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Private equity deal making post-AIFMD: asset stripping rules

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1. Introduction

The Alternative Investment Fund Managers Directive (2011/61/EU) contains rules prohibiting "asset stripping" by private equity firms in the case of an acquisition of control over a non-listed company having its registered office in the EEA.

The rules apply to deal making activity by firms authorised under the Directive or which market their funds to EEA investors, and must therefore be borne in mind by managers working at such firms when structuring or implementing acquisitions and other corporate transactions (such as dividend recaps).

The majority of private equity firms in the UK which have applied to become authorised under the Directive are expected to become authorised on or shortly before 22 July 2014. The full impact of these rules will therefore begin to be felt from such date.

This note provides a summary of the relevant rules and explains what their impact is expected to be.

2. What do the rules on asset stripping provide?

The rules on asset stripping provide, in a nutshell, that when a private equity fund, individually or jointly with others, acquires control (i.e. more than 50% of the voting rights) over a non-listed company having its registered office in the EEA, the manager of that fund is not allowed, for a period of 2 years following the acquisition of control, to facilitate, support, instruct or vote in favour of certain distributions, capital reductions, share redemptions and/or acquisitions of own shares by the relevant company, and must in fact use its best efforts to prevent any such transaction from taking place.

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The details of the restrictions that apply are technical in nature and overlap with (but are more restrictive than) the pre-existing requirements regarding the availability of distributable reserves under UK law. The key messages are however that:

(i) when considering any distribution or return of capital within 2 years of completion of an acquisition, specific advice in this area should be sought; and

(ii) there will often be ways of ensuring that the commercial goal can be achieved without falling foul of the new rules.

As the rules extend to prohibiting the facilitation of restricted activities, any preparatory steps taken within the 2 year period in relation to a transaction to be effected after such period has expired could also be caught.

The rules do not apply to any distribution, capital reduction, share redemption or acquisition of own shares made by a non-listed company that qualifies as a small or medium-sized enterprise (i.e. an enterprise which employs fewer than 250 persons and which has an annual turnover not exceeding €50m and/or an annual balance sheet total not exceeding €43m) or a special purpose vehicle having the purpose of purchasing, holding or administering real estate.

Similarly, the rules do not apply to any distribution, capital reduction, share redemption or acquisition of own shares made by a non-listed company that has its registered office outside of the EEA.

A private equity firm that contravenes the above rules is to be treated as having contravened a rule made by the FCA under FSMA and could therefore be subject to disciplinary and enforcement measures by the FCA.

A breach of the rules, however, would not constitute a criminal offence and would not have any impact on the validity from a company law perspective of any distribution, capital reduction, share redemption or acquisition of own shares that has taken place in breach of the rules.

3. When are these rules relevant in practice?

The asset stripping rules are relevant if a transaction such as a dividend recap, refinancing, disposal of assets, merger or reorganisation of a portfolio company takes place within 2 years following the date of acquisition of that company. This is because such transactions often involve, or are shortly followed by, a distribution, capital reduction, share redemption or acquisition of own shares by the portfolio company.

The rules do not contain a blanket prohibition on such transactions taking place but should always be borne in mind by private equity managers and their legal advisors when planning and structuring such transactions. This is because, with the necessary

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planning, it will often be possible to structure and implement a proposed transaction without contravening the rules.

For example, a distribution of value to shareholders will not be caught by the rules if it is implemented by means of the repayment of shareholder loan or loan notes. Inserting such instruments in a company's capital structure is therefore likely to provide more flexibility than equity instruments (such as preference shares), in particular if a refinancing is expected to take place shortly after completion. This is likely to be the case in an all-equity deal or where equity finance is being provided to a portfolio company to finance a bolt-on acquisition.

There is no statutory definition of the term "capital reduction" and it is currently unclear whether such term refers only to a reduction of the nominal value of a company's subscribed share capital or would also include a reduction of a company's share premium account. It is accordingly unclear whether a capital reduction which transfers an amount from a company's share premium account to a distributable reserve would be permissible.

Careful consideration should also be given to any intra-group transfer of assets because such transactions could also involve a distribution in certain cases.

The rules provide that a private equity firm must use its "best efforts" to prevent any prohibited transaction from taking place during the requisite period and do not provide that such obligation ceases to apply upon the private equity firm disposing of its shares in the relevant company.

Accordingly, if shares in a portfolio company are sold to a third party prior to the expiry of the 2 year period, the private equity firm selling the shares should seek to negotiate the inclusion in the sale and purchase agreement of a provision whereby the buyer of the shares would be prevented from entering into any prohibited transaction until 2 years have elapsed from the date of the original acquisition.

Even if the buyer of the shares refused to include such provision in the agreement, the private equity firm would be able to demonstrate in this case that it did use its "best efforts" to prevent any such transaction from taking place during the requisite period.

It also appears that, under the asset stripping rules, whether a distribution is permitted is to be determined by reference to a portfolio company's net assets as set out in the company's most recent annual accounts. This suggests that distributions that are justified solely by reference to a portfolio company's interim accounts may not be permitted if the company's most recent annual accounts do not show sufficient surplus net assets. The drafting of the rules is not entirely clear on this point and, if this issue became relevant in the context of a proposed transaction, individual guidance could be sought from the FCA.

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To conclude, while we do not expect that the asset stripping rules will limit the freedom of private equity firms in any significant way, it is important that such rules are borne in mind by private equity managers and their legal advisers when planning and structuring an acquisition or other corporate transaction in order to avoid the situation where portfolio companies are prevented from carrying out a proposed transaction that, with the appropriate planning, would have been permitted.

4. To which managers do the rules apply?

Broadly speaking, the asset stripping rules apply to the following categories of private equity managers:

(i) UK and EEA managers that have been authorised as AIFMs under the Directive; and

(ii) non-EEA managers that have notified the FCA (or the equivalent competent authorities of another EEA state) of their intention to market their fund to investors based in the UK (or such other EEA state).

Accordingly, the rules do not apply to the following categories of managers:

(i) managers of private equity funds that qualify as "small AIFMs" for the purposes of the Directive (i.e., in summary, managers who have assets under management of less than €500m and manage unleveraged closed-ended funds having no redemption rights within five years);

(ii) non-EEA managers of private equity funds established outside of the EEA which are not marketed to EEA-based investors.

As mentioned, since the majority of private equity firms in the UK which have applied to become authorised under the Directive are expected to become authorised on or shortly before 22 July 2014, we anticipate that the full impact of these rules will begin to be felt from such date.

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