Buying trouble?

How to manage conflicts in MBOs

Management buyouts can have significant advantages for vendor companies and the new owners – but the sale process can be a minefield of conflicts.

JUSTIN RYAN and NICK WORMALD explain how to deal with the potential problems.

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Although management buyouts have been a preferred sale option for vendors in the United Kingdom for many years, it is only in the past couple of years that they have featured as a major part of the negotiated sales scene in Australia.

Some of the benefits that an MBO offers a vendor of a business are:

- **Confidentiality.** Competitors need not know that the target is in play.
- **A quick and relatively clean exit.** Since management is running the business and will continue to do so after the acquisition with an ownership stake, the financial backers may be more relaxed about the level of warranties required from the vendor. A number of Catalyst-led management buyouts illustrate the point. In the buyout of Filligree Textiles, the advisers to the UK parent (Basford Group), which was in financial difficulty at the time, took the view that it was better to achieve a quick and convenient sale to management at a reasonable price (the deal was completed in two weeks) than to hold out for the possible price benefits that might be obtained through a more protracted sale process. In the MBO of Atlas Environmental, the parent company (McLeod Russel Plc) had already sold a number of other businesses in the group. One of the key issues in the sale was calculating the stand-alone costs of the Atlas business, given an overhead structure that had changed very dramatically and recently. In this situation, the management team was in a position to calculate the firm's true cost structure and consequently pay the highest value for the business.
- **The avoidance of ACCC issues.** The target may be in a market where a sale to an established player would raise concerns about market concentration (for example, the disposal of Snack Brands Australia by Frito Lay). When an industry is concentrated, an MBO of a divested business can create a new player.
- **Flexibility.** An MBO affords the vendor

an opportunity to maintain some sort of a stake in the target or an ongoing relationship (such as a supply agreement). The buyouts of Forgecast from Email and Wridgways from TNT each involved some ongoing supply relationships with the vendor or its associates. The buyout of National Textiles from the Sara Lee Group enabled National Textiles to obtain a new customer, "Yakka" (in addition to its main existing customer, "King Gee"), that had not been prepared to source from National Textiles while it was part of the Sara Lee Group. In this sense, the MBO also helped create value in the business being acquired.

- **Competitive tension.** Where the vendor is also marketing the business to trade buyers, the presence of an MBO option can help to keep real tension in a competitive tender situation. In the buyout of Eureka Tiles from BTR Nylex, Macquarie Bank, as corporate advisers, maintained an auction throughout the sale process between the MBO and a trade buyer. Indeed, in the recent buyout of Rexam Australia (now Australia's largest envelope manufacturer) the corporate adviser to the vendor successfully ran an auction which took two financial buyers through full due-diligence to unconditional bids.

Despite the benefits, there have been a number of reasons for the slow pick-up in MBO activity in Australia.

Initially, there was a lack of institutional expertise or inclination but this has been remedied, with a range of competent and cashed-up MBO firms now competing to find bankable deals. Indeed, it is arguable that the equity capacity that has recently become available to private equity groups is driving the new-found growth of the market as investors work harder to find suitable investments.

There has also historically been limited awareness on the part of management teams of how MBOs work and how well they can work for management.

Last, and most importantly in the context of this article, there has been some reluctance on the part of vendors and managers to consider this form of sale because of uncertainty about how to deal with the conflict-of-interest issues which arise in the context of an MBO. These conflicts of interest stem from the fact that the managers of the target are expected to be an integral part of the sales process while at the same time having an interest as a potential buyer.

In this article the MBO transaction discussed is one where a business or company (the target) is sold by way of negotiated sale to a buyer vehicle, the equity of which is held in part by management of the target, but principally by an institutional investor. That institution will also typically provide mezzanine or subordinated debt, and will arrange for senior debt to be provided by a bank so that the combination of senior debt, mezzanine debt and equity will be sufficient to fund the purchase and to meet initial working capital needs of the target.

WHAT ARE THE POTENTIAL CONFLICTS?

The obligations and duties of a manager stem from his or her position as a senior employee and possibly director of the target and/or the vendor.

A director or employee of the target will have the following fiduciary duties:

(a) if a director, duties at common law are:
- to act honestly in the best interests of the target as a whole;
- to exercise his or her powers for the purpose for which they are conferred and not for any collateral or improper purpose; and
- to avoid conflicts of interest (such as between his or her capacity as an investor in the purchaser of the shares in, or assets of, the target and his or her capacity as a director of the target, in which case, his or her responsibilities to the target must prevail);

(b) if an employee (whether or not a director), duties under his or her employment contract with the target; and
(c) duties under the Corporations Law.

A manager's service agreement may contain provisions imposing obligations of confidentiality about information gained during the course of employment; an obligation to work full-time in the business; an obligation to work at all times in the best interests of the employer and to avoid conflicts of interest with the employer. Certain of these express contractual obligations are reinforced by the fiduciary duties imposed at common law even in the absence of a written service agreement.

Under the Corporations Law, if a manager is a director of the vendor and/or the target, the manager is, *inter alia*, subject to the obligations in section 232 to:
- at all times act honestly in the exercise of his or her powers in the discharge of his or her duties;
- exercise reasonable care;
- not make improper use of employer information or improper use of his or her position to gain an advantage for himself or herself, or for any other person, or to cause detriment to the employer.

A director must declare an interest in any contract in which the director may be concerned and, if the employer is a public company, must not vote in relation to a relevant resolution.

There is also the general prohibition in section 995 of the Corporations Law against any person, in connection with any dealing in shares of a corporation, engaging in conduct that is misleading or deceptive or likely to mislead or deceive.

Between them, the obligations and duties described above create a minefield for an unwary manager.

Equally, the board of the vendor will be concerned that, in allowing an MBO to proceed, it can still properly meet its obligation to manage the vendor's investment in the target and the sale process in the best interests of the its shareholders as a whole. Practical concerns which may occur to the vendor are:

- a concern that managers could influence the decision-making process as to whether or not a sale proceeds and whether or not it proceeds by way of an MBO;
- if an MBO is being run as an alternative to a possible trade sale or float, a concern that managers deal equally and fairly with each of the sale options under consideration;

- the damage to the day-to-day management of the business which may result from a management team being distracted by the demands of participating in an MBO process; and
- in relation to the warranties or indemnities that may be required by the purchaser, the fact that there may be many areas of the business of the target in respect of which the only persons having knowledge are managers involved in the MBO team.

While these issues for management and vendor alike can seem daunting, with the right advice and a controlled and careful management of the MBO process, they have been and can be dealt with in an appropriate and effective way.

HOW TO DEAL WITH THE POTENTIAL CONFLICTS

The practical issues are best addressed up-front by putting in place a formal set of protocols between the vendor and management, committing both to ground rules on how the MBO bid is to be conducted. These would include the following items.

- *The vendor will establish a decision-making committee in relation to the sale process which will be independent from any of the managers.* If the managers are part of the group that chooses the successful bidder then this is where the strongest conflict of interest arises. Managers will always have a preference for who is the new owner of the business, whether it is a trade buyer or otherwise, and they will seek to influence the result accordingly. Management's role is to help in the sale process, but not to take responsibility for it.
- *The vendor agrees to the management being involved in an MBO proposal, usually on the basis that the identity of the MBO fund is approved by the vendor.*
- *The vendor acknowledges that the managers may spend a certain amount of time working on the MBO bid without breaching their service agreements.* The demands on a management team in assisting a vendor in preparing an information memorandum, conducting management presentations, building a data room and answering information requests from bidders are already a great distraction from the day-to-day running of the business. All parties must ensure that the value of the ongoing business is maintained despite the distraction of a sale process.
- *The vendor agrees that confidential information about the target may be made available by the managers to the other participants in the MBO bid.* There may be some debate about the freedom of flow of information. Some vendors may wish to confine the information flow to documented information approved in advance by the vendor.
- *Most important, the managers will agree that they will not make available information about the target to the MBO fund which is not known to the vendor.* The vendor will usually form its own view as to whether all the available information needs to be made available to all the prospective buyers of the target. There is certain information that vendors may be unwilling to make available to the target's competitors because of the risk of damaging the target's business (such as trade secrets or customer lists). Conversely, an MBO fund has a different and more comprehensive set of information needs than a trade buyer and a vendor is usually less concerned about making available to a financial buyer things like the strategic plans for the target. The greater information needs of an MBO fund arise because it is not already in the target business and must rapidly get up to speed. It is becoming more common for financial buyers to be given a special tailored management presentation even before making indicative bids on a business.
- *If there is a trade sale or float being run in parallel, the managers will agree to participate to the best of their abilities as required by the vendor in those other processes.*
- *The managers will be required to obtain their own independent legal and financial advice in relation to the buyout proposal and the vendor will make clear that it assumes no responsibility of disclosure of information to the MBO team.*
- *It should be made clear who is to be responsible for any professional or other costs incurred by the managers in exploring the MBO proposal.* It is not unusual for the vendor to underwrite the managers' costs.
- *The managers will agree to participate as required by the vendor in preparing a contract of sale for the target business, including providing information, to the best of their knowledge, as to matters which may be inconsistent with any warranties offered in the sale contract.*

It is also important that any negotiations between the MBO team and the vendor are run by the representatives of the MBO fund, rather than management themselves. This helps ensure that the management team does not jeopardise its working relationship with the vendor. The main areas of negotiation by the MBO fund with the vendor would include the purchase price and the sale and purchase contract.

Finally, from the vendor's point of view, if it is running an alternative trade sale process in tandem with an MBO, it may consider the provision of a special bonus contingent upon a successful conclusion of the trade sale option. In this way, even though management may prefer the MBO outcome, they will have adequate incentive to assist in achieving the other sale outcome if that proves more attractive to the vendor than the MBO proposal.

CONCLUSION

The establishment at the outset of a transaction of a set of protocols to govern the relationship between the management team and the MBO fund and the other parties in an auction process can help avoid the potential conflict issues that we have identified. In bidding for businesses in Australia the writers have seen these protocols used successfully by a number of corporate advisers including Warburg Dillon Read, Goldman Sachs, Macquarie Bank and Ord Minnett.

Corporate advisers have become increasingly comfortable with the inclusion of MBO and other financial bidders in a sale process. This is in part a result of the globalisation of the corporate advisory firms and the consequent transfer of UK and US experiences with buyout funds to the Australian landscape. If Australia follows the experience of the UK and the US, we can expect financial buyers to play an increasingly important part in the Australian mergers and acquisitions scene.