DENTONS

UK Private Equity Transactions

The essential differences from the US market

A US private equity fund seeking to acquire a target in the UK will soon notice a number of differences from the US market. It is important to be aware of these differences if you are competing against UK private equity houses. The key features are that in the UK we still have a seller's market and management incentives are structured differently (however, they achieve the same economic result).

Below are 10 ways in which English law is more seller-friendly.

Deal Certainty

The common theme among the first three distinctions is deal certainty. A typical UK agreement assumes that, even where there is a gap between signing and closing, deal certainty is required from signing.

1. Conditions: Typically UK agreements contain only those closing conditions required by law or regulation e.g. anti-trust clearances or other regulatory approvals. These are generally specified together with detailed provisions on timings for filings and consequences based upon the response from the relevant regulatory body. In contrast, US deals are more likely to have greater conditionality and to provide for a meaningful period of time before closing, known in the US as the "marketing period", for the buyer to have a fair shot at securing acquisition financing.

2. Material Adverse Change: It is unusual for UK deals to be subject to a MAC condition. Even if a MAC condition is included, it is likely to be relevant only if an "armageddon" event occurs which is not the result of macro-economic factors. By contrast, MAC clauses are far more common in the US, although they are also interpreted very narrowly.

3. Financing: UK deals are usually done on a "certain funds" basis with no financing condition or financing out. Some strategic and private equity deals in the US contain financing conditions. If there is no financing condition, as is the case in virtually all US large cap private equity deals, there will typically be a reverse termination fee which requires the buyer to pay a fixed amount if the financing is not available and the other closing conditions are met. This reverse termination fee is usually the seller's exclusive monetary remedy against the buyer.

Although reverse termination fees are seen in the UK, they are relatively rare, certainly by comparison with US practice.

Transfer of Risk

The common theme among the next three distinctions is the timing of when the risk of ownership transfers.

4. Price certainty: It is has been common for a number of years in English law acquisition agreements, particularly in auctions, for the acquisition price to be structured on a "locked box" basis. That is, the price

payable for the target company is agreed upon in advance of signing based on a balance sheet drawn up to an agreed locked box date. The buyer then bears the risk and rewards of the target's performance from the locked box date through signing to closing. In return, the seller undertakes that there will be no "leakage" of value from the "locked box" to the sellers in that period in the form of dividends or otherwise. This is entirely in keeping with the philosophy that risk passes to the buyer from signing. The advantages for the seller in using a "locked box" include the ease with which bids can be compared and price certainty (as there is no post-closing adjustment).

Although the use of locked boxes is increasing in the US, it is still common to have a purchase price adjustment based on the working capital or net worth of the company as of the closing date (which is typically estimated at closing and trued up post-closing), and the seller is free to make ordinary course distributions out of the company during the interim period. Unlike the locked box mechanism, and depending on the precise formula used in any particular adjustment, the seller retains the commercial risk and reward until closing. Furthermore, the seller has less control over the final amount of the purchase price, and the price is likely to be subject to a post-closing adjustment and potential dispute based on the closing accounts.

5. Control Between Signing and Closing: The covenants to which the target business and seller are subject in the period between signing and closing are likely to be significantly more extensive in the UK than in the US.

6. Bring Down of Representations: In the UK, it is unusual for warranties to be repeated (or "brought down") at closing, although, as a compromise, sellers may agree that a small number of fundamental warranties, such as those regarding title and legal capacity, are brought down at closing. In the US, the practice is generally to require representations and warranties to be accurate as of closing as a condition to the deal, subject to MAE and materiality qualifications.

Seller's Liability

The position on seller's liability when comparing the UK and US is more balanced. On the one hand, a UK private equity seller is unlikely to give any warranties and other warrantors are unlikely to repeat them on closing. Also disclosure will be more comprehensive. On the other hand, the scope of warranties and caps and time limits on liability are likely to be higher and longer in the UK than the US.

7. Limits on Liability: Private equity sellers in the UK never give business warranties in an acquisition agreement. Instead, a buyer relies upon warranties received from the management team. That, combined with a management team rolling over 50% or more of its post-tax sale proceeds, gives the buyer some comfort in what it is acquiring. If a buyer requires a higher level of recovery against the purchase price in the event of a breach of warranty, then it can also acquire warranty and indemnity insurance. Warranty and indemnity insurance is now very common in the UK private equity market. Typically, the premium costs around 1.5% of the amount covered.

In the US, the construct is different. A selling private equity fund is unlikely to give business warranties and any management liability of this kind seen in the UK is extremely rare (perhaps reflecting the reality that a lawsuit against one's new management team is an unattractive proposition). However, both the selling private equity fund and management team may fund, proportionate to their shareholdings, an escrow in an amount equal to 5-10% of the equity value. The escrow is typically paid over to the sellers once the representations and warranties expire, subject to reserved amounts for any pending claims. The corollary of this is that in the US the seller's representations and warranties can survive for as little as the first anniversary of the closing or, alternatively, the completion of the first audit cycle under the buyer's ownership. By contrast, in the UK, time limits tend to be longer - typically two years for non-tax warranties and seven years for tax warranties. A UK agreement will also contain more extensive general limitations on the seller's liability.

Also in the UK, express contractual indemnification is far less common than in the US, except in relation to tax or other specifically identified risks (e.g. environmental exposure). The buyer's remedy for breach of a warranty in a UK acquisition agreement will instead usually be a contractual claim for damages, with a duty to mitigate losses and a requirement for any damage to be reasonably foreseeable. Some US deals actually end up with a similar result, notwithstanding the express contractual indemnification due to waivers by buyers of consequential damages and a contractually imposed duty to mitigate.

8. Disclosure: The style and substance of the disclosure process differs between UK and US documents. Under a UK acquisition agreement, the seller's disclosures are typically contained in a separate disclosure letter, rather than the schedules to the sale agreement itself, which is often the case in the US. A UK disclosure letter will contain a mix of general and specific disclosures against the warranties. Even the specific disclosures are normally deemed to qualify all warranties and not just the specific warranties to which they relate. More significantly, in auctions it would be usual for the entire contents of the data room and of any vendor due diligence reports to be deemed to be generally disclosed against the warranties. In the US, the buyer will usually allow specific disclosures against specific warranties, and any other warranties as to which it is readily apparent that such disclosures might relate. General disclosures, or imputations to buyers of the entire contents of the data room, are far less common in the US and not typically accepted by US buyers.

9. Specific Performance and Liquidated Damages: While the test for granting specific performance is the same between the US and the UK (i.e. monetary damages would not be an adequate remedy), an order for specific performance is generally easier to obtain in the US than the UK. Liquidated damages are also easier to obtain in the US, since in the UK the onus is on the enforcer to prove that the amount claimed is a reasonable estimate of its loss i.e. UK courts do not award penalties.

10. Buying from an Administrator: In the UK our equivalent of buying a business out of Chapter 11 is acquiring it from an "Administrator". Buyers of businesses from an Administrator will, typically, receive no warranties or representations on the target business from the sellers, and have no post-closing recourse against the sellers. At best, they will receive a warranty from the Administrator confirming the validity of its appointment. It is possible for the buyer to have an escrow arrangement or deferred consideration, but if there are competing bids the Administrator will favour the bid that provides the maximum cash payment on closing. The solution is for the buyer to price in the risks.

Conclusion

These differences demonstrate why sellers might prefer that international deals are done under UK law. However, in making tactical decisions about the choice of law, sellers should be mindful of the likely pool of buyers. If buyers are predominantly based in the US, sellers may find it difficult to insist on the use of UK-style share purchase agreements for targets based outside the UK.

Management Incentives

In the UK we structure management incentives a little differently from the US, but with the same economic result.

In the UK, all share incentives are awarded to the management team on closing, but entirely subject to forfeiture if the manager leaves before the exit. The reason is entirely tax driven i.e. if shares are awarded at less than their market value at the time of award then the recipient will suffer income tax on the difference between the price he pays (if lower) and the market value. The employer will also suffer a tax bill on the difference (employer national insurance which is currently charged at 13.8% on the difference). Because it is assumed the market value of the shares will increase during the lifespan of the investment, it therefore makes sense to award all the incentives at the outset of the investment period. That is why the issue of shares during the investment period pursuant to staggered vesting under an option plan makes no sense in the UK.

If a manager leaves before the exit, then all the shares will be forfeitable. The question is at what price. A bad leaver will be required to offer his shares for sale at the lower of market value and the subscription price. The price for a good leaver will be market value (since the higher of market value and the subscription price would, perversely, reward a departing manager if the company is underperforming). A third category has developed in the UK market - the intermediate leaver, who is essentially someone dismissed without cause on full notice. He will receive the lower of market value and the subscription price for a portion of his shares and market value for the balance. The portion that must be offered for market value will increase in line with how long the relevant manager has been in the business. This is what we call "value vesting". Four years is a typical period for the manager's entire holding to "value vest" i.e. be forfeitable entirely for market value.

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