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The Legal 500 Country Comparative Guides

United Kingdom
PRIVATE EQUITY

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This country-specific Q&A provides an overview of private equity laws and regulations applicable in United Kingdom.

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UNITED KINGDOM
PRIVATE EQUITY

1. What proportion of transactions have involved a financial sponsor as a buyer or seller in the jurisdiction over the last 24 months?

Complex geopolitical effects and macroeconomic factors including higher interest rates and persistently rising inflation made for a complex deal making environment for private equity in 2023. While overall PE M&A activity was lower in the first half of 2023, PE investors remain focused on setting up portfolio companies for a good exit and sponsors main poised to execute on acquiring attractive assets. According to data available from Mergermarket, approximately 25% of all M&A activity recorded in 2023 involved a private equity sponsor.

2. What are the main differences in M&A transaction terms between acquiring a business from a trade seller and financial sponsor backed company in your jurisdiction?

The principle of a 'clean exit' for private equity sellers in order to return cash to investors following an exit is a key driver for some of the main differences between M&A transactions involving sponsors versus trade sellers though trade sellers are increasingly seeking to replicate a sponsor's clean exit. Private equity sellers typically favour locked box pricing mechanisms to provide pricing certainty at signing. Trade sellers are not in principle opposed to locked box mechanisms but many trade sales involve a level of separation or carve-out from the trade seller's business that could make locked box mechanisms unsuitable.

Normally, selling sponsors only give fundamental warranties on capacity and ownership, with management giving the business warranties. A trade seller will normally give both fundamental and business warranties as management are unlikely to see a significant payout from the transaction. A trade seller may also give a tax indemnity. That being said, W&I insurance is relatively standard in transactions involving PE and trade sellers. Buyers are unlikely to obtain comfort from private equity sellers with respect to non-competition or non-solicitation covenants relating to the business, while trade sellers are likely to offer some protections within acceptable parameters.

3. On an acquisition of shares, what is the process for effecting the transfer of the shares and are transfer taxes payable?

Shares in certificated form (which is usually the case for private limited companies) are transferred by an instrument of transfer, most commonly a stock transfer form. On the sale of a UK company, unless the transfer value is less than £1,000 or certain exemptions apply, the signed stock transfer form will need to be approved as stamped by HMRC (which usually takes around 6 weeks) in order for the transfer to be written up in the shareholders' register (note that the stamping process is now virtual and physical stamping of STFs is a thing of the past). HMRC will charge stamp duty of 0.5% of the total consideration attributable to the shares being transferred and this duty is customarily for the buyer's account. Until a stamped form is returned, and the shareholders' register is updated to reflect the new ownership, legal title of the shares does not pass to the buyer. Accordingly, the buyer will require voting powers of attorney from the selling shareholders to enable it to vote in respect of the purchased shares prior to the register being updated.

Main market listed company shares typically take the form of uncertificated shares and may be transferred without a written instrument of transfer through an electronic clearance system. Such transfers generally attract stamp duty reserve tax at a rate of 0.5% of the consideration payable by the buyer.

4. How do financial sponsors provide comfort to sellers where the purchasing

entity is a special purpose vehicle?

It is standard for sponsors to provide an equity commitment letter at signing to provide the seller with comfort that the sponsor's fund(s) will provide equity financing to the acquisition vehicle to fund the equity financing portion of the purchase price. It is also common to include a separate commitment to fund damages suffered by the seller should closing not occur as a result of the buyer's breach of the terms of the purchase agreement. A debt commitment letter may also be used to evidence the availability of sufficient funding to the acquisition vehicle. This will often be supported by an interim facility agreement that the debt provider agrees to sign on short notice if required. Some sponsors will seek to equity underwrite the entire purchase price at signing and put in place debt in the period between signing and completion to obtain a competitive advantage in auction processes.

5. How prevalent is the use of locked box pricing mechanisms in your jurisdiction and in what circumstances are these ordinarily seen?

The 'locked box' mechanism is the most common pricing structure on UK private equity deals. The key advantage of the locked box is that it gives both the seller and the buyer certainty of a fixed price and does not give rise to the same complexity and risk of associated disputes as the completion accounts mechanism.

However, not all deals are suited to a locked box mechanism – for example (i) if the transaction involves a business reorganisation or carve-out following the locked box date and therefore the target does not have appropriate standalone accounts or (ii) if the target's working capital is subject to high degrees of volatility (e.g. open to the effects of seasonality) and therefore it is difficult to price based on a fixed historic date. While some buyers have argued for post-closing true-up mechanisms citing volatility in trading caused by recent economic volatility, sellers of attractive assets have not generally been under pressure to take on any risk on price certainty. However, with the latest constraints on debt financing and gaps in valuation expectations between sellers (particularly those who are under pressure to sell and return funds to investors) and buyers, we are starting to see buyers and sellers sometimes using deferred consideration mechanisms or vendor loan notes to bridge the buyer's financing gaps. This still remains fairly uncommon in a private equity context given it cuts across the principle of clean and price-certain exits for selling financial sponsors.

6. What are the typical methods and constructs of how risk is allocated between a buyer and seller?

In competitive processes, sellers will usually propose terms that pass all risk relating to the target business to the buyer at signing. From a deal pricing perspective, the locked box mechanism is a seller friendly pricing mechanism as the buyer has no opportunity to adjust the price following signing. The buyer will need to manage its risk by diligencing the locked box balance sheet and ensuring that the locked box is effectively 'locked' (i.e. with no value leakage to the sellers or their connected persons post the locked box date).

Risks associated with operational matters of the business are normally only covered by warranties given by management and backed by W&I insurance. Material adverse change clauses are unlikely to be accepted and bring-down of business warranties at closing is also uncommon. Indemnities or escrows for contingent liabilities are normally strongly resisted by sellers, and bidders in competitive processes often prefer to 'price in' any contingent liability so as not to be uncompetitive by requesting indemnities or escrows. Risks associated with deal certainty are also usually for the buyer's account. A seller will normally not accept conditionality to closing, save for anti-trust, foreign direct investment or other regulatory consents which are mandatory and suspensory in effect.

7. How prevalent is the use of W&I insurance in your transactions?

The use of W&I insurance is very common in private equity exits. For sellers, W&I insurance can help achieve a clean exit (e.g. with no escrow) and in some cases offer nil exposure for the warrantors for warranty claims. For buyers, W&I insurance can enhance the warranty protection on offer by extending the duration and scope of warranty coverage. It is also possible for buyers to include a tax deed (subject to a £1 cap or synthetic) to cover most unidentified tax risks and/or to obtain separate coverage for identified tax risks. It is common in auction processes for the seller to arrange a stapled sellside policy which 'flips' to a preferred bidder. The stapled policy can help with a quicker underwriting process and, if well managed, the W&I process can be a useful sellside tool to manage auction dynamics. In highly competitive auctions, a bidder may forego the inception of a W&I policy at signing (to deliver signing earlier than other bidders who see signing contingent on the inception of the policy) and finalise its work on W&I post-signing.

8. How active have financial sponsors been in acquiring publicly listed companies?

2022 was a comparatively subdued year for private equity-backed takeovers of UK-listed companies, 2023 saw an uptick in activity (in Q1 of 2023, 55% of binding bids announced for UK public companies were from PE-backed bidders). Broadly, valuations on the London Stock Exchange have lagged behind other institutional stock markets and accordingly companies are undervalued, which has created take private opportunities for financial sponsors. In addition, the weakness of the GB pound sterling has made prices more affordable for non-UK sponsors. The UK Takeover Code's requirements can reduce a sponsor's willingness to pursue the takeover of a public company subject to the Code. These requirements include 'certain funds' obligations and bid timing requirements such as the 'put up or shut up' rules. UK P2Ps by financial sponsors normally occur in situations where the financial sponsor is willing to commit the resources required to carry out the bid and where it believes it has the backing of the board of the target company. However, because of the strict framework of the Code, the volumes of UK public takeovers by financial sponsors have been overall traditionally lower than in other jurisdictions even with the bidder favourable market conditions referred to above.

9. Outside of anti-trust and heavily regulated sectors, are there any foreign investment controls or other governmental consents which are typically required to be made by financial sponsors?

The UK's national security regime, operating under the National Security and Investment Act 2021 (NSIA), comprises a hybrid investment screening system, consisting of a mandatory regime for 17 of the most sensitive sectors of the economy and a voluntary regime for all other sectors. Under the mandatory regime, an investor (even from the UK) must notify the Investment Security Unit (ISU), now seated within the Cabinet Office, if they acquire more than 25%, 50% or 75% of the voting or share capital (or the ability to block or pass shareholder resolutions) in a target active within a specified sector in the UK. The 17 sectors caught by the mandatory regime are: advanced materials, advanced robotics, artificial intelligence, civil nuclear, communications, computing hardware, critical suppliers to government, critical suppliers to the emergency services, cryptographic authentication, data infrastructure, defence, energy, military and dual-use, quantum technologies, satellite and space technologies, synthetic biology and transport (with additional categories of semiconductors and critical materials expected to be introduced this year). Under the voluntary regime, parties are encouraged to notify voluntarily any transactions which – regardless of the sector concerns – may be of interest from a national security perspective. The regime is also broader in scope than the mandatory regime, capturing acquisitions of 'material influence' over a company and acquisitions of a 'right or interest' in qualifying assets (such as land or intellectual property).

Once a notification has been submitted and accepted, the ISU has 30 working days in which to review the transaction and decide whether to approve it or to issue a "call-in" notice for a Phase 2, in-depth review. Where a "call-in" notice is issued (either following a Phase 1 review or for non-notified transactions), the ISU has 30 working days (which can be extended by a further 45 working days) to reach a decision, either approving the transaction – conditionally or unconditionally – or prohibiting the transaction. Exceptionally, a further extension can be agreed with the ISU.

In FY2023, there were 866 transactions notified under the NSIA, a figure which significantly exceeds the equivalent total for each of France, Germany, and the US. Financial sponsors will therefore likely take a conservative view when deciding to make notifications under this regime. This is because of the risk that an acquisition is void if the pre-closing approval is not obtained, and the parties being subject to both civil and criminal liability (including significant fines) for failure to file. Furthermore, the UK government has the power to "call in" non-notified transactions for a period of up to five years post-completion (reduced to six months once it has become aware of the transaction).

10. How is the risk of merger clearance normally dealt with where a financial sponsor is the acquirer?

Sellers normally require that each bidder submits details of any required merger and other regulatory clearances (including foreign investment) at the bid stage since each bidder's risk profile with respect to regulatory clearance will form part of the seller's assessment of a bid. Sellers are likely to request a 'hell or high water' obligation (i.e., a divestiture obligation in respect of both the financial PE sponsor's portfolio and the target group) from buyers in the purchase agreement, as well as provisions to allow the seller to closely monitor the merger clearance process. We are also seeing some examples of sellers arguing for a break fee payable by the purchaser to address specific antitrust risk,

particularly given the prevalence of discretionary powers of review by merger control authorities worldwide (e.g., even where the relevant mandatory notification thresholds are not satisfied).

11. Have you seen an increase in (A) the number of minority investments undertaken by financial sponsors and are they typically structured as equity investments with certain minority protections or as debt-like investments with rights to participate in the equity upside; and (B) 'continuation fund' transactions where a financial sponsor divests one or more portfolio companies to funds managed by the same sponsor?

Minority investments remain common and take a number of forms including LPs investing alongside the sponsor as a passive co-investor (likely on a no carry, no fee basis) or credit funds making use of equity instruments to complement their investment model (e.g. in the form of preferred equity). PE's investment into high growth companies in the form of non-controlling stakes have also seen a marked rise in the last two years with many PE funds raising funds dedicated to growth investments. In the context of larger deals, club or consortium deals are also on the rise with no one sponsor having a controlling majority and these types of transactions have recently served to bridge the gap in debt financing availability. We are also seeing a continuing trend in selling sponsors rolling over or retaining a minority interest in respect of attractive assets by selling a stake to a continuation/affiliated fund sometimes with third party investors taking a significant minority position alongside the continuation fund to set the arm's length price at which the continuation fund buys from the original selling fund. In the last two years, continuation fund transactions have become an increasingly popular route to achieving liquidity for existing LPs while allowing the sponsor to retain control, continue to grow their assets under management or 'AUM' and to not miss out on potential future upside in respect of the particular portfolio company.

12. How are management incentive schemes typically structured?

Typically senior management are incentivised with direct equity interests in the investment holding structure (in the form of 'sweet' equity) at the same level as the sponsor's investment and any rollover investment. This 'sweet' equity takes the form of ordinary shares and sits behind the investor and rollover investments (usually including loan notes or preference shares providing a 'hurdle' to be cleared before management equity becomes valuable). The size of the sweet equity pot for allocation and the terms relating to sweet equity are deal specific. It is quite common to see ratchet provisions. Sweet equity typically vests over a 4-5 year period, sometimes 100% vesting only being achieved at the point of exit for the sponsor. Bonus schemes are seen as a drain on cash, and management typically prefer the capital gains tax treatment in respect of equity rather than income tax levied on a cash bonus.

13. Are there any specific tax rules which commonly feature in the structuring of management's incentive schemes?

The UK rules on employment related securities should always be considered when structuring equity incentives for UK management. UK managers will commonly want to 'roll over' gains on any existing securities they hold into their new investment so the capital gains tax rules on share for share exchanges are often relevant and commonly require the use of put and call options to permit UK managers to roll up the new structure. Typically, management will make section 431 elections, which means that they will be subject to a charge to income tax by reference to the unrestricted market value of their sweet equity where this exceeds the amount they pay for their shares. As a result, the valuation of the sweet equity is an important consideration in deals which fall outside the BVCA memorandum of understanding safe harbour. Valuation issues can also be significant on the award of sweet equity to new managers during the investment lifecycle when the value of the business may have increased. Future disposals of sweet equity are typically subject to capital gains tax for UK managers at a 20% tax rate.

14. Are senior managers subject to non-competes and if so what is the general duration?

It is usual for non-competes (as well as other restrictive covenants including non-solicitation obligations) to be given by senior management and the duration will depend on the context in which they are given. Where a manager is a selling shareholder (and is receiving a notable portion of the sale proceeds), then such manager will typically be expected to give a noncompete covenant in the sale and purchase agreement which applies for between 12 months and at the upper limit 36 months from completion. Reinvesting or new managers will be expected to give restrictive covenants in the

investment agreement which typically have a tail of 12 months to 24 months from the time of the senior manager's departure from the business or the last date on which they hold shares. Typically, service agreements for senior management will also include restrictive covenants which run for a period of 6 to 12 months from when they cease to be employees. The UK Government has recently published proposals to limit the duration of noncompete covenants to three months in employment and worker contracts. The proposals as they currently stand would not restrict the use of noncompete provisions in other contracts (e.g. sale and purchase agreements and investment agreements) but the impact of the UK Government proposals and its implementation remain to be seen. It is possible for these obligations to overlap in scope and duration. In all cases, care should be taken in determining the scope and duration of the restrictive covenants. The English courts will normally only enforce restrictive covenants to the extent that the restrictions are reasonable and serve to protect legitimate business interests.

15. How does a financial sponsor typically ensure it has control over material business decisions made by the portfolio company and what are the typical documents used to regulate the governance of the portfolio company?

On control investments, the sponsor will typically hold at least 75% of the voting rights and therefore maintain effective shareholder voting control over its investment. Additionally, the sponsor will wish to ensure that it has multi-layered contractual protection (in the form of positive covenants and negative controls regarding the operation of the business) over governance maters. The principal governance documents are the investment agreement and the company's articles of association. Key forms of contractual protection and controls for the sponsor include: (i) the investor consent regime pursuant to which sponsors will have a consent (or veto) right over key decisions relating to the company (e.g. new acquisitions and disposals, capital expenditures etc.); (ii) enhanced information rights for the sponsor; and (iii) the ability to appoint and remove any director to the board.

16. Is it common to use management pooling vehicles where there are a large number of employee shareholders?

A separate management pooling vehicle on UK deals is unusual. However, it is fairly common for managers to be required to hold their shares through a nominee (e.g. the trustee of an employee benefit trust). This allows the sponsor to deal with a single legal holder of the shares, but it is not a perfect solution as managers (as beneficial owners) will generally be entitled to call for delivery of their shares from the nominee.

17. What are the most commonly used debt finance capital structures across small, medium and large financings?

Large private equity backed financings historically involved senior secured debt consisting of a broadly syndicated 'term loan B' together with a revolving facility that are each secured on a first ranking pari-passu basis. Senior secured debt can also take the form of New York law governed high yield bonds as well as, or instead of, a term loan B. The extent to which high yield bonds supplement loan financing or become the primary source of debt finance (and whether a European issuer seeks to tap into the US leveraged finance markets) are a feature of the markets and investor appetite at any particular time. With the slow-down in the syndicated bank loan and high yield bond markets in the last year or two, the majority of leveraged finance deals we have seen been tapping into the private credit lending market or alternatively running dual track syndicated and private credit financing processes to achieve the most desirable competitive outcome. Credit funds have been a source of senior secured term loan financing by way of "jumbo" unitranche on a number of more recent large cap financings and they now regularly club together to provide a private market alternative in this space. Larger private equity backed financings also frequently incorporate additional layers of debt to stretch leverage. Holdco (junior) level debt and second-lien debt is sometimes introduced and has historically been privately placed with credit funds. In addition, unsecured New York law governed high yield bonds or payment-in-kind notes or loans are often incurred at a holding company above the senior secured group. Small to midsized private equity financings are typically in the form of senior secured loans. Traditional banks continue to offer this capital solution but these are more commonly provided by credit funds offering unitranche loans. A commercial bank is then typically engaged to provide a 'super senior' ranking revolving facility.

18. Is financial assistance legislation applicable to debt financing arrangements? If so, how is that normally dealt with?

English company law prohibits a public company from providing financial assistance for the purchase of its own

shares or the shares of its holding company, and a private company from providing financial assistance for the purchase of shares of a public holding company. For this reason, where a transaction includes a target that is a public company, it is common for the public company to re-register as a private company before it provides the relevant financial assistance to avoid any breach of the prohibition.

19. For a typical financing, is there a standard form of credit agreement used which is then negotiated and typically how material is the level of negotiation?

A sponsor backed borrower typically provides its own bespoke precedent documentation and will usually use precedent documentation for another portfolio company of the sponsor as a starting point. The Loan Market Association precedents can be useful references for boilerplate drafting but are largely no longer the starting point. Negotiation is typically material around deal specific requirements of the sponsor, and in private deals can be highly bespoke with negotiation often being often more significant where there are a limited number of debt providers willing to underwrite the financing.

20. What have been the key areas of negotiation between borrowers and lenders in the last two years?

Negotiations over the last two years have continued to focus heavily on the definition of EBITDA in leveraged finance transactions both in the loan and high yield bond markets. EBITDA is not only relevant to calculating maintenance covenants but it also remains the benchmark for incurrence covenants and is fundamental to the calculation of basket thresholds as many of such baskets grow as EBITDA increases. Uncapped addbacks for projected cost savings and synergies had crept into documentation in recent years, but with the switch to private credit lenders, they have now been more commonly met with resistance from lenders. The ability to incur incremental debt on a senior secured, junior secured and/or unsecured basis either inside or outside the day one finance documentation is also a key area of negotiation. While borrowers have successfully negotiated broad flexibility in this area, lenders continue to push for key structural protections including, maturity and amortisation limitations, non-obligor debt caps, intercreditor accession thresholds and yield protection. Negotiation is most significant around pricing terms including margins, margin ratchets, fees and call protection. On syndicated financings, sponsors and banks will carefully negotiate pricing and other flex items which are lender improvements to the terms of the finance documents which may be implemented if it becomes necessary to enhance the prospects of the banks being able to sell down their commitments to an agreed level. As there has been a general tightening of terms in the market with the switch to private credit fund lenders, what would have historically been negotiated as part of flex-items, we now often see included in side letters with individual lenders. This often gives the lenders the requisite comfort on terms, while maintaining flexible precedent provisions in the documentation for the sponsors.

21. Have you seen an increase or use of private equity credit funds as sources of debt capital?

Credit funds have continued to increase their share of loan activity across Europe and in 2023 took a significant leap forward in market share as pricing to secure a bank underwrite ramped up dramatically. Notwithstanding their historic focus on lower mid-market financings, credit funds are increasingly looking to deploy capital in the upper midmarket and large-cap transactions. To this end, certain credit funds are teaming up with other credit funds or underwriting banks to provide capital solutions for larger financings. Credit funds with a distressed focus are regular participants in the loan market and are regularly a source of debt capital, particularly in bespoke situations where liquidity is needed.

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