SECONDARY BUYOUTS
ADVISING THE MANAGEMENT TEAM

Johnathan Rees of Laytons LLP explains the principal commercial issues facing management in secondary buyouts with particular emphasis on their equity arrangements with the new investor.

A secondary buyout (SBO) involves the sale of a group (the target) by a private equity fund and the target's management team to a company (newco) funded by a new private equity investor in conjunction with the management.

The SBO has become a popular exit route for private equity funds. SBOs raise a number of questions and challenges from the perspective of the acquiring investor and its limited partners (*see box "Pros and cons of an SBO"*).

Although the process and documentation are similar to that of a primary buyout (PBO), SBOs raise particular issues and challenges for the management and the new private equity investor. This article looks at the principal commercial issues facing the management in these transactions with particular emphasis on their equity arrangements with the new investor.

PROCESS

From the management's perspective, an SBO involves two transactions running in parallel: the sale of the target; and an investment by the new investor and the management in newco.

Typically, the management will sell their shares in the target in return for a combination of cash, shares and loan notes of newco. The transaction may also trigger the exercise of the management's share options in the target, which would commonly either be exercised on completion or exchanged for share options in newco.

As part of the acquisition process, the incoming investor will present the management with their proposed equity arrangements. The new investor will want to ensure that its offer is competitive and motivates the management. It will be even keener to ensure that the management have a vested interest in terms of the success of the business so that their respective interests are aligned. In addition, the management will have a number of different, and potentially conflicting, roles in the transaction process which require careful management (*see "Conflicts" below*).

FUNDING STRUCTURES

Depending on the size of the transaction, the corporate structures deployed by the new investor will typically contain a chain of corporate entities, one or more of which may be incorporated in an overseas jurisdiction (*see box "Simplified SBO structure"*). While tax efficiency from the target group's perspective will be key, the structure also plays a key role in helping to generate the return on the management's equity (*see box "Funding structure"*).

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Pros and cons of an SBO

Pros	Cons
• A secondary buyout (SBO) is perceived as less risky than a primary buyout (PBO).	• SBOs offer fewer "stellar" returns than PBOs.
• The selling investor has "de-risked" the target business and introduced good governance practices, and so improved the quality of information.	• The selling investor has already extracted value and taken the "low-hanging fruit".
• An SBO has an established management team.	• An SBO has to work harder to generate returns.
• A change of ownership introduces fresh impetus and motivation.	• An SBO is less attractive to limited partners invested in both seller and buyer investors.

The funding will typically be a combination of equity (ordinary shares) and debt in the form of senior (bank or high-yield debt) and unsecured shareholder debt (preference shares or loan notes, or both).

Senior debt

Depending on the transaction size, an investor may finance the debt element through a mixture of preference shares and loan notes (*see "Investor investment" below*). On larger deals, any debt requirement will normally be provided by one or more banks or, increasingly, by alternative lenders. This debt can include, in order of risk, senior (unsubordinated) debt, mezzanine debt and payment-in-kind notes (where the company can satisfy the interest by the issue of further notes). This debt will be repaid in priority to the investor and the management team.

Investor investment

The investor's investment is known as the "institutional strip" and typically takes the form of a combination of ordinary shares and shareholder debt in the form of preference shares or loan notes, which will entitle the investor to interest in the form of a fixed dividend and interest respectively.

Management investment

The management's investment in newco will take the form of new ordinary shares, known as the "sweet equity", which will be subscribed for in cash. Depending on the circumstances, the management may also acquire institutional strip in exchange for their target shares (*see "Rollover" below*). The sweet equity is priced cheaply and is intended to incentivise the management on the basis that the return on this investment is potentially significant.

DOCUMENTS

The investment documents on an SBO closely follow that of a PBO and will principally include:

- For the equity investment side of the transaction: a management term sheet; an investment agreement; a shareholders' agreement; articles of association; and a disclosure letter.
- For the mergers and acquisitions (M&A) sale side of the transaction: heads of terms; data room and due diligence materials; a share purchase agreement; a management warranty deed; and a disclosure letter.

The management will be involved to a greater or lesser degree in the negotiation and finalisation of each of these documents (*see "Conflicts" below*).

KEY ISSUES

An understanding of the economic and commercial aspects of an SBO and its financial model are key for the management (*see box "Checklist of issues"*). The key terms should be settled before the legal documents are circulated to avoid the risk of damaging relations with the investor in the latter stages of the transaction process.

The management should also understand the investor's red lines. The management's advisers have a key role to play in this regard in ensuring that the management's expectations are realistic and that, as far as possible, negotiations are pragmatic and focused.

The term sheet issued by the investor setting out the arrangements for the management's participation in newco will typically cover the following areas: capital structure (sweet equity); management rollover; anti-dilution; leaver provisions; drag along; tag along; lock-up; investor vetoes; management vetoes; further funding; M&A; restrictive covenants; out-performance (ratchet); management warranties; board composition; fees and expenses; exit; and refinancing. Some of the key aspects of the term sheet are analysed below.

Capital structure

In discussions relating to the capital structure, key issues for negotiation around the management's sweet equity will involve the following:

Equity percentage. The proportion of newco's fully diluted equity capital, that is, taking into account any share options and the like, represented by the sweet equity will determine the management's financial return on the SBO exit. This percentage will vary from deal to deal and by size of the deal but, as a rule of thumb, is commonly between 10% and 20%.

Cost. The cost of the sweet equity is usually low as it is intended to provide a tax-efficient incentive to the management. There are important tax considerations to be taken into account, particularly if the management are acquiring the shares at a discount to their actual value (*see "Tax" below*).

Funding. To the extent that the sweet equity is not financed from any cash proceeds on the PBO, any loan made by a newco group company to fund the management's acquisition of shares should be scrutinised carefully for any disadvantageous tax treatment. Alternatively, part-paid shares can be issued to assist the management in their funding arrangements.

Allocation. The apportionment of the sweet equity among the management is a sensitive discussion. Important considerations include:

- The proportion of the management's sweet equity "pot", which is reserved for future hires and appointments.
- Future M&A transactions and the use of equity in their financing.
- How any unallocated or unissued part of the pot is dealt with on an exit of the investment.

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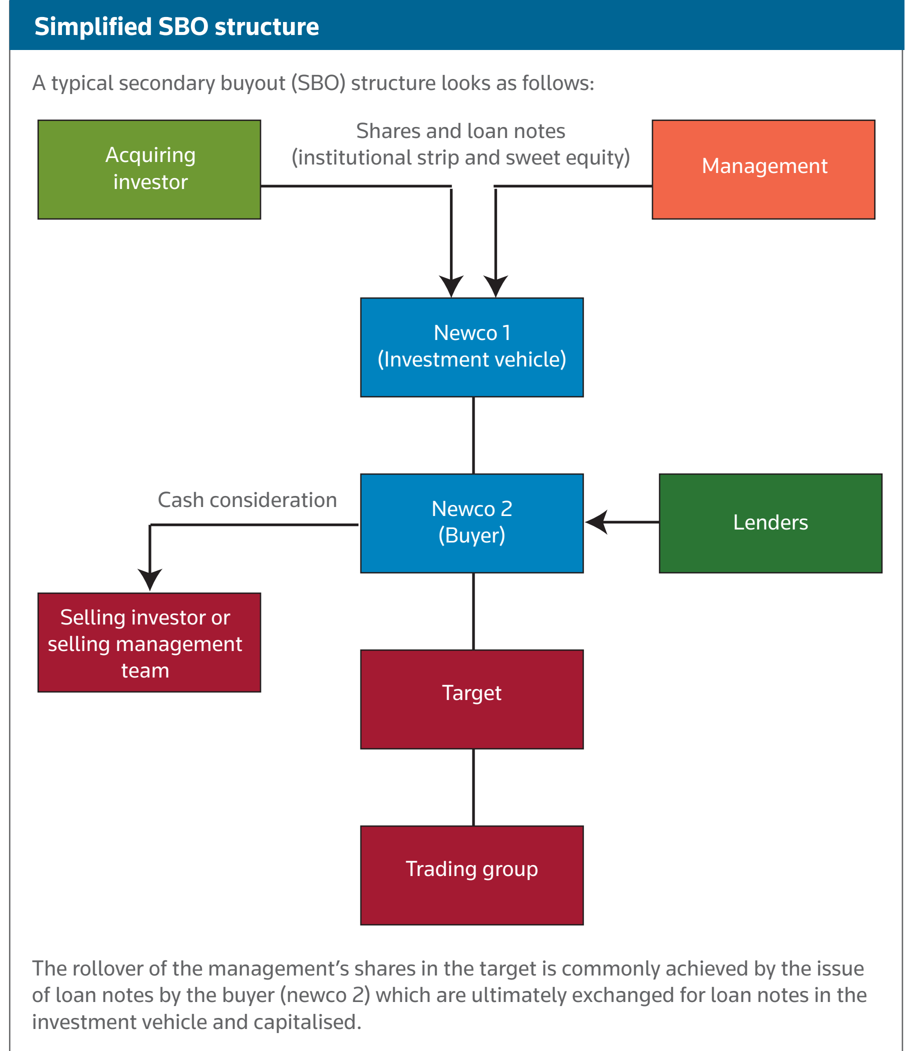

The management will typically wish to ensure that any unallocated sweet equity is issued to them on an exit (even though there may be an associated tax charge) and that any equity allocation to an incoming chairman or other non-executive director should be funded from the investor's share of the equity. The latter is not universally acceptable to investors. The management will wish to ensure that as far as possible the sweet equity is not diluted by further issues of shares (*see "Anti-dilution" below*).

Leaver provisions

Leaver provisions are one of the most sensitive areas of negotiation for the management as it goes to the heart of their financial compensation. These provisions deal with the right of a manager who leaves the business before an SBO exit (a leaver) to retain their shares and the price payable for any shares that they are forced to sell (*see "Leaver provisions" below*).

Rollover

The new investor will invariably insist on a reinvestment by the management of part of the proceeds of sale of their target shares. The investor will want to ensure that the management are suitably motivated to drive the value of newco and that the interests of the management are aligned with those of the investor. The reinvestment will also provide some additional comfort for the investor given its limited warranty protection (*see "Warranties" below*).

Typically, this reinvestment, or "rollover", will take the form of an exchange of some of the management's target shares for new shares in newco or the sale of the management's target shares and the investment of part of the cash proceeds for shares or loan notes of newco, or a combination of both. A rollover can also help a manager's tax planning if they do not have the requisite period of employment to qualify for entrepreneurs' relief.

The proportion of cash proceeds that the management will be expected to reinvest will vary but, as a rule of thumb, it will generally be between 40% and 50% after tax. The investor is usually less concerned with the amount being reinvested than the percentage of proceeds that it represents.

The management will argue that any amount of their investment in newco beyond their sweet equity should mirror, in economic terms, the investment made by the investor. In other words, any rollover should be in the form of those preferred ordinary shares, preference shares and loan notes taken by the investor and in the same proportions. This part of the management's investment will rank ahead of their sweet equity, with the economic effect being that the management will participate equally with the investor further up the "waterfall" (that is, the application of the proceeds on exit of the investment) and so go some way to de-risking their reinvestment (*see "Waterfall" below*).

The management will also argue that their reinvestment is protected from any leaver arrangements. This position is increasingly resisted by investors and typically some form of penalty applies to the management's interest in the institutional strip (*see "Leaver provisions" below*).

Anti-dilution

The management will wish to ensure that, as far as possible, the sweet equity is not diluted by any further issues of shares. Accordingly, as a default position, the management will require that they have the right to subscribe pro rata alongside the investor on any future share issues. The principle should not be contentious subject to limited exceptions; for example, where emergency funding is required by the target group or where shares are issued as part of an M&A transaction.

In the case of emergency share issues, the management might also request catch-up rights to subscribe subsequently for more shares at the relevant issue price.

The management will have particular regard to future M&A transactions. Specifically:

- The management should have transparency on any future M&A plans and the amount of the sweet equity "pot" reserved for those allocations. They will reasonably argue that funding for further acquisitions should not dilute their equity.

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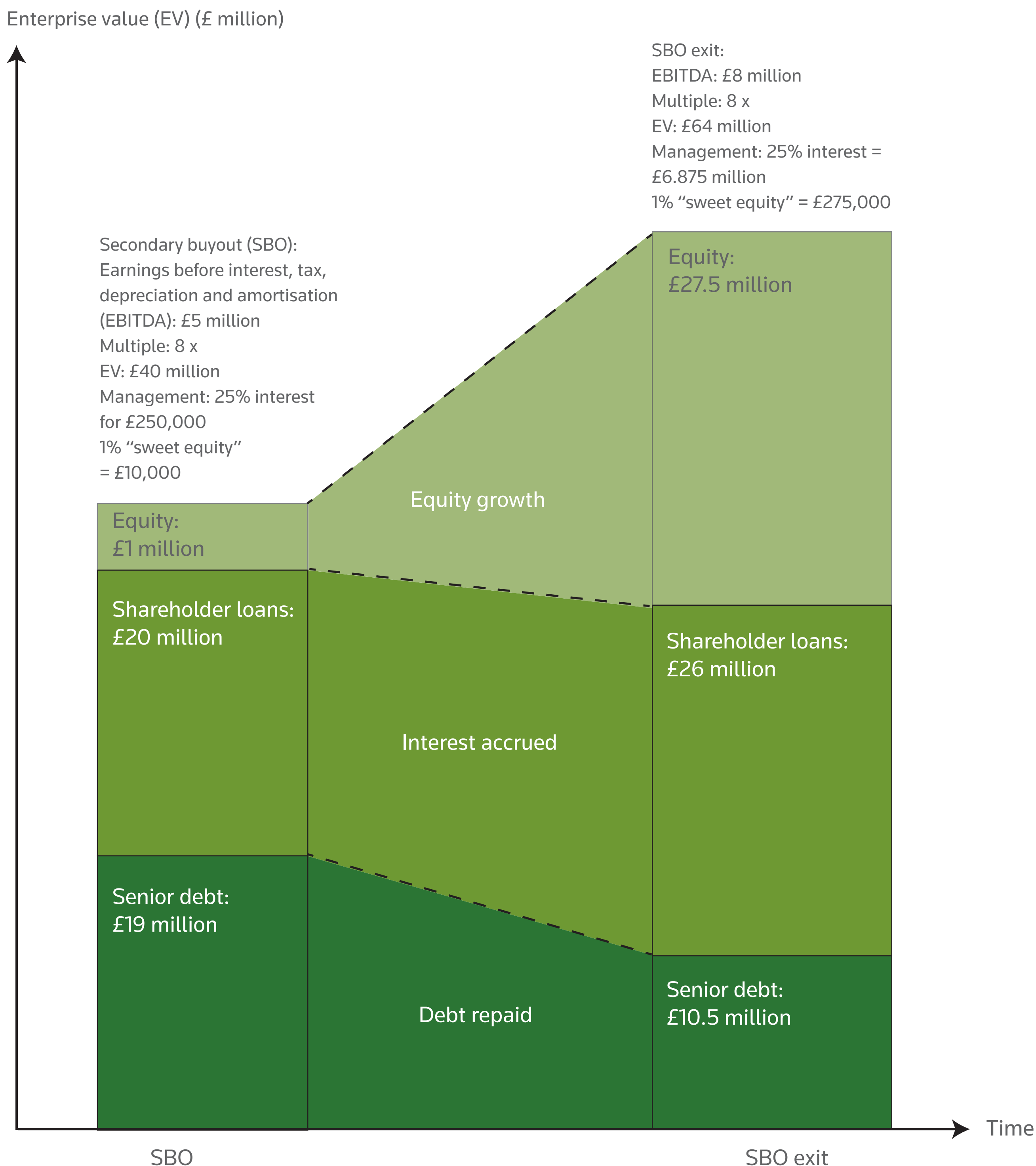
Funding structure



The value of the management's ordinary shares on exit has increased from £250,000 to £6.875 million representing a multiple of around 27.5. While the investor enjoys the same return on its equity and receives interest on its loan notes, its actual cost of investment (£20.75 million) means that the new investor's overall return on its equity investment is inferior to the management's return. In this way, the investor's investment in the non-equity elements of the institutional strip (the investment made by the investor in newco group) acts as a premium to the cost of the investor's equity subscription.

- The investor will typically agree a financial threshold below which funding for these transactions is financed through debt facilities. The management will expect to have the right to invest on the same terms as the investor beyond that threshold to maintain their equity percentage.

Leaver provisions

The treatment of a leaver's (that is, an employee or director shareholder who ceases to be an employee or director) shares is one

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of the most contentious areas of negotiation, not least as this goes directly to the heart of the management's financial deal. There are two principal considerations:

- Whether a leaver should be permitted to keep all or any of their newco securities.
- If not, what is the price that a leaver should receive for any securities that they are required to sell.

These matters in turn are determined by the type of leaver in question. There are a few principles from the perspectives of the investor and the management that provide some context to these discussions.

Investor. Typically, an investor will be reluctant for any leaver to retain their shares after departure, regardless of the circumstances of departure and whether the shareholding represents sweet equity or rollover shares.

The investor will want to ensure that the management are committed to the target business for a minimum period (ideally until exit) before they can realise any meaningful financial return. The sweet equity is priced cheaply with the specific intention of incentivising the management to generate enhanced value on the SBO exit. The investor and the remaining managers will want to use a leaver's shares to incentivise and attract a replacement.

The prospect of a leaver retaining their sweet equity and continuing to benefit from the efforts of the remaining managers will not sit comfortably with the investor and nor will the potential logistical implications of an absent shareholder for any exit process. The remaining managers are likely to share this view. Subject to the target's working capital position, the investor may reserve the right to issue loan notes to the management to satisfy a leaver payment.

The management. Where the SBO follows a successful PBO, management may feel in a stronger negotiating position. If the management have been unable to realise a meaningful return on the PBO exit, they will be reluctant to see their entire investment at risk once again. Accordingly, the management will expect to realise some of their PBO exit proceeds and for their reinvestment in newco to be ring-fenced from the leaver provisions. A leaver will want to ensure that any leaver-related payment is paid in full in cash on departure.

Checklist of issues

For a successful secondary buyout, the management will need to understand, and have made decisions on, a series of key points:

- ✓ The cost and size of the sweet equity "pot".
- ✓ The point at which the management's sweet equity participates in exit proceeds, because an excessively leveraged structure can leave limited meaningful value for the sweet equity.
- ✓ How that "equity break" is calculated and the target EBITDA (earnings before interest, tax, depreciation and amortisation) that it assumes.
- ✓ The deliverability of the proposed business plan and safety of the funding structure.
- ✓ The investor's proposed returns and whether the management's incentives represent a fair reward.
- ✓ In respect of any rollover the management will need to:

- understand the capital structure into which the management are investing and where their investment sits in that structure;
- adopt cautious tax assumptions when calculating net proceeds available for re-investment;
- maximise the amount of cash that the management are permitted to take out on the primary buyout;
- de-risk their investment by ensuring that any rollover is in the form of the institutional strip and on the same terms as the investor;
- exclude the reinvestment from the leaver arrangements;
- ensure that the vesting provisions (leaver definitions and vesting periods) fairly reflect the management's expectations in the context of newco's capital structure and growth plans;
- include a worked example of any ratchet, as the drafting is invariably complex and it is helpful to have an illustration.

Depending on the SBO's funding structure and gearing, it may be a number of years before newco group's valuation grows to a point where the management's equity has any significant value. This, in turn, will affect the fair market valuation (FMV) of a leaver's shares at the relevant time. Given that FMV is the best outcome that a leaver can expect to receive for their shares, the funding structure and business plan will influence the management's approach to any vesting schedule (*see below*).

Good, bad and intermediate leavers. There are essentially three types of leaver: good, bad and those in between (intermediate). An investor will commonly have a standard approach to these categories, which are linked to the circumstances of the leaver's departure.

Broadly, a good leaver is a manager who leaves the target business under no-fault circumstances, such as illness or death. An investor will typically exclude illness that is related to drug or alcohol abuse and, increasingly, retirement and redundancy. A bad leaver is generally a manager who resigns

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voluntarily, other than in circumstances amounting to constructive dismissal, or who has been dismissed for cause, that is, they are guilty of conduct justifying summary dismissal. The management will reasonably argue that exceptions should include unfair or wrongful dismissal. The investor will require that mere procedural errors in a dismissal process are disregarded for this purpose.

An intermediate leaver category is used to capture a leaver who:

- Is neither good nor bad.
- Leaves the business within a short period of time following completion.
- The investor wishes to designate as intermediate and would otherwise be a bad leaver.

The management's optimum position will be to have a narrow list of circumstances in which they will be designated as bad leavers and for the default position to constitute them as good leavers. Unsurprisingly, the investor approaches this debate from a different angle and will seek to define both good and bad leavers, and for intermediates to be the catch-all category (*see box "Negotiating positions on leaver provisions"*).

Negotiating positions on leaver provisions

	Management position	Investor position
Good leaver	• Any leaver other than bad or intermediate.	• Illness or death.
Bad leaver	• Dismissal for cause or voluntary resignation.	• Voluntary resignation. • Breach of restrictive covenants. • Any leaver other than good or intermediate.
Intermediate	• Good leaver who leaves within a specified period of completion.	• Any leaver who is not a good or a bad leaver. • A bad leaver designated as intermediate by the investor.

Vesting. Having settled on the leaver definitions, the next issue is the rights of that leaver: specifically, whether a leaver is able to retain their shares or, if not, what price is payable for those shares. The outcome of this debate has material consequences for the management. The issues vary according to each category of shares.

Given the nature of the sweet equity investment (it is more in the nature of an incentive) there is a compelling argument that a leaver cannot retain their sweet equity. As explained, an investor will want to use a leaver's sweet equity to recruit a replacement and the remaining management team will be demotivated by a leaver benefitting from their efforts. The management will argue however that, provided they are a good leaver, they should receive FMV for their shares regardless of the date of departure. Given the investor's key principles, it will typically insist on a sliding scale of sweet equity being eligible for FMV and will argue strongly that any person becoming a leaver soon after completion regardless of the circumstances should not benefit. Whether that FMV scale operates on an annual, half yearly or quarterly basis will also be material to a leaver.

Perceptions of the management and the investor around the rollover shares are very different. The management may justifiably regard themselves as co-investors of the investor to the extent of their reinvestment on the basis that it represents cash that crystallised on the PBO exit, which they have agreed to exchange for newco shares. In contrast, the investor will view the rollover more as a standard prerequisite of any SBO intended to align the interests of the parties. For the same reason, the investor is also likely to resist the contention that this investment should be excluded from the leaver provisions and this attitude is becoming an increasing trend.

In terms of rollover shareholder debt, the management will typically require that their reinvestment is made in the same proportion between shares and debt as the investor's proportions. In this way, the management will enjoy some return (fixed dividends or interest) and also de-risk part of their investment.

Given the conflicting positions, the permutations around vesting arrangements are numerous (*see box "A typical vesting proposal"*). An investor may also seek to freeze the interest payments on a bad leaver's loan notes and, in some cases, will also seek to adjust the principal. A compromise might involve interest being suspended, rolled-up and paid on an exit.

Vesting discussions tend not to be overly scientific and are often reduced to a choice between a cliff-edge (that is, where vesting occurs in full on a specified event or date, such as an exit) or straight-line (that is, time-based vesting where an agreed percentage of shares vest at set intervals, such as by reference to the number of months or years of employment served during the relevant period). Given that an investor typically holds its investments for four years on average, a 25% per annum straight-line vesting arrangement is fairly common. There is an increasing trend among investors towards limiting the overall number of a leaver's shares that can vest before an exit. Commonly, the limit is around 80%.

Transfer of shares

There are a number of key considerations in respect of the transfer of shares by parties to an SBO.

Pre-emption. The default position is that, subject to a few specific exemptions, a right of first refusal for existing members should apply on any transfer of shares. The investor will typically specify a number of exclusions to this rule to enable it to transfer to other funds in its group and for the management to transfer shares as part of their tax planning, and these are known as permitted transfers (*see feature article "Private equity: understanding share transfer provisions", www.practicallaw.com/w-018-4120*).

The sequence of the offer-round will vary but the management will commonly propose that any shares held by them, sweet or otherwise, are first offered to fellow members of their team and otherwise held for the benefit of the remaining management team or new hires; for example, through an employee benefit trust or other warehousing structure.

The investor's primary concern will be that sweet equity shares are available

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A typical vesting proposal

Leaver	Sweet equity		Rollover shares	
	Management	**Investor**	**Management**	**Investor**
Good	• Fair market value (FMV) for 100% of shares.	• FMV capped number of shares.	• Retain pending exit or cash out at FMV for 100% of shares (at option of manager).	• Retain pending exit or cash out at FMV, capped number of shares (at option of investor). • Retained shares disenfranchised.
Bad	• Cost.	• Lower of cost and FMV.	• Same as good leaver.	• FMV but cap on future growth.
Intermediate	• FMV for agreed proportion of shares.	• Cost if leaver in year 1. • X% at FMV for quarter 5 leaver, Y% at FMV for quarter 6 leaver, and so on, subject to an overall cap.	• Same as good leaver.	• Same as good leaver.

for distribution among existing or future members of the management team and are likely to insist on equal rights for all shareholders in relation to other equity or, alternatively, that the matter is determined by the remuneration committee.

However, an investor will often insist that any transfer of shares by the management, other than a tag along (*see below*), will be subject to its consent. This reduces the significance of these right of first refusal mechanics.

Drag along. A key issue for an investor is its ability to realise its investment in the knowledge that any potential buyer is unlikely to be willing to buy anything less than 100% of the target. Accordingly, the investor will ensure that it can require the management, and other shareholders, to sell alongside it on the same financial terms, and for the rights of first refusal on transfer of shares to be disapplied in those circumstances.

It is not inevitable that the management's and the investor's attitudes and interests will be aligned on a prospective exit. From the management's perspective, the commercial issues might range from being able to influence the timing of a sale (for example, to allow the opportunity to develop the business and enhance value) to a minimum exit price or the right to match the buyer's price. In addition, the management will want to ensure that they cannot be forced to accept any form of non-cash consideration. In practice, an investor will not want any block on its ability to force a sale.

Tag along and co-sale. The corollary of the investor's drag-along right is the right for the management not to be left behind if the investor finds a buyer for its shares. This tag-along right requires the investor to procure that its proposed buyer will buy the management's minority stake on the same terms. This is commonly extended to capture any transfer of shares by an investor, not merely one resulting in a change of control, so that the management have the right to sell a pro rata number of their institutional strip shares alongside the investor. This is known as a co-sale.

Permitted transfers will fall outside of these arrangements. That said, the management will look closely at the substance of any transaction where the investor realises any part of its investment for more than cost, regardless of whether the buyer is a group or syndicate member of the investor. The management will be concerned to capture any transfer that represents a partial exit on the basis that those arrangements should trigger a purchase of a corresponding amount of their institutional strip holding.

Refinancings

It is reasonably common for the investor to look to recover some of the cost of its investment as part of a wider refinancing or recapitalisation of the target group. The management will argue that they should share equally with the investor the economic benefits of a refinancing by participating in the proceeds pro rata to their holding of the relevant strip instruments.

Restrictive covenants

The investor and remaining management team will want to ensure that the target is adequately protected should any member of the team leave. Restrictions on a manager's activities for a period of time following departure, typically 12 to 24 months, are common in the equity documents. These will include non-competition and the non-solicitation of staff, customers and suppliers and non-disparagement provisions.

The management should find these principles acceptable but will want to ensure that any garden leave or notice periods in their service agreements are taken into account in calculating the relevant restricted period. As similar restrictions will be included in the management's service agreements, they should ensure that these are consistent.

Management veto rights

While the investment documents will include a traditional suite of protections for the investor relating to operational and financial matters, the management should also consider those areas where they might require a veto. These areas could include:

- The issue of further shares other than on pre-emptive basis, with agreed exceptions.

- Share buybacks and distributions that are outside the scope of the equity documents.

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- Constitutional changes, such as resolutions to wind up the company or to alter its articles that are materially prejudicial to the management's economic interests.

- Changes to the terms attaching to the investor's loan notes or preference shares.

- Non-arm's length transactions with the investor group.

- The granting of any share options.

As minority investors in newco, these are all matters that are outside the management's control and represent legitimate concerns for the management team. These veto rights will be exercisable either by a majority of the managers or by a representative appointed by them for the purpose.

Conflicts of interest

Typical conflicts among the management on a secondary buyout include:

Sell side	Buy side
Director of target.	Director of newco.
Employee of target.	Employee of newco.
Target shareholder.	Newco shareholder.
Warrantor under the share purchase agreement and investment agreement.	Warrantor under the investment agreement.
Assisting with seller due diligence.	Assisting with newco's due diligence.

Board composition

The management team will wish to be able to appoint directors to the boards of the relevant target group companies not least to ensure compliance with the relevant provisions of the equity documents. While, in principle, an investor may be willing to accept a management appointee, it will commonly resist this becoming a contractual right.

The investor will invariably have the right to appoint a combination of non-executive directors, the chairman and observers and, in certain circumstances, to control the board. Given adequate contractual protections in the equity documents, the composition of the board is likely to be less contentious than the prospective fees that the investor might levy (*see "Fees, costs and expenses" below*).

Ratchets

A ratchet allows the management team to get a larger slice of the proceeds if the target business exceeds its projected performance, so that the sweet equity pot increases by reference to the achievement of specific financial hurdles. Ratchets are frequently used as an incentive by the investor both to improve the value of the sweet equity offering to the management and to encourage them to work harder to improve the performance and value of the target group.

A typical ratchet is linked to the return on the investor's money represented by the exit: this may be a hurdle based on a money multiple but may also include a hurdle linked to the internal rate of return (IRR), which will factor into account the time between investment and exit. Investors will commonly have a standard view on the use of ratchets and their preferred form.

From the management's perspective, the devil is very much in the detail. Beyond the multiples and the amount of additional equity available, the management will need to pay careful attention to:

- The definitions of the components of the mechanism; for example, the methods of measuring performance under the hurdles (the money multiples or IRR).

- What is included in calculating the investor's return, that is, the investor's inflows and outflows.

- The mechanics of the ratchet; for example, ideally the initial equity structure should assume the ratchet is achieved so that the number of the management shares in issue stays the same and the investor's shares convert into deferred shares.

As a rule of thumb from the management's perspective, a money multiple is a less complex concept than IRR, and less capable of manipulation, so is usually the prefered measure for the management. The tax implications of these arrangements will also need to be addressed (*see feature article "Management and MBOs: risks and rewards", www.practicallaw.com/3-201-0755*).

Follow-on funding

The management need to understand the investor's appetite for further funding and how this will affect their equity holdings. If the target group's growth strategy includes M&A transactions then a plan should be discussed with the investor at the outset so that the management are clear on its impact for them and their equity.

Fees, costs and expenses

There are a range of fees that an investor might levy as part of its transaction costs from deal and arrangement fees (which are typically 0% to 4% of the investment) to monitoring, non-executive director, advisory and exit fees which will be met out of newco's investment funds. The management will also expect their advisory fees and costs to be paid from those investment funds.

Exit

On an SBO exit, the exiting investor will give few warranties beyond those linked to ownership of its shares. The management will be expected to bridge the gap in terms of disclosure and liability (*see "Warranties" below*).

The new investor is also likely to require the management to participate in any lock-up appropriate to the relevant SBO exit, such as on an initial public offer. Although these are customary measures, the management need to understand the financial implications of these arrangements before agreeing to them.

Warranties

The management may be in the invidious position of giving warranties on the PBO exit (on the sale of the target to newco) and separately to the investor and newco under the SBO investment documents. The PBO exit warranties are commonly included in a separate management warranty deed.

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Where the management are receiving little or no cash on the PBO exit, they should consider:

- The right to set off any potential warranty liability against any loan notes or other shareholder debt that they hold.

- The inclusion of sensible warranty limitations. The management will wish to include financial thresholds that are usually linked to the amount of the deductible on any relevant warranty and indemnity (W&I) insurance policy, and a reasonably short time period for claims (typically 12 months for non-tax matters).

- Giving warranties on a several and proportionate basis.

It is increasingly common for W&I insurance policies to be taken out either by the selling or buying investor (*see feature article "Covering the risks: warranty and indemnity insurance", www.practicallaw.com/5-382-3120*).

The SBO equity documents will also seek to commit the management to giving appropriate warranties on an exit, which could be to a trade buyer, another private equity fund or a broker on an IPO, depending on the circumstances. Increasingly, these types of clauses are being tightened and extended to include other exit related matters, such as establishing data rooms. Leaving aside the enforceability of those provisions, the management should take care with the relevant wording and reserve the right to protect themselves with customary limitations and qualifications on any SBO exit.

Waterfall

The application of the proceeds of an exit and the priority of distributions between the equity providers is frequently a complex analysis which will factor in the various interests that will take priority to the management. These range from senior debt, the investor's ordinary and preference shares and loan notes, and interest on the investor's debt which usually has been rolled-up, fees, expenses and taxes (VAT, PAYE, and National Insurance contributions). The economic impact of shareholder debt should be modelled carefully, particularly where debt interest compounds.

It is vital that the management understand the economic effect of the waterfall and they would be well-advised to ensure that this is set out in a funds flow statement attached to the term sheet. The management's advisers will need to ensure that this is accurately reflected in the equity documents.

Share options

In certain circumstances, the management may be in a position on the PBO exit where the transaction value means that their existing equity has no value or that unexercised options are also worthless.

To address this, solutions which result in additional value flowing to managers might involve:

- Resetting in newco of the existing target option hurdles.

- Adjusting the "equity break" for the SBO; for example, by reducing the debt in the capital structure.

- Increasing the sweet equity allocation for affected managers.

Performance-related cash bonuses and options are other alternatives but these tend to be tax inefficient. Although a consequence of the exit price and funding structure of the primary buyout, these are discussions that the management team will need to have with the new investor sooner rather than later.

TAX

There are numerous, and potentially significant, tax implications for the management to consider both in the context of the acquisition of their sweet equity and their rollover. However, where entrepreneur's relief is available there is a trend towards triggering a "dry" tax charge (meaning that the manager will not be in funds to satisfy the liability) at 10% because of the possibility of this rate disappearing in the future given the likelihood that entrepreneur's relief will continue to be a topic for review.

The headline objectives for the management from a tax perspective include:

- Minimising any income tax charge on the acquisition of their sweet equity or institutional strip.

- Paying capital gains tax on the consideration they receive in cash.

- Deferring any tax on their rolled portion until the SBO exit.

- Paying capital gains tax on that rolled portion and the sale of their sweet equity.

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Where possible, the management will want the equity investment structured so that it falls within the British Private Equity & Venture Capital Association's Memorandum of Understanding. Failing that, the management will want a valuation of their sweet equity shares to be conducted, at newco's cost and, if necessary, to pay any relevant income tax to the extent that the subscription price represents an undervalue.

CONFLICTS

It goes without saying that the variety of roles played by the management in an SBO means that there is plenty of scope for a breach of the many statutory and contractual duties to which the management team may be subject (*see box "Conflicts of interest"*).

The management team owe a raft of duties both to the target and newco, ranging from statutory obligations under the Companies Act 2006 to contractual obligations under the employment contracts. It will be essential for the management to remember which hat they are wearing at any given moment to avoid falling into traps and committing any breaches.

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