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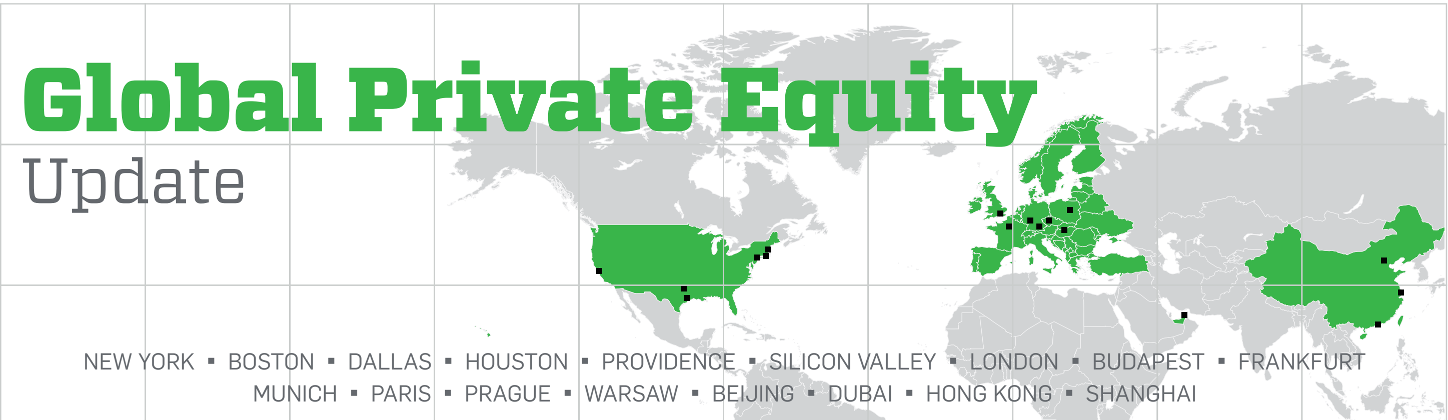
Global Private Equity Update



Unlocking "Locked Box" Deals

By Samantha McGonigle and Michael Weisser

Accurately reflecting the outcome of key value negotiations between seller and buyer is a critical element of a transaction. Traditionally, this was done through some form of closing accounts mechanism where the closing date purchase price is initially determined based on the target's closing date balance sheet of the business (or certain line items from the balance sheet) and then tested after the closing to ensure that those balance sheet items had actually been transferred. However, for some time now European transactions have commonly included a "locked box" pricing mechanism as a simpler alternative to traditional closing accounts.

"Locked box" structures offer a number of advantages primarily for sellers, but despite this the trend has been slow to catch on in the US market, where locked box mechanisms have only recently gained some traction.

In This Issue

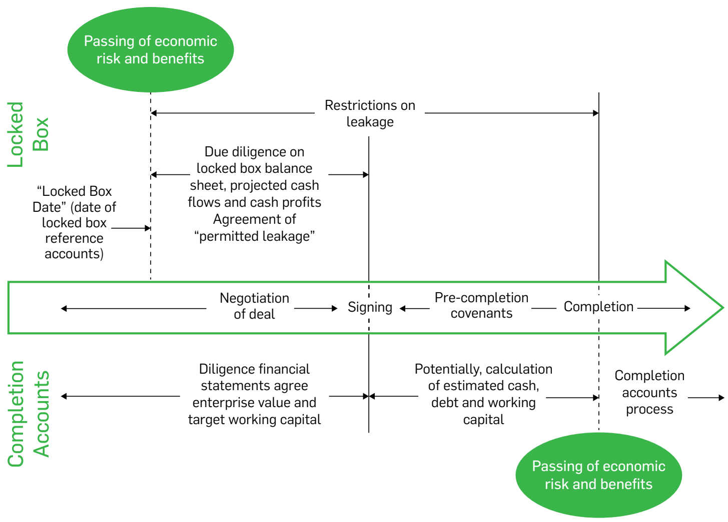
How do you "lock the box"?

In a locked box structure, the economic risks and benefits are passed from seller to buyer at a historical balance sheet date prior to signing. This is known as the "locked box date" and can be the date of the last audit or a more recent set of unaudited financial statements. The relevant financial statements are referred to as the "locked box accounts." The buyer, having conducted careful diligence, then values the business to determine an equity value from the locked box accounts (i.e., the equity value based on the debt, cash and working capital as reflected in those locked box accounts). From the locked box date, the seller is not permitted to allow any "value" to leak out of the business to the seller (beyond a list of "permitted leakage" items which the seller and buyer agree to cover planned dividends etc.) and if there is any unplanned (i.e., not permitted) leakage of value, each seller covenants to repay to the buyer immediately the leakage value it has received.

The definitive sale and purchase agreement will then include a fixed price for the equity value instead of a formulaic approach to determining price. Unlike the traditional structure, the buyer in a locked box deal will not have the ability to adjust the price following the closing – instead, it will need to rely on the warranties given by the seller on the locked box accounts (which will usually only be to management accounts warranty standard if the locked box accounts are not audited) and the covenant from each of the sellers to repay leakage.

Additionally, depending on the amount of time that may pass from the locked box date to closing (for example, due to regulatory clearances, third party consents or other relevant factors), the seller may expect the buyer to pay an additional daily sum on top of the price – this is a topic of negotiation and a seller will usually argue that this is necessary to compensate it for the cash flow generated between signing and closing and/or the time value of money between the date the economic interest passes and the date it is actually paid.

Locked box timeline



Contrast this locked box structure with the traditional closing accounts mechanism where equity value is determined by starting with an enterprise value and adjusting for debt, cash, working capital or other items at closing. Typically there is a true up at closing based on an estimate of cash, debt and working capital and then a second true up post-closing. In this traditional structure, the economic benefits and risks are passed from seller to buyer at closing (i.e., the cash generated from the business prior to closing is for the seller's account and the buyer is paying the seller at closing in part based on the specific value of the assets and liabilities of the company as they stand on the closing date).

As can be seen, in order to be comfortable with a locked box mechanism, buyers need a high degree of detailed diligence on the locked box accounts and cash flows in the period through to closing. This can make the use of locked box mechanisms difficult in a number of situations, such as complex carve outs (where standalone entity accounts did not exist), deals pre-empted by the buyer or situations where cashflows are volatile.

How is the approach different in Europe to the US?

Relatively low deal activity in the period following the financial crisis (caused primarily by continued scarcity of top quality assets being put up for sale and therefore sellers being able to dictate sale terms to a greater extent) has meant that locked box structures have continued to be the mechanism of choice to reflect value negotiations in European private equity deals. Sellers have been able to resist a shift to the more traditional closing accounts mechanism which is perceived as offering a buyer more protection, and locked box structures have even been seen creeping into transactions between corporate buyers and sellers where there is a desire on the part of sellers to prevent post-closing price reductions through closing accounts and to be able to walk away from closings on a "clean" basis. Over time, the locked box mechanism itself has evolved and buyers and sellers continue to add sophisticated tweaks (such as an ability to deduct pre-closing leakage that a buyer is aware of from the price at closing) as the popularity of the mechanism overall continues.

The locked box structure has not historically been used with any degree of regularity in deals in the US, although US buyers who have been active in Europe have already had to work with locked boxes and become familiar with them. However, in the past year, we have seen a marked increase in use of locked box deals as buyers and sellers alike are becoming educated on the pros and cons of using the structure. In the US, locked box deals still represent a small minority of deals, but we expect to see a modest uptick in its use over the next few years.

What are the advantages and disadvantages for buyers and sellers?

In theory, both sides should be indifferent from an economic perspective as to whether a traditional or locked box structure is used. So, why choose one versus the other? Here are some things to consider:

Comparison of Mechanisms

	Locked Box	Closing Accounts
Simplicity	Simple and straightforward – eliminates time, effort, money and risk associated with negotiating closing accounts	Complex, time consuming and expensive – open to manipulation and abuse and usually results in post-completion disputes
Certainty	Gives certainty of price on completion which allows a PE seller to make a full distribution to LPs shortly after closing and does not require the buyer to find additional cash to fund any upwards adjustment But, if you don't get it right at signing you can't fix it afterwards and claims for breach of warranty on locked box balance sheet are subject to usual limitations on liability Also, buyer takes risk of any downturn in business between locked box date and completion	Allows for £ for £ adjustment to price if the target is wrong – so, in theory, fair but does not deliver certainty of final price to the buyer or seller until post-closing adjustments are agreed Particularly useful for buyers on carve out transactions, providing an opportunity for a "second look"
Management Time	Allows management to focus on the business post-closing – any efforts are front-loaded into the diligence process arguably saving management's time	Relies heavily on management post-closing in back and forth between buyer and seller negotiating final purchase price adjustments
Focus on Diligence/ Cash Flows	Need to test price through diligence and understand cash flows before signing, which can have a timing impact Separate locked box accounts may not be available, or may be old	Diligence needed on financial but provides most accurate snap-shot of net asset position/working capital/net debt at completion
Ability to Use Across All Deals	Not suitable for certain deals for example complex carve outs where it is not straightforward to identify the "box" and agree permitted leakage or seasonal businesses where working capital varies significantly	Can use across all types of deals – can agree relevant line items to adjust from broad net asset adjustment to more narrow cash/debt adjustment
Use in Auctions	Can be effective auction tool – gives buyers a competitive advantage if they accept without amendment given the fixed value it delivers to sellers and allows sellers to compare bids on a "like for like" basis	Rarely offered in European auctions – seen more often in the US

Representation and Warranty Insurance – Back In Fashion…

By Simon Lyell and Kevin Sullivan

For years representation and warranty insurance (also known as warranty insurance) (WI), has been talked about a lot in deals but traditionally was used very little. It was perceived as expensive and difficult to implement, often providing patchy coverage. However, it is being used particularly recently in the US market by buyers and sellers to allocate risk to a third party insurer, facilitating the successful evaluation, negotiation and closing of an acquisition. More than that, it has become a competitive tool for buyers to enable sellers to solve for any ongoing liabilities in a deal.

What is WI and how has the product changed?

WI shifts risk of unknown breaches of reps and warranties to a third party insurer. Historically premiums were high and the process of obtaining insurance slow and painful; using a WI policy to unblock a last minute deadlock over the level of liability to be borne by the sellers was often impractical, as the delay putting a policy in place might put a deal in jeopardy.

More recently, the competition created by new entrants into the insurance market has resulted in improved terms and reduced premiums. Also, the insurers have expanded their teams (often with ex-transactional lawyers) to enable a relatively efficient policy negotiation process to meet tight deal deadlines. Insurance brokers are pushing the product hard, raising awareness in the market.

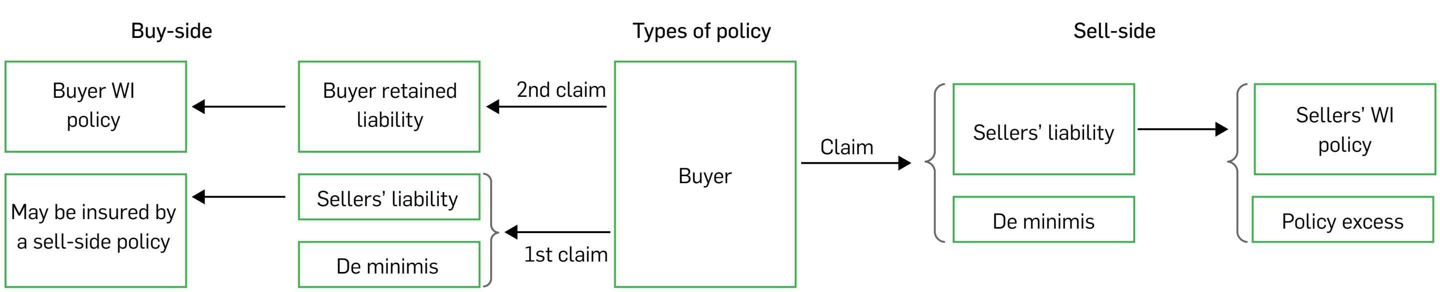
While this has resulted in a surge in the use of WI in the US where we are seeing its use in a significant proportion of secondary buyouts across all deal values, in Europe the response has been more muted with any increase in use arising at the smaller end of the value spectrum. This lower enthusiasm can be put down to a number of factors:

- as a general rule the European market accepts that PE sellers don't usually give reps and warranties about business matters, so the approach to warranties is more a means of forcing good disclosure from management teams rather than apportioning risk, so buyers are more likely to be comfortable with the lower liability caps that sellers are willing to offer (provided that the sellers have sufficient "skin in the game" to encourage disclosure); and
- as disclosure increases, buyers become aware of more about the target and this knowledge often restricts their ability to make warranty claims.

We often now see sale processes where sellers put together a stapled insurance package that is presented to the bidders in the auction process by a strong management team. It is not often used, but it is an interesting development.

Buy-side or sell-side policy?

When negotiating a deal, one thing at the front of the sellers' mind is the ability to step out of the picture after the transaction closes. A buyer may prefer a sell-side policy where it need only make a claim against the sellers, and any insurance claim is dealt with by the sellers, although buy-side policies may be preferred due to the potentially greater coverage offered (as buyers will have less knowledge of potential breaches than sellers). The sellers, by contrast, would prefer a buy-side policy so that once the excess has been paid by the sellers, the buyer must claim under its own policy. A buy-side policy may also be used where a buyer wants to top up the quantum of cover being offered by the sellers.



How do WI terms differ between the US and Europe?

Term	US Approach	European Approach
Limitation on Scope	■ Can be tailored for specific areas of cover ■ No coverage for certain matters (e.g., pensions, environmental, tax or “special” indemnities), although separate cover available at a cost ■ If scope of warranties is broader than market, exclusions will be imposed or premium increased	■ Same as US
Premium	■ 2%-4% of the cover	■ 1%-2% of the cover plus insurance premium tax (as high as 26% of the premium cost in the Netherlands)
Deductible	■ Similar to what sellers would normally provide as a deductible on a transaction	■ Higher than what sellers would normally provide as a deductible on a transaction
Survival	■ Longer than typical limitation periods in acquisition agreement	■ Dovetails with limitation periods in acquisition agreement
Limitations	■ Matters known by the insured not covered (so theoretically a buy side policy provides greater coverage as has less knowledge than the seller)	■ Same as US

Where is WI particularly useful?

WI is a useful implement in the toolbox that buyers and sellers should consider in scenarios such as:

- where the sellers are a credit risk and an escrow is not feasible or desirable;
- where the sellers are management against whom buyers do not wish to claim;
- in the US where sponsors give representations and warranties but resist long tail periods (due to life of funds and requirement to hold back monies that would otherwise be distributed);
- when buying from a sponsor that does not customarily give representations and warranties beyond title and capacity;
- in a competitive auction where sellers wish to walk away (giving a competitive edge, providing some downside protection and shortening negotiations with the sellers); and
- selling to a strategic which is less ready to accept that sponsors will not want to give representations and warranties.

Points to keep in mind when considering and negotiating a policy

Limited Coverage: Coverage under WI is in several ways more limited than what buyers would expect from sellers of a business. For example, breaches of covenants are not covered as well as matters that are known prior to closing (for example, with a buy-side policy there would be no coverage for breaches that occur between signing and closing that buyers learn about prior to closing).

Limp Away: Insurers do not like full walk away deals. They prefer that sellers have some risk post-closing to ensure they are diligent in their disclosure and negotiations of the reps and warranties. Premiums for pure walk away deals can be much higher than partial indemnity deals. On the other hand, part indemnity/part WI deals can erode some of the speed and simplicity of pure walk away deals.

Underwriting Process and Cost: The insurer will retain legal counsel or use specialist in house counsel to conduct due diligence on the target (normally reviewing all due diligence reports) and review the acquisition agreement, disclosures and other transaction documents. This typically takes two or more weeks and includes a due diligence session with legal counsel, but often can be completed in a one week period if the parties are well organized. Insurers typically expect the cost of this review, which customarily ranges from $20,000 to $40,000, to be paid for up front by the insured.

Process: The process for obtaining WI in an auction situation should be carefully managed. Insurers are often reluctant to begin the underwriting process in an auction before a winning bidder is chosen (as doing so may prejudice the insurer's ability to underwrite a policy for another bidder). As such, a buyer may need to rely on placing the policy between signing and closing (but after the buyer has signed a deal with limited or no rep and warranty protection from the seller). In these cases, obtaining indications of coverage prior to signing is prudent. In many cases, experienced brokers and legal advisors with a pre-negotiated form policy and strong relationships with insurers can be helpful in creating solutions to mitigate these potential timing issues.

Buyer Policy

- Match policy terms and purchase agreement
- Retention - should erode at the same time as seller's liability cap
- Documents disclosed - buyer will be deemed to have knowledge of all matters disclosed by sellers and those apparent through diligence
- Knowledge of insured - don't get burdened with management's knowledge
- Pay attention to subrogation provisions (where insurer takes over rights of buyer against seller)

Seller Policy

- Severability - ensure knowledge of one insured does not impede coverage of the other sellers, particularly regarding fraud
- Knowledge - track the wording in the purchase agreement to ensure no gaps
- Claims co-operation and control - sellers can only offer whatever rights they have under the purchase agreement. As a seller with an economic interest in an escrow, conduct will be a key consideration
- Retention – an escrow will be required

Weil's Global Private Equity Practice

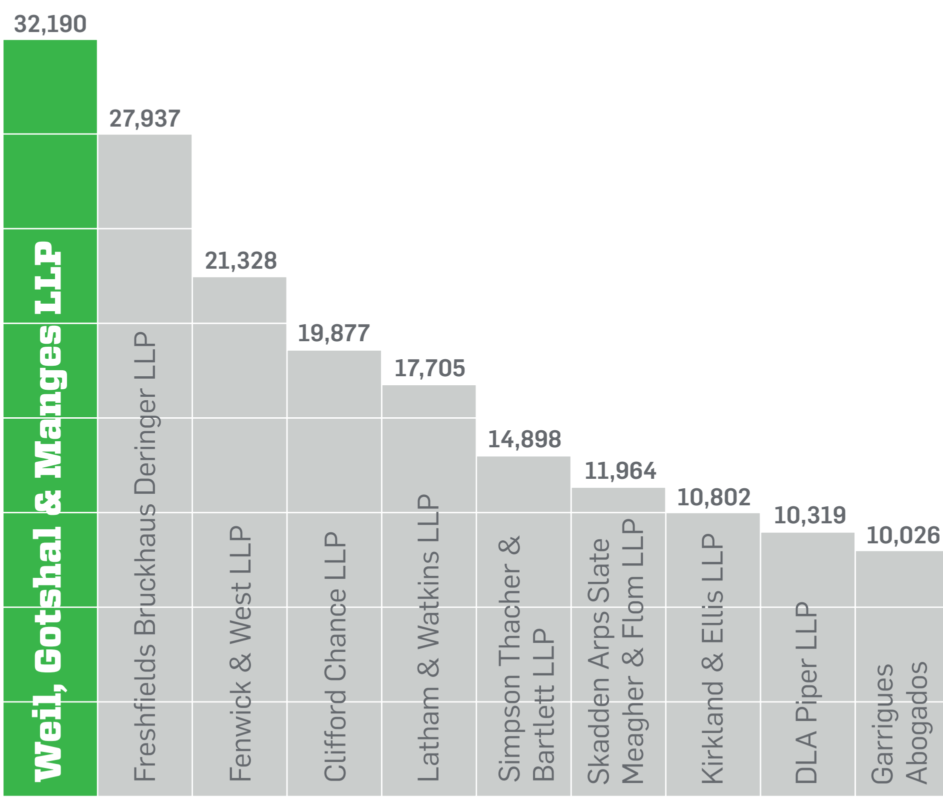
20 offices worldwide, of which **16** are ranked in the top tier for Private Equity by Chambers and Legal 500

Ranked **Band 1** for Global Private Equity by Chambers

The global private equity team acts for more than 200 private equity clients worldwide, including more than **80%** of the world's top 25 funds, as ranked by PEI 300, 2014

#1 for Global Private Equity (by value) — Bloomberg Q1 2014

29 Chambers ranked private equity partners worldwide, including **8** ranked Band 1



Global Private Equity Announced Deals 1Q 2014
Volume in US$ millions

Source: Bloomberg Global M&A Legal Advisory Rankings Q1 2014

Market Recognition

Band 1 for Private Equity Global-wide, Asia-Pacific-wide, and across Europe

— *Chambers Global 2014, Chambers Asia Pacific 2014, Chambers Europe 2014*

M&A **Deal of the Year** for AAR/TNK-BP

— *IFLR Awards 2014*

Private Equity Team of the Year

— *IFLR Americas Awards 2013*

Most Innovative Firm in Corporate Law

— *FT Innovative Lawyers Awards Europe 2013*

Private Equity Client Program named one of the **most "Innovative" Business of Law Initiatives of Year**

— *Financial Times 2013*

Law Firm of the Year – Transactional

— *Financial News Awards for Excellence in Private Equity Europe 2013*

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An investor consortium, including HOPU Fund and Bank of China Global Logistic Properties 普洛斯	CVC PAREXGROUP Building expertise, together	Irving Place Capital VICTOR TECHNOLOGIES	Montagu Private Equity REXAM	PAI Partners Schneider Electric	Thomas H. Lee Partners 1800 CONTACTS

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