

Issues for management on secondary buy-outs

Secondary buy-outs raise particular issues for management. The main issues are as follows:

Who will continue with the business and who will be exiting?

The new VC will almost certainly be looking to make management changes. For continuing management this means obtaining a limited exit from the initial investment, participating fully in the new round of investment and ensuring that continuing management's position is adequately protected and that continuing management is adequately incentivised going forward. For departing management this means ensuring the best possible exit from the business and limiting their exposure post exit.

Future exits

Continuing management will need to consider the value of their investment should they choose to leave the business at some point in the future. Continuing management will have already been through one MBO and they should seek to ensure that the secondary buy-out does not put them in a position where they can be forced to sell their shares at a nominal value at some point in the future should they leave. The secondary

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buy-out can be a good opportunity for continuing management to determine a benchmark for the value of their shares.

The warranty gap

One common issue for both groups of management will be the gap in warranty cover. The level of comfort that would normally be obtained in terms of warranty cover from a seller is absent in secondary buy-outs. A selling VC will not in normal circumstances provide any warranties to the seller save in relation to ownership of its shares and their valid execution of the transaction documents. The purchasing VC will look for warranty cover from both management teams.

It should be noted that any warranty claim brought by the purchasing VC could mean suing continuing management and thus damaging their investment. This may mean that continuing management is shielded from warranty claims except in cases of serious fraud. It is important to recognise that when it comes to warranty cover the agendas of departing management and continuing management will be different. Departing management will need to ensure that if any

warranty claim is brought against them they can join continuing management as co-defendants. On this basis, the negotiation of whether warranty liability among departing and continuing management is to be joint, several, or joint and several will be important. If these negotiations culminate in joint or joint and several liability, departing management may need to draw up a deed of contribution to ensure that continuing management are tied in to sharing responsibility for whatever liability arises in agreed proportions.

Additional cover

Additional solutions for VCs when looking at the issue of the warranty gap are the use of retentions, completion accounts and earn-out mechanisms that make payments to management conditional. Insurance cover is also available and should be investigated at an early stage in the transaction.

Taxation input


Both management teams will need to obtain appropriate personal taxation advice in relation to any consideration received as part of the exit, shareholdings going forward and incentive arrangements. Management may incur



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significant tax consequences as a result of the transaction and they will need to ensure that all available relief and roll-overs are utilised. Tax considerations should be addressed at the outset of the negotiations as these may impact on the structure of the deal.

Conclusion

The nature and complexity of secondary buy-outs requires the consideration of additional issues to those usually considered as part of an MBO. These additional issues are particularly important for both departing and continuing management. 

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