CENTER FOR PRIVATE EQUITY AND VENTURE CAPITAL

KEY DIFFERENCES IN THE U.S. AND EUROPEAN PRIVATE EQUITY INVESTMENT PROCESS

Selected topics from the lower middle market

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The following report includes a list of key differences between the private equity transaction processes in the USA and Europe, specifically focusing on topics from the lower middle markets. The research consists of excerpts from internet accessible publications issued predominantly by US and European legal practices reviewed by selected industry experts. All sources have been quoted in the footnotes.

1. **Vendor due diligence (VDD) Report *(Latham & Watkins LLP[1])***

    i. **Europe:** In Europe, you do encounter vendor due diligence reports during transactions. These reports are prepared or commissioned by the seller. They provide an overview of certain matters relating to the target, typically covering past financial results, commercial relationships, environmental status and — less often — the legal structure and terms of the target's legal contracts and ongoing legal risks. The report's purpose is to enable the bidders in a transaction to familiarize themselves with the target as quickly as possible. VDD reports are not supposed to replace the buyer's due diligence; instead they are meant to facilitate it. They are particularly useful when you have complex targets and structures, and in the context of leveraged transactions they provide the financing sources a helpful picture for facilitating the lender-diligence.

       As far as the legal aspects of the reports are concerned, they are more often written as fact books. The firm's lawyers summarize the relevant terms of the contracts, legal relationships (such as joint ventures and licenses) and litigation fact patterns, rather than offering legal conclusions. The potential buyers need to rely on their own counsel for evaluating these facts to form legal advice and conclusions.

    ii. **USA:** It is very rare in the US for the seller or the seller's counsel to provide a legal diligence report on the target company. In the US, diligence is done almost exclusively — at least in the form of a report — by the buyer and its advisors. The target or its financial advisors will often prepare an information memorandum giving an overview of the business; and counsel will often conduct some sell-side diligence as a practical matter, but this is generally not provided in the form of a report to bidders. For instance, the seller may have its counsel help in preparing disclosure schedules, but these are limited statements in response to specific reps and warranties, as opposed to a full-blown report.

2. **Material adverse effect (MAE) clause as a closing condition *(Latham & Watkins LLP)***

    i. **USA:** Buyers and potential lenders seek protection to ensure that when the transaction closes, the target hasn't lost substantial value between the date on which the buyer based its purchase price versus the actual closing date when the buyer assumes ownership of the asset. In the US, part of the package for limiting this risk is a material adverse effect closing condition both in the purchase agreement and in the financing documents as a condition for funding any acquisition debt at closing.

[1] Key differences between European and US private equity transactions, Latham & Watkins LLP, https://www.lexology.com/library/detail.aspx?g=7085bdc6-8b95-4cab-998d-fe0b3ed4e6d8

In the US, an MAE closing condition is very customary. In a financed deal, it's going to be in the bank commitment letter as a condition of financing and ultimately the loan documentation. Buyers will need a similar MAE condition in the acquisition agreement, but will customarily seek the condition even in deals that aren't financed. While the exact interpretation of an MAE is based on state-by-state caselaw in the US, it is generally considered a very high hurdle — it's not a minor blip; it is typically thought of as something that has substantially changed in the business in an adverse and enduring way.

ii. **Europe:** However in most markets in Europe, banks offer "certain funds" to finance leveraged acquisitions of companies and therefore do not insist on this material adverse effect closing condition. Similarly and as a result the condition has become increasingly rare in purchase agreements. Europe also has comparatively little case law or precedent around the interpretation of these clauses. So there is a stronger tendency in Europe that the Purchaser takes the risk of the decrease of value of the target company after signing. However when material adverse effect closing conditions are used they tend to be more specific than the clauses in the US.

3. Lockbox financials *(Osler Hoskin & Harcourt LLP[2])*

i. **Europe:** Very much the norm in European deals is the use of a lockbox structure in the sales process. Use of a lockbox mechanism involves the parties agreeing to a fixed equity price calculated using a recent historical balance sheet of the target prepared before the date of signing the purchase agreement. Cash, debt and working capital as at the date of the lockbox reference accounts are therefore known by the parties at the time of signing and there is no post-completion adjustment.

From the selected date forward, the box is locked and therefore the risks and rewards of the business transfer to the purchaser as of the effective date, with some negotiated protections to address agreed "leakage" between signing and closing. The result is no closing statements and hence no purchase price adjustment.

While not perfect, and some would argue very seller-friendly, the lockbox mechanism provides certainty of price to both buyer and seller, eliminates the need to negotiate purchase price adjustment provisions (including agreeing to working capital targets). It also avoids protracted post-closing disagreements around price adjustment.

ii. **USA:** Lockbox structure is still uncommon in North America. There is typically an assessment of cash and debt in the time just preceding the deal closing. That assesment is potentially adjusted few days later.

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[2] What Europe may be able to teach us about private equity, Osler Hoskin & Harcourt LLP, https://www.lexology.com/library/detail.aspx?g=b3b82ee7-3a57-42a6-900f-fd1f751d5035

4. Liquidated damages reverse termination fee *(Latham & Watkins LLP)*

i. **USA:** Reverse break-up fees are often used in US deals, particularly if those deals involve third party financing. In financed deals, this is motivated in part because you don't have a funds certain regime like in Europe, and the buyer is relying on a third party for the money it needs to close. These reverse termination fees are often liquidated damages, so they serve to compensate the seller, and also as a cap on damages for the buyer. However, there are many variations on when a reverse break-up will be paid and whether it is the sole remedy. You may essentially have a two-tiered approach: where if the financing is not there, there is a reverse termination fee payable; and if the financing is there, then there is an additional remedy, which might include a higher fee, the right to seek additional damages or equitable relief.

   In that context, you will often see reverse break-fees coupled with specific performance — the ability of a seller to specifically enforce the buyer's obligations to seek the financing, and close the transaction if the financing is actually there. This is a fairly common approach, although it all gets negotiated.

   Such clauses also appear when there are regulatory concerns. It's used when the buyer brings an antitrust risk to the table — a risk that the transaction will not be approved by merger control authorities (maybe because the buyer already has a dominant market position). So in that event, if the seller does the transaction at all, it wants to be sure that the buyer carefully assesses the antitrust risks and then incurs a potential financial loss if it can't close, to make sure that there is a high degree of deal certainty in the end. You'll sometimes see a reverse break fee to bridge that gap. It can compensate the seller if the deal doesn't get done for regulatory reasons and essentially cap the buyer's liability for regulatory undertakings.

   The amount the private equity buyer is obligated to fund to support the damages would typically be capped at an applicable reverse break fee or damages cap. But if you have a deal with specific performance, the private equity buyer may also be on the hook to fund the full equity commitment in order to cause a closing (as distinct from the payment of damages)

ii. **Europe:** In Europe, in transactions that are not financed — a reverse break-up fee is often requested — but is relatively rare. It's normally used when the buyer brings an antitrust risk to the table.

   In transactions that are financed, the buyer normally does not have the right to walk away with payment of a break fee. The banks in Europe typically draw upon certain funds so the likelihood they can walk away is very low. And if they walk away, the buyer is on the hook — it is obliged to pay losses incurred by the seller.

This results in two issues: the first is how do you do define and prove the losses? And secondly, does the buyer have enough liquidity to pay these losses? This issue comes up when you deal with private equity buyers, which have formed a holding company that has no liquidity. The private equity owners of the holding company are then obliged to fund the amount of damages into the buyer, so the buyer can pay the damages.

In Europe, the amount of damages is customarily capped at the amount of the equity the private equity fund would have funded to the buyer if a closing had occurred, which should help align the incentives of the buyer and seller to get the deal done. However, the difficulty in Europe is that the seller would have to prove what the amount of the losses are. Whereas in the US, with a true reverse break-fee, the private equity fund is exposed only to the damages the seller and buyer agreed upon.

5. Disclosure of data room *(Latham & Watkins LLP)*

i. **Europe:** In Europe, the seller compiles a data room for the buyer for its diligence. Then the seller will give representations and warranties in the purchase agreement. The representations and warranties in that purchase agreement are subject to two significant caveats. First the seller may specifically disclose exceptions to the representation and warranties through specific contractual delineations. Alternatively, the seller may disclose the entire data room, which basically means that the contents of the data room serves as a contractual exception to all of the representations and warranties. If there are facts that result in a breach of the representations and warranties — and those facts are included in the data room — they are deemed to be disclosed with the result being that the representation or warranty is not breached. These facts in the data room need to have been fairly disclosed (i.e., you shouldn't list a major litigation case in a data room in the category of a material contract because that's not where you would look for them), but it is still a very general disclosure that has become more or less market standard. This practice raises particular challenges when the data room has restrictions on download permissions (e.g. documents can be viewed only online), printing, or it is partly physical rather than fully electronic (e.g. documents are accessible only at the seller's attorney office in a paper format)

   USA: In the US, this is fairly uncommon and you get a lot of resistance to this from buyers. US buyers generally want specific disclosures tailored to the representations and warranties in the form of disclosure schedules. These schedules can be expansive (and may ultimately more or less list everything from a data room), but they are generally expected to be fairly self-contained, without reference to an additional outside data room.

6. **Distribution waterfalls *(Adrien Motte, Director at Hellman & Friedman, Quora[3])***

   i. **Europe:** Under the European waterfall, the fund must first return all drawn capital back to its investors (the LPs) before then sharing the incremental profits between the LPs and the GP (private equity management company). Under the European waterfall, fund managers may find it more rewarding to keep their portfolio companies for shorter durations, particularly at the end of the fund life, in order to obtain liquidity rather than optimize for returns.

      Example: a fund invests $100m and buys 5 companies for $20m each. After 5 years, it has sold three of these companies for $90m in total. At this stage, the fund still needs to return another $10m before incremental profits can be shared.

   ii. **USA:** Under the United States waterfall, the fund is instead allowed to start sharing any incremental profits between the LPs and GPs on a "per realized" investment basis, and therefore does not have to wait for all the invested capital to be returned. In practice, this has the impact of "speeding up" the time at which the GP is able to receive its share of the profits (but doesn't change the final amount).

      Example: a fund invests $100m and buys 5 companies for $20m each. After 5 years, it has sold three of these companies for $90m in total. On these three investments, the fund realized a $30m return, so a portion of that profit is shared with the GP.

7. **Carry clawbacks (*Alternative insight*[4])**

   i. **Europe:** Both U.S. and European funds typically contain a GP clawback mechanism as protection against the overpayment of carried interest. By virtue of the way in which it calculates carry, a European style waterfall is less likely than an American style one to result in overpayment of carry during the life of a fund. Therefore, in Europe, it is common for the clawback to kick in at liquidation only, often backed up by escrow protection.

      For funds adopting a European style waterfall, the inclusion of other carry guarantees is somewhat less ubiquitous, perhaps because of the much greater use of escrow protection and, indeed, the lower overpayment risk that is inherent in whole fund waterfalls.

   ii. **USA:** In funds with American style waterfalls, clawback protection takes on an altogether greater significance, and LPs are more likely to negotiate for interim

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[3] Are there any differences between US and European based private equity models, Hellman & Friedman, https://www.quora.com/Are-there-any-differences-between-U-S-and-European-based-private-equity-models

[4] Two paths diverge in a wood – differences between U.S and European fund terms, Alternative Insight, https://www.mjhudson.com/newsletter/two-paths-diverge-wood-differences-american-european-fund-terms-march-2018/

clawbacks, with multiple test dates, from the end of the investment period through to liquidation of the fund. Escrow accounts are less common in U.S. funds than in European funds. Only 14% of funds in the MJ Hudson 2017 research survey that utilized a deal-by-deal waterfall built in some form of escrow protection.

The other type of investor protection that is commonly seen alongside American-style waterfalls is the personal guarantee – in MJ Hudson's 2017 fund terms survey, 71% of funds with a deal-by-deal waterfall required either the recipients of carried interest or the fund's sponsor to guarantee the GP's obligation to return overpaid carry. In MJ Hudson's 2017 survey of funds, we found that some 80% of such guarantees came from management team members who were ultimately entitled to receive carry distributions, whereas only 20% were given by the private equity firm itself.

8. Management fee waivers (*Alternative insight*)

i. **USA:** Another major in the U.S. funds is the option to finance GP commitment via management fee waiver and it has a history of being widely used in the U.S. The waiver mechanism involves reducing capital calls to investors for management fees and instead drawing down the saved amounts from investors to meet the GP's obligation to contribute capital alongside investors toward the fund's investments and expenses.

By recycling cash within the fund structure, rather than drawing it out in the form of fees and then ploughing it back in as capital, the GP can make its contributions on a gross basis for tax purposes. It also has the advantage of allowing first time fund managers and more junior members of the management team, who may not have enough cash on hand to meet regular drawdowns on account of GP commitment, to make a more meaningful contribution to the fund. But some LPs question whether fee waivers mean that the GP has less 'skin in the game' – the latter being seen as an important way of aligning the interests of manager with those of its investors.

ii. **Europe:** Management Fee Waivers is seldom seen in European fundraising

9. Full equity backstop *(Osler Hoskin & Harcourt LLP / Debevoise & Plimpton LLP[5])*

i. **USA:** A common feature of U.S. deals is a requirement for the sponsor purchaser to provide an equity backstop for the full amount of purchase price in the transaction documents. While the failure of banks to fund at closing may be somewhat of a distant memory, such incidents are not forgotten and therefore this requirement to provide the full equity backstop is still a hotly negotiated and at times a contentious part of private equity deals.

[5] Introducing full equity backstops to the PE toolkit, Debevoise & Plimpton LLP, https://privateequityreport.debevoise.com/-/media/spring2018_per_full_equity_backstops.pdf

Under the traditional deal model, sponsors commit to fund a limited equity contribution in the event debt financing is available and guarantee payment of a reverse termination fee in the event debt financing is not available. In providing a full equity backstop, however, the sponsor commits to fund the full purchase price. Full equity backstops came to prominence with Vista's $4.2 billion take private of TIBCO in 2014. Vista never intended to fully fund the transaction with equity (it secured debt financing commitments the day after the acquisition agreement was signed), but the additional closing certainty that its bid contained helped Vista win a hot auction. At the time, Vista's use of a full equity backstop in such a substantial deal raised eyebrows among practitioners. Although full equity backstops have become more common in the past few years, they remain most often seen in smaller- to middle-market deals.

ii. **Europe:** In Europe, on the other hand, no such commitment is required. This is how one commentator put it: "Even during the financial crisis our banks showed up. Once contractually obligated to fund, they do so."

10. Management at the table *(Osler Hoskin & Harcourt LLP)*

i. **Europe:** Management equity terms form an integral part of the deal process in Europe, unlike North America, where such matters would still be considered ancillary. In Europe, particularly in mid-market deals, it is not uncommon for the management team to hire advisors (financial and legal) early in the process and develop a term sheet setting out management asks that will go to bidders in the second round of an auction.

Typically at the time of signing the purchase agreement, a wrapper agreement setting out legally binding indicative terms relating to management is signed, with detailed documents being drafted, negotiated and settled between signing and closing. Key equity terms covered typically relate to economics, leaver mechanics, vesting periods, tax sharing and planning, and minority protections.

ii. **USA:** North American practitioners may view this management involvement as having the potential to derail or at least distract from the main deal. However, U.K. advisors insist it can help in the long run to ensure management's interests are being protected and needs are being met, and therefore they are supportive of the deal and there at closing.

As it can be observed above, there are significant differences in the operational and contractual models that are used in the USA and Europe. It is important to note that the presented list is not exhaustive and the discussed topics are particularly dynamic as both the legislative structure and the expectations of the GPs/LPs in the two regions have been evolving. Given that, the research has been developed for informational purposes only and we strongly recommend seeking professional advice before any investment.