MANAGEMENT BUY-OUTS: PUBLIC INTEREST OR PRIVATE GAIN?

SUMMARY

Traditionally, local authorities have used their own workforces to provide the majority of their services. However, the Local Government Act 1988 requires that for a range of services an authority can use its own workforce only if the work has been won after seeking competitive tenders from the private sector. This legislation appears to have encouraged a significant increase in the number of management buy-out proposals.

A local authority management buy-out (MBO) involves the setting up of a company by managers previously employed by the authority. These managers acquire a substantial equity stake in the new company, with the balance typically being held by financial institutions. Usually the majority of the local authority workforce transfer to the company. The new company is almost invariably tied, at least initially, to its parent authority by a contract for service delivery.

Buy-outs may appeal to many authorities. They may be seen as an opportunity for an authority to re-orientate itself as a service enabler rather than as a service provider and thus to divest itself of a long-term commitment to its workforce, while maintaining continuity of employment. Buy-outs may be seen as a more efficient way of delivering a service, because the buy-out company may be more businesslike in its approach and able to spread its overheads more widely.

But while there are attractions, there are also pitfalls. Unless carefully handled, MBOs may look as though they bring substantial financial rewards to the managers involved at the ratepayers expense. There are clear potential conflicts of interest within the authority as the buy-out is negotiated.

To guard against such charges, employees who are proposing an MBO should declare their interest as soon as the MBO looks feasible. An authority would generally be in breach of its fiduciary duty to its ratepayers/chargepayers if it awarded a long-term contract to a management buy-out company without seeking competitive tenders, because otherwise the authority would have no certainty that the deal being offered by the management buy-out team represents the best value for money. Indeed, it is likely that the buy-out team members would not offer all the potential savings to the authority - their interest would be naturally to try and retain as much as possible for themselves as profit.
If an authority wishes to award a contract to a buy-out company without competition then it should be able to demonstrate that this is in the interests of the ratepayers/chargepayers, and only exceptionally should the contract be for more than one or two years.

Other issues to which authorities need to give careful consideration include:

— the status of the buy-out company. The Local Government and Housing Act 1989 defines the types of company in which local authorities have an interest. It is expected that most management buy-out companies will not fall into any of these types, but authorities should nevertheless seek advice;

— the status of the potential buy-out team’s members while they negotiate the buy-out. The legality of allowing staff paid time off to organise a buy-out and the use of central support services to assist in preparing the buy-out is open to considerable doubt. The management buy-out team should not be involved in preparing any rival DSO bid;

— the procedure by which employees will leave the authority’s employment. The Commission’s legal advice is that the Transfer of Undertakings Regulations 1981 would not apply and that buy-out companies cannot be admitted to the Local Government Superannuation Scheme;

— the valuation of assets to be purchased by the buy-out company. Assets must be sold for their market value, which should be assessed independently. Authorities should be alert to the possibility of considerable windfall profits accruing to a small number of people if a management buy-out company wins an over priced tender or is sold assets for below their market value. Another company may recognise the full potential and take over the buy-out company;

— the potential ‘exit routes’ for members of the buy-out team. The most common exit route is a trade sale to another company. This is particularly true of public sector buy-outs. Of the MBOs that have exited recently, the age of the company was typically between two and four years.

Authorities are advised to consult their auditors on these matters before a proposed buy-out takes place.

INTRODUCTION

1 A management buy-out (MBO) in the private sector refers to the transfer of ownership of a firm, whereby the incumbent senior management, taking the initiative, acquire a substantial equity stake. In practice, the proportion of equity retained by management will depend on the amount of external funding required.

2 In local authorities, because there is not usually a company to purchase, most deals do not fall within the above definition, but the term is also applied to situations where the existing management form a company which then tries to win work from the authority which previously employed them.

3 In the case of some buy-outs, the equity may be spread across more employees than just a small management team. This would be known as an employee buy-out. This is not common, although there is often an option for employees to obtain shares in the company.

4 There are some variations from these definitions. For example, where the vendor takes the initiative to sell to the existing management, the action would still be called a management buy-out. Likewise, a third party financier might initiate the transaction but involve the existing management in a buy-out.

5 Management buy-outs have become an increasingly common feature of the British economy in the last decade, accounting for approximately £3.75 billion of acquisitions in 1988, yet only £28 million in 1980 (Exhibits 1 and 2). Before the 1980s they were essentially an American phenomenon.
Exhibit 2
THE VALUE OF MBOs IN THE UK (1979-1988)
The value of MBOs has increased dramatically...

![Graph showing value of MBOs from 1979 to 1988.]

Source: CMBOR

6 Some buy-outs have attracted a lot of media attention due to the amount of money made by shareholders on the sale of their shares (Exhibit 3). A recent public sector example (not shown in the exhibit) is the National Freight Consortium which was bought-out by employees in 1982 for £53 million and floated on the stock exchange in 1988 at a market valuation of £890 million. Another case was ITEL, bought out from British Leyland for £26 million in 1987 and sold for £180 million in 1989.

7 The public sector has provided quite a number of buy-outs in the 1980s (Exhibit 4). There have already been a few management buy-outs of local authority services such as that of Westminster’s cleansing DSO and Bath’s DLO (Exhibit 5 overleaf). Compulsory competitive tendering (CCT) seems to be providing a spur for further buy-out activity although some of the proposals are for services not directly affected by it. Now that sport and recreation management is due to be added to the list of activities defined under the Local Government Act 1988 there is likely to be an increase in buy-out activity. In this service, some authorities will be particularly attracted by management buy-outs because there are currently few existing sports management contractors in the U.K. and there may be fears of receiving no bids from the private sector, or only from unproven companies.

8 This paper supplements Competition - Advice To Auditors* released in January 1989. It provides an introduction to management buy-outs, covering when, how, and why they may occur. Included are a series of questions which should help authorities and auditors review a buy-out proposal.

Exhibit 3
INCREASE IN VALUE OF MBOs
The value of some buy-out companies has increased significantly between buy-out and exit...

![Graph showing increase in value of MBOs.]

Source: CMBOR

9 The paper takes a neutral stance on the principle of whether MBOs should be encouraged. It is too early to review in depth the few local authority MBOs which have occurred. The paper therefore concentrates on the legal and probity issues which authorities need to take into account.

* Competition - Advice to Auditors available to authorities from the Audit Commission, Nicholson House, Lime Kiln Close, Stoke Gifford, Bristol, BS12 6SU. Price £10.00.
LOCAL AUTHORITY MBOs

Some local authorities have already allowed MBOs...

<table>
<thead>
<tr>
<th>Authority</th>
<th>Services provided</th>
<th>Number of employees</th>
<th>Date of MBO</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bath City Council</td>
<td>Highway maintenance, ground maintenance, street cleansing, office cleaning, housing repairs.</td>
<td>186</td>
<td>April 89</td>
</tr>
<tr>
<td>Hinckley &amp; Bosworth BC</td>
<td>Leisure management</td>
<td>60</td>
<td>April 88</td>
</tr>
<tr>
<td>ILEA</td>
<td>Educational TV service</td>
<td>11</td>
<td>August 89</td>
</tr>
<tr>
<td>Mid Sussex DC</td>
<td>Refuse collection, street cleansing, building maintenance, ground maintenance, office cleaning, miscellaneous services.</td>
<td>176</td>
<td>August 89</td>
</tr>
<tr>
<td>Rochford DC</td>
<td>Leisure management</td>
<td>110</td>
<td>April 88</td>
</tr>
<tr>
<td>Stratford-on-Avon DC</td>
<td>Refuse collection, street cleansing, leisure management ground maintenance, building cleaning, sewer maintenance.</td>
<td>239</td>
<td>August 89</td>
</tr>
<tr>
<td>Westminster City Council</td>
<td>Leisure management</td>
<td>75+</td>
<td>September 88</td>
</tr>
<tr>
<td>Westminster City Council</td>
<td>Refuse collection, street cleansing</td>
<td>800+</td>
<td>February 89</td>
</tr>
<tr>
<td>West Wiltshire DC</td>
<td>Computing services</td>
<td>20</td>
<td>July 88</td>
</tr>
<tr>
<td>West Wiltshire DC</td>
<td>Legal services</td>
<td>8</td>
<td>July 89</td>
</tr>
</tbody>
</table>

Source: Audit Commission and CMBOR

The advice is intended to be general enough to apply to all local authority MBOs, not just those related to activities defined by the Local Government Act 1988.

1. THE ATTRACTIONS OF BUY-OUTS

10 An MBO is generally a relatively low-risk way of starting a profitable new business; MBOs have a low failure rate compared to other types of new company. This is so for several reasons:

- the buy-out team usually know the concern well. If they did not believe they had a good chance of success, they would not buy it out;
- the buy-out team often see ways in which operating efficiency can be increased. Some of these improvements may not be possible under current ownership;
- in the private sector, the concern is often bought for, or below, its book value, not its market value. Its book value may be understated because of undervalued assets.

11 It is also widely believed that operating efficiency is usually enhanced after an MBO. Five main factors are likely to promote increased efficiency and productivity:

- employees may work harder. Employee/manager shareholders commonly say that they can better identify with the company, and that there is a clearer link between non-shareholder employees' well-being and that of the company;
- management may become more prudent about the use of resources when it is spending its own money;
- buy-outs may offer a practical way to recruit and retain key staff. The flexibility to pay market related salaries may be enhanced;
- freedom from the divesting organisation's constraints (particularly where it is in the public sector) gives management more freedom to manage;
- buy-outs may be able to attract additional finance from lending institutions for new expansion. This is particularly true where the company was previously competing for limited funds with other parts of a large organisation.

WHY SUPPORT A LOCAL AUTHORITY MBO?

12 Most of these factors are relevant in the local authority world as elsewhere - indeed often more so. But there are also several reasons why a local authority may want to allow a management buy-out of all or part of its workforce.

13 It may be seen as an opportunity for the authority to re-orientate itself as a service enabler rather than as a service provider, and thus divest itself of a long-term and potentially expensive commitment to its workforce.
while maintaining continuity of employment and management. The authority may have a declining or erratic need for the service, while elsewhere there is a reasonably buoyant market. An MBO may allow the authority to divest itself of staff while ensuring continuity of service. And outside the authority the former DSO will be able to seek additional work (closed to it under current legislation) which may in turn allow it to spread overheads and offer lower prices to the authority.

14 Some authorities' main motive in allowing an MBO may be to protect the existing workforce and to avoid the rigours of competition (the CCT requirements of the Local Government Act 1988 only apply if the authority wants to consider awarding the work to a local authority workforce). However, it would be unlawful for a local authority to participate in an MBO with the sole or principal purpose of avoiding the CCT process. In any case there can be no guarantee of employment once the company is in the private sector.

15 But while there may be attractions there are also pitfalls, and months of planning and negotiation to be undertaken. The fact that the authority will be negotiating with part of its own workforce means that great effort will be needed to ensure that the process is - and is seen to be - impartial. The next section of this paper briefly considers the buy-out process - a problem mainly for the buy-out team - and the subsequent sections discuss the issues an authority needs to consider in negotiating with a buy-out team.

### REVIEW QUESTIONS

- What is the rationale behind the proposed MBO?
  - has the authority identified the benefits and disadvantages?
  - what will be done more cheaply or better than under other arrangements?
- How does the authority see its responsibilities to its existing workforce?
- Has the authority sought advice on the buy-out?
  - if so, is that advice impartial?

### 2. THE BUY-OUT PROCESS

16 In the private sector it is usual to set up a non-trading company, 'Newco', which is used as a vehicle for the purchase of the buy-out target. In addition, Newco will qualify as a 'close' company, which means that equity holders can obtain tax relief on any loans taken out to purchase shares in it. At a later date the non-trading company 'hives-up' into the target company.

17 In local authorities the process will be similar, with the notable exception that there is not usually an existing company to buy-out. The newly formed company will either try to win, or be awarded, contracts from the authority, and possibly also win work from other sources (indeed, if it has no realistic prospect of doing so it is unlikely to be successful in the long run).

18 The usual principle behind making money in a management buy-out is a simple one. The concern is purchased for a negotiated sum. This sum is financed by a mixture of equity and debt. It is the process of paying off debt from profit that increases the value of the equity. Thus, in many management buy-outs, equity holders receive no dividends until all loans are repaid. Where significant expenditure is incurred in buying assets, and the company has a high gearing ratio, the buy-out team must be aware that small changes in the interest rate can have a substantial effect on the cost of financing debt. Debt is also frequently paid down by selling undervalued assets which are unnecessary (e.g. property), or whole sections of the business.

19 Local authority buy-outs are likely to work in the same way where significant assets are purchased, or where the MBO has had to borrow significantly to cover its working capital requirement. Where few assets are purchased, working capital may well represent the majority of a firm's indebtedness. In instances where the MBO has little debt and a small working capital requirement, it is likely that equity holders will benefit from dividends from year one of the buy-out.

20 As long as the buy-out company makes enough profit to service its debts, it is in the buy-out team's interests to retain as much of the equity as possible.

### EXIT ROUTES

21 The management team and the authority should be aware of the options for exit routes. Research published in the Harvard Business Review in November/December 1989 and information from the Centre for Management Buy-Out Research (CMBOR) at Nottingham University show that for those who cash out, the
Exhibit 6
EXIT ROUTES OF MBOs IN THE UK (1985-mid 1989)
The most common exit route for an MBO is a trade sale to another company...

Source: CMBOR

Exhibit 7
EXIT ROUTES OF PUBLIC SECTOR MBOs
Trade sales are particularly common with public sector MBOs...

Source: CMBOR

typical period from buy-out to exit is between two and four years.

22 Exhibit 6 shows the exit routes chosen by British MBO companies from 1985 to mid 1989. The most common exit route is a trade sale, and this is particularly true of public sector MBOs (Exhibit 7).

23 Taking over a buy-out company is an appealing route into the local authority market for contractors currently without a foothold there. An authority may want to re-evaluate its decision to allow a buy-out if it considers that the company would be unlikely to continue long in its initial form.

24 The next most likely option is for some form of flotation, perhaps on the Over The Counter Market (OTC) or Unlisted Securities Market (USM) rather than a full listing (though the liquidity of these markets should not be overstated).

25 Experience suggests that in many cases outside investors will require a change in the management of the buy-out company. Ex-local authority managers may not always possess the skills and aptitude needed to make a success of the company, which will almost always require it to get work from clients other than the parent authority.

FUNDING A MANAGEMENT BUY-OUT

26 An MBO may structure its capital in a number of ways. The main possible components of the liability side of the balance sheet are (in increasing order of cost to the borrower):
- secured bank debt
- unsecured bank debt
- redeemable preference shares
- convertible preference shares
- ordinary shares.

The mix chosen will affect debt servicing costs because from the lender's point of view each option carries a different level of risk.

27 The buy-out team must obviously put up some of its own money. Lending institutions usually require that the team members put up enough money to demonstrate their commitment, but not enough to give them severe financial worries – the lending institution wants the buy-out to work too! Research published recently in the Harvard Business Review has shown that on average managers invest more than 25% of their personal net worth in the MBO, equating to 30% of the equity. Information from CMBOR suggests that for smaller MBOs (more typical of those in local authorities) the proportion of equity held by the management team is higher - over 50% on average. A typical rule of thumb is that the management team should put up about one year's salary each. This can often involve second mortgages on their homes.
3. NEGOTIATING WITH AN MBO

THE BUY-OUT TEAM AND CONFLICTS OF INTEREST

As soon as the possibility of an MBO is considered, there is a potential conflict of interest for the members of the proposed buy-out team. On the one hand, they may be involved in contract specification and tender evaluation, and on the other, they are potential bidders for the authority's contracts. They may therefore be privy to sensitive client-side information, which they may pass on to lending institutions in their business plan proposal. Officers and employees who are proposing an MBO should, therefore, declare their interest as soon as the MBO looks feasible.

However well the team cope with the conflict of interest, they may be spending some of their time, as well as that of other officers, negotiating the buy-out, rather than doing the job they are paid to do. An important point which must be settled at the outset is the status of the potential buy-out team's members while they negotiate the buy-out. There are several options:

— remain in post and negotiate at the same time (obviously with safeguards to ensure that they are not acting as both buyer and seller);
— be suspended while the MBO is negotiated;
— resign, but return to the job if the MBO doesn’t happen;
— resign.

In the private sector there is a range of practice covering all these options, though on the whole, where MBOs are encouraged, the first is most common. Authorities should make up their own minds on these options, but must ensure that there is no conflict of interest, or that where there is it is identified and declared. They will wish to ensure, here as throughout the process, that the ratepayers’/chargepayers’ interests are protected.

PERSONNEL IN THE BUY-OUT COMPANY

Both the authority and the MBO company need to recognise that the company will have to be completely self supporting, in that the authority will not be able to give them any administrative or other services.

An issue here is how the employees of the new company will leave the authority’s employment. Either they can resign or be made redundant. It is likely that employees will prefer to be made redundant.

Authorities should seek their own legal advice, but the Commission’s advice is that the Transfer of Undertakings Regulations 1981, cannot be applied to MBO companies, and that MBO companies cannot be admitted to the Local Government Superannuation Scheme.

Because most employees will be leaving a local authority scheme, pensions are likely to be a very important issue for them. Trade unions will also be particularly concerned about this aspect of the buy-out.

• Does the MBO include the existing workforce?
• If so, how will they leave the authority’s employment:
  — resign;
  — be made redundant?
• Is the authority and the MBO company aware that the authority will not be able to offer the company any administrative services?

ASSETS TO BE PURCHASED BY THE MBO

One of the more commonly heard claims about private sector MBOs is that they buy assets for less than their market value. Assets typically include property, stocks, plant and machinery and excessive bad debt provisions. It is possible that a local authority buy-out may not involve the purchase of any assets. However, some buy-outs may involve the purchase of depot and other facilities. Re-development of these might provide the buy-out team with substantial windfall profits. On the other hand if the assets are over valued the buy-out company may fail, and leave the authority in an awkward position.

Authorities should therefore obtain an independent valuation of assets before they are sold. The buy-out team is also likely to get a valuation, though this should be at their own expense. The selling process should be the same as that which the authority would use for selling such as-
sets to the private sector. Assets must be sold for their market value.

37 The authority should be aware that it is, in effect, selling a going concern. The MBO might therefore be expected to pay in excess of the net asset value. Any difference between the net asset value and the purchase price is represented by 'goodwill'. It is particularly appropriate to consider goodwill where the MBO team is taking over a DSO which is already providing services to other authorities.

38 Vendor authorities may want to afford themselves some protection against subsequent sell-offs of assets. The authority should thus write into the sale contract that if assets are sold within a given time period, some or all of the increase in value is clawed back by them.

• Which assets will be bought by the MBO?
  — at what price will they be bought?
  — what is their highest realisable value?
  — how will leased assets be treated?
  — has the authority taken 'goodwill' into account?

• Has the authority considered the longer term exit routes of equity holders in the MBO?
  — has the authority built in any safeguards against asset stripping activities by the MBO?

HOW IS THE LOCAL AUTHORITY CONDUCTING THE NEGOTIATIONS?

39 Local authorities need to consider carefully how they conduct the negotiations. These negotiations must be at arms length. This may become very difficult because of previous close working relationships. Usually the local authority should adopt a two-stage approach - a negotiating team consisting of perhaps no more than two people and a committee or subcommittee to whom the negotiating team should report. As a general rule, a negotiating team should always have the opportunity to seek further instruction or to obtain advice. This can substantially strengthen the negotiator's hand.

40 Both officers and members should be involved in the negotiating process, and legal and financial considerations as well as wider service implications should be taken fully into account.

41 The local authority may find it valuable to employ professional negotiators, particularly if it has few client-side staff. It should define the terms of reference of the negotiators carefully and take fully into account the fees which will be charged. The objective of the employment of consultants should be firstly to maximise the return to the local authority and secondly to ensure that the deal is a fully 'arms length' transaction.

42 Local authorities are likely to hire consultants to advise them during the buy-out. This is reasonable, and may indeed be essential in some circumstances. But the legality of allowing staff paid time off to organise a buy-out and the use of central support services to assist in preparing the buy-out is open to considerable doubt.

43 Authorities may be asked to offer warranties or indemnities to the management buy-out company, but in general they have no powers to do so.

• Has the local authority considered the employment of consultants?
• Are members of the MBO spending some of their work time and that of other officers negotiating the buy-out?
• Who is providing the support services used negotiating the buy-out?
• Has the authority been asked to offer any warranties or indemnities to the MBO?

4 . T R A D I N G W I T H A N M B O

44 In the early years of a local authority MBO there is likely to remain a special relationship between the authority and the company. But some friction should be expected in the relationship, otherwise it is unlikely to be in the long term interests of ratepayers/chargepayers. After a period of time the MBO will probably act, and be treated, like any other private sector contractor. Indeed, the authority should treat the MBO as though it were any private sector contractor; for example, the authority should satisfy itself that the MBO is viable, as it would with any other contractor (Exhibit 8).

45 The buy-out company is in the private sector. An authority may therefore award contracts to it without complying with the competitive tendering requirements of the Local
Exhibit 8
CONSIDERATIONS WHEN AWARDING A CONTRACT TO AN MBO
Authorities should ensure that they have discharged their fiduciary duty if they wish to award a contract to an MBO...

46 Besides the requirements of the 1988 Act, authorities must satisfy themselves that they have discharged their fiduciary duty. This could be achieved by allowing open competition for contracts along the lines of the 1988 Act. Although encouraging a management buy-out and awarding contracts to it without competitive tenders may be administratively convenient, in most circumstances it is not likely to be in the best interests of ratepayers/chargepayers. The Commission believes that value for money is best obtained by exposing services to competition. The existing DSO management is likely to know the scope for efficiency improvements in the service. When they propose a contract for the buy-out company they are not likely to offer the client all the potential savings - their interest will naturally be to try and retain as much as possible for themselves as profit.

47 Authorities may wish, however, to consider awarding a contract to the MBO company without competitive tender to get it off the ground, because they believe that in the longer term this will benefit the authority. A buy-out is unlikely to take place without the assurance of some business.

48 If an authority wishes to award a contract to an MBO company without competition, then it should be able to demonstrate that this is in the interests of its ratepayers/chargepayers and only exceptionally should the contract be for more than one or two years. After the end of that period the authority should go through a competitive tendering procedure, treating the MBO company as it would any other contractor. If the authority does not wish to award a contract for such a short time period, then it must be able to demonstrate that its proposed contract represents value for money. For example:

— the annual cost of the contract reduces the longer the contract; and
— the contract price is less than the present cost of the service; and
— the contract price compares favourably with other prices, such as published benchmarks and other local authorities’ prices, if these are available.
Has the authority let the contract to the MBO without external competition?
- what do financial regulations/standing orders say on competition for contracts?
- has the authority changed these requirements by using Director of Finance/Chief Executive delegated powers, or committee/council resolution?
- what is the length of the contract? How does this compare with the lengths allowed under CCT? What is the justification for the period chosen?
- in the absence of open competition, how has the authority satisfied itself that it has discharged its fiduciary duty?
- have the necessary post-contract financial and performance monitoring procedures been put in place?
- Will there still be an in-house bid for contracts?
- Has the packaging of work been biased to allow the MBO company an advantage in competition?
- Is the MBO company viable?
- has the authority taken financial references similar to those it would of any other private sector company?
- Will there be redundancies in the authority?
- what redundancy costs (if any) will the authority have to pay to employees?
- have these matters been considered in awarding contracts to the MBO?
- have other costs been taken into consideration?
- Is tender evaluation consistent with Audit Commission advice?

Exhibit 9
MAXIMUM CONTRACT LENGTHS FOR DEFINED ACTIVITIES
An MBO company should not be awarded a contract in excess of the maximum period for defined activities under the Local Government Act 1988...

<table>
<thead>
<tr>
<th>Activity</th>
<th>Maximum contract length (years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Refuse collection</td>
<td>7</td>
</tr>
<tr>
<td>Building cleaning (education authority)</td>
<td>4</td>
</tr>
<tr>
<td>Building cleaning (other authority)</td>
<td>6</td>
</tr>
<tr>
<td>Other cleaning</td>
<td>6</td>
</tr>
<tr>
<td>School and welfare catering (education authority)</td>
<td>5</td>
</tr>
<tr>
<td>School and welfare catering (other authority)</td>
<td>6</td>
</tr>
<tr>
<td>Other catering</td>
<td>6</td>
</tr>
<tr>
<td>Maintenance of ground (education authority)</td>
<td>4</td>
</tr>
<tr>
<td>Maintenance of ground (other authority)</td>
<td>6</td>
</tr>
<tr>
<td>Repair and maintenance of vehicles</td>
<td>6</td>
</tr>
</tbody>
</table>

Source: SI 1988 No. 1373 (England)
SI 1988 No. 1470 (Wales)

49 It would be difficult for an authority to demonstrate that it has discharged its fiduciary duty if it awarded to an MBO a contract in excess of the maximum duration laid down in the relevant Statutory Instruments (Exhibit 9).

50 There are indications that private sector contractors will not be greatly interested in bidding against an MBO company, particularly if they think the result is a foregone conclusion. The authority therefore needs to make efforts to attract outside contractors.

51 At all times when there is competitive tendering for contracts and an MBO company is likely to tender, the DSO should be allowed to enter a bid if it wishes to. If there is to be a DSO bid, consultants should be engaged to formulate it (the buy-out team should not be allowed to put in one of its competitor’s bids). There may be particular problems where there is an employee buy-out. In such a case it is
unlikely that the employees will allow the DSO to put in a serious bid, so the client should make extra efforts to ensure that other private sector companies are interested.

52 The authority should take account of redundancy costs, if these are to be incurred, when evaluating whether or not to award a contract to a buy-out company.

53 An authority might decide to encourage an MBO to be set up and award it a contract without competitive tendering, following a bid from its DSO which was not the lowest. Auditors may wish to review carefully probity and value for money in these circumstances. The authority's action may be tantamount to post-tender negotiation, about which the Commission has expressed grave reservations for service contracts.

STATUS OF THE MBO COMPANY

54 The Local Government and Housing Act 1989 defines categories of company in which local authorities have an interest. It is expected that MBO companies will not fall into any of these categories, unless, for example, current or previous members or currently serving officers have voting rights in the company. It is not, therefore, expected that Part V of the Act will apply to MBOs, but authorities should nevertheless take advice on whether a proposed management buy-out is affected by the Act. The Secretary of State may widen the definition of the categories in a way which might bring in some MBOs.

55 Some authorities may try to retain an interest in an MBO company by retaining some voting rights or otherwise. There is considerable doubt about local authorities' powers to do so in the absence of local legislation. Insofar as such powers exist, in appropriate circumstances their exercise will be subject to the consent of the Secretary of State under section 71(2) of the Local Government and Housing Act 1989, where the authority takes a minority interest. Moreover, all companies in which a local authority has an interest are now, by virtue of Schedule 11 of the 1989 Act, also 'associated companies', and section 33 of the Local Government Act 1988 will apply.

56 Section 33 of the Local Government Act 1988 states that work cannot be awarded to an associated company unless:

"the authority or body has taken reasonable steps for the purpose of securing competition for the carrying out of that work."

- Has the authority and the proposed company considered the implications of the Local Government and Housing Act 1989 and the Local Government Act 1988?

CONCLUSION

57 A local authority should always bear in mind that an alternative to allowing an MBO may be to retain the business proposed to be purchased and seek to obtain equivalent benefits by improving the efficiency of operation. After all, the buy-out team members are presumably confident that they can improve efficiency.

58 However, a number of members and officers of local authorities have come to the conclusion that, in the light of the compulsory competitive tendering legislation, the long-term interests of both their ratepayers/chargepayers and their employees will be best served if the authority divests itself of many of its direct service employees. Ratepayers will have a free choice of contractor, unencumbered by the complex considerations which arise in the tendering process where a DSO is involved. Former employees engaged in an MBO will have the opportunity of seeking additional work elsewhere, without the constraints imposed on DSOs' freedom of action by legislation.

59 It is open to authorities to reach such a conclusion. But in pursuing it and in encouraging or responding positively to MBO proposals, authorities must be sure that ratepayers'/chargepayers' interests are paramount. They must secure a fair price for the assets sold and pay no more than a fair price for subsequent services provided. The aim of this paper has been to chart a course through the inevitable complexities of the process, to ensure that these outcomes are achieved. If these guidelines are followed, then there is no reason why public interest should be sacrificed to private gain.

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