Newsletter

BURGES SALMON

# Private Equity News

December 2015

## Welcome

Welcome to Private Equity News, our private equity update which keeps you informed of current issues and news in the private equity industry.

For further information on any issues raised in Private Equity News or private equity generally please email **richard.spink@burges-salmon.com** or **mark.shepherd@burges-salmon.com**

**Welcome to the winter edition of Private Equity News.**

**The Bank of England's most recent quarterly inflation report has conceded that inflation is much lower than had been expected this time last year as a result of falling energy, food and imported goods prices. However, the UK employment market remains strong and UK house prices are on the rise. It still remains to be seen when the Bank of England will finally conclude that there is sufficient stability in the UK market to enable it to raise interest rates. In his Spending Review and Autumn Statement, Chancellor George Osborne confirmed that the UK economy was on course for predicted growth of 2.4% in 2015 and a further 2.4% in 2016. In the UK deals market, transaction values remain high with significant trade and private equity interest in quality assets, backed by a strong appetite for debt. Against this backdrop of relative economic stability and ongoing low interest rate environment, legal and regulatory developments continue to provide fresh challenges and opportunities for investors and businesses alike.**

In this edition, we take a look at a recent case which heralds good news for bad leaver provisions from the perspective of investors and ongoing management.

We also look at a number of recent developments which may impact on private equity backed portfolio companies and targets alike. First, for businesses operating in Europe and the USA, we look at the implications of a recent judgment which ruled that the "Safe Harbour" agreement for the transfer of personal data between Europe and the USA is no longer valid (page 2).

We then highlight the changes to insurance law which will affect all businesses next year (page 3), and provide an update on the forthcoming introduction of the PSC Register (page 4).

Our article on the Working Time Regulations on page 5 will be of particular relevance to portfolio companies that employ mobile workers who regularly travel between different locations.

In the wake of the criminal prosecution of three former directors of parcel delivery firm City Link for the failure to follow consultation procedures for redundancy when the firm went into administration last Christmas, our article on page 6 considers just how practical it is for directors to comply with those statutory duties in insolvency situations.

## Good news on bad leaver provisions

The Supreme Court has clarified the scope of the doctrine of contractual penalties and laid out a new, more commercial test to determine whether a particular contractual provision is a penalty. Going forward there should be less room to suggest that properly drafted and negotiated bad leaver provisions fall foul of the rule.

Contractual provisions deemed to be penalties are unenforceable. The penalties rule catches more than just straightforward liquidated damages clauses, potentially including provisions which withhold or reduce payments or require transfer of property in connection with a breach of contract.

*continued overleaf*

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In Cavendish Square Holdings BV v El Makdessi, Makdessi had breached restrictive covenants in a sale and purchase agreement. The agreement provided that, where Makdessi was a defaulting shareholder (including where he had breached the restrictive covenants), he would not be entitled to deferred consideration payments and Cavendish could buy his retained shareholding at a reduced option price. The Court of Appeal had said these were unenforceable penalties, they were extravagant and unreasonable and their primary function was to act as a deterrent to breach. That decision led to concerns that many more contractual provisions of this ilk could be unenforceable.

Cavendish appealed and the Supreme Court agreed, deciding that the provisions were not penalties. Cavendish had a legitimate interest in ensuring that the restrictive covenants were observed (the protection of goodwill) and the provisions reflected the reduced price Cavendish was prepared to pay in circumstances where they were not. The provisions were the result of lengthy negotiations between legally-advised, commercially-sophisticated parties. Against this background, the Court held that the provisions were in the nature of agreed price adjustment mechanisms and were not unenforceable penalties.

When considering the penalties rule, the Court clarified the key considerations:

- Is the detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in enforcing the contract?
- Is there a negotiated contract between sophisticated commercial parties? If so, the parties themselves are the best judges of what is legitimate.
- The innocent party can never have a legitimate interest in simply punishing the breaching party.

What of the typical bad leaver provision which provides for the compulsory transfer of shares at a reduced price in certain agreed circumstances? Problems with the rule against penalties should not be encountered assuming that the provision has been well drafted, negotiated between sophisticated parties who have taken expert legal advice and it exists to protect the legitimate interests of the continuing party (or parties).

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# Safe Harbour Agreement no longer valid – is it still safe to send personal data to the USA?

In October, the Court of Justice for the European Union (CJEU) passed judgment on a case concerning the transfer of personal data from Europe to the USA. The outcome of this case is that organisations can no longer rely solely on the terms of the EU/US Safe Harbour Agreement to ensure that they are compliant with European data protection laws in respect of the transfer of personal data to the USA. Organisations should review any new or ongoing transfers of data to the USA and ensure that adequate contractual safeguards or corporate rules are put in place.

## What is the Safe Harbour Agreement?

The EU/US Safe Harbour Agreement was drawn up in 2000 as a means of wholesale approval of data transfers from Europe to the USA.

American organisations seeking to receive European data sign up to the agreement voluntarily, which is self-certification that they will comply with European data protection standards.

Over 4,000 American entities have signed up to the terms of the Safe Harbour Agreement, which has allowed them to receive unscrutinised transfers of personal data from across the Atlantic, on the assumption that adequate protection will be given to that data.

## International transfers of personal data

Where organisations seek to transfer data out of the EEA (the EU member states plus Norway, Iceland and Liechtenstein), EU data protection law imposes restrictions and places an absolute prohibition on transferring European data out of the EEA unless certain criteria are met. Only those countries and organisations that are able to provide an 'adequate' level of data protection (that is, comparable to European standards) are exempt from this rule. Since 2000, the USA has been considered as having 'adequate' data security standards as a result of the EU/US Safe Harbour Agreement.

However, since the revelations by Edward Snowden in 2013 regarding the direct access capabilities of American security agencies, the credibility of the USA as an 'adequate' jurisdiction has been doubted, leading to legal challenges of the Safe Harbour regime.

## The CJEU ruling

The CJEU declared the Safe Harbour Agreement itself to be invalid, as it no longer provides sufficient protection to European citizens when their personal data is transferred to the USA.

Within days of the judgment, EU data protection authorities tasked a working party with discussing the consequences of the decision and to consider the next steps for the regulation of data transfers from the EU to the USA.

## What next?

For businesses operating in Europe and the USA, the significance of this decision should not be under-estimated. The EU working party came to the unambiguous conclusion that data transfers which rely solely on the Safe Harbour for compliance with data protection law are no longer lawful.

The immediate repercussion of this judgment is that transfers of personal data from Europe to the USA made solely on the basis of the protection afforded by the Safe Harbour Agreement are no longer compliant with data protection law. Organisations that carry out such transfers should reconsider how they will comply with their data protection obligations.

Where transfers of data to the USA are still necessary, organisations should consider putting in place model data protection contractual clauses in respect of those transfers, or setting up corporate rules in respect of intra-group transfers of data. These options were noted as being viable alternatives to the Safe Harbour Agreement by the EU working party.

It is also worth noting that, in the absence of an EU-wide blanket authorisation for transfers of personal data to the USA, each Member State may need to create their own regulatory mechanism to plug the gap left by the CJEU's declaration of invalidity of the Safe Harbour Agreement. The UK Information Commissioner has issued a response to the CJEU ruling and recognises that it will take organisations some time to ensure that their transfers of data to the USA comply with data protection law.

Looking further ahead, it is expected that a replacement for the Safe Harbour regime will be in place by the end of January 2016.

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# Insurance Act 2015 – are you ready for the change?

The Insurance Act 2015 (the "Act") is due to come into force in August 2016 and will make substantial changes to insurance law in England & Wales. This will affect not only how disputes between businesses and their insurers are dealt with by the Courts but also the obligations on a business when purchasing insurance.

Some of the changes will soften the harshness of existing insurance law on businesses and make it more difficult for insurers to decline claims. However, the new law still places significant obligations on businesses in respect of their insurance. Businesses should prepare for these changes now so that when they obtain or renew their insurance they are able to comply with the new obligations. This will ensure that appropriate cover is obtained and the risk of disputes is minimised.

## Buying insurance

The Act sets out what a business has to disclose to insurers, whose knowledge has to be disclosed and the steps a business must take to find out information.

It requires the insured to:

- disclose all material circumstances which the insured knows or ought to know; or
- failing that, make sufficient disclosure to put a prudent insurer on notice to make further enquiries.

***What circumstances does a business "know"?***

For a business, its knowledge is that of individuals who are:

- part of its senior management; or
- responsible for its insurance.

The business will be taken to know all circumstances that those individuals know and those they suspected but deliberately refrained from confirming.

***What are the circumstances a business "ought to know"?***

A business ought to know information that should have been revealed by a reasonable search of information available to it – whether by making enquiries or otherwise.

This means that businesses should undertake a reasonable level of investigation for information which, if material, must then be disclosed to the insurers.

### Buying insurance – key points

- Duty to make a fair presentation of the risk.
- Knowledge of senior management and staff responsible for insurance is critical.
- A need to undertake a reasonable search for information.
- Disclosure information must be presented clearly and accessibly - 'data dumping' is prohibited.

## New remedies

One of the most significant changes to insurance law brought about by the Act concerns the remedies available to insurers where there has not been a fair presentation of the risk. The remedies are now proportionate to the breach.

Where an insured fails to comply with the duty to make a fair presentation of the risk, the insurer's remedy depends on the nature of the breach.  For example: where the breach was deliberate or reckless the insurer may avoid the entire policy and keep the premium; but where the breach is not deliberate or reckless, but the insurer can prove that if the breach had not occurred it would not have provided the policy, the insurer may avoid the policy but must return the premium.

## Remedies for breach of policy terms

Breaches of warranty no longer automatically discharge the insurer from liability under the policy.

Instead, an insurer is only alleviated of liability under the policy while the breach is ongoing. Once the insured remedies the breach the insurer is back on risk and cannot rely on the breach to escape liability. If the breach is not remedied before the loss, or the breach is not capable of remedy, this change will not assist insureds. However, the Act also prohibits insurers from rejecting a claim for breach of a term, where non-compliance with the term could not have increased the risk of the loss actually suffered.

## Contracting out

An important point for businesses to be aware of is that it is possible to contract out of the provisions in the Act (apart from those relating to basis of contract clauses) by including terms in the policy which are more onerous to the insured than the provisions of the Act.

An insurer must draw such clauses to the insured's attention and the clause must be drafted clearly and unambiguously.

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### New remedies – key points

- Proportionate remedies for breach of duty to make fair presentation.
- Insurers can no longer refuse to pay on the basis of a breach of a term (compliance with which tends to reduce the risk of loss) unrelated to the loss.
- Breaches of warranty only suspends the insurer's liability under policy, remedying the breach puts the insurer back on risk.

# Limited partners – people with significant control?

A significant change to UK company law is anticipated to take effect from April 2016 - the introduction of a new company register of people with significant control (the PSC register). This register has its roots in the Government's drive over recent years to improve transparency and trust in our companies.

The implementation of a compulsory regime for the majority of UK companies* which captures information on a wide range of people with significant influence or control over a company (PSCs) and, in most cases, makes it publicly available, will have a material impact on the administration (and, potentially, the ownership structures) of all applicable UK companies.

## How does it apply to LPs?

The position of limited partners in private equity funds in the context of the PSC register was a key concern for the private equity sector during the consultation stage of the new legislation. The problem arises from the nature of a limited partnership** - it is not itself a legal entity capable of being registered in a company's PSC register as the holder of a significant interest in the company. Would this mean that (where a registrable interest is held in a company) all the limited partners (perhaps numbering in the hundreds) would need to appear in the PSC register of the company? That concern has been answered with the legislation confirming that individual limited partners (or individuals with interests in corporate limited partners) will not need to be included in the PSC register merely because they hold that position. The general

rule of thumb will be that (where a limited partnership has a registrable interest in a company) only those who exercise significant control or influence over the management or activities of the limited partnership (such as a general partner) will need to be captured in the PSC register.

There may of course be other reasons why a particular limited partner or individual sitting behind a corporate limited partner may satisfy one of the tests for being a person with significant control or influence over a company. A full discussion of the various tests is outside of the scope of this article but in broad terms, a person will be a PSC of a company if they:

- hold shares (or voting rights) of more than 25% (directly or indirectly);
- have the right to appoint or remove a majority of the board (directly or indirectly); or
- otherwise exercise significant influence or control over the company.

## Implementation

The Government will be publishing comprehensive guidance for companies and prospective PSCs on how to apply the new PSC regime. Promised for the Autumn, we are expecting this to be available shortly. Look out for our next briefing giving an in-depth review of the new PSC regime.

**Certain companies subject to similar disclosure regimes will be exempt, including companies with shares admitted to trading on the London Stock Exchange main market or AIM.*

***A limited partnership registered under the Limited Partnerships Act 1907 and certain foreign limited partnerships to be specified in further legislation.*

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# Does travel time count as "working time"?

Employers of mobile workers, who have no fixed place of work and travel directly from home to and from their first and last customers, will need to review their current working patterns and check their compliance with the Working Time Regulations (the Regulations). This is as a result of a recent European case which has decided that the time spent by these peripatetic workers driving to and from their first and last appointment of the day should count as working time under the EU Working Time Directive (the Directive).

## Who is affected?

This ruling will have implications for many businesses with workers who regularly travel between different locations or sites as part of their job, for example, care workers, travelling sales reps and maintenance engineers. However, it does not apply to the large majority of workers who have a permanent place of work. For them, travel time to and from home to an office or depot will not count as working time.

## What was the case about?

The case was brought by Spain's largest trade union, Comisiones Obrerars, against a security company, Tyco. Following the closure of Tyco's regional offices and depots, its technicians were required to travel from home to their first appointment and were provided with mobile phones to receive instructions from Tyco. This journey varied but sometimes it was over 100 kilometres and could take up to three hours.

However, Tyco only calculated the working time of its technicians from when they arrived at their first appointment until they left their last appointment of the day. The workers claimed that this breached their right to a rest period of 11 consecutive hours under the Directive and Spain's High Court referred the question to the Court of Justice of the European Union (ECJ) as to whether this time should be regarded as working time for the purposes of the Directive.

## What was decided?

The ECJ determined that:

- the travel in question formed an integral part of the work and was a necessary means of providing services to customers - it should therefore be regarded as forming part of the workers' activities;
- the workers were also at their employer's disposal during the journey as they acted on the instructions of Tyco who could change, cancel or add an appointment. It was for the employer to put in place procedures to avoid any potential abuse of the working arrangements by employees; and

- it would be contrary to the objective pursued by the Directive of protecting the health and safety of workers if the rest periods of those workers without a fixed place of work were reduced because the time spent travelling between home and customers was excluded from the concept of working time in the Directive.

## What is the impact of this decision?

UK courts and tribunals are required to interpret the Regulations in accordance with the Directive. Therefore, as a result of this ruling, employers with mobile workers will need to review their current working patterns and check their compliance with the Regulations.

In particular, employers should check whether an employee's total average working time each week will result in the employee exceeding the 48 hour limit imposed by the Regulations (unless the employee has opted out of this limit), as well as any time restrictions contained in the employee's contract of employment.

In addition, employers will need to consider whether employees are able to take the daily and weekly rest periods to which they are entitled under the Regulations.

If current working patterns are not compatible with the working time limits, it may be necessary to consider how these can be adapted and whether employees should be asked to opt out of the 48 hour limit on working time. Contracts of employment and policies may also need to be reviewed.

The requirement to count travelling time of mobile workers from home to and from their first and last customers could have significant implications for some businesses as it may reduce the number of appointments that a worker can deal with in a day and have a knock-on effect on the efficiency and costs of the business.

However, the decision only concerns working time and the ECJ expressly stated in the case that it is for national legislation to determine whether or not this travelling time is paid or unpaid. The Regulations do not deal with pay, so for many employers a lot will depend on the specific wording of particular contracts of employment, travel policies and collective agreements, so these should be reviewed and legal advice obtained.

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# Insolvency situations – is it possible to avoid criminal liability?

You may have seen our separate briefing in October which highlighted the fact that three former directors of parcel delivery firm City Link were facing criminal prosecution over their failure to follow the correct procedures for making their staff redundant when the company went into administration last year. They have recently been found not guilty but the case highlights the risk of personal criminal liability in insolvency situations.

## The alleged criminal failure

The Company called in administrators on Christmas Eve 2014. 2,356 job losses were announced on New Year's Eve 2014, with a further 230 redundancies announced the following week. As a result, the Insolvency Service is reported to have paid out some £5m in statutory redundancy pay to former employees of the Company.

It was alleged that the directors failed to give sufficient notice of the redundancies to the Department for Business, Innovation and Skills ("BIS"). If an employer proposes to make 20 or more employees redundant at one establishment within a period of 90 days or less, notice should be given to BIS by completing a form HR1.

In addition, whenever large scale redundancies such as this are proposed, the employer is under a duty to carry out collective consultation with employee representatives. Consultation should begin in good time and in any event:

- at least 30 days before the first dismissal takes effect where 20-99 redundancies are proposed; or
- at least 45 days before the first dismissal takes effect where 100 or more redundancies are proposed.

The verdict was very much based upon the facts of this case. It was found that the directors in question had real evidence that they believed that a sale of the company out of administration was very likely and that jobs would be saved. However, this verdict should not detract from the importance to comply with the consultation requirements.

## The problem facing directors

But, what does this mean in practical terms for directors of companies in financial difficulties?

The laws relating to consultation for redundancy and insolvency remain almost diametrically opposed, and this prosecution does little to help the situation. Employment law fundamentally fails to recognise the time-critical dynamics governing insolvency situations, and insolvency itself is not counted as a "special circumstance" under section 188 of the Trade Union and Labour Relations (Consolidation) Act 1992 ("TULCRA"), although courts may decide that special circumstances apply in insolvency situations. The case of Shanahan Engineering Ltd v Unite the Union UKEAT/0411/09I showed that a lack of time for consultation did not of itself do away with the need for consultation. Given that employers must show that they have taken "reasonable steps" to comply with TULCRA, the answer does not appear to be that directors must simply "do the best they can in the time available". Instead, they should be able to demonstrate that real pre-planning has taken place to establish timing, scope and numbers – including consultation – before a process is launched, notwithstanding that in practice there may not be time to do so, which is an uncomfortable outcome.

## Future developments

In recognition of these problems in insolvency in particular, in March 2015 The Insolvency Service published a call for evidence on how directors and insolvency practitioners comply, in an insolvency context, with their obligations under TULCRA in relation to large scale redundancies (Insolvency Service, Collective Redundancy Consultation for Employers facing Insolvency). It is anticipated that the results of this will be made public before Christmas 2015, and that a policy review will then be carried out in the light of the evidence received. We will report further as and when the recommendations from this call for evidence become clear.

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# ELTIFs – PE's gateway to EU retail investors?

## The EU's current retail AIF marketing landscape - a patchwork quilt

EU PE managers of alternative investment funds (or 'AIFs') can currently only access the huge pool of EU retail investors through the patchwork regimes across the various EU jurisdictions. Of course, since July 2013 such EU 'alternative investment fund managers' (or 'AIFMs') can market to professional investors across the EU using the Alternative Investment Fund Managers Directive ('AIFMD') passport.

This is in contrast to the framework that permits marketing of 'undertakings for collective investment in transferable securities' (or 'UCITS') to retail investors across the EU (as well as professional investors).

## The ELTIF Regulations and a new retail AIF marketing passport

As of 9 December 2015, the 'European Long-Term Investment Fund' ('ELTIF') Regulations permit EU AIFMs authorised under the AIFMD to market ELTIFs (a form of AIF) to EU retail investors using a passport in a manner, and with protections, similar to the UCITS framework. Under the Regulations, marketing of ELTIFs to professional investors is also permitted, though it is not clear what additional benefit the additional regulatory compliance, with the ELTIF Regulations, brings over standard AIFMD marketing.

The EU Commission's intention behind the ELTIF Regulations is to create a prominent 'brand', emulating to the UCITS success-story, and improve long-term non-bank investment in unlisted companies and long-term assets, such as real estate and infrastructure throughout the EU. But there are real questions about whether the regulatory requirements will put off PE managers, or the retail investors, ELTIFs are in part designed to attract.

## Strict ELTIF Regulation requirements…

In order to provide suitable finance to long-term projects, the ELTIF Regulations only provide a limited ability for investors to redeem their investment early. This may well put off many retail investors who typically want more liquid investments, as facilitated by UCITS, to reduce liquidity risk. Further, the Regulations provide that potential retail investors with less than €500,000 must invest an initial amount of €10,000 in ELTIFs, if they are to be allowed to invest in them at all. There are member state concerns this could severely restrict the amount of retail investment available to these funds.

Under the ELTIF Regulations, ELTIFs are governed by both the AIFMD and the more stringent requirements of the Regulations themselves. These impose a large number of restrictions on AIFMs, especially when marketing ELTIFs to retail investors, including requirements for AIFMs to:

- assess and recommend the suitability of the fund for marketing to retail investors based on the investor's investment knowledge and experience, financial situation and objectives against the duration and intended investment strategy of the ELTIF;
- ensure that the ELTIF has a depository, subject to stricter requirements than under the now-familiar AIFMD, on discharge and limitation of liability, as well as re-use of assets;
- produce a 'key information document' outlining the nature of the fund.

There are also further restrictions on the assets an ELTIF can invest in, and requirements for the diversification of its investment portfolio - all very similar to the UCITS regime, as well as other EU product-regulation piggy-backing on the AIFMD since 2013, such as 'EuVECA' and EuSEF'.

## …but potential for significant gain (for Super ManCos)?

How extensively ELTIFs are used will depend on the cost-benefit analysis of cost of compliance versus additional investment, which could be facilitated by the taxation regimes member states decide to apply to ELTIFs and their investors.

As a combination of UCITS-style product regulation on AIFMD rails, ELTIFs certainly offer a potential opportunity for PE managers to more easily access EU retail investment.

However, it is perhaps those PE firms with a 'Super ManCo', authorised to manage and market AIF and UCITS, and able to benefit from the experience of closed-ended fund management under AIFMD with UCITS-compliant systems and processes designed to protect retail investors, that will be most suited to an ELTIF strategy.

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# News in brief

## Gender Pay Reporting

In September, the Government closed its consultation on the implementation of an obligation on large employers (with 250 or more employees) to publish their gender pay gap data.

In October, David Cameron announced that, as well as basic pay, bonus information broken down by gender would have to be published. This suggests that the draft Regulations will require employers to publish more detail than just a single, business wide figure comparing the pay of male and female employees.

The more detail employers are required to publish the more likely it is that the spotlight will fall on pay fairness within organisations, potentially triggering claims for equal pay.

Whilst draft regulations are expected shortly it is likely that there will be a lead in time before publication. It would be prudent for employers to use this period to carry out a review of pay practices so they can identify any areas of concern and begin to address them prior to the publication deadline.

For more information on this please see our briefing on **Burges Salmon Gender Pay Audit Service.**

## Group reorganisations – introducing a new holding company

When a new holding company is inserted into a group by way of a share for share exchange, an application for relief from Stamp Duty can be made under section 77 of the Finance Act 1986, provided certain conditions are fulfilled (including the requirement for the new shares issued to be a mirror image of those being acquired).

Historically, there has been considerable uncertainty as to whether such a transfer continues to be exempt from Stamp Duty where there is debt owed by the target company. HMRC has recently considered this point further, although we are awaiting the publication of formal guidance.

Until such guidance is published, we are working on the assumption that if loan stock has been issued in the target, then mirror image loan notes will need to be issued by the new holding company, which could potentially have wider commercial or banking implications. It will also increase the costs of tax analysis and so this should be borne in mind when considering any group reorganisation.

# Burges Salmon accredited with Investors in People Gold Standard

Burges Salmon is pleased to announce that is has been accredited with the prestigious Investors in People (IiP) Gold Standard.

Investors in People is a management framework for high performance through people. Its accreditation is recognised as a mark of excellence. IiP optimises performance by championing best practice in people management and equipping organisations with the tools to succeed. Organisations that demonstrate the Investors in People Gold Standard achieve accreditation through a rigorous and objective assessment in all aspects of people development, communications and engagement.

Some of the notable highlights from Burges Salmon's assessment:

- The firm's People Plan and how it has been placed centrally as a driver for business development.
- Responsiveness to feedback from all sources including staff surveys.
- The firm's Values and Strategy being brought into day-to-day communications at firm, department and team levels.
- How the vast majority of people are engaged in CR activity and in celebrating CR achievements.
- The majority of people feel that the firm is a great place to work and there is a solid commitment to the success of Burges Salmon across the business.

Burges Salmon's Chief People Officer Robert Halton said: *"Achieving Gold recognises the commitment and investment we place in our people. This puts us in the top seven per cent of organisations across the UK who hold the Gold Standard and we are delighted with the recognition."*

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