CHAPTER 1

The Role of Private Equity

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1.1 PRIVATE EQUITY EXPLAINED

1–01 Private equity and venture capital describe equity investment in unquoted companies. It is most simply described as "not debt" funding invested in private companies.

It is applicable where the perceived levels of risk, the time horizon associated with the investment or simply the sums required do not suit debt providers or the public equity markets.

These conditions apply to companies in their early stages, or those operating in fast changing environments. It has also become the common mechanism to finance the separation of non-core assets from a parent company, to facilitate management succession in family-owned firms ("management buy-outs") and to delist firms from a stock exchange ("public-to-private transactions").

Private equity providers become co-owners of the companies, sharing risks and returns.

The term "private equity" is the term generally used in the UK to cover the industry as a whole including buy-outs and venture capital. "Venture capital" is a sub-category covering the start-up to expansion stages of investment.

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1.2 PRIVATE EQUITY OVERVIEW

1.2.1 Type of private equity firms

1–02 There are three main categories of private equity firms:

Independents These are the majority of firms which raise their funds from a number of external sources including pension funds, insurance companies, wealthy individuals, and corporate investors. Independent private equity firms usually manage the funds through fixed life limited partnerships. A limited partnership usually has a fixed 10-year life with between 10 and 30 limited institutional investor partners. Within this period the funds invest the money committed and return these funds plus any returns made. This generally requires the investments to be sold before the end of the fund.

The independent acts as a general partner selecting and structuring investments in return for a management fee and usually a share of any upside on achieving capital gains. The upside share is referred to as carried interest.

The independent funds invest 75 per cent to 90 per cent of all UK private equity investment.

1–03 **Captives** These private equity firms obtain their funds from parent organisations which are usually financial institutions. Following the financial crisis, their investment levels have fallen to less than 5 per cent of all funds invested.

Semi-captives Some of the captives also raise funds from external investors. They are known as semi-captives and manage and invest 10–15 per cent of all funds invested.

The venture capital trusts ("VCTs") represent a different dimension to the venture capital market. The VCTs are quoted and offer a private investor the prospect of a tax advantage and an opportunity to invest in venture capital. Publicly quoted VCTs also give independently managed private equity firms the ability to raise significant additional capital.

In addition to the type of fund, most venture capital firms can be broken down into two main categories, namely the "generalist" firm and the "specialist" firm.

1–04 **Generalists** Firms which will invest in a wide range of industries and covering all investment categories from start-up businesses to later stage investments.

Specialists Firms which will invest only in certain product categories and/or sector areas of specific interest such as:

- management buy-outs (product specialisation); and
- high-technology propositions (sector specialisation).

1–05 Many of the generalist funds avoid areas which are outside investment criteria or the mandate of the fund. They invariably consist of the following areas:

Product exclusions Start-ups/early stage investments and/or rescue/turnaround situations.

Sector exclusions Such as high-technology investments, property investments, gambling or any others set by their investors.

Within the generalist category, most funds have a particular sector or product specialisation, which is derived from past investment experience or the career bias of the fund's investment executives. Conversely, the high-technology funds dedicate their entire focus and resource to the more speculative investment, which often involves dealing with early stage propositions rather than with established companies.

1.2.2 Private equity investments

1–06 Private equity investments can typically be subdivided into the following product categories:

Management buy-outs/buy-ins

1–07 A MBO gives an incumbent management team the opportunity to purchase the company from its present owners. MBOs represent around a half of all private equity funds invested. The average private equity firm equity investment is in the range of £10 million to £20 million. MBOs typically arise in the following situations:

- disposal by the parent of a non-core subsidiary;
- succession issue in a family owned company;
- disposal to management as an alternative to a trade sale; or
- management buy-back from receivership.

The use of venture capital in MBOs has allowed employees the opportunity to become owner managers and receive a significant equity stake, disproportionate relative to the level of funding invested by the venture capital.

1–08 The management buy-in ("MBI") is an extension of the MBO principle in that a manager or group of managers actively search for an acquisition target to buy into. The MBI may be an outright takeover of a company or alternatively the MBI team may join forces with members of the existing management team to form a "BIMBO" (buy-in/management buy-out).

Investment returns have been lower for MBIs, possibly because buy-in candidates are unlikely to have the same level of inside knowledge on the operation of a company than existing management. MBIs represent about 10 per cent of private equity funds invested in MBOs.

The most significant recent development has been the rise of the very large MBO, one requiring more than £100 million of private equity investment. This segment represents about one half of all UK private equity investment funding in MBOs.

Rescues

1–09 In a rescue situation, venture capital can have a role to play in re-capitalising a company's balance sheet and provide a contribution to ongoing working capital requirements. Venture capital firms tend to view rescues with extreme caution and do not invest on the proviso that things will change. The management team are held accountable for past mistakes, and without strong mitigating circumstances it is unlikely that the private equity firm will inject new funds. Mitigating circumstances may include:

- a delay in developing a new process or product which creates a financial strain on the company's funding resources;

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- production problems brought about by the failure of a key piece of plant or machinery;
- failure of a key customer or key supplier; or
- more simply an overgeared balance sheet.

Rescue or turnaround financing attracts very little private equity investment.

Secondary purchase investments

1–10 This involves a private equity firm purchasing shares in an investee company from another private equity firm, from other shareholders who wish to exit from the company, or refinancing bank debt investments. The number of these investments has increased in recent years and represents 5–10 per cent of private equity funds invested.

Purchasing shares from a private equity firm

Despite occasional variations, independent private firms' shares typically raise funds in 10-year limited partnerships. This means the venture funds typically have an investment time horizon of between four and seven years with the need to achieve an exit at the end of this period. Often management of an investee company may wish to develop further the business beyond this timeframe, thereby providing an opportunity for a new private equity investor.

Purchasing shares from existing shareholders

1–11 In the unquoted company market, it can be difficult for shareholders to exit their position due to the general illiquidity of the shares. The venture capital firms represent liquidity for those shareholders and can also provide additional funding for companies.

Shareholders can also realise just a part of their shareholdings. This route can provide owner managers with a certain element of cash and financial independence, without giving up their entire interest in the business. Similarly, private equity firms can be used to fund a settlement of a shareholder dispute, buying-out an exiting shareholder.

Expansion capital

1–12 Sometimes known as "development capital" or "growth capital", half of all companies backed are in the expansion capital investments. These are typically existing venture capital investments requiring a fresh injection of private equity to finance growth, refinance debt or to fund acquisitions. The average investment expansion capital is smaller than for management buy-outs, with average financings of around £2 million to £4 million.

Early stage investments and start-ups

1–13 There is always a strong need for funding in companies at an early stage of their development. Given the associated high risk profile and the historic low investment return most venture capital firms steer well clear of this area, although they still represent around one-third of all companies receiving investment they usually only account for 5 per cent of funds invested with average equity investments of less than £1 million. Fortunately, there are still some funds which see a real opportunity for significant capital gain by backing such ventures. Early stage and start-up investments represent the difficult end of the market for those seeking funds. In looking at a start-up, it is unlikely that an entrepreneur with merely a good idea will receive significant backing without a demonstrable track record of success in that industry.

The start-ups which find most favour tend to be those that have an experienced management team.

To achieve funding for early stage or start-up ventures, proposals must contain some of the following characteristics:

- a well balanced and experienced management team;
- a fully developed product;
- a growing existing market place which is not dominated by a few firms.

1–14 A management team seeking investment in a start-up involving a new product or a new market will find fund raising extremely difficult, irrespective of their track record.

In summary, when reviewing venture capital investments, the MBO and development capital type propositions have generated the highest investment returns for venture capital firms, whilst early stage and rescue propositions have produced the lowest returns.

1.2.3 Recent trends in the industry

Equity gap—£100,000 to £1 million investment range

1–15 Most of the independent private equity firms are principally only seeking investments in excess of £1 million. This is a strong and continuing upward trend as historic investment returns have been better for larger transactions. This has serious implications for the new and emerging businesses in the UK which have a requirement for less than £1 million. On a more positive note, a number of smaller independent funds and government backed regional funds concentrate on the £100,000 to £500,000 sector. However, they are in the minority and generally lack the funding strength to provide significant follow-on investment capability.

There are two major problems with smaller investments: First, investee companies often lack the financial or management resources to withstand adverse changes in trading. Secondly, and equally detrimental to the venture capital firms, are transaction fees associated with completing an investment below £500,000.

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On lower end transactions, professional advisors' costs will often account for more than 10 per cent of the investment monies raised. These costs divert funds and also erode investment returns.

1–16 Venture capital trusts can fund transactions at the smaller end of the market, but generally they seek equity investment opportunities requiring £2 million or more. VCTs have a duty to make investment returns just as well as mainstream fund management and it is likely that the smaller end of fund raising will continue to be under-serviced.

The equity gap is almost inevitable in any economy, despite continued initiatives to "Bridge the Finance Gap".

Business angels—£100,000 and below

1–17 In recent years a number of networks of high net worth individuals prepared to invest in smaller companies have emerged and these individuals have become known as "business angels". A number of sophisticated "angel networks" have been created across the UK which attempt to match private investors to appropriate opportunities.

The angel formula has a good precedent in the US where many smaller end propositions are now funded through individuals or syndicate groups of private investors. The typical profile of a business angel is someone who has previously generated financial independence in business and wishes to invest in a new venture. It is not uncommon for business angels to monitor their investment in an active way, which often leads to their appointment as a non-executive director. Other angels may wish to be passive investors with the whole aim of realising their investment on the future sale of the company.

Move away from start-ups and early stage

1–18 Many of the independent UK venture capital firms are actively targeting a minimum £2 million investment and ideally only £5 million plus investment propositions. In addition the mainstream primary funds are seeking average equity investment of at least £10 million and there exists a large nucleus of "premier funds" who will only consider investments with a minimum private equity funding requirement of £20 million or higher. Such investment minimums tend to place the focus on expansion capital and MBOs/MBIs. These product groupings are positioned at the lower end of the risk scale, and usually involve dealing with established businesses with proven track records. This trend looks set to continue because large management buy-outs (equity investment over £10 million) have produced the highest long term returns of all private equity investment categories.

The early stage investment or start-up may produce significant up-sides, however, the risks of failure are greater. Overall returns for early stage investments are significantly lower than any other private equity categories, thus the investment trend away from these opportunities is likely to continue.

Technology funds

1–19 Until 1998, technology funds undoubtedly suffered from the perception of high-risk and low-return. Then the technology sector became the hottest area of the economy and, not surprisingly, private equity followed.

UK high-technology companies (communications, software and computer services, biotechnology and medical) receive more private equity than any other industry category: accounting for about one half of the total number of UK companies backed and 10 per cent of the total amount invested. The lower average value reflecting the fact that over half of the companies backed are early stage investments.

1.2.4 Developments in the MBO marketplace

1–20 Of the total funds raised since 2000, around 70 per cent is expected to be invested in large (over £10 million) or very large (over £100 million) MBO/MBI opportunities.

The MBO/MBI product grouping also usually accounts for around half of UK venture capital investments by value. Given the importance of MBOs to the venture capital industry, it is essential to review the latest trends in the MBO market place.

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The very large buy-out funds

1–21 UK private equity fund raising since 2000 has been dominated by the very large buy-out funds and has pushed those private equity firms into the spotlight. Now most public company takeover speculation, no matter what the size, automatically assumes the presence of these financial buyers as well as trade buyers.

Private equity firms could become the main source of fresh capital for companies with more than £100 million if the bias towards bigger companies on the stock market continues.

The bought deal or institutional buy-out ("IBO")

1–22 The development of the large buy-out fund and the increasing size of average investment has led to vendors directly approaching venture capital funds in the sales auction process. Having won the auction, the venture capital firm then assembles the management team, which may include members from outside the target company. This "bought deal" is in stark contrast to the MBOs completed in the 1980s, where the management team obtained the MBO opportunity and then selected their preferred funding provider. The bought deal will continue and reduce the importance of the management team in initiating the MBO process. At the lower end of the buy-out scale, management in conjunction with their advisors are still likely to lead and co-ordinate the MBO process for the foreseeable future.

The BIMBO

1–23 As with all venture capital products, hybrid versions are inevitable and the BIMBO is no exception. The BIMBO is a combination of a buy-in candidate or candidates working with the existing MBO team to effect a MBO. The use of buy-in candidates helps to strengthen an existing management team in an area of weakness. The emergence of the bought deal on larger transactions has also encouraged the BIMBO trend.

Gearing

1–24 Gearing represents the amount of debt compared to the amount of equity used to fund transactions. In management buy-outs above £10 million, the ratio of debt to equity is typically in the region of 60:40 to 55:45 with greater amounts of debt being provided to companies with stronger and more predictable cash flows. The focus on cash flow lending has also led to the development of mezzanine funding. Mezzanine funding is debt charging high rates of interest (partially deferred) and with the added bonus of options or warrants to subscribe for equity on preferential terms. Mezzanine finance appears in about 20 per cent of management buy-outs over £10 million.

1.3 RATIONALE FOR USING PRIVATE EQUITY

1.3.1 Limitations of debt funding

1–25 In the UK, most companies think of conventional bank lending when it comes to meeting funding requirements. If security cover is good and the funding requirement does not materially affect the level of gearing, many businesses will not require any alternative source of funding. The increasing development of the debtor based finance industry with its invoice discounting and factoring products, means that often a working capital intensive company can continue to meet its funding needs through debt.

However, banks are in the business of secured lending, and additional unsecured finance must come from private equity. Venture capital firms provide private equity funding in return for a shareholding in the company. The implications of taking venture capital and, in particular, the equity "give-away" factor are discussed in detail at 1.4.

1.3.2 Funding key change

1–26 A company's evolution may precipitate the need for venture capital funding. The key changes could include buying-out retiring or dissenting shareholders, funding a management buy-out, to provide new succession or funding organic growth or acquisitions.

Organic growth may involve the development of a company's branch network or sales infrastructure, or the building of a new factory and its subsequent equipping with plant and machinery.

1–27 Many companies elect to grow by means of strategic acquisition to obtain an immediate increase, rather than to develop gradually by implementing an organic growth plan. While the acquisition may utilise a considerable amount of management time in consolidating the enlarged operation, the future benefits may be considerable.

Whether growth is organic or by acquisition, private equity may be required if the funding requirements exceed the enlarged company's debt capacity.

1.3.3 Alternatives to private equity firms

Business angels

1–28 Business angels can have a strong role to pay in the smaller funding market place. In the absence of networks of angels, problems can arise, particularly in matching differing private investor requirements.

Agreement on investment deal structures, and taking account of their preferences, can be time consuming. For example, some individuals may wish to invest through offshore trusts whilst others may wish to use some form of tax relief, such as the Enterprise Initiative Scheme. Some investors may want to be active and have a non-executive role within the investee company, which can conflict with the preferences of the existing management team. In terms of exit planning and investment yields, some business angels can have different priorities and it is important to obtain a balanced solution which takes account of most of the individual preferences. Often the best way to achieve consensus amongst business angels is to be prescriptive in setting the investment framework. Under this approach, the business angel has to subscribe on prescribed terms.

The British Business Angels Association ("BBAA") is the UK trade association for promoting angel investing.

Industry partnership

1–29 Industry partnerships or corporate venturing can be a useful way of obtaining funding which would otherwise not be available. In the case of early stage and start-up ventures, the industry partner can often be the most sympathetic investor to a proposition because they are likely to understand the nature of a related industry and can see commercial advantage by backing such a company.

A difficulty of this route may be that a management team may lose both equity control and day-to-day control of the organisation with disagreement most likely in exit planning. In particular, industry partners have firm views on whom the business should and should not be sold to. Conversely, a private equity firm, free of trade interests, backing a management team, will rely on the judgment of management and are focused on maximising exit gains for all shareholders.

Vendor finance

1–30 Transactions have been completed entirely using vendor deferred consideration. This is where the vendor acts as a deferred lender to the transaction and allows

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the acquirer to pay the purchase consideration over a period of time. This route lends itself particularly to opportunities which are of little interest to venture funds.

The vendor usually takes the view that unless some form of guarantee or security can be given on the deferred consideration element, the risk factor in not accepting cash consideration may prove to be too great, but the vendor may not have a choice. Where a company is asset rich, security can usually be offered and, in the event of default, equity claw-back provisions can be incorporated into the sale and purchase agreement. It is common to reward the vendor with a commercial rate of interest on the funds deferred and perhaps an additional premium, over and above the acquisition price, is justified to reflect the risk of agreeing to this route.

1–31 Vendor finance is also favoured in transactions, requiring speed and the prospect of subsequent refinancing of the vendor finance at a later date, post transaction.

Deferred vendor consideration is also used to increase the price paid for the business, meeting the price gap between the vendor's requirements and the abilities of the company to raise external finance. As a "price gap filler", deferred consideration and earn-out arrangements can make a deal happen that would otherwise be considered unfundable.

1.4 IMPLICATIONS OF PRIVATE EQUITY

1.4.1 Equity "give-away" factor

1–32 The issue of equity "give-away" in privately owned companies is always an emotive subject and companies will always seek to meet their funding requirements from sources not requiring an equity share in the business.

Private equity funding is frequently provided as a package which will include ordinary shares with either redeemable preference shares or redeemable loan stock. A prerequisite of most venture capital investments is a requirement to pay dividends on the ordinary shares and a dividend on the preference shares or interest on the loan stock. The ordinary shares owned by the private equity fund will tend to be designated as "A" ordinary shares or preferred ordinary shares or some other variant of that theme in order to differentiate their dividend and minority protection rights from those pertaining to the other ordinary shareholders. The venture fund may insist on a dividend expressed as a percentage of net profits before tax and this is known as the participating dividend. The range of such a participating dividend tends, in the main, to fluctuate initially between 5 to 10 per cent of pre-tax profits, these may also rise rapidly over time to encourage an exit. The redeemable preference shares, or loan stock, are likely to carry a fixed income with a significant premium above commercial bank interest rates.

The redemption of preference shares or loan stock tends to be over a three to six-year period which usually lags, the repayment of bank debt and coincides with the forecast timeframe of the investment. Where cash is a critical issue in the early phase of an investment, it is usually possible to agree reduced or deferred dividend and capital repayments to fit in with the cash flows of the business.

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1.4.2 The institutional relationship

1–33 In accepting private equity, the management team will have to abide by a new code of rules as detailed in the share subscription agreement, new articles of association and new service contracts. Whilst most venture capital funds back the judgment and abilities of management, provisions are required which ensure that in the event of default, and/or under-performance of the company, a remedy can be achieved. Furthermore the funds also have safeguards in the articles of association to protect them as minority shareholders.

Venture capital funds generally insist on a service agreement to govern remuneration and service contracts of the directors. This is designed to ensure that directors do not pay themselves more than has been agreed, thereby reducing profits attributable to shareholders as a whole, and will cover matters such as pension and bonus arrangements, and benefits to be provided. The agreements will have provisions to cover arrangements for the management to leave the company as either a "good" or a "bad" leaver. The later usually covering such areas as negligence, incompetence or misappropriation of company funds.

1–34 The articles of association will usually have provisions where if dividends and capital redemptions are in arrears then, during those arrears, the private equity firm can take control (see Ch.9). Similarly, on the theme of control, the shareholders' agreement or investment agreement is likely to contain restrictions relating to the purchase of significant capital assets, the acquisition of any companies, or the ability of management to diversify into other trades without the consent of the venture fund (see Ch.8).

As in all partnerships, the venture capitalist needs to be consulted on significant events and developments within the company. The primary way by which this is done is through the appointment of a non-executive director often the Chairman. The function of a non-executive director is mainly to attend the board meetings of the investee company and to advise management on strategic and business issues. The non-executive director also has a monitoring role and will feed back to the venture capital provider how the company and the investment are developing.

In essence, as a partner in the investee company, the venture capitalist needs to be kept abreast of all material developments which affect the company's performance. While most venture funds are hands-off in approach, regulatory provisions are in place to monitor and control, particularly where events are going badly or in a direction which differs materially from the original business plan.

1.4.3 Pros and cons of private equity

1–35 As in most key business decisions, acceptance of venture capital can have important implications on the future of an investee company. It is necessary to summarise objectively the pros and cons of private equity.

Pros

- In the case of a management buy-out, private equity enables employees to obtain some degree of ownership and control of their company.

Continuously improve. Increase your capabilities. Be a constant learner. Develop feedback systems—both formal and informal. Act on the feedback you receive. Don't assume today's knowledge and skills will be sufficient for tomorrow's challenges.

A private equity or funded transaction can be very complex. It becomes at its most complex when the heads of terms have been signed and the legal negotiations begin. The number of people involved increases significantly including numerous due diligence bodies and a host of specialist lawyers. The leadership of the transaction becomes the key that will unlock the deal and make it happen efficiently and smoothly with few tantrums along the way. Project management and strong leadership are essential. The lead lawyer if he wants to add real value must become the dealmaker and at the same time the trusted advisor to his client.

CHAPTER 7

Managing the Transaction

7.1 INTRODUCTION

A typical investment may have four separate phases: 7–01

(1) the preparatory phase;
(2) the offer phase—until such time as agreement has been reached in principle on price and major commercial terms;
(3) the document phase—when the terms agreed in the offer phase are turned into a legally binding document; and
(4) the completion phase.

7.2 THE PREPARATORY PHASE

The phase starts in the boardroom when the directors form the opinion that for whatever reason the company requires an injection of capital. Bank finance may be too expensive or simply not available and the board determines to use the company's equity to secure financing. A committee of the board may be formed to pursue the introduction of private equity. It is at this stage that the board or the committee will consider whether they should seek preliminary advice from their lawyers, accountants and other professional advisors. The likelihood is that their first port of call will be to their accountants who will advise them on the preparation of a business plan and will guide them on the private equity institution most suited to their needs. In some cases the lawyer may be the first contact. He may be prepared to take on the corporate finance accountant role or alternatively he may prefer to introduce a corporate finance accountant to advise the board. 7–02

All too often however, the lawyer plays a very little part at this stage. If the lawyer does have a role it can often be in preparing the company for the investment. Before an investor makes an investment he will instruct a firm of accountants to prepare a due diligence report on the company, and his lawyers will be instructed to prepare a legal report. A legal audit at an early stage by the company's lawyers, therefore, may help to exclude any difficulties that otherwise may occur and become apparent at a later time.

In order to avoid delays in negotiating or completing the investment, the company should gather together, in advance, all material that will reasonably be expected to be required by an investor for the purposes of their due diligence, or by the company to ensure the correctness of the warranties that will be given. In

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Ch.7 there is a list of the kind of information that the solicitors to the investor are likely to request and an indication of the areas that accountants are likely to cover. If it has not previously been prepared it is likely to cause delay. Also, the information may disclose a problem which requires attention. Becoming aware of such a problem too late will only cause delay and embarrassment. The amount of time consumed in gathering such information should not be underestimated. In particular, the company should not only make enquiries of its employees but also of any professional advisors such as auditors, solicitors and pension consultants.

7.3 THE OFFER PHASE

7–03 The business plan will have been submitted to a small number of private equity houses (or banks if the transaction can be achieved on debt alone) who will have met the management team and visited the business. They will have decided in principle whether they want to invest in the company and will have submitted an offer to the company or to the accountants or intermediary acting for them. The role of the intermediary is to elicit the best possible offer and he may return to the investor on several occasions to improve on their terms.

It is important at this stage that the board and their advisors determine the fundamental requirements, other than cost, that they are setting out to achieve and lay down the parameters before any offers are received. In particular, for example, the management must decide the role they wish the investor to play once the investment has been made. Generally private equity investors will not act as a bank lender would be expected to act. They will be more hands on in protecting and growing their investment. In addition they can bring expertise to the board that is often not there.

7–04 There will inevitably be some disruption to the business during this process. Frequent numbers of grey-suited men will be found parading through the warehouse. Staff morale may be affected and rumours may abound. Every effort should obviously be made to contain the disruption. The speed of the process is essential.

The greater the number of investors approached, the greater the risk of the proposed matter becoming public knowledge. It is therefore important that the proposed investment be kept confidential. Ideally therefore, from the outset, each prospective investor should be asked to execute a confidentiality agreement before any confidential information about the company is released.

7–05 By the end of the offer phase the company will have agreed a price and the amount of the share capital being released along with other commercial terms. This will be documented in an offer letter from the investor to the company. By signing such a letter, the parties will have a moral commitment but it will be expressed to be non-legally binding. Non-legally binding heads of agreement can be as brief or as detailed as the parties require. Generally they will contain financial details of the proposed investment, followed by a long list of conditions to be satisfied before the investment is made, including the obtaining of a satisfactory due diligence report. Apart from agreeing the financial and commercial terms there is often little point discussing the remainder of the offer letter which will be standard to the investor and the industry.

At this point in time exclusivity has not been granted to any of the parties. From a legal perspective it is therefore very important to make the most of a strong bargaining position by agreeing as many key terms as possible. Clearly areas such as warranties and indemnities are unlikely to be agreed but there are a large number of key issues in the document that can be agreed saving time and costs later and ensuring a better deal for the management and/or the vendor before exclusivity is granted.

7.4 TRANSACTION MANAGEMENT

7–06 Private equity transactions are different from other commercial transactions. When buying and selling businesses, the vendor and the purchaser will not continue to deal with each other after the completion. Partly as a result of this, the transaction can and often does become aggressive and unpleasant with each party stubbornly arguing his corner. In private equity transactions, no matter how difficult the bargaining between the investor and the board, once the deal is completed the investors need to work closely with the management in order to further develop the company. A smooth and efficient negotiation and completion will set the relationship between the management and the investor off to a good start. In addition, a private equity transaction, or more particularly, a MBO with all its different facets can be one of the most difficult transactions that a lawyer will undertake. Managing the transaction is therefore very important. Set out below are guidelines to assist in the transaction management of a MBO or MBI. These principles can be adapted to other simpler forms of transactions.

7.4.1 Timetable

7–07 It is very tempting when the accountants, the directors and the investors have been in negotiations for a long time and those negotiations have come to a satisfactory conclusion to assure the management that there are only a small number of legal details to sort out before the transaction is completed and the company will receive its desired funding.

Whilst understanding that the transaction needs to be done quickly, for many numerous and varied commercial reasons, the management should also be made aware of the amount of time that will need to be devoted to the legal process. To set a deadline of three weeks for example to complete a large management buy-out is not sensible and is bound to have the consequence that the management team will be frustrated and angry when the transaction finally completes at least some six weeks later. However, it is acknowledged that there are some transactions which need to be done very quickly for obvious commercial reasons, in particular a receivership buy-out from a receiver. Nonetheless, it is important to consider at the outset whether the tight deadline really is essential.

7–08 Often deadlines which are set without the input of the lawyers and which the parties clearly believe to be unachievable will simply be ignored and the consequence will be that there are in fact no deadlines at all. From a lawyer's

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point of view it can be very frustrating to receive an exquisitely prepared timetable and action list from a merchant banker or financial advisor into which the lawyer has had no input.

A timetable should therefore be justifiable and one which all parties recognise as justifiable. As a result it is worthwhile spending a certain amount of time analysing what needs to be done when drawing up the timetable but at the same time one must be sufficiently flexible to cater for issues arising during the legal process which no-one had anticipated and which will upset the timetable. Externally imposed deadlines are more effective than self-imposed ones and even something as trivial as a key player's holiday can sometimes be the trigger to get the transaction done on time, despite the grumblings that will occur. However, in the author's view it is always better to be honest about the timetable and the project leader should work hard at encouraging everyone to buy in.

7.4.2 What is transaction management?

7–09 The management of a private equity transaction is the process that is established in order to utilise the appropriate resources within or outside your own organisation in order to bring about the successful conclusion of a management buy-out or buy-in. The most important part of project management is to ensure that the right people are on the bus. Too often the selection of members of the buy-out team is controlled less by the skill that is required and more by the "who is available". You should always ensure that, as the leader of the transaction, you play a significant part in the selection process. Having the wrong people on board can make the transaction much more difficult than it need be.

7–10 The legal team you bring together will almost certainly have come from different departments in your organisation and perhaps even different sites. This in itself brings some interesting challenges, for example:

- team members will only report to you for their work on the buy-out but will report to their departmental partner or manager for other work, who may have different priorities;
- the team is less likely to have stability over a protracted period due to changes in priority of the members or their departmental partner;
- often team members don't know each other and, as a result of unfamiliarity, there can often be immediate barriers. They will be hesitant to share information and opinions openly; and
- the limited timescale means there is little time for coaching.

Success in transaction management is not achieved only by using the right tools and techniques. It is achieved by giving time to lead the team and overcoming these areas of potential difficulty. This will then reduce the risk of failure.

7.4.3 Transaction leadership

7–11 Project managing the buy-out is a complex role. The transaction manager is involved in a changing environment where his primary purpose is to achieve a successful outcome of the transaction. At the same time it is a temporary

management role with specific responsibilities that are linked only to the deal. Therefore he/she has to create a balance between the demands and needs of the client, the transaction, the organisation and the transaction team.

The transaction manager must do everything that he believes is necessary to achieve the desired outcome. He is the hub around which the deal operates. It is not a recipe for a quiet life. The transaction manager knows his own organisation and the people with whom he is expecting to work and might expect opposition, conflict, etc. Of course from his own organisation he should always expect full co-operation, enthusiastic support, and plenty of helpful advice. The reality tends to be somewhere in between. In addition, if the transaction manager has not been assigned full-time to the role he must balance the time between deal activities during the buy-out and his other responsibilities. This can test a project manager's ability as a time manager and may influence members of the legal team who are in a similar situation. The main characteristics and roles of a transaction manager are:

- responsibility for achieving a successful outcome;
- pleasing the client;
- proven skills in the use of project tools and techniques;
- proven team leadership skills;
- authority to secure resources internally and externally;
- the ability to cut through hierarchical boundaries to get things done;
- an ability to work with the unknown and the unpredictable; and
- regarded sometimes with distrust by many of those not involved.

7–12 When a transaction manager brings the core team together they may not have worked with each other before or even know each other. In addition, the transaction manager is an unknown entity to them, if he has not worked with them before and they expect him to build the group into a team. This is therefore a complicated process but is made easier by a clear sense of direction and good leadership. Everyone should know why they are in the team and that they have been selected by the transaction leadership. They will all have experience and skills that are considered relevant to the transaction. The objective is to gather together their abilities, creativity and efforts to take the transaction to closing. A successful team consists of a carefully designed mixture of the right skills and personalities who are able to work together without conflict. They are likely to have been selected because the leadership value and respect their ability to deliver the right technical skills and to deliver a good service under pressure.

These elements demand and extend leadership skills beyond those normally associated with the fixed team leadership role. If the transaction manager is unable to bring along the team with him the position can quickly turn into a lonely one. It is essential therefore that he gets total support and guidance at all times from the deal leader (lead partner).

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7.4.4 Lead partner

7–13 The lead partner takes the ultimate responsibility for delivery of the transaction. The responsibilities include:

- selecting the transaction manager;
- scoping the transaction;
- ensuring the proper resources are assigned to the transaction;
- overseeing the deal process and procedures, budgets and controls; and
- approval of status reports, milestone reports and risk management reports.

In addition, the lead partner will be the lead negotiator on the acquisition documentation and possibly on the equity documentation.

7.4.5 Transaction manager

7–14 The transaction manager is responsible for the project work from the initial kick-off through to completion. Responsibilities should include:

- selecting the core due diligence and negotiating team with the lead partner;
- scoping the due diligence and identifying the greatest risks;
- planning and scoping the work involved in the buy-out and the resources required;
- identifying and managing the risks;
- allocating and securing the appropriate resources;
- monitoring on a daily basis the progress of the buy-out in conjunction with the milestone plan;
- solving problems that interfere with the progress or ensure that they are raised early and the right people are solving them;
- controlling costs;
- leading the transaction team; and
- preparing status reports and risk assessment or management reports with the approval of the lead partner.

Both the transaction manager and the lead partner need to demonstrate leadership qualities. There are no common characteristics that make an effective leader. The core of the issue is how the transaction manager uses his/her skills to influence the behaviour of people to achieve the successful outcome of the transaction. One type of leadership is to tell people what to do using a "you will" approach. The other extreme is the democratic approach, where information is shared; the manager consults widely and asks people to do the work using a "will you" approach. In reality a good manager will adopt a style that is often subconsciously directed by the situation and environment in which he/she operates, the type of work and its priority of urgency and the way the team act in the environment.

7–15 There is no particular right style in how to operate. The manager's skill is the ability to recognise what approach is appropriate at any particular time in order to get the achieved results.

To achieve the desired objectives the manager must use some particular skills to ensure the transaction is completed on time to the quality desired; create co-ordination between the team members and develop team work; and support individual team members and develop their skills.

Keeping a balance between each of these tasks occupies much of the manager's time. The actions a manager takes at each stage of the project are focused and maintain this balance, adopting a range of styles according to the prevailing situation. However, the manager always needs to be aware that there is not just him/her and the team but there is also a client.

7–16 A manager spends much of the time as a transaction manager directed on inner tasks, bringing focus to the transaction, developing and maintaining good team work and making sure that the right skills are in the team. He/she also spends time with the client, understanding their needs and expectations, using their skills when appropriate and keeping them informed of progress.

Establishing the client's requirements very early in the deal is essential. They can influence the transaction at any time with serious consequences to timing and to the legal costs being incurred.

The three essential dimensions of transaction management and leadership are:

(1) identifying, managing and communicating with your client throughout the buy-out;
(2) managing the buy-out once the legal process has started. No other advisor is in a better position than the lawyer to do this; and
(3) managing his/her own performance, the team and his client.

Success with your transaction is directly related to balancing the time and effort the manager gives to each of these dimensions from the start.

7.4.6 Managing performance

7–17 The transaction manager must demonstrate throughout the project that he/she is concerned about the performance of everyone involved with the transaction.

The transaction manager is responsible for delivering the results expected by the client and evaluating his/her own performance regularly will help improve the way the job is undertaken. A transaction such as a buy-out requires effective team work. If the team is not well co-ordinated the transaction work suffers and the transaction can become reactive and at worst move from crisis to crisis without clear leadership. This is always made more difficult in a transaction because team members are likely to come from different departments or even other sites. The transaction manager must make an effort early in the transaction to understand the team members and their working environment. Set out below is a checklist for the transaction manager to manage his/her own performance:

- assess own performance continuously;
- pay particular attention to helping and supporting team members;
- coach individual team members when opportunities arise;
- respond promptly to personal issues raised;
- demonstrate continued enthusiasm for the project;

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5.13 Investor director consents may also be given by investor in writing.

6 Transfer of shares

6.1 Any transferee to whom shares are transferred must adhere to the subscription agreement.

7 Announcements

7.1 No announcements before or after completion without prior approval of each of the other parties.

7.2 Investors may use information which they receive under the provisions of the agreement to report to their other syndicate investors.

8 Exit

8.1 Managers agree that they will notify the investor[s] of details of any written offer from any third party for the whole or part of the share capital of the company.

8.2 No warranties on sale or listing to be provided by the investor except as to title.

8.3 Listing to extend to all shares.

9 Costs

9.1 All fees including legal fees, accountants' fees, headhunters' fees and stamp duty and expenses incurred by the investors in connection with the agreement to be paid by the company on completion in accordance with agreed fee schedule.

9.2 The Investor[s] authorise[s] the payment by the company of the specific fees incurred by the company and the vendors in connection with this agreement on demand on completion in accordance with fee schedule.

9.3 Provisions for collection (and confirmation of amount) of negotiation fee.

10 Service Agreements/Non-Compete

10.1 Obligations on managers to comply with service agreement.

10.2 After termination of employment managers will not solicit or interfere or attempt to entice away employees or customers, or interfere with suppliers for at least [two] years following completion and will not carry on or be interested in any competing business for at least [one] year following termination.

CHAPTER 12

Articles of Association

12.1 INTRODUCTION

12–01 The articles of association (the articles) represent a contract between the company and its shareholders. A statutory contract which binds the company and its members to the same extent as if they were respectively signed and sealed by each member.

Subject to the provisions of this Act, articles, when registered, bind the company and its members to the same extent as if they respectively had been signed and sealed by each member, and contained covenants on the part of each member to observe all the provisions of the articles.

On becoming a shareholder each member to this contract is deemed to have undertaken to observe all provisions contained in the memorandum and articles. On the other hand the investment agreement is a device resorted to by private companies to supplement the basic infrastructure provided by the articles. While the enforceability or otherwise of the articles is subject both to the numerous principles developed by the courts and to the various statutory powers imposed on companies, the shareholder's agreement is regulated by the law of contract. The aim of the articles is to regulate how the company is governed and how power and control is shared between the shareholders and the directors and how the rights of different classes of shareholders operate among themselves.

It is essential when drafting the articles of association that the legal advisors understand the economics of the transaction and the equity deal agreed between the parties. It is probably the most important part of the transaction and as a result the area that should receive the most attention.

12–02 The articles are a public document of the company which requires registration at Companies House. The investment agreement generally does not require filing though draftsmen should be careful to ensure that it does not fall within provisions of the Companies Act requiring filing. The Companies Act states that a company may alter its articles by special resolution. Any alteration has effect as if originally contained in the articles. The articles cannot be entrenched by a provision stating that they cannot be altered (*Malleson v National Insurance and Guarantee Corp* [1894] 1 Ch. 200). In contrast a shareholder agreement can only be varied with the consent of all parties.

Frequently companies adopt a standard form of articles of association. For new companies, under the Companies Act 2006 Table A is replaced by two forms of model articles—a new radically simplified set of model articles more suited to small private companies and a more extensive form for public companies. However, its promoters may adopt such provisions as they wish on incorporation

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(subject to statute and the common law) and its shareholders can later make alterations. Private equity transactions usually call for a complex share structure, and a number of articles which are common only to an investment of private equity. Hence this leads to a very complex set of articles. We have already considered the need for different classes of shares and the types of shares which are likely to be subscribed for in order to provide equity finance in a venture capital transaction. In the main, this is to facilitate financial engineering so that a comparatively large amount of share capital can be introduced by an investor without diluting management interests in the equity of the investee company to an almost negligible figure. There are various other reasons including the operation of a ratchet, which we will discuss more fully in this chapter.

12.2 *RUSSELL V NORTHERN BANK DEVELOPMENT CORP LTD*

Controls

12–03 As we have seen in Ch.9, venture capital is approached from the stand point of a passive investor or "sleeping partner". The investor controls are usually reserved to the investor in order that it can veto any significant changes in an investee company's businesses activities or operational strategies. The appropriate place for inserting the investor controls within the legal documentation is often a matter of some contention and the case of *Russell v Northern Bank Development Corp Ltd* [1992] 3 All E.R. 162, HL has made the decision more complicated. Controls which limit the company's "statutory powers" cannot after *Russell* be imposed on the company itself. Therefore binding the shareholders themselves is vital.

If there are shareholders who are not party to the investment or shareholders' agreement, for example because they are junior managers in a MBO, or there are a large number of small shareholders, then certain controls, such as transfer provisions, must be included in the articles as this is the only way of binding them.

12–04 Controls can appear in the articles of association or in the investment agreement or in both. However, provided that all the shareholders have also executed the investment agreement, the legal effect will be the same between the shareholders whether the controls are contained in the articles of association or in the investment agreement. There are, however, conflicting authorities as to whether a member can enforce the articles generally against another member or whether such a right should be effected through the medium of the company (*Welton v Saffery* [1897] A.C. 299) because the articles would amount to a breach of contract in the same way as a breach of the investment agreement. However, if a company appoints a director under the articles for 10 years this term can be reduced by the passing of a special resolution. If the company wishes to remove the director instead, an ordinary resolution pursuant to the CA 2006 s.168 will be sufficient. In either case no liability for breach of contract will occur unless this also results in a breach of a service agreement in which case the director will be eligible for compensation in accordance with the ordinary principles of contract law.

Subject to this qualification, the courts have generally given members the freedom to determine the terms of any shareholder agreement. In *Bushell v Faith* [1970] A.C. 1099, for example, the validity of agreements used to entrench rights which prevented the company from exercising its statutory power was recognised. The shareholder agreement, in this case, which was contained in the articles was designed to entrench the position of a director by an artificial use of extra voting powers where there was a desire to remove him. On a resolution under what is now the CA 2006 s.168, the director was to have "weighted" votes attached to his/her shares which virtually made the passing of an ordinary resolution impossible.

12–05 The vote attached to a share is a right of property which the shareholder is entitled to exercise in his/her own interests and to deal with as he/she thinks fit (*Northern Counties Securities Ltd v Jackson and Steeple Ltd* [1974] 1 W.L.R. 1133). It follows therefore that an agreement between two or more shareholders to co-ordinate their votes is lawful. In contrast to this the companies legislation confers many powers on companies, the most important of which are to alter objects and articles by special resolution, and the power to alter share capital provided there is authority in the articles. The question of whether it is possible to contract-out of these statutory powers was discussed in *Russell v Northern Bank Development Corp Ltd*. A company and all its shareholders entered into a shareholder agreement. One of the clauses provided that, "no further share capital shall be created or issued in the company … without the written consent of each of the parties hereto". Can one of the shareholders who is a party to that agreement obtain an injunction restraining his co-shareholders from voting in favour of a resolution to increase the share capital? To restrain the company, a co-shareholder, would in effect prevent the exercise of the statutory power conferred on the company under the CA 2006 s.617 to increase its share capital by ordinary resolution. The decision in *Russell* provides a firm and unequivocal answer: there can be no contracting-out by a company in respect of its statutory powers. At the same time, the House of Lords sanctioned the making of voting agreements which can have the effect of fettering the exercise of a statutory power. The House therefore made a distinction between an undertaking by a company which restricts its statutory powers to alter its articles or increase its share capital, and an agreement between the shareholders for the time being of a company as to how they will exercise their rights if any such alteration or increase is proposed. The former is void as an unlawful fetter on the company's statutory rights, but the latter is valid.

12–06 As well as voting arrangements, practitioners have found other ways of circumventing the restriction with the effect that, except for those who are poorly advised, the practical effect of the *Russell* case is limited. Rights may be entrenched in articles either by using the concept of separate classes of shares to which are attached the rights which are sought to be protected (and which can only be amended with the separate consent of the holders of the shares of each separate class: CA 2006 s.633), or by increasing the voting power of specific shares in the article which embodies the special rights if and to the extent that a special resolution is proposed to alter that article, and so allowing the protected shareholder to prevent the passing of a special resolution if he/she wishes. Alternatively, the rights could be set out in the memorandum and declared

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unalterable. In the Court of Appeal, it was held that the fetters on the company's statutory powers rendered the entire agreement void. Fortunately the House of Lords offered a lifeline which should save most existing shareholder agreements by ruling that it was possible to apply the doctrine of severance, and allowed *Russell* to enforce the parts of the agreement that fell into the category of an agreement between shareholders as to how they will exercise their voting rights. At the same time it issued a warning that there is danger in seeking to extend the scope of such agreements beyond their proper sphere, and in particular in making the company itself a party.

Class rights

12–07 Under the typical Newco structure, the investor and management team members are issued with different classes of shares. Management shares are usually "plain vanilla" ordinary shares. The Investor usually receive preferred ordinary shares ("A" ordinary shares). Together these will be the equity shares. Separate classes are usually required to reflect the different rights that will attach to the different classes of shares. For example in relation to voting rights and dividends, the investor may be seeking a yield from their equity shares in the form of dividends whereas it is unusual for managers to receive dividends prior to exit. In the same way the investor will often have a priority when Newco has underperformed.

One of the most fundamental controls which an investor requires is a veto over changes to the memorandum and articles of association of the investee company. *Russell*, as we have seen, determines that a company cannot restrict its power to change those articles of association. Therefore a provision in the investment agreement whereby the company covenants not to change its articles of association without the consent of the investor beforehand would not be enforceable. There are obviously other examples of powers which a company cannot fetter its power to change, for example, winding up the company, reducing the share capital, changing the company's name, increasing the authorised share capital etc.

It seems fairly certain that an agreement between the shareholders themselves not to vote their shares to change the articles of association, reduce share capital, etc, will be enforceable if the company is not a party to that agreement but invariably the investee company is party to the investment agreement. The House of Lords' decision suggests that a severance clause could be inserted in the investment agreement to make it clear that certain controls are not intended to bind the company but only to bind the shareholders which, in effect, would cause the company to comply with the control. But what if not all the shareholders are party to the investment agreement? It could be possible to get a voting covenant from each of the other shareholders but that would be cumbersome and it would be difficult to establish what consideration there would be for such a covenant. The alternative is to insert weighted voting rights in the articles of association so that to pass specific resolutions (for example, amending the articles of association) certain classes of shares will have more than one vote. This effectively ensures that unwanted amendments cannot be passed without the agreement of the holders of those shares.

12–08 Alternatively, these controls could be enshrined as class rights. If the controls are put in the articles of association and the investor has its own separate class of shares, the rights contained in this separate class will be class rights. They generally attach to the preference shares or the preferred ordinary shares being the shares held by investor. For any of the particular rights attached to the investor's shares to be incapable of amendment without the consent of the investor, they must amount to "class rights". They can then only be varied in accordance with the provisions of the CA 2006 ss.630–634. Some of the more important points of this section are:

(1) Different rules will apply depending upon whether the class rights are contained in the articles, the memorandum or the resolution creating the shares and depending whether or not the articles contain provisions relating to the variation of class rights.
(2) Depending upon where the class rights are contained and whether the memorandum or articles contain any mechanism for approving a variation of class rights, it is likely that in addition to a special resolution to change the company's articles, an approval of a variation may require:
    (a) the holders of three-quarters in nominal value of the issued shares of the relevant class consenting in writing to the variation or an extraordinary resolution being passed at a separate class meeting consenting to the variation; and
    (b) all of the members of the company agreeing to the variation.
(3) The quorum requirements for the class meeting are two persons holding at least one-third in nominal value of the shares of the relevant class, or one person at an adjourned meeting if the first meeting was adjourned because of an insufficient quorum.

12–09 The power to create class rights has not been affected by *Russell*. So for example, the preferred ordinary shares could have attached to them, as a right in the articles of association, the stipulation that the articles of association may not be changed, the share capital reduced, the company wound up etc, without the consent of the preferred ordinary shareholders. Care, however, must be taken to ensure that these rights attach to shares which will be retained by an investor and not to redeemable or convertible shares.

There is continuing debate about what matters should properly be the subject of class rights. On the one hand, dividend rights clearly affect the essence of the shareholders' rights in the shares and are doubtless capable of being class rights. On the other hand, a right to prevent the company from entering into a joint venture or partnership cannot be said to affect the nature and relative rights of the shares themselves but rather the business of the company. There is doubt therefore whether such a control will be a class right. Shareholders are often surprised at the ways in which their position can be changed without there being a variation of their class rights. Other examples are:

- An issue of bonus shares to holders of other shares in the company, which has the effect of increasing their voting power compared to his own will not amount to a class right (*White v Bristol Aeroplane Co Ltd* [1953] Ch. 65).

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- An issue of new shares to rank ahead of his/her preference shares will not be a variation of his/her class rights if there was no contractual promise to him/her that such prior ranking shares would not be issued (*Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch. 656).

12–10 Traditionally in private equity transactions, a long list of matters that were to be regarded as class rights were set out in the document containing the preference share or preferred ordinary share rights, normally the articles. However, more practitioners now consider the better view to be that a fairly narrow range of matters can genuinely be construed as class rights and so a limited list should be contained in the articles and restrictions of the sort that do not affect the share rights should go into the investment agreement since they are highly unlikely to be fetters on the statutory powers of the company. Therefore the company as well as the other parties to the investment agreement undertake to be bound by such restrictions.

Below are fundamental controls required by an investor and drafted as class rights attaching to the shares held by the investor for inclusion in the articles.

Without prejudice to the generality of this article the special rights attached to the preference shares and the preferred ordinary shares shall each be deemed to be varied at any time by any of the following:

(1) an increase, reduction or other alteration in the issued share capital of any member of the group or a variation in the rights attaching to any class thereof, apart from an alteration arising out of a conversion or a redemption of shares under these articles;

(2) the grant of an option to subscribe for shares in any member of the group or the issue of any securities convertible into shares of the company or any of its subsidiaries;

(3) the creation by any member of the group of any mortgage, charge, pledge, lien, encumbrance or other security interest (excluding an interest arising by operation or of law in the ordinary course of business);

(4) the directors permitting the borrowings of the group to exceed the limit imposed by these articles;

(5) the making of any material change (including cessation) in the nature of the business of the group taken as a whole;

(6) the alteration of the memorandum of association of the company or these articles or the passing of any special or extraordinary resolution of the members (or any class of them);

(7) the declaration or payment of any dividend or the making of any other distribution in respect of the profits, assets or reserves of the company or any of its subsidiaries other than the preference and preferred ordinary dividends and any other dividends declared and paid strictly in accordance with these articles;

(8) the institution of any proceedings or the passing of any resolution for the winding-up of any member of the group;

[(a) the removal of an investor director otherwise than in accordance with art.[ ];] and

(9) incurring an obligation to do any of the foregoing.

12.3 MINORITY SHAREHOLDER PROTECTIONS

12–11 Class consents will be included as a matter of course for the benefit of the investor. Management advisors will wish to obtain a limited set of protections for management particularly if together they only represent a minority shareholding in the company. Most investors will not wish to provide management with any form of class rights over and above their statutory rights as to do so would further their controls. The ability of management to secure class rights will depend on the strength of their negotiating position and ultimately their importance to the deal. Without any protection, a shareholder without control of the company will be in a vulnerable position. Some investors are reluctant to provide management with any protection, others will do so providing it does not restrict their ability to refinance the company should the need arise. The clause below includes some limited class protections but allows the investor to refinance without restriction if required. The management are the holders of the ordinary shares.

12–12

1 Unless the [finance documents] require the following actions to be taken, the consent of the holders of the ordinary shares [*NB: generally the shares held by management*] as a class shall be required to and accordingly the special rights attached to the ordinary shares shall be deemed to be varied only by:

1.1 any alteration or reduction or increase of the authorised capital or issued capital of the company [(other than any issue of up to [ ] ordinary shares in aggregate to employees of or consultants to any member of the group (or any nominee of any of the same),] in terms of cl.[ ] of the subscription agreement, to which issue the holders of the ordinary shares are hereby deemed to have consented); or

(As a practical point, often the company will wish to provide for shares to be issued to employees at a later date. It is easier to allow for this at the time of the investment).

1.2 the passing of the resolution effecting the amendment of the articles of association of the company; or

1.3 the passing of a resolution for the solvent winding-up of the company; or

1.4 the application by way of capitalisation of any sum in or towards paying up any debenture or debenture stock of the company; or

1.5 the capitalisation by the company of any undistributed profits (whether or not the same are available for distribution and including profits standing to any reserve) or any sum standing to the credit of its share premium account or any capital redemption reserve; or

1.6 the creation or grant of any option or other rights to subscribe for shares in the equity share capital of the company or securities convertible into shares in the equity share capital of the company.

Provided always that without prejudice to any other right available to them under the Act such consent or sanction of the holders of ordinary shares shall not be required in respect of any increase in the authorised share capital of the company or allotment of shares in the capital of the company or the creation or grant of any

option or other rights to subscribe for shares or securities convertible into shares in the capital of the company which would otherwise require such consent or sanction of the holders of the ordinary shares pursuant to art.[ ] above or of any alteration to these articles necessary to provide for the rights attaching to any class of shares in the capital of the company which would otherwise require such consent or sanction of the holders of the ordinary shares pursuant to art.[ ] above if such increase, creation, grant or alteration is made in order to facilitate a further investment in the company to the extent only to which it is in the opinion of any member or members holding in aggregate 50 per cent in nominal value of the preferred ordinary shares then in issue the same is necessary to remedy any breach by the company of any covenant to any banker to the company or to prevent such a breach from arising which, in such opinion, but for the allotment would arise.

12–13 If the investor is adamant that he/she will not allow class protections to the management, and many investors are, it is worth exploring whether the investors will agree to some of the more fundamental concerns of management being included in the investment agreement.

An alternative and more aggressive way of dealing with this is to provide the managers with minority protection rights (either in the investment agreement or in the articles) but to agree that such rights will terminate if the targets set out in the business plan (or within a narrow range of them) are not achieved. This should be more palatable to most investors though many will still regard it as an unnecessary restriction on their contract.

12.4 SHARE TRANSFER PROVISIONS

12–14 In most buy-outs the guiding principle is that shares are used by the investor to incentivise employees and directors to add value to the business at the exit. The ordinary shares issued to the managers are likely to be cheaper than the equity shares issued to the investor, hence the term "sweet equity". If the projections set out in the business plan are achieved then the upside is great. As a result managers are generally not allowed to transfer their ordinary shares without the consent of the investor, except in certain limited circumstances. At the same time management will have put a lot of due diligence into choosing the investor and will be keen to see the ability of the investor to syndicate limited.

12.4.1 Pre-emption rights

12–15 It is normal for articles used in investment capital transactions to include pre-emption rights upon a transfer which are appropriate to private companies. First and foremost, however, the institutional investor will wish to ensure that it can transfer shares within its own group and also that it will be able to syndicate to another investor if necessary without having to go through the pre-emption hurdle. If syndication after the transaction is suggested, management should explore the reasons why. If the reason is insufficient funds and the management are expecting to seek further funding later, perhaps by way of example for acquisition, then it may be that the private equity house is an inappropriate

choice. Moreover the relationship between the private equity house and management is a partnership and the management have every right to feel comfortable with the purposes of the syndication. Nevertheless the institution is likely to insist on an article allowing syndication.

Any shares (other than any shares in respect of which the holder shall have been required by the directors under these articles to give a transfer notice or shall have been deemed to have given a transfer notice) may at any time be transferred:

(1) by any member being a company (not being in relation to the shares concerned a holder thereof as a trustee of any family trusts) to a member of the same group as the transferor company; or

(2) by a holder of preference shares or preferred ordinary shares which is a fund or by its trustee custodian or nominee:

  (a) to any trustee nominee or custodian for such financial institution and vice versa;

  (b) to any unit holder, shareholder, partner, participant, manager or advisor (or an employee of such manager or advisor) in any such fund;

  (c) to any other fund financial institution managed or advised by the same manager or advisor as the transferor; or

  (d) to any person, company or fund whose business consists of holding securities for investment purposes; or

  (e) to any co-investor or its trustee, nominee or custodian thereof; or

(3) to a nominee, custodian or to a member of the same group of any of the persons referred to in sub-paras (a), (b), (c) or (d) of para.(2) of this art.[ ].

12–16 The definition of a fund should include any bank, investment trust or investment company, unit trust, building society, industrial provident or friendly society or any other collective investment scheme (as defined by the FSMA), any investment professional (as defined in art.19(5)(d) of the FSMA (Financial Promotion) Order 2001 (the "FPO")), any high-net-worth company or unincorporated association or high-value trust (as defined in the FPO art.49(2)(a)–(c)), partnership, limited partnership, pension fund or insurance company or any person who is an authorised person under the FSMA, any subsidiary undertaking or parent undertaking of any of the foregoing and any co-investment scheme in relation to any of the foregoing.

It is unlikely that the investor will be able to syndicate more than 12 months after the transaction even if he/she should wish to do so. The management's lawyers will probably therefore have little difficulty in restricting the syndication provisions to 12 months.

Where transfer provisions are included allowing movement between corporate groups, provisions should also be included to ensure the transfer back to the holding company if ownership of the subsidiary changes to a third party. So, for example, if the original member has left or is leaving the wholly owned group of companies which the transferee is leaving, then the transferee will be obliged to transfer the shares back to the original member and in the event of the transferee failing to execute such a transfer and to present it to the board duly stamped for registration of the transfer, the board may appoint some person to execute (an)

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instrument(s) of transfer of such shares in favour of the original member and shall thereupon cause the name of such original member to be entered in the register of members of the company as the holder of the shares.

12–17 Other matters that are often included in the provisions permitting transfers without triggering the pre-emption clauses are:

- where more than 95 per cent of the members agree such a transfer;
- a transfer in consequence of the death or bankruptcy of an individual member to allow for any transfer that such person, if not dead or bankrupt, could undertake;
- to a close relation (but always include a clause providing for the transfer back if such a person ceases to be a privileged relation, for example following a divorce);
- to or within a family trust. This is usually to facilitate tax planning for the managers; and
- for the purpose of warehousing. We will see later in the chapter that a departing employee or director will be obliged to sell his/her shares. The investor will be keen to ensure that these shares are held until such time as a replacement for the departing executive has been found and will be used to attract suitable management.

Broadly speaking, having dealt with permitted transfers, any other transfers of shares which are offered for sale, must first be offered to other shareholders before they can be transferred to third parties.

Market value

12–18 The market value of shares is usually determined by virtue of a third party having offered to buy them at a specified price, in which case such price then becomes the "sale price". If there is not such a third party available, the board and the proposing transferor will attempt to reach agreement on the sale price. Failing this, final determination of the sale price representing the fair market value of such shares will be made by independent third parties such as auditors or an independent accountant or merchant bank. Once the sale price has been determined provisions relating to the transfer of shares usually provide that an "offering-round" procedure begins. The proposing transferor must serve a transfer notice notifying the company of his intention to sell and constituting the company as his agent to offer the shares to the members in priority to a transfer to a third party. There is no fixed sequence and any number of permutations are possible. For example:

- shares may be offered to other members of the same class in priority to all other shareholders of the company; or
- shares may be offered with equity shares to all other equity shareholders pro rata to their total holdings of equity shares in the capital of the company, irrespective of the class of equity concerned; or
- there may be an intervening right for the founders or key members of the management team to pick off the shares before a general offer round; or

- there may be an intervening right for the investor or the board to specify that shares should not be offered round but instead should be "warehoused".

In addition, it is likely that the articles will contain an absolute prohibition on the sale or transfer of shares to someone carrying on business in competition with that carried on by the company and its subsidiaries. From an investor's point of view, this is not always prudent, as it is quite possible that the highest price offered for the shares would come from a rival competitor.

12.4.2 Compulsory transfer notice

12–19 The articles will usually provide that if an executive director or employee ceases to be employed by the investee company then he/she shall be deemed to have served a transfer notice in respect of those shares he/she holds in the capital of the investee company. There are a number of variations to this provision. For example, management may be allowed to keep an increasing proportion of their shares as time elapses from the date of the investment until such cessation occurs. Additionally, compulsory transfer notices may be excluded if cessation of the executive's appointment with the company is a result of:

- wrongful dismissal or redundancy;
- retirement at normal retirement age or due to ill health or disability;
- death; and/or
- [if a majority of the non-executive directors and/or the investors sold with the investor's approval.]

Generally, however, any negotiation of the compulsory transfer provisions is a negotiation as to price and not as to whether the transfer notice is obligatory or not.

12–20 Quite often the investor, in order to ensure the continuing commitment of the managers at least until such time as he/she understands the business, will include a clause preventing a manager from selling his/her shares for an initial period.

No transfer notice shall be served in respect of [ordinary shares] until the [third] anniversary of the adoption of the articles other than served in accordance with the art.[ ] (the compulsory transfer provisions) or with the consent of the investor's director.

A strong argument can be made by the investor that not only are they investing in the business but they are also investing in the management who should not be free to walk away prior to the private equity house exiting.

It is not uncommon to see "good and bad leaver" provisions included in the compulsory transfer provisions so that management who walk out or leave the company voluntarily are penalised by receiving an amount equal to whichever is the lower of market value or the amount which they subscribed or par. This will deprive management of any uplift in the market value for a specified period from completion.

Note that a mandatory transfer notice merely obliges a party to offer his/her shares for sale and does not oblige the other shareholders to buy such shares.

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12–21 Set out below is a fairly common provision found in the articles.

1 Compulsory transfers—management shareholders

1.1 In the case of a relevant member (being a person who has acquired shares from a relevant executive) or the relevant executive (defined as an employee, director or consultant of the company or a subsidiary of the company) in relation to a relevant member ceasing to be a relevant executive at any time, then within 12 months after such cessation, the directors may serve notice on such relevant member requiring such relevant member to give a transfer notice (as defined in art.5) in respect of all of the shares held by such relevant member for a price per share of either:

(a) if such relevant member or relevant executive in relation to a relevant member shall have ceased to be a relevant executive in circumstances involving a breach by the relevant executive of his/her service agreement or leaves voluntarily (even if proper notice has been given) except on death, ill health or on retirement age, then the price per share and market value as determined in accordance with art.[ ]; and

(b) if such relevant member or relevant executive in relation to a relevant member shall have ceased to be a relevant executive for any other reason than those reasons specified in para.(a), then the price per share shall be market value as determined in accordance with art.[ ].

In the clause above, the directors have the right to require the relevant executive or relevant member to transfer his/her shares upon a relevant event. In fact it is more usual to see a deemed transfer provision trigger immediately upon the event occurring. In any event, the draftsman should ensure that in addition to this clause there is an "attorney" clause allowing a member of the board to execute the necessary transfer documents should the relevant executive or relevant member fail to do so.

12–22 If this clause is to stand, the relevant executive will be concerned that para.(a) cannot be exercised if he has been wrongfully dismissed. However, for the relevant executive to prove wrongful dismissal will be time consuming and costly. His advisor may attempt to include something along the following lines as a compromise.

1 If a transfer notice is served or deemed to be served pursuant to art.[ ] and the relevant executive is not found to be wrongfully dismissed from his employment with the company in breach of any service agreement, the sale price shall be the lower of the par, the subscription price per share and market value.

2 If for the purpose of this article, the directors and the relevant executive cannot agree as to whether or not his/her dismissal was wrongful, the matter shall be determined by a Queen's Counsel experienced in employment law who shall be appointed by agreement between the directors and the relevant executive or, failing agreement on such appointment within seven days of commencing negotiations on such appointment by the Chairman of the Bar Council on the application of either party (the QC). The parties shall jointly instruct the QC and shall submit, so far as possible and as soon as reasonably practicable, an agreed statement of facts or, failing such agreement, their separate statements of fact. The parties shall use their reasonable efforts to ensure that the QC shall give and be able to give his/her determination of whether or not the dismissal was wrongful within 14 days after the dispute has been referred to him/her. Any determination of the QC shall be final and binding on the parties (in the absence of manifest error) and he shall act as expert and not as arbitrator. The costs of the QC shall be [shared between the relevant executive and the company] [borne by the company].

12–23 Often, as can be seen, most of the discussion will revolve around the price to be paid for the shares. The investor will be more likely to look more kindly on employees leaving who are "good leavers". This will be defined as an employee leaving by reasons of death, disability or incapacity. The management's lawyers should extend the same reasons to those of the spouse or immediate family of the employee. Doctor's advice may cause a manager to leave the company either because of his/her own health or that of his/her immediate family. It is difficult for any caring investor to argue against these reasons. Moreover, it is a time above any when the employee will require full value from his/her shares. In addition, an investor will agree to a good leaver being one who has been unfairly dismissed. The management's lawyers should attempt to ensure that this is extended to situations where the company chooses not to renew a fixed-term contract or after proper notice has been given. If the investor accepts that he is likely to exclude termination made summarily, other than on grounds of insanity or illness. Of more concern to the investor will be a desire to prevent a good leaver going to work for a competitor and the investor will be keen to ensure that a proviso to a good leaver definition is included as follows:

> Provided that any relevant executive who, before the relevant transfer of shares pursuant to the transfer notice is employed by or acts as consultant to, or agrees to be employed by or act as consultant to, any competitor of any member of the [group] shall be deemed not to be a [good leaver].

12–24 A further concern often raised by the management's lawyers is that the company may dispense of the relevant executive's services at a crucial time, either prior to a sale or a listing and as a result the employee will not enjoy the fruits of his/her hard work at the company by sharing in any enhanced premiums paid on a sale or listing. As a compromise, the following may be included:

> If there is a realisation within [six] months after the date of any transfer resulting from death or ill health pursuant to art.[ ] or from a wrongful dismissal pursuant to art.[ ], the holder or holders of the ordinary shares which shall have been transferred pursuant to arts [ ] or [ ] (each a "relevant transfer share") shall upon the realisation receive payment in respect of each relevant transfer share from the person or persons who hold such shares at the time of the realisation of an amount for each relevant transfer share equal to the amount by which the value of the share on the realisation exceeds the price paid to the relevant member or relevant executive in

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