Legal Terms and Documentation (Private Equity)

Interview preparation summary · PE track

IN THIS SUMMARY

- Buying the company: the SPA
- Owning it: the shareholders' agreement and the debt

INT.LG.1.a · Buying the company: the SPA

Explain how the price is set and adjusted in a share purchase agreement, compare locked box with completion accounts, and size a leakage claim.

The headline price in a share purchase agreement is an enterprise value; the buyer pays equity value, which is enterprise value less net debt and other debt-like items, adjusted for working capital. Under completion accounts the price is estimated at completion and trued up afterwards against accounts drawn up at completion, so disputes over definitions are common. Under a locked box the price is fixed off a balance sheet at an earlier date and the seller promises that no value leaks to it or its connected persons since then; leakage is repaid pound for pound, and a ticker may add an agreed daily amount for cash generated. Locked box gives certainty and a clean exit for the seller, but the buyer takes trading risk from the box date, so permitted leakage must be listed and the box accounts diligenced. The definitions of net debt and working capital, and the normal level or peg, decide the money. English-law deals often use locked box and US deals more often use completion adjustments, though practice varies. The usual mistake is to discuss structure and ignore the definitions.

WORKED EXAMPLE: SIZING A LOCKED-BOX PRICE AND A LEAKAGE CLAIM

A fund agrees an enterprise value of 120.0m for Brindle Fasteners, a locked-box deal on a balance sheet showing net debt of 28.0m. Between the box date and completion 90 days pass. The agreed ticker is 12k per day. In that period the company paid the seller a dividend of 1.5m, paid 0.3m of the seller's own adviser fees, and paid a 0.45m bonus to the seller's brother, a director. It also paid ordinary salaries of 0.6m, listed as permitted. What does the buyer pay and what can it claim? Convention: all amounts in £ millions, ignore tax and interest on the claim.

Answer: The buyer pays 93.08m at completion (92.0m plus a 1.08m ticker) and recovers 2.25m of leakage, an effective price of 90.83m.

> **Interview tip:** Name the three things that make locked box work: reliable box accounts, a closed list of permitted leakage and a ticker that matches real cash generation. Then say which side bears trading risk.

INT.LG.1.b · Buying the company: the SPA

Explain warranties and indemnities, size recoveries under a cap, a de minimis and a basket, and say when W&I insurance or a specific indemnity is the better tool.

Warranties are statements of fact about the target given by the seller; if one is untrue the buyer can claim damages, usually the loss in value, subject to the limits in the agreement. The limits are where the negotiation happens: a de minimis excludes small individual claims; a basket sets an aggregate amount that claims must pass, and it is either tipping, so that once passed the whole amount is recoverable, or deductible, so that only the excess is; a cap limits total liability, often well below the price for general warranties and higher for title and tax. Time limits are often shorter for general claims and longer for tax. Disclosure against the warranties narrows them. A specific indemnity is pound-for-pound cover for a known issue and is not defeated by disclosure. Warranty and indemnity (W&I) insurance lets a seller, often a fund distributing proceeds, cap its liability at a small amount while the buyer claims on a policy that excludes known matters. Management sellers usually give warranties capped low. The usual mistake is to treat a high cap as protection when the basket and exclusions mean it is rarely reached.

WORKED EXAMPLE: RECOVERING UNDER A BASKET, DE MINIMIS AND CAP

Under the SPA for Ardent Signs the price is 80.0m. General warranties have a de minimis of 0.05m per claim, a basket of 0.8m (1% of price) and a cap of 24.0m (30% of price). After completion the buyer finds five breaches with losses of 0.04m, 0.30m, 0.45m, 0.90m and 1.20m. How much can be recovered under a tipping basket and under a deductible basket? Convention: the claims are valid, undisputed and brought in time.

Answer: Recovery is 2.85m with a tipping basket and 2.05m with a deductible basket; the 0.04m claim falls away and the cap is not reached.

Interview tip: Say that the cap sets the maximum but the de minimis and the basket decide most real recoveries, and that W&I insurance or a specific indemnity is the answer when a known risk or a seller who cannot stand behind a large cap is the problem.

INT.LG.1.c · Buying the company: the SPA

Explain conditions precedent, material adverse change clauses, interim covenants and restrictive covenants, and what each does for buyer and seller between signing and completion.

Where signing and completion are separate, the agreement binds both sides but completion depends on conditions precedent, such as merger clearance or a key third-party consent, with a long-stop date after which either side can walk away. The seller wants few conditions. A material adverse change (MAC) clause lets the buyer refuse to complete, and its drafting is the fight. A general MAC is vague and courts in many systems set a high bar for invoking one. So buyers push for quantified triggers, for example a fall in earnings or loss of a named customer, and sellers resist them or exclude market-wide events. Interim covenants stop the seller running the business outside the ordinary course between signing and completion; they should allow ordinary trading and require consent only for defined actions. Non-compete and non-solicit covenants protect the goodwill the buyer paid for; to be enforceable they must be reasonable in duration, scope and geography, and courts treat them differently by jurisdiction. A buyer who needs a financing or clearance condition should say so early. The usual mistake is to treat these clauses as boilerplate.

WORKED EXAMPLE: SIZING A QUANTIFIED MAC TRIGGER

A fund agrees to buy Coldwater Logistics at 10.0x last twelve months EBITDA of 15.0m, an enterprise value of 150.0m, with an equity cheque of 60.0m. The seller offers a MAC defined as a fall in LTM EBITDA of more than 20% before completion; the buyer wants 10%. What is the EBITDA movement and the value change at each threshold, and which should the buyer press? Convention: the buyer values the business at the same 10.0x multiple.

Answer: A 10% trigger exposes the buyer to a 15.0m value fall and a 20% trigger to 30.0m; a trigger near 15% (22.5m) with company-specific exclusions is a sensible middle.

Interview tip: Say that a MAC is a walk right, rarely used in practice, and that buyers who want protection short of walking ask for specific conditions and interim covenants as well.

INT.LG.2.a · Owning it: the shareholders' agreement and the debt

Explain governance, reserved matters and share transfer provisions in a shareholders' agreement, and compute what drag, tag and pre-emption mean for each holder.

A shareholders' agreement sets how the company is run and how holders can sell. Governance: the sponsor usually appoints a majority of the board or enough seats to control quorum, management gets one or two seats, and an independent chair may be agreed. Reserved matters are decisions that need the sponsor's consent whatever the board vote: budget, debt, acquisitions, senior hires, changes to the articles; management asks for a short list. Information rights give regular accounts and board papers. Transfer provisions: pre-emption gives existing holders first refusal on new shares or on a sale by another holder; tag-along lets minorities sell on the same terms when the sponsor sells; drag-along lets holders of an agreed percentage force all others to sell to a third party, giving a buyer 100%; a lock-up stops management selling for a period. Typically a drag threshold sits at a majority or a higher level such as 75%, with minority protections of equal price and form of consideration. The usual mistake is to forget that costs and escrows are shared, so net proceeds differ from headline value.

WORKED EXAMPLE: NET PROCEEDS ON A DRAGGED SALE

The shareholders in Larkspur Dental are the fund (70%), management (20%) and the founder (10%). A buyer offers an equity value of 150.0m for 100%, with a retention of 7.5m held in escrow for 18 months and 2.0m of sale costs, both shared pro rata. A drag needs 75% of the shares. Can the fund drag alone, and what does each holder receive at completion? Convention: single class of share, no loan notes, ignore tax.

Answer: The fund cannot drag alone at 70% against a 75% threshold; at completion it receives 98.35m, management 28.1m and the founder 14.05m, with 7.5m held back in escrow.

Interview tip: Say what a tag-along does for a minority (the same price per share and form of consideration), and that a drag usually carries the same protections plus limits on the liability a dragged holder gives.

INT.LG.2.b · Owning it: the shareholders' agreement and the debt

Explain management equity (sweet equity, ratchets, vesting and leaver terms) and compute the payoff to management and the sponsor at exit.

Management equity aligns the team with the sponsor and rewards outperformance. Typically the sponsor invests mostly through loan notes or preference shares that accrue a fixed coupon, and the ordinary shares are a small slice of the total. Management buys a share of the ordinary equity at low cost, the so-called sweet equity, so that once the coupon-bearing instruments are repaid at exit the ordinary shares take the upside, giving management a large multiple on a small investment. A ratchet raises management's share if the sponsor reaches a return hurdle such as a money multiple; the test should say whether the return is measured before or after the ratchet. Vesting spreads management's entitlement over time, often accelerating on an exit. Leaver terms say what a departing manager receives: a good leaver, for example through death, ill health or redundancy, typically receives fair value; a bad leaver, for example resignation within a period or misconduct, typically receives the lower of cost and fair value. Practice differs between English-law and US documents. The usual mistake is to ignore that the loan note coupon is paid before the sweet equity.

WORKED EXAMPLE: SWEET EQUITY PAYOFF AND THE LOAN NOTE COUPON

A fund invests 58.5m in Quillon Engineering: loan notes of 45.0m paying 10% compounded annually (paid at exit) and 13.5m for 90% of the ordinary shares. Management pays 1.5m for the other 10% of the ordinary shares. Equity value at exit after five years is 190.0m. What do management and the fund receive, and what are the multiples? Convention: ignore tax and fees, no ratchet.

Answer: Management receives 11.75m on 1.5m (7.8x) and the fund receives 178.25m on 58.5m (3.05x).

Interview tip: Explain that the instrument mix (loan notes versus ordinary) is a deliberate leverage of management's upside, and say how a ratchet and leaver terms would modify the result.

INT.LG.2.c · Owning it: the shareholders' agreement and the debt

Explain the debt package in outline (maintenance covenants, equity cure, change of control, portability) and say what a sponsor and a management team each look for.

A leveraged buyout is usually financed with senior facilities, and their terms decide how much room the company has. A maintenance covenant is tested at regular dates, for example net debt to EBITDA, and a breach is a default unless waived; covenant-lite term loans have none, with at most a springing test on the revolver. Headroom is the fall in EBITDA before the test fails, and sponsors negotiate a cushion to the base case. An equity cure lets the sponsor inject money to remedy a breach. It is usually capped in number and amount and applied either as extra EBITDA or as a reduction in debt. A deemed-EBITDA cure is far cheaper because each pound is multiplied by the covenant level. Change of control triggers prepayment or a put when ownership changes; portability lets the loan stay on a sale to a qualifying buyer if conditions are met, which supports exit value. Sponsors look for flexibility, generous EBITDA definitions and baskets; management looks for headroom and operating freedom. The usual mistake is to forget that tests use defined EBITDA, not reported.

WORKED EXAMPLE: HEADROOM AND THE COST OF AN EQUITY CURE

Orrin Foods has net debt of 100.0m and EBITDA of 25.0m, a leverage of 4.0x, against a maintenance covenant of 5.2x. In a downturn EBITDA falls to 18.0m. What is the headroom at the start, and what must the sponsor inject to cure by debt reduction or by deemed EBITDA? Convention: cure cash is not netted against debt in the EBITDA cure, and the covenant is tested on the figures given.

Answer: Opening EBITDA headroom is 23.1%; at EBITDA of 18.0m a debt-reduction cure costs 6.4m and a deemed-EBITDA cure costs 1.23m.

Interview tip: Say that a cure buys time, not a fix, that lenders cap the number of cures, and that a sponsor weighs the cheap cure against the signal it sends and against whether a waiver or reset is available.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.