

“The management team were made up of the directors of the three companies,” he said. “This meant that the management team were only aware of the issues relating to their particular company and not necessarily all issues affecting the other two. In practice, this meant ensuring that there was a sufficient flow of information through the due diligence process so that each member of the MBO team had as much core information as possible, allowing them to make informed assessments.”

Looking beyond the present

The adviser's involvement in Newco post-deal may be limited, depending on the preferences of a private equity sponsor. Often financiers will use their own advisers for any significant transactional issues following the MBO. However, if the deal has been self-funded, trusty advisers can expect continued involvement in the company, allowing the minutiae of the due diligence report to be put on hold during the stressful period of seeing through the MBO.

Long term challenges can also rear their heads mid-deal when advisers draw the MBO team's attention to exit strategies. The legal adviser must gain a thorough understanding of each member's agenda, and varying ages within the MBO team can often have a significant bearing on this. John Thelwall explained that some may want to retire while others will want to continue, and it is the adviser's role to confront this issue during the MBO process.

“As an adviser you would explore whether the team itself has a mid to long term strategy. The MBO team are business focused, and it's a major art of our job to say, ‘it's fine today, everything's

going swimmingly, but at some point in the future, one of you will want out.”

It is nevertheless a challenge to pre-empt the future intentions of every member of a management team. According to Kevin McCarthy at Mishcon, the most important thing is to get clear agreement between the MBO team and the incoming purchaser as to what management are prepared to commit to going forward. “Often, the equity sponsor is buying into the management team and what they can deliver over time. They will be tied into a specific time frame, and this agreement simply unravels if one or two key members decide to move elsewhere.

“The team rely on one another, so the key is to determine exactly what they will commit to as a unit – once you have those parameters, you can negotiate accordingly, tying things (earn-outs, exit strategy, restrictive covenants, leaver provisions) to that committed timeline.”

When MBO team members exit outside this committed timeframe, the disposal of shares can be a delicate issue, which lawyers will factor into the Articles of Association; the legal constitution of Newco. The way that shares are redistributed depends on the shareholding manager's legal status as a ‘good’ or ‘bad’ leaver. As David Tighe at Manches LLP explained, if someone leaves after three months, having contributed little to the company, it is pre-empted that this bad leaver's shares will be redistributed unfavourably for him.

While the legal adviser is key to avoiding ongoing disputes during the transaction process, it is impossible to pre-empt every kind of eventuality. As Duncan Reid observed: “The MBO team are supposed to be able to run the business as sophisticated managers,” he said. “we can't run it for them, but we can get them to go into these things with eyes wide open, and knowledge of the consequences if things don't work out.”



David James



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